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Investment Strategy
Private Clients

1/4

January 2019 · 1st quarter

Macro insights

Lessons from 2018 and what to expect of 2019

p.03

At a glance

- Despite some slowdown in activity, we expect the overall picture to remain relatively supportive next year, with growth exceeding long-run potential in all the main economic blocs – and no major accident.
- In the US, we forecast 2.6% GDP (Gross Domestic Product) growth in 2019, a return closer to earth from the 3%+ levels of the past quarters.
- Eurozone domestic demand remains very resilient, on the back of continued labour market tightening, suggesting a pick-up in growth to 2%.
- Within a still positive cyclical context, supported notably by strong job creation, Japanese GDP growth should slow only slightly in 2019, to 0.9%.
- Currency-induced tighter monetary policies have dampened emerging growth – but the cycle is still young, and the major economies appear safe from crisis.
- With risk assets now more sensitive to macroeconomic factors and political uncertainty playing an increasing role, volatility in market sentiment is here to stay. Nonetheless, we see reasons to remain cautiously optimistic: the new year will begin with more favourable valuations and still sound fundamentals.
- In Forex, we forecast broad-based dollar depreciation due to gradually fading impulses from the 2018 expansionary US fiscal policy and a narrowing of the US/rest of world interest rate differential from unprecedently wide levels.

Forex views

Buckle up back... it will be a rough 2019

p.13

Also featured

Brexit: timeline and potential outcomes

Quarterly publication of
Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 3 December 2018

Lessons from 2018 and what to expect of 2019

After the stellar act of 2017, we did anticipate greater financial market volatility and lower returns this year, just not quite this bad. At the time of writing, global equity, commodity, sovereign and credit indices are all posting negative year-to-date performances in USD terms – despite a pretty solid macro landscape and still strong earnings growth.

Why such a disconnect between markets and fundamentals? A number of factors contrived to dampen financial returns in 2018. Fiscal stimulus boosted US growth and inflation more than initially expected, causing a significant repricing of the US interest rate curve. A higher dollar cost of capital is, and always has been, a natural stress factor for the global economy and markets. Asset valuations had to adjust to this cost and idiosyncratic risks in specific emerging markets (highly indebted Argentina and Turkey in particular) then fuelled volatility.

Political risks added to investor discomfort. The trade dispute between the US and China, uncertainty around the US mid-term elections, complicated Brexit negotiations and the Italy-European Union (EU) budgetary tug of war all contributed to making the investment environment challenging.

Finally, the Eurozone's economic momentum of 2017 proved unsustainable. Although the broad picture remains healthy, growth moderated throughout this year because of temporary factors, such as the new emission standards in the car industry (which mostly hurt the German economy), as well as structural issues, notably weaker external demand due to US import tariffs.

Can we look forward to a healthier 2019?

Despite some slowdown in activity, we expect the overall picture to remain relatively supportive next year, with growth exceeding long-run potential in all the main economic blocs – and no major accident. Put differently, we do not foresee a US recession, a hard landing in China or a dismantling of the Eurozone. This is not to say, however, that the investment skies are cloudless.

2018 demonstrated that rising US yields are not always easy for markets to digest, even if they are an entirely predictable consequence of a sound economy, one that is growing above its potential and closing the output gap. This source of volatility will likely remain with us next year, as monetary tightening continues in the US (at least until the neutral level is reached – see chart 1, page 04) and gets under way elsewhere, for instance in the Eurozone.

Trade tensions, with their ability to undermine confidence and markets, could also make a virulent comeback, unless the US and China turn the 90-day "cease fire" agreed at the recent G20 summit into a longer-term compromise. And political risk is unlikely to disappear from the radar – although an important lesson from 2018 is that headlines are often worse than the underlying developments.

But while China should continue to suffer from trade tensions, policy easing measures and past currency depreciation will provide some macro stability, both domestically and across the emerging markets more broadly. And one of our important expectations for 2019 is that the US should lose some of its economic outperformance versus the Eurozone. With the effects of US fiscal stimulus likely to

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculations.

wane just as the headwinds facing European economies drop, growth levels on either side of the Atlantic should start to converge by the end of next year (see chart 2).

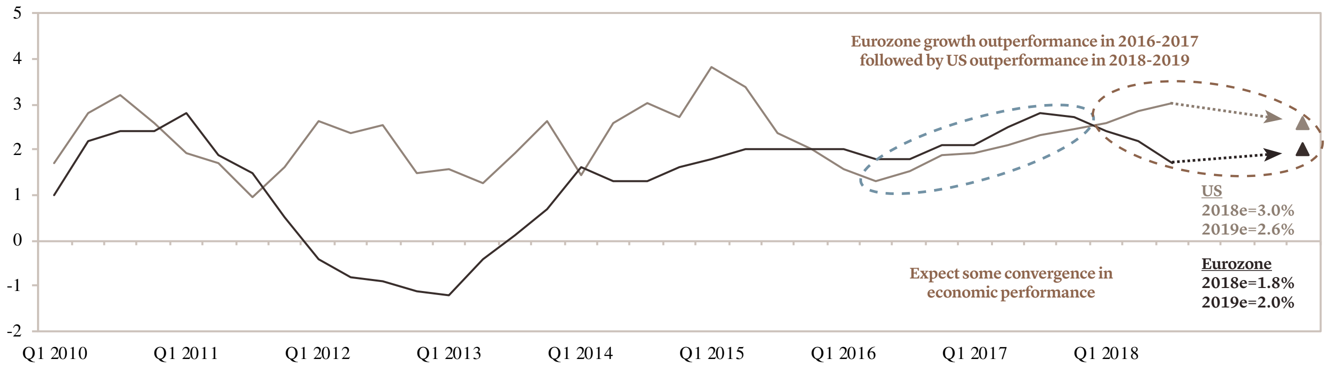
All told, as we look to the new year, we feel that a neutral, but not risk averse, portfolio positioning remains appropriate. Investment discipline and strengthened risk management are, however, key at this stage of the cycle, with asset quality and liquidity being the foremost considerations. As such, we favour equities over high beta[1] fixed income segments, maintain above-average cash holdings and are starting to opportunistically reduce our long-held underweight in sovereign bonds.

Samy Chaar, Chief Economist

[1] Beta is a measure of the volatility, or systematic risk, of an asset relative to the overall market. It reflects how that asset's returns tend to respond to market swings.

