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FX Monthly

The first signs of dollar weakness

01/12

January 2019

There are increasing signs that the US dollar is gradually coming under pressure. Since mid-December, the Bloomberg trade-weighted (TW) USD index has fallen 2.2% with broad losses against G10 and emerging market currencies.

We believe this new theme of dollar weakness will stay with us for most of 2019. We expect that the market will price out its "unrealistic excitement" over the US fiscal stimulus and refocus on the US's twin deficit problem and mounting dysfunctionalities in Washington. Eventually, US-Rest of World (RoW) yield differentials should narrow to levels consistent with relative economic developments.

We remain bullish on the euro. So far, EURUSD's modest upside is all about USD weakness and lacks idiosyncratic factors. The deceleration in regional growth has likely spooked investors but we anticipate a growth rebound that should provide a more convincing and sustained impetus to the currency.

Following recent Brexit developments, the environment is turning constructive for GBP (in line with our medium term view) but an extension of the Article 50 deadline is now likely. While this should be fundamentally positive for the currency, it implies a longer period of negotiations and uncertainty during which we cannot rule out tail risks. We keep our bullish end-2019 view for GBP but have trimmed our 1Q 19 and 2Q 19 forecasts to 1.32 and 1.35 to reflect this prolonged uncertainty and volatility.

While we maintain our bearish stance on USDJPY, the very rapid depreciation since December suggests a near-term consolidation as the currency pair stepped into oversold territory.

Turning to Switzerland, we continue to expect a modest and gradual depreciation of the franc, as the SNB retains a firm dovish stance and the expected rebound in euro area activity should act as a catalyst for Swiss investors to slowly direct flows to the region. On the Nordic front, we reiterate our constructive view because we believe monetary policy expectations are under-priced in both Norway and Sweden.

Moreover, we advocate a positive but selective positioning on the commodity FX bloc: we see upside in CAD (partly due to the rebound in oil prices, which we expect, will continue further) and AUD (where we see market expectations for a rate cut in 2019 as too exaggerated). NZD, however, is likely to lag.

Finally, in China, and following the recent rally in CNY, we have fine-tuned our renminbi forecasts: we see the outlook for the CNY neutral in the near-term, but trade dispute resolution could lead to its substantial strength.

FX Committee targets

	Q1 19	Q4 19
EURUSD	1.18	1.24
GBPUSD	1.32	1.37
EURGBP	0.89	0.91
EURCHF	1.15	1.17
EURSEK	9.90	9.75
EURNOK	9.20	9.10
USDCHF	0.97	0.94
USDJPY	109	104
USDCAD	1.27	1.23
AUDUSD	0.72	0.75
NZDUSD	0.66	0.67
USDCNY	6.80	6.65

At a glance

Special focus:
EURUSD's modest upside reflects dollar weakness but currently lacks idiosyncratic factors

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Data as of 17 January 2019

FX Forecasts

	Current spot	1Q 19	2Q 19	3Q 19	4Q 19	Estimates of long term fair value[1]
EURUSD	1.14	1.18	1.20	1.22	1.24	1.17
GBPUSD	1.29	1.32	1.35	1.37	1.37	1.39
EURGBP	0.89	0.89	0.89	0.89	0.91	0.84
EURCHF	1.13	1.15	1.16	1.17	1.17	1.09
USDCHF	0.99	0.97	0.97	0.96	0.94	0.93
USDJPY	108.80	109	108	106	104	98
EURJPY	124.08	129	130	129	129	115
EURSEK	10.28	9.90	9.85	9.80	9.75	9.29
USDSEK	9.02	8.39	8.21	8.03	7.86	7.94
EURNOK	9.76	9.20	9.15	9.15	9.10	8.99
USDNOK	8.56	7.80	7.63	7.50	7.34	7.68
USDCAD	1.33	1.27	1.25	1.24	1.23	1.24
AUDUSD	0.72	0.72	0.73	0.74	0.75	0.77
NZDUSD	0.67	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.

EUR
bulls need to be patient

Forecasts: Q2 19: 1.20 - Q4 19: 1.24

- **EURUSD has seen some modest upside since mid-December...**
- **...mirroring the USD's weakness. The EMU growth deceleration however, is proving to be a headwind....**
- **...but we expect this will reverse over the next few months providing more convincing and sustained impetus to the euro**

EURUSD has developed a modest upside potential since December. Since 14 December (when the USD started rolling over) it has appreciated around 0.8% against the USD (although it is down by 0.5% on a YtD basis).

We think a large part of the EUR's limited appreciation has been due to dollar weakness (which is down 2.2% on a trade-weighted basis over the same period). Due to a dovish shift by the Fed in late December and early January, US yields have retraced considerably lower – US 10Y yields have undone around 70% of their increase over the last twelve months – resulting in a meaningful narrowing of the US-Rest of World (RoW) yield spread. We have been expecting this move for a few months now and believe it has further to run. As chart 1 shows, the differential between German and US yields has moved in favour of the EUR, undoubtedly contributing to EURUSD's upside.

Improvement in sentiment over Italy's political developments also helped. Italian lawmakers have recently approved the revised 2019 budget, ending months of standoff with the European Commission. As a result, the Italian to Bund 10Y yield spread has compressed considerably towards 260 basis points, a significant narrowing from the highs of 326 bps hit in late November (see chart 2).

