LOMBARD ODIER

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Investment Strategy
Private Clients

4/4

October 2019 · 4th quarter

Key highlights

- Without a genuine de-escalation of the US-China dispute, involving a significant reduction in existing import duties, a revival in global output and trade is not to be expected.
- Resilient consumption has upheld US growth in recent months – although the picture is becoming more complicated as job growth slows and sectors like manufacturing and business investment emit signs of concern.
- In Europe, the ECB is taking extensive action to counter the continuing – even extending – slowdown, but the potency of its measures is doubtful.
- Having just implemented the much-awaited VAT hike, Japanese policymakers will now focus on containing the near-term economic fallout.
- Trade uncertainty is taking its toll on emerging economies, but improved fundamentals and extensive monetary easing are helping them navigate the tougher global waters.
- The 4th quarter could see a continuation of recent market dynamics, with the global trade outlook determining investor appetite for equities. We maintain a defensive asset allocation, underweighting equities and overweighting both gold and the Japanese yen – while still clearly favouring carry strategies.
- Although the USD will retain its safe haven status, we continue to expect modest medium-term weakness – the misalignment with fundamentals is becoming stretched and further Fed rate cuts will likely weigh on the greenback.

Quarterly publication of Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 30 September 2019

Trade shock still weighing on global growth – but no US recession in view

The US-China trade dispute has sucked all the oxygen out of the global economy. Central banks are working the monetary pumps to make the atmosphere more breathable and prevent severe fainting spells – even though they do not have the means to fully offset the strain. Do better days lie ahead of us?

The debate about global recovery is of a more structural than cyclical nature, given that there does not seem to be a reasonable prospect of significant revival in output and trade without a genuine de-escalation of the US-China dispute.

While such a best-case scenario does remain possible, repeated rounds of tariffs have already been implemented and, even if political considerations do lead to a deal before the 2020 US elections, it would probably not involve a significant reduction of the existing levies. Trade flows and global supply chains started to be disrupted already in late 2018 (see chart 1, page 04) and an agreement bringing tariffs back to the levels that prevailed then seems unlikely. For sure, any temporary truce between the two global powerhouses would be welcome, but we doubt that a major withdrawal of tariffs lies around the corner – with both Democrats and Republicans seemingly in favour of a hard-line strategy of economic containment with regards to China.

The question then becomes: will the ongoing trade shock prompt a recession in the US – and by extension the world?

Our take is that preconditions for a US recession in the coming quarters are not (yet) met. Such a development would require that the US consumer comes under pressure and credit risk arises on a significant scale, neither of which is currently apparent. The overall deterioration of monetary and credit conditions in the US – or even in Europe for that matter – remains modest to non-existent (see chart 2, page 04).

As for US consumption, which accounts for more than 70% of the economy, concerns will only be warranted if/when businesses start to let go of their workforce. For now, the job market remains tight. In a context of relatively full capacity but reluctance on the part of company managements to commit to long-run investment plans because of the global uncertainty, labour is needed to offset the lack of capital spending. Note for instance that the manufacturing sector, while clearly in contraction, has created an average of 11,000 jobs per month over the past year.

If the externally driven slowdown does come to spill over to the domestic economy, we should first observe a pickup in jobless claims. Historically, their lead time to both peaks in the payroll and recessions has been significant. The unemployment rate also typically troughs ahead of recessions, so is another indicator to be monitored.

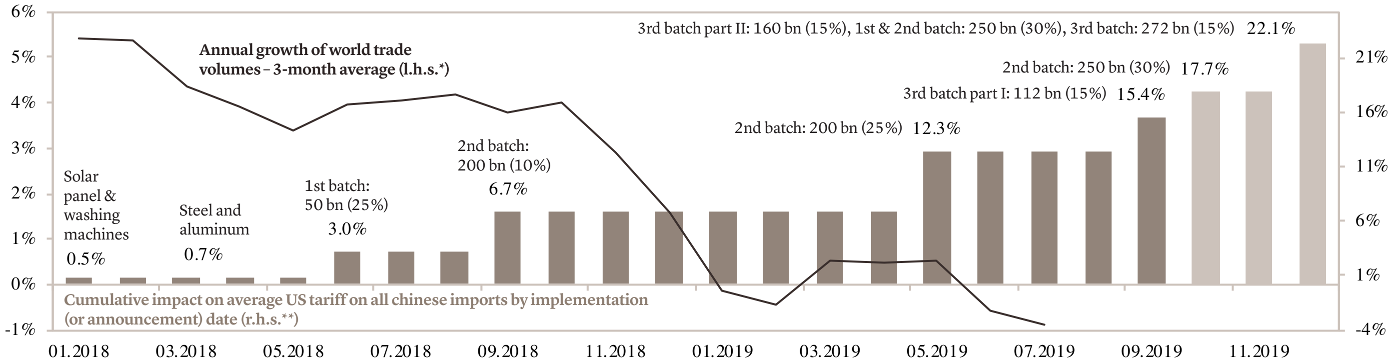
Finally, dismissing employees is a solution of last resort for businesses. In difficult times, they tend to first try to contain labour costs by reducing the average workweek, increasing the number of employees working part-time for economic reasons, and resorting to temporary layoffs. No change in trend in any of these indicators is apparent at this point.

