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LOMBARD ODIER
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Investment Strategy
Private Clients

3/4

July 2019 · 3rd quarter

Key highlights

- Given still depressed global trade, growth in most major economies is likely to slow during the coming months – prompting easier monetary policies (although their impact may prove limited).
- We expect the Fed to proceed with a first round of two rate cuts, given subdued inflation, the fading impact of Trump tax policy and uncertainty regarding a trade agreement.
- In Europe, the ECB will also seek to provide stimulus in response to persistent risks and falling inflation expectations, although we are sceptical about its effectiveness.
- The celebratory tone of the imperial succession appears to have bolstered Japanese domestic consumption – somewhat offsetting external pressures on the industrial sector.
- Emerging economies' dependence to Chinese growth is high and US dollar appreciation would also be harmful, making escalation of the trade dispute the key risk.
- During the past quarter, we took an additional defensive step in our asset allocation, reducing equities (in May) and upping our exposure to safe havens (gold and government bonds).
- In Forex, we confirm our long yen position and will be looking for opportunities to gain overweight exposure to emerging currencies – in this context of persistently low yields.
- **Also featured:** Gold is reaching a 6-year high – what next?

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Quarterly publication of
Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 1 July 2019

A pickup in the global business cycle is postponed

The global economy remains in a trade-induced slowdown, with signs of recovery still elusive. Manufacturing and trade-related sectors are suffering, with the most acute damage observed in foreign companies based in China. Other Asian and emerging economies, especially those integrated in Chinese supply chains, are also feeling the pain.

For now, notwithstanding this diagnosis of significant recession in Asian trade flows (see chart 1, page 04), we continue to judge the global slowdown as mild, with consumption and the (increasingly important) services sector proving resilient across the main economic blocs. Indeed, tight employment markets are supporting a still moderate uptrend in household real income, putting the global consumer in a relatively comfortable position.

That said, the trade dispute remains the key macroeconomic risk. The length and severity of the global slowdown are crucially dependent on a hypothetical deal between the US and China. After further escalation of tensions in May, when US President Trump pushed up already implemented tariffs and threatened to extend them to a further USD 325 billion of Chinese products, the late June G20 meeting in Osaka provided a welcome opportunity for both parties to calm the situation.

But while commitments were made to keep negotiations alive, and any new US tariffs thankfully postponed, no framework to remove existing tariffs was communicated, nor a clear timetable set out for the signing of an agreement. A short-term resolution of the conflict is thus not to be expected, meaning that trade flows and supply-side dynamics in the main open economies will remain depressed. The longer existing tariffs stay in place, the greater the negative consequences in terms of slower growth, disrupted supply chains and heightened uncertainty, which is already starting to weigh on consumer and business confidence. In these conditions, it is difficult to argue for a pick-up in capex programs during the coming months.

We have thus downgraded our global growth forecasts for 2019. Our base case was for the main economies to gradually fall back to their potential growth rate in 2020. We now expect this slowdown to trend growth to take place already this year (see chart 2, page 04). At the same time, however, odds of an outright global recession have decreased thanks to the avoidance of any new tariffs.

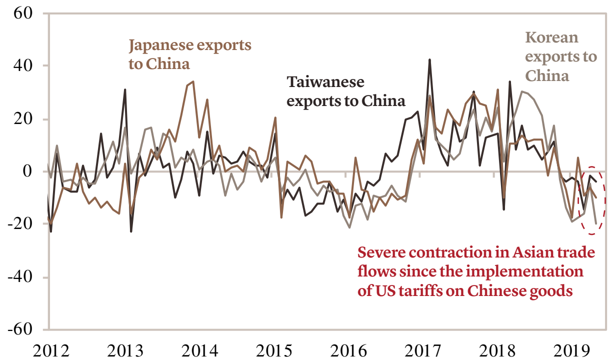
Slower growth in turn argues for continued central bank compression of the cost of capital – even though its direct impact on fluctuations in world trade and output is limited. The US Federal Reserve (Fed) now considers the economic damage sufficient to warrant an accommodative stance, effectively putting an end to its tightening cycle. The European Central Bank (ECB) has meanwhile eliminated any prospects of a rate hike before mid-2020 and is implementing additional accommodation in the form of new long-term loans.

In China, there is still some time before significant economic concerns become warranted. Stimulus measures are being deployed, with the People's Bank of China having also signalled its willingness to do all that is needed to boost growth. Admittedly, however, recent supportive policy action has been more modest than during prior

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

1. Asian exports to China

In % yoy*

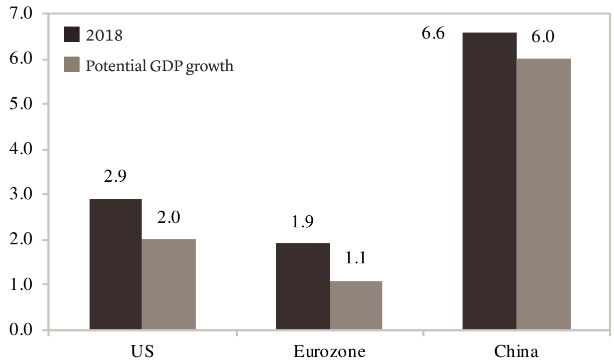


* year on year

Sources: Datastream, Lombard Odier calculations

2. Growth slowing down to potential in 2019

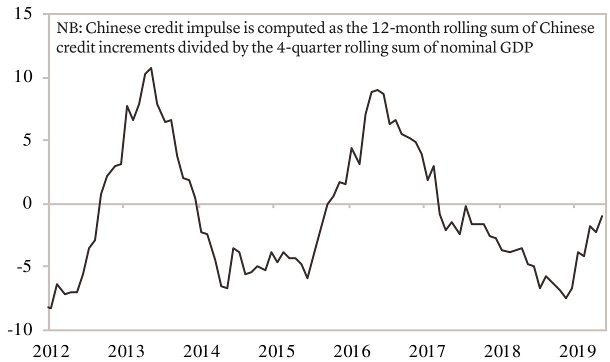
Annual GDP growth, in %



Sources: Bloomberg, Lombard Odier calculations

3. Chinese credit impulse

12-month change, in %



Source: Bloomberg

slowdowns (see chart 3) and evidence of the lesser effectiveness of credit creation is mounting.