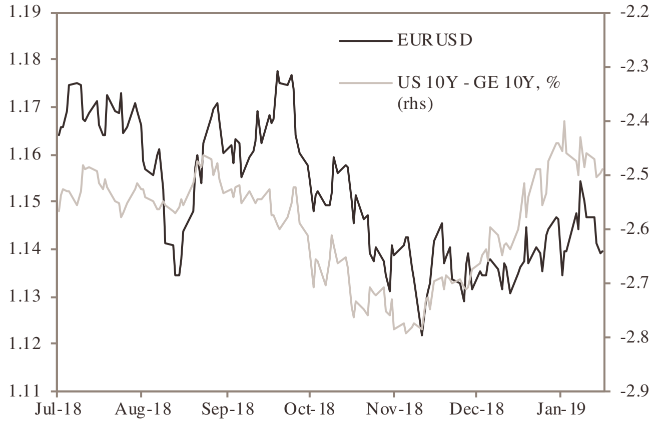
That said EURUSD has lagged against the US dollar in this rally (and it marginally down on a YtD basis). We believe that the main reason holding investors back from bidding the euro higher has been the marked deceleration in regional economic activity. The euro area PMI composite index hit its lowest level (51.1) since July 2013 after four successive monthly declines. At the same time, data released in mid-January revealed that the region's industrial production contracted 3.3% on an annual basis in November. These are certainly worrying developments but it is worth putting them into perspective.

Aside from some one-off factors (new emissions testing regime in the auto industry, protests in France) the weakness in eurozone numbers has come exclusively from external factors. Internally, consumption and investment remain robust, the labour market is getting tighter and wage growth has started accelerating recently. The external factors that have weighed on the common currency include China's slowdown (exports to China have remained almost unchanged) and massive drops in exports towards Turkey and the UK. Absent a no-deal Brexit (not our central scenario), these sizeable negative contributions are likely to prove more temporary than long lasting. In China, economic data have been particularly soft recently but we still believe that authorities will manage to engineer a soft landing through fiscal and monetary policy measures.

If we are right in expecting a rebound in euro area activity, then we believe that the next move higher in EURUSD will be more convincing and sustained. Outflows from the region are slowing and the end of the ECB's Quantitative Easing, combined with improving growth prospects, should act as a catalyst for flows into the eurozone.

1. EURUSD and GE 10Y – US 10Y yield differential

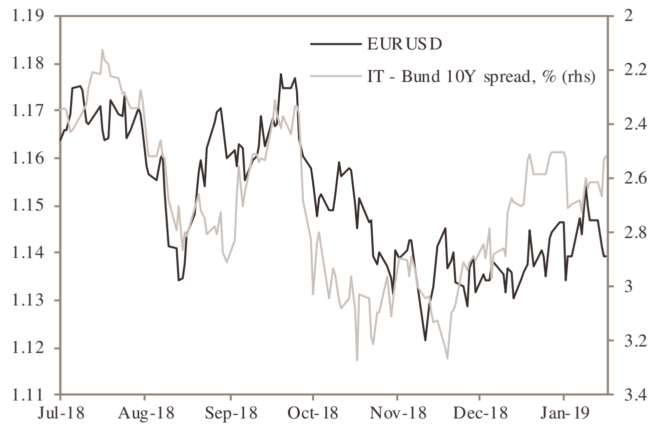
Yield differential in percentage points



Sources: Bloomberg, Lombard Odier.

2. Italy – Germany 10Y yield spread off its highs

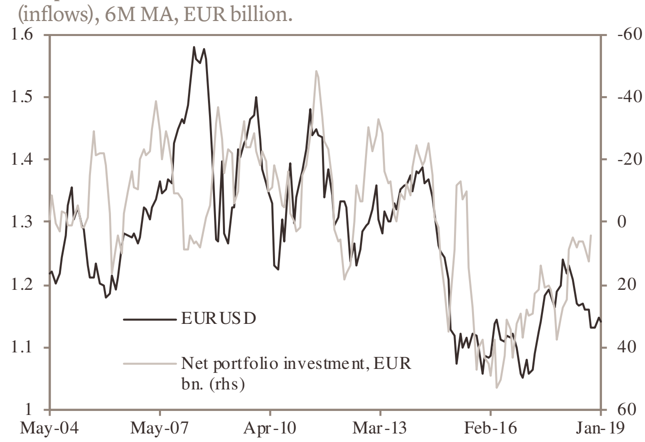
Italy – Germany spread in percentage points



Sources: Bloomberg, Lombard Odier.

3. Portfolio flows to the euro area are reversing

Net portfolio investment is defined as Assets (outflows) – Liabilities (inflows), 6M MA, EUR billion.



Sources: Bloomberg, Lombard Odier.

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

CHF
It's all about the lack of flows

- **CHF has remained resilient and EURCHF has traded within narrow ranges...**
- **...despite sizeable fluctuations in risk appetite**
- **We believe the main reason has been the reluctance of Swiss investors to purchase (or sell) foreign assets over the last couple of quarters**
- **We expect this will change gradually as eurozone activity picks up again and outward flows from Switzerland slowly revive**

For now, it is all about flows...or their lack. The Swiss franc has remained resilient (see chart 4) despite some improvement in euro area's political risk (Italian yields have fallen and spreads versus Bunds have compressed significantly).

In all likelihood, this is mainly due to domestic investors' reluctance to acquire assets abroad (which most of them typically go to the eurozone). Foreign asset purchases/sales have stalled in the last couple of quarters (see chart 5), suggesting that domestic investors are in a "wait-and-see" mode. The lack of any outward flows has deprived the EURCHF from any meaningful upside.