All told, continued slow growth is definitely to be expected, but no

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

1. Average US tariffs on all Chinese imports (USD 522 bn) vs world trade volumes

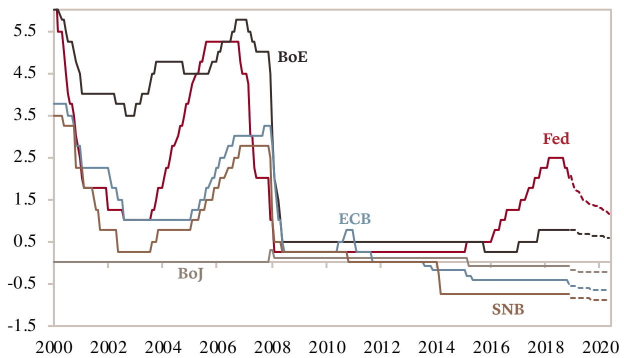
In % – Substantial and systematic tariffs have been implemented (dark bars) and announced (light bars)



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

2. Except for the Fed, major central banks have limited room to cut policy rates and much easing is already priced in

Global policy rates (plain) and market expectations (dashed) – in %



Sources: Bloomberg, Datastream, Lombard Odier calculations

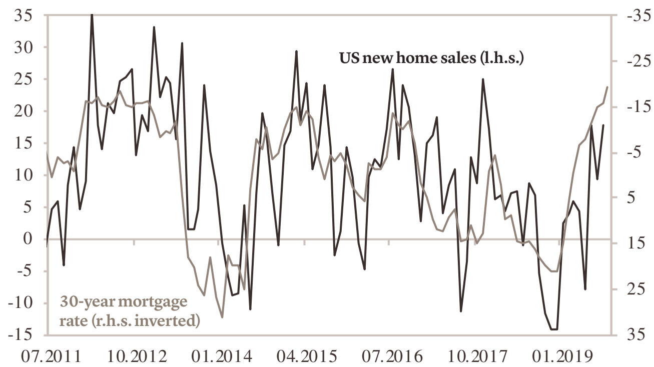
recession in the near future – with the US consumer still supported by a tight labour market, resilient wage growth, low gasoline prices (see box on page 11), high savings and a booming real estate sector on the back of the low cost of debt (see chart 3).

In this environment of material risks to economic growth (the above-discussed trade shock being compounded by the Brexit saga and mounting tensions in the Middle-East) – but no US recession in view – and thus interest rates that are set to stay low, we continue to favour a slightly defensive bias in equities, long carry strategies in fixed income, and volatility hedges such as the yen, gold and put options.

Samy Chaar, Chief Economist

3. Lower rates heve helped drive home sales

In % yoy*



* year on year
Sources: Bloomberg, Datastream, Lombard Odier calculations

United States
Soft landing: a complicated mission

In a nutshell
- Resilient consumption has upheld growth in recent months – even though the economy is slowing down to trend, as expected.
- The picture is becoming more complicated as job growth slows, trade uncertainty persists, and sectors like manufacturing and business investment emit signs of concern.
- Trade developments will be critical going forward, particularly in the event that pending US tariffs on a broad range of consumer products were to take effect, pushing inflation higher and taking a toll on consumer sentiment.

The US economic outlook is becoming much more mixed than at earlier points in the cycle. Headline GDP growth has slowed somewhat but remains decent, supported by strong consumption. But manufacturing continues to suffer – as evidenced by the ISM survey of purchasing managers, which has dropped sharply over the past year and is now in contraction territory (see chart 4).

Meanwhile, job growth, although still running at a healthy pace, has been steadily slowing since the turn of the year – the 3-month average is now roughly 100,000 below last January's level. Preliminary revisions to past data suggest that the pace of job creation might have been even slower and only slightly above the break-even rate required to keep up with population growth.

Much now hinges on the outlook for trade, which we see as a key risk for the final quarter of this year. The new tariffs on Chinese imports that are scheduled to take effect on 15 December would affect a broad range of consumer products, thereby having a more direct impact on inflation – and possibly on consumer sentiment. With some surveys having already started to point to deteriorating consumer sentiment, such an effect would obviously be unwelcome.

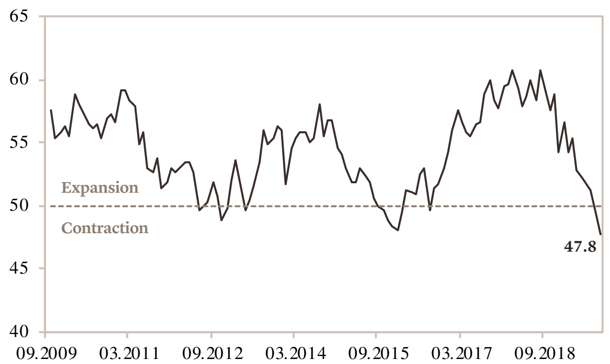
While the Federal Reserve (Fed) previously had the "luxury" of being able to switch to a patient stance and then even ease policy, thanks to consistently subdued price pressures, the trend in inflation data has changed since mid-year. Core CPI already exceeds its 2018 highs, and core PCE, while still below the Fed's 2% target, is also trending up (see chart 5). With inflation facing upside risks due to the late-cycle conditions and impact from additional tariffs, the Fed might have less flexibility in coming months.

The combination of these forces makes soft landing a complicated mission. Rather than undershooting its inflation target, the Fed may soon be facing inflation high enough to limit its leeway. Meanwhile, a wide budget deficit and divided government make it unlikely that fiscal support will be forthcoming in the event of a slowing economy. A healthy consumer has been a strong support for the economy, but a softer labour market, higher inflation, and persistent uncertainty could cause renewed risks as the economy slows down to trend. Jerome Powell's job may soon get harder.

