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FX Monthly

Quo vadis, dollar?

02/12

February 2019

The dollar rebound in February has admittedly caught us by surprise. We attribute this USD strength to a confluence of factors, including a technical correction and angst about a global slowdown (ex-US) that has proven to be deeper than we expected. We notably think hunt for yield (the carry trade) has helped the dollar against G10 FX, which also explains why higher-yielding EM FX has held up well in the past couple of weeks. This has prompted us to revise a number of our forecasts while maintaining a bearish stance on the greenback.

More specifically, we have lowered our EURUSD forecast trajectory and now see the pair ending the year at 1.20 (1.24 previously). This change is based on a euro-area slowdown that has been sharper and more protracted than we anticipated. It suggests that low-yielding currencies such as the euro will struggle in the near term. However, the external headwinds to the region are likely to abate if the US and China reach a compromise (our central scenario). The subsequent economic recovery should allow the euro to appreciate against the USD which, in our view, remains vulnerable to a rise in US risk premia due to the ballooning twin deficit.

On CHF, we maintain our forecasts unchanged, expecting a very gradual EURCHF appreciation later this year as the SNB retains and potentially intensifies its dovish stance. On sterling, economic data and monetary policy expectations seem irrelevant for now as all that matters is Brexit negotiations. Although we still hold the view of a soft Brexit – which would propel GBP higher – we would point out that the market so far has been fairly complacent as regards the tail risk of a no-deal Brexit.

We have turned slightly cautious on our bullish call for the yen, at least in the near term, as positive developments on the trade front would support risk appetite and penalise safe havens. Eventually, however, USDJPY will end up being a dollar play. This, together with still-wide yen undervaluation, suggests that USDJPY will move south throughout 2019.

In China, we strongly believe that financial stability and thus currency stability continue to reign supreme for the country's leadership. We remain constructive on the yuan in anticipation of a trade cease-fire between the US and China.

Turning to Nordic currencies, we have revised higher our EURNOK and EURSEK forecasts, but still expect NOK (mostly) and SEK gains this year as we feel monetary policy expectations are currently under-priced. In the commodity FX bloc, our preference remains for the CAD and (less so) for the AUD.

FX Committee targets

	Q1 19	Q4 19
EURUSD	1.14	1.20
GBPUSD	1.32	1.37
EURGBP	0.86	0.88
EURCHF	1.15	1.17
EURSEK	10.40	10.00
EURNOK	9.45	9.10
USDCHF	1.01	0.98
USDJPY	109	104
USDCAD	1.30	1.23
AUDUSD	0.72	0.75
NZDUSD	0.66	0.67
USDCNY	6.80	6.65

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Important information
Please read important information at the end of the document.

Data as of 13 February 2019

At a glance

Special focus:
Quo vadis, dollar?

FX Forecasts

	Current spot	1Q 19	2Q 19	3Q 19	4Q 19	Estimates of long term fair value[1]
EURUSD	1.13	1.14	1.16	1.18	1.20	1.17
GBPUSD	1.28	1.32	1.35	1.37	1.37	1.39
EURGBP	0.88	0.86	0.86	0.86	0.88	0.84
EURCHF	1.13	1.15	1.16	1.17	1.17	1.09
USDCHF	1.00	1.01	1.00	0.99	0.98	0.93
USDJPY	110.64	109	108	106	104	98
EURJPY	124.95	124	125	125	125	115
EURSEK	10.49	10.40	10.30	10.10	10.00	9.29
USDSEK	9.29	9.12	8.88	8.56	8.33	7.94
EURNOK	9.77	9.45	9.30	9.20	9.10	8.99
USDNOK	8.63	8.29	8.02	7.80	7.58	7.68
USDCAD	1.33	1.3	1.27	1.25	1.23	1.24
AUDUSD	0.71	0.72	0.73	0.74	0.75	0.77
NZDUSD	0.68	0.66	0.66	0.66	0.67	0.69
USDCNY	6.77	6.80	6.75	6.70	6.65	

[1] The estimates of long-term (L-T) fair values are calculated as the average value estimated using FEER and BEER models. The FEER (Fundamental Equilibrium Exchange Rate) model calculates the exchange rate required to bring macroeconomic balance i.e. full-employment, low inflation and a sustainable current account balance. The BEER (Behavioral Equilibrium Exchange Rate) model uses econometric methods to estimate equilibrium FX rates based on a set of macroeconomic variables (our model uses terms of trade, investment as a share of GDP and real rates within a panel data set across G10 FX).

Note: Past performance is not a reliable indicator of future performance.

Special focus
Quo vadis, dollar?

The USD rebound (1.3% since the end of January) has caught many investors – including us – by surprise. Shortly after the US Federal Reserve (Fed)'s dovish pivot on 30 January (when the central bank dropped the hiking bias from its official communiqué), we suggested that the dollar downside – which had started since late Q4 18 – would accelerate as the Federal Reserve seemed to be entering an indefinite pause mode. Developments since then have seriously challenged our view: the USD has appreciated against all G10 currencies and has managed to reverse losses against a number of emerging market currencies. In what follows, we go through a number of potential explanations and discuss our thoughts on future prospects.

Technically, the Bloomberg Dollar Index appeared to have reached somewhat oversold levels at the end of January, so a correction might have been due. We believe this factor played a role, but it is difficult to quantify its importance.

Another potential explanation is market concerns on the state of the global economy and the outlook for growth – and hence flight to safety. We certainly think there is credence to this argument as the global composite PMI registered a rather significant drop between December and January (from 52.7 to 52.1, its lowest reading since September 2016). Data in the eurozone has been particularly weak, and surely weaker than we expected at the turn of the year.

