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LOMBARD ODIER

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Investment Strategy

Private Clients

4/4

October 2018 · 4th quarter

At a glance

- Our central scenario does not foresee a major downturn over the next year or so, only some deceleration in world economic growth.
- Strong growth momentum, ongoing fiscal support, a tight labour market and mounting inflationary pressures all suggest that the Fed will deliver on its plan to further tighten monetary policy.
- Although the trade dispute has weighed on Eurozone growth this year, domestic indicators remain very solid, even suggesting that the inflation (and ECB) outlook may finally be changing.
- The Japanese economy is currently strong, and Abe's remaining reform objectives would help make these improved dynamics durable.
- Investor flight from emerging markets is inflicting damage to their financial markets and currencies – even though underlying fundamentals remain broadly supportive.
- In the FX space, we see upside on the CAD and NOK, USD stabilisation (ahead of longer-term depreciation) and progressive CHF weakening – with the RUB and MXN our favoured emerging currencies.
- Late-cycle phases can offer robust returns but pose new challenges and demand careful risk management. We intend to remain nimble, containing overall portfolio risk while maintaining selective cyclical exposure.

Also featured

FX view: US fiscal policy will prove the dollar's Achilles heel

Oil price: upward-skewed short-term risk

Quarterly publication of
Lombard Odier Investment Solutions – Strategy

Mounting pressure from higher dollar funding costs and trade tensions

Our central scenario does not foresee a major downturn over the next year or so, only some deceleration in world economic growth. The balance of risks is nonetheless becoming less favourable, owing to tighter US monetary policy and the escalating trade dispute between the two economic powerhouses. A progressive reduction of portfolio risk is thus warranted, towards a more neutral positioning.

As we enter the final stretch of 2018, the economic and financial picture remains globally positive. Rising employment is supporting domestic demand across all regions. Even trade volumes are still running at a decent pace. Some clouds are, however, gathering on the horizon – headwinds to the 2019 cyclical outlook. First is the US interest rate cycle, which is ultimately the only monetary cycle that matters given the dollar-centric nature of the global financial system. Strong US growth momentum, a very tight labour market and inflation now at the target level make the Federal Reserve (Fed) unlikely to deviate from its pledged rate tightening path, with one further hike planned before the end of this year and three in 2019 (see chart I, page 04). The Fed will also continue to normalise (i.e. reduce) its balance sheet, adding to the stress inflicted on the more vulnerable economic actors. Emerging countries with large currency mismatches and highly leveraged companies are most at risk, as has been obvious for some months already. Note in the latter regard that the total liabilities of the non-financial corporate sector neared a record high at the end of 2017, and currently well exceed the peaks that preceded the past two economic downturns.

The other main cause for concern is the trade dispute between the US and China. Just as progress was being made with other US trade partners, such as Mexico, Europe and Japan, the confrontation with China has taken a nastier turn. September saw the Trump administration announce a 10% tariff on the vast majority of the initially-identified USD 200 billion Chinese products, to take effect almost immediately (see chart II, page 04). The scope of this measure exceeded expectations, even if the level of tariff was lower than could have been feared – limiting the immediate negative impact on financial markets. That said, the initial 10% rate could rise to 25% in January, if no compromise is reached in the meantime. President Trump also again threatened to impose tariffs on a further USD 267 billion of Chinese goods in the event of retaliatory Chinese action – which of course occurred.

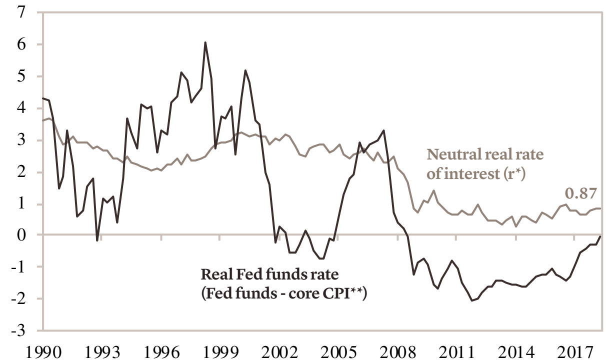
We see no rapid resolution of the US/China trade dispute. In the US, mid-term elections look set to bring about a divided Congress, with the Democrats winning back the House of Representatives and the Republicans holding on to their Senate majority. But even if the Democrats manage to gain control of both houses, they would not have the votes to overturn President Trump's signature economic policies: stimulus, deregulation and protectionism. Not to mention that the Democrats would have little reason to become fiscally conservative and are traditionally more aligned with the President's protectionist views than some of the more old-fashioned Republicans. So, whatever the outcome of the midterm elections, there is little in the US that could get in the Trump administration's way as pertains to its dealings with China.

On the Chinese side, we very much doubt that currency devaluation will be actively used to counter US tariffs. This is not to say that the yuan could not be allowed to depreciate somewhat relative to the dollar, while remaining broadly stable versus the basket of currencies against which it is managed (see chart III, page 04). Letting

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

I. **With the policy rate still below the Fed's estimate of "neutral", more hikes are on the way**

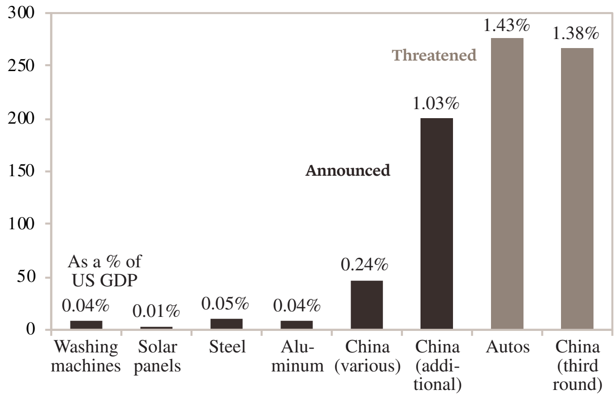
Estimates of the "neutral" rate have gradually started to rise