Bill Papadakis, Macro Strategist

4. Headline growth has held up well, but manufacturing is sending signs of concern

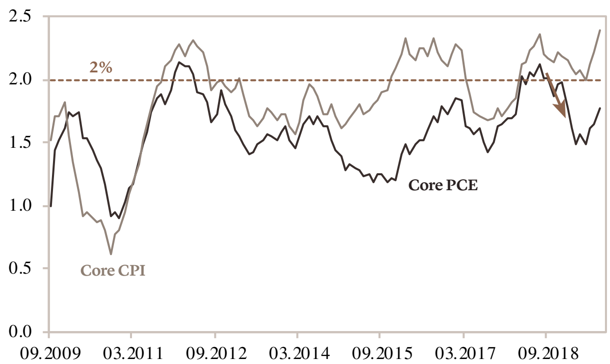
ISM manufacturing survey (10-year history)



Sources: ISM, Bloomberg, Lombard Odier calculations

5. Inflation has started to pick up

Core CPI and core PCE inflation – In % yoy



Sources: BEA, Bloomberg, Lombard Odier calculations

Europe
Fiscal policy to lend a helping hand?

In a nutshell

- The European slowdown continues and is extending, with added risks posed by trade tensions and Brexit.
- The ECB is going all-in to counter downward economic pressures, having just cut rates and reinstated monthly asset purchases, but the potency of its measures is doubtful.
- Coordinated fiscal easing – taking advantage of the low government borrowing costs – would be much needed at this juncture, but governments have been slow to act.

Against the persistent Eurozone slowdown, monetary policy has been the first line of defence. The European Central Bank (ECB) delivered a broad package in September, including a deposit rate cut, a tiered reserves system shielding banks from the impact of negative rates, renewed asset purchases, and more generous TLTRO (targeted longer-term refinancing operations) terms.

Notwithstanding the ECB's ambition, the direct impact on growth and inflation may prove limited. The deposit rate was already at a very low level and credit growth has been so healthy that some national regulators have imposed macroprudential measures in order to prevent excesses.

Increased government spending would have a greater impact. But the degree of monetary and fiscal policy coordination that would be particularly useful in battling the ongoing slowdown simply does not seem to exist in the Eurozone. Might a change lie ahead on this front?

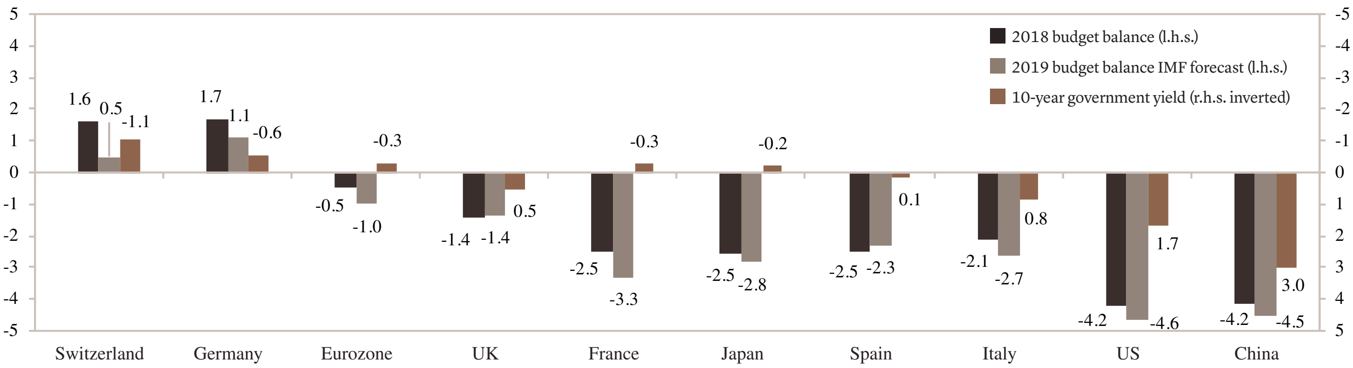
Notably, a critical – if underreported – effect of the ECB package is the creation of fiscal room. Open-ended asset purchases alongside continued reinvestments mean that low government bonds yields are here to stay. The ECB even followed up its action with forceful rhetoric, explicitly asking governments to activate fiscal policy. This prompt was mainly directed at the core countries – who have ample fiscal space (see chart 6) but have so far been unwilling to use it.

The combination of persistent economic weakness and extremely low borrowing costs makes a compelling case for fiscal stimulus. Some encouraging signs are indeed starting to emerge. The Dutch government recently announced fiscal easing measures amounting to roughly 1% of GDP in its 2020 budget, as well as a multi-year investment fund to improve potential growth. German policymakers remain reluctant, but there are signs that the debate is shifting there too (the recent announcement of a multi-year climate change package may be a first move in that direction).

While Eurozone monetary policy has often exceeded expectations, fiscal policy has tended to underdeliver. A sea change looks unlikely, but we will continue to watch for signs that the wind is changing, as a more balanced fiscal stance would significantly improve the medium-term outlook. The situation may need to worsen before the signs become clearer – but this moment feels much closer today than it did just a few months ago.

Bill Papadakis, Macro Strategist

6. **Low borrowing costs and a healthy budget balance make a compelling case for fiscal easing in the Eurozone**
Budget balance (% of GDP) vs 10-year government bond yield (in %)



Sources: Bloomberg, IMF, Lombard Odier calculations

Japan
After the consumption tax hike

In a nutshell

- Having implemented the much-awaited VAT hike, Japanese policymakers will now focus on containing the near-term economic fallout.
- The BoJ will likely take a cue from the ECB in relying more heavily on negative rates – but it faces significant political and technical constraints.
- The political backdrop remains favourable to steady implementation of Abenomics, but Abe's continued push for the revision of the constitution is a risk to reform momentum in the next few years.

