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FX Monthly
The dollar at a tipping point as recovery begins

06/20

June 2020

Key highlights

- Global developments appear to be setting off a structural USD downtrend
- We have raised our EURUSD forecast to 1.17 by year-end
- In line with this upward revision, we have upped our 2020-end EURCHF target to 1.11
- We maintain our medium-term GBP-constructive view, but for the near term we think the market has only just begun to price in the "no-deal" Brexit risk
- JPY remains a solid play; we still target 103 for year-end
- In EM, we believe that PLN, CZK and ILS are best poised to benefit in CEEMEA, while in Asia we like the IDR, KRW and TWD. In LATAM the CLP should perform nicely and we are modestly constructive on the MXN.
- That said, a number of currencies like TRY, ZAR, BRL and COP will face ongoing depreciation pressure.

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	7.06	6.98
	USDINR	77.1	75.0
	USDIDR	13 902	13 612
	USDMXN	22.0	21.8
	USDBRL	5.41	5.55
	USDRUB	70.2	69.5
	USDZAR	17.90	18.40

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Important information: Please read important information at the end of the document. Data as of 22 June 2020

At a glance

Introduction

We have revised higher our year-end EURUSD and EURCHF forecasts to 1.17 and 1.11, respectively

A number of key developments in the past few weeks have delivered a blow to the dollar and have turned us constructive on EURUSD again.

Topping these developments are:

1. Significant progress on the EU recovery fund
2. An expansion beyond expectations of the ECB stimulus pandemic programme
3. A very dovish Fed that now foresees rates at near zero though 2022
4. Green shoots in the economic landscape which, together with trend improvement in virus infections, set the stage for an economic recovery in H2 20.

As a result, the correction of dollar overvaluation (which persisted due to the pricing-in of risk premia) has finally been set in motion.

We have revised higher our year-end EURUSD and EURCHF forecasts to 1.17 and 1.11, respectively. JPY remains a solid play in this environment, able to exploit USD downside as well as act as a hedge in case of an adverse scenario (see below). Meanwhile, the market has been somewhat complacent on Brexit risks, and has only just begun to price in the possibility of a "no-deal".

Following some short-term consolidation, we expect commodity currencies (mostly the AUD) to capitalise on USD weakness. In the Nordic region, the NOK should outperform the SEK.

In EM, the softer USD should allow currencies with relatively lower debt levels and exposure to improving Eurozone policy signals to benefit as well as stronger infrastructure spending from China (and potentially the US).

We believe that PLN, CZK and ILS are best poised to benefit in CEEMEA, while in Asia we like the IDR, KRW and TWD.

In LATAM the CLP should perform nicely and we are modestly constructive on the MXN. That said, a number of currencies like TRY, ZAR, BRL and COP will face ongoing depreciation pressure.

Given that the GBIEMFX index[1] has exposure to both winners and losers, we have a more neutral view on the benchmark index.

The main risk to our views is clearly a second virus wave to derail the recovery and increase demand for dollars again. We think recent trends are very encouraging and believe that authorities and the public are better equipped now to contain potential clusters of virus resurgence. Nonetheless, it is impossible to rule out such an adverse scenario.

[1] The GBIEMFX index is an EMFX index based on the JP Morgan GB EM global diversified index, a benchmark for EM local currency debt.

FX forecasts – G10 and gold

	Current spot	Q3 20	Q4 20	Q1 21	Q2 21	Estimates of long-term fair value[2]
EURUSD	1.12	1.15	1.17	1.18	1.18	1.17
GBPUSD	1.24	1.26	1.28	1.30	1.30	1.40
EURGBP	0.90	0.91	0.91	0.91	0.91	0.84
EURCHF	1.06	1.10	1.11	1.12	1.12	1.04
USDCHF	0.95	0.96	0.95	0.95	0.95	0.89
USDJPY	107	104	103	102	102	94
EURJPY	120	120	121	120	120	109
EURSEK	9.45	9.09	8.97	8.90	8.90	8.58
USDSEK	10.58	10.45	10.50	10.50	10.50	9.95
EURNOK	9.63	9.09	8.89	8.77	8.73	7.96
USDNOK	10.78	10.45	10.40	10.35	10.30	9.24
AUDUSD	0.69	0.71	0.72	0.73	0.73	0.73
NZDUSD	0.64	0.66	0.67	0.67	0.67	0.64
USDCAD	1.36	1.32	1.31	1.30	1.30	1.26
Gold	1 752	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 24 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	7.08	7.08	7.06	7.03	6.98
USDHKD	7.75	7.75	7.75	7.75	7.75
USDIDR	14 174	13 972	13 902	13 756	13 612
USDINR	76.1	76.9	77.1	76.1	74.99
USDKRW	1 215	1 202	1 196	1 184	1 172
USDMYR	4.28	4.27	4.24	4.20	4.15
USDPHP	50.1	50.3	50.5	50.6	50.7
USDSGD	1.40	1.39	1.38	1.38	1.37
USDTWD	29.6	29.5	29.3	29.2	29.0
USDTHB	31.0	31.0	30.9	30.7	30.6