December's deterioration in risk appetite also played a role in keeping the franc resilient but we note that correlations between EURCHF (or the trade-weighted CHF) and risk assets have been neither robust nor consistent over the last three years. Looking at the very recent history, two things worth highlighting underscore this point.

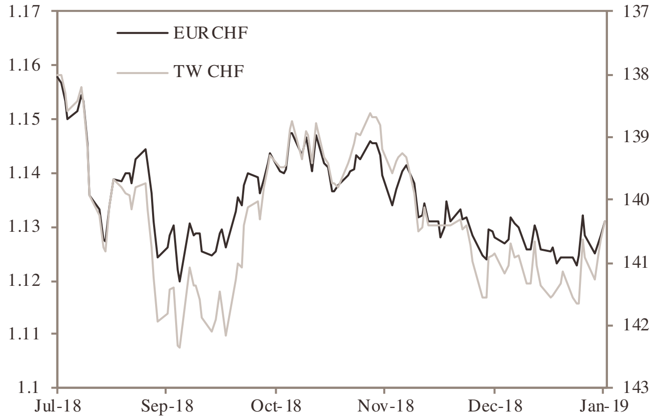
First, when equities went into a tailspin during December with major stock indices dropping more than 10%, JPYCHF soared nearly 2%, suggesting that investors overwhelmingly favoured the yen as a haven asset over the Swiss franc. Chart 5 shows that the currency pair traded roughly in line with the MSCI World equity index, showing that the CHF offered little-to-no protection against sudden risk aversion.

Second, risk appetite has started the year on a strong footing with most major equity indices registering gains of between 2% to 3%. However, the EURCHF has barely moved so far (+0.3% YtD).

On the data front, Swiss inflation has continued to moderate in the last couple of months, but should normalise somewhat, although it is likely to remain substantially below target. The parallel deceleration in Swiss GDP growth closer to its long-term potential (after the boost from sporting events in 2018), should keep the SNB firmly dovish at its next meeting on 21 March. It should provide a "floor" to the EURCHF of around 1.1200 – 1.1250, which has proven to be a strong support zone.

In the medium term, we still expect some gradual EURCHF appreciation (our target for 2019-end is 1.17) which is predicated on continued dovishness by the SNB and a gradual pickup of Swiss portfolio flows towards the euro area as regional economic activity rebounds. The end of the ECB's QE should also help, as it will allow investors who were crowded out from the EMU bond market since 2015 to return. However, the prerequisite for this remains a rebound in the euro area's economic growth.

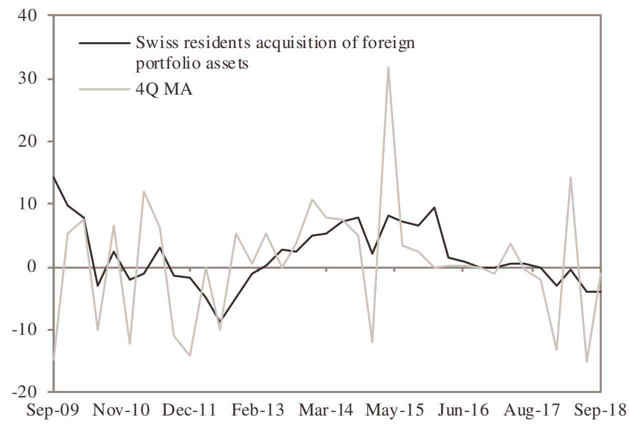
4. The resilient Swiss franc



Sources: Bloomberg, Lombard Odier.

5. Swiss residents' acquisition of foreign portfolio assets

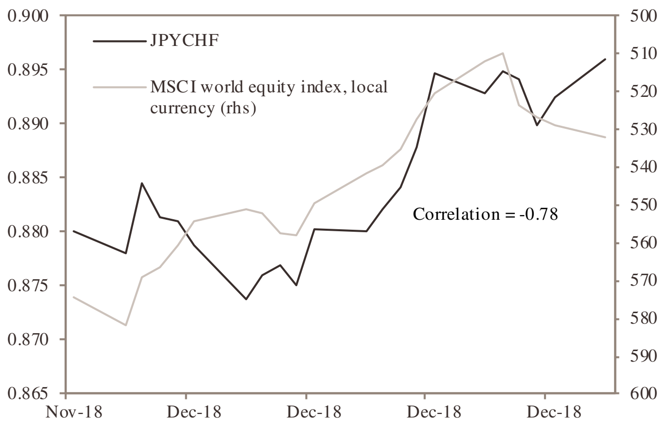
EUR billion



Sources: Bloomberg, Lombard Odier.

6. JPYCHF and World equity performance

World equity performance based on MSCI World equity index in local currency



Sources: Bloomberg, Lombard Odier.

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

GBP
A Q&A on Brexit developments and GBP implications

What was the outcome of the UK parliament vote on the Withdrawal Agreement (WA)? The WA between the UK and the EU, which was endorsed by the two sides in late November 2018, was finally brought for a vote to the UK parliament on 15 January. It was rejected, as expected, by a surprisingly wide margin of 230 Members of Parliament – 202 in favor and 432 against. It was the biggest defeat inflicted on any government in modern history, which prompted Labour party leader Jeremy Corbyn to call for a vote of no confidence in the government.