Japan has finally done it. On 1 October, the Value added tax (VAT) was raised from 8% to 10% on all goods and services, except food and beverages. This fourth hike since 1989 will obviously be the main source of volatility in domestic consumption indicators during the next months. A shift in the timing of purchases (substantial front-loading was evidenced by August's jump in retail sales) and a higher price tag will depress consumption at least temporarily – as observed with previous VAT hikes (see chart 7).

Needless to say, policymakers will now have to focus almost exclusively on containing the impact. We have noted previously that the Abe cabinet seems much better prepared this time, with more practical exemptions, granular incentive schemes for consumers (i.e. rebates for cashless transactions), and targeted fiscal support for households. And, if additional measures are warranted, the ruling party has more than enough seats in the Diet to get them voted quickly. Meanwhile, the Bank of Japan (BoJ) has already signalled that it will actively consider policy tweaks at its late October meeting.

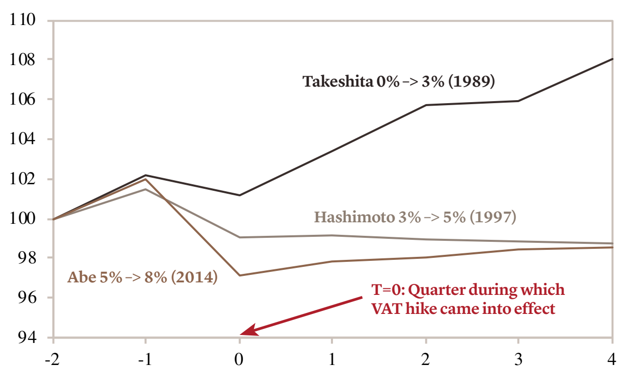
None of the instruments currently available to the BoJ are, however, politically easy. Outright foreign asset purchases cannot be considered due to G7 sensitivities (US especially) and domestic purchases are limited by the shortage of available financial assets. This leaves deeper negative interest rates coupled with a tiered reserve system as the more convenient option for the BoJ – just as is the case for the ECB. In comparison to the ECB, the BoJ could face even more intense opposition from the banking sector, deeply unhappy about the negative rates' impact on its business (see chart 8). The next policy tweak might thus just entail a perfunctory 10 bp cut in the rate applied to a portion of banks' excess reserves.

The good news for Japan is that the political backdrop remains favourable to steady implementation of Abenomics. After the recent victory in the upper house, Prime Minister Abe reshuffled his cabinet in favour of close allies and effectively co-opted the younger challengers to his reign – strengthening his ability to navigate the rest of his term and take some hits on matters of free trade, nuclear power, and other reform initiatives. That said, Abe's likely focus on his long-term legacy means that he will continue to look for an opportunity to revise the country's constitution. This will be a key risk to reform momentum in Japan in the medium-term.

Homin Lee, Macro Strategist – Asia

7. **The VAT impact will be felt in Q4 2019**

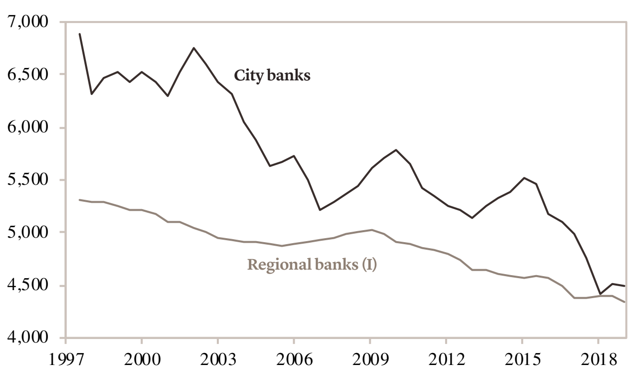
Real consumption level around previous VAT hikes (T-2 level = 100)



Sources: CEIC, Bloomberg, Lombard Odier calculations

8. **Japanese banks remain unhappy about interest margins**

Interest margin of Japanese city and regional (I) banks – In JPY billion, rolling annual



Sources: CEIC, Lombard Odier calculations

Emerging Markets
A massive wave of rate cuts

In a nutshell

- The disruption in trade and generalised uncertainty has taken its toll on the emerging complex.
- Fortunately, improved fundamentals and extensive monetary easing are helping emerging economies navigate the tougher global waters.
- This resiliency would come under challenge in the event of a global risk-off scenario, or a marked deterioration in domestic fundamentals – causing capital outflows, currency depreciation and a resurgence in inflation.

That emerging markets are slowing down amid a protracted trade dispute between the two largest world economies should come as no surprise. While secular forces may also be at play, most emerging economies are open, export- and/or import-dependent, and well-integrated into increasingly complex global value chains.

1st quarter 2019 GDP growth for the emerging complex thus hit a low (outside of crisis episodes), with no region escaping the downdraft. Asia, being a large net manufacturer/exporter with close ties to China, unsurprisingly bore the immediate brunt of the trade disruption. Latin America actually proved the worst-performing region, hurt not only by declining commodity prices and mounting global uncertainty, but also a number of idiosyncratic issues. As for Eastern Europe, its economic path is closely correlated to Eurozone, and more specifically German, manufacturing indicators – which have dropped markedly.

