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EM FX Monthly
Climbing the wall of worry, but climbing nonetheless

01/12

January 2020

Key highlights

- Over the past month, EM FX has shown a positive, albeit mixed, performance, with Asian FX outperforming but LatAm lagging.
- Our preferred list of currencies, which includes CNY, MYR, IDR (Asia), MXN, and PEN (in LatAm) as well as RUB (CEEMEA) have performed better than we had forecast. On the other hand, some currencies on which we were already cautious (like BRL) have understandably underperformed.
- We further upgrade our projections for the CNY, KRW, TWD, MYR, and IDR (Asia) as well as for RUB and CZK (CEEMEA). On the other hand, we tweak MXN higher over H1, but downgrade our BRL and THB forecasts.
- For the CNY, we revise our year-end forecast of 6.80 down to 6.70. Even if a further reduction in tariffs does not occur before 2020, CNY should perform better as USDCNY fixings converge with a softer USD and activity data stabilises over Q1.
- The Wuhan coronavirus epidemic has emerged as a potential wildcard. We will continue to assess the extent of the epidemic and its impact on our scenarios and forecasts.

FX forecasts

	Q1 20	Q4 20
USDCNY	6.85	6.70
USDIDR	13'522	13'150
USDMYR	4.04	3.97
USDTHB	31.25	30.50
USDMXN	18.60	18.30
USDBRL	4.20	4.12
USDCOP	3'300	3'350
USDRUB	60.76	59.80
USDTRY	5.85	6.21
USDZAR	15.00	14.66
EURPLN	4.21	4.21
USDILS	3.47	3.36

At a glance

Fx views by region

Monthly publication of Lombard Odier Investment Solutions – Investment Strategy department

Contributors:
Kiran Kowshik, Global FX Strategy
k.kowshik@lombardodier.com

Homin Lee, Macro Strategist Asia:
ho.lee@lombardodier.com

Vasileios Gkionakis, Head of FX Strategy
v.gkionakis@lombardodier.com

Contact: is-fxstrategy@lombardodier.com

Important information: Please read important information at the end of the document. Data as of 24 January 2020

Climbing the wall of worry, but climbing nonetheless

In the final two weeks of December, EM currencies posted a strong rally as the likelihood increased of a phase one deal being signed between the US and China. Several currencies posted 1-2% returns and EMFX aggregates rose. USDCNY fell sharply to 6.85 before retracing higher.

However, a "buy the rumour, sell the fact" response to the phase one US-China trade deal — on top of emerging concerns over a new virus in China – have now curtailed risk sentiment. This situation could persist in the weeks ahead pending signs that the number of virus cases has peaked. A short-term hit to activity is likely, particularly in tourism, which poses downside risks to certain currencies like the Thai baht.

Looking ahead, other risk factors such as the democratic primaries kicking off in Iowa at the start of February could cause consolidation. That said, beyond these noises, we remain constructive on EMFX for the coming months given some more positive details in the phase one deal as well as signs of green shoots in EM and Chinese data.

Regional summaries and forecast changes

In **Asia**, the CNY and MYR remain our top picks, but we have also added KRW to that list. We revise down our USDCNY forecast to 6.70 for end-2020, from 6.80 previously. The recent rally offers opportunities, in our view. We also tweak lower our USDMYR and USDIDR forecasts to reflect price moves, as we fundamentally like both local currencies. On the other hand, we see THB weaker given downside due to disruption to tourism-related flows.

Turning to **LatAm**, last month we indicated a strong preference for the MXN, but were quite cautious on the BRL. Similarly, we projected PEN higher but CLP lower given political uncertainty. A month on, these views are playing out. We tweak our forecasts to show an even better MXN performance but a softer BRL over the next three to six months. The CLP is cheap on fundamentals, but political insecurity will keep it that way until the potentially serious event risk of the constitutional referendum (26 April). Performance could improve after May.

Finally, in CEEMEA, we maintain our preference for the RUB and ILS, and add the CZK to our list of favourites. We have lowered our USDRUB forecast only modestly to reflect price action so far, but have cut our EURCZK more significantly. Conversely, we maintain our cautious stance on the ZAR as a number of rating-sensitive event risks will arise from February onwards.

EMFX: three key charts

In our inaugural EMFX monthly, we made the point that EMFX was undervalued overall and that declining trade policy uncertainty could allow for some of this valuation gap to close.

But what about the flows? The chart opposite looks at an aggregate measure of FX flows for the GBI EMFX index of currencies. We look at the twelve-month (12M) sum of the broad basic balance (BBB), which includes the current account (trade-related transactions) as well as foreign direct investment (FDI) and portfolio investment (financial transactions).

It shows that – somewhat similar to late 2015 – overall flows to EM are already depressed, and thus there is scope for flows to increase on better fundamentals (and external news). This contrasts with the situation over 2018-19 when overall EM flows were deteriorating from a peak. **Hence, both valuation and flows make us more confident of calling for an EMFX recovery at the start of 2020**.

In last month`s EMFX monthly, we used the simple chart on the left to demonstrate our out-of-consensus bearish view on USDCNY (given our view for a modestly weaker USD).

The sizeable divergence between USDCNY and the broader USD is closing. This is somewhat similar to the situation after December 2018 and the trade “cease-fire” that followed the G20 meeting in Buenos Aires.

Such a re-alignment could occur via lower USDCNY fixings and bring the USDCNY closer to 6.80 or below (we forecast 6.70 given that we expect the broad USD to weaken further).

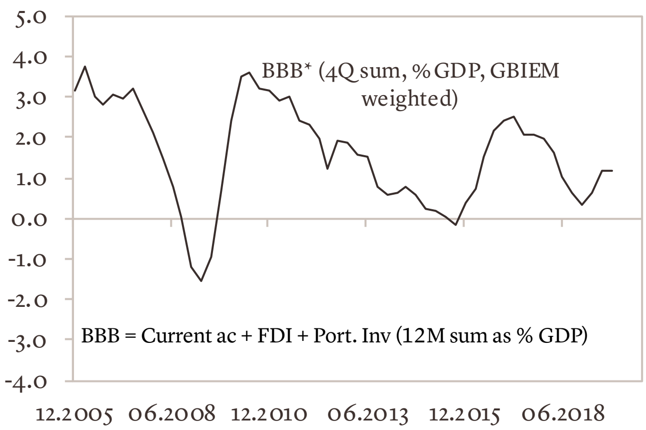
While domestic flows (e.g. scaling down of repatriation) ahead of the Chinese New Year holidays could see a retracement, **we expect further downside in spot as USDCNY fixings are set lower.**

At the time of writing, concerns over a new respiratory illness in China (termed the Wuhan coronavirus) are hurting markets. China has confirmed 830 cases in total and the number of fatalities has risen to 26. The WHO has confirmed that the virus is contagious and Chinese authorities have classified it as a Class B infectious disease, like the SARS virus.