However, linking USD strength in February to flight to safety is difficult to square with what has happened to other asset classes. For example, global equities have gained around 2.5% since the close of 29 January (one day before the Fed meeting), the Brent crude price has risen by more than 2.5%, and copper prices have gained 1.8%. Yields have fallen, but modestly – while the US yield curve has steepened somewhat, consistent with the message that the Fed sent in its January meeting. The VIX index – which measures the implied volatility of the US equity market – has fallen by four points. This is not the typical market reaction associated with flight to safety.

The super-strong US non-farm payroll for January could have also revived the notion of US exceptionalism, i.e. further ongoing growth outperformance by the US vis-à-vis the rest of the world. We think there is an element of truth in this theory, but would highlight that the US-rest of world (RoW) swap spreads have narrowed somewhat at the 2Y horizon and have remained virtually unchanged at the 10Y tenor.

An additional factor might have been hunt for yield (the carry trade). When we compare currency returns (against the USD) since 29 January with the level of each currency's interest rate (proxied by the 2Y swap rate – see chart 1), we find that there is a close correlation of nearly 0.6. Historically, periods when the Fed paused (or stopped) its hiking cycle in a global growth slowdown have been consistent with FX carry trades performing well (see chart 2). That would also explain why a number of high-yielding currencies (TRY, INR, RUB, IDR, PHP) are still holding up against the dollar.

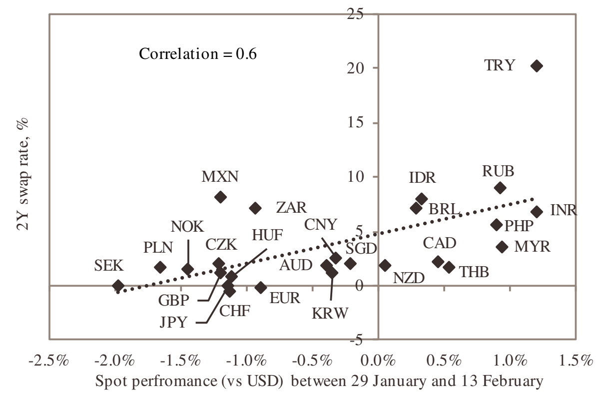
In the end, we believe a confluence of all these factors led to renewed support for dollar demand. The question is whether this recent trend is sustainable or not.

We now think that in the near term (the next month or so), G10 FX – especially the low-yielders – will struggle against the USD. Global monetary policy tightening is being priced out on the back of the growth slowdown, which means that the USD will have an edge in the near term over currencies with exceptionally accommodative monetary policy stance. How things develop from then onwards will be a function of the US-China trade relationship: assuming a compromise is reached (our central scenario), we would expect a rebound in sentiment that would also translate into a rebound in economic activity. In such a case, we would expect markets gradually to start becoming more upbeat about global growth prospects and we would anticipate broad-based dollar depreciation.

In emerging market currencies, we expect the carry trade to remain supportive as long as the slowdown does not manifest as something more sinister. TRY, RUB, MXN, BRL and ZAR should perform well in this environment, holding their gains against the USD. The single-most important risk to this view is a collapse in US-China negotiations. This would trigger a more pronounced slowdown in Chinese growth, with significant negative repercussions for global trade and growth. Monetary policy tightening would be put on hold, investor sentiment would turn outright bearish and the dollar would thrive on the back of flight to safety

1. **Higher yielding currencies have performed stronger**

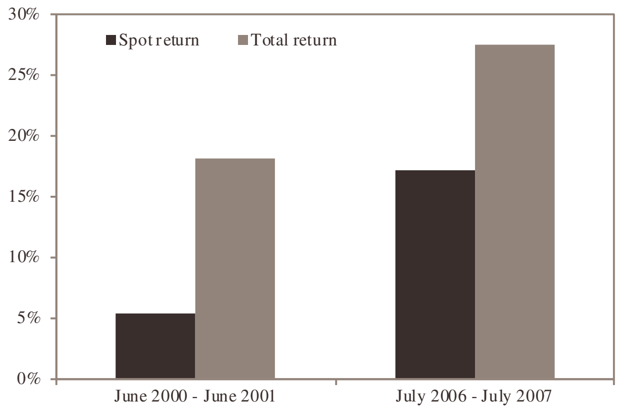
All FX spot returns against the USD



Sources: Bloomberg, Lombard Odier.

2. **Carry trade (FX) performance in similar stages in the cycle**

The strategy involves going long the three highest yielding EM FX vs USD



Sources: Bloomberg, Lombard Odier.

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EUR
Euro down but not out

- **We revise lower our EURUSD forecasts but keep the upward-sloping trajectory**
- **The euro-area slowdown has been deeper than we expected and will act as a drag on the euro for now**
- **Further out, however, a stabilisation in global trade should lead to a rebound in regional activity and afford the euro some headway**

We revise lower our forecasts for EURUSD while keeping the trajectory upward-sloping. We now see EURUSD ending Q1 19 around 1.14 (from 1.18 before) – virtually trendless – while rising gradually to 1.20 by the end of the year.

Data in the eurozone has significantly disappointed this year, with the region-wide composite PMI falling to 51, its lowest level in over five years – see chart 3. Other confidence indicators (such as the IFO and ZEW surveys) have kept on falling, registering multi-year lows. As we have argued before, the euro-area slowdown is mainly due to external factors (i.e. softening in global trade as the US-China trade disputes intensified in the second half of last year), **but it has been sharper than we expected and it now risks spreading into domestic activity**. Our macroeconomics team has revised lower their GDP growth forecast for 2019 from 2% YoY to 1.6% YoY. Market expectations for the first European Central Bank (ECB) deposit rate hike have been pushed well into 2020. A deeper slowdown than we expected, the associated negative market sentiment towards the region, and the pricing out of ECB rate hikes form the basis of our forecast revisions, especially for the near term.