1. US versus Eurozone real GDP growth

In % yoy* – Lombard Odier growth forecasts



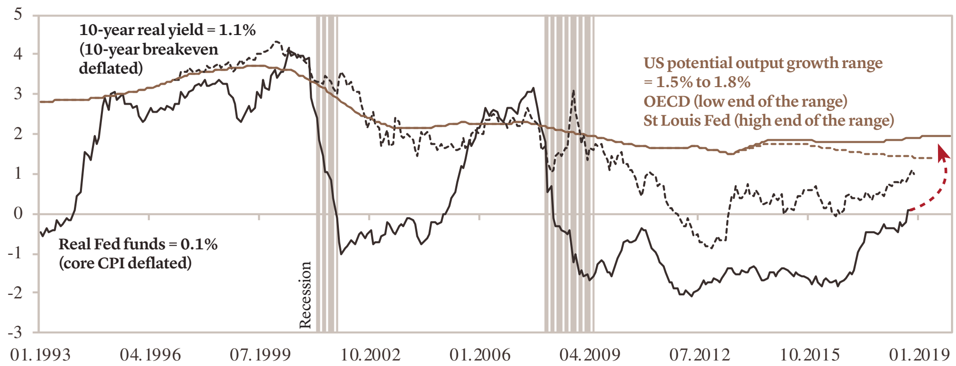
* year on year

Sources: Datastream, Lombard Odier calculations

2. The Fed wants to be neutral, not restrictive. Which still means higher!

When the output gap is closed, we view monetary policy as neutral when the interest cost is more or less in line with the economy's long-run potential

US real Fed funds and real 10-year yields versus real potential growth assumptions, in %



Not yet in the neutral range, but getting closer, especially on the long-end of the curve...

	Low end	High end
Potential growth	1.5	1.8
Inflation regime	1.7	2.2
Nominal neutral rate	**3.2**	**4.0**

Sources: Datastream, Lombard Odier calculations

United States
Coming down to earth

In a nutshell

- The US economy delivered significantly above-potential growth in 2018, supported by a tight labour market and stimulative fiscal measures.
- While the 2019 outlook remains constructive, a slowdown is to be anticipated – as tighter monetary policy starts to bite, and the effects of the tax boost subside.
- We forecast 2.6% US GDP growth in 2019, a return closer to earth from the 3%+ levels of the past quarters.

There is little doubt that the US economy ends 2018 with strong cyclical momentum: full-year growth is on track to reach 3% and the jobless rate stands at multi-decade lows. The strength of the labour market is particularly impressive when considering that, despite low unemployment, an average of 210,000 new jobs per month were created this year, for an annual total of some 2.5 million. The economy has benefited from the virtuous cycle between employment, wage growth and consumption, along with a favourable backdrop of healthy risk appetite and an expansionary fiscal stance.

Most of these elements are still in place, supporting a constructive 2019 outlook. But simply extrapolating recent trends would be a mistake as some key factors are in the process of changing. Monetary policy is one crucial such factor, bound to dampen growth in coming quarters – especially since we expect the rate hikes to continue well into 2019.

Although the Federal Reserve's (Fed) stance is not yet particularly restrictive, the policy rate has already risen from 0.5% in late 2016 to 2.25%. Unlike in the earlier stages of the hiking cycle, long-end rates have also moved up substantially, to levels now above 3% (see chart 3). Interest rate-sensitive sectors such as housing are starting to show some strain (see chart 4) – a textbook illustration of the impact of tighter monetary policy. In addition, the broad dollar index strengthened significantly over the course of 2018 – gaining some 10% from its April lows and effectively undoing almost all of the 2017 depreciation.

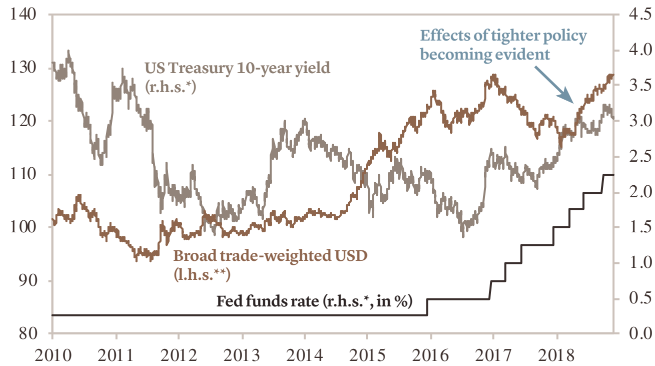
Importantly, the impact of fiscal stimulus, while still growth-supportive, will start to wane in late 2019. With the midterm election results having all but eliminated the possibility of a renewed round of tax cuts, and increased infrastructure spending a rather remote prospect, it is fair to say that the US economy can expect less of a fiscal boost going forward.

All told, while US growth prospects remain healthy, a significantly above-potential pace cannot persist forever. The slowdown that we are projecting, from 3.0% in 2018 to 2.6% in 2019, is a natural step in the cycle. We are getting closer to the point at which the US economy comes back down to earth.

Bill Papadakis, Macro Strategist

3. In 2018, policy started to bite...

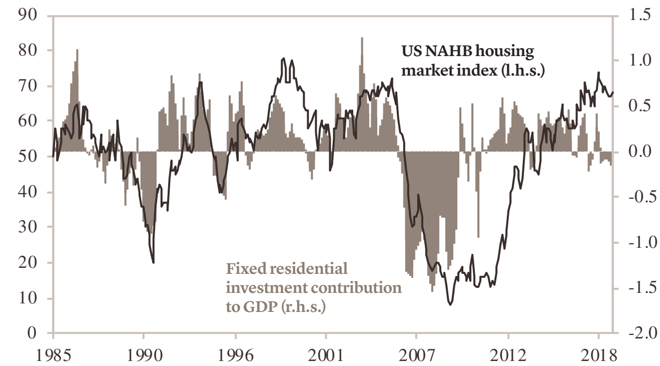
Fed funds rate, US Treasury 10-year yield, and trade-weighted USD index



* right hand scale, ** left hand scale
Sources: Bloomberg, Lombard Odier calculations

4. ...and interest rate-sensitive sectors feel the effects

Contribution of residential investment to GDP vs NAHB* index



* National Association of Home Builders
Sources: Datastream, Lombard Odier calculations

Europe
Fighting back

In a nutshell

- 2018 saw Eurozone growth fall back behind that of the US, hurt by lower external demand and an auto sector-induced German slowdown.
- Domestic demand nonetheless remains very resilient, on the back of continued labour market tightening, suggesting a pick-up in growth to 2% next year.
- In this context, a normalisation of monetary policy is underway, with asset purchases about to end and negative interest rates to be abandoned by late 2019.