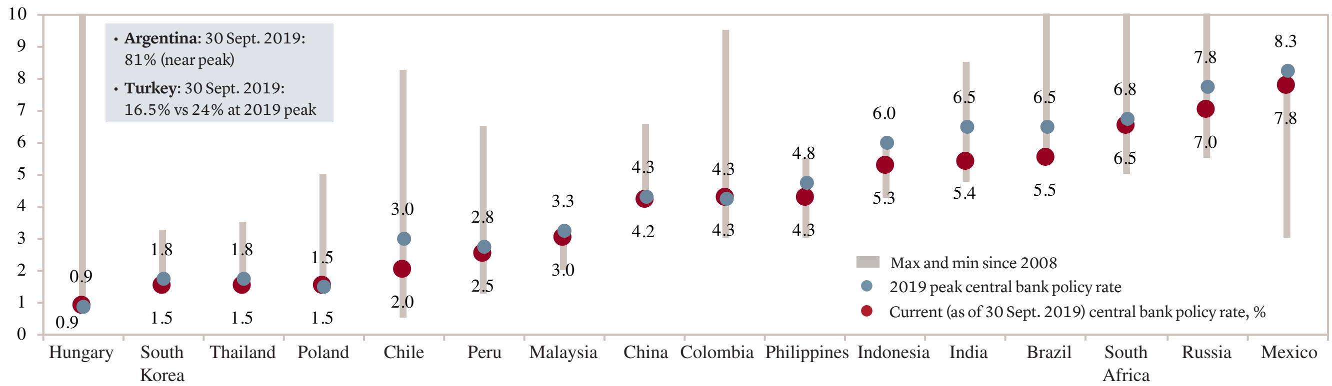
That said, the small bounce then experienced during the April-June period suggests that emerging economies do have resiliency. Their fundamentals have improved over recent years, notably on the current account and foreign reserve fronts, allowing for longer-lasting confidence and credibility. And, importantly, emerging central banks have been able to lower rates – alongside the Fed and other developed monetary authorities. Indeed, there has been a massive wave of financial easing this year across the emerging complex, with 14 of the 18 central banks that we monitor having cut their policy rate (see chart 9) and leeway for further action in at least 10 countries.

Of course, this trend towards easier monetary policy in emerging economies could be halted by a global risk-off scenario, whereby capital outflows put downward pressure on the currencies, in turn making it more difficult to service external debt and driving up inflation metrics. Domestic fundamental issues could also trigger such a capital flight, particularly with respect to the rising debt level (now at a record US 69 trillion, or 216% of GDP).

All told, absent a clear resolution of the US-China trade dispute, "muddle through" is probably the best that can be expected for the emerging markets.

Stéphanie de Torquat, Macro Strategist

9. Largest emerging markets central bank policy rates
Current vs 2019 peak and 10-year min & max



Sources: Bloomberg, Lombard Odier calculations

Asset Allocation
Still collecting carry cautiously

In a nutshell

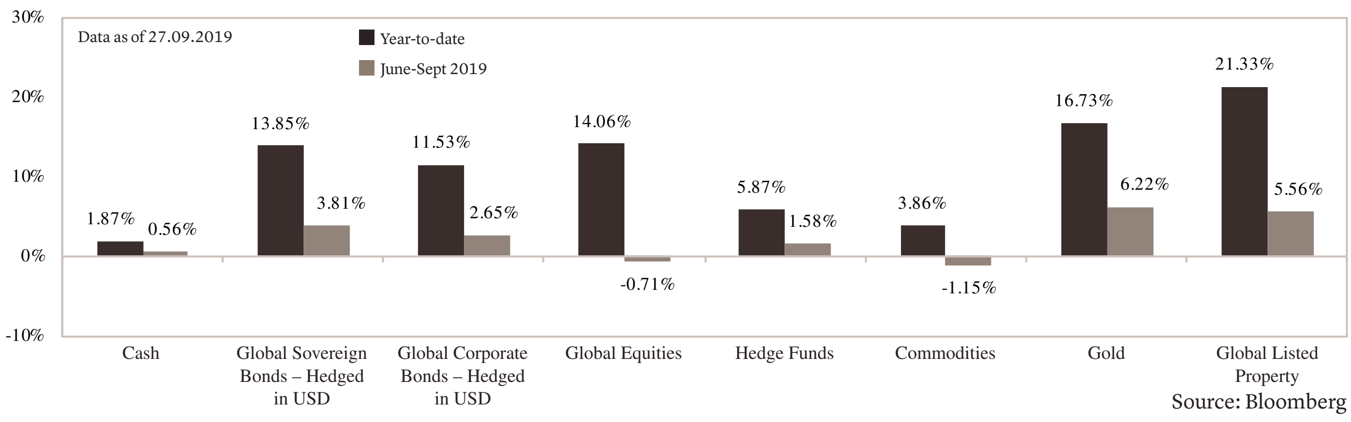
- Last quarter saw two opposing forces at play: a decidedly more dovish central bank stance on the one hand, and further escalation of the US-China trade dispute on the other.
- Oil prices spiked in mid-September, driven by an attack on Saudi oil processing facilities – geopolitical risk is alive and well.
- Global equity returns and credit spreads essentially did a round trip, but the quarter ended with government bond yields lower, the USD stronger and gold prices higher.
- The 4th quarter could see a continuation of recent market dynamics, with the global trade outlook determining investor appetite for equities.
- Over the past three months, we kept the level of risk in our asset allocation broadly unchanged. We closed our overweight position in local currency denominated emerging bonds but went overweight their hard currency peers. We also reduced our gold overweight in EUR and CHF portfolios, and added exposure to direct real estate in EUR portfolios.

The quarter just ended saw similar market dynamics to the prior one. Global equities and commodities posted flat to negative returns over the July to September period, while global credit remained in positive territory – helped by another decline in government bond yields (see chart 10) and broadly unchanged credit spreads. Indeed, both the 10-year US Treasury and its German counterpart hit new year-to-date lows at, respectively, 146 basis points (bp) and a negative 71 bp.