The three main central banks' dovish stance is spreading to the rest of world, with their Indian, Russian, Philippine, Malaysian, New Zealand and Australian counterparts also adopting easier monetary policies.

All told, even though central banks do have tools to mitigate some of the uncertainty, a prolonged trade war would seriously undermine a recovery in the business cycle. A balanced exposure to risk, keeping adequate downside protections (gold and Japanese yen) in place, is still warranted.

Samy Chaar, Chief Economist

United States

Fed back to easing mode

In a nutshell

- The G20 summit brought a welcome truce in the US-China trade dispute, but existing tariffs remain in place and no timeline for an agreement was provided.
- The Fed is thus likely to go ahead with monetary easing, probably cutting rates twice during the 2nd half.
- Still, US growth can be expected to fall back towards its long-run potential, with the impact of Trump tax cuts now fading and no near-term resolution of the trade conflict in sight.

The stance recently adopted by the Fed seems to have less to do with current economic growth than with its extension into the future. Which also happens to be the only way to ensure that inflation exceeds 2% when the next recession does hit.

Although guidance towards easier policy was provided (see chart 4), the US central bank stopped short of cutting rates already in June – likely awaiting confirmation that economic data is falling sustainably short of its projections. On the inflation front, the question is whether the current weakness is only transitory or of a more structural nature, with the Fed apparently increasingly leaning towards the latter view. As for employment, while the market remains tight, the latest jobs report was clearly less buoyant.

Of course, the Fed is also at the mercy of external factors. The G20 summit promised a binary outcome: either Presidents Trump and Xi stroke a truce, avoiding an escalation of the US-China trade war, or tensions intensified further. It is not surprising that the Fed was reluctant to take rate action ahead of this crucial event.

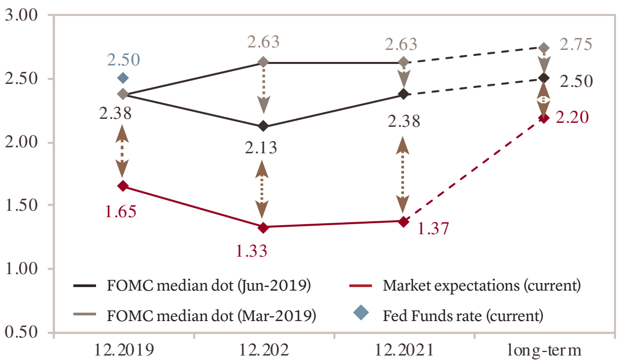
As it were, the outcome of the G20 summit was of the reassuring nature, albeit not to the extent of removing existing tariffs or providing a clear timetable as when a trade deal will be finalised. As such, the Fed is likely to go ahead with monetary easing, probably cutting rates twice during the 2nd half of this year. The market is vying for a move already in July and the Fed has little reason to go against that.

Still, US growth can be expected to fall back towards its long-run potential. The Trump tax cuts boosted profits and confidence, but did not deliver in terms of capex programs (see chart 5), the housing and auto sectors, or trade. Worse, the public deficit has swelled, and corporations are saddled with debt. Counter-cyclical monetary policy will extend the credit cycle, hence limiting downside risk, but, this late in the expansion, and with fiscal policy running out of steam, the key to the US economic outlook lies in how the just revived trade negotiations evolve during the coming weeks or months.

Samy Chaar, Chief Economist

4. Fed guidance vs market expectations: A large gap has opened

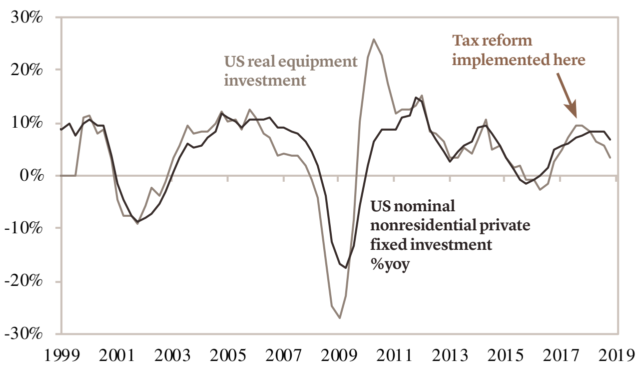
Markets now expecting 100 bp of cuts – which might be a little excessive



Source: Bloomberg

5. Transitory impact of tax cuts

If anything, capex has weakened since the change in fiscal policy stance



Sources: Datastream, Lombard Odier calculations

Europe
The normalisation that never comes

In a nutshell

- Domestic demand has not weakened markedly but persistent external risks, as well as stubbornly low inflation, seem sufficient for the ECB to take easing action.
- Deposit rate cuts may, however, do little to counter the ongoing slowdown – centred on the trade and manufacturing sectors.
- With monetary policy unable to do much, fiscal policy unlikely to be a big factor, and persisting trade uncertainty, the euro area outlook is likely to remain challenging.