** Consumer Price Index / Sources: Federal Reserve Bank of New York, Bloomberg, Lombard Odier calculation

II. **The volume of trade affected by already implemented US measures is now substantial**

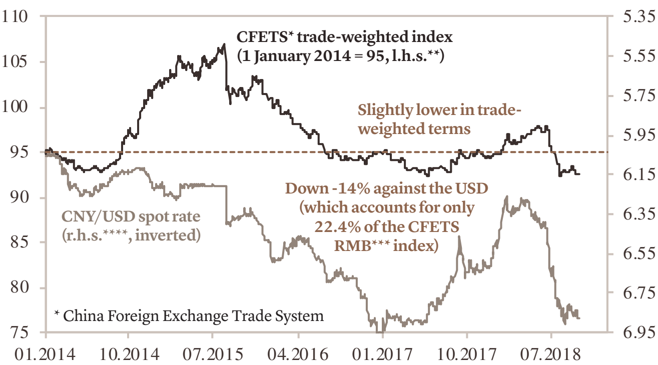
Volume of US imports affected by tariffs, in USD billion



Source: Lombard Odier calculation

III. **Chinese exchange rates over recent years**

Spot rate in trade-weighted terms and versus the USD



** left hand scale, *** renminbi, **** right hand scale
Sources: Datastream, Lombard Odier calculation

market forces weigh on the currency would clearly help mitigate the impact of US tariffs on the Chinese economy. A sustained yuan depreciation would, however, undermine Chinese policymakers' rebalancing efforts in favour of domestic activity, increase financial sector risks and trigger capital outflows. Rather than a repeat of 2015, we thus expect adjustments at the margin and continued volatility.

With President Trump unlikely to drop the issue and China reluctant to back down, odds of a near-term trade agreement are low, even if additional rounds of negotiations take place in coming weeks. Our base case continues to be that a full-blown trade war will be avoided, given the economic costs involved – but probably only after some of these costs have started to materialise. Put differently, some escalation of the conflict is to be expected before an eventual compromise can be reached.

The resulting slowdown – but not collapse – in Chinese and US growth will weigh on the global economic trajectory next year. For China, we currently project GDP (Gross Domestic Product) expansion of 6.3%, slightly below the 6.5%+ pace of 2018. And in the US, where the effects of fiscal stimulus will also begin to wane, growth should slow to around 2.5%, versus the 3% to be posted in 2018. Other regions should, however, hold up better. Japanese cyclical conditions appear stable and sustainable. And there might even be a slight pickup in Eurozone growth (and inflation), given the robustness of internal demand and positive "export-switching" effects. For, no matter what President Trump would like, the US are simply unable to immediately source all their needs domestically.

Samy Chaar, Chief Economist

United States
How long will the cycle last?

In a nutshell

- Strong growth momentum, ongoing fiscal support, a tight labour market and mounting inflationary pressures all suggest that the Fed will deliver on its plan to further tighten monetary policy over the next few quarters.
- While a number of risks are worth monitoring, the determinant factors for US monetary policy will remain domestic inflation and employment.
- Looking at the next few quarters, interest rate market expectations about the path of the policy rate seem too conservative.

Having delayed "lift off" for longer than anticipated, the Fed has now delivered more than most thought likely. September saw the eighth hike of the cycle, taking the policy rate to 2.25%. In the meantime, the Fed has also been scaling down its balance sheet, now reduced to just below USD 4 trillion – and continues to let assets run off.

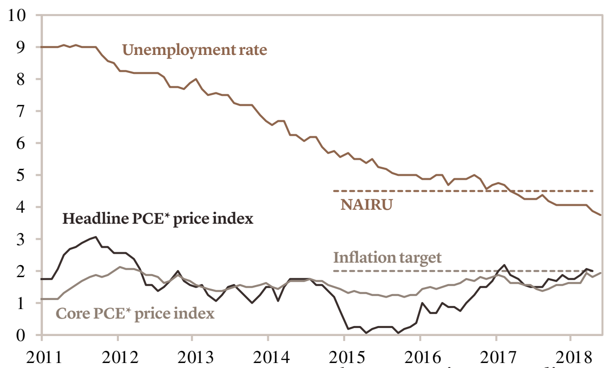
The objective of monetary tightening is to prevent overheating, i.e. the risk of growth rising too far beyond the economy's potential, triggering high inflation that could later prove hard to rein in. In this regard, the current picture suggests that the Fed's tightening cycle still has some way to go. Strong growth momentum, supported by the ongoing fiscal boost, has kept job creation running at a pace roughly double that needed to keep unemployment stable. Meanwhile, inflation, which is now back at the Fed's 2% target (see chart IV), faces near-term upside risks owing to a tight labour market, little spare capacity, higher commodity prices and the impact from tariffs.

The list of risks to a steady policy outlook is long: emerging market turbulence, domestic issues such as political uncertainty, rising trade tensions, or financial risks like those related to a flattening yield curve. Each of these can have an impact at the margin – if inflation disappoints, or when growth momentum starts to slow. But we would highlight that unless these factors are seen to exert an effect on its domestic mandate, the Fed has shown an intention to stay the course – which means that US inflation and employment remain the most critical indicators to watch.

Our base case is that the outlook for Fed policy is tilted to the hawkish side. This contrasts with market expectations, still doubtful of the Fed's intention to deliver further tightening (see chart V). How this divergence plays out will be a critical development in coming quarters – both for US interest rate markets and for many other asset classes, given the global influence of US monetary policy.