In 2002-03, SARS affected Hong Kong`s activity and especially the tourism sector. **Looking at both Chinese outbound tourism by destination and the importance of tourism to EM country GDP, Hong Kong and Thailand stand out.**

Tourism-related flows having been a big supporter of the Thai baht until now, and Chinese nationals make up over 20% of total incoming tourists. If the situation worsens and tourism is impeded, **the THB could potentially face some near-term downside risks**.

1. GBI EMFX FX flows show scope for recovery

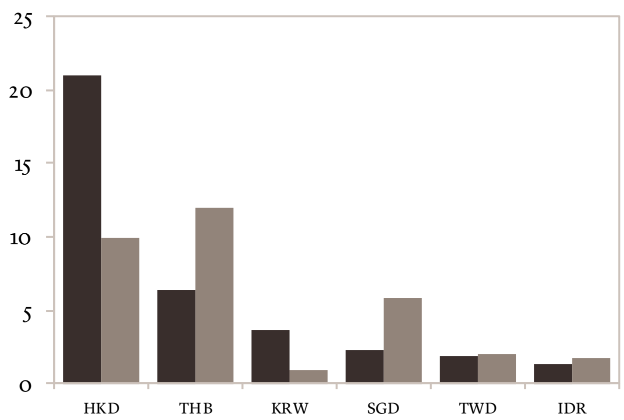


Sources: Bloomberg, Lombard Odier.

2. USDCNY is “catching down” to the broad USD

Sources: Bloomberg, Lombard Odier.

3. What if the China virus risk increases? THB may lose support



Sources: Bloomberg, Lombard Odier.

Note: Past performance and forecasts are not a reliable indicator of future performance.

FX forecasts

Asia

	Current spot	Q1 20	Q2 20	Q3 20	Q4 20
USDCNY	6.94	6.85	6.80	6.75	6.70
USDHKD	7.78	7.80	7.80	7.80	7.80
USDIDR	13’615	13’522	13’398	13’274	13’150
USDINR	71.44	70.84	70.84	70.84	70.84
USDKRW	1’169	1’153	1’142	1’131	1’120
USDMYR	4.06	4.04	4.02	3.99	3.97
USDPHP	50.84	50.84	50.76	50.68	50.60
USDSGD	1.36	1.34	1.33	1.32	1.31
USDTWD	29.99	29.68	29.39	29.09	28.80
USDTHB	30.71	31.25	31.00	30.75	30.50

LatAm

	Current spot	Q1 20	Q2 20	Q3 20	Q4 20
USDMXN	18.94	18.60	18.50	18.40	18.30
USDBRL	4.21	4.20	4.17	4.15	4.12
USDCOP	3’366	3’300	3’317	3’333	3’350
USDCLP	786	790	770	759	749
USDPEN	3.32	3.28	3.25	3.23	3.20

CEEMEA

	Current spot	Q1 20	Q2 20	Q3 20	Q4 20
USDRUB	62.65	60.67	60.06	60.24	59.79
USDTRY	5.95	5.84	5.91	6.06	6.20
USDZAR	14.54	15.00	14.88	14.77	14.66
USDILS	3.46	3.47	3.44	3.40	3.36
EURPLN	4.27	4.21	4.19	4.20	4.21
EURCZK	25.23	24.92	24.72	24.79	24.74
EURHUF	338	339	340	339	338

Note: Past performance and forecasts are not a reliable indicator of future performance.

Asia FX
Still climbing the wall of worries

- **We maintain our forecasts for a modest appreciation of our preferred Asian currencies. The US-China trade deal and the dovish US Fed support this outlook.**
- **We remain cautious on the relative outlooks for the Indian rupee as well as the Philippine peso. We downgrade our forecast for the Thai baht due to uncertainty about Chinese tourism.**
- **The trajectory of the new coronavirus epidemic will be a key near-term risk for our forecasts. Our baseline scenario is for the eventual control of the disease.**

Asia's top-performing currencies in the new year of the rat have been Indonesian rupiah (IDR), Chinese renminbi (CNY), and Malaysian ringgit (MYR) while Korean won (KRW), Indian rupee (INR), and Philippine peso (PHP) showed relative softness (see chart 1). This ranking of spot returns in the emerging Asian region is roughly consistent with our earlier outlook, but the pronounced weakness of the Thai baht (THB) came to us as a modest surprise. We maintain our previous constructive forecasts for the currencies, as we judge that the positives (US-China "phase 1" deal, data improvements, geopolitical calm despite some recent noises on Iran and North Korea) outweigh the near-term impact of China's new coronavirus (nCoV) epidemic.

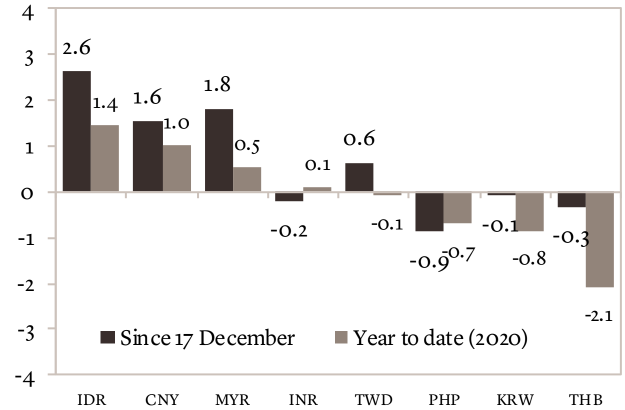
We are vigilant about the risks that the new epidemic poses to our scenarios for 2020. We still assume that public health authorities in the region will respond adequately to the risk as they have in South Korea's Middle East Respiratory Syndrome (MERS) outbreak in 2015 and Ebola threats in 2014-2016, but markets will likely gyrate somewhat during the regional public health authorities' initial containment efforts. We note that Asian currencies fared surprisingly well during the severe acute respiratory syndrome (SARS) epidemic of 2003, although this was partly due to the lack of genuine floating currency frameworks (e.g. MYR was a peg at the time) and the relative immunity of South Korea from the epidemic at the time (see chart 2).