Three months ago, we wondered whether externally-driven weakness would start to affect domestic demand in the euro area. No such clear deterioration has taken place thus far. But the lack of improvement, along with the persistence of risks and – critically – stubbornly low core inflation, seems sufficient for the ECB to take easing action.

So far, it has acted to ensure that no unwarranted tightening takes place, by extending its forward guidance on interest rates and unveiling a new series of long-term loans. It now looks very likely that it will announce further easing steps in its upcoming meetings, and that "normalisation" of interest rates be indefinitely postponed (see chart 6).

Is such action really called for? We are sceptical, on two fronts. First, we find the overall macro picture more mixed than alarming. Undoubtedly, growth has slowed and inflation remains way below target. But, looking at recent macro data, GDP grew at an annualised rate of 1.6% in the 1st quarter and unemployment fell to an 11-year low of 7.5% (down from a 2013 peak of 12.1% and only 0.2% above its all-time low). Contrasted with the ECB's own projections of 1.2% GDP growth and 7.7% unemployment for 2019, these numbers hardly call for urgent action.

In addition, measures such as further deposit rate cuts may do little to counter the ongoing weakness, which is most evident in trade and manufacturing. The traditional channel through which monetary policy works is a reduction in the cost of capital that eases borrowing conditions and stimulates demand. But the lending channel does not appear in need of fixing.

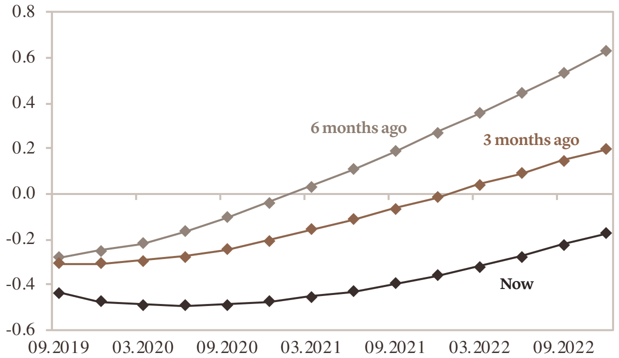
Lending to the private sector has been consistently above 3% this year (see chart 7). In fact, credit growth in core countries has been strong to the point that some national central banks have increased (and others are considering increasing) countercyclical buffers. It looks like the ECB may be trying to address the wrong problem.

At the same time, fiscal policy – which could be more effective in stimulating demand at this point – is only likely to make a marginal contribution, as the euro area countries with the most fiscal leeway are reluctant to use it. All told, as long as global trade tensions persist, the outlook for the euro area – an economy chronically reliant on external demand – is unlikely to brighten significantly. Normality remains elusive.

Bill Papadakis, Macro Strategist

6. The ECB has clearly indicated its intent to cut rates, leading markets to price out a normalisation...

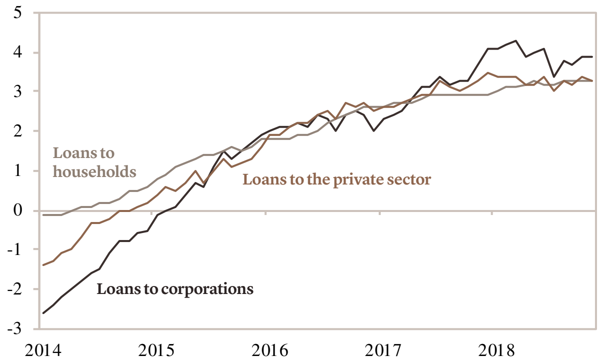
3-month Euribor rates, derived from futures prices (in %)



Sources: Bloomberg, Lombard Odier calculations

7. ... although solid credit growth points to a healthy lending channel

Adjusted loans to the private sector (annual growth, in %)



Source: ECB

Japan
Onward to larger projects

In a nutshell

- The celebratory tone of the imperial succession appears to have bolstered domestic consumption.
- External conditions are, however, taking their toll on the industrial sector, with businesses having had to cope with yet another period of escalation in the US-China trade dispute.
- The Abe cabinet will likely go ahead with the unpopular consumption tax hike – so as to ensure the fiscal flexibility required by longer-term political and economic goals.

The 2nd quarter marked the dawn of Reiwa era, with Emperor Naruhito ascending to the Chrysanthemum Throne after three decades of reign by his father, Akihito. The celebratory tone and orderliness of the imperial succession proceedings on 1 May stood in pleasant contrast to Akihito's own ascension 30 years ago, when the entire nation mourned the unexpected death of his father, Hirohito. The national celebration will also show up in economic data: Japanese private consumption appears to have bounced back in the 2nd quarter, possibly offsetting much of the weakness in investment and trade (see chart 8).

Industrial woes will, however, still limit headline GDP growth to 0%, with businesses having had to cope with yet another period of escalation in the US-China trade dispute. Indeed, key surveys leave little doubt that overseas conditions are starting to bite into capex and hiring, despite relatively resilient domestic demand.