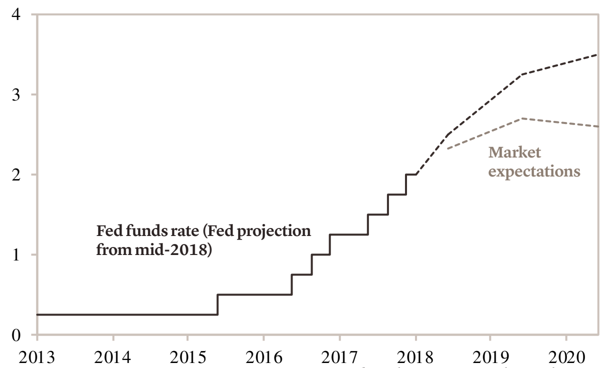
Bill Papadakis, Macro Strategist

IV. Unemployment continues to drop while inflation has risen to the Fed's target



* Personal Consumption Expenditures
Sources: Federal Reserve, BEA, Lombard Odier calculation

V. Fed guidance points to continued rate hikes, but markets remain doubtful



Sources: Federal Reserve, Bloomberg, Lombard Odier calculation

Europe
Still a rather positive outlook

In a nutshell

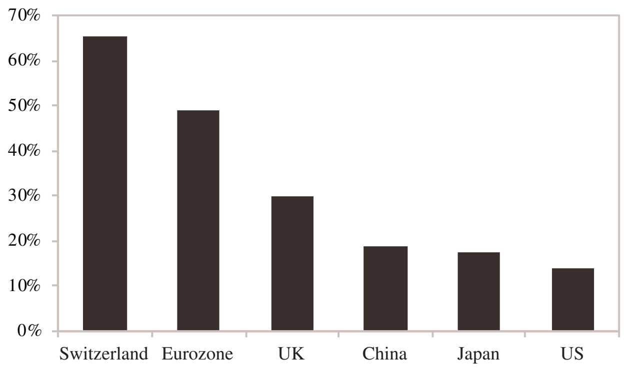
- The trade dispute has weighed on headline Eurozone growth this year, owing to the very open nature of its economy.
- Domestic indicators nonetheless remain very solid, even suggesting that the inflation outlook may finally be changing – and with it the ECB's policy stance.
- The just released Italian budget promises further tensions with Brussels, hence continued market volatility.

Eurozone economic growth has slowed this year but is still broad-based, with all countries participating in the upturn, and firmly above potential. Lesser external demand accounts for much of the slowdown – the Eurozone being more open than most other large advanced economies (see chart VI). Domestic indicators remain robust: employment and real income are trending up and lending growth to non-financial corporates has accelerated.
A tighter labour market also means rising wage pressures (see chart VII). With the unemployment rate now approaching the NAIRU (Non-Accelerating Inflation Rate of Unemployment) threshold, shortages are becoming visible in Germany, the Netherlands and even France, where the share of firms citing the lack of workers as a constraint on production has almost doubled over the past year. For the Eurozone at large, nominal hourly wages posted 2.2% year-on-year growth in the 2nd quarter, their fastest pace since the 4th quarter of 2012.

Given the positive correlation between wage growth and the core consumer price index, the inflation outlook may finally be changing in the Eurozone. Of note also is the fact that, according to a European Commission survey, consumer inflation expectations have now reached their highest level since 2013.
In turn, the pickup in underlying inflation pressures lessens the case for massive monetary stimulus. The ECB appears set to end its asset purchases this year and we expect the negative interest rate policy to be abandoned in late 2019.
On the political front, Italy is obviously the main issue right now. The just presented budget involves a 2.4% deficit, well above the previously discussed 1.6% level (not to mention the 0.8% targeted by the prior government). It would appear that the more populist members of government had their way. And with the plan focused on domestic demand, rather than productive investment, tensions with Brussels are likely to intensify – as might the risk of a debt rating downgrade. So, although Italy's significant current account surplus and mostly domestically held public debt suggest no solvency risk, additional volatility can be expected in the coming weeks.

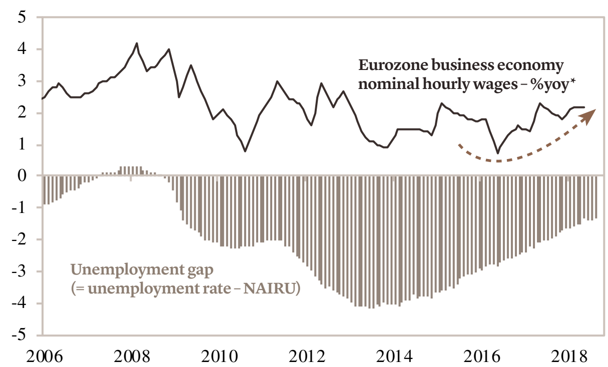
Samy Chaar, Chief Economist

VI. Exports as a % of GDP



Sources: Datastream, Lombard Odier calculation

VII. A tightening labour market: shrinking unemployment gap versus wage growth



* year on year
Sources: Datastream, Lombard Odier calculation

Japan
Three more years

In a nutshell

- Following his re-election at the helm of his party, Abe will likely serve three more years as Japanese Prime Minister – making his tenure the longest in the country's history.
- The Japanese economy is currently strong, and Abe's remaining reform objectives (consumption tax hike, higher retirement age, easier immigration policy) would help make these improved dynamics durable.
- The political calendar remains the key risk, with the complex revision of the country's pacifist constitution liable to take up much time and political capital.