At the same time, we do not foresee material EURUSD downside either, as **1)** the dovish Fed is likely to cap near-term dollar rallies, in our view, and **2)** portfolio flows to the eurozone continue to improve. ETF flows to the euro area have continued to rise in the past few months – despite the slowdown in activity - which should lend some support to the euro (see chart 3).

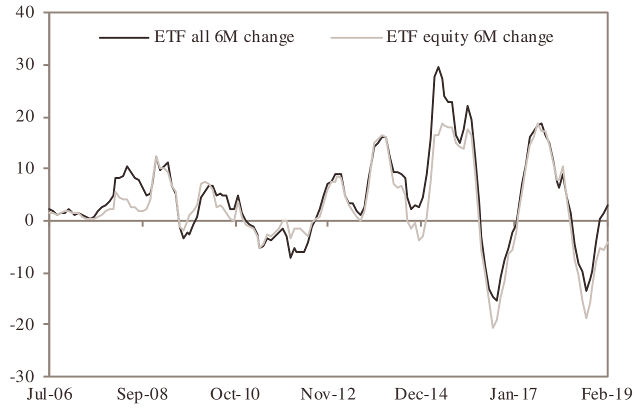
The ECB meeting early next month (7 March) is unlikely to bring fresh impulses for the currency. The updated economic projections are virtually guaranteed to show downgrades in the GDP growth trajectory, but this should already be in the price, given the ECB's assessment of risks (to the downside) in its January meeting. Updates to inflation forecasts are trickier to predict, but there is a case to be made that they will be left broadly unchanged. Oil prices have bounced back from the late-December lows while the latest core inflation reading surprised slightly on the upside. Overall – and absent a major surprise in the February PMIs that could shift the central bank rhetoric – we do not expect the meeting to leave visible marks on the currency.

Further out, the key to euro direction will be global trade. Assuming the latter stabilises on the back of a compromise between the US and China (our central scenario), then the external headwinds to the euro area should abate and regional activity should start rebounding (see chart 4). This, together with dollar weakness (which we expect because of fading fiscal impulses and the mounting US twin deficit), should enable the euro to find its footing and converge towards 1.20 against the dollar by the end of the year. This is why we keep a small EURUSD overweight in our portfolios.

If, however, the global slowdown persists and becomes deeper (potentially due to a failure in trade negotiations between the US and China), then activity in the euro area could take a turn for the worse as external pressures would soon materialise as depressed consumer and business confidence. ECB rate hike expectations would be pushed farther out, and that could act as a catalyst for a EURUSD slide towards 1.10. For the time being, we see this as a risk to our central scenario, and the next few weeks should be monitored very closely for developments on global trade.

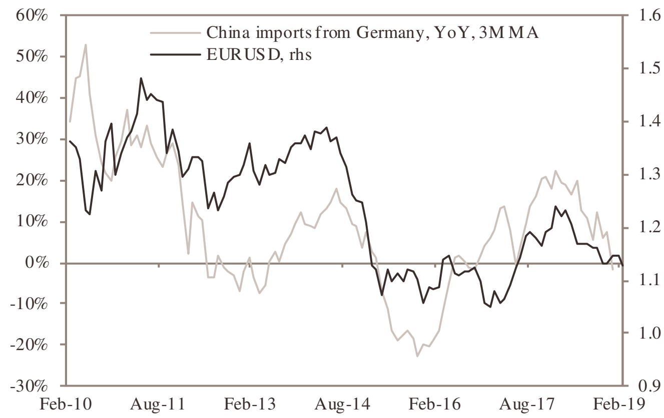
3. Despite the recent slowdown flows to the region are coming back

All amounts in EUR bn



Sources: Bloomberg, Lombard Odier.

4. A stabilization in Chinese activity should bode well for the euro



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

CHF
Stuck in a range

- **EURCHF remains stuck in the 1.1250-1.1450 range for now**
- **Italian politics are likely to remain a source of downside risk...**
- **... but once euro-area data stabilises EURCHF should be able to gradually appreciate**

EURCHF rose in the second half of January, but has given back its gain so far in February. Although correlations between EURCHF and peripheral euro-area risk have been quite erratic since Q4 18, it appears that this modest move lower in EURCHF could be linked to the recent (also modest) re-widening of Italian-German yield spreads (see chart 5).

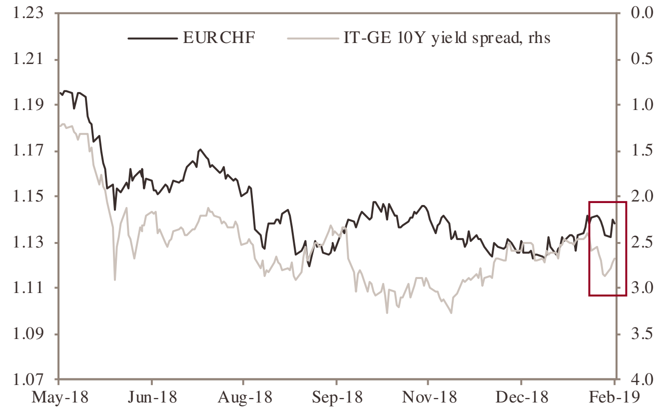
Italian developments will continue to pose a risk to EURCHF as the European Commission's scepticism about the country's achieving its budget targets is growing, especially since Italy fell into recession at the end of last year. Moreover, this is working in tandem with a broad-based euro weakness on the back of faltering regional sentiment. So for now, EURCHF is likely to remain soft, trading with a downside bias. Still, we would not expect a break of the strong support area around 1.1250 (see chart 6), which appears to have been a line in the sand for the Swiss National Bank (SNB).

At the same time, the broader deterioration in global data is likely to make the SNB shift towards more dovishness in order to push back against a potential tightening of financial conditions.