CNY

We remain constructive on the yuan despite the recent challenge from nCoV epidemic, and we keep our 12-month target for USDCNY at 6.80. The "phase 1" deal between the US and China has put the yuan back where it was before Mr Trump's last tariff threats in August 2019, irrespective of the nCoV epidemic starting to hinder this reversal (see chart 3). The recovery seems reasonable as the deal removed the threat of additional tariffs and rolled back half of the newly imposed tariffs (15% —> 7.5%) on roughly USD 100 billion of Chinese exports to the US. We expect China to maintain the value of the yuan against the CFETS basket close to 92, and this, in combination with our USD view, would yield our new USDCNY 12 month forecast.

1. Asian currencies' spot performances

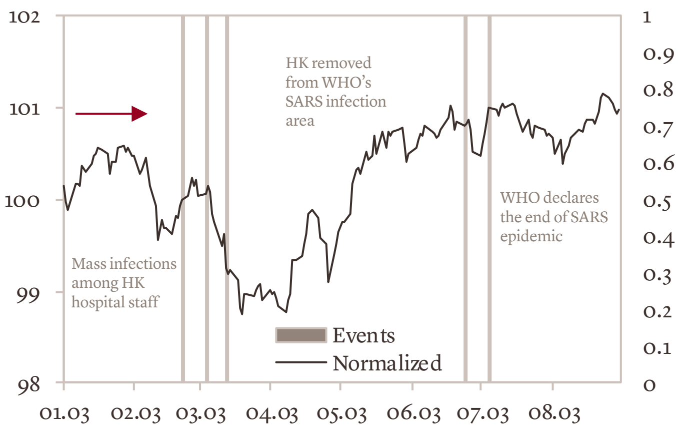
% gain versus US dollar, year-to-date and since the last publication, as of 21 Jan. 2020



Sources: Bloomberg, Lombard Odier

2. Asian dollar index (i.e. Asian FX vs USD) in SARS episode

1 Jan. 2003 = 100, key episodes in SARS epidemic



Sources: CEIC, Bloomberg, Lombard Odier

Note: Past performance and forecasts are not a reliable indicator of future performance.

Asia FX
Still climbing the wall of worries

KRW, TWD, THB

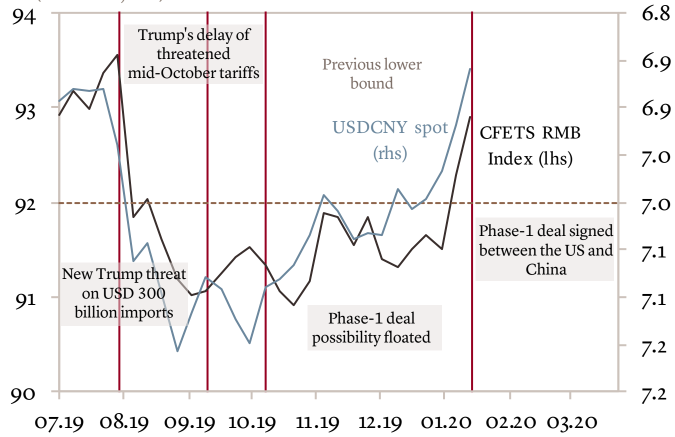
We upgrade our forecasts for KRW and new Taiwan dollar (TWD) and downgrade our forecast for THB. For these trade-sensitive currencies, the prospect of relative calm between the US and China and recovery in global trade should be sufficient reason for them to perform well versus the US dollar, notwithstanding the nCoV epidemic. For South Korea, we were cautious in December due to what appeared to be imminent North Korean provocations (“Christmas gift”). Fortunately, this did not materialise. Furthermore, the ruling party was able to pass a substantially larger budget with the help of minor parties in the National Assembly’s early December session. This will boost the country’s fiscal impulse in 2020 (see chart 4).The voter discontent over rising property prices appear to be nudging the government toward macro-prudential control, hence making the Bank of Korea flinch before easing. These combinations point to KRW appreciation.

We still believe that TWD is set for a solid year in 2020 despite its mixed performance thus far. The ruling party’s clear mandate in the January double elections (presidency and legislative yuan), while widely anticipated, ensures a stable terrain for macro policy in the next few years. The country’s solvency metrics are the best in the entire emerging market complex as we highlighted earlier, and its tech exporters will likely benefit from the near-term recovery in semiconductors as well as medium-term upturn in global demand for high performance computing and next generation telecommunication equipment.

While THB also tends to benefit from a positive turn in global trade, the Bank of Thailand’s determination to fight baht strength and the possible coronavirus-related disruption in Chinese tourists arrivals will weigh on the currency in the near term. We note that Thailand is more exposed to China’s outbound tourism due to the importance of its tourism industry and simple geographical proximity (see chart 5). We downgrade our forecast for THB in H1 2020 for this reason. Thailand’s strong external balances, however, should still limit the downside risk.

3. "Phase-1" deal restored the yuan’s value to summer 2019 levels

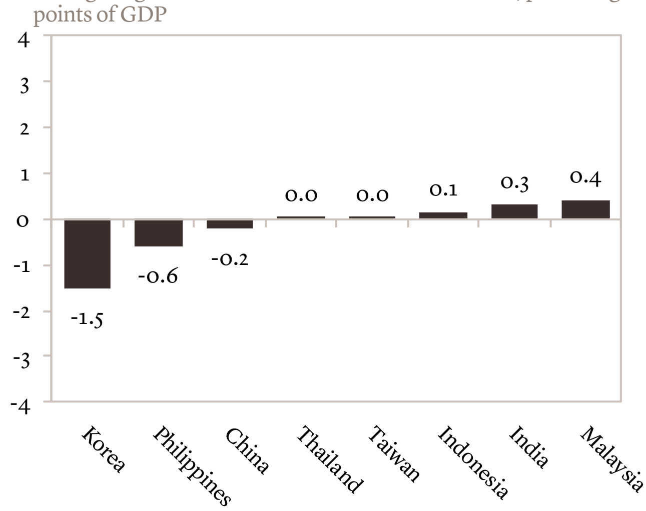
CFETS RMB Index (31 Dec 2014 = 100, left), USDCNY spot (inverted, rhs)



Sources: Bloomberg, Lombard Odier

4. Fiscal impulse should be substantial in South Korea

Change in government balance from 2019 to 2020, percentage points of GDP



Sources: Bloomberg, Lombard Odier

Note: Past performance and forecasts are not a reliable indicator of future performance.