LatAm

	Current spot	Q3 20	Q4 20	Q1 21	Q2 21
USDMXN	22.6	22.2	22.0	21.9	21.8
USDBRL	5.31	5.33	5.41	5.49	5.55
USDCOP	3 741	3 786	3 815	3 843	3 872
USDCLP	816	793	789	783	776
USDPEN	3.50	3.49	3.48	3.46	3.44

CEEMEA

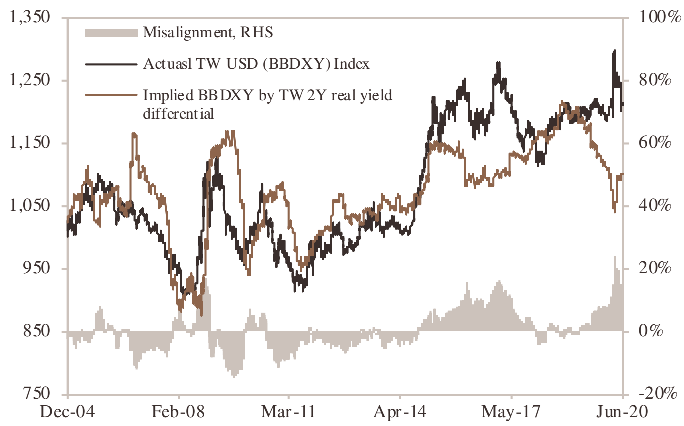
	Current spot	Q3 20	Q4 20	Q1 21	Q2 21
USDRUB	69.5	69.8	70.2	69.8	69.5
USDTRY	6.84	6.99	7.13	7.28	7.42
USDZAR	17.4	17.7	17.9	18.2	18.4
USDILS	3.46	3.38	3.37	3.36	3.35
EURPLN	4.46	4.44	4.43	4.42	4.41
EURCZK	26.7	26.5	26.4	26.3	26.2
EURHUF	346	345	346	346	346

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

G10FX: Three key charts

The dollar has finally started its long-overdue correction lower. The size of overvaluation remains significant, so the move should extend further into the second half of the year. The main question now has become how quickly the USD downfall will unfold – and how deep it will go. Implied volatility has declined significantly from its peak in mid- to late March, and is approaching more normal levels.

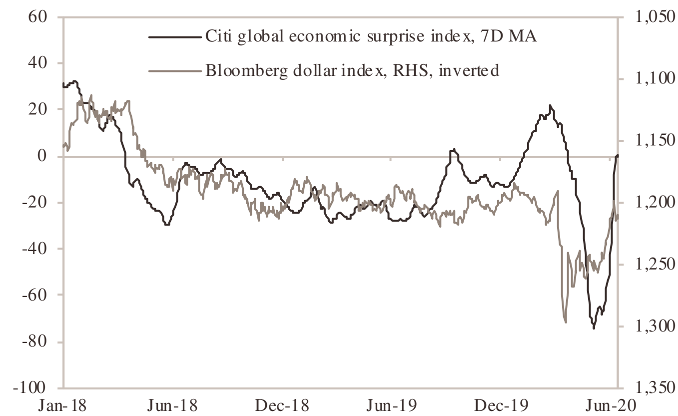
1. The beginning of the USD correction



Sources: Bloomberg, Lombard Odier.

The catalyst has been an improvement in the global economic landscape (albeit from extremely low levels) that has fuelled expectations of a swift recovery in H2 20. This has forced the market to begin pricing out risk premia that had kept the USD overvalued for a considerable period.