Abe's re-election as president of the Liberal Democratic Party means that he is almost certain to become the longest-serving Prime Minister in Japan's history. This impressive milestone, however, masks the fact that the next three years will likely be his last, as the party has a three-term limit. Will it be enough for Abe to cement a change in Japan's long-term economic trajectory?

His three remaining major reform initiatives will be key in this regard: a further 2% hike of the consumption tax rate, raising the retirement age to 70, and a more friendly visa policy for foreign workers. The economic rationale for these proposals is very clear. The last consumption tax hike improved Japan's fiscal balance and made room for business tax cuts. It did hurt consumption, but that impact should be lesser this time due to childcare support and food item exemptions. Later retirement will boost labour participation modestly while curbing pension-related spending, and any opening-up of immigration policy is welcome given Japanese demographics.

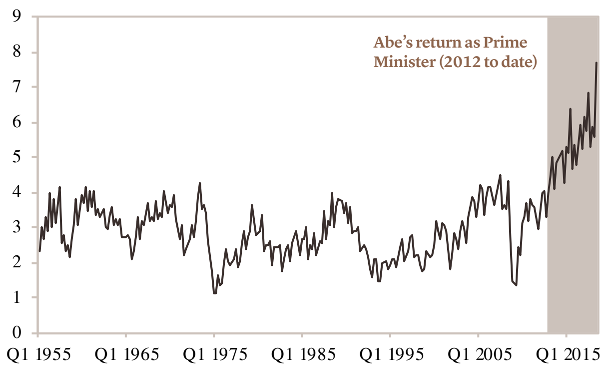
Investors' working assumption should be that Abe goes ahead with the tax hike in 2019, and possibly reform of the national pension and visa systems before 2021. But while he seems very confident about public acceptance, the political calendar remains a key risk. The lengthy and complex process of revising Japan's pacifist constitution will occupy the earlier part of this new term. If it takes up too much of Abe's remaining political capital, he might enter his final year in office without the ability to push for more meaningful economic reforms. Come 2020 or 2021, other ambitious politicians will also be jostling for his position.

The good news is that the longevity of Abenomics has already materially enhanced the Japanese corporate sector, thanks to more sustainable revenue growth, favourable financing conditions, and a decline in effective tax rates. Profitability has rocketed since Abe's return in 2012 (see chart VIII). The Bank of Japan has also successfully engineered a steady tightening of the labour market, with very encouraging results in terms of wage growth and household outlook (see chart IX). Recent weather-related volatility aside, we see good reason to characterize the Japanese economy as strong.

Homin Lee, Macro Strategist - Asia

VIII. Current profits as a % of overall sales

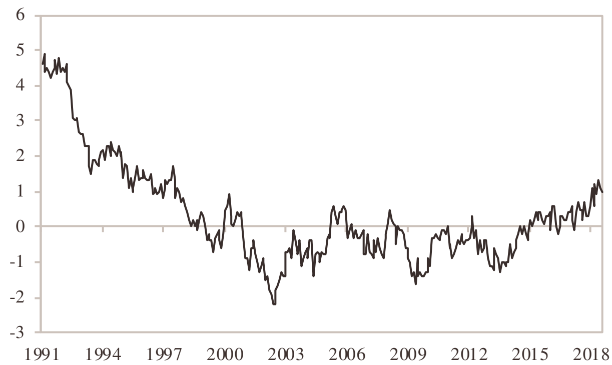
All industries, Ministry of Finance survey



Source: Ministry of Finance

IX. Scheduled cash earnings

%yoy, all companies with more than 5 employees, Ministry of Health, Labour and Workforce



Source: Ministry of Health, Labour and Workforce

Emerging Markets
Structural upside remains, despite tightening conditions

In a nutshell

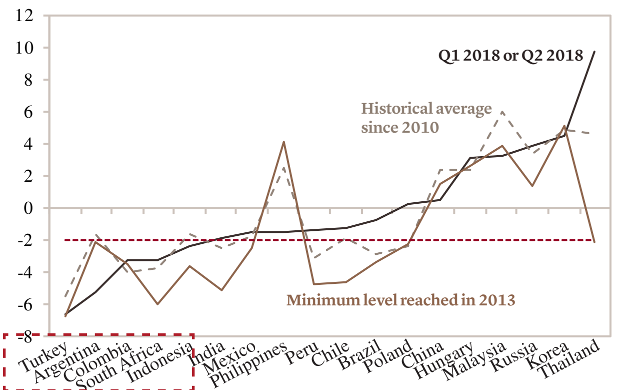
- Investor flight from emerging markets is inflicting damage to their financial markets and currencies – even though underlying fundamentals remain broadly supportive.
- With emerging central banks forced to take a tighter stance, the risk is that economic growth be hindered during coming months, albeit not to the point of falling into recession.
- A selective approach remains warranted, but structural upside remains.

Emerging markets are enduring their most challenging year since the 2014-2015 commodity collapse, amid rising US rates, a stronger dollar, mounting trade tensions and a slew of domestic political risks.
Of our 18-country universe, all currencies except the Columbian peso, Mexican peso and Thai baht are down year-to-date versus the greenback, with moves ranging from over -50% for the Argentinian peso, -40% for the Turkish lira and -20% for the Brazilian real to just -2% for the Malaysian ringgit or the Peruvian sol[1]. Against the dollar, all the currencies we monitor now look cheap, Thai baht and South Korean won excepted.
Is this a fair representation of domestic economic realities? We don't believe so. The risk is, however, that a prolonged period of currency-induced tight financial conditions starts to affect otherwise broadly sound fundamentals – indeed much improved in recent years.
Current account deficits have for instance narrowed meaningfully, with only five countries still below the -2% mark (see chart X). The countries under most pressure are precisely those with the weakest external position: Turkey and Argentina. On that count, we should carefully monitor South Africa and Indonesia, while Colombia does display a relatively large deficit but with an improving dynamic. External reserves have also grown markedly, now above 20% of GDP on average. Here again Turkey, Argentina, Indonesia and South Africa look weakest.
Finally, the still young recovery means that central banks started 2018 with near all-time low interest rates. As we expected, they have begun to use this leeway to support their currencies, with Mexico, Argentina, Indonesia, India, the Philippines, Turkey and Russia having already raised rates. Outside of the two extreme cases of Turkey and Argentina, monetary policies can now be deemed broadly neutral (see chart XI). Monetary tightening will be another headwind to future growth, but not enough to cause a recession.
Overall, economic fundamentals indicate that most emerging markets can still deliver structurally, but tighter US dollar funding, trade tensions and rising rates will weigh on growth in coming months, warranting a selective approach.