Overall, we maintain our forecast of 1.15 for the end of this quarter because we believe that signs of euro-area recovery by then will be marginally supportive of the euro and will allow EURCHF to break above the upper end of the 1.1250-1.1450 band.

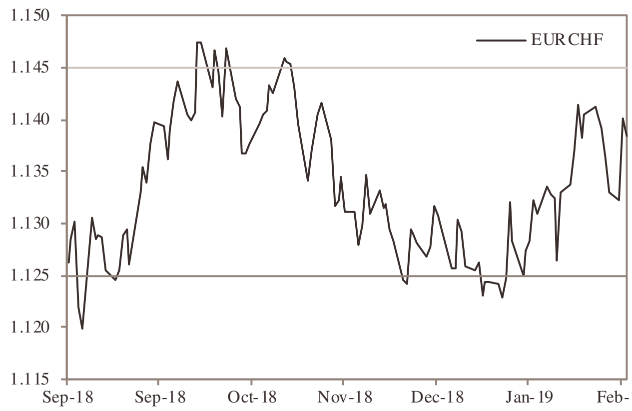
Italian political and economic developments will certainly not have been sorted out by quarter-end (especially as the rise in the League party's popularity is fuelling tensions in the coalition government, causing some to call for national elections). However, we believe that a potential normalisation in eurozone data (which we believe is in the cards) would alleviate broader market worries regarding the region and overshadow any Italy-specific issues.

5. Recent widening in IT-GE yield spreads put some pressure on EURCHF...



Sources: Bloomberg, Lombard Odier.

6. ...but the pair remains stuck in the 1.1250-1.1450 range



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

GBP
Remain on the sidelines

- **Brexit angst continues to dominate sterling price action**
- **Most likely scenario remains an extension of the article 50 deadline and a soft Brexit: sterling-positive**
- **But the tail risk of a no-deal Brexit would result in a full blown sterling collapse**

GBPUSD has given back some of its January gains against the dollar, trading now below 1.29, while implied volatilities have started rising again, although they remain significantly below the November peak, suggesting that the market is somewhat complacent to the tail-risk of no-deal Brexit (see chart 7). Aside from the broad-based dollar strength in the past couple of weeks, sterling depreciation reflects the ongoing angst about Brexit developments, especially since the UK House of Commons rejected the "Cooper Amendment" that sought to mandate the parliament to extend the article 50 deadline, and voted in favour of replacing the Irish border backstop with "alternative arrangements".

As we have highlighted on a number of occasions in the last few months, it is extremely unlikely for the EU to concede the elimination of the Irish border backstop from the Withdrawal Agreement, and communication from European officials has confirmed that so far. This leaves the UK with no real progress in the Brexit negotiations, less than two months before the article 50 deadline.

To add to the pain, domestic sentiment and activity are deteriorating, dragged down by the ongoing uncertainty. The UK PMIs for January fell across the board, house prices are softening, while Q4 18 GDP growth came in below expectations at 0.2% QoQ (vs. 0.3% expected). More worryingly, the report showed a quarterly slump of 0.5% in private investment (see chart 8), which ended the year down by 1.4% – the largest annual decline since 2009.

Separately, the Bank of England (BoE) kept monetary policy unchanged – as expected – in its February meeting and downgraded growth forecasts from 1.7% to 1.2% for 2019. However, the central bank kept its (conditional) tightening bias, which took the market somewhat by surprise (with only limited and temporary impact on sterling). Market pricing suggests investors expect around one hike in three years, whereas BoE communication implies a faster tightening cycle conditional on a soft Brexit deal.

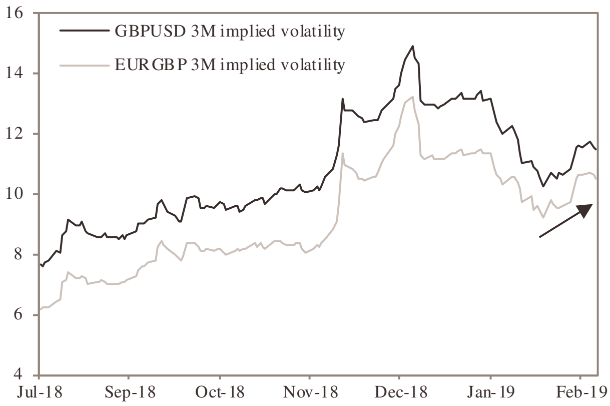
In the near term, we think rate hike expectations (and economic data) will matter little for sterling. All that matters is Brexit developments. Our central scenario remains an extension of the article 50 deadline, and in the end a form of soft Brexit. But in the meantime, we expect GBP to continue trading in a narrow range, close to the 1.30 level.

Assuming that a no-deal Brexit is indeed averted, we would anticipate GBPUSD to start rising towards our 1.38 estimate of short-term fair value (see chart 9). We maintain our year-end forecast of 1.37 for GBPUSD but our EURGBP year-end target has been lowered to 0.88 (from 0.91) due to our euro forecast revisions. A cliff-edge scenario would likely see GBP collapsing across the board, with GBPUSD gravitating towards 1.15 or below.

Given the asymmetrical pay-off of the alternative scenarios, we prefer to stay on the sidelines for now.

7. Sterling implied volatility on the rise again but still low compared to November 2018...sign of market complacency?

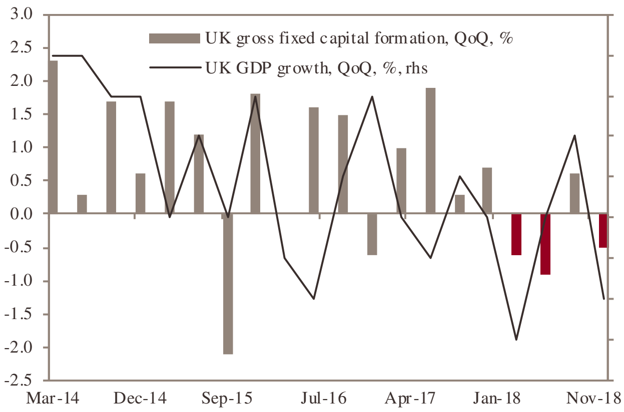
In %



Sources: Bloomberg, BBC, Lombard Odier.