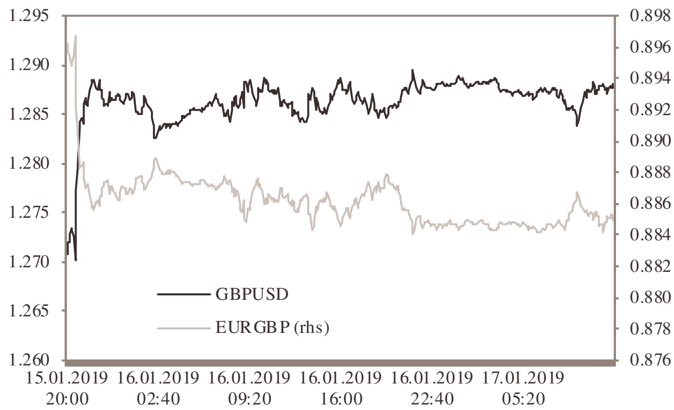
Vote of no confidence in the government: The motion took place on 16 January and it was rejected as the Democratic Union Party (DUP) – which has supported the Conservative minority government since the general elections of 2017 – stood by the May administration.

How did sterling react to these developments and why? Despite the rejection of the WA, GBP has rallied since Tuesday evening (see chart 7), rising towards 1.29 and EURGBP dropped below 0.89. We think two developments have contributed to market optimism. First, the defeat of the no confidence motion has substantially reduced the probability of a general election and its associated uncertainty (e.g. the - low - probability of a Corbyn-led government, which would be perceived as business-unfriendly). Second, and most importantly, Prime Minister May's determination to continue with the negotiations gave the market a positive signal: in particular, her statement to seek cross-party discussions on how to proceed with potential adjustments to the WA opens the way for a broader support to a "modified deal", offsetting the dissent of hard Brexiteers.

How will things move forward? An extension of the Article 50 deadline (currently 29 March) is highly likely as time is very limited. PM May will consult with party leaders in order to draft a set of proposals for changes to the WA to be communicated to the EU (Jeremy Corbyn has refused to participate in the discussions so far, unless PM May "removes the prospect of a no-deal Brexit", which certainly complicates the situation further). Currently, it looks unlikely that the EU will agree to grant the UK the right for a unilateral exit from the Irish border backstop. Offering to strengthen the political declaration to reach a trade deal with the UK during the transition period is highly probable. Whether more meaningful changes to the WA would be accepted by the EU remains to be seen (and this is very hard to achieve). In our view, the aim now is to agree a set of modifications to increase the chances that in a subsequent round of voting the modified WA gets broader parliamentary support.

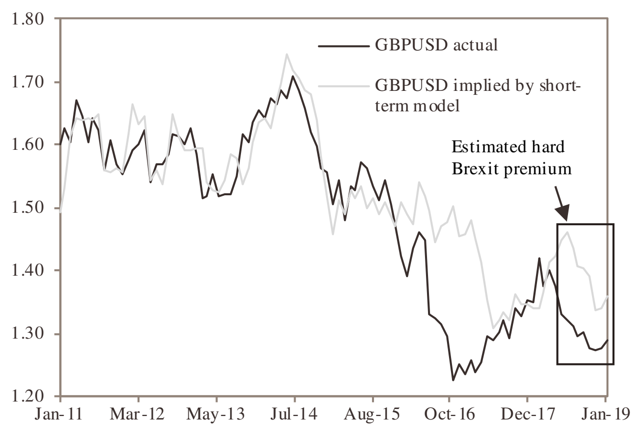
What does this mean for sterling? No doubt the situation remains highly complex and fluid. But May's decision not to resign – after such a resounding defeat – and her determination to proceed with the negotiations offered some comfort to the markets. It has been interpreted as further reducing the probability of a disorderly Brexit and increasing the likelihood that – after intense debate and some changes to the WA – there will eventually be a UK parliamentary compromise leading to a soft Brexit. In line with this assessment we reiterate our view that **the medium-term outlook for GBP is bullish:** we expect a gradual pricing-out of the hard Brexit premium (see chart 8) as well as some repricing higher on the BoE rate trajectory (subject to a soft Brexit). However, near-term the currency will remain subject to political headline risk and vulnerable to sell-offs each time it rallies – we expect gyrations between 1.26 and 1.30. The likely extension of the Article 50 deadline is fundamentally positive for sterling but it does suggest that we will go through a longer-than-initially-expected period of negotiations and uncertainty. Hence, we have cut our 1Q19 forecast for GBPUSD to 1.32 from 1.35, and our 2Q19 forecast to 1.35 from 1.37. Our year-end target remains unchanged at 1.37 under our central scenario of an eventual soft Brexit deal.

7. **Sterling rallies after the WA rejection**
Spot prices, data in five-minute intervals



Sources: Bloomberg, Lombard Odier.

8. **GBPUSD trading at a discount due to the hard Brexit premium**
Short model based on 2Y real yield differential and the oil price



Sources: Bloomberg, Lombard Odier.

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

JPY
Taking a breather...but more upside in the pipeline

- **We recently turned cautious on USDJPY in anticipation of a short period of consolidation around current levels**
- **Medium term we still expect further JPY strength and maintain our year-end target at 104 for USDJPY**

During the last quarter of 2018, we spelled out our bearish outlook for the dollar and suggested that one a straightforward way to express this view was via short USDJPY. Our reasoning was based on

1. The yen's substantial undervaluation (nearly 15% at the time, by our estimates),
2. Increasing signs of volatility in risk appetite,
3. Stretched short yen positioning by the speculative community,
4. Expectations of some hawkish shifts in BoJ communication later in 2019, and
5. Spill over effects from a weaker dollar over the course of the year.