The fact that 2018 GDP growth just shy of 2% is considered disappointing says a lot about how far the Eurozone has come since the crisis years. More meaningful perhaps is to look at growth in relative terms: after slightly outpacing the US in 2016 and 2017, the Eurozone is lagging by more than 1% in 2018 – a marked reversal of the differential.

Examining the numbers in more detail reveals the vulnerabilities at the core of the Eurozone's current growth model. What stands out first is the reliance on external demand. Having come into the crisis with a small current account deficit, the Eurozone has now built up a very substantial surplus of roughly 3.5% of GDP. This has made its economy dependent on swings in global trade, and in particular on the evolution of demand in its major trade partners.

The second factor worth highlighting is the Eurozone's dependence on one major engine, namely Germany. This became more evident in recent months as German growth slowed down (indeed contracted in the 2nd quarter). While this development is largely attributable to temporary weakness in the auto sector (due to the introduction of new emission standards), and thus bound to revert, it does illustrate a key Eurozone vulnerability.

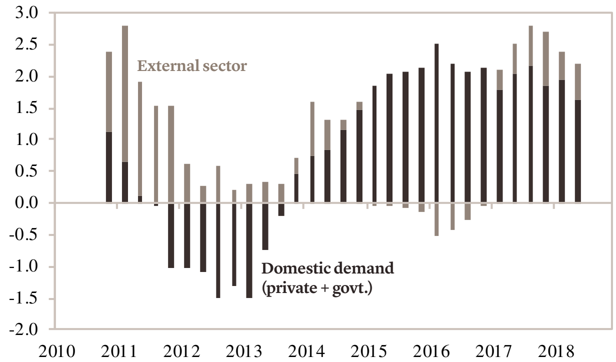
The bigger economic picture is, however, one of highly resilient domestic demand (see chart 5). This is what makes us optimistic about near-term Eurozone growth prospects, driving our forecast for a pick-up to 2% in 2019. Even without a substantial trade contribution, the economy is likely to maintain an above-trend pace, as unemployment comes down and income growth improves further (see chart 6). This increasingly normal macroeconomic picture also implies a normalisation of monetary policy. The European Central Bank (ECB) is wrapping up its asset purchases this month, and we expect it to end its negative interest rate policy by late 2019.

Closing on the Eurozone without a word about politics feels incomplete. Yet we see no big threat on that front and tend to view the European Parliament elections as a minor risk event, given that policymaking power remains with national governments. For more "exciting" political risks in 2019 investors may need not look very far: Brexit is scheduled for March and remains wrapped in a cloud of uncertainty.

Bill Papadakis, Macro Strategist

5. Diminishing support from external sector, but domestic demand remains solid

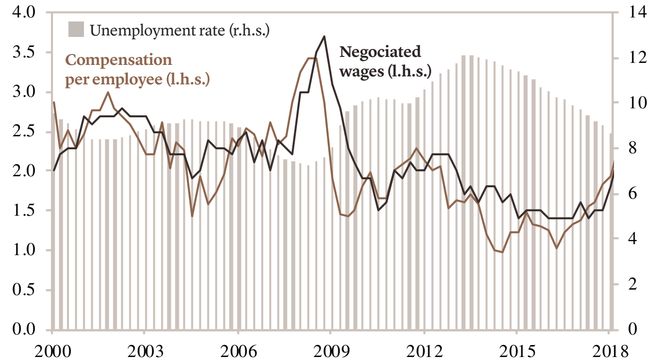
Contribution to GDP growth, in %



Sources: Eurostat, Markit, Datastream, Lombard Odier calculations

6. A trend that is likely to continue, thanks to a tightening labout market

Unemployment rate and wage growth metrics, in %



Sources: Eurostat, ECB, Bloomberg, Lombard Odier calculations

Brexit: timeline and potential outcomes

UK and EU negotiators reached a draft withdrawal agreement which was subsequently signed by the leaders of the two sides. Importantly, this deal involves a transition period running until the end of 2020, possibly to be extended, during which the UK remains part of all EU structures – although it will no longer have a vote.

At the end of the transition period, either a new trade agreement has been negotiated (which in our view would be of a rather "soft Brexit" nature, keeping the UK fairly close to the EU) or the "backstop" stipulating that the UK stays in a customs union takes effect – so as to avoid a hard border in Ireland. This would mean tariff-free trade with the EU, likely covering goods to a meaningful extent, but not services. It would not entail free movement of citizens, nor any contribution to the EU budget. However, the UK government would be constrained in its ability to negotiate separate trade agreements.

Theresa May secured her cabinet's approval of the agreement, but now faces a challenging vote in Parliament. While not a formal necessity, she promised to give MPs a say in the decision. That said, the mechanism for the vote is not clear – nor even to what extent it would be binding.

Most probable, in our view, is that the UK Parliament does approve the agreement, whether in its current form or a renegotiated version (with the emphasis likely placed on the non-legally binding political declaration on the future relationship) – although we recognise the large degree of uncertainty around this question.

Should new negotiations be required and led not by May, but by another Conservative Prime Minister (i.e. May loses a confidence vote and no general election follows) or, less likely, by another Prime Minister of either party (after a general election), an extension of the 29 March 2019 Brexit deadline would be required – which is conditional on unanimous approval by all other 27 EU members. While the ultimate economic impact of this scenario would not be too severe, sterling would be weighed down in coming months by the renewed uncertainty – particularly in the event of new elections bringing the "risk" of a Corbyn-led government.

A "No deal Brexit" in March 2019 also remains a possibility, unlikely at this stage although its probability could rise according to how the UK political landscape evolves in the near-term. The implications would be dire, both for the UK economy and for sterling.

Finally, the UK could remain in the EU or agree on a very "soft" Brexit, developments that would only come about after a new general election and/or a second referendum. In this case too, an extension of the 29 March 2019 deadline would be necessary. And again, it is as yet a rather improbable perspective, subject to change in the political configuration.

Japan
VAT hike – Fourth time is the charm?

In a nutshell

- The consumption tax hike will dominate Japan's outlook, but its negative impact should not be over-estimated as the government seems better prepared this time round.
- The Japanese cyclical context remains positive, with Q4 growth set to rebound solidly and employment growth continuing at strong pace.
- Unless external conditions deteriorate substantially, the Bank of Japan (BoJ) will maintain its current strategy of silently tapering asset purchases.