8. Business investment collapsed in 2018

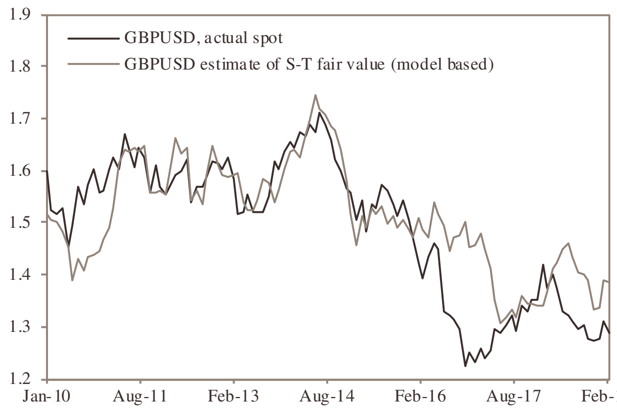
Not annualised rates



Sources: Bloomberg, Lombard Odier.

9. Estimates of S-T GBPUSD fair value

Model utilises real yield differentials and oil prices



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

JPY
Headwinds in the near term

- **USDJPY likely to trade with a small upside bias in the near term...**
- **... but medium term, yen undervaluation and re-emergence of dollar downside should send USDJPY lower**

In our previous FX monthly, we argued that yen appreciation between December and early January was too intense, and that the currency was likely to take a breather for a short time. Very recently, and following the Fed's dovish pivot, we suggested that the period of USDJPY consolidation (around 109-110) had ended, and we expected downside to re-emerge.

With the benefit of hindsight, our call proved wrong as the dollar rose and USDJPY gravitated above 110.50. Since the Fed meeting in late January, USDJPY has risen by more than 1% (see chart 10).

The move is clearly linked to the broad-based dollar rebound in February, so we think that near-term USDJPY moves will be dictated by the general dollar direction. As we argued in the USD section, the moves in the last couple of weeks show some evidence of the carry trade becoming prominent again, something that does not bode well for the yen. Potential progress on US-China trade discussions may prove supportive of risk appetite and weigh on the currency as well.

Near term, then, USDJPY is likely to trade with a modest upside bias, although a significant and sustained move higher over the next few weeks seems unlikely. When USDJPY hit 114 in early October, risk sentiment was notably better, with equities having enjoyed six consecutive months of solid gains (see chart 11). The environment is different now, as growth risks have increased and the cycle is even more mature. Although progress on US-China talks may support risk assets and improve global sentiment, they are unlikely to lead to similar equity market performance.

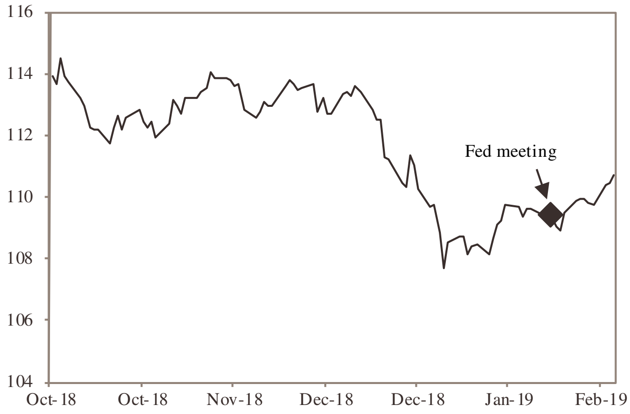
Medium term, we stick to our forecast trajectory and see USDJPY lower by the end of the year (104 by end-2019) because of a persistent and material yen undervaluation and the broader dollar downside that we expect.

Another point worth noting is that the dollar rally has resulted in USDJPY decoupling from US10Y yields (the picture is the same if one utilises spreads over Japanese yields – see chart 12). This may be sustained for some time as USD momentum remains (and the carry trade plays out), but it is likely that the gap will eventually close. Back in August, the gap closed because US yields moved higher, effectively catching up with the appreciating USD. Now, however, the dovish Fed is capping any substantial US yield upside.

In our portfolios, we remain underweight USDJPY from a medium term perspective, a position that expresses the fundamental view of yen undervaluation, but also serves as a hedge to our risk exposure.

10. USDJPY continues to correct following its rapid decline

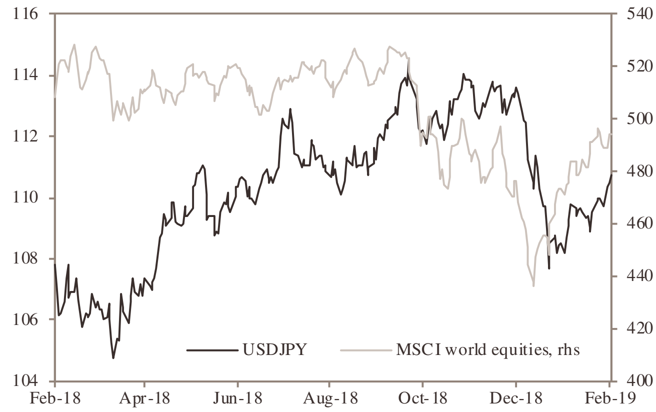
Spot price



Sources: CFTC, Bloomberg, Lombard Odier.