Since the beginning of October 2018, USDJPY has fallen by 4.5% and the trade-weighted (TW) JPY has appreciated by more than 5%.

In all likelihood, most of the reasons cited above played a role in the move, though December's rise in risk aversion was quite decisive (in contrast, there are virtually no signs so far of the BoJ switching to a less dovish stance).

In our recent **Investment Strategy Bulletin ("Why is the yen roaring ahead, and is its rise sustainable?)**, we analysed the JPY move in more detail and importantly, highlighted that we adopted a cautious stance for the near term, expecting some USDJPY consolidation (or even a modest rebound towards 110). We identified two reasons.

First, the move from 113 to 108 was very fast, sending USDJPY into oversold territory (see chart 9). Similar extreme falls in the past have led to some near-term consolidation, and even modest rebounds.

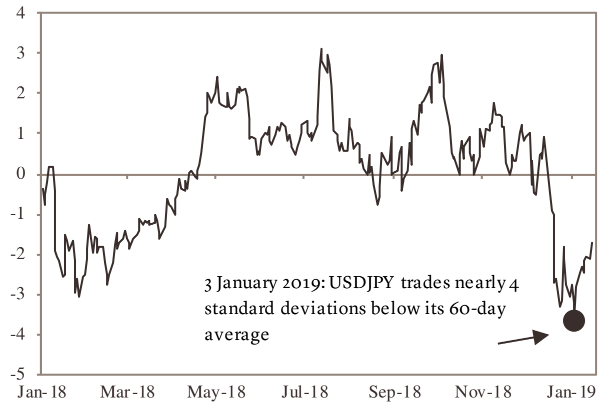
Second, risk appetite has improved recently following constructive trade talks between the US and China, with China taking policy action to cushion the slowdown and the Fed crystallising its stance in early January, allowing for patience and flexibility in adjusting monetary policy. This offered a soothing message to markets, worried US rates may rise to levels that could derail the economy.

Since then, USDJPY has weakened somewhat and the TW JPY index has fallen about 1% from recent highs. We think this "range-trading" is likely to continue in the short term, but medium term we believe USDJPY downside will resume.

Yen undervaluation remains in place (admittedly less so than before), short JPY positioning is still wide (see chart 10) and the maturity of the US business cycle suggests that it would be too soon to declare the end of volatility in risk sentiment. Above all, USD weakness – the Bloomberg dollar index started rolling over in mid-December (see chart 11) - will be with us for some time. Washington is struggling with mounting dysfunctionalities, the US fiscal boost to growth will fade exposing the economy's vulnerability to the rising twin deficit, and the odds of the Fed nearing the end of its tightening cycle have sharply increased. We still target USDJPY at 104 by the end of the year.

9. Big moves took USDJPY into oversold territory

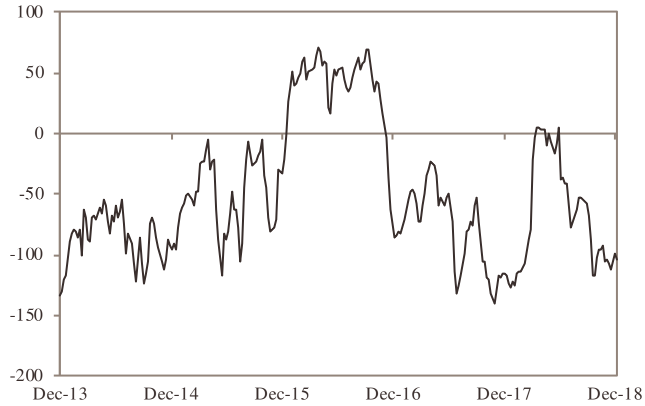
60-day z-Score: measures the number of standard deviations that the latest price is away from the 60-day average



Sources: CFTC, Bloomberg, Lombard Odier.

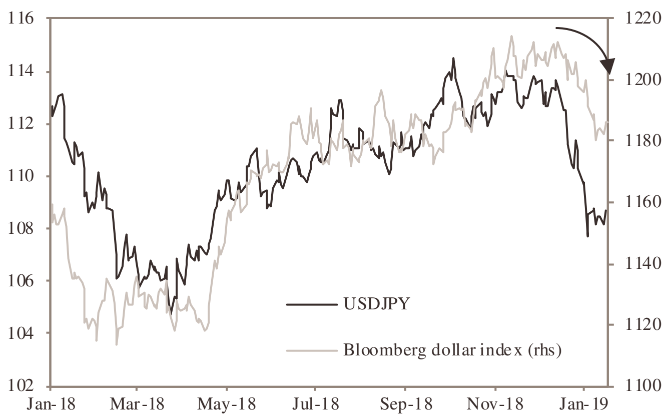
10. JPY speculative shorts still quite stretched

JPY speculative positioning on futures and options against the USD, thousands of contracts



Sources: Bloomberg, CFTC, Lombard Odier.

11. The beginning of the USD's downfall?



Sources: Bloomberg, Lombard Odier.

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

CNY
Neutral in the near-term, but medium-term constructive

- **The recent rally in the renminbi is mostly driven by the relative weakness of the US dollar, and optimism on trade discussions**
- **The outlook for the currency remains neutral in the near-term, but a trade dispute solution could lead to substantial strength**
- **USDCNY targets: 6.80 (Q1 19), 6.65 (Q4 19).**

China's implicit yuan target value (against a basket of currencies) is a more important indicator than any adjustments to domestic liquidity or interest rates. This is because the impact of such adjustments can easily be reversed by later efforts to prevent the currency's weakness or strength. The currency target also makes domestic macroeconomic variables relatively unimportant to policy decisions because the primary focus is not inflation targeting. In short, the activities of the People's Bank of China should not be seen through the same prism as the US Federal Reserve, or the European Central Bank.