Stéphanie de Torquat, Macro Strategist

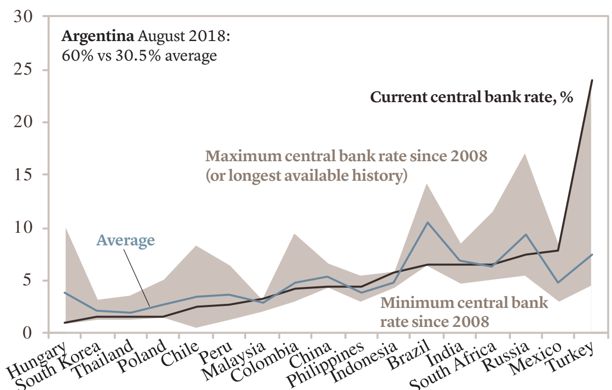
[1] As of 28 September 2018, close of business.

X. Current account deficits as a % of GDP
Latest data versus history



Sources: Bloomberg, Datastream, Lombard Odier calculation

XI. Monetary policy turning more neutral
11 of the 18 countries still have rates below their historical mean



Sources: Bloomberg, Datastream, Lombard Odier calculation

Asset Allocation
Finding the balance between sound fundamentals and a growing set of risks

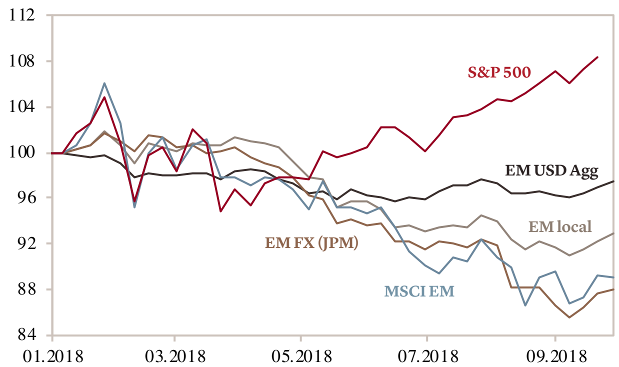
In a nutshell

- Late-cycle phases can offer robust returns but pose new challenges, as the cost of capital is rising, and demand careful management of risk, particularly liquidity risk.
- We have thus reduced exposure to assets likely to prove least liquid in the event of a downturn, notably emerging market assets and convertible bonds.
- Our exposure to emerging markets is now neutral: in the most vulnerable economies, sharp currency losses threaten to affect (improved) structural dynamics, with the pick-up in inflation forcing central banks to adopt a less accommodative stance.
- We will rigorously monitor market conditions and remain nimble in our tactical asset allocation – keeping the overall risk level close to our Strategic Asset Allocation while maintaining selective cyclical exposure, so as to benefit from the still sound global fundamentals.

The past quarter has proved tough for risk assets, with emerging market turmoil and mounting uncertainties weighing on performance. The most meaningful bastions of strength have been the US economy and stock market, in part thanks to the ongoing fiscal package. The corollary is that the Fed will have no choice but to continue to tighten US financing conditions, regardless of the international impacts. Consequently, we have engaged in a gradual reduction of our overall portfolio risk level. We began 2018 in a "goldilocks" economic environment (i.e. strong growth and low inflation), with well-oriented markets and a relatively high level of risk relative to our newly initiated Strategic Asset Allocation. We were notably overweight emerging equities, small-cap equities, high yield debt, as well as emerging debt in both hard and local currencies. We maintained this pro-risk stance throughout the 1st half of the year, even though we foresaw lower future returns and more episodes of volatility as the "goldilocks" period came to its end in the US. Since June, we have been aiming for a more neutral stance. We have reduced exposure to emerging debt (in hard and local currencies), convertible bonds and equities. Indeed, as the US cycle advances, the most vulnerable economic actors find themselves challenged by a rising cost of capital. We feel that the risk of financial market accidents is increasing and it is time to be more selective.

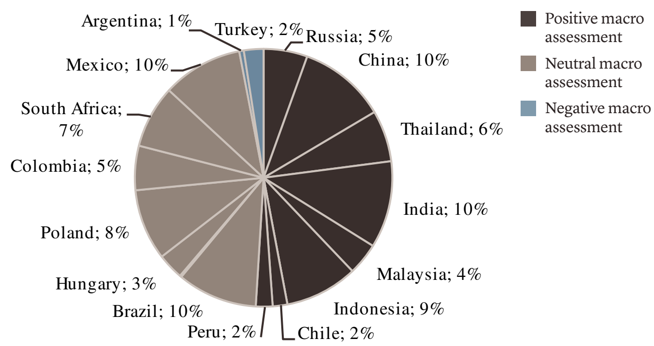
Summer emerging market turmoil provides a good illustration of what a maturing US cycle means for financial markets (see chart XII). Although the currency crises do have idiosyncratic roots, they are intensified by the Fed's continued tightening. The fact that emerging central banks are in turn being forced to become more restrictive, in reaction to their devaluating currencies, is only adding to the pressure on emerging assets. We have taken a number of steps over the past months to reduce exposure to emerging market risk. We started in May by cutting our overweight of local currency-denominated emerging debt in USD portfolios. In June and July, we then cut our overweight of, respectively, emerging equities and hard currency-denominated emerging debt. Finally, in September, we further decreased our holdings of local currency-denominated emerging debt. **Across the various risk profiles, our emerging market exposure has thus now been brought back to neutral.**