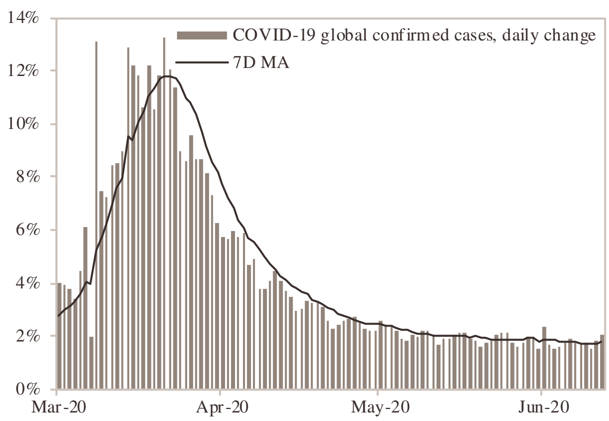
2. TW USD turns lower as economic data surprises on the upside…



Sources: Bloomberg, Lombard Odier.

Developments in the global infection rate have been positive and have boosted optimism. Despite pockets or clusters of virus resurgence (which are to be expected), we believe the trend-improvement will remain in place to allow the recovery to gain momentum. Authorities are now better equipped to contain potential virus incidents, and the public more knowledgeable to act appropriately. If we are right in our central scenario, the USD should continue to depreciate, also helped by the global fiscal and monetary policy response, which will support the economic recovery. Clearly, a second strong Covid-19 wave – similar to that in early 2020 – currently represents the main risk to our view.

3. … and the rate of new Covid-19 confirmed cases falls



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

EUR: Europe getting its act together

- A number of key developments have turned us constructive on the euro again
- We have raised our EURUSD forecast to 1.17 by year-end
- Moreover, we see risks as tilted to the upside.

In our last FX monthly, we argued in favour of a neutral stance for the euro. As we explained, a number of fundamental tailwinds (eurozone's large current-account surplus, EURUSD undervaluation, and substantial USD overvaluation) remained in place. However, we believed that these would be offset by headwinds generated by the constitutional challenges related to the 5 May German court ruling on the ECB's Public Sector Purchase Programme (PSPP) as well as uncertainty regarding the EU co-ordinated fiscal response to the pandemic. At the same time, we highlighted that a swift agreement and implementation of an EU recovery fund would represent a clear upside risk to our view.

Fast-forward one month and there have been a number of developments that have surprised us; we judge them sufficient to turn us EUR-constructive again. We summarise them below.

First, it seems that Europe is "getting its act together". The European Commission's proposal of a coordinated fiscal package to the tune of EUR 750 bn is not only sizeable, but also offers a (likely) acceptable compromise to the "frugal four", via a mix of budget transfers (supported by peripheral countries as well as France and Germany) and loans (supported by Austria, Denmark, The Netherlands, and Sweden). Additionally, the implementation of further fiscal stimulus by Germany (EUR 130 bn) will not only provide material support to the economy; it notably heralds a massive shift in the decades-long approach to balanced budgets and fiscal policy. The "signalling effect" is quite significant, in our view.

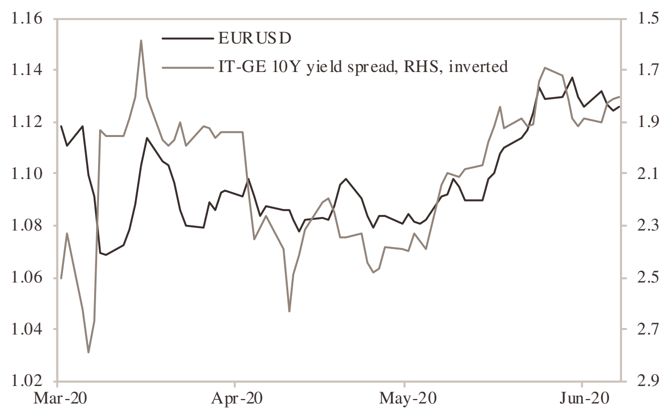
Second, the ECB appears to be adopting a more conciliatory tone to the German court ruling, publicly stating that if requested the bank would help resolve the conflict. This was an unexpected and certainly a positive development. **Third**, in the US the recent Fed meeting issued a very dovish signal. The central bank's officials now see the Fed rate at near zero through 2022, while the pace of asset purchases will remain (at least) the same for the near future. As a result, US short-term rates remain compressed and the USD's carry advantage has been virtually eroded (see chart 4).