Two opposing forces were at play during this period. On the one hand, central banks took on a decidedly more dovish stance. The Fed made two 25 bp rate cuts and the ECB lowered its policy rate by 10 bp, while also announcing further asset purchases and other easing measures. On the other hand, the US-China trade dispute escalated further, with additional tariffs announced by both parties. This led to a continuation of the market volatility already observed during the 2nd quarter, exacerbated by seasonally low liquidity during the month of August. The equity reporting season was broadly in line with expectations and confirmed that we remain in an environment of weak earnings growth. Finally, the oil price spiked mid-September, driven by an attack on Saudi Arabian oil processing facilities. Although oil has since almost fallen back to pre-attack levels, this served as a reminder that geopolitical risk is alive and well (see box, page 11).

Global equity returns and credit spreads essentially did a round trip, but the quarter ended with government bond yields lower (see chart 11, page 10), the USD stronger and gold prices higher. It is also worth noting that equity markets experienced a significant rotation during the month of September, from growth to value stocks (see chart 12, page 10). The picture as of early October is one of lower government bond yields and weak global equity momentum.

10. Global asset class performances
Total return



Source: Bloomberg

Demand for safe haven assets persists and investors seem to have an defensive positioning overall.

As the 4th quarter unfolds, we expect a continuation of the most recent macro trends: supportive central banks offsetting trade uncertainty to a certain extent, against a backdrop of slowing growth and low inflation. As regards financial market performance, we could see a continuation of the 2nd and 3rd quarter dynamics, with the global trade outlook determining investor appetite for equities. In the credit space, spreads will most likely remain range-bound, with returns provided by the carry element. Finally, government bond yields should remain subdued and continue to provide support to equity valuations.

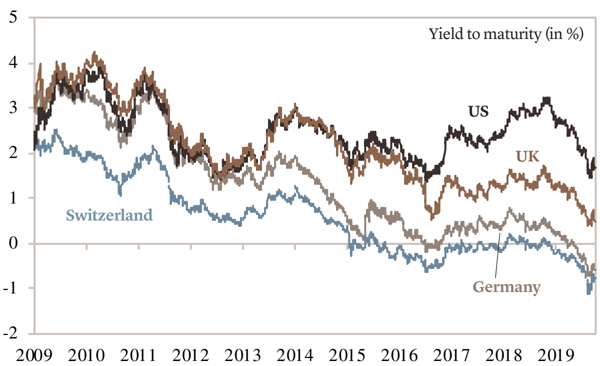
Over the past three months, we kept the level of risk in our asset allocation broadly unchanged. We closed our overweight position in local currency denominated emerging bonds but went overweight their hard currency peers – across all portfolios. In EUR and CHF portfolios, seeking further diversification, we also reduced our gold overweight. And we added exposure to direct real estate in EUR portfolios.

All told, we maintain a defensive stance, underweighting equities and overweighting both gold and the Japanese yen. Our clear preference continues to go to carry strategies – EM hard currency bonds and real estate being two examples – supported by the current combination of slowing global growth and very accommodative central banks. We retain an additional layer of downside protection via put options on broad equity indices.

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

11. Yields are trending ever lower

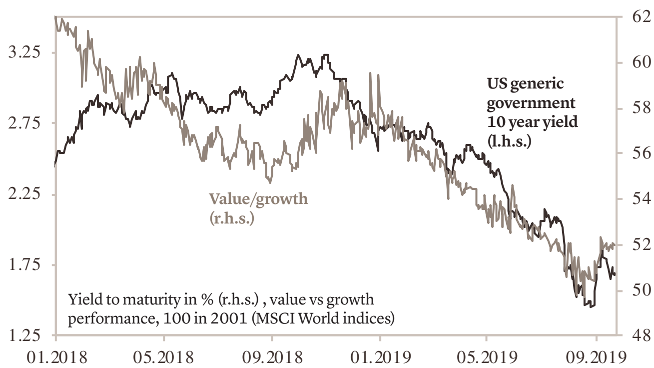
European yields have fallen deeper into negative territory



Source: Bloomberg

12. Value stocks have outperformed in September...

... in line with the move in yields



Source: Bloomberg

What the attacks in Saudi Arabia mean for oil markets

Oil markets experienced historically high volatility mid-September after the announcement of the attacks on Saudi Arabian oil processing facilities (see chart 13). The risk of a long-lasting oil shock then dropped significantly following Saudi Aramco's update. The market now has a clear timeline to assess the progress of repairs (see chart 14). In our view, the two major implications for the oil market are (i) that the event will have no impact on the physical market as Saudi inventories will make up for lost production until the facilities have returned to their normal level of activity (planned for the end of September), but (ii) that the oil market will be vulnerable to further disruption, due to limited spare capacities in Saudi Arabia during the coming months.

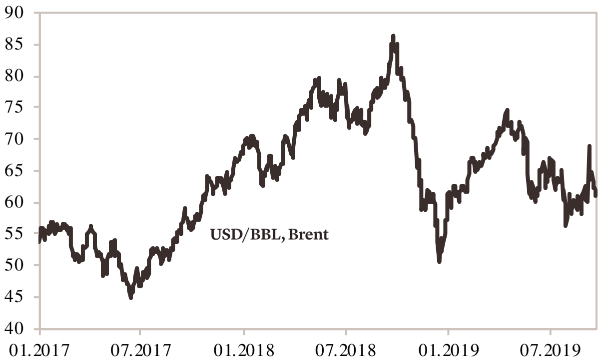
If Saudi Aramco delivers on its repair timeline – a crucial point that market participants will be closely monitoring – then the impact on our supply/demand model, and inventories in particular, will remain contained. **Our baseline scenario thus still foresees Brent trading at around USD 60 per barrel**, with demand affected by the uncertainties on global trade. Indeed, during the summer, we had revised down our 12-month forecast for Brent to that level, in order to acknowledge the global economic slowdown and its consequences in terms of oil demand for the remainder of this year and in 2020 – requiring further action by OPEC/Russia to limit the anticipated oversupply (a discussion of new production cuts likely lies at the top of their next meeting's agenda) and maintain Brent prices above USD 60 per barrel (considered as a floor by the organisation).