XII. Emerging markets turmoil
100 in January 2018



Sources: Bloomberg, Lombard Odier calculation

XIII. Countries with good fundamentals represent only 50% of the local currency emerging debt market



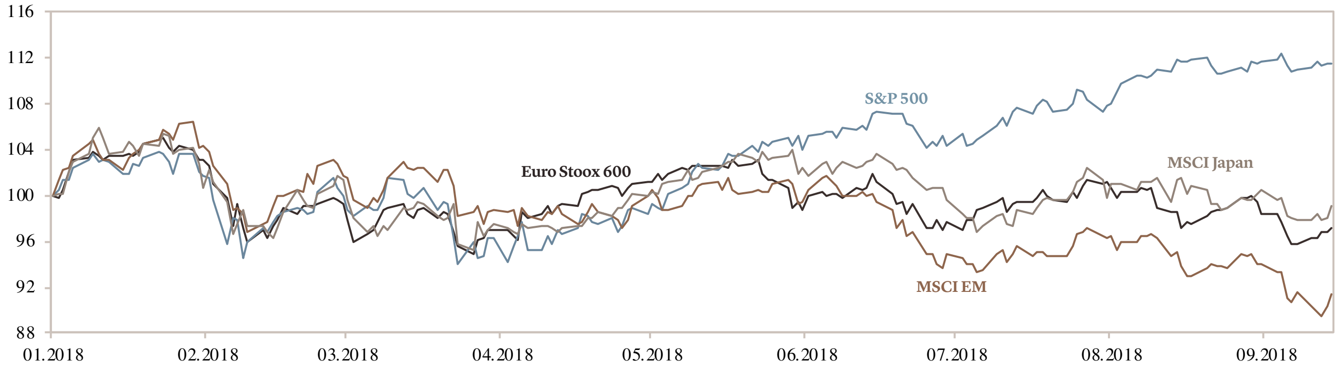
Sources: J.P. Morgan, Lombard Odier calculation

The decision to focus the latest reduction on emerging bonds rather than equities was based on two considerations. First, countries with poor fundamentals represent a large share of the bond market (see chart XIII, page 09) whereas countries with good fundamentals make up 75% of equity indices. Second, we note that back in 2013, when the Fed announced the tapering of its quantitative easing program (which was a source of dollar tightening comparable to today's), local currency-denominated emerging debt underperformed other asset classes.
Interestingly, emerging equities have also historically shown a tendency to rebound faster than bonds, meaning that holding on to this exposure should enable portfolios to benefit from a potential bounce.
As regards developed market equities, the main striking fact has been the continued divergence in performance between the US and other regions (see chart XIV, page 11). This divergence is mainly attributable to fears of a trade war and its potential impact on export-driven economies (Europe, emerging markets), but also reflects impressive earnings dynamics in the US (see chart XV, page 11). **In line with the changes initiated in May, we recently elected to further reduce active risk within our regional allocation.** Current political uncertainties pertaining to the Italian budget, relative valuation, earnings momentum and a lack of positive short-run catalysts all contribute to making Europe seem less attractive than we previously thought. Our exposure is now back to benchmark in all regions except for Japan, where we remain overweight. Japanese equities are cheap and bring a pro-cyclical tilt to our equity allocation.
In fixed income, unattractive expected returns, especially in the European sovereign and credit segments, continue to warrant a defensive stance. **In USD portfolios, we have started to buy some short-term paper, reinvesting the proceeds from the sales of emerging debt and European equities.** But we recommend maintaining a short duration and underweighting the high yield segment, as yields (i.e. the cost of capital) have room to rise further. In EUR, CHF and GBP portfolios, yields are still too low to make a similar move – we thus kept the proceeds in cash. As described earlier, our stance on emerging market debt, both hard- and local currency-denominated, is now neutral. And we remain slightly overweight convertible bonds.
Turning to currency markets, we expect the US dollar to stabilise in the near-term, as this year's upward drivers wane, and then depreciate on a 12-month and beyond horizon (see Box A, page 12). Elsewhere in the G10, we look for upside on the Canadian dollar and Norwegian Krone (due to strong oil prices and tighter monetary policy), while expecting the pound sterling to continue to be driven almost exclusively by Brexit headline risk. Finally, we anticipate a resumption in Swiss franc weakness although the process is likely to be particularly slow. As regards emerging currencies, we suggest cautiousness and selectivity: cautiousness because (i) there are downside risks to global growth and (ii) higher US yields are likely to weigh on externally vulnerable emerging market economies; and selectivity because, in the late stages of the cycle, investors typically reward currencies with strong economic fundamentals.
Among the emerging FX universe, we favour the Russian ruble (on oil price grounds) and Mexican peso (due to positive spillovers from US growth and resolution of the NAFTA – North American Free Trade Agreement – negotiations). We are turning neutral on the South African rand, as we feel the currency will be subject to opposing forces: too much negativity already in the price on the one hand but looming domestic and external growth risks on the other. Finally, we think the Turkish lira will resume its weakness as higher inflation has pushed real yields back into negative territory and high energy prices are starting to bite on consumer firepower.
Within the commodities space, our preference goes to oil (see Box B, page 13) and base metals. The latter market saw considerable Chinese destocking during the period of dollar appreciation, meaning that the world's largest consumer will need to come back to the market – all the more so if it implements a domestic stimulus plan. With physical supply/demand currently at equilibrium, and extremely bearish investor positioning, the upside on base metals could be material if stronger manufacturing data is reported or the trade dispute shows any signs of waning. As for gold, while it remains the ultimate hedge against an "end of the world" scenario, its attractiveness is limited by rising US yields – in the wake of a quite normal return of inflation. Physical demand in large gold consuming countries, such as India and China, will likely suffer from currency depreciation and seems little inclined to pick up soon.

