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FX Monthly
Euro breaking free from political hurdles

07/12

July-August 2020

Key highlights

- The structural theme of the dollar correction lower remains in place
- We maintain our EURUSD forecast to 1.17 by year-end
- EURCHF should gradually gain, but the road may be subject to frequent setbacks
- Near term, GBP should struggle, but medium term a basic EU/UK deal should lend support
- JPY remains a solid play; we still target 103 for year-end
- We modestly lower our USDCNY forecasts and expect spot to be heavy in July before facing volatility in August. In EMFX, we stay constructive on CLP, CZK, ILS and KRW
- We expect more near-term stability for COP (one of our EMFX year-ahead "underperformers") on government FX sales, but foresee more volatility for the RUB as markets re-focus on the potential for US sanctions heading into the US elections.

FX forecasts		Q420	Q221
G10	EURUSD	1.17	1.18
	USDJPY	103	102
	EURCHF	1.11	1.12
	GBPUSD	1.28	1.30
	EURGBP	0.91	0.91
EM	USDCNY	6.99	6.94
	USDINR	75.1	74.5
	USDIDR	14 638	14 492
	USDMXN	22.3	22.1
	USDBRL	5.44	5.55
	USDRUB	73.0	72.5
	USDZAR	17.40	17.80

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Important information: Please read important information at the end of the document. Data as of 21 July 2020

At a glance

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Introduction

Euro breaking free from political hurdles

The dollar correction remains largely in place. After a short (technical) move higher in late June, the Bloomberg USD index is down 1.5% so far in July, with most major G10 and EM currencies registering gains.

- Absent a significant global virus resurgence (or any other "black swan" event), we expect this trend to continue throughout H2 20. Three factors shape our reasoning. **First**, the pricing out of risk premia as the global economic recovery gets under way in the second half of this year; second, ongoing dollar overvaluation (around 10% based on our estimates) on a trade-weighted basis; and third, a significant shift in euro-area solidarity, cooperation, and fiscal management in periods of crisis.
- We maintain our target of 1.17 for the euro/US dollar (EURUSD) by year-end, and see risks to the upside. At the same time, we expect only a gradual euro/Swiss franc (EURCHF) appreciation: pricing out political risk premia in the euro area will be a tailwind, but Switzerland is showing an unwillingness or inability to recycle abroad its sizeable current account surplus. For sterling, we continue to see a bumpy road in the near term, and recovery will materialise only once a basic EU/UK deal becomes imminent. We remain constructive on the Japanese yen (JPY) primarily due to its very attractive valuation.
- In the Nordics, we keep our preference for the Norwegian krone (NOK) over the Swedish krona (SEK), due to stronger Norwegian fundamentals. Within the commodity FX bloc, we favour the Australian dollar (AUD) due to its sensitivity to the Chinese business cycle (which is currently in an upswing), and to a lesser extent the Canadian dollar (CAD) and New Zealand dollar (NZD).
- The US dollar-Chinese yuan cross (USDCNY) could move towards the bottom of a 6.92-7.16 "tariff-neutral" zone initially before grinding higher as the August Republican and Democratic conventions begin. However, we would expect spot to move back towards 7.00 in Q3. We would view a Biden Presidency (and Democratic sweep) as bullish for the Chinese yuan (CNY), but bearish for the Russian rouble (RUB).
- In emerging markets (EM), a sharp turn lower in EM data surprises has seen EM currencies lag behind broader risk assets.
- Valuation-wise, we remain neutral on the overall GBIEMFX index, as better growth differentials will be offset by rising debt burdens. We maintain our preference for currencies with healthier fiscal balances and exposure to Chinese infrastructure (Chilean peso - CLP and South Korean won - KRW), as well as to European growth (Czech koruna - CZK) and to the resilient tech sector (Israeli shekel - ILS). We remain cautious on the Brazilian real (BRL), Columbian peso (COP), South African rand (ZAR), and Turkish lira (TRY), although the COP could hold up temporarily as the government pursues its FX sales.

Main risks to our USD-bearish view: First, a second strong Covid-19 wave that again disrupts economic activity and increases demand for dollars. While the rise in the US infection rate is worrisome, we think it will prove mostly localised due to transportation restrictions and governments around the world being better prepared. Second, a re-escalation of China-US trade frictions (in the form of higher or new tariffs) would halt the recovery in global trade and would underpin the greenback.

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FX forecasts – G10 and gold

	Current spot	Q3 20	Q4 20	Q1 21	Q2 21	Estimates of long-term fair value[2]
EURUSD	1.14	1.15	1.17	1.18	1.18	1.18
GBPUSD	1.27	1.26	1.28	1.30	1.30	1.40
EURGBP	0.90	0.91	0.91	0.91	0.91	0.85
EURCHF	1.07	1.10	1.11	1.12	1.12	1.04
USDCHF	0.94	0.96	0.95	0.95	0.95	0.89
USDJPY	107	104	103	102	102	94
EURJPY	123	120	121	120	120	110
EURSEK	10.26	10.45	10.50	10.50	10.50	10.05
USDSEK	8.97	9.09	8.97	8.90	8.90	8.60
EURNOK	10.53	10.45	10.40	10.35	10.30	9.28
USDNOK	9.21	9.09	8.89	8.77	8.73	7.94
AUDUSD	0.70	0.71	0.72	0.73	0.73	0.73
NZDUSD	0.66	0.66	0.67	0.67	0.67	0.64
USDCAD	1.35	1.32	1.31	1.30	1.30	1.26
Gold	1 811	1 700			1 600	

2 The estimates of long-term (LT) fair values are calculated as the average value estimated using FEER and BEER models. The FEER (fundamental equilibrium exchange rate) model calculates the exchange rate required to bring macroeconomic balance, i.e. full-employment, low inflation and a sustainable current account balance. The BEER (behavioral equilibrium exchange rate) model uses econometric methods to estimate equilibrium FX rates based on a set of macroeconomic variables (our model uses terms of trade, investment as a share of GDP, and real rates within a panel data set across G10 FX).
Please refer to page 27 for a more detailed explanation.

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

FX forecasts – EM

Asia

	Current spot	Q3 20	Q4 20	Q1 21	Q2 21
USDCNY	6.99	7.02	6.99	6.96	6.94
USDHKD	7.75	7.75	7.75	7.75	7.75
USDIDR	14 785	14 711	14 638	14 564	14 492
USDINR	74.9	75.29	75.14	74.88	74.54
USDKRW	1 203	1 202.16	1 196.15	1 184.19	1 172.34
USDMYR	4.26	4.25	4.24	4.22	4.20
USDPHP	49.4	49.48	49.38	49.48	49.38
USDSGD	1.39	1.39	1.38	1.38	1.37
USDTWD	29.5	29.46	29.32	29.07	28.80
USDTHB	31.8	31.73	31.65	31.57	31.49

LatAm

	Current spot	Q3 20	Q4 20	Q1 21	Q2 21
USDMXN	22.5	22.4	22.3	22.2	22.1
USDBRL	5.39	5.41	5.44	5.47	5.55
USDCOP	3 651	3 687	3 715	3 743	3 771
USDCLP	785	784	780	773	766
USDPEN	3.52	3.54	3.53	3.52	3.50

CEEMEA

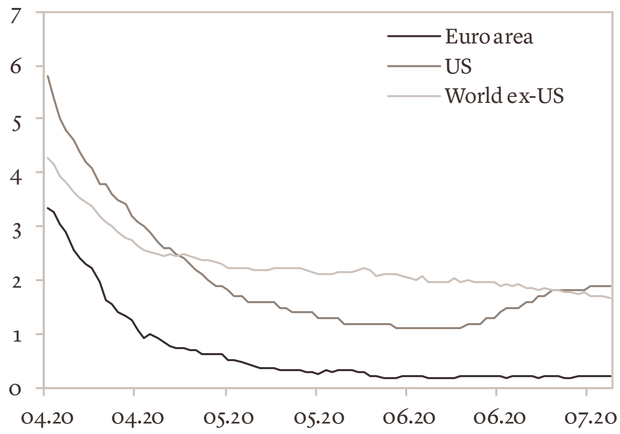
	Current spot	Q3 20	Q4 20	Q1 21	Q2 21
USDRUB	71.7	72.8	73.0	72.9	72.5
USDTRY	6.86	6.99	7.13	7.28	7.42
USDZAR	16.7	17.0	17.4	17.6	17.8
USDILS	3.43	3.38	3.37	3.36	3.35
EURPLN	4.47	4.44	4.43	4.42	4.41
EURCZK	26.6	26.5	26.4	26.3	26.2
EURHUF	353	353	354	355	355

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

G10FX: Three key charts

The Covid-19 infection rate has stabilised in most developed countries. Euro-area countries appear to have managed the pandemic successfully, with the virus spread remaining under control despite the re-opening of their economies. In contrast, the absence of coherent and responsible policies in the US has led to a significant resurgence of the virus there.

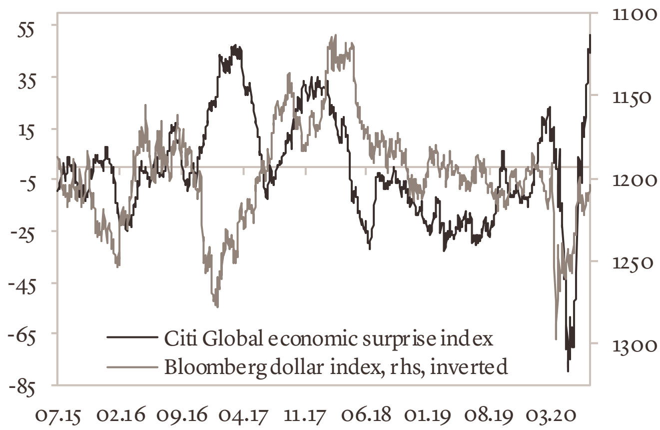
1. Covid-19 infection rates, daily % change, 7-day moving average



Sources: Bloomberg, Lombard Odier.

The gradual exit from stringent lockdowns and improvement in the infection curve (barring the US) has led to economic data rebounding – albeit from low levels. This recovery in activity – likely to remain in place for the remainder of this year – has put pressure on the dollar as risk premia are being priced out.

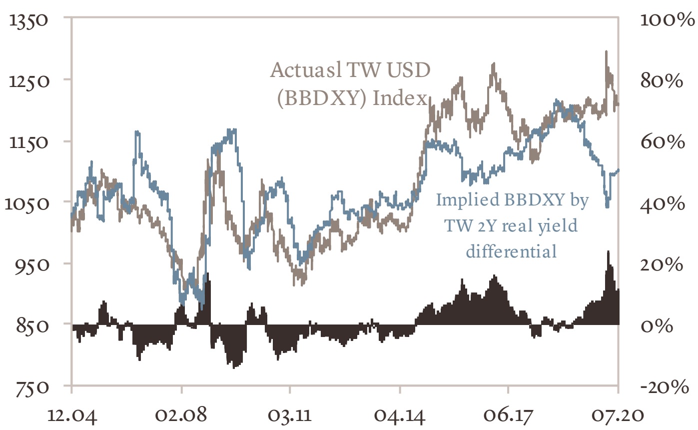
2. Dollar down as data improves... more USD weakness ahead



Sources: Bloomberg, Lombard Odier.

Since mid-March of this year, the trade-weighted (TW) dollar has depreciated by 7%. However, the greenback remains overvalued, and we expect further pressure to materialise in the course of H2 20. The **main risk** currently to our USD bearish view is a second strong pandemic wave that would re-ignite demand for dollars.

3. TW USD should remain under pressure



Sources: Bloomberg, Lombard Odier.

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Special: Biden and the dollar

The US elections will be held on 3 November 2020. The Democratic Party's presidential candidate Joe Biden has consistently led versus incumbent president Donald Trump in the opinion polls of the past few months. However, since early June – a period coinciding with the virus resurgence in multiple US states – Biden's lead has increased considerably (see chart 4).