Fourth, the recent expansion of ECB stimulus (additional asset purchases under the pandemic programme of EUR 600 bn) is actually positive for the euro. In our view, given how much bad news has been priced in, ECB balance sheet expansion is no longer about having a dampening effect on the currency – but about reducing tail risks. This is why EURUSD has rallied in tandem with the compression in peripheral spreads (see chart 5).

4. EURUSD still too low relative to GE-US yield differential

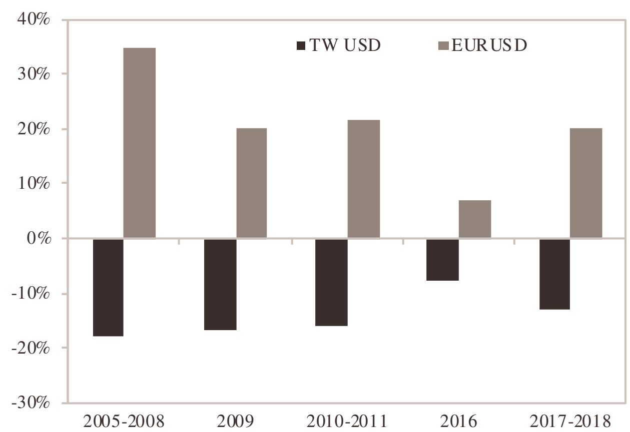
Sources: Bloomberg, Lombard Odier.

5. Recent EURUSD appreciation associated with tighter peripheral spreads



Sources: Bloomberg, Lombard Odier.

6. Episodes of USD sell-offs and EURUSD performance



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

Fifth, US-China relations (a source of downside risk for open and trade-intensive economies) will continue to produce harsh rhetorical exchanges, but recent statements by officials suggest that both sides are committed to the phase one deal. Finally, on the back of all this, the dollar overvaluation has started narrowing at a significant pace. As we argued before, the TW USD was trading considerably higher than fair value due to the pricing in of risk premia: first, it was about the impact of trade wars, then about the shock from the pandemic. However, as these risks normalise, their associated risk premia are being priced out, allowing the USD to converge lower and closer to its equilibrium value.

Consequently, we have raised our EURUSD forecast to 1.17 by the end of the year and now foresee it at 1.18 by Q2 21. Furthermore, **the balance of risks** is now to the upside. Subject to our revised view about improved sentiment towards the euro area being correct, history suggests that when the dollar starts turning lower, the ensuing sell-off tends to be deep and EURUSD upside quite pronounced (see chart 6).

Of course, there are also **downside risks to our forecasts**. These include 1. a second strong pandemic wave that would reignite appetite for dollars; 2. EU leaders failing to implement a coordinated fiscal response; and 3: a re-escalation in US-China frictions.

CHF: Weakness likely to continue on the back of euro strength

- In line with a stronger EURUSD, we have revised our EURCHF forecast higher
- We now target 1.11 by the end of the year.

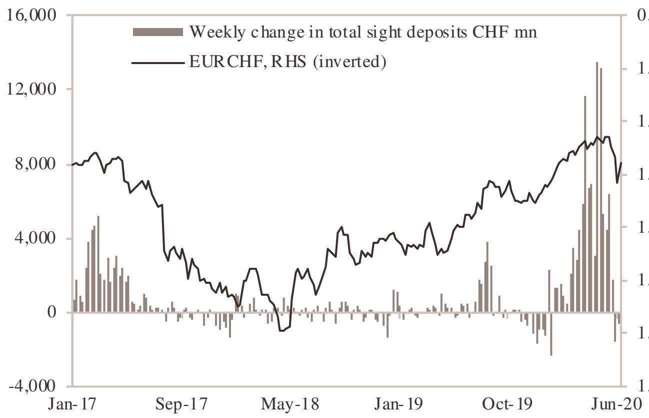
In line with the EURUSD appreciation, EURCHF has risen to levels not seen since the beginning of the year (now around 1.07). Reasons for CHF weakness include the marked improvement in risk appetite due to the global policy response, and better sentiment towards the euro area that has resulted in narrower peripheral spreads.