A year from now, Japan will likely be coping with the initial negative shock of Abe's second consumption tax hike (from 8% to 10%). Given the rough patch that followed the first hike in 2014, most view this event as a hard constraint on policymakers. We beg to disagree. The scale of the hike is smaller this time, and it represents the final leg of Abe's tax reform. More importantly, the government has learnt the lessons from the painful last three tax hikes (1989, 1997, and 2014). In addition to granting exemptions for food (excluding dining) and non-alcoholic beverages, it is drawing up offsetting fiscal support measures. The extreme granularity of some of these preparations suggests that a large decline in consumption will be avoided.

We also note that the Japanese cyclical context remains positive, even though unexpected weather-related shocks muddied 3rd quarter data. October saw industrial output surge, merchandise trade volume growth swing back into positive territory, and year-on-year total employment growth accelerate to over 2% (see chart 7). With the government having begun disaster relief disbursements, public spending will increase materially through Q1 2019. The combination of a potentially "back-loaded" second supplementary budget for FY 2018, VAT mitigation measures, and project completions and foreign visitor flows ahead of the 2020 Olympics will then preserve positive labour market and economic momentum.

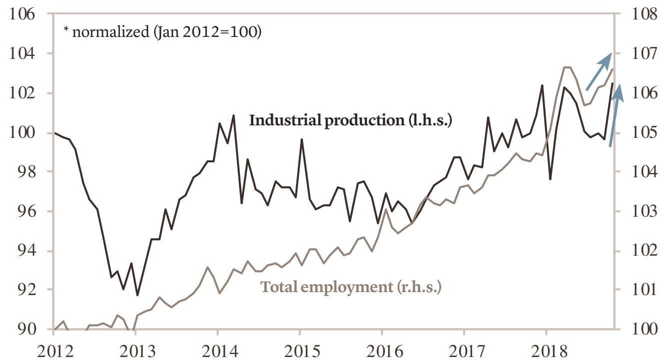
As we wrote last quarter, the remainder of Abe's probably final term should see focus shift to the revision of Japan's pacifist constitution. This is no done deal, as the ruling Liberal Democrats don't have a clear two-third majority in the Upper House and face new elections in the summer. The resulting distraction from supply side policies might, however, be manageable with the cabinet having already carried out or formalised many important reform measures.

This encouraging cyclical and structural backdrop means that the likely tax hike induced softness should not be significant enough for the BoJ to change its current policy of silent bond purchase tapering (see chart 8). It might similarly move away from a crude quantity target to a purchasing budget approach in the exchange-traded funds (ETF) space – effectively not changing guidance much but giving a more concrete signal on future action if/when economic upside risk materialises.

Homin Lee, Macro Strategist – Asia

7. The Japanese cyclical context remains positive

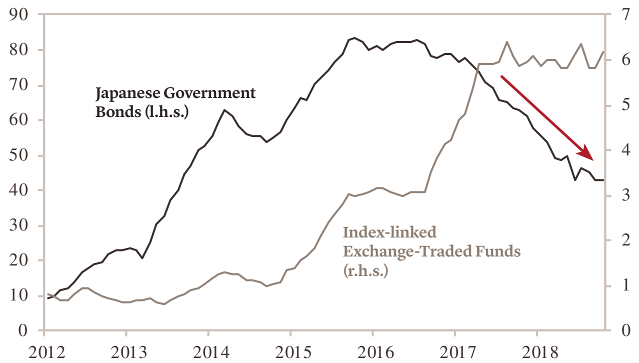
Industrial production and total employment*



Source: Bloomberg

8. Little change to the BoJ's monetary policy

12-month change in BoJ's total asset holdings (JPY trillion)



Source: CEIC

Emerging Markets
Towards a stabilisation of growth dynamics in 2019

In a nutshell

- Currency-induced tighter monetary policies have slowed emerging growth – but the cycle is still young, and the major economies appear safe from crisis.
- Political issues will remain key in 2019 for Latin America, notably in Mexico, Brazil and Argentina.
- In Asia, Chinese policymakers should be able to manage the slowdown while still strong growth in India might be dampened by uncertainty going into the general elections and fiscal tightening thereafter.

2018 proved particularly challenging for emerging economies. Currency depreciation and nascent domestic price pressures forced a number of central banks to start tightening monetary policy.

That said, we would stress that the weakest links in the emerging space have already broken. Although South Africa currently does show some worrying vulnerabilities, the other main economies appear safe from crisis. Most of the emerging economy cycles are still young. Outside of a few countries that are reaching capacity constraints (India) or overheating (Hungary, the Philippines), interesting upside growth potential remains. Also, improved current account balances and higher foreign exchange reserves significantly limit solvency risk.

As such, any positive surprise in the global environment would pave the way for an emerging rebound. That is admittedly a steep assumption to make, since it would require a clear resolution of trade disputes, stronger global demand, a weaker USD and oil prices that stabilise around a sweet spot, appealing to both producers and consumers. Our base case is rather a stabilisation of economic growth dynamics (see chart 9).

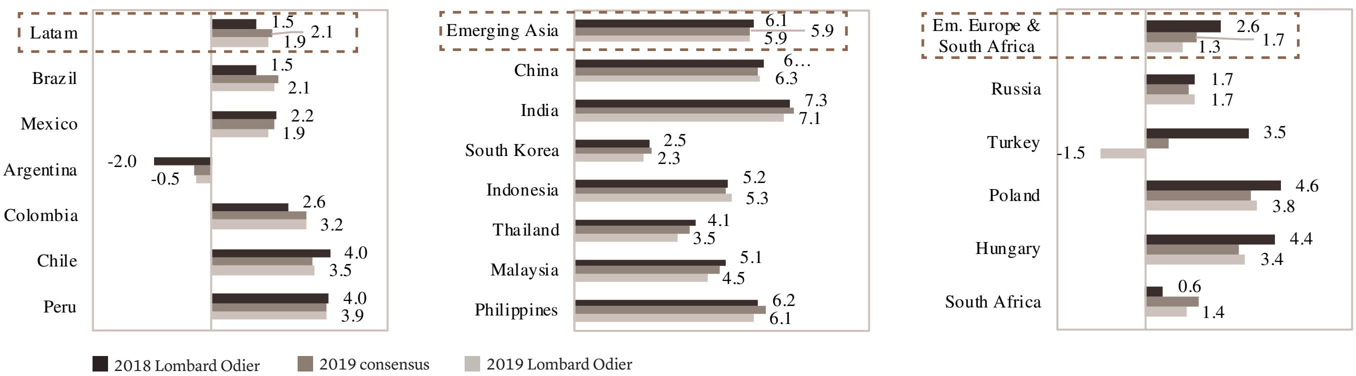
In Latin America, growth should recover from a low base, albeit remain slow owing to the tightening monetary and fiscal framework. Mexican President AMLO’s governing style could deter foreign investors, while President Bolsonaro may not fully deliver on high investor expectations regarding Brazilian pension reform. In Argentina, October 2019 elections will be a big challenge for President Macri.