There are still three and a half months until Americans head to the polls, and a variety of developments could change the end-result. In addition, opinion polls are always subject to a margin of error and have provided faulty estimates on several occasions in the past.

Nonetheless, the magnitude of Joe Biden's lead, coupled with 1) the increasingly worrisome and complex Covid-19 situation in the US (due to the absence of a coherent strategy by the current administration) and 2) the fact that Biden is leading in most key battleground states, suggests that the Democratic candidate is likely to become the next US president.

What would a Joe Biden presidency mean for the USD? In short, we think it would point towards a softer dollar. We base our assessment on the following considerations.

First, a Biden presidency would represent a return to normalcy and more conventional policymaking. In that respect, currencies would be "allowed" to trade more on the back of economic fundamentals rather than on political risk premia. On that metric, the USD remains (at least for now) overvalued.

Second, Biden is likely to remove the risk of tariff wars, something that propelled the USD higher in 2018 and 2019. As he discussed in an article for Foreign Affairs (Why America Must lead Again), the best way to ensure that China opens up to world trade in a fair way is for the US to form strong alliances to protect intellectual property/technology transfers as well as human rights. Biden opposes tariffs, so it is likely that under his presidency, the import tariffs unilaterally imposed on China will be scrapped or significantly reduced.

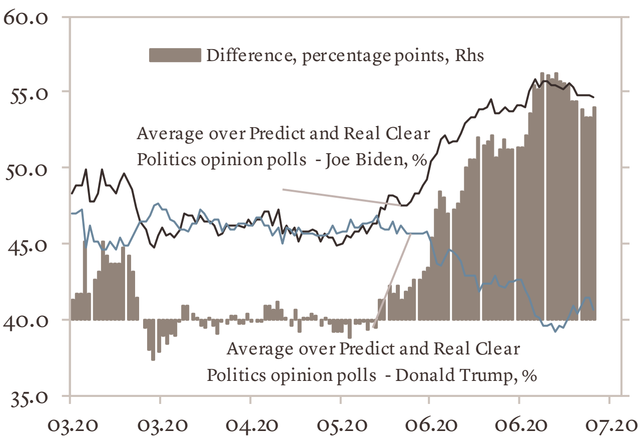
Third, while Joe Biden should not be seen per se as bad for markets, an increase in the corporate tax rate from 21% to 28% (according to his pledge) is likely to see outflows from the US, which in turn would pressure the dollar.

Fourth, Biden is likely to make active use of fiscal policy (especially if Democrats manage to control the Senate), with a focus on tax reform, income re-distribution, and health care. Biden has said he is committed to paying for all spending rises with tax increases. However, out of the nearly USD 7 trn that his plan envisages in public spending, his tax plans are estimated to raise only USD 4 trn in revenues over the next ten years. This suggests that further increases in the federal deficit (currently at 14% of GDP) and federal debt (currently at 108% of GDP) are likely. While the servicing of debt remains rather easy given nearly-zero interest rates, currencies are a relative play: at the margin, further significant rises in the US deficit and debt – coupled with an existing current account deficit – should be negative for the dollar (see chart 5). Of course, there is the possibility of large infrastructure spending, which – if it raises the productive capacity – would be a positive driver for the USD. Even in such a scenario, the impact on the USD would more likely be felt over the medium term; it is highly improbable that markets would see such a policy as having the same immediate effect as that of the corporate tax rate reduction by the Trump administration. Moreover, any near-term dollar support would likely be more than offset by the increase in the corporate tax rate, which would be perceived as unfriendly for portfolio flows to the US.

Fifth, Biden is likely to re-appoint Jerome Powell as the Federal Reserve Bank (Fed)'s chair. Current Fed communication has been rather dovish, with a strengthening of the forward guidance, which now suggests no rate hikes until at least 2023.

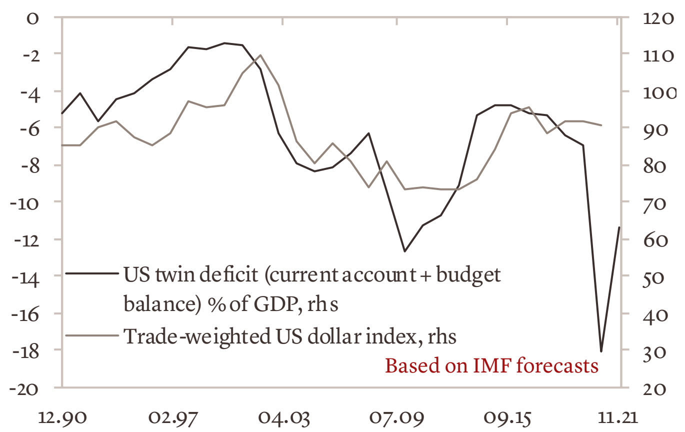
In all, there are still plenty of uncertainties regarding both the outcome of the US elections and the exact policies to be enacted by a Biden presidency. Given what we know so far, we believe that on balance, a Biden victory would point towards a softer dollar.

4. US election opinion polls



Sources: Bloomberg, Lombard Odier.

5. Long-term relationship between US twin deficit and the dollar



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Euro: Stay constructive

- **We maintain a positive EUR stance and target 1.17 for EURUSD by year-end; we see risks for further upside**
- **The ingredients of the euro recovery – valuation, USD downside, and more euro-area solidarity – remain largely in place.**

EURUSD has risen by nearly 7% since its year-low in mid-March (1.0688), and is now up 1.9% for the year. USD downside and optimism on euro area economic prospects have contributed to this appreciation.

We maintain a constructive stance on the currency – and recently purchased 2% of EURUSD in most of our portfolios – based on the factors below.

First, valuation remains attractive (we estimate fair value at around 1.18 – see chart 6).

Second, the global economic recovery that is likely to continue throughout H2 20 should weigh further on the (still) overvalued dollar. With rates in the US at near-zero and the dollar's carry advantage having eroded, rate differentials continue to suggest upside for EURUSD – see chart 7.

Third, developments in the euro area on the political/fiscal front are quite encouraging (see chart 8), marking a shift towards more solidarity and cooperation. In that respect, the EU agreement on the EU recovery fund is a major step forward.

Fourth, the Chinese rebound appears to have gained traction, with domestic demand picking up quickly – as evidenced in the recent Chinese import data. Historically, periods of sharp acceleration in Chinese activity have coincided with EURUSD appreciation cycles.

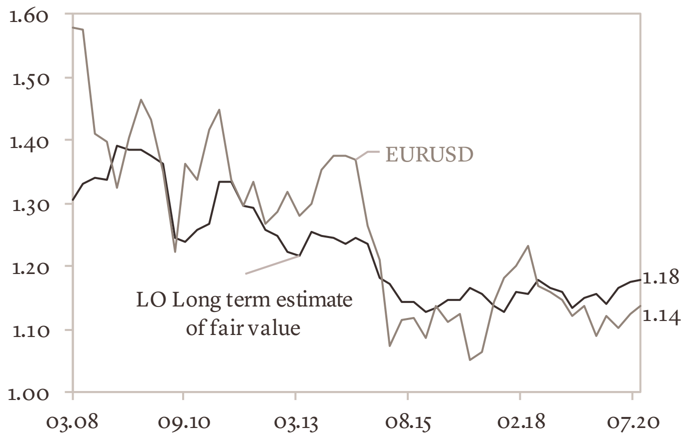
Fifth, while EUR upside is becoming a "consensus" trade, the speculative community is not heavily long – and certainly not near the extreme positioning seen in 2017. Hence, it is unlikely to prove an impediment to EUR gains for the time being.

We maintain a target of 1.17 for year-end, and we think the balance of risks is to the upside

Main risks to our view:

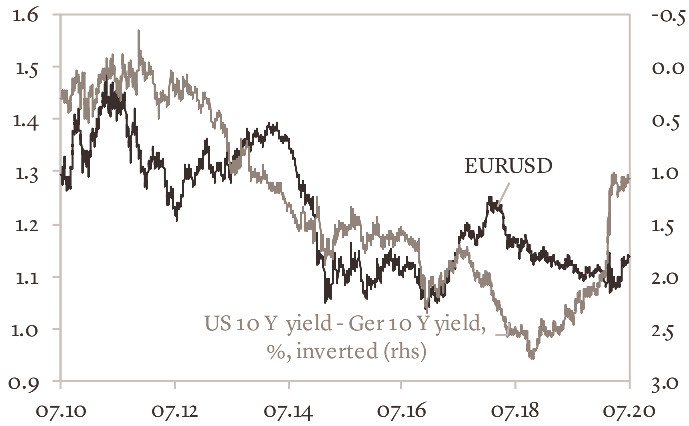
1. A second strong and widespread Covid-19 wave that would derail the global and euro-area recovery and increase demand for dollars.
2. A re-escalation of China-US frictions, mostly via a ramping-up of trade tariffs.
3. A premature scaling-back of euro-area member states' fiscal support that would curb the trajectory of the euro area recovery.

6. EURUSD to close the undervaluation gap



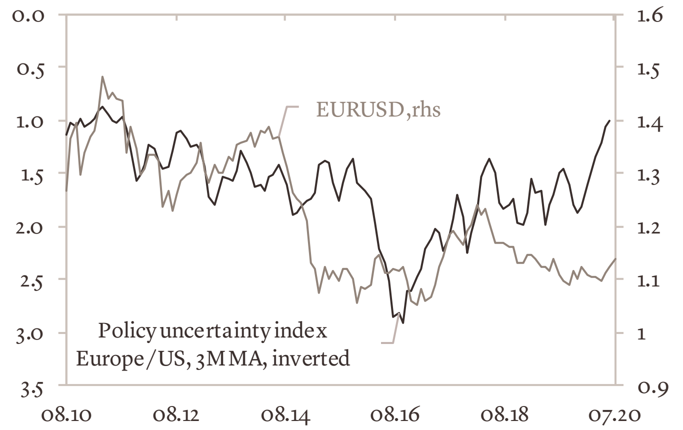
Sources: Bloomberg, Lombard Odier.

7. EURUSD still too low relative to the GE-US yield spread



Sources: Bloomberg, Lombard Odier.

8. Political risk perception improves in Europe



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Swiss franc: A mild EURCHF recovery, but hurdles on the way

- **EURCHF has diverged from EURUSD recently**
- **We still expect a pick-up in Swiss outflows, but this may be gradual.**

Despite EURUSD appreciation, EURCHF has failed to follow through, having dropped from above 1.08 in early June back to 1.07 as of writing. In fact, there is a growing wedge between EURUSD evolution and that of EURCHF (see chart 9). We attribute this to the following three factors.

First, with US real yields so compressed, there has been enormous pressure on USDCHF that effectively has spilled over to EURCHF.

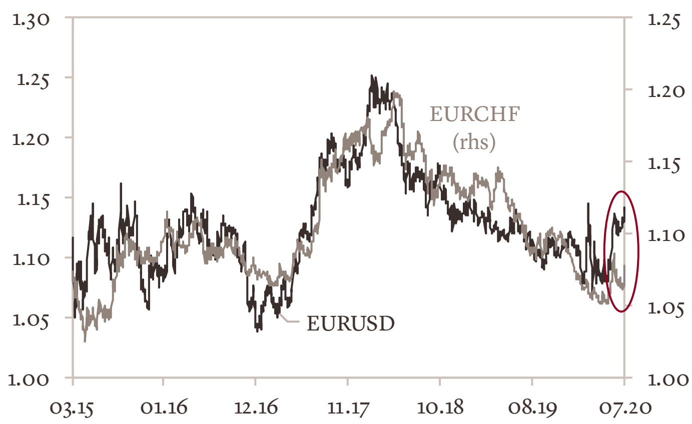
Second, as Covid-19 risks subsided, the SNB stepped back from aggressively intervening in the foreign exchange market. If we model the historical relationship between EURUSD and EURCHF and calculate the "residuals" (i.e. the portion of EURCHF that cannot be explained by movements in EURUSD), we find that (a) this portion has increased recently; and (b) this increase appears to correlate with the SNB's withdrawal of FX intervention (see chart 10). Put simply, left to its own devices, EURCHF exhibits an inability to appreciate even as euro political risk premia decline.