Sophie Chardon, Cross-Asset Strategist
Vasileios Gkionakis, Global Head of FX Strategy

XIV. Increased dispersion of equity market performance

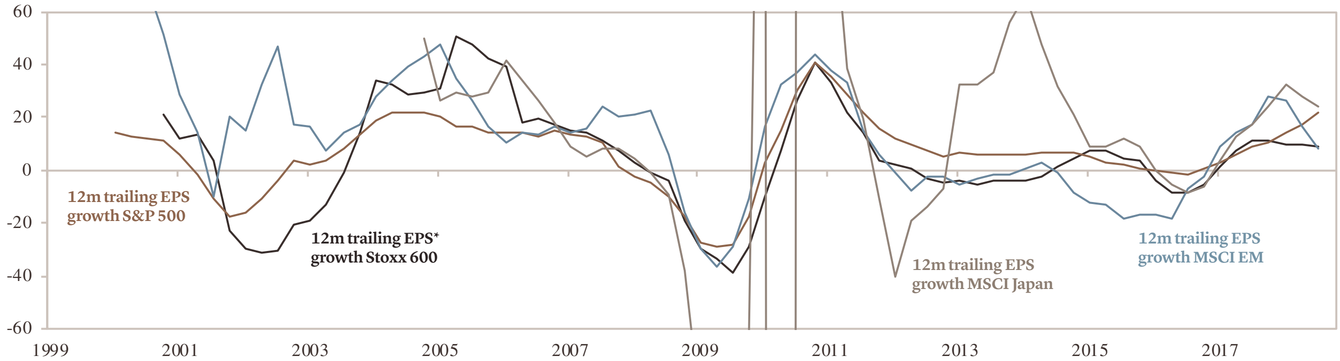
EUR-based performance (100 in January 2018)



Sources: Datastream, Lombard Odier calculation

XV. Equity fundamentals remain solid

12-month earnings growth (%)



* earnings per share
Sources: Datastream, Lombard Odier calculation

A. FX view: US fiscal policy will prove the dollar's Achilles heel

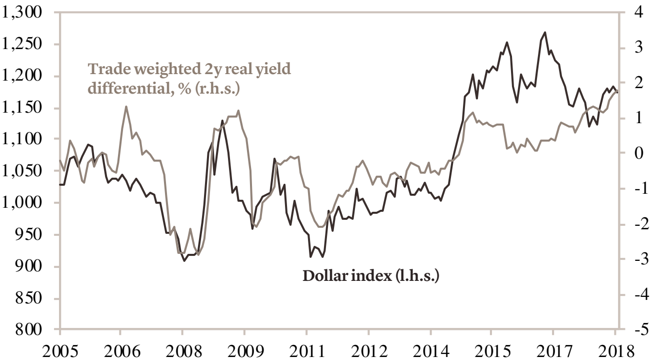
On a trade-weighted basis, the dollar is up 7% since mid-April (3% year-to-date). Its momentum was particularly strong through late June, with price action more two-way over the last few months. We attribute the summer uptrend to three (interrelated) factors. First, a slew of idiosyncratic risks flared up in emerging markets (Turkey, Argentina and Brazil), with typical spill-over effects on risk appetite – driving investors to safe haven assets such as the greenback. Second, the 2-year real yield differential between the US and its seven most important trading partners widened from 129 bps (basis points) at the end of January to just over 180 bps (see chart XVI), due to continued Fed policy tightening while the other major central banks stood pat. Finally, activity indicators have moderated outside of the US, with the trade dispute also contributing to dampen sentiment about world economic growth.

These forces are likely to wane – though will not disappear completely – over the next few months. For starters, the pockets of country-specific risk have mostly been contained. While Brazilian political developments do warrant close monitoring, given the country's prominence in emerging market indices, the majority of emerging economies have reduced their external imbalances. Vulnerable and high beta emerging FX could see bouts of selling but we doubt that – absent a global growth shock – emerging market currencies will see a pronounced and sustained weakness. As regards real yields, although monetary policy is set to continue to tighten in the US, higher inflation relative to the rest of the world should keep the differential from widening further. **We also note that the later stages of Fed tightening have historically not been a barrier to USD depreciation.** In the prior three rate cycles, dollar returns were quite poor once the Fed had covered about 60% of the hiking ground – which is more or less where we think we are currently. In 2004-2006, the trade-weighted dollar shed 2.6% as the central bank kept on raising the policy rate (from 3.25% to 5.25%), and in 1994-1995 it was more or less flat as the final hikes were made (before depreciating sharply). Only in 1999-2000 did the dollar manage to gain 4% as the policy rate rose from 5.75% to 6.5%. But this was a materially different period: financing costs were significantly higher than today, and emerging growth had been declining sharply since 1996, amid a large number of external crises. Finally, while global activity has admittedly shifted to a lower gear, recent PMI (Purchasing Managers' Index) data still suggest a growth rate of around 2.5% for world GDP.