Asia is most at risk from trade tensions, but strong fundamentals and fiscal leeway should allow growth to slow without collapsing. In China, policy easing alongside past CNY depreciation should ensure a gradual slowdown, while solvency is not at risk. India should remain the fastest growing Asian country in 2019 although political risk will intensify with general elections scheduled for May.

Finally, Russia should remain stable at a structurally low base although oil prices and US sanctions remains a big unknown, while overheating signs should drive Hungary and Poland to slow down. Turkey will contract amid a balance of payment crisis, and South Africa muddle through after a bout of technical recession in 2018.

Stéphanie de Torquat, Macro Strategist

9. Lombard Odier growth forecasts versus consensus



Sources: Bloomberg, Fitch Solutions, Lombard Odier calculations

Asset Allocation
Cautiously optimistic, despite political and economic risks

In a nutshell

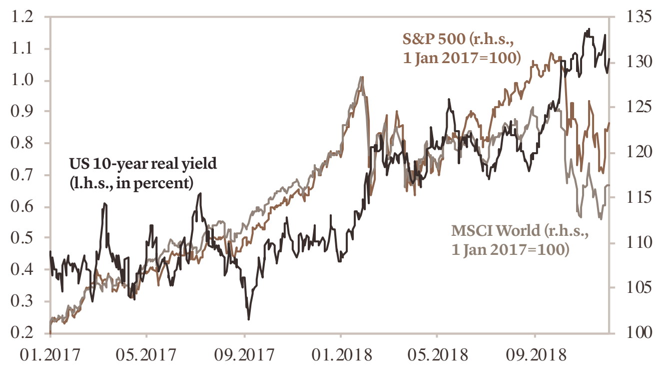
- With risk assets now more sensitive to macroeconomic factors, such as monetary policies and normalising inflation, and political uncertainty playing an increasing role, volatility in market sentiment is here to stay.
- Nonetheless, we see reasons to remain cautiously optimistic: 2019 will begin with more favourable valuations and still sound fundamentals. And US monetary policy, while approaching neutrality, is unlikely to take a restrictive turn in the short-term.
- The current level of real rates justifies a more neutral, but not risk averse, portfolio positioning.
- Keeping in mind that investment discipline and strengthened risk management are key at this stage of the cycle, asset quality and liquidity are the foremost considerations. As such, we favour equities over high beta fixed income segments, maintain above-average cash holdings and are starting to opportunistically reduce our long-held underweight in sovereign bonds.
- We highlight two major risks to our scenario: an overheating of the US economy that would force the Fed to accelerate its hiking cycle and a full-blown trade war accompanied by heightened geopolitical tensions. Recent Fed comments and the outcome of the US-China meeting at the G20 summit suggest that these risks have abated somewhat near-term, but they will likely continue to drive investor sentiment throughout 2019.

The latter phase of an expansionary cycle poses specific challenges for investors, who must gear up for lower and more volatile returns across the board. Market corrections can occur without recessions, as valuations adapt to a higher rate environment, but they tend to be short-lived and losses are generally recouped in the following months. 2018 was marked by two such major volatility episodes, in February and in October-November (see chart 10) – three when taking into account the summer emerging rout. Markets reacted to strong US macroeconomic data by materially re-pricing interest rates, driving nominal and real yields to multi-year highs. There was nowhere to hide, with the correlation between equities and bonds notably becoming less negative. Through mid-October, commodities did provide some diversification, supported by a supply-driven energy sector, but, at the time of writing, all asset classes are headed for flat or negative annual total returns (see chart 11).

To navigate this troubled 2018 environment, we have been very selective and prudent with respect to our risk exposure. At this point in the cycle, we believe the main indicator to monitor is the level of real rates versus potential US growth. Indeed, continued monetary policy tightening increases the risk of financial market accidents, as the most vulnerable economic actors find themselves challenged by the rising cost of capital. Begun in June, our process of risk reduction has been gradual and focused on the least liquid assets. Positions in emerging debt in local and hard currencies as well as convertible bonds have been cut, effectively reducing exposure to the high yield segment.

10. The market's revaluation process was somewhat similar in February and October-November

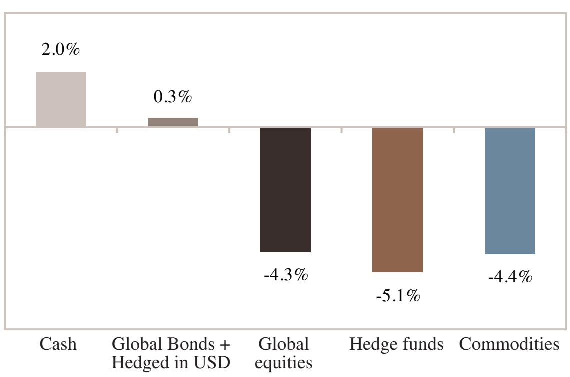
US 10-year real yield vs equity markets



Sources: Bloomberg, Lombard Odier calculations

11. Global asset class performances (in USD)

Year-to-date total returns, as of 30 November 2018



Sources: Bloomberg, Lombard Odier calculations

These actions have reinforced our ability to act nimbly under any market conditions. Asset liquidity helps us adjust risk exposure amid rising uncertainty while higher cash holdings allow us to selectively seize tactical opportunities as they arise. Indeed, we see at least three reasons to embrace the coming year with a cautiously optimistic stance.

First, the good news is that we will enter 2019 with more favourable valuations and investor positioning. Asset valuations have adjusted down, sometimes very abruptly. For instance, 2018 saw the S&P 500 index undergo its 3rd largest multiple contraction in 40 years, despite stellar earnings growth. In addition, crowded trades, such as US technology, have been unwound.