This brings us to our third factor: Switzerland is currently finding it difficult to recycle its sizeable current account surplus abroad. Eventually, we think improving euro-area prospects will lead to a pick-up in portfolio outflows that should in turn weigh on the franc. But the EURCHF trajectory is likely to be only mildly upward sloping and fraught with frequent setbacks

Main risks to our view:

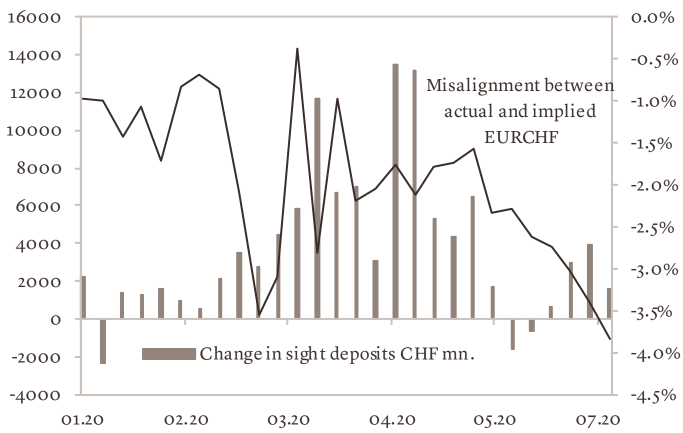
1. A second strong Covid-19 wave that affects Europe significantly would increase demand for Swiss francs.
2. An intensification in EU-US trade frictions (going beyond the tariffs recently announced for a certain number of French products) would also disrupt euro-area recovery prospects and underpin the franc.
3. CHF could also find support in a scenario where China-US frictions escalate to the point that the hit to global trade undermines EMU export prospects.

9. A recent divergence between EURUSD and EURCHF...



Sources: Bloomberg, Lombard Odier.

10. ... partly reflects the SNB stepping back from FX intervention



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Pound sterling: Recovery on shaky ground

- **Sterling finding its footing but on shaky ground, at least for now**
- **Farther out, we expect a recovery under the assumption of a basic EU/UK deal before the end of the transition period.**

Sterling has managed to find its footing somewhat in recent weeks, rising to 1.26 against the USD (from the June low of 1.23) and to 1.1050 against the EUR (June low of 1.0940). Part of the appreciation reflects the USD downside, and another part, the recent additional UK fiscal stimulus (worth approximately 1.4% of GDP). We expect a bumpy road for GBP in the next few months and anticipate a convincing recovery only once a "skeleton" deal with the EU becomes imminent (Q4 20).

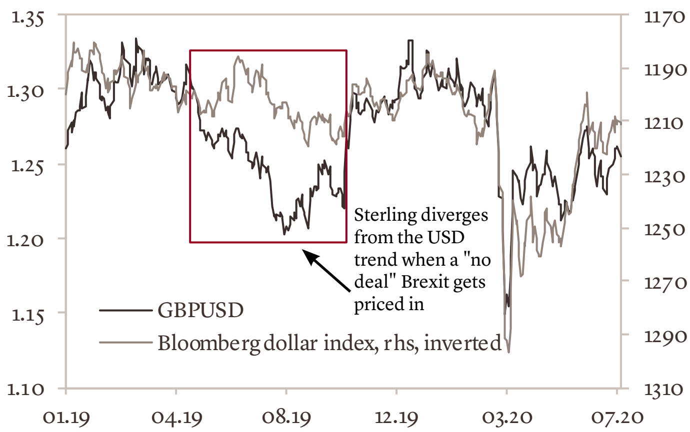
First, we are surprised about the market's complacency on the lack of Brexit developments. While the two sides have intensified the frequency of their discussions, Michel Barnier, the EC Head of Task Force for Relations with the UK, expressed very recently that significant divergences remain. The rest of the summer will likely see plenty of headline risk that could push sterling lower (even diverging from the dollar trend – see chart 11), especially since time has now become extremely tight.

Second, data in the UK underscore the economic challenges ahead; the latest monthly GDP figure showed a monthly expansion of 1.8% (from -20.3% in April) falling far short of expectations for a 5.5% bounce.

In the medium term view, we still expect a basic EU/UK deal by 2020-end sparing the UK from the structural damage associated with defaulting to WTO rules. This should support GBP towards the end of the year.

Main risks to our view: For the near term, a risk to our cautious GBP stance emanates mainly from a swift progress in Brexit discussions. Our medium term constructive view would be seriously challenged in case EU/UK negotiations fail to find common ground and the UK exits the transition period with no deal. If so, we would expect GBPUSD to fall to 1.10 or below and EURUSD to rise to parity.

11. More divergence around the corner?



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Japanese yen: Stability only temporary

- **USDJPY has been trendless since mid-June as solid risk appetite is offsetting the broad USD downside**
- **However, all previous USD depreciating cycles have seen both the JPY and equities gain. This time should be no different.**

USDJPY has been relatively trendless since mid-June, hovering close to the 107 level. It is likely that JPY tailwinds from broad USD downside are being offset by headwinds due to better risk appetite. However, we maintain our view of USDJPY depreciation for the rest of the year, and remain underweight in our portfolios. This is based on the following factors.

First, although it is true that JPY is historically negatively correlated with equity prices, previous cycles of USD depreciation have seen both equities and the yen rise (see chart 12). If we are right that we are currently in the midst of a dollar correction, then the USD factor should matter more and put pressure on USDJPY.

Second, USDJPY remains significantly overvalued as well as considerably dislocated from US-JN yield differentials. The negative carry of being short USDJPY is minimal and this should see investors hedge their foreign equity and, most importantly, bond exposure – especially as expectations of USD downside are rising.

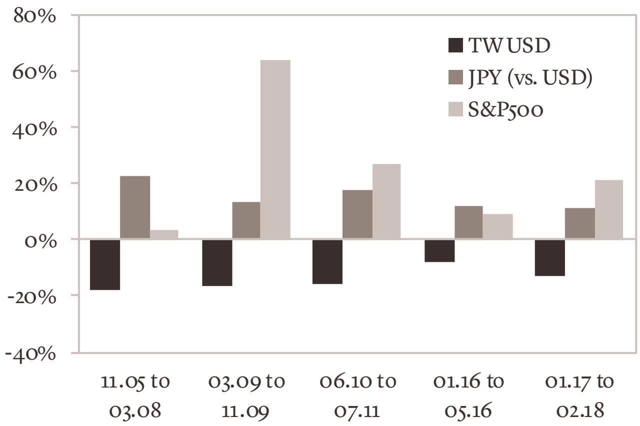
Third, JPY still serves as a solid hedge against an adverse scenario of risk appetite deterioration.

Fourth, Japanese buying of foreign equities – a source of USDJPY support lately – has moderated significantly recently and, given current stock valuations, is unlikely to return to the extremely high levels of April/May.

Main risks to our views:

1. A far stronger global economic recovery than the one we expect.
2. A quick discovery and wide distribution of a Covid-19 vaccine would serve as a catalyst for a temporary appreciation in USDJPY.
3. The BoJ increasing its sovereign bond-buying programme (quite unlikely in our view).

12. USDJPY has depreciated in all other USD depreciation cycles



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

Nordics: we still prefer the Norwegian krone to the Swedish krona

- **EURNOK has stabilised recently, while EURSEK has continued depreciating**
- **Better domestic data should allow EURNOK to resume depreciation; EURSEK should benefit from improving euro area prospects, but only modestly given domestic hurdles.**

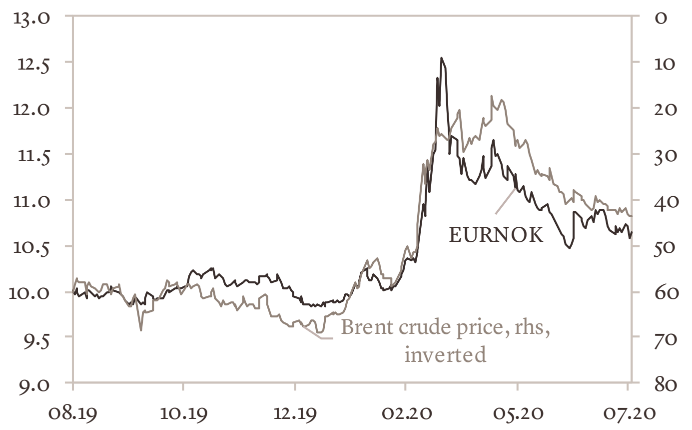
The Nordic currencies (NOK and SEK) have followed somewhat differing paths recently: EURNOK has stabilised below 10.60 (following its heavy depreciation since mid-March), while EURSEK has continued south, now at the 10.25 level. On one hand, stability in EURNOK mainly reflects range trading in the oil price – see chart 13 (as well as some recent declines following a decision to curb OPEC+ production cuts). On the other hand, ongoing SEK appreciation is likely driven by the pricing in of economic recovery; SEK is considered a leveraged play on trade and growth, as Swedish exports account for 46% of GDP, compared to 38% for Norway.

NOK: We still expect a gradual return to EURNOK depreciation towards 10.45 by year-end. We base our view on three factors. **First**, EURNOK remains considerably overvalued. **Second**, historically, upside in EURUSD has coincided with EURNOK downside – because better euro-area prospects imply improvement in Norwegian underlying fundamentals. **Third**, domestic economic dynamics remain robust (the Norges Bank has acknowledged that activity has picked up faster than expected), with underlying inflation rising by over 3%, making the Norges Bank one of the first central banks likely to raise rates (slated for mid-2022, as communicated in its latest monetary policy report).

SEK: Turning to the SEK, we think that the sell-off in EURSEK is approaching oversold levels (see chart 14) and we expect a rebound in the near term, potentially towards 10.60 or higher. Farther out, the pair should converge towards 10.50 or so. On one hand, this positive view rests on SEK's sensitivity to global trade and growth (improving). On the other, SEK appreciation should be modest given continued sluggish domestic data. Unemployment has shot up this year to 9% from 6%, something that bodes ill for household incomes and domestic consumption. At the same time, inflation is well below the Riksbank's target, which will allow the central bank to stay pat for a considerable time.

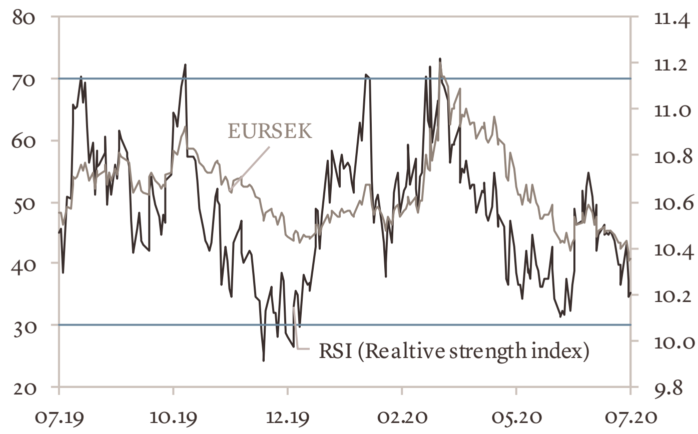
Main risks to our view: In the case of NOK, there are two main risks, which may be interrelated: the failure of the euro-area recovery to gain traction (e.g. because of a second strong virus wave), and/or oil price declines. In the case of the SEK, the main risk relates to external factors that could disrupt the global recovery and weigh on cyclically sensitive currencies like the SEK.

13. EURNOK roughly in line with oil price



Sources: Bloomberg, Lombard Odier.