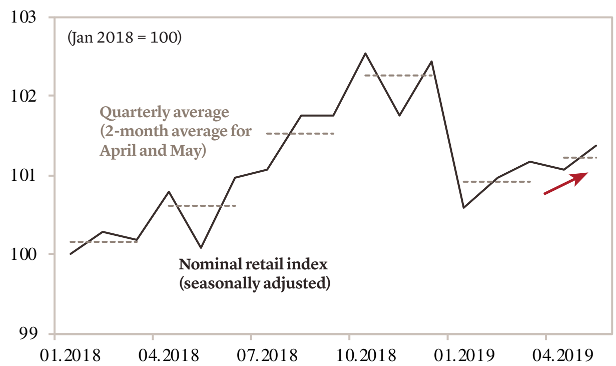
Given the ambient uncertainty and inflation still well below target, investors might wonder why the Abe cabinet is even bothering with the politically unpopular consumption tax hike. Yet, Abe has more or less ruled out the possibility of a double election (both chambers of the Diet) as a way to claim a popular mandate on any tax delay. Moreover, he recently stated that his cabinet will raise the tax "unless something on par with the global financial crisis (...) takes place".

Why such a stance? Now positioned to become Japan's longest serving prime minister, Abe's sights are likely on his legacy. Expanding defence capabilities against perceived threats from neighbouring powers, tackling the burden associated with demographic ageing, and nurturing strategically important industries all require a degree of fiscal flexibility that can only be secured via the final leg of the tax hike. To mitigate the short-term hit, the Abe cabinet has the legislative clout to consider another supplementary budget.

Meanwhile, the Bank of Japan, boxed in by widespread discomfort about negative rates and increasing logistical constraints in its asset purchases, will be content to play a supporting role – keeping rates low until the tax hike is implemented in October or Fed cuts force its hand (see chart 9). In the background, however, the "tiering" of reserves leaves the door open to deeper negative rates, should a crisis condition warrant further easing.

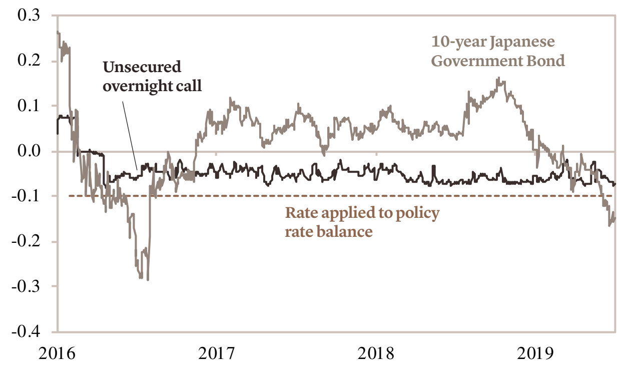
Homin Lee, Macro Strategist – Asia

8. Retail sales are bouncing back from Q1 weakness



Sources: CEIC, Lombard Odier calculations

9. The BoJ will ease after the VAT hike or in reaction to the Fed



Sources: Bloomberg, Lombard Odier calculations

Emerging Markets
Hoping for trade tensions to subside

In a nutshell

- The Fed's more dovish stance has removed pressure on emerging central banks to tighten their policy.
- 2019 elections have so far gone smoothly, allowing for policy continuity and supporting reform prospects.
- Watch out, however, for further escalation of the trade dispute: emerging economies' dependence to Chinese growth is high and US dollar appreciation would also be harmful.

At the onset of 2019, we identified three prominent risks for emerging markets: tighter financial conditions, a heavy political agenda and trade tensions. Six months into the year, the first two concerns have abated.

US rate hikes are out of the picture, with cuts now even looking possible, removing pressure on emerging central banks to tighten their own policies. India, Malaysia, the Philippines, Chile and Russia cut their benchmark rates during the 1st half, while others – such as Turkey, South Africa or Indonesia – were able to remain on hold rather than proceed with the expected tightening.

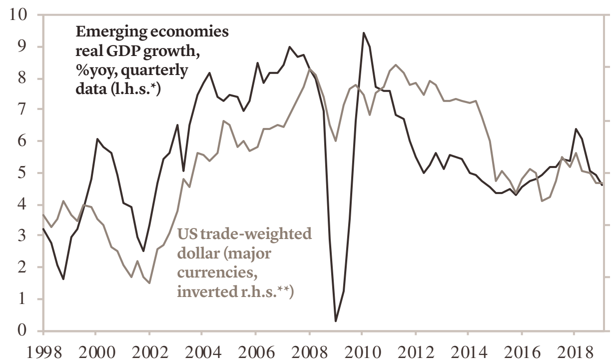
On the political front, Jokowi was re-elected in Indonesia, Modi in India and Ramaphosa in South Africa, allowing for policy continuity and supporting reforms prospects. The biggest remaining risk is October's presidential election in Argentina. Developments in Turkey also remain volatile, but the opposition's victory in the re-run of the Istanbul elections was welcomed by the markets. In any event, Turkey and Argentina were already under pressure last year, without proving systemic for the broader emerging universe.

The trade picture, however, has deteriorated and could harm emerging markets through two key channels. First, China is the main trading partner of Brazil, Russia, India, Peru, Chile and most of South East Asia, so ripple effects from a Chinese slowdown would be large. Second, a substantial appreciation of the US dollar – driven by safe-haven flows in a risk-off context – would lead to emerging market weakness, to a degree perhaps even greater than in 2018 (see chart 10). In turn, emerging central banks may again be forced to tighten policy to support their currencies, at a time of slowing growth.

Thus far, though, emerging market fundamentals have not been severely affected. The fact that their economic cycle is young helps, as do improved solvency credentials, with only three major countries posting a current account deficit in excess of 3.5% (Argentina, Colombia and South Africa). We expect emerging markets to remain relatively resilient but, until trade tensions really subside, risks remain skewed to the downside (see chart 11).