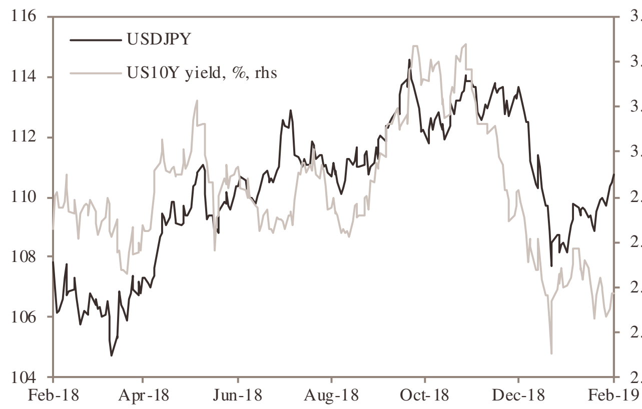
11. Equity upside is putting upward pressure on USDJPY for now... but a repeat of 2018 seems unlikely

MSCI world equities in local currency



Sources: Bloomberg, CFTC, Lombard Odier.

12. USDJPY seems to be running ahead of US 10Y yields



Sources: Bloomberg, Lombard Odier.

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CNY
All eyes on trade negotiations

- **US-China trade negotiations continue to be the dominant near-term driver of the yuan. Our base case remains for a cease-fire**
- **We maintain our medium-term constructive view on the yuan and expect China's outlook to stabilise**

Our key argument for the yuan remains unchanged: China targets the stability of its currency, not domestic macro variables. As long as the Chinese leadership prioritises the stability of the yuan over domestic counter-cyclical needs, the currency will be somewhat insensitive to the ebb and flow of domestic economic data that have sharply weakened since the second half of 2018. We have also often stressed that the country's strategic considerations, such as the Belt and Road initiative, raise the hurdle for the active use of currency depreciation as an economic stabilisation tool.

For these reasons, since the last devaluation scare (see chart 13), the People's Bank of China has resolutely kept the value of the yuan versus the CFETS basket of trading partners' currencies above 92. Many market participants seem to agree that this implicit guidance will be the essential pillar for the yuan.

Still, the speed of China's growth slowdown in the past few months warrants some caution. Reliable indicators, such as purchasing manager surveys and growth in manufacturing imports (excluding processing and assembly), fell sharply in the final months of last year, raising the risk that the timing of the country's cyclical trough may be pushed further (see chart 14). As credit growth languished at its decade low in December, the usual 6-to-9 month lag between credit and GDP growth points to the trough in Q2 or Q3 at the earliest. We view this development as the outcome of unique but reversible shocks from the government's aggressive crackdown on interbank lending and trade disputes with the US. A far more protracted slowdown, however, will trigger much stronger policy intervention by Beijing, potentially putting the yuan's stability in the crosshairs.

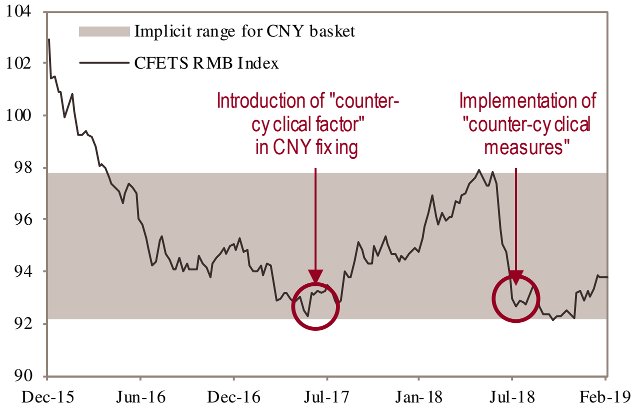
This delicate balancing act would certainly be easier if the US-China trade negotiations produce a meaningful, even if not permanent, cease-fire. A consequence of the yuan's sudden 10% depreciation versus the US dollar in the midst of successive tariff impositions was that Chinese firms were able to maintain their US market share better than their US counterparts in China. The scale of depreciation gave China a buffer to absorb the impact of the US tariffs, while cuts in export-related fees and taxes also helped. However, if all China's goods exports to the US were subject to punitive tariffs in March, Beijing's temptation to use additional currency weakness would grow.

Our base case scenario is for both sides to achieve a cease-fire by "trading" China's limited concessions on tech transfers and soybean purchases with US delays in tariff implementation. A game-changing compromise on Chinese telecommunication technology and state-owned enterprises is unlikely, but at this stage, we do not believe that is what markets realistically expect.

On the technical front, there is a review on whether to include Chinese onshore stocks and bonds in their respective global indices (MSCI, FTSE, and Bloomberg-Barclays). If the combination of a trade deal, USD softness and stimulus measures from March's National People's Congress significantly brightens investors' outlook, this would create the potential for further large inflows into the country (see chart 15).

13. CFETS renminbi index remains above its implicit lower bound

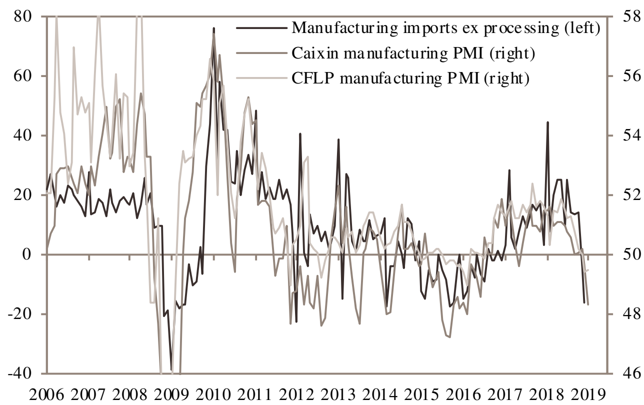
CNY vs. CFETS basket of 24 key currencies, 31 Dec 2014 = 100



Sources: Bloomberg, Lombard Odier.