That said, even if the fundamental backdrop is unchanged, **we identify at least three risks likely to fuel upward oil price volatility in the short term**: (i) increased vulnerability of the oil market without the usual Saudi Arabian spare capacities, (ii) rising geopolitical risk in the Middle East, and (iii) uncertainties as regards the repair of Saudi production facilities, which might take longer than initially thought.

OPEC likes to define itself as the central bank of the oil market, providing or withdrawing liquidity when needed to dampen price volatility. But in fact, Saudi Arabia has always been the main provider of this liquidity. Until mid-September, the country was pumping 9.8 million barrels per day, leaving a theoretical 1.3 million barrels of usable spare capacities, now temporarily unavailable. Outside of Saudi Arabia, we estimate that the remaining spare capacities amount to roughly 0.8 million barrels per day, spread between Russia, the United Arab Emirates and Kuwait. OPEC thus has a much-reduced leeway until Saudi Arabia returns to full production.

13. Attacks in Saudi Arabia halved the Kingdom's daily production

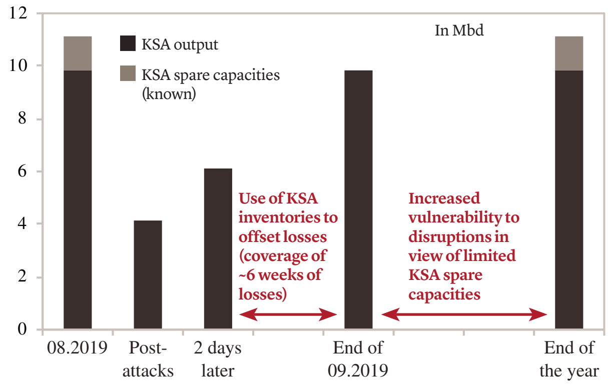
Oil prices rose almost 15% in one day, on fears of prolonged disruption



Source: Bloomberg

14. Expected evolution of Saudi Arabian output and spare capacities over the coming months

... according to official communication



Source: Lombard Odier estimates

Forex
Navigating FX markets as major central banks ease further

In a nutshell

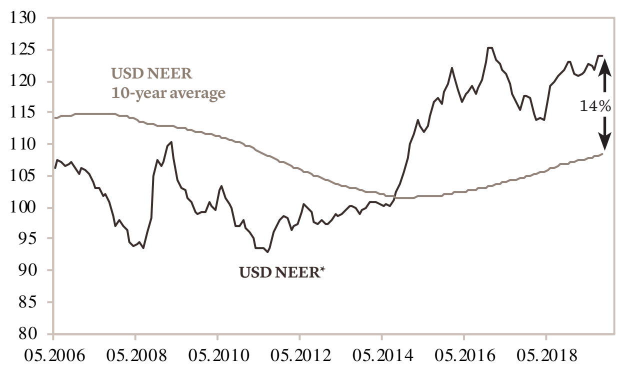
- Although the USD will retain its safe haven status, we continue to expect modest medium-term weakness – the misalignment with fundamentals is becoming stretched and further Fed rate cuts will likely weigh on the greenback.
- Much negativity is already priced into the EUR: a turn in German data or explicit hints of fiscal stimulus would serve as a catalyst to initiate long positions with stronger conviction.
- We keep our neutral stance on the CHF (expecting the SNB to defend the 1.08-1.09 level), prefer to stay out of the GBP until the probability of a no-deal Brexit diminishes sharply, and still like the JPY for hedging purposes (even if near-term seasonality is unfavourable).
- Unless frictions intensify, we see little reason for the CNY to trade materially lower.

Following additional monetary policy easing by the world's two major central banks (Fed and ECB), currency markets are likely to grapple with opposing forces: more accommodative financial conditions, which push investors towards carry trades (risk-positive), but also continued uncertainty pertaining to the US-China trade dispute and, potentially, the recent escalation of tensions between Saudi Arabia and Iran (risk-negative).

In a nutshell, the USD will continue to be viewed as a safe haven by investors during a period of mounting global growth and geopolitical risks. Greenback overvaluation (relative to interest rate differentials and the long-run trend) has, however, extended considerably and should begin to weigh going forward (see charts 15 and 16). Moreover, and despite the Fed's median expectations (dot plot) pointing to no further easing, we would highlight that seven of the seventeen Federal Open Market Committee (FOMC) members expressed the need for lower rates before year-end. Jerome Powell also corroborated that dovish spin – rather subtly – during his press conference. The Fed Chairman repeatedly underscored the main risks to the outlook (trade, geopolitics, global economy) and stated that extensive cuts may be needed in the event of further macro activity deterioration. Powell also expressed the view that, in the face of rising risks, one should not hold back but act pre-emptively. We see no reason to change our core view of modest USD weakness over the medium term, as the misalignment with fundamentals stretches to levels historically consistent with dollar reversals. That said, it will not be a one-way street.