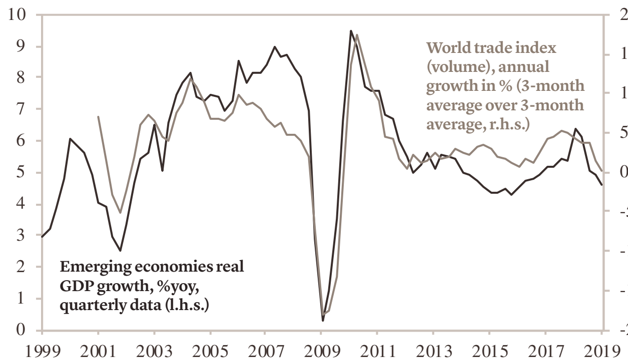
Stéphanie de Torquat, Macro Strategist

10. Emerging markets growth weakens when the USD rises
22-year correlation: -0.5



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

11. Emerging markets are highly exposed to global trade
18-year correlation: 0.8



Sources: Bloomberg, Datastream, Lombard Odier calculations

Asset Allocation
Collecting carry cautiously

In a nutshell

- Risk assets took a breather during the last quarter, after a very strong start to the year.
- The picture as of early July is thus one of a weaker US dollar, lower government bond yields, strong gold appreciation and positive global equity momentum.
- During the past quarter, we took an additional defensive step in our asset allocation, reducing equities (in May) and upping our exposure to safe havens (gold and government bonds).
- A repeat of the recent large decline in government bonds yields seems unlikely, with the shift in central bank stance essentially reflected in bond prices.
- Absent any additional support from lower bond yields, equity prices offer limited upside going forward, and will primarily be driven by earnings dynamics. In the credit space, spreads will most likely remain range-bound, with returns provided by the carry element.
- We continue to see the rationale for holding gold as a hedge in a multi-asset portfolio.

Risk assets took a breather during the last quarter, after a very strong start to the year. Global equities and commodities posted flat to negative returns for the April to June period, while global credit remained in positive territory – helped by the large decline in government bond yields (see chart 12). Indeed, the 10-year US Treasury fell below 2% for the first time since September 2016 while its German counterpart hit an all-time low at a negative 36 basis points.

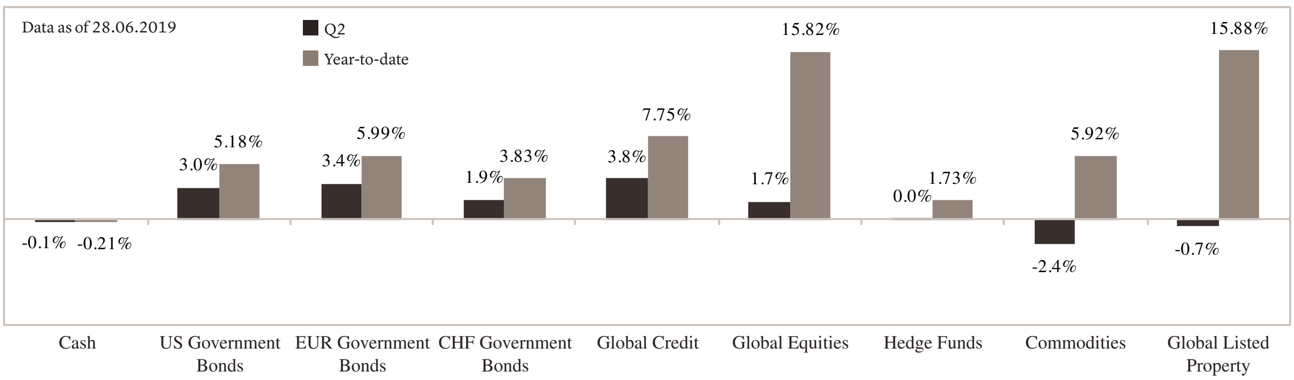
The strong first-quarter performance momentum had carried over into April, but a combination of investor fatigue and re-escalating US-China trade tensions then pushed equities down and credit spreads up in May (with gold prices also moving up at a later stage). June saw central banks take on a more dovish tone, led by the Fed and the ECB, which enabled an improvement in the risk environment towards the end of the quarter. US equities were even able to reach new highs.

The picture as of early July is thus one of a weaker US dollar, lower government bond yields, strong gold appreciation and positive global equity momentum. Of note also is the fact that the divergence between interest rates and equities (see chart 13, page 10) has become even larger – driven in our view by easier monetary policy, which puts downward pressure on yields while supporting equity market valuations.

As this quarter unfolds, we expect a continuation of the most recent macro trends: supportive central banks offsetting trade uncertainty to some extent, against a background of slowing growth and low inflation. Volatility is currently subdued, but we would not be surprised to see it rear its ugly head during the slow summer months. An important event for us will the forthcoming earnings season. We still anticipate mid-single digit earnings growth in 2019, close to the long-term average, but will clearly be watching out for any signs that trade uncertainty is hurting corporate capex and growth plans.

As regards financial markets performance, a repeat of the recent strong decline in government bonds yields seems

12. Global asset class performances
In total returns



Source: Bloomberg

unlikely. The shift in central bank stance now appears fully reflected in bond prices. That said, we see no catalysts for a meaningful upward repricing of yields either – meaning that we would view such a move as an opportunity to add protection and diversification to portfolios. Absent any additional support from lower bond yields, equity prices offer limited upside going forward, and will primarily be driven by earnings dynamics. The global trade outlook will thus be key in determining investor appetite for equities (see chart 14). In the credit space, spreads will most likely remain range-bound, with returns provided by the carry element. Finally, dollar weakness should persist, and gold keep appreciating (see box on page 11 for details).