14. Domestic slowdown remains worrisome

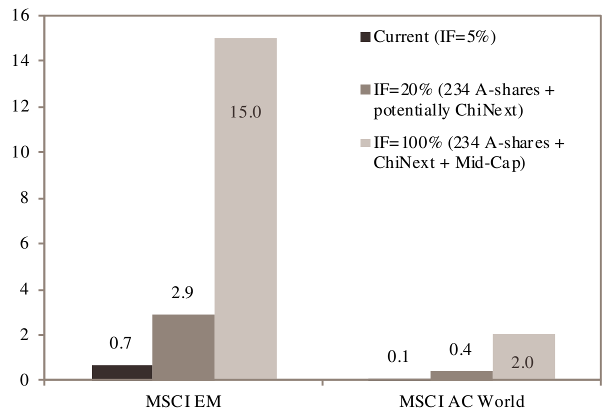
China's manufacturing import ex processing % Y/Y (left), Manufacturing PMIs (right)



Sources: Bloomberg, Lombard Odier.

15. Index inclusion could be powerful boosts if trade risk fades

A-shares' weight in MSCI indices depending on "inclusion factor (IF)" levels



Sources: CEIC, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

Nordic currencies
Still room for upside

- **We revise higher our EURNOK and EURSEK forecast paths for this year**
- **We now see EURNOK still converging to 9.10 by year-end but at a slower pace in H1 19...**
- **... and EURSEK ending 2019 at 10.00 (9.75 previously)**

The NOK has weakened noticeably so far in February against both the USD and the EUR. Part of the move could be attributed to a correction following the steep 3.7% decline in EURNOK between late December and January-end (2% decline for USDNOK over the same period) – but other factors have been at play as well.

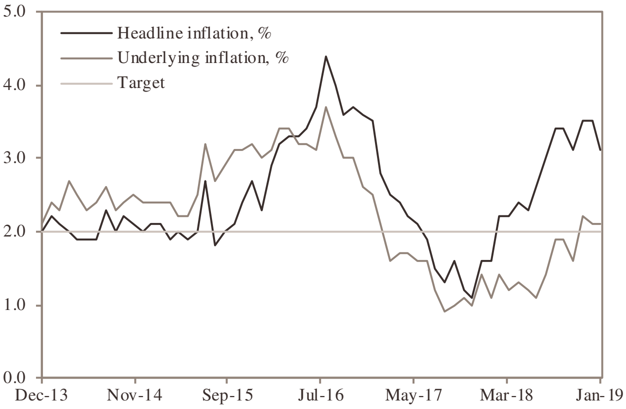
Monetary policy tightening has been modestly repriced lower in tandem with the general repricing towards looser monetary policies for major central banks worldwide. Oil prices lost momentum in February, raising doubts about further future gains. Finally, the recent miss in Norwegian CPI for January has the market reassessing the probabilities of a March hike by the Norges Bank.

The global slowdown is likely to leave some marks on the Norwegian economy (which, however, is holding up quite well so far), and that is the main trigger for revising our EURNOK forecasts lower in H1 19. However, the recovery we expect should support the krone. Importantly, we do not think that the latest round of CPI numbers will derail the Norges Bank from hiking in March. Inflation is still above target and monetary policy remains very accommodative on the face of a near-zero output gap (see charts 16 and 17). On balance, we expect NOK appreciation, but at a slower pace in H1 19 than previously.

Turning to the SEK, our forecast revisions have been more substantial. We now see EURSEK ending the year around 10.00 instead of 9.75 previously, i.e. we now foresee a krone appreciation that is half of what we expected a couple of months ago. The rationale of our forecast changes is based on the significant deterioration in domestic data over the last month. It appears that the economic slowdown in Germany has weighed significantly on consumer and business sentiment, with confidence surveys free-falling: the economic tendency survey (which measures overall business and consumer confidence) has registered its lowest point since September 2016, while consumer confidence has plummeted to levels not seen since 2013 (see chart 16). Hard data such as retail sales and the unemployment rate corroborates this negative message. All this adds uncertainty to the monetary policy outlook, which we feel is likely to be reflected in the price of the currency.

However, we still see room for modest appreciation. This is because inflation is still running just above the central bank's target, while the output gap remains in positive territory. Therefore, we see it as more likely than not that the Riksbank will be forced to hike once this year (something confirmed in its monetary policy meeting this week), in contrast to consensus expectations that see a 50% chance of a 25bp hike over the next year. Stabilisation and a rebound in German economic activity (Germany is Sweden's top export destination, accounting for 11.5% of all Swedish exports) should also help in that respect.

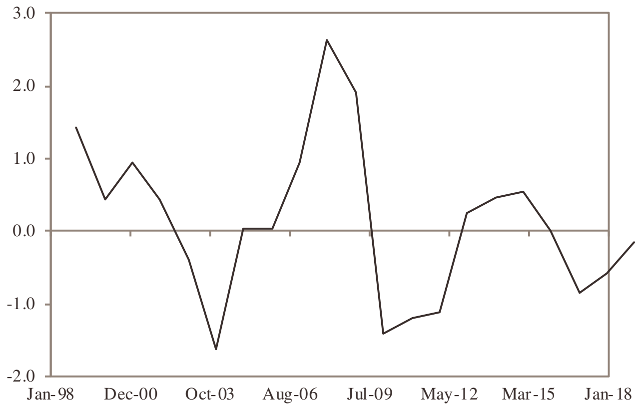
16. Although Norwegian inflation has moderated it is still running above the Norges Bank's target of 2%....



Sources: Bloomberg, Lombard Odier.