Dollar stability thus seems the likely path for the near term. **On a medium-term horizon, however, the elephant in the room is US fiscal policy.** Although it has clearly had an immediate positive impact on the economy, it lacks the productivity-enhancing measures that would raise output growth sustainably. It also came at exactly the wrong time in the cycle, just when the output gap was turning positive. In fact, accounting for the latter, fiscal policy is now the loosest in decades and bodes ill for the future of the dollar (see chart XVII). Such ill-timed debt accumulation is bound to raise US risk premia – particularly since the US have been the recipient of record inflows during the past decade – and weigh on the dollar. **Looking out a year and beyond, our forecast is thus for the greenback to depreciate, with the EURUSD moving above 1.20 and the USDJPY towards 110 and below.**

XVI. Dollar index and the trade-weighted 2-year real yield differential

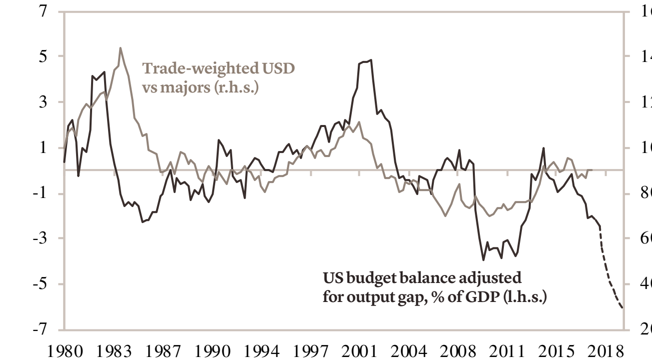
In %



Sources: Bloomberg, Lombard Odier calculation

XVII. US fiscal policy poses a colossal challenge for the dollar

US budget balance leads the exchange rate by 4 quarters



Sources: Bloomberg, Lombard Odier calculation

B. Oil price: upward-skewed short-term risk

At USD 86 per barrel, the Brent oil price is trading at its highest level for the year, indeed since October 2014. The expected drop in Iranian exports accounts for much of this strength, with large Chinese and Indian refiners reportedly the latest to halt purchases of Iranian crude, following the drop in exports to Europe that was reported in June/July.

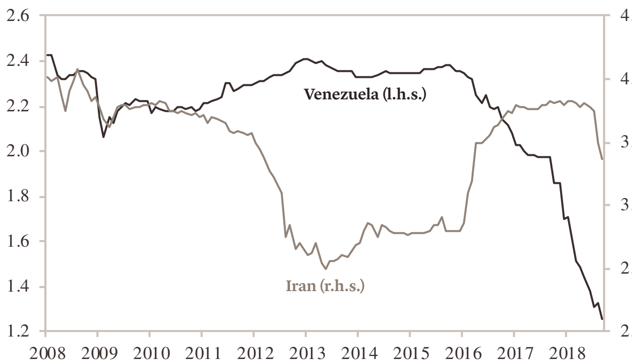
The Iranian disruption (alongside the difficult Venezuelan and Libyan situations) makes for a deteriorating near-term oil supply outlook (see chart XVIII). Our base case has Iranian exports falling 500,000-1,000,000 barrels per day as a result of US sanctions, while Venezuelan output should stabilise at the current low level and Libyan production should average 1,000,000 barrels per day – while remaining volatile. We expect OPEC (Organization of Petroleum Exporting Countries) to stay intent on meeting consumer needs at a "fair price" but not overproducing the physical, showing an unwillingness to increase output pre-emptively (see chart XIX). **With demand showing no signs of slowing down and the US administration proving reluctant to tap into the Strategic Petroleum Reserve, this new framework makes for upward-skewed risk to the oil price during the next quarters.**

The spectre of a return of the US shale industry, the famed swing producer, should not affect market dynamics in the short term. Indeed, even though current oil prices are likely to generate additional cash flow and thus capital expenditure, the lack of infrastructure in the Permian basin limits output for the time being. New pipeline capacity out of this basin is, however, scheduled for the latter half of 2019, anchoring our medium-term oil price forecast at USD 75 per barrel.

For the oil price to move sustainably higher, another supply catalyst beyond Iran would be needed. Keep in mind also that, in the current strong dollar environment, any short-term price spike might eventually weigh on demand, notably from China and other emerging markets. We thus expect the Brent price to return to the USD 70-80 range towards the end of 2019. **We nonetheless confirm our recommendation to maintain oil exposure in portfolios, given the positive carry implied by the current backwardation of the futures curve (ca. 7-8% per annum) and oil's hedging virtues with respect to geopolitical tensions** – a risk that cannot be totally excluded after the US mid-term elections, given escalating US posturing in the Middle-East.

XVIII. Sharp fall in Venezuelan and Iranian production

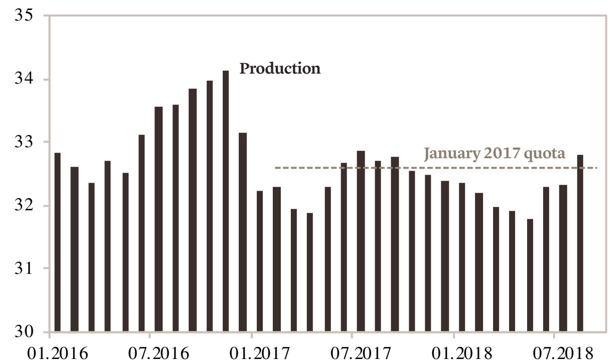
In Mb/d*



* million barrels per day
Source: Bloomberg

XIX. OPEC members have agreed to bring compliance back to 100%

OPEC oil production, in Mb/d



Source: Bloomberg

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