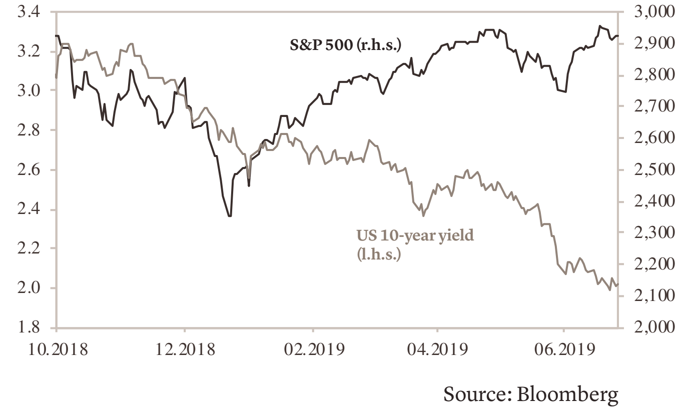
During the past quarter, we took an additional defensive step in our asset allocation, reducing equities in May and upping our exposure to safe havens (gold and government bonds). We effectively acknowledged the increasing uncertainty surrounding trade negotiations and its implications for both business sentiment and the earnings outlook. More specifically, we moved to an underweight stance in emerging equities, which we consider to be the most vulnerable asset class in the event of an escalation in the US-China trade dispute. The current combination of slowing global growth and very accommodative central banks continues to support carry strategies, explaining our reduced level of cash in portfolios compared to the prior quarter. As for currency exposure, we have mostly maintained our preference for the Japanese yen safe haven and moved back to a neutral stance on emerging currencies.

In EUR- and CHF-based portfolios, seeking further diversification, we sold some sovereign debt positions that might prove a less efficient hedge than in the past, given the record low rate level. The proceeds were used to increase gold exposure in April. In EUR portfolios, we also reinvested some cash into real estate (already strongly overweighed in CHF portfolios) and closed our underweight of the base currency.

In USD portfolios, we reinvested the proceeds of the May equity reduction into US Treasuries – ahead of the collapse in global yields – as the odds of a Fed rate hike were fading. As a result, duration is currently neutral in these portfolios and we intend to wait for higher yields to increase sensitivity to interest rates.

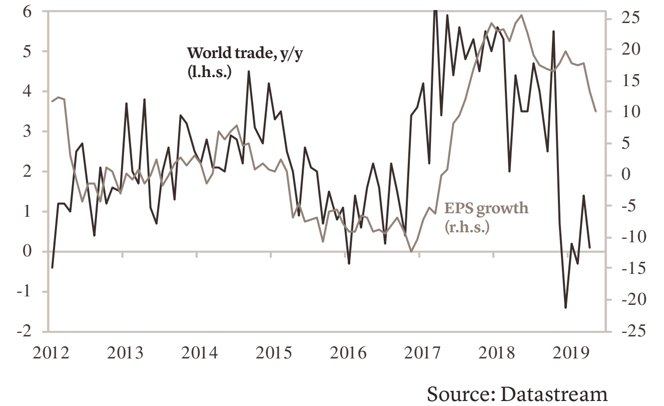
Carolina Moura Alves, Head of Asset Allocation
Sophie Chardon, Cross-Asset Strategist

13. Divergence between equity markets and rates continues
US 10-year yield vs S&P 500



Source: Bloomberg

14. Global trade is key for the earnings outlook
MSCI A/C World EPS vs global trade (in % yoy)



Source: Datastream

Gold is reaching a 6-year high – what next?

Gold has risen to its highest level in six years, mainly on the back of prospective Fed monetary easing, a weakening US dollar, and mounting US-China and then US-Iran tensions – which all drove investors towards safe-haven assets. After trading sideways during the April-May period, gold went on to experience an impressive rally in June, closing the month at USD 1410/oz (up 8%). As such, it has exceeded the 12-month target associated with our baseline scenario (USD 1350/oz) and approached the level that we initially targeted in a risk scenario (USD 1450/oz).

Our portfolios have long gold exposure, a position first implemented in January and then strengthened in April in non-USD accounts, i.e. at a time when gold prices were trading below the USD 1300/oz mark. The change in central banks' stance and resulting fall in global yields actually date back to January, but initially had little effect on gold prices (see chart 15) – with the US dollar remaining disconnected from rate differentials and stubbornly supported through the end of May.

At these prices, it is worth reviewing the investment case for gold, particularly given G20 summit-induced changes to our baseline scenario.

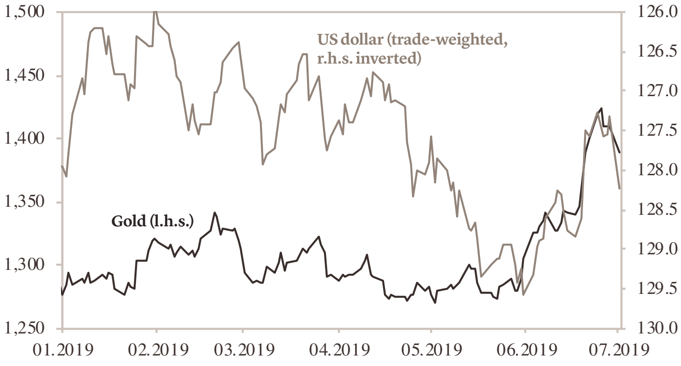
Going forward, gold may suffer from some profit-taking, to the extent that a US-China trade dispute risk premium might have been priced in by investors during the past few weeks. We nonetheless continue to see the rationale for holding gold in a multi-asset portfolio. Indeed, as hopes for a quick recovery in global trade fade, Fed cuts are looming, such that dollar depreciation should continue (see the forex section) – as will investors' quest for alternatives to negatively yielding government bonds. We have accordingly revised our 12-month target for gold up to USD 1400/oz. In a geopolitical/financial stress scenario, we believe that the USD 1500/oz mark could easily be reached.