14. EURSEK approaching oversold levels



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Commodity currencies: Poised for some further (selective) upside

- **Commodity currencies have on average performed well during Q2 20**
- **We expect further Australian dollar and Canadian dollar gains, and some modest New Zealand dollar upside.**

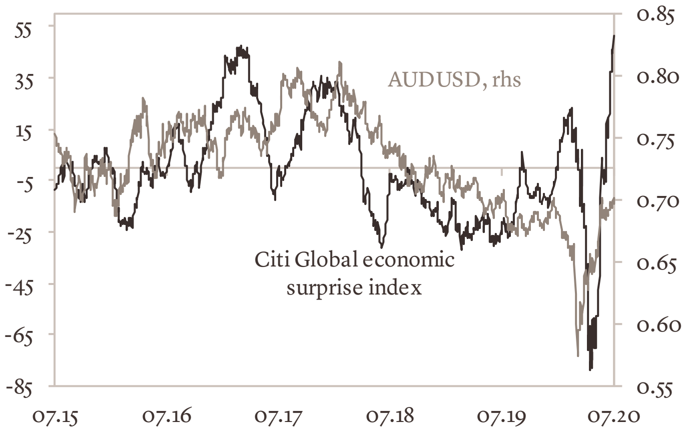
AUD: AUD has been on a very strong appreciating trend since mid-March, having risen by 21%. While this gain seems quite sizeable and subject to some reversal, we still hold a constructive medium-term view. **First**, the rebound in Chinese activity – especially in imports of raw industrials – will remain a source of support for the AUD. Global economic data corroborate this view (see chart15). **Second**, AUDUSD is still undervalued to the tune of 4% (based on our estimates). **Third**, AUD has one of the highest correlations/beta to the dollar, so continuation of USD downside should propel AUD even higher. **Fourth**, despite the recent appreciation, the Reserve Bank of Australia shied away from expressing concern over the currency in its latest monetary policy meeting. **Fifth**, the speculative community has only recently started building long exposure, which means that AUD longs are still not a crowded trade.

CAD: Following the CAD's rapid appreciation in the latter half of May, USDCAD has modestly appreciated towards 1.36. One important driving force has been the rise in virus cases in the US, which is likely to dampen and prolong the recovery with spill over effects on the US' main trading partners. Domestic labour market conditions have also deteriorated, with the unemployment rate having surged to 12% from 5.6% at the end of last year. We see two reasons for CAD gains to resume in the course of H2 20. **First**, valuation remains very attractive. **Second**, CAD should also benefit from USD downside. However, we acknowledge that our forecast of 1.31 for USDCAD by the end of the year is currently under upside risk.

NZD: NZDUSD has appreciated in line with AUDUSD, largely as a function of USD depreciation. While we think that the lower US dollar could drag NZD higher, we believe gains are likely to be modest. The Reserve Bank of New Zealand still sees risks to the downside, and has reiterated that it is prepared to deploy all policy tools to cushion the impact of the virus. The possibility of such measures is likely to restrain any NZD appreciating pressure, at least for the next three months or so, in our view.

Main risks to our view: First, a second virus wave affecting China and/or re-escalation of Chinese-US trade frictions would hurt the commodity FX bloc, most notably the AUD. **Second**, commodity price declines (due to subdued demand and/or increased supply) would deliver a blow to all commodity-linked FX. **Third**, if virus cases in the US continue to rise, then the prospect for a US recovery would become more distant, affecting the CAD negatively.

15. AUD has further upside in this cyclical recovery



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

Gold: Ongoing support from real yields

- **Gold has been trading in a range recently**
- **Near term, support is around USD 1,700/oz**
- **Medium term, we maintain our target of USD 1,600/oz.**

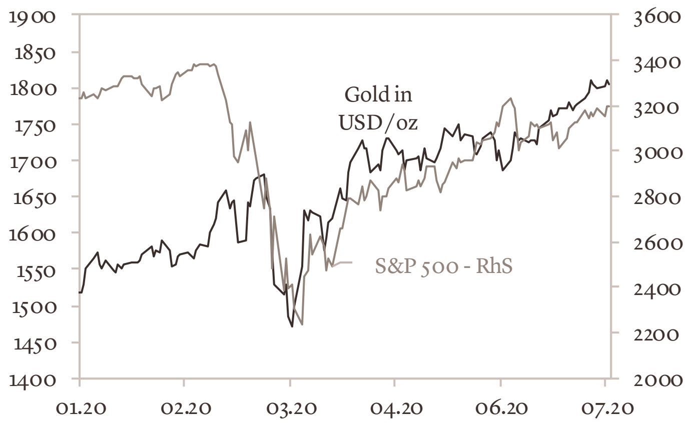
Gold is the only major commodity to post year-to-date double-digit gains (close to 20%), having recently broken the USD 1,800/oz mark, a level not seen since 2011. Short term, the combination of real rate compression, TINA (There Is No Alternative for investors), and expansive fiscal and monetary policies has lifted both equity markets and gold, exhibiting a positive correlation between the two asset classes – which is counter-intuitive as we consider gold as a hedge in our multi-asset portfolio (chart 16).

The still-high level of uncertainty surrounding the Covid-19 pandemic and weaker USD will prevent a strong correction in the near future such that gold should continue to overshoot our medium-term target.

The US Federal Reserve Bank's balance sheet expansion is a strong support, but its impact should fade as the recovery takes hold in the coming quarters. We maintain our 12M gold forecast at USD 1,600/oz.

Regardless of the recovery type, the pandemic will likely have a lasting effect on asset allocation. It will also continue to reinforce the role of gold as a strategic asset. Strategically, gold should remain in investors' portfolio allocation because it is one of the best alternatives to government bonds in periods of zero rates. It thus often (albeit not always) represents protection against a revival of market stresses at a time when the hedging capacity of traditional safe havens will be limited.

16. Gold and US equities both nearing historical highs
Central banks' liquidity injections and declining US real rates a support



Sources: Bloomberg, Lombard Odier.

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

EMFX: Three key charts

After trading in a low range from end-March, the GBIEMFX index rallied 7% between mid-April and 8 June, before falling again in June. The support came from energy prices, which increased the aggregate terms of trade for EM – an input into our model. EMFX now looks fairly valued (chart 17). From here, we maintain a neutral bias on the currency complex as a whole: while growth differentials may improve a little in EMs' favour, the rise in government debt/GDP will weigh on fair value. As far as energy prices are concerned, our year-end target (USD 40 per barrel) has already been reached. Gains from here may be harder to come by, and there will be more volatility as energy price returns are increasingly correlated with global equity markets.

A much weaker USD base, accompanied by a stronger recovery in global trade, could see GBIEMFX overshoot. However, we would prefer currencies of countries with manageable debt levels that would benefit from stronger Chinese stimulus (North Asia FX and Chilean peso in LatAm) as well as a stronger rebound in EURUSD (Czech koruna, Polish zloty and Israeli shekel).

Chart 18 compares the global PMI set against China's credit impulse, with the latter leading by 9 months. Since 2009, each strong recovery in global manufacturing activity (using the global manufacturing PMI as a proxy) was preceded by a rise in Chinese credit. We are seeing a rise in the latter in response to the negative growth shock from the lockdowns in response to Covid19.

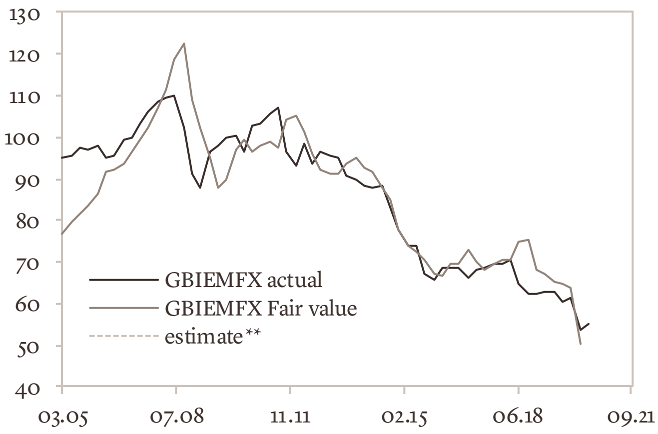
The National People's Congress (NPC) called for monetary policy to remain "prudent", and called for an "increase in money and credit growth". While this should broadly support growth-sensitive FX, including in emerging economies, currencies such as the Australian dollar in the G10 and Chilean peso and Korean won in EMs tend to show higher beta.

USDCNH has fallen to 7.00 in recent weeks, helped by a softer USD and markets pricing a stronger Chinese recovery, visible in higher Chinese yields and copper prices. We assume that US-China tensions will stay focussed on non-tariff areas and the "phase one" deal remains intact, allowing Trump to use this "success" in his presidential debates against Joe Biden after August and keeping China high on the debate agenda.

This could allow USDCNH to extend declines in the weeks ahead towards the bottom of a 6.92-7.16 "tariff neutral zone" (+/- 1.8% from implied fair value based on our model, see chart 19). However, we would turn cautious on CNH closer to August as we expect stronger anti-China rhetoric going into the US Presidential elections in early November. Relevant dates here are the Democratic National Convention (17-20 August) and Republican Convention (24-27 August). Expect rhetoric to increase ahead of (and after) these dates.

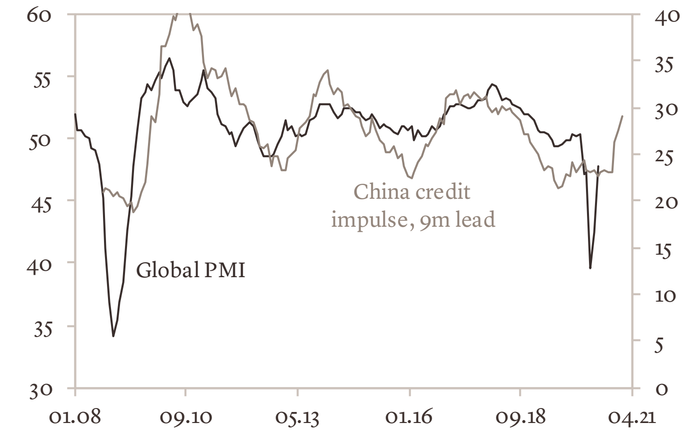
We see a Biden US Presidency, and especially a Democratic sweep, as bearish for USDCNH and bullish USDRUB.

17. GBIEMFX valuations in line with the recovery in energy prices



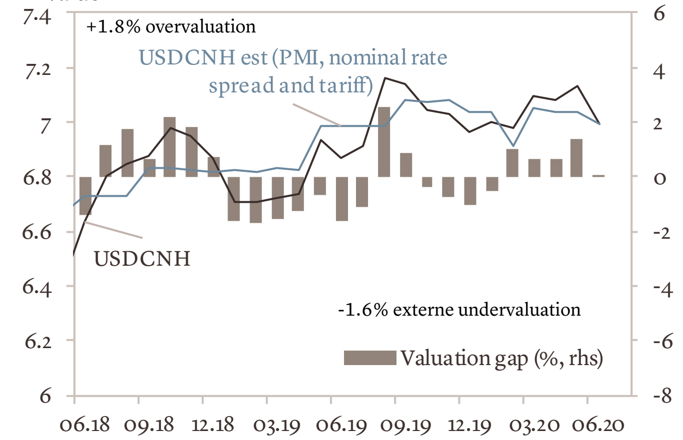
Sources: Bloomberg, Lombard Odier

18. Chinese credit impulse could benefit some parts of EM



Sources: Bloomberg, Lombard Odier

19. USDCNY range between 6.92 to 7.16 around short term fair value



Sources: Bloomberg, Lombard Odier

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Asia FX
Islands of relative stability

- **The outlook for Asian currencies remains positive as the region enjoys multiple advantages in public health infrastructure, economic positioning, and policy manoeuvring room**
- **We maintain our preferences for Korean won, Taiwanese dollar and Malaysian ringgit with neutral views on Chinese yuan, Indonesian rupiah and Thai baht. We remain cautious on the Indian rupee and Philippine peso, despite their recent gains**
- **China's stance on the yuan (CNY) in the renewed US tensions will continue to be the main risk for Asian currencies, but we expect China to keep CNY stable in H2 2020.**

Chinese yuan (CNY)

We continue to see a modest upside vs. USD in next 12 months. **First**, in line with our expectation, the value of the yuan relative to the official basket of trading partners' currencies (i.e. renminbi index) bottomed at around 92, underlining the importance of this level for Beijing in terms of stability guidance (see chart 20). **Second**, China's relatively high onshore rates remain a key anchor for the currency as rates elsewhere have fallen close to zero. Even if the People's Bank of China (PBOC) implements a few rounds of rate cuts in the near-term to support growth, the yield advantage could persist for some time. This will in turn dampen domestic depositors' appetite for foreign currencies and underpin foreign inflows into the country's onshore bond market. **Third**, the "phase 1" trade deal with the US remains in place, despite the recent noises on the US technology-related restrictions and Hong Kong. The tension will certainly cap the upside for the yuan, but we expect solid fundamentals to offset some of this pressure in the medium-term.