Second, fundamentals remain solid. Global growth will decelerate, and corporate profits may have peaked in the US but still offer a decent outlook. Our analysis calls for US earnings to grow in line with their long-term average (see chart 12) based on (i) stable sales growth (ca. 8% as we expect a weaker USD to offset slower nominal growth); (ii) continued strong buyback activity, with company balance sheets still being cash-rich; and (iii) some downside risk on margins as input costs are increasing and additional tariffs cannot be ruled out, but of limited amplitude. These estimates are quite close to consensus expectations which, interestingly, were not meaningful revised down during the latest volatility episode.

Finally, but very importantly, with markets having paid the price of Fed hiking in 2018, some reversal may occur. A number of Fed Committee members, including Chairman Powell, have acknowledged that the policy rate is now close to the neutral level, meaning that a more flexible Fed stance is likely going forward. Market expectations of US monetary tightening should thus be more data-dependent, reducing the risk of a surge in real rates in the short-term. In our view, the current level of these rates, still well below estimated potential US growth, warrants a neutral, not risk averse, portfolio positioning (see chart 13).

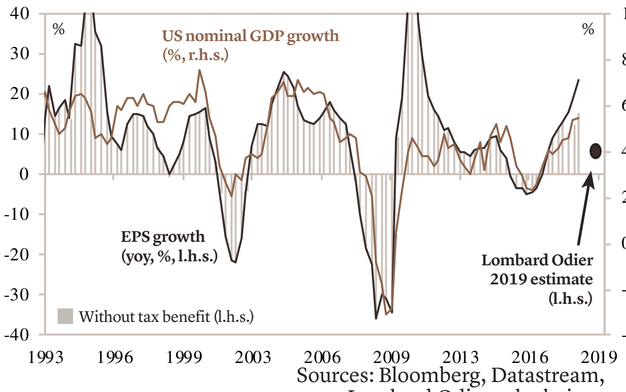
In terms of asset class preferences, we continue to favour equities. At this stage of the cycle, we believe that high beta fixed income segments are more sensitive to the level of rates, as well as possibly suffering from illiquidity. Since the beginning of the year, the financing cost for a high yield issuer has risen by more than 130 bp to 7.40% (respectively +230 bp and 6.61% for investment grade emerging corporate debt) and credit quality is about to deteriorate consequently, suggesting a rise in idiosyncratic risk (see chart 14, page 12). We thus remain underweight credit and hold no high yield bonds. Conversely, we believe that equities are less at risk with valuations having adapted to the current level of rates and corporate profitability unlikely to suffer so long as real rates remain below potential growth.

From a regional viewpoint, Eurozone, Japanese and emerging markets continue to look cheap (see chart 15, page 12) but we see little chance of a significant re-rating outside of the US and are thus making no change to our allocation. At this point, we favour the Japanese market on relative valuation, rising capex spending, positive market reforms and absence of political risk. More tactically, following the positive outcome of the G20 summit, we recently added some exposure to emerging equity markets as we expect the temporary truce in the US-China dispute to lead to some reduction of trade-related risk premia and support investor sentiment

Our sovereign bond positioning differs according to portfolios' base currency. In USD portfolios, we have gradually bought into sovereign bonds as yields began to look attractive. We were careful to maintain a rather short duration, while balancing the exposure between nominal and inflation-linked bonds so as to preserve capital in the event of a rise in inflation and/or an acceleration of Fed hiking. Following these moves, our sovereign bond exposure is now neutral in USD portfolios, while still underweight in their European counterparts. We have nonetheless tactically reduced our long-held underweight of EUR sovereign bonds to take advantage of markets' exaggerated

12. US earnings growth to remain solid, albeit trending lower

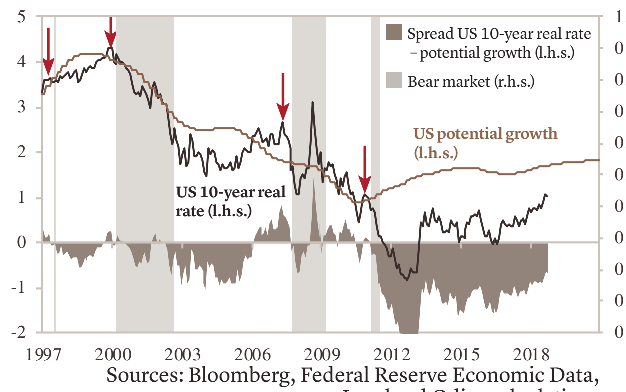
S&P 500 earnings growth and US nominal GDP growth



Sources: Bloomberg, Datastream, Lombard Odier calculations

13. Higher rates derail bull markets when real rates exceed potential growth

In %



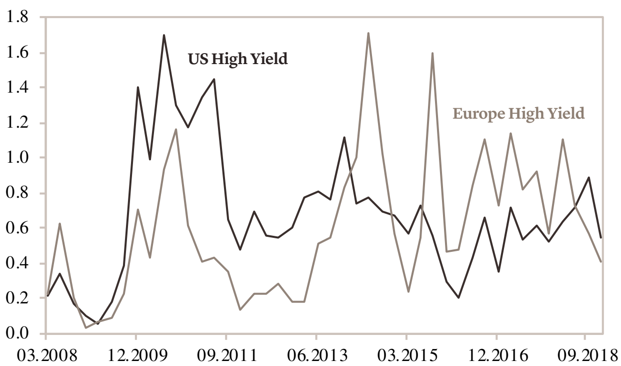
Sources: Bloomberg, Federal Reserve Economic Data, Lombard Odier calculations pricing of Italian political risk. With consensus expectations of the upcoming ECB tightening cycle in line with ours, we found the pick-up in yield and the roll-down offered by the steep Italian curve particularly attractive.

While history shows that maturing economic expansions can offer decent returns, they also bring about palpable risks. The two major ones that we would highlight are an overheating of the US economy, that would force the Fed to shift from a gradual and flexible pace to an accelerated hiking cycle, and a full-blown trade war accompanied by heightened geopolitical tensions across the globe. Given the lack of buffer provided by government bonds, we seek diversification and hedging strategies beyond this traditional safe haven, especially in European portfolios. In the currency space, we have tactically deployed hedging strategies, buying the Japanese yen first against the euro and now against the USD, to provide some cushion during volatility episodes. We also believe that having diversified exposure to commodities remains appropriate in this late-cycle environment and provides an interesting asymmetry to multi-asset portfolios. Current price levels do not reflect tight supply-demand balances, with potential upside notably in oil and base metals in our baseline scenario (we still forecast Brent at USD 75 per barrel on a 12-month horizon). In the event of an escalating trade war and/or rising geopolitical tensions in the Middle East, the upside on gold and/or oil would obviously be meaningful. And were the US-China trade dispute to be resolved, base metal prices should outperform markedly. Finally, we took advantage of a technically-driven episode of volatility in the Swiss real estate market to strengthen our exposure to this asset class, which in our view still exhibits sound fundamentals and attractivity in the low yield environment.