The Fed's change of stance, our bearish call on the dollar, as well as EM central bank buying, make for limited downside risk on gold in our view. It has also been supported more recently by financial demand – reflecting the lack of alternatives when it comes to diversifying non-USD portfolios, which we consider a structural trend. And gold of course remains an effective hedge in the event of equity market turmoil (see chart 16).

From a portfolio construction standpoint, we thus maintain exposure to gold, all the more so in non-USD accounts considering that the protection offered by government bonds outside of the US is no longer adequate, with most yields now trading in negative territory.

15. Gold is reaching a 6-year high

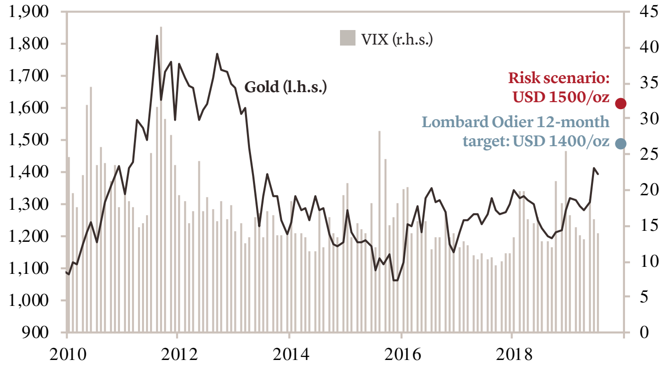
Mainly on weaker USD and geopolitical uncertainties



Source: Bloomberg

16. Upward revision in our targets, given more accommodative central banks

Lombard Odier baseline scenario vs risk scenario



Source: Bloomberg

Forex
Some dollar headwinds in the 3rd quarter

In a nutshell

- Low US yields and the Fed veering towards an easing cycle argue for some further dollar weakness.
- The euro should benefit only marginally for now, as the ECB also moves closer to easing.
- Our top pick among G10 currencies remains the Japanese yen, against a backdrop of low yields, undervaluation and mature US cycle.
- We are gradually again turning constructive on emerging FX, as we expect the hunt for yield to continue.

Last quarter, we discussed our anticipation of dollar weakness, predicated on a dovish Fed as well as data stabilisation in the rest of the world. At the same time, we argued that this weakness might not be broad-based and gave the example of the euro, which back then was facing headwinds due to renewed ECB dovishness. Our top pick remained the Japanese yen, owing to the maturity of the cycle and its sizeable undervaluation.

Since then, many things have happened. US-China trade negotiations broke down in early May, maintaining pressures on trade flows and increasing the risk that global growth remains subdued for longer. This led to a massive downward repricing of US yields, with the US 2-year shedding nearly 50 bp (basis points) (to 1.75%) and the 10-year dropping by 39 bp (to 2%). In turn, this has implied significant compression of the rate differential between the US and the rest of the world. In the end, the trade-weighted dollar closed the quarter down some 1.0%, although the move in global yield spreads would have suggested a much more pronounced decline (see chart 17).

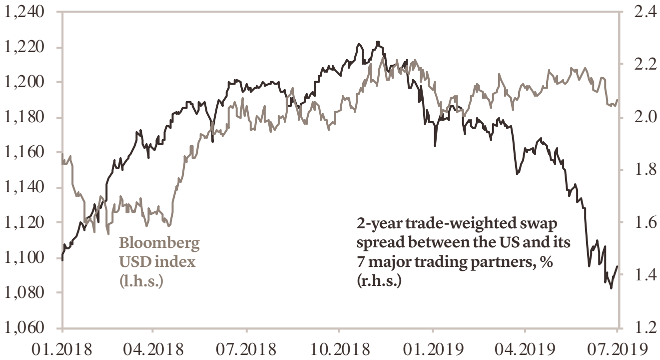
Part of the reason for this contained decline is the risk premium associated with the resumption in trade concerns. Also at play is the fact that – even though spreads have moved against the greenback – the US dollar still maintains a meaningful yield advantage in the G10 space.

Over the last three months, the EURUSD gained 1.5%, the JPY appreciated by nearly 3% against the USD, followed by the CHF (up 2%). The main underperformer among G10 currencies was the pound sterling, due to domestic political developments. Emerging market (EM) currencies fared decently (EM FX index +0.5%), thanks to lower US yields, which more than offset trade worries.