The SNB appears to have welcomed these developments, as it has reduced FX intervention significantly over the last few weeks (see chart 7). We think that as long as EURCHF continues to trade above the 1.06/1.07 level, the central bank will not be too keen to intervene in the currency market.

Historically, EURCHF has been tightly correlated with EURUSD (see chart 8). Consequently, any further upside in the latter is very likely to see EURCHF appreciating as well. Our upward EURUSD forecast revisions have led us to up our EURCHF targets also, seeing the pair at 1.11 by year-end.

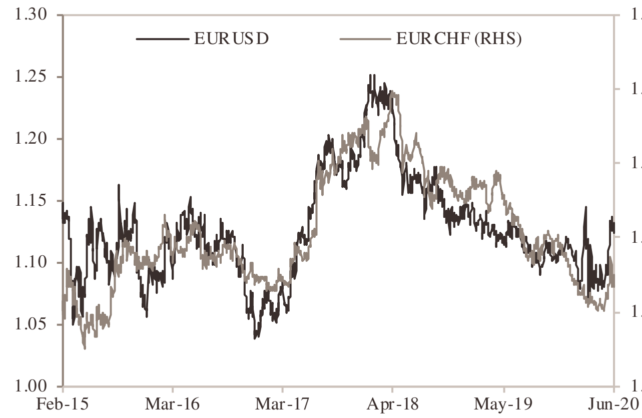
Risks to our view: 1. On one hand, a deterioration in risk appetite is likely to see EURCHF returning towards 1.05, a level at which the SNB would step in to prevent further CHF strength. 2. On the other hand, a more rapid euro appreciation would generate more upside pressure on EURCHF, potentially taking it closer to 1.15.

7. The SNB steps back at last from FX intervention



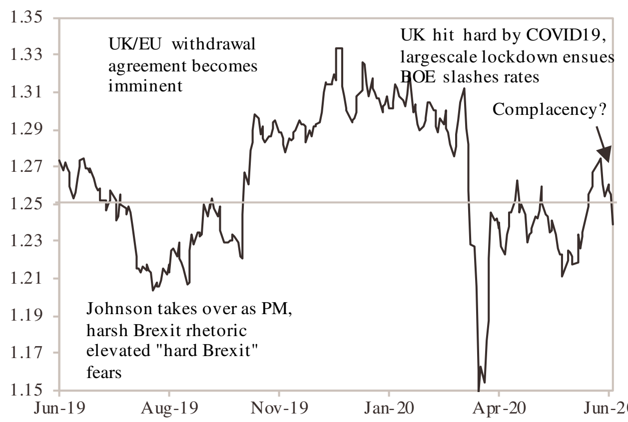
Sources: Bloomberg, Lombard Odier.

8. EURUSD and EURCHF highly correlated over time



Sources: Bloomberg, Lombard Odier.

9. Sterling just beginning to price in a "no-deal" Brexit risk



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

GBP: A rude awakening

- GBPUSD initially rallied by around 10% since its bottom in late March
- While fundamentally constructive, our short-term view is that a too-complacent market has just begun to price in the "no-deal" risk
- We expect continued near-term weakness, followed by strength once a skeleton EU-UK deal is reached at the end of 2020.

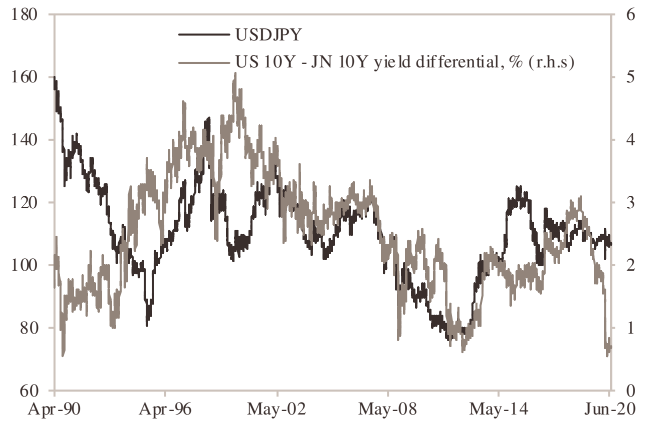
Starting mid-March, sterling enjoyed a strong rally, only recently beginning to retrace lower. The first stage of the rally was largely due to GBPUSD having plummeted to oversold territory, and the build-up of short positioning led to a sizeable short-squeeze. The more recent stage has been due mainly to broader USD weakness as well as some expectations of positive developments on Brexit.