Asia FX
Still climbing the wall of worries

INR, IDR, MYR, PHP

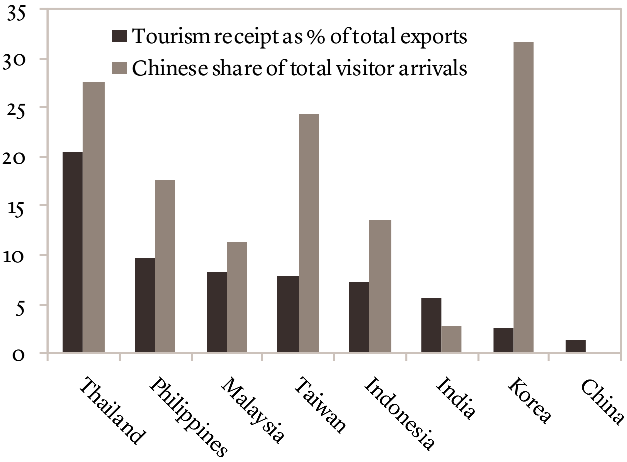
We maintain our relatively negative view on the Indian rupee. The latest data on overall goods and services tax (GST) receipts suggest that growth bottomed in Q3 2019, and we believe that the combined fiscal and monetary easing last year should support cyclical recovery in next few quarters. The Reserve Bank of India, however, will likely tolerate a period of low real interest rate to ensure that the country achieves a clear escape from the recent downturn (see chart 6). While we expect India's real rates in 2020 to be better than the deep negative levels seen in December (mostly due to brief food price spike), we believe that the rupee has to be softer than its regional peers to allow growth recovery.

We also maintain our slightly cautious view on the Philippine peso. The Bangko Sentral ng Pilipinas (BSP) appears to be biased to act again to bring headline inflation back to its target range, but the fading impact of the end of rice quota system and better fiscal impulse create the risk of slightly better than expected inflation in H1 2020. In that case, domestic real rates will fall further while twin deficits widen. The corresponding pick-up in domestic growth could still attract foreign capital, but we expect any gain in the currency to be more limited versus its peers.

In terms of sensitivity to real rate and global cycle, IDR and MYR look better in comparison to INR and PHP. Incidentally, Indonesia and Malaysia are also popular destinations for global investors chasing returns outside the US. They are also benefiting from the recent upturn in palm oil prices. For this reason, we modestly upgrade our forecasts for these two currencies, especially since we believe there is scope for the US Fed to express its dovishness again and cause the USD to depreciate further. We believe that local politics will remain mostly conducive to a degree of policy discipline in 2020.

5. Thailand's sensitivity to Chinese tourism warrants caution

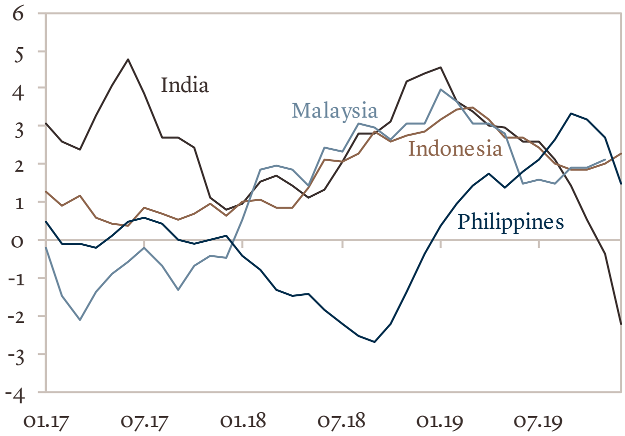
Tourism receipt as % of total exports and Chinese share (%) of total visitor arrivals



Sources: Bloomberg, Lombard Odier

6. India has undergone a steep decline in real interest rate

South Asia's policy rate (monthly average) minus headline CPI inflation, %



Sources: Bloomberg, Lombard Odier

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LatAm FX
Re-iterating our preference for MXN over BRL

- **Within LatAm, the MXN has strengthened even as the BRL weakened, both in line with our fundamental preferences. We further tweak forecast to show MXN outperforming BRL**
- **The COP, one of our least preferred currencies, has rallied sharply though this is broadly in line with the performance of petro-currencies. We stay defensive**
- **The CLP is cheap but faces a potentially seismic constitutional referendum in late April.**

Mexican peso: Staying constructive and marking-to-market recent gains

At the end of 2019, our MXN forecasts were more optimistic versus market consensus. We expected USDMXN to drift lower to 18.30. Consensus was extremely conservative at 19.50. We have lowered our USDMXN forecast to 18.60 (from 18.88) but keep a year-end forecast at 18.30. With year-end forwards at 19.66, we believe MXN provides an attractive opportunity.

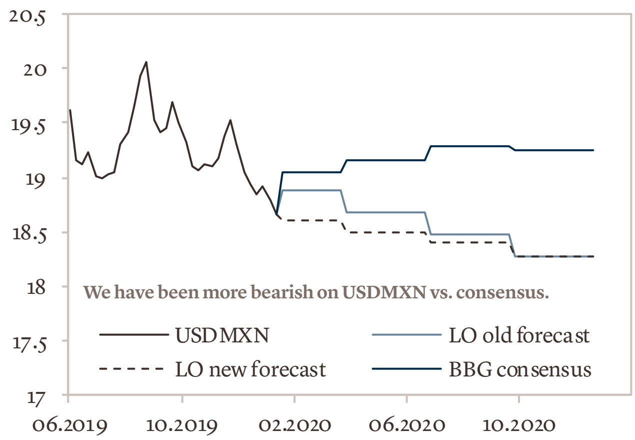
Our reasoning remains. **First**, the MXN undervaluation looks extreme (-8%) and at levels that saw the currency recover. **Second**, the current account position has been improving, partly due to weak growth. These flows should prove supportive for the MXN. **Third**, FX carry and real rates remain attractive and will remain so, even if the central bank eases further. **Fourth**, concerns may be overdone about the impact of a potential rating downgrade to state-owned enterprise PEMEX. This is because a downgrade is priced into USD bonds, while Mexico`s still-strong investment grade (IG) sovereign rating should remain intact given low government debt levels. Fifth, with the IG rating and debt-related flows at historically weak levels, there is scope for a recovery in flows.