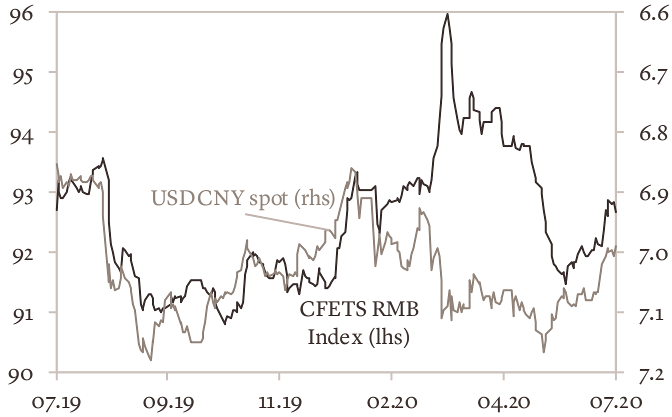
Risks to our views: Any escalation of tension with the US that leads to punitive restrictions on China's trade and investments will be the most important risk to monitor before the US presidential election. Second-wave infections (e.g. the new cluster in Beijing) will also be a risk, but we note that China has demonstrated the ability to contain potential new waves of infections so far.

Indian rupee (INR)

We remain somewhat cautious on the near-term prospects for the rupee and expect only slight appreciation vs. USD before the end of the year. **First**, India has not succeeded in controlling the Covid-19 epidemic despite a national lockdown lasting more than 70 days through June (see chart 21). **Second**, the Reserve Bank of India has shown its clear dovish bias on many occasions since March.Hints of calm in headline inflation and weak economic conditions will likely motivate the central bank to resume its easing in Q3 with additional cuts in benchmark rates and cash reserve ratio as well as

20. Renminbi index has rebounded from the 91~92 band

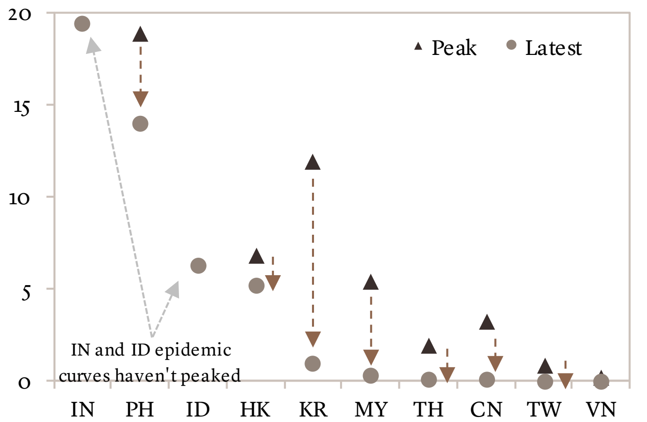
CFETS RMB index, 31 Dec 2014 = 100 (left), USDCNY spot, inverted (rhs)



Sources: Bloomberg, Lombard Odier

21. India suffers from one of the worst epidemic curves in Asia

Daily Covid-19 infections per million (7D rolling average), peak level v. now



Sources: Our World in Data, Lombard Odier

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

Asia FX
Islands of relative stability

expanded refinance operations (TLTROs).
Third, the good news is that state governments are implementing reforms in the country's growth-inhibiting labour market and land acquisition laws. Improved external balances (e.g. first current account surplus in 12 years in Q1 2020) also provide an anchor for the rupee, which will prove temporary.

Risks to our views: Second-wave infections will be the most important risk for INR's trajectory in H2 2020. The banking sector's fragility (especially in the aftermath of loan moratorium), the border conflict with China, and industrial commodity prices will remain as key risks.

Korean won (KRW)

We maintain our relatively constructive view on the Korean won despite the intermittent geopolitical risks in the surrounding regions. **First**, the country has been able to avoid extreme shocks to its economic activities thanks to its successful containment of Covid-19 epidemic and well-controlled re-opening process. Domestic consumption in particular has begun to grow already rapid disbursement of direct income support for households in early May (see Chart 22). This will make the country a global outperformer in growth in 2020.

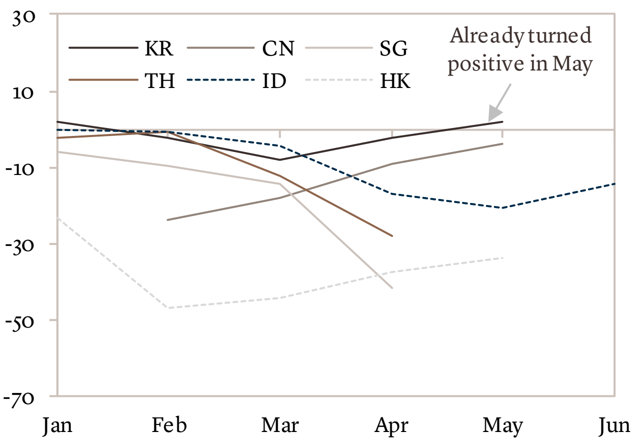
Second, strong tech demand, stable industrial commodity prices, and collapse in outbound tourism have pushed the current account balance back into surplus territory, and the external balance will likely remain positive in H2 2020 as the global economy recovers. **Thirdly**, public discontent over rapidly appreciating urban home prices has led the government to tighten its macro-prudential regulations for the sector, and this political pressure will weigh on the Bank of Korea's rather conservative in monetary easing, relative to its OECD peers.

Risks to our views: Geopolitical risks surrounding China and North Korea will remain a key risk for the Korean won. The rumours of an October tri-lateral summit between the two Koreas and the US, if confirmed, could push KRW higher.

Taiwanese dollar (TWD)

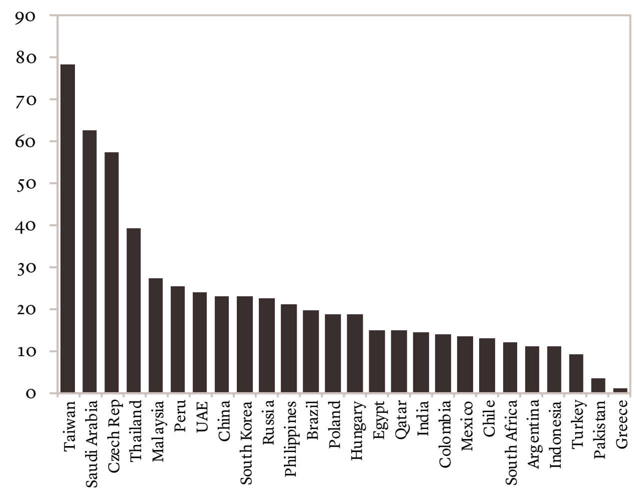
The TWD remains our favorite pick in emerging Asia due to its well-known sources of strength. **First**, Taiwan's public health responses to the Covid-19 epidemic have been particularly successful, and the country can anticipate the full normalisation of economic activities, unlike most of its neighbours. **Second**, the currency is underpinned by one of the most solvent systems in the world with net claims on foreign assets, FX reserves, and an external balance that is very high as a percentage of GDP (see chart 23). **Third**, the country may see the combination of life insurance companies' repatriation flows and equity flow recovery in H2 2020 if the global recovery, especially in the goods sector, continues as we predict.

22. Korean consumption already back to growth path
Real retail sales growth, % Y/Y (not seasonally adjusted)



Sources:Bloomberg, Lombard Odier.

23. Taiwan has the strongest solvency metric in emerging markets
FX reserve as % of nominal GDP (2018)



Sources: CEIC, Bloomberg, Lombard Odier

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

Asia FX
Islands of relative stability

Risks to our views: The main risks are a potential direct confrontation with China on President Tsai Ing-wen's hawkish stance on cross-strait relations, further escalation of tension between the US and China, and a shift in the US stance on Taiwan's currency policy.

Indonesian rupiah (IDR)

The rupiah turned out to be the worst performer among Asian currencies since mid-June, contrary to expectations. We remain neutral on the currency, but we see some scope for reversal of this modest loss in next few months. **First**, the details of the scheme to lower the government's financing costs via Bank Indonesia's primary market intervention ("BI-MOF burden sharing") were more conservative than many investors feared. Many of the bonds that Bank Indonesia will absorb via private placement will be in the form of special bonds that can be sold back to the market in the future as part of an exit strategy. **Second**, the government may not be able to distribute benefits to lower income households and informal sectors due to administrative bottlenecks, and spending in 2021 could be relatively muted due to the Finance Ministry's desire to control fiscal deficits. This could anchor market expectations of local currency bond supply. **Third**, the calm in global markets, the declining outlook for US real returns and Indonesia's newly acquired access to the Fed's USD liquidity (repo facilities) could underpin some recovery in portfolio flows to the local debt market.

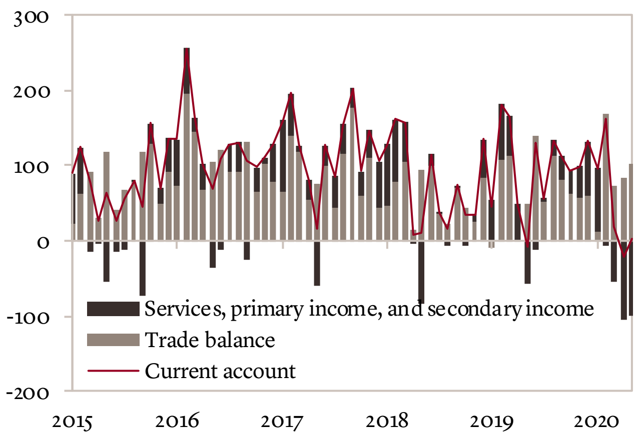
Risks to our views: The country's steadily rising Covid-19 epidemic curve with more than 1,000 cases per day, will be a key risk. Unexpected changes in President Joko Widodo's spending plans or the BI's bond market intervention could also put more pressure on the rupiah.

Thai baht (THB)

The trajectory of the baht since May has been in line with our view that the worst may be over for the currency. We are now neutral for THB over the next 12 months. **First**, Thailand has experienced an extreme collapse in tourism receipts, but a stable trade surplus, helped in part by more favourable terms of trade amid declines in industrial commodities. This has provided some buffer for the overall current account balance (see chart 24). **Second**, the Bank of Thailand has not been able to overcome the zero interest rate bound while the overall economy suffered a rapid lapse into deflation. This led to a spike in real returns in Q2, providing some anchor for the currency (see chart 6). **Third**, Thailand's response to Covid-19 has been very strong so far, and the country has begun to re-open without experiencing a second wave of infections. Still, the fragility of the vital tourism sector will continue to cap the currency's upside.