Our central scenario remains one of a basic compromise/deal being reached between the UK and the EU by year-end; this should eventually support sterling further. However, the reality is that no substantive progress has been made in the discussions and time is running short. With GBPUSD now at just below 1.25, the market appears rather complacent about the rising risk of a "no-deal Brexit". Over the last year, the 1.25 has been a key level (see chart 9, p.8): when Boris Johnson became UK prime minister having campaigned with harsh Brexit rhetoric, GBPUSD fell below 1.25 (and towards 1.20). It managed to recover above this level only once a withdrawal deal with the EU became imminent. Tough negotiations around very complex issues and political posturing are likely to "force" sterling to start pricing in some further "'no-deal" Brexit premia in the summer months. This would see GBP weaken against the EUR, the JPY, and (to a lesser extent) the USD. Put differently, we expect things to get worse before they get better, with a last-minute skeleton deal providing relief some time in that last quarter of the year.

Finally, we do not believe that BoE monetary policy will affect the exchange rate much in its own right. As we discussed in our recent Investment Strategy Bulletin, in the post-Brexit referendum era, sterling has had a weak relationship with the BoE base rate. Any realistic scenario on interest rates and/or asset purchases is unlikely to change this in the near future.

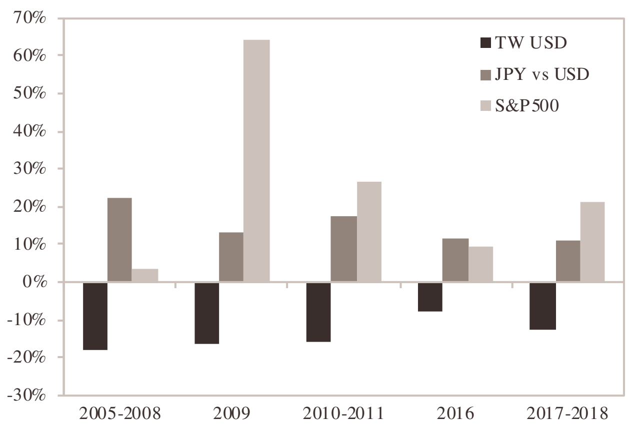
Risks to our views: The main risk to our near-term bearish GBP view relates to significant progress on Brexit discussions. The latter, together with broad dollar weakness, could push GBPUSD significantly higher. The main risk to our medium-term constructive view is a "no-deal" Brexit, which would represent a severe structural shock to the UK economy and potentially see GBPUSD falling towards or below 1.10 and EURGBP rising to parity.

10. USDJPY still trading considerably higher than the US-JN yield differential



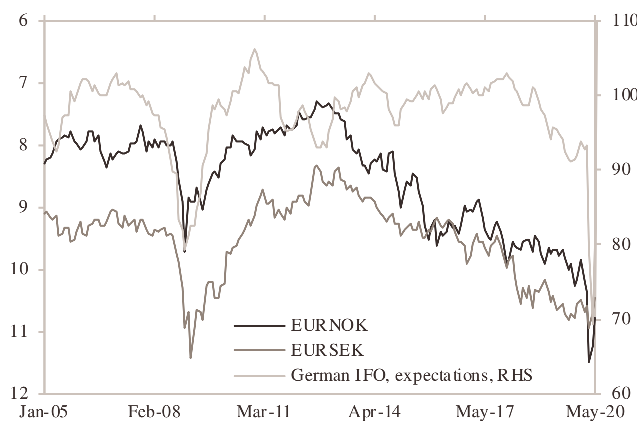
Sources: Bloomberg, Lombard Odier.

11. Episodes of USD sell-offs and JPY performance



Sources: Bloomberg, Lombard Odier.

12. A rebound in German confidence should support the Nordics



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

JPY: Fundamental dislocations still suggest USDJPY downside

- JPY has underperformed in the rally against the dollar
- Improved risk appetite has played a role by dampening demand for safe havens
- However, major fundamental dislocations point to USDJPY downside in the medium term.

The JPY has underperformed other major G10 currencies in this rally against the USD. The main reason has been improved risk sentiment, which has seen equities higher, Japanese investors pouring