Event and risks to the view: Democratic primaries in Iowa (starting February) could create some volatility. Main risks likely in H2, including US focus on migration in lead-up to US election, some likely weakening in fiscal figures and a reshuffle of the central bank board in Q4. CB meetings take place on 13 Feb. and 26 March.

Brazilian real: Lagging as expected. We lower the forecast profile

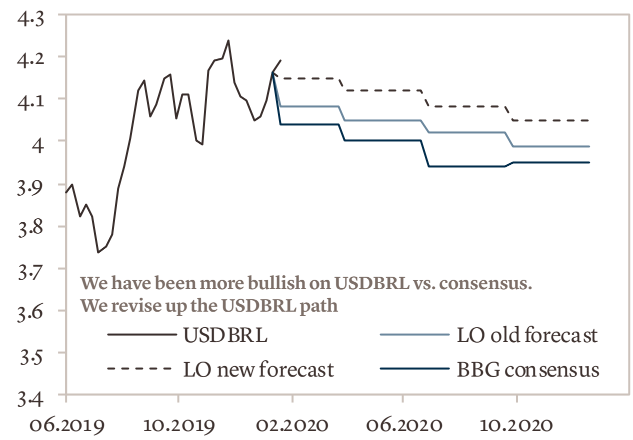
At the end of 2019, we signalled a more conservative view on the BRL, forecasting USDBRL at 4.08 at the end of Q1, versus market consensus of 4.05. Our year-end forecast of 3.99 was also above the 3.95 consensus. This said, our caution was well founded in both valuations and the direction of FX flows. We believe we are seeing the impacts of both in the 2% rally in USDBRL over the past month. We therefore revise our USDBRL forecast (turning more negative on the BRL) to 4.15 for Q1, and a more modest decline to 4.05, striking a balance between weaker BRL FX fundamentals and our expectations for a more positive backdrop for EM and softer USD.

1. We remain bullish relative to consensus for the MXN…



Sources: Bloomberg, Lombard Odier

2. …and stay more bearish on the BRL vis-à-vis consensus



Sources: Bloomberg, Lombard Odier

Note: Past performance and forecasts are not a reliable indicator of future performance.

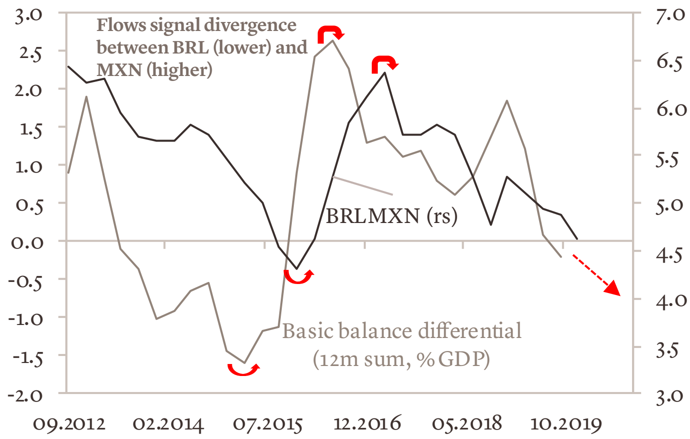
LatAm FX
Re-iterating our preference for MXN over BRL

Our cautious BRL view is based on the following. **First**, the BRL is undervalued but not yet at extreme historic levels. Hence we do not think the current levels provide value. **Second**, a weaker current account (C/A) position will likely offset the FDI potential improvement expected by markets. The C/A was already deteriorating even as Brazil benefitted from increased exports to China. Slower China-bound exports (as China buys more from the US) may further compromise the C/A. **Third**, portfolio inflows, while depressed, are unlikely to re-rate significantly higher. Much of the decline in debt-related inflows was a function of the sovereign losing its IG status.

While reforms are moving in the right direction, Brazil is still quite far from re-gaining its investment grade rating. This will limit debt-related inflows. **Fourth**, there is some evidence that lower local rates have resulted in Brazilian corporates issuing more in local currency (as opposed to hard currency), reducing some BRL support. Further rate cuts from the CB will likely accelerate such trends. For more on our economic outlook on Brazil, please see [Investment Strategy Bulletin: Has Brazil turned a corner? Five key points on what to expect in 2020)].

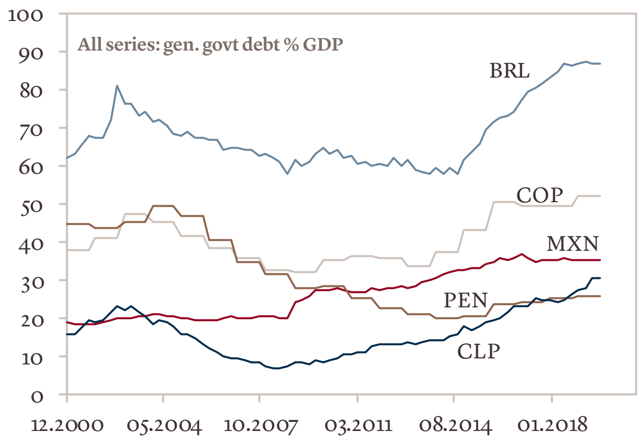
Events and risks to the view: CB meetings (Feb 5, Mar 18) and the return of Congress (Feb). The pace of FDI inflows and IPOs expected by market watchers underwhelms the market. Slowing in reform momentum ahead of October municipal elections.

3. Flow direction points to further BRLMXN downside



Sources: Bloomberg, Lombard Odier

4. Govt debt: MXN, PEN, and CLP in a healthier place



Sources: Bloomberg, Lombard Odier

Chilean peso: valuations attractive but wait for April event risk to pass

We summarise our CLP view as follows. **First**, the CLP offers value. Relative to longer-term macro fundamentals (copper prices, government debt, and growth differentials compared with the US), it appears 12% undervalued and at historical extremes (chart 4). **Second**, in the next 3-6 months, political risks will play a large part until an important constitutional referendum in late April. The referendum will ask voters whether a new constitution is required, and if so, who should draft it. This marks a potential shift from a 1980s market-oriented constitution. **Third**, the CLP has historically performed poorly in March. **Fourth**, the real impact of the referendum, like increased fiscal spending and other populist policies, may not hurt the CLP later. This is because Chile (along with Peru) has much lower government debt levels compared with other countries (chart 4). Hence, we believe that the CLP can recover after May.

Events and risks to the view: CLP could perform better if the central bank of Chile decides to increase USD selling intervention and USD liquidity provisions, after reducing them last month. The referendum is scheduled for 26 April.

Note: Past performance and forecasts are not a reliable indicator of future performance.

LatAm FX
Re-iterating our preference for MXN over BRL

Colombian peso: oil prices help but curb your enthusiasm

We remain cautious on the COP because, **first**, the trend in the basic balance (current account and FDI) are the most important COP factors. With the country receiving a consistent 3%-plus of GDP in annual FDI, the current account deficit has widened to -5.4% of GDP in recent quarters. This widening has been driven by the trade balance and so tends to be persistent. **Second**, while the focus is on Chile, if protests in Colombia escalate and result in more populist policies, it will put COP under pressure. This is because debt levels for Colombia are already high, and the sovereign rating is on shakier ground (with S&P rating agency having the sovereign just one notch above investment grade). For now, this risk should be contained with Colombia`s constitution already more socially-oriented compared with Chile, in the new year.

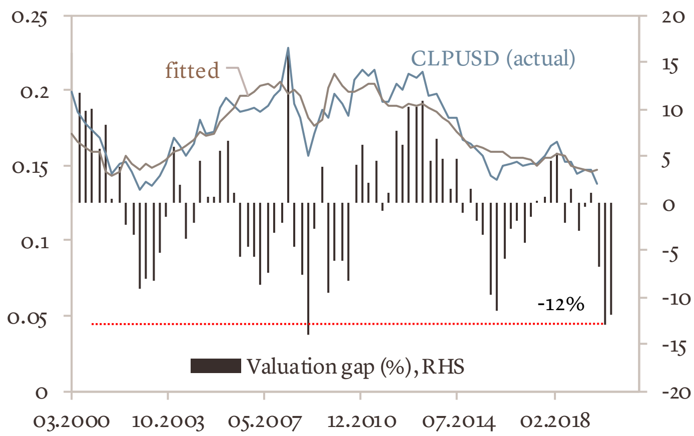
Event and risks to the view: National committee to hold a national meeting to discuss strikes (Jan 30). Spreading protests leads to more fiscal spending, worsening the budget profile. Real rates currently too low for this risk.

Peruvian sol: a good carry play

We like the PEN because first, the currency is undervalued relative to its long-term drivers. Second, as a commodity-exporter (mostly copper), Peru's currency may benefit from some small recovery in commodity prices over H1. Third, any prospect of fiscal loosening could help the PEN as activity recovers. Its relatively low government debt (under 30% of GDP) and high credit rating should serve the PEN well. Fourth, with the PEN's FX carry almost comparable with the BRL, but consistently lower realised volatility, the PEN is a good FX carry vehicle.

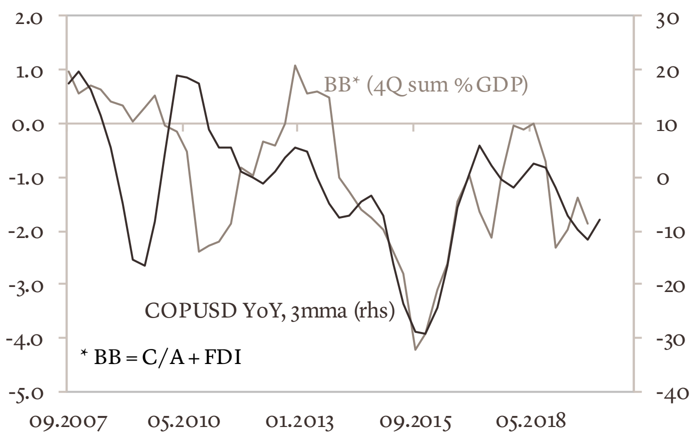
Event and risks to the view: Weaker copper prices given concerns over the China virus. Monitor CB`s interventions.

5. CLP – still as cheap as ever.



Sources: Bloomberg, Lombard Odier

6. COP: Wider external balance signals vulnerability



Sources: Bloomberg, Lombard Odier

Note: Past performance and forecasts are not a reliable indicator of future performance.

CEEMEA FX
Upgrading the RUB and the CZK

- **We revise our RUB forecasts higher on a higher likelihood of fiscal spending in Russia**
- **Similarly, we revise CZK higher. The currency offers a decent yield, exposure to better eurozone growth and improved flows**
- **We stay cautious on the ZAR with several events likely to highlight the country`s weak fiscal position in February and March.**

Russian ruble: recent political developments increase our conviction

The RUB remains one of our favoured currencies. **First**, the RUB is undervalued, even though the undervaluation has decreased somewhat. **Second**, any fiscal policy loosening should see the RUB strengthen as the country's central bank slows FX purchases linked to the budget rule. This should allow the RUB to strengthen towards fair value. Recent developments, including the duty cuts provided to Finance Minister Siluanov, point towards further fiscal spending. **Third**, a short-term seasonal factor: Q1 tends to be positive for the RUB given a rise in the trade balance and a decline in external debt payments compared with Q4. **Fourth**, both FX carry and real yields remain high.

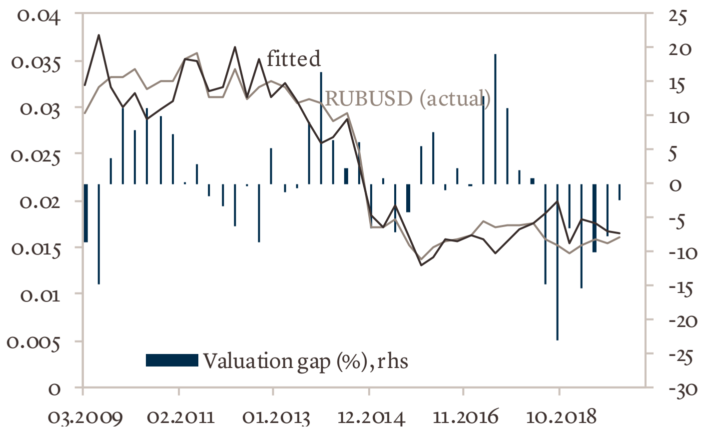
Events and risks to the view: Weaker energy prices. The risk of US sanctions have been a concern, but now appear to have receded. However, any renewed talk of sanctions may lead to periodic volatility in the RUB. Portfolio flows were high at the end of last year, making them vulnerable to negative news.

South African rand: good performance, so far

Our more bearish view on the ZAR can be summarised as follows: First, the ZAR is about 5% overvalued when we factor in government debt and commodity prices. Second, South Africa is heavily dependent on risk-sensitive portfolio investment, in debt and also equities. Third, a downgrade by Moody's rating agency looks likely in Q2. This would trigger automatic selling by benchmarked funds (representing more than 2% of GDP in debt-related portfolio outflows with benchmark fund trackers holding nearly 67% of all outstanding local debt). USDZAR will then likely rally sharply. Fourth, beyond such an initial shock, a more benign backdrop for EM and expectations for a weaker USD, USDZAR should remain capped around 15.00 with some softening in H2.

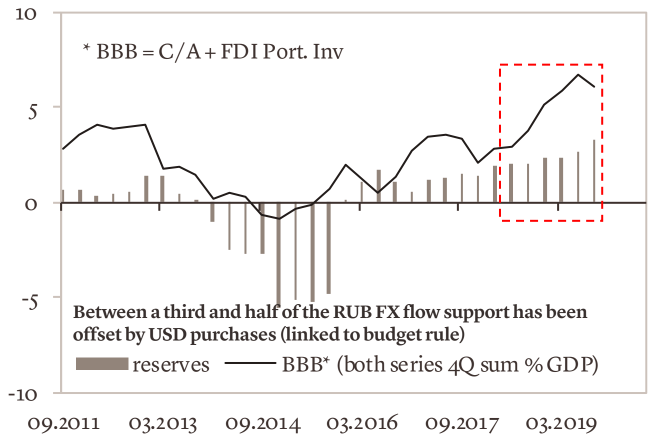
Events and risks to the view: Key dates include the President`s State of the Nation Address (13 February) and national budget (26 February), followed by a likely Moody's rating update (27 March). The rating agency put sovereign paper on a negative outlook in November 2019.

1. RUB – currency is undervalued



Sources: Bloomberg, Lombard Odier

2. Budget rule-related FX reserve accumulation should reduce under fiscal stimulus, seeing RUB rally with strong flows



Sources: Bloomberg, Lombard Odier

Note: Past performance and forecasts are not a reliable indicator of future performance.

CEEMEA FX
Upgrading the RUB and the CZK

Turkish lira: Hard to play

Our cautious TRY view can be summed up as follows: First, while the TRY is likely to weaken, it is not clear if USDTRY will outperform FX forwards. This favours exposure when risk premia are high, but holding off when risk premia are low (as is the case now). Second, while in recent years the TRY has weakened sharply to fresh lows, we see that once we normalise for structurally higher unit labour costs and worsening external debt trends, the currency appears about 5% overvalued. Third, the improving current account and decline in local dollar holdings has helped the TRY remain relatively stable. However, this may reverse as the recent increase in credit growth filters through. Fourth, fiscal deficit has been widening fast and may weaken the current account. Fifth, while the country's central bank has cut rates, further small cuts are priced in. This suggests that the catalyst for a TRY sell-off is unlikely to come from a central bank policy signal.

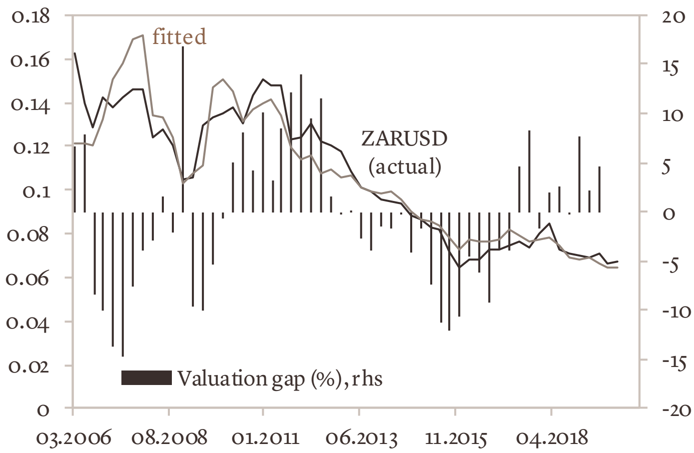
Events and risks to the view: US potentially imposing sanctions on Turkey for its acquisition of Russian S-400 anti-aircraft weapons. The country`s Financial Action Task Force (FATF) status following a December report which pointed to serious shortcomings.

Israeli shekel: resilient low-yielder

We like the ILS, despite its low yields. First, flows support ongoing ILS appreciation pressures. All three levers of balance of payment flows, namely the current account, FDI and portfolio investment have been FX-supportive (chart 4). Second, while the ILS is considered a safe haven, we believe the currency will still hold up, even in our favoured scenario where global uncertainties dissipate in 2020. This is because over the past year, large equity outflows (equivalent to 3% of GDP) outpaced net bond inflows, and likely helped recycle Israel's sturdy C/A surplus. In a better global backdrop, if equity inflows recover, this will likely increase appreciation pressure on the ILS (chart 5). Third, neither rate cuts nor small interventions by the Bank of Israel (BoI) are likely to weaken the ILS. Over December, the pace of FX intervention has picked up to levels not seen since Q3 2016 (chart 5). However, it is not clear if this will reverse the ILS trend rather than slow it. More significant intervention – as seen in H1 2009 - would be needed, but this seems unrealistic.

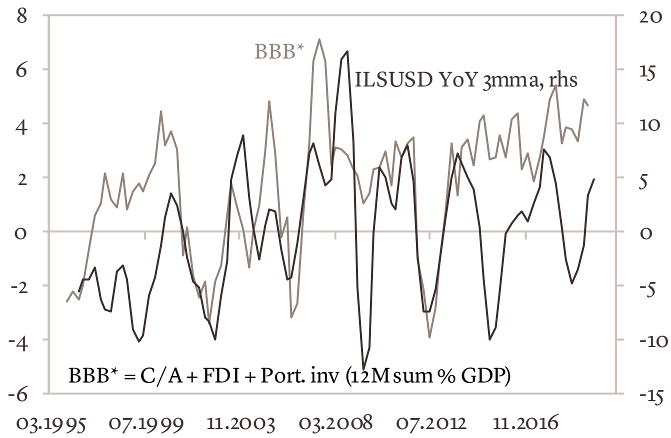
Events and risks to the view: We would be bearish if BoI flags significant FX intervention, or an outright USDILS floor (as the CNB did).

3. ZAR: still expensive relative to its drivers



Sources: Bloomberg, Lombard Odier

4. ILS – supported by formidable inflows



Sources: Bloomberg, Lombard Odier

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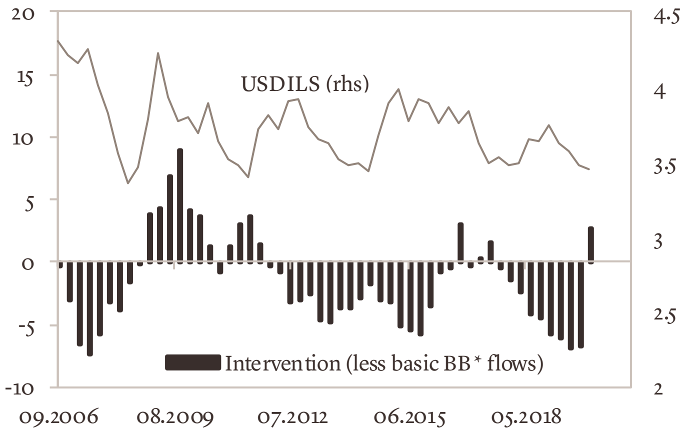
CEEMEA FX
Upgrading the RUB and the CZK

Central Eastern Europe: More constructive on Czech koruna. Hungarian forint is our preferred funding currency

For CEE, in general a stronger rebound in EURUSD and better news on global growth should result in a fall in the EURCEE. We have already seen this in recent weeks with EURCZK selling-off sharply from above 25.50 to under 25.10 and EURPLN (euro-Polish zloty) from 4.28 down to 4.23. In contrast, EURHUF rallied from 330 up to 335 over the same period. We believe this divergence will continue and so lower our EURCZK forecast in line with our preference for CZK. CZK is supported by higher interest rates, strong domestic activity, a tight labour market and improving flows (chart 6). We also lower our EURPLN forecast, but less aggressively, as we believe that a widening C/A deficit and specific risks related to the stock of Swiss franc mortgages will hold the currency back. Finally, we agree with the bearish divergence in HUF. The current account surplus, previously a source of HUF support, has been softening, driven by a rise in energy related imports. We do not believe the central bank will turn hawkish given recent rises in inflation.

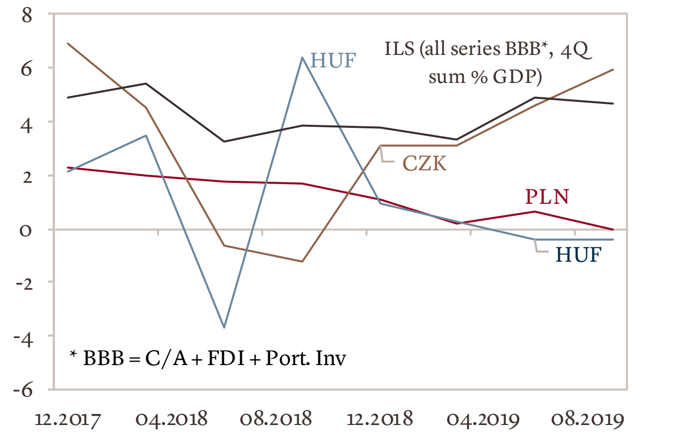
Events and risks to the view: Faltering positive indicators for the eurozone and auto sector and/or a re-escalation in tariff concerns over the auto sector. Noise on CHF mortgages for PLN ahead of the May 2020 presidential elections.

5. Amid very strong inflows, an aggressive BoI intervention would be needed to stop the ILS from appreciating



Sources: Bloomberg, Lombard Odier

6. FX flows improve most for the CZK



Sources: Bloomberg, Lombard Odier

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Glossary

ASEAN
Association of South East Asian nations

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

BIS
Bank for International Settlements

BRL
Brazilian Real

CEEMEA
Central eastern Europe, middle east and Africa

C/A
Current account

CFETS
China Foreign Exchange Trade System.

CFTC
Commodity Futures Trading Commission

CLP
Chilean Peso

CNY
Chinese Yuan

COP
Colombian Peso

CZK
Czech Koruna

DXY index
US Dollar Index (DXY)

EM
Emerging market(s)

EMFX
Emerging market currencies

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

GBIEMFX
JP Morgan Emerging Market Currency Index

HUF
Hungarian Forint

IDR
Indonesian Rupiah

ILS
Israeli Shekel

INR
Indian Rupee

KRW
South Korean Won

LATAM
Latin America

MXN
Mexican Peso

MYR
Malaysian Ringgit

PEN
Peruvian Sol

PHP
Philippine Peso

PLN
Polish Zloty

RT
Real time

RUB
Russian Ruble

SGD
Singapore Dollar

THB
Thai Baht

TRY
Turkish Lira

TW
Trade-weighted (dollar, etc.)

TWD
Taiwan dollar

ZAR
South African Rand

1W
1-week

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SWITZERLAND

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

LONDON
Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom · london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
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Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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MADRID
Lombard Odier (Europe) S.A. · Sucursal en España[2]
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
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Bank Lombard Odier & Co Ltd · Representative Office Moscow
2 Letnikovskaya st.2, bld.1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
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PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
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RCS PARIS B 803 905 157 · paris@lombardodier.com
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South Africa Representative Office · Bank Lombard Odier & Co Ltd
140 West Street · Sandton
Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

MONTEVIDEO
Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com
Supervised by Banco Central del Uruguay.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
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