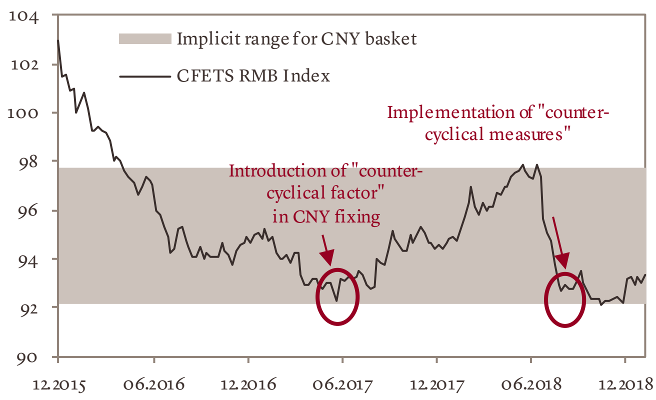
As we have said many times, China remains very serious about keeping the value of the yuan vs. its official basket (CFETS benchmark) stable in a range, even spending foreign exchange reserves to defend the currency's implicit lower bound vs. the basket. Indeed, the CFETS renminbi index (versus 24 currencies of major trading partners) hovers stubbornly above the minimum level seen since the introduction of the new currency framework in 2015 (see Chart 12). This implied tightness in monetary policy explains why, in spite of successive liquidity injections, macroprudential easing, and speculation about interest rate cuts, domestic money market rates have traded in a stable range between the standing lending facility rate and the PBOC's reverse repo rate (see Chart 13).

Fortunately, the flipside of this situation for China is that when the US dollar is weaker and the external pressures on the yuan lower, constraints from the currency targeting become less binding. In other words, the impact of various stimulus measures may be significantly enhanced. This is precisely the dynamic we have witnessed this year. A whiff of optimism about US-China trade negotiations (for which China's currency stance hangs in balance) and market-wide re-assessment of the US Fed's policy plan, were all that was needed to bring the yuan 1.6% higher against the US dollar this year. We note that, in terms of value vs. the CNY basket, the yuan did not move much since the end of last year.

Our base case is for an eventual compromise or cease-fire in the US-China trade disputes and the stabilisation of China's credit impulse and growth in coming quarters. We acknowledge, however, that predictions on the trade negotiations remain difficult and that the timing of China's stabilisation is more complex than we anticipated amid the slowdown in the second half of last year. Various domestic indicators suggest that the downward pressures on the Chinese economy remain substantial (see Chart 14). We suspect that, if trade negotiations do not go well, Beijing has compelling reasons to consider a fully-fledged stimulus programme entailing much weaker currency. Therefore, we are more cautious about chasing the currency's recent appreciation and we assume that the likely trajectory of the CFETS renminbi index will be 92~93 for the remainder of the year. This leads us to our cautious near-term and more constructive medium-term targets (in line with our bearish USD view). We will of course re-assess if there is more clarity on the US-China trade negotiations before March.

12. CFETS renminbi index remains above its implicit lower bound

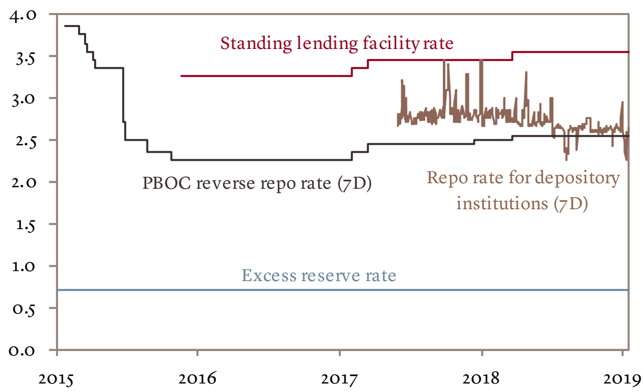
CNY vs. CFETS basket of 24 key currencies, 31 Dec 2014 = 100



Sources: Bloomberg, Lombard Odier .

13. Currency targeting is mirrored in money markets

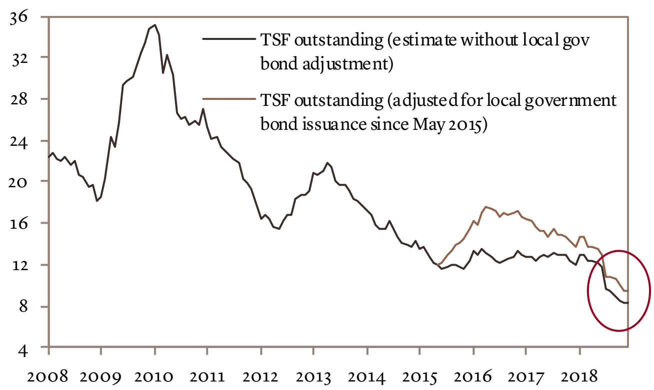
China's interest rate corridor and implicit target rate, %



Sources: Bloomberg, Lombard Odier.

14. Uncertainties remain on the timing of growth stabilization

China's credit proxy (all systems financing aggregate), % Y/Y



Sources: CEIC, Lombard Odier.