Sophie Chardon, Cross-Asset Strategist

14. Credit quality is starting to deteriorate

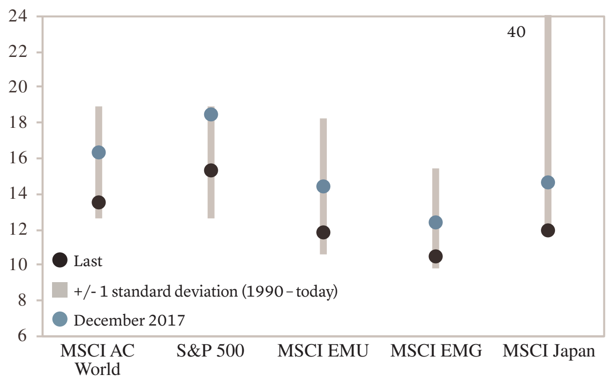
Upgrades/downgrades ratio



Sources: Bloomberg, Lombard Odier calculations

15. Equity valuations: Eurozone, Japanese and Emerging markets continue to look cheap

12-month forward P/E vs history



Sources: Datastream, Lombard Odier calculations

Forex
Buckle up back... it will be a rough 2019

In a nutshell

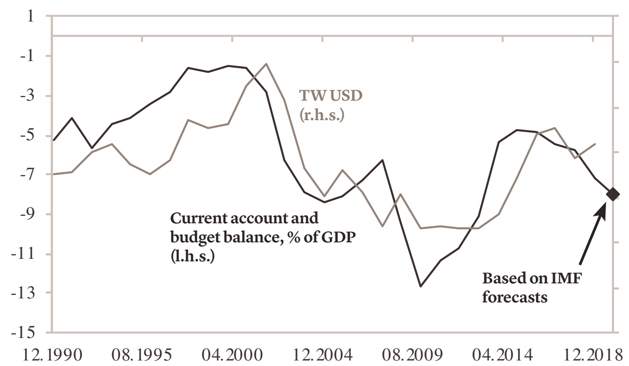
- **Our 2019 USD view is bearish**, forecasting an 8% depreciation on a trade-weighted basis against major currencies.
- We expect the unprecedentedly wide rate spread between the US and the rest of the world to compress, as markets better align monetary policy expectations with (non-US) fundamentals.
- As the effects of fiscal stimulus fade, the US economy will find itself with slower growth and a sizeable twin deficit problem.
- We see upside in EUR, GBP, JPY, NOK, SEK and CAD. AUD should make some headway, assuming the Reserve Bank of Australia moves closer to tightening policy.
- Our stance on emerging currencies is cautious and selective, favouring those with high real yields, momentum in reform implementation and low dependence on external debt. We mostly prefer relative value trade ideas.

US dollar strength this year (trade-weighted (TW) USD up 3.5% to date) has been driven by the narrative of growth divergence between the US and the rest of the world (RoW), an outcome largely credited to the US fiscal stimulus. The market priced up US rates while, somewhat surprisingly, remaining complacent about monetary policy tightening by other major central banks. In effect, this has created an extremely wide wedge between US and RoW rates.

On the back of these developments, we see two themes playing out in forex (FX) markets in 2019. First, the effects of the fiscal stimulus will start to wane as the year progresses, resulting in slower US growth. While this alone is not de facto dollar negative, the US economy will also find itself with a sizeable twin deficit (current account and fiscal balance) problem. Based on International Monetary Fund (IMF) forecasts, the current account balance will stand at -3% of GDP (from -2.5% in 2018 and -2.3% in 2017) and the fiscal balance at -5% of GDP (from -4.6% in 2018 and -3.4% in 2017). The direction of the “twin balance” is clear and similar trajectories have in the past led to multi-quarter dollar depreciation (see chart 16), largely due to the pricing in of higher US risk premia. Second, in our view, the US-RoW rate spread is now at unsustainable levels compared to relative economic developments. Unemployment rates have been falling faster outside than in the US, while market pricing of monetary policy expectations (ex-Fed) has been very slow to evolve (see chart 17). We expect a narrowing of US-RoW rate spreads in 2019 as markets better align (increase) their rates expectations, to reflect still healthy RoW fundamentals. In turn, this should lead to dollar weakness throughout the year.

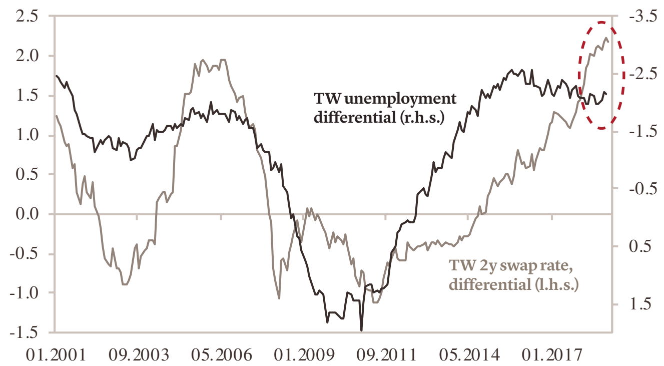
Aside from region- (or country-) specific issues, we see three main risks to this bearish dollar view. To begin with, it is possible that the US fiscal impulse lasts longer than we anticipate, extending the growth divergence story. There is also a (related but small) possibility that US inflation accelerates sharply, driving the Fed to tighten more aggressively and thus triggering a renewed widening of US-RoW rate differentials. Finally, a major negative shock to world growth (e.g. because of a sharp

16. US twin deficit bodes ill for the dollar



Sources: Bloomberg, Lombard Odier calculations

17. Rate differentials out of sync with relative (US-RoW) fundamentals



Sources: Bloomberg, Lombard Odier calculations

escalation in US-China trade frictions) would see investor "flight to safety", pushing up the USD against a number of high yielding and cyclically sensitive currencies.