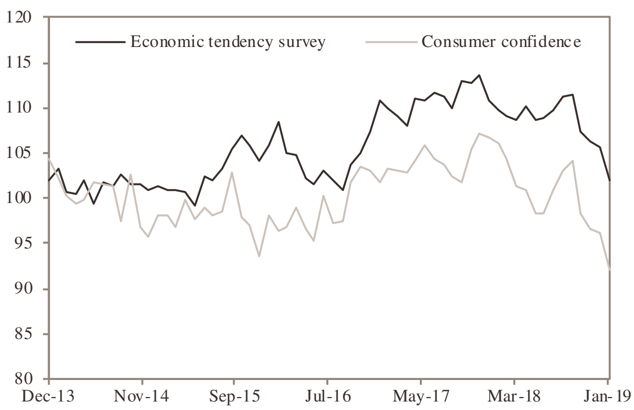
17. ...while the output gap is virtually zero

Percent deviation from potential output



Sources: Bloomberg, IMF, Lombard Odier.

18. Swedish sentiment in a free fall



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

Commodity FX
Remain constructive despite the sell-off

- **Commodity FX has felt the wrath of dollar upside this month…**
- **… but monetary policy expectations in Australia and Canada are too pessimistic in our view, and subject to a repricing higher**

The Australian dollar has come under immense pressure so far in February, losing more than 2.5% against the dollar and 1.4% in trade-weighted terms. Two things have weighed on AUD. First, the broad-based USD appreciation, and second, the dovish shift by the Reserve Bank of Australia (RBA), which abandoned its previous policy-tightening bias, leaving the chances of a rate cut or hike more evenly balanced. The Chinese slowdown is certainly a source of great concern for Australia and has likely been the main trigger for this shift in policy communication – despite the multi-year low in the unemployment rate at 5%.

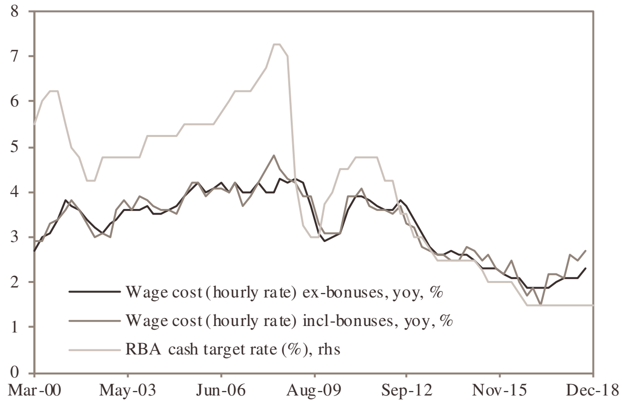
However, we think that the market reaction – i.e. of nearly pricing in a full 25-bps hike over the next year at this point – is overdone. A likely ceasefire on trade between the US and China should improve the Chinese growth outlook and limit any negative impact on Australia. Furthermore, wage growth has shown signs of picking up (latest data as of Q3 18 – see chart 19). Therefore, the release of the Q4 18 wage index on 20 February will be very important. Any continuation of the recent pattern could lead the market to reassess its dovish expectations and support the AUD. We maintain our forecasts unchanged and see AUDUSD at 0.75 by the end of the year.

In Canada, the CAD has not been spared by the dollar upswing, but it has outperformed other G10 FX. On a YTD basis, it is the best-performing G10 currency against the dollar, having appreciated by 2.7% (see chart 20). This is most likely because it is the highest G10-yielding currency after the dollar, and it has also enjoyed the rally in oil prices so far this year.

We still expect USDCAD downside over the course of 2019, albeit at a less rapid pace than before during H1 19. This is again because the global slowdown has been more pronounced than we expected, and it should affect an open economy such as Canada. But the market pricing in only a 30% probability of a 25-bps hike this year seems too low to us. The labour market is solid, and ongoing labour shortages are bound to start materialising into higher wages, especially in the energy-related sector given the normalisation of oil prices higher this year. Moreover, the official statement by the Bank of Canada reaffirms its intention of bringing interest rates to neutral territory (which the bank judges to be between 2.5% and 3.5%; current rate is 1.75%).

Finally, in New Zealand, data has remained unexciting, with inflation consistently undershooting the 2% level (the mid-point of the RBNZ's target band). In its latest monetary policy meeting this week, the RBNZ surprised markets by maintaining its view that the next move in interest rates could be up or down (investors were expecting a dovish bias). However, realistically we think New Zealand is the only country in the core commodity FX bloc were monetary policy expectations (pricing of a cut) seem aligned with fundamentals i.e. subdued inflation and depressed business investment.

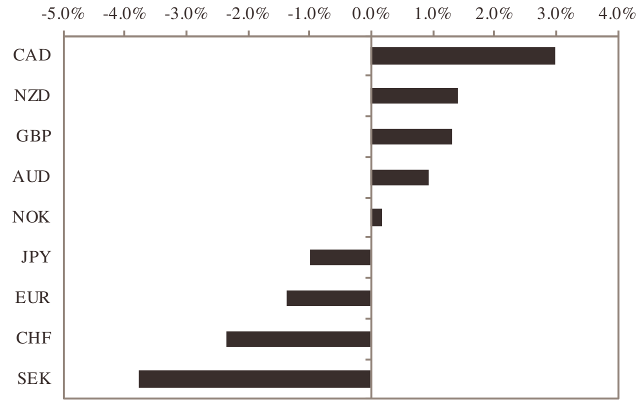
19. Wage growth is picking up (albeit slowly) in Australia



Sources: Bloomberg, Lombard Odier.

20. CAD the best performing G10 currency YTD against the USD

Spot returns



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

Glossary

1W
1-week

BEER
Behavioural Equilibrium Exchange Rate – one method for evaluating the fair value of a currency.

BIS
Bank for International Settlements

C/A
Current account

CFETS
China Foreign Exchange Trade System.

CFTC
Commodity Futures Trading Commission

EM
Emerging market(s)

FEER
Fundamental-equilibrium exchange rate – rate consistent with a steady economy at full employment and a sustainable current-account balance.

RT
Real time

TW
Trade-weighted (dollar, etc.)

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