The G20 summit now being behind, without a major breakthrough on the trade front but with the US and China having at least agreed to resume discussions in view of an eventual deal, we detail below our outlook for the currency market. This outlook is based on three main assumptions:

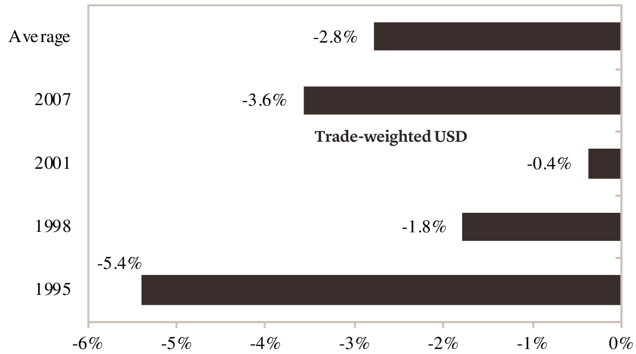
- With the disaster scenario of a collapse in negotiations having been averted and no new tariff implementation (at least for now), the odds of an outright global recession have been reduced.
- Despite that, weak manufacturing developments during the 1st half and meaningful residual uncertainty on trade are likely to prompt the Fed (and the ECB) to ease

17. Dollar misaligned with falling US spreads



Sources: Bloomberg, Lombard Odier calculations

18. USD weakens in the run-up (90-day window) to the first Fed rate cut



Sources: Bloomberg, Lombard Odier calculations

monetary policy. It is worth emphasizing here that, given the starting point, the Fed has far greater room to cut. Additionally, US growth is likely to slow due to the fading fiscal impulse.

- This backdrop implies that, although US yields might reprice modestly higher in the near-term, they are likely to stay at very low levels for the foreseeable future.

For the currency market, these assumptions suggest:

First, that the dollar should weaken (although weakness may not be broad-based). Historically, it tends to depreciate in the run-up to the start of a Fed easing cycle (see chart 18, page 12). Additionally, the current rate differential with major US trade partners suggests that the greenback is about 5% overvalued.

Second, there should be some EURUSD upside but likely of limited nature, potentially towards the 1.15 level by year-end. This upside will be driven mainly by dollar dynamics but capped by potential ECB easing, which will keep rates negative for longer. Only once (if) a big part of the remaining trade risk is removed and trade channels start to function properly again, would we adopt a more bullish view on the euro.

Third, notwithstanding short-term moves, the Japanese yen should continue to strengthen because of Fed easing, undervaluation and a potentially volatile risk appetite that should keep demand for safe haven assets in place. At the same time, we envisage a modest and gradual depreciation of the Swiss franc: the currency is now less correlated to risk than it was in the past and the EURCHF is likely to gravitate upwards thanks to the modest euro upside.

Fourth, the pound sterling will remain largely Brexit-driven. US dollar downside may exert its impact but we think the likely election of Boris Johnson as new Prime Minister, with a pledge to deliver Brexit by the end of October, deal or no deal, will keep upward pressure on UK risk premia and weigh on the currency for the next couple of months. Of course, ultimately, we continue to expect some form of soft Brexit, which will be positive for sterling – but we are certainly not there yet.

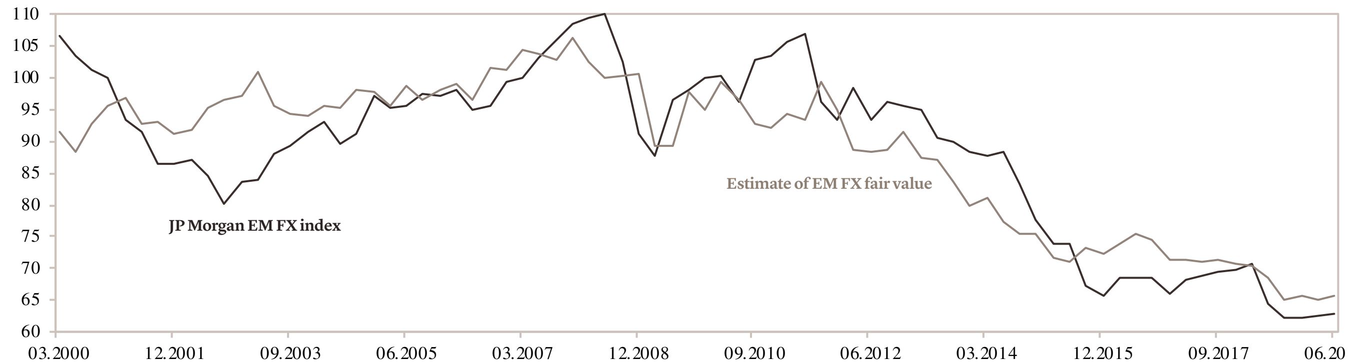
Fifth, the hunt for carry should continue, resulting in upward pressure on EM currencies. Low US yields, reduced odds of a global contraction and EM FX undervaluation (by our estimates – see chart 19) suggest that investors will increase exposure to EM assets, leading to stronger currencies. Indeed, portfolio flows (into both equities and debt securities) have started to pick up since late May and will likely continue given the general benign macro backdrop. Fundamentally, we still think the Brazilian real stands to benefit from the likely enacting of pension reform, while the Russian rouble should keep up its appreciating trend thanks to solid fundamentals and a very credible central bank. Subject to the USMCA (United States-Mexico-Canada) treaty being ratified by the US Congress, we would also expect Mexican peso appreciation, as it tends to be among the currencies that rise most in periods of dollar weakness. Finally, we would expect USDCNY stability for now, with some gradual Chinese yuan gains further out if prospects for a trade deal start to become more concrete.

In conclusion, regarding portfolio exposure, we maintain our long yen position, still seeing good reasons to hold onto it. Additionally, and assuming we are correct in expecting core yields to remain low, we will be looking for opportunities to gain overweight exposure to EM currencies. Needless to say that we will monitor yield and FX developments closely and adjust our views accordingly.

Vasileios Gkionakis, Global Head of FX Strategy

19. Emerging currencies undervalued to the tune of 5%

Fair value model estimate, based on EM-US growth rate differential, US 10-year yields, EM debt as % of GDP and the incidences of US recession



Sources: Bloomberg, Lombard Odier calculations

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