Based on our central scenario, and within the **G10** space, our favourite currency picks are summarised below:

EURUSD: bullish – Valuation is unlikely to be a strong tailwind, but the single currency should benefit from (i) the end of ECB asset purchases; (ii) a rebound in domestic growth on the back of strong regional demand dynamics; (iii) a return of portfolio inflows (in part because the ECB will stop crowding out foreign investors in the bond market); (iv) expectations of ECB future monetary policy tightening at a time when the Fed will be nearing the end of its hiking cycle; and (v) broad-based dollar weakness.

GBPUSD: bullish – Assuming our central scenario of a soft Brexit proves correct, the cable should benefit from (i) the pricing out of the hard Brexit premium; and (ii) an upward market review of the expected Bank of England rate trajectory. However, a disorderly exit from the EU would drive the GBPUSD down to between 1.15-1.20 in our view.

USDJPY: bearish – We expect the yen to appreciate over the course of 2019 because of (i) still substantial undervaluation (15% by our estimates); (ii) likely (small) hawkish tweaks to the BoJ's monetary policy communication – potentially starting by altering its yield-curve management program – in order to begin counterbalancing the negative impact of its extra loose monetary policy on the banking sector; and (iii) ongoing volatility in risk sentiment, typical of late US cycle phases.

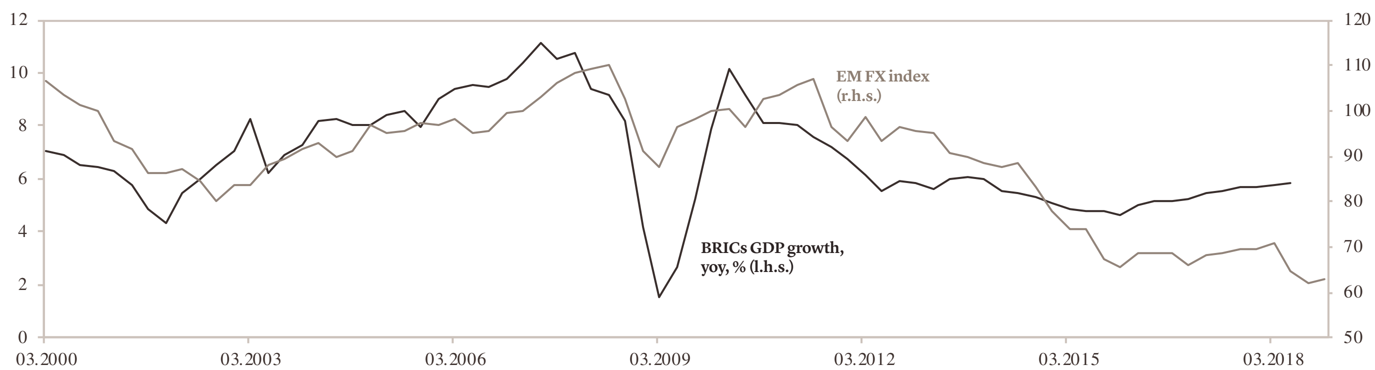
NOK & SEK: bullish against both USD & EUR – The Nordic currencies have been trading below fair value for a number of years, as monetary policies have been relatively loose when compared to underlying fundamentals. We expect them to bounce back in 2019 on the back of monetary policy normalisation (hiking cycle), as spare capacity has evaporated, and inflation risen. The main risk for the NOK is clearly oil prices. We anticipate a rebound towards USD 75 per barrel – failing that, the NOK would come under pressure. Falling, or still weak, oil prices would turn us bearish on NOKSEK.

CADUSD: bullish – Canadian economic fundamentals are very strong, and the central bank remains firmly in tightening mode. This has not yet translated into currency strength because of the oil price collapse. A rebound in the latter should allow the CAD to capitalise on solid domestic fundamentals and appreciate closer to its fair value – which we estimate at around 1.25 against the USD.

AUDNZD: bullish – We anticipate upside in the pair, considering that (i) the market is underpricing monetary policy tightening in Australia, and (ii) in our view, it is a straightforward play on growth divergence (the AU – NZ difference in annual growth rates has risen to 0.3%, up from -0.5% at the end of 2017 and -1% at the end of 2016).

In the emerging market FX space, the situation is more complicated due to offsetting forces. On the one hand, there are several headwinds: a potential disruption to global trade, higher US funding costs, slower global growth and a number of political risks that could escalate into more generalised shocks. On the other hand, taken as a whole, the EM currency complex appears overly cheap relative to real GDP growth (see chart 18) – especially after the big sell off in 2018 – while a number of important fundamental metrics such as current account balances and dependence on foreign-denominated debt have improved. Additionally, one would think that the dollar downtrend we envisage against most G10 currencies would spill over to the USD-EM. This has not, however, always been true. Over the last 18 years or so, there have been periods when the dollar fell on an annual basis and EM currencies also experienced losses (2002 and 2011), as well as periods when a lower dollar (against majors) was associated with meagre EM FX gains (2006). On balance, our approach remains cautious and we believe that selectivity will matter. In terms of outright bets against the USD, we prefer currencies with overall solid fundamentals that experienced steep losses over the course of 2018, such as RUB (although potential sanctions pose a risk) and

18. Current EM FX pricing too pessimistic on EM growth



Sources: Bloomberg, Lombard Odier calculations

INR (though we remain mindful of the risk associated with the general elections). Moreover, we have a slight preference for relative value trades (to mitigate risks associated with higher USD funding costs), which are summarised below:

BRLCLP: bullish ¬– We expect Brazilian growth to pick up in 2019 and inflation to remain contained (high real rates). Additionally, we anticipate progress on reforms under the Bolsonaro administration, while Brazil's low exposure to external financing should insulate it from higher USD financing costs. In contrast, growth in Chile has peaked, current account balance dynamics have deteriorated, and the economy is highly exposed to external debt (64% of GDP). Importantly, the currency pair is trading more than 25% below its 10-year average.

RUBZAR: bullish – Russian real rates continue to be among the highest in the EM universe with the economy still enjoying solid fundamentals (credible central bank, current account surplus and high FX reserves). In contrast, ZAR real rates have been eroded by high inflation and the country has one of the largest external debt exposures (54% of GDP) among emerging markets. South African political developments and willingness/ability to reform will remain hurdles in attracting foreign investment and enabling an economic rebound from the 2018 recession. There are two risks to this trade, related to Russia: the possibility of weaker oil prices and the threat of fresh sanctions. That being said, the pair is currently trading at rather cheap levels, some 17% below its 10-year average.

Vasileios Gkionakis, Global Head of FX Strategy

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