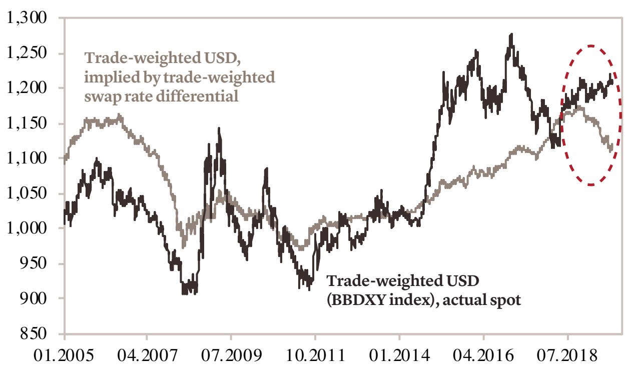
Turning to the EUR, we maintain our small upside bias on the EURUSD over the next few months. Despite the ECB's bold package, the measures were not enough to dampen the common currency. Short-end rates have spiked since the ECB meeting, lending some support to the EUR. Moreover, rate differentials with the US suggest that EURUSD should be trading higher than its current levels (see chart 17, page 13). Finally, we think that plenty of negativity (Eurozone slowdown and ECB easing) has already been priced in. For sure, our EURUSD 1.15 forecast by year-end is subject to downside risk, but our key message is that we feel

15. Dollar trading significantly above its long-term average



* Nominal Effective Exchange Rate
Sources: Bloomberg, Lombard Odier calculations

16. USD out of sync with rate differentials



Sources: Bloomberg, Lombard Odier calculations

it is more likely than not that the pair will end the year higher than it is now. Still, we prefer to stay on the sidelines in terms of portfolio exposure. A catalyst to initiate long positions with stronger conviction would be a turn in the German data and/or explicit hints by German officials that a fiscal stimulus package is in the making.

We retain our neutral stance on the CHF. On the one hand, risk appetite remains fragile, which will be a positive for the currency. On the other hand, though, the Swiss National Bank (SNB) will be present in the FX market and we now have a fairly reasonable estimate that 1.08-1.09 is the area that it would like to defend – though its interventions are likely to remain modest. Additionally, the central bank's ongoing material downward revisions to Swiss inflation forecasts suggest that the possibility of a rate cut remains on the table – or at the very least that rates will stay low for longer.

As far as the GPB is concerned, recent developments suggest that the probability of a no-deal Brexit by 31 October has fallen materially. That said, the tail risk has not been entirely removed, which means that sterling still incorporates a sizeable risk premium. Based on our estimates, GBPUSD is undervalued to the tune of 11% and EURGBP overvalued more than 7% (see chart 18). We prefer to remain on the sidelines for now, until there is greater clarity on the date of a potential general election, possible alliances between parties (e.g. Conservatives and the Brexit party) and more information on election opinion polls. There will likely come a time when the probability of a no-deal scenario diminishes sharply (based on our core view), at which point sterling will undergo significant appreciation. But we are not there yet.

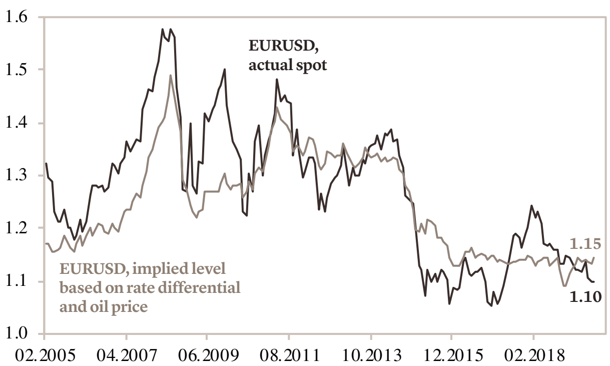
Turning to the JPY, odds are that it will consolidate near-term following its rally earlier this year and due to negative October-November seasonality. However, the cycle is very mature, and the currency is still rather undervalued (nearly 10% against the USD based on our estimates). Moreover, we think there is still value in holding on to short USDJPY positions in global diversified portfolios, as a hedge against rising trade and geopolitical risk. In summary, we see scope for some further modest USDJPY downside on a medium-term perspective.

At the same time, we remain of the view that China has managed the trade dispute with the US in a cautious and controlled manner. This is why USDCNY, after rising to near 7.20, has since fallen back towards 7.10. We consider this in line with China's long-held desire to ensure currency and financial market stability. Unless frictions intensify, we see little reason for the CNY to trade materially weaker.

In the Nordic space, we prefer the NOK to the SEK because of better underlying fundamentals (as well as good carry in the G10), oil prices and our view that the SEK faces the risk of a Riksbank reversal to a more dovish stance. In the commodity bloc, we think the AUD is close to bottoming out, as multi-month depreciation (in excess of 17%) has brought the currency into significantly undervalued territory. We also expect the CAD to regain some marginal appreciating dynamic on higher oil prices and strong labour market developments.

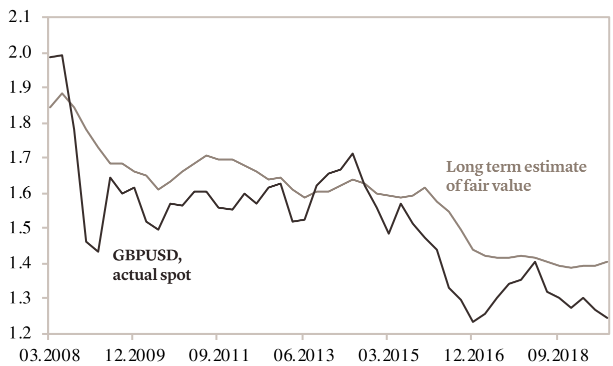
Vasileios Gkionakis, Global Head of FX Strategy

17. EURUSD somewhat undervalued



Sources: Bloomberg, Lombard Odier calculations

18. Sterling significantly undervalued due to the Brexit risk premium



Sources: Bloomberg, Lombard Odier calculations

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