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

Nordic currencies
Upside potential remains in place

- **We keep our bullish view on the NOK and SEK against both the EUR and the USD...**
- **...as we believe data suggest that monetary policy expectations are under-priced in both economies**
- **The NOK should also benefit from a resumption in oil prices**

We maintain a positive view on the NOK. Economic activity continues to be solid – despite a temporary slowdown in 3Q18 – with strong growth in employment and the labour force, the erosion of spare capacity and capacity utilisation is close to normal levels. Headline inflation continues to surprise on the upside (see chart 15), suggesting that monetary policy normalisation will continue.

Interestingly, in its December rate decision (when the Norges Bank kept the rate at 0.75%) the central bank said that lower oil prices and weaker global prospects "imply a slightly lower rate rise [path] than in the September report". However, the recent rally in oil prices (especially if it continues) and a more constructive environment in global trade suggest that both of these risks are now less binding than before.

Consequently, the market has started repricing higher monetary policy expectations and EURNOK has fallen 2.1% since 28 December 2018. Investors now assign a 88% chance of a single 25 bp hike this year.

We think that – absent a major global shock – a hike in March is a near certainty (the Norges bank is likely to leave rates unchanged in its 24 January meeting). The odds are then in favour of an additional hike before the end of this year. As a result, we feel there is room for a further repricing higher in rates that should support the NOK. Additionally, the sharp rise in oil prices (13% YTD) is providing an additional direct tailwind (see chart 16). We believe that this year there is ample room for the NOK to gain against the USD and the EUR, and we maintain our target for EURNOK at 9.10 and for USDNOK at 7.34 by the end of 2019.

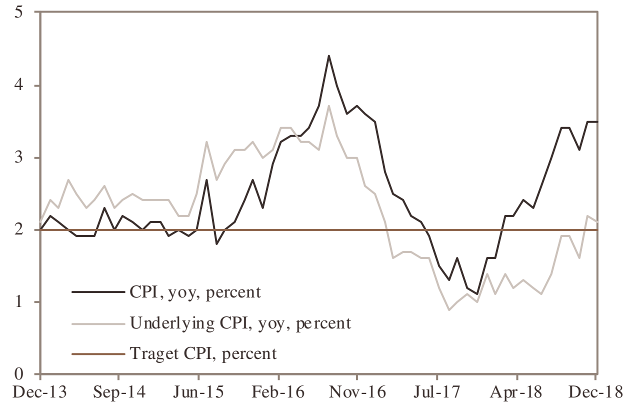
The next important data releases will be: 1. GDP for 4Q18 on 8 February (this will likely be affected by the collapse in oil prices during the period) and 2. January's CPI reading on 11 February. The latter continues to be slightly higher than the central bank's forecasts. Any continuation of this CPI trend increases the chances that monetary policy will be repriced higher more quickly.

Turning to Sweden, we hold a similar view on the SEK. EURSEK has been on a slowly depreciating path since September when the Riksbank hinted at the start of its policy normalisation. This kicked-off on 20 December when the central bank hiked its policy rate to -0.25% from -0.5%. The central bank also mentioned that the next rate rise is likely to occur during the second half of 2019, "as inflation and inflation expectations have become established at around 2%" amid strong economic activity.

The market is not very convinced, pricing in only a 60% probability of a 25 bp hike over the next twelve months. In general, the market has become too pessimistic on growth prospects globally and has repriced lower monetary policy expectations across the board. We believe that the global economy is going through a slowdown – rather than the much deeper contraction that December's price moves may lead you to think – and we expect to see tighter Riksbank policy this year, which should underpin (see chart 17) the undervalued SEK. We see EURSEK at 9.75 and USDSEK at 7.86 by the end of 2019.

15. Accelerating inflation in Norway

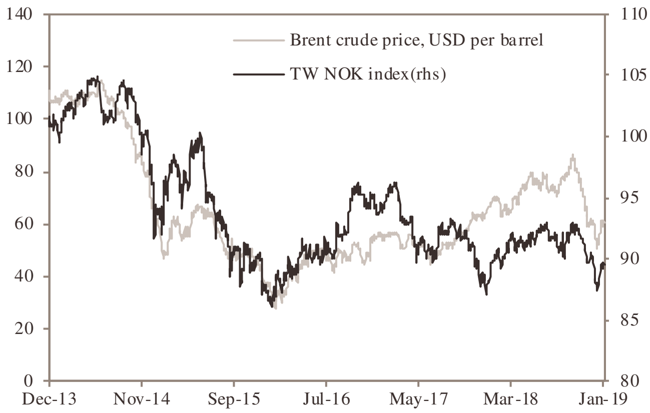
Underlying CPI is adjusted for tax changes and excludes energy



Sources: Bloomberg, Lombard Odier .

16. Higher oil prices should help lift the NOK higher

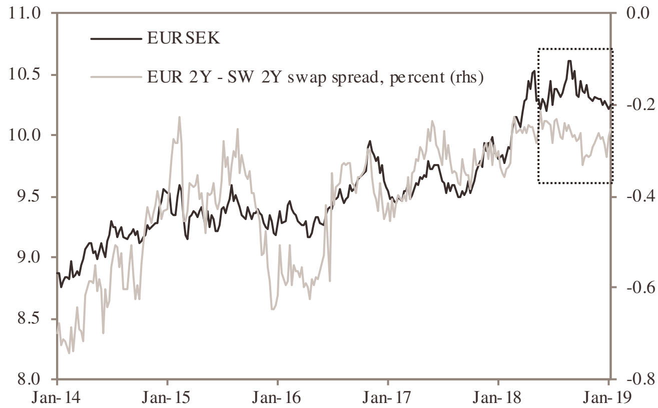
Historical correlation 0.8



Sources: Bloomberg, Lombard Odier.