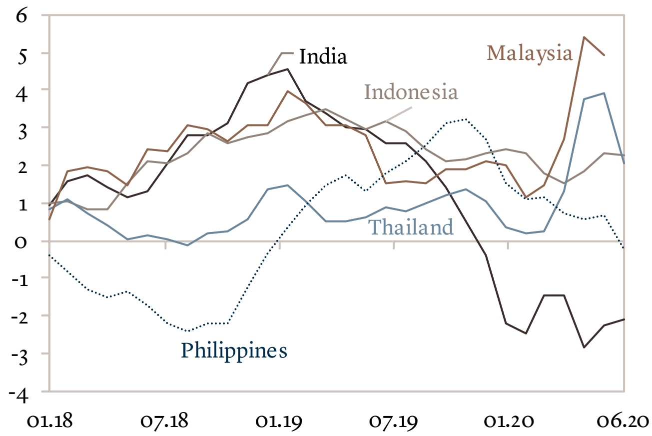
Risks to our views: The main risks are deterioration of the Covid-19 outbreak in Thailand's neighbours, the US stance on the country's currency policy, and the BoT's stance on widening fiscal deficits.

24. Goods trade offsetting tourism collapse in Thailand
Thailand's current account balance, THB million



Sources: CEIC, Lombard Odier

25. Deflation pushed real rates higher in Thailand and Malaysia
Benchmark policy rates minus CPI inflation, %pt



Sources: Bloomberg, Lombard Odier.

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

Asia FX
Islands of relative stability

Malaysian ringgit (MYR)

The ringgit's performance has been somewhat mediocre, but we maintain our constructive views for the currency in H2 2020. **First**, real rates in Malaysia have risen substantially in past few months due to deflation, and the real returns are in line with higher yielding markets such as Indonesia. This will appeal to investors who face years of limited real returns in key developed markets. **Second**, the government's record supplementary budget will ease the pressure on Bank Negara Malaysia (BNM) to cut its benchmark rates aggressively, which the bank is likely reluctant to do, given its focus on currency stability. We believe that the BNM will cut its benchmark rate just once in 12 months and then pause. **Third**, the country has been able to substantially contain the epidemic curve with more disciplined testing and contact tracing programme on par with better-known successes such as South Korea's. This enhances the credibility of the government's gradual re-opening strategy and improves growth prospects, especially as H2 2020 will see a recovery in overseas demand for Malaysia's merchandise exports.

Risks to our views: The main risks are an unexpected election decision by the ruling coalition, trajectory of local confirmed cases of Covid-19, oil price trends and their impact on the government's fiscal balance, and global demand for its industrial commodities and mid-end manufactures.

Philippine peso (PHP)

The peso has been a surprising outperformer in Asia due to its low sensitivity to China and domestic growth recovery underpinned by fiscal spending. We are not particularly bearish on the currency, but we believe that there will be better opportunities besides PHP once there is visibility about the global recovery in H2. **First**, the Philippines continue to face unstable epidemic curve despite punitive lockdowns in key metropolitan areas due to the extreme fragility of its public health infrastructure. **Second**, the Bangko Sentral ng Pilipinas (BSP) has been the most aggressive rate-cutting central bank in the region, and we expect the bank to maintain this dovishness in the remainder of the year to ensure a strong recovery amid the lingering epidemic challenges. This has already compressed real interest rates in the country substantially. **Third**, the peso tends to be an underperformer when there is a more broad-based recovery at the global level. We believe that it will underperform its Asian peers in H2 2020.

Risks to our views: Main risks are the trajectory of local confirmed cases of COVID19, investor pricing for the likely period of political uncertainty ahead of 2022 presidential election, and industrial commodity price trends.

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

LatAm FX
Focus on Chile and Colombia this summer

- **The Chilean peso is our top pick in LatAm and could benefit from increased China infrastructure spending. A pension-withdrawal bill that results in repatriation of foreign assets poses upside risks**
- **Colombian peso has been better supported by the government's large FX sales, but remains in our list of "vulnerable EMFX"**
- **We prefer the Mexican peso to the Brazilian real, but remain cautious given oil volatility and the rise in Covid cases.**

Chilean peso (CLP): Our favourite LatAm currency

The CLP is the only LatAm FX to fall into our EMFX "outperformer" category. We pencil in 2.5% gains until June 2021, with risks skewed for stronger gains.

Tactically, the CLP could face upside risks if a bill that allows for exceptional pension fund withdrawals for Chilean citizens becomes law. The bill would allow an exceptional withdrawal of up to 10% of individual pension savings in the pension funds (AFPs) which should result in about a USD 2billion inflow over four monthly instalments. Currently, the bill has to pass the Senate and it remains to be seen if President Sebastián Pinera vetoes the plan. We would make the following points about the currency:

First, as the largest copper exporter in the world, supplying China as the biggest importer, we believe the CLP will benefit from increased Chinese infrastructure spending, supporting copper prices. While copper has recently done better due to production shortages in Chile due to Covid, historically, even production-driven copper rallies have helped the CLP.

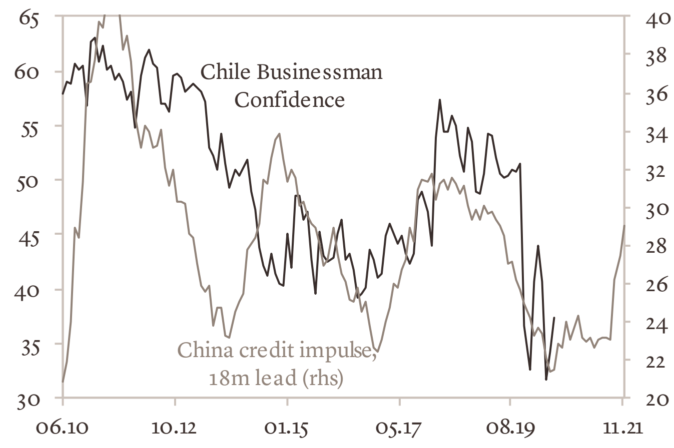
Second, the valuation is compelling: the CLP screens as extremely undervalued against longer-term macro fundamentals, even allowing for some modest weakness on the fiscal side. Short-term models suggest USDCLP should be trading significantly lower (chart 27).

Third, Chile has among the lowest government debt levels within LatAm. Gross government debt for Chile is expected to rise from 28% (end-2019) to a still relatively low 35% (end-2021). Hence, increased fiscal spending can support growth without undermining respective currencies.

Fourth, Chile has weaker external balances, with reserves covering only six months of imports (compared with some 25x for Brazil). That said, the authorities have been proactive in guarding against risks, and the central bank in mid-May presented a request to the International Monetary Fund for a flexible credit line (FCL) to shield the financial system. This should provide a backstop for the currency.

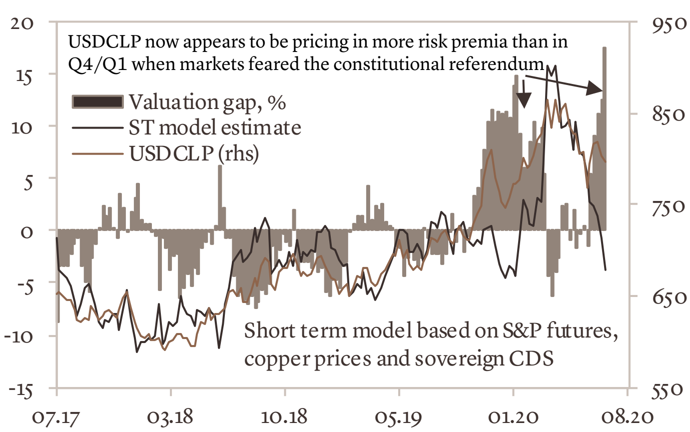
Fifth, the constitutional referendum in Chile that has been postponed to 25 October (from March previously). This remains an event risk for the currency and could cause some

26. Chile should benefit from improved Chinese credit impulse



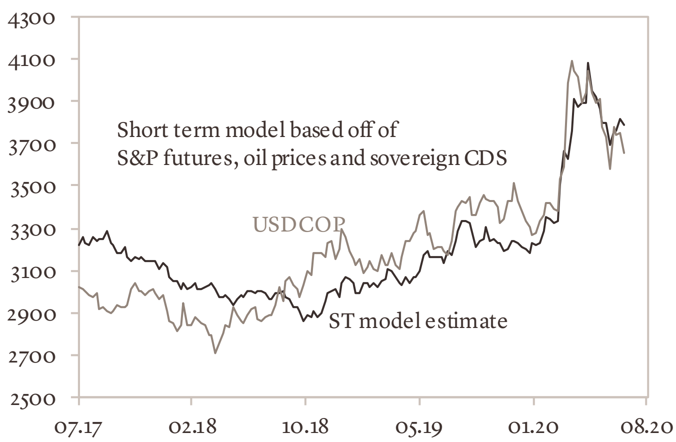
Sources: Bloomberg, Lombard Odier.

27. USDCLP is more than adequately pricing in risk ahead of the October constitutional referendum



Sources: Bloomberg, Lombard Odier.

28. USDCOP is 5% undervalued versus its short-term drivers



Sources: Bloomberg, Lombard Odier.

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

LatAm FX
Focus on Chile and Colombia this summer

volatility heading into the vote. That said, USDCLP now already appears to incorporate more risk premia compared with Q4/Q1 when markets were first negatively shocked by developments towards an overhaul of the 40-year old constitution (chart 27).

Risks to our view: In terms of risks, a significant escalation in US-China tensions and tariffs would likely weigh on both currencies.

Colombian peso (COP): Resilient for now on Government FX sales, but likely to turn weaker in months ahead

The COP falls into our category of "fragile currencies" alongside the Brazilian real, South African rand and Turkish lira. That said, we believe the COP will be the relative outperformer within this group. We forecast spot depreciation of 3% by June 2021. We would make the following points regarding the currency:

First, COP has held up better than we expected because: (a) government USD sales (totalling USD 5.8bn YTD) and (b) lower non-commodity imports has likely narrowed the country's large non-commodity trade deficit (chart 29). However, these supportive drivers should prove temporary and lessen in intensity in the months ahead.

Second, a model based on crude energy prices and government debt-to-GDP shows that USDCOP is 6% overvalued, not far from the 10% seen in 2015. Using IMF projections for government debt, fair value may rise to 3,705 by the end of 2020, suggesting limited scope for a sharp decline for USDCOP. On short-term metrics, USDCOP is slightly undervalued (chart 28), likely due to the government FX sales mentioned above.

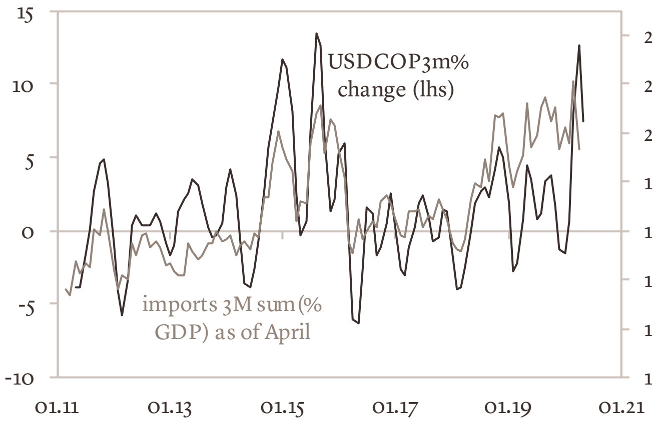
Third, fiscal risks will likely remain and re-emerge more strongly in Q4. Gross government debt/GDP is projected by the IMF to reach 58% (end-2020) from 51% (end-2019), but is expected to decline modestly to 55% (end-2022). Similar to Mexico, a continued deterioration in public finances would pose rating downgrade risks. Colombia`s sovereign rating is on thin ice: it has the lowest investment grade rating from all three rating agencies, two of which have a negative outlook.

Risks to our view: A likely deterioration in growth on renewed lockdowns would make the fiscal math more challenging and could increase the risk of a sovereign rating downgrade.

Brazilian real: To remain the LATAM laggard

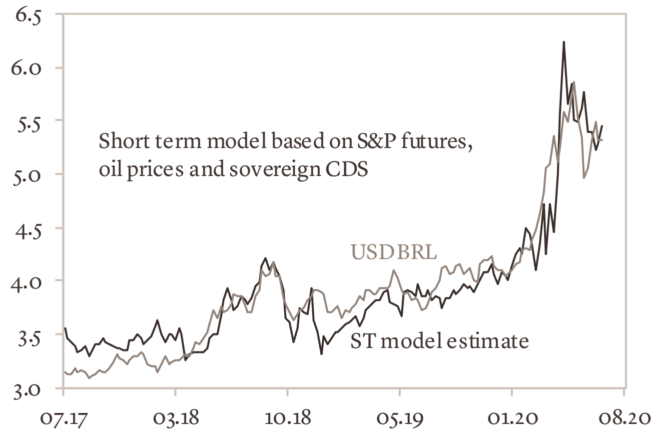
Along with TRY and ZAR, BRL remains in our group of "fragile" EM currencies given rising political risks and extremely elevated debt levels. In June, we had pencilled in 6% depreciation by June 2021. It has already depreciated by half that amount. While we keep our forecasts unchanged this month, we remain cautious on the currency. We would make the following points:

29. Current account adjustment likely to keep COP stable near term



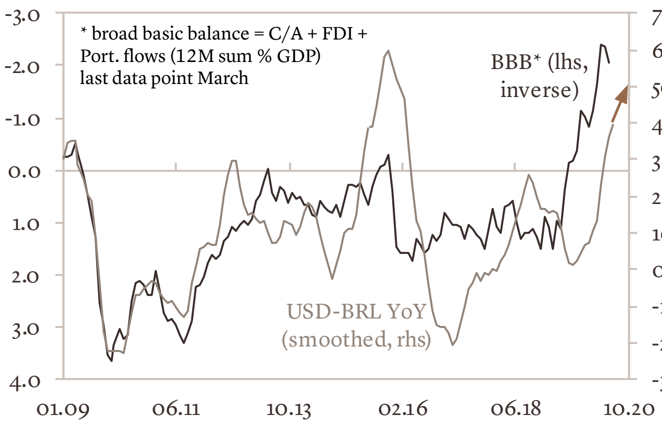
Sources: Bloomberg, Lombard Odier

30. USDBRL elevated, but in line with short-term drivers



Sources: Bloomberg, IMF, Lombard Odier

31. Weaker turn in BRL flows suggests currency will be a laggard



Sources: Bloomberg, Lombard Odier.

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

LatAm FX
Focus on Chile and Colombia this summer

First, while the BRL appears undervalued, we believe it will continue to underwhelm. A short-term valuation model suggests USDBRL is trading in line with short-term drivers (chart 30). The country was slow to contain the virus, with President Jair Bolsonaro resisting lockdown measures, and the epidemic is not yet under control. This suggests there will be more downside risks to growth, and hence fiscal slippage. The IMF projects gross government debt to rise from 92% (end-2019) to 98% (end-2021).

Second, against these rising risks are political risks surrounding President Bolsonaro's term, linked to the handling of the Covid-19 virus and to corruption charges. A number of key government officials have already resigned given the poor handling of the crisis. This suggests that headline risks will remain high in the months ahead; even if we assume that the President retains enough popularity to avoid impeachment.

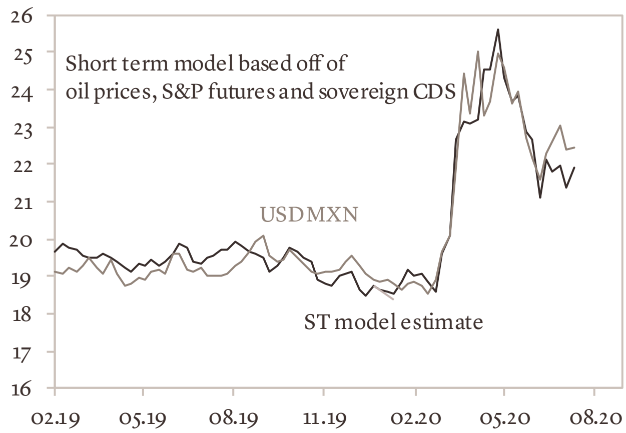
Third, against the fiscal and political risks noted above, the carry available for the BRL is too low: 12M implied FX carry has gone from over 5% last year (and as high as 10% in 2016) to just 1.90% at present. The central bank has cut policy rates by 225 bps since the beginning of the year. With inflation near 2% (well below the 4.25 +/-1.5% range) and the central bank remaining dovish (and even entertaining quantitative easing), FX carry will likely decline further.

Fourth, while speculative positions in BRL are extremely low, the softening current account trend and very sharp reduction in portfolio inflows (see from the broad basic balance, chart 31) suggest that USDBRL overshoots are a possibility.

Risks to our view:

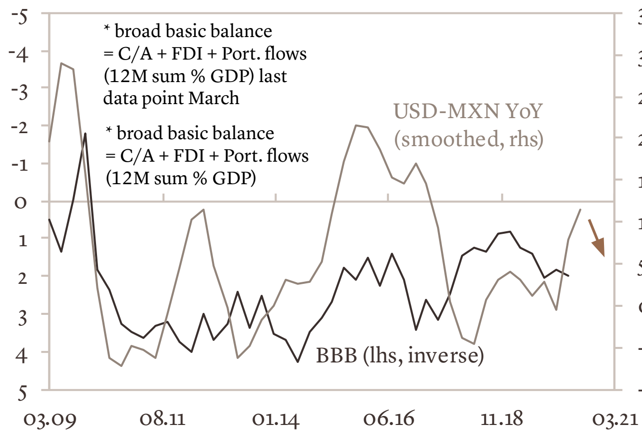
1. A critical risk remains an uncontrolled virus breakout with Brazil – which, unlike its neighbours, refrained from adopting a coherent national strategy on the lockdown.
2. Growing risk of a Bolsonaro impeachment should warrant an additional risk premium, though this is more likely an H2 risk, with Congress currently busy dealing with Covid-19.

32. USDMXN is 2% overvalued versus short-term drivers



Sources: Bloomberg, IMF, Lombard Odier

33. Improving external balance should cap USDMXN



Sources: Bloomberg, Lombard Odier.

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

CEEMEA FX
Russian ruble (RUB) to price in rising sanctions risk

- **The usually stable RUB will face downward pressure as markets price in sanctions risk moving into the US election. We revise forecasts lower.**
- **Amongst the high-yielders, we stay cautious on the Turkish lira and South African rand given weakness in external and fiscal balances, respectively**
- **We believe CEE currencies as well as the Isreali shekel will perform better against the USD. However, an increased FX intervention by Israel's central bank could see USDILS better supported.**

Russian ruble: still pricing-in sanctions risk

We have classified the RUB as falling into our category of "modest underperformers". In June, we had forecast flat returns until June 2021, but this month decide to downgrade the currency, now pencilling in losses of 1% over the same time frame. This is because one of our previously mentioned "risks," sanctions, has returned to markets. Reports suggest that the Russians paid the Taliban bounties to kill American troops in Afghanistan. The Trump administration is confronted with growing criticism over its failure to authorize a response to Russia, with both Democrats and Republicans pressuring a tougher stance. We would make the following points:

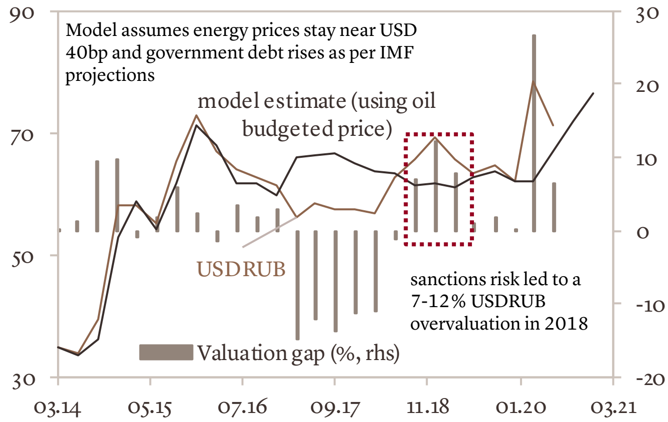
First, our model, based on the budgeted oil price and government debt to GDP, suggests the USDRUB's fair value now stands just under 70, but is seen rising to 75 by the end of the year (chart 34). The main driver for this is government debt that we expect to rise from low levels.

Second, we assume that tactically, markets continue to price in a growing risk of US sanctions heading into the US elections. Such a risk premium was extremely prevalent back in 2018 and USDRUB traded as much as 8 figures above our model's implied value (chart 34), but now such a risk premium is still small. Our model signals 69 as equilibrium, so it is entirely plausible that USDRUB could reach 74-75 if calls for sanctions grow louder.

Third, the central bank had been relatively cautious in its easing so far, but recently accelerated its pace. However, with inflation well below target (3.2% YoY vs 4% target) and real rates ample (at 130 bps), more easing appears likely. **Fourth**, given the increase in energy prices, the CBR will reduce its FX sales to RUB 5.7bn per day for this month, compared to RUB 10.2bn per day sales seen over the month of June.

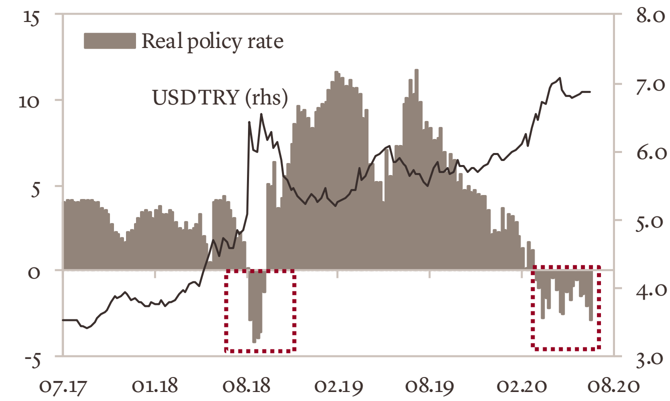
Risks to the view: Markets are no longer pricing in US sanctions risk as they did in 2018-19. Hence, the new developments should be seen as RUB-negative. We would view a Joe Biden US Presidency, and especially a democratic sweep, as negative for the RUB and markets will expect US policy towards Russia to turn harsher. On the other hand, a sharper energy price rally could support the RUB.

34. USDRUB could trade with higher risk premium like in 2018 sanctions concern phase



Sources: Bloomberg, Lombard Odier.

35. TRY real policy rates extremely negative, risking TRY instability



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX
Russian ruble (RUB) to price in rising sanctions risk

Turkish lira: Staying wary of the unstable high-yielder

Along with the BRL, ZAR, and COP, the TRY is in our group of "fragile" EM currencies. We forecast near 8% depreciation by June 2021. We make the following points regarding the currency.

First, we are bearish on the TRY given sharply negative real rates, weakening external balances and low FX reserves. Recent data showed inflation coming higher than expected in May. While the CBRT did well to hold off from further reducing interest rates at the June meeting, real rates have now turned negative making the TRY vulnerable to shocks like in 2018 (chart 35).

Second, credit growth has risen to extremely high levels and should result in the current account balance weakening. Coming at a time when citizens continue to accumulate US dollars (chart 36), this means TRY will remain under weakening pressure.

Third, the recent rise in energy prices, alongside the decline in tourism due to Covid-19, will be challenging for the external accounts. Turkey receives 40-50% of its tourism revenues between May and August, and the seasonal support this time around will be lower than normal.

Fourth, and on the more positive side, the private sector external debt repayment schedule remains lighter over July and August (compared to Q2), which could allow for lower TRY volatility temporarily.

Risks to the view: Given the bearish outlook due to negative real rates and very low FX reserves, we highlight two positive risks: rate hikes to get real rates into positive territory, and the possibility of Turkey seeking assistance from the IMF to obtain an external backstop.

South African rand: Losing share in Chinese imports

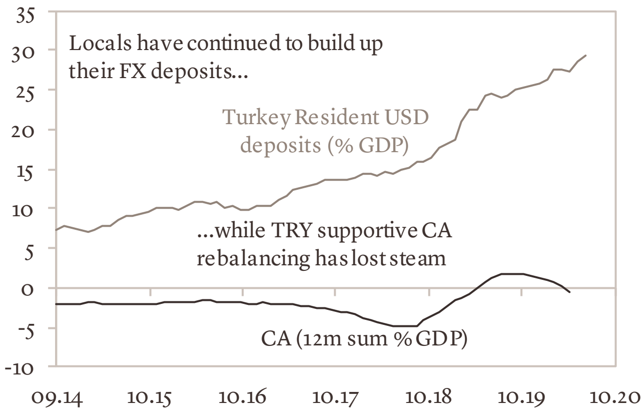
Along with the TRY, BRL, and COP, the ZAR is in our group of "fragile" EM currencies. We forecast near 6% depreciation by March 2021. We make the following points regarding the currency.

First, in our sample of EM countries, South Africa (along with Brazil) faces the worst fiscal position, with both high gross debt levels and growth likely to undershoot the real interest rate on debt (chart 37). This means that beyond simply the effect of weak growth, the gross debt trajectory will continue to move higher.

Second, despite the profound losses, the ZAR is not cheap when we factor in longer-term drivers like government debt and commodity prices.

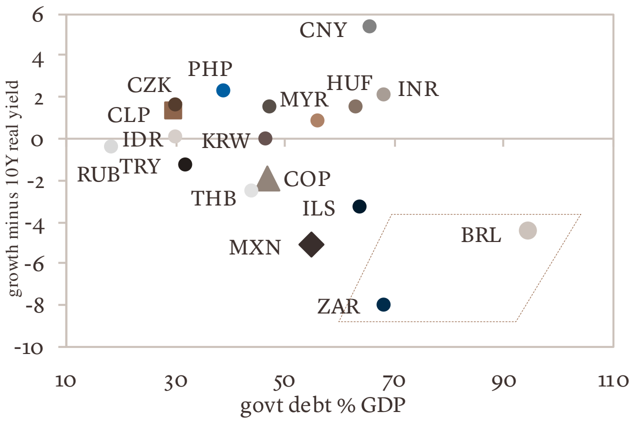
Third, South Africa is heavily dependent on risk-sensitive portfolio investment, in debt and equities. While there have been persistent equity-related outflows, the foreign investor debt position – while reduced – remains large and a source of vulnerability for the currency.

36. TRY undermined by rising local dollarization and softening current account



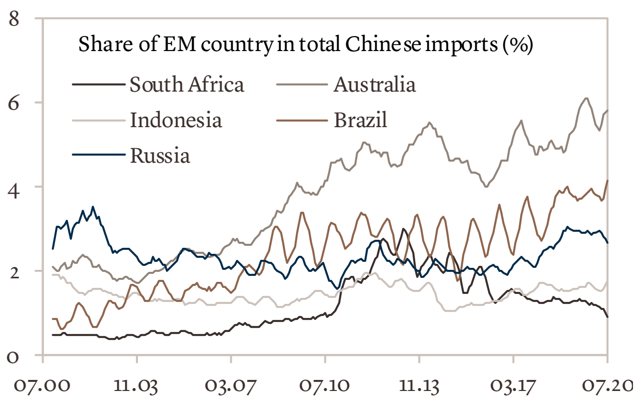
Sources: Bloomberg, Lombard Odier

37. ZAR faces rising fiscal risks



Sources: Bloomberg, IMF, Lombard Odier

38. South Africa stands out in mainstream EM as having lost import share of China: less likely to benefit from infrastructure push



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX
Russian ruble (RUB) to price in rising sanctions risk

Fourth, while in theory South Africa should benefit from a Chinese growth recovery, we note that its share of Chinese imports continues to decline in recent years, in contrast to other major emerging markets and commodity exporters (chart 38). This suggests the marginal benefit from a Chinese recovery will be lower for the ZAR, compared with peers.

Risks to the view: Given the bearish view painted, we would highlight a positive risk: that of South Africa seeking assistance from the IMF to obtain an external backstop.

Central and Eastern Europe FX: Czech koruna still our preferred CEEMEA long against the USD

We believe that the currencies of Central and Eastern Europe may be among the best positioned to benefit against the USD. In our previous monthly, we had forecast 4% to 6% gains for the CEE currencies against the USD by the end of June 2021, largely because of a more positive outlook on EURUSD. We maintain our forecasts.

First, Central and Eastern Europe (CEE) appears to have already priced in the hit to global growth, and the region is now looking forward to a recovery, especially in the euro area (chart 39 compares EURCZK with the German IFO gauge). Going forward, a more accommodative ECB policy and positive surprises on both the eurozone recovery fund as well as German fiscal policy should profit the CEE, which benefits from eurozone (especially German) demand.

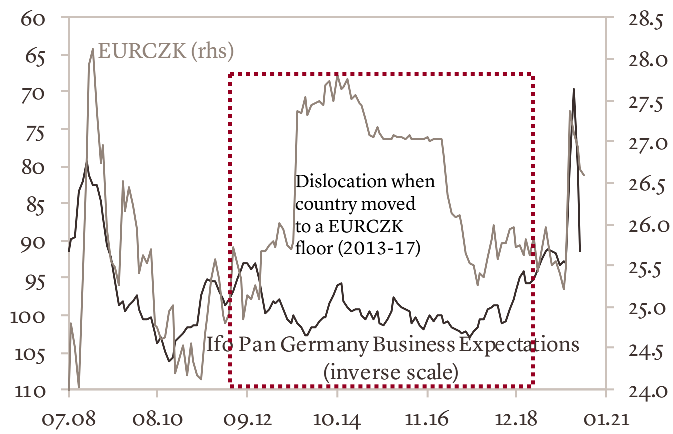
Second, CEE external balances and fiscal policy ammunition are superior to those of other EM countries, which should hold CEE currencies in good stead. The Czech koruna, one of our favoured currencies, has relatively low debt levels (gross government debt/GDP stood at 32% in 2019).

Third, CEE countries imposed social distancing measures earlier in March, ahead of other EM countries. Hence, they have been able to open their economies earlier than others, which may imply that growth downgrades will slow. Data has already begun to show signs of recovery.

Fourth, we prefer the CZK to the Hungarian forint (HUF), as the National Bank of Hungary generally appears predisposed to easier policy and checking FX appreciation. This should keep the HUF a laggard within CEE. On the other hand, the Czech National Bank (CNB) signalled that monetary policy had done its job, showing some aversion to the idea of additional measures like QE and/or negative rates.

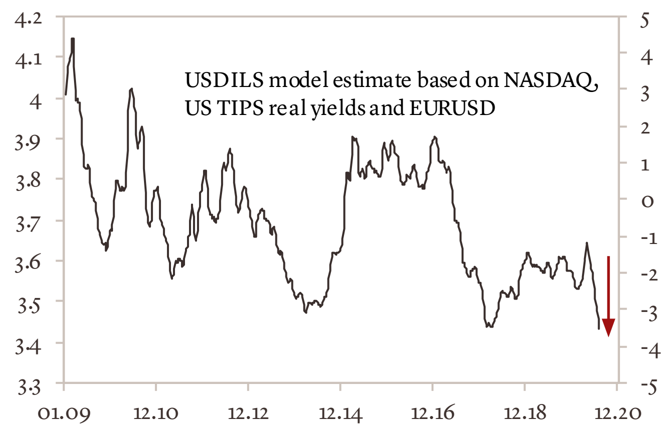
Risks to the view: A sharper slowdown in global growth and the auto sector is a negative risk for CZK and HUF. For the Polish zloty (PLN), the central bank has been expanding its balance sheet at quite a fast pace because of QE. This could keep a check on PLN.

39. EURCZK decline consistent with recovery in German IFO



Sources: Bloomberg, Lombard Odier

40. Long-term USDILS fair value continues to move lower



Sources: Bloomberg, Lombard Odier.

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

CEEMEA FX
Russian ruble (RUB) to price in rising sanctions risk

Israeli shekel: Central bank intervention step-up to slow pace of appreciation

The Israeli shekel (ILS) is in our group of "outperformer" EM currencies. We forecast near 3% appreciation by June 2021, with USDILS expected to decline towards 3.35 on a 12-month view. We would make the following points regarding the currency.

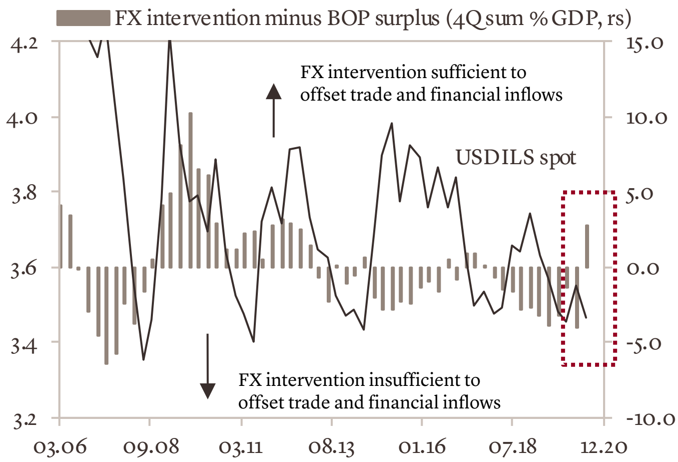
First, our financial fair value model suggests USDILS is sensitive to US real yields and to tech sector performance (proxied by the NASDAQ). USDILS has recently declined towards the lower 3.40-3.45 range implied by the short-term model (chart 40). Assuming that tech shares remain well supported, US real yields anchored at low levels and EURUSD develops a rally (our base case), then USDILS downward pressure should remain strong as USDILS fair value declines further.

Second, the Bank of Israel (BOI) has increased its verbal intervention against ILS appreciation and substantially increased FX intervention since the end of May. Accounting for Israel's traditional strong trade and capital inflows (include a strong tech-related Foreign Direct Investment pipeline), the central bank is now fully absorbing these flows for the first time since 2012 (chart 41). If this continues, then USDILS will likely grind lower but with the 3.40 level offering strong support.

Third, while we remain ILS constructive, we believe a big change to FX policy that goes beyond regular FX intervention would be needed. In our view, big moves like conducting "unsterilized" FX intervention (where influencing FX is seen as an outright policy tool) and eventually a possible peg (as in Switzerland after 2011 or Czech Republic after 2013) would be a game changer. However, these measures seem distant for now.

Risks to the view: A sharp slowdown in the global tech sector is a downside risk for ILS, as is the central bank departing from its current managed FX float framework would shift our view from constructive to bearish.

41. Bank of Israel`s increased FX intervention now offsetting all FX inflows for the first time since 2012



Sources: Bloomberg, Lombard Odier.

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

Our Lombard Odier long-term FX fair valuation framework

BEER
Behavioural equilibrium exchange rate model

Definition

Econometric model, which estimates FX fair values by "mapping" the exchange rate to a set of fundamental economic variables

Inputs

- Terms of trade
- Rate differentials
- Investment as % of GDP
- Inflation differentials

Output

Fair value estimates for major forex crosses Updated 2 to 3 times annually Weight: 50%

FEER
Fundamental equilibrium exchange rate model

Definition

Framework tries to identify the level of the exchange rate that would bring the economy into macroeconomic equilibrium (Current account balance sustainably financed by flows)

Inputs

- Price elasticity of trade
- Current account
- Output gap
- Capital flows

Output

Fair value estimates for major FX crosses Updated 2 times annually Weight: 50%

COMBINED OUTPUT – LO FX long-term fair value estimates

Usage

Anchor for long-term forecast

Usage

Degree of misalignment can be a sell or side signal

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

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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9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
Regulated and supervised by the Financial Services Agency (FSA) in Japan. It holds a trust business license (FSA No.208) and is registered with Kanto Local Finance Bureau for Financial Instruments Business Operator (No.470).

[1] *Private bank and securities dealer authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).*

[2] *Branch of Lombard Odier (Europe) S.A., a credit institution based in Luxembourg, authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.*

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