17. Current rate differentials point to EURSEK downside...

...and further repricing higher of Swedish rates should add more pressure



Sources: Bloomberg, Lombard Odier.

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

Commodity FX
Constructive but selective

- **The core commodity FX bloc is rebounding in 2019**
- **Improvements in trade talks, a weaker dollar and higher oil prices have been the main catalyst**
- **We expect most of these to remain in place for the foreseeable future**

The late-2018 sell-off in commodity currencies appears to be reversing. CAD has gained 2.7% against the USD, AUDUSD is up 1.7% while NZD has lagged, gaining a marginal 0.3% on a YtD basis (see chart 18).

The catalysts have been: 1. a broad-based USD weakness, 2. optimism on trade talks between the US and China and hence expectations for improvement in global trade, 3. the oil price surge.

As mentioned above, USD weakness is likely to stay with us for some time so that dynamic in itself should allow further gains for the commodity FX bloc, although to varying degrees.

On trade developments, as discussed already, there have been some improvements but nothing is yet settled. Eventually we think there will be a compromise that leads to a de-escalation, but clearly, the risk of trade conflicts is worth monitoring, especially for commodity-related currencies.

Finally, on oil we maintain our forecast of USD 75 per barrel by the end of the year because we think supply cuts will bite further. Excessive fears about the global economy and aggregate demand were, in part, responsible for the recent oil price collapse.

In summary, we are constructive on the commodity FX bloc. In particular, we expect CAD outperformance because the pricing of monetary policy tightening (11 bps over the next year) appears extremely benign to us, while a further rise in the oil price should provide an additional boost (see chart 19).

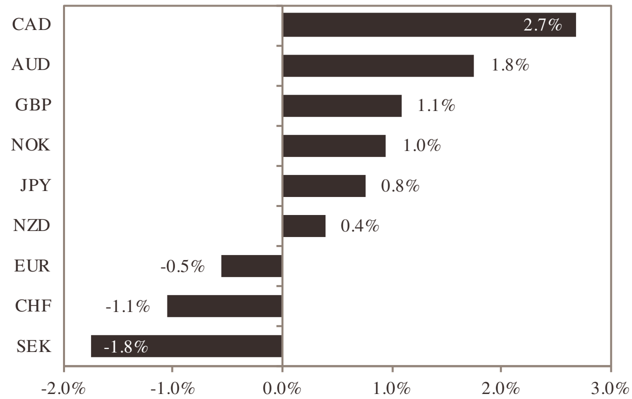
We also think the market is excessively bearish on Australia, pricing in nearly a 50% chance of a cut by the Royal Bank of Australia over the next twelve months. Increasing policy action by the Chinese authorities means that a controlled and soft landing in the Chinese economy is more likely, significantly limiting the impact on Australian exports. In addition, domestic unemployment is at its lowest point in six years while the economy is expected to grow above trend.

This is likely to push wage growth up further (we have seen a modest uptick recently – see chart 20) which, we believe, suggests that the bar for cutting interest rates is too high. Admittedly, the odds of rate increases are now lower than we thought a few months ago as inflation has remained low, but this implies that rates are more likely to remain unchanged than cut.

Finally, we are less upbeat on the outlook for the NZD as inflation remains vulnerable to the downside given ongoing weakness in business investment. This has increased the odds of the RBNZ easing policy further down the road.

18. Commodity FX is outperforming this year

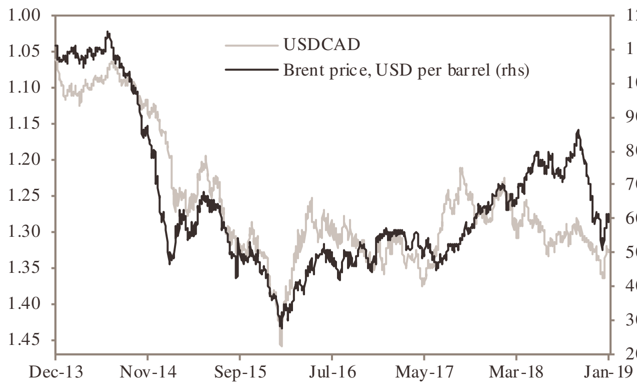
Spot return against the USD



Sources: Bloomberg, Lombard Odier .

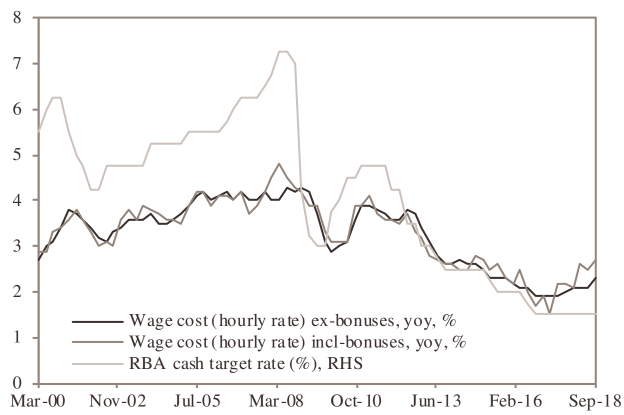
19. USDCAD should already be trading lower based on oil prices...

....and further upside in the latter should add more pressure on the currency



Sources: Bloomberg, Lombard Odier.

20. Wage growth in Australia is showing signs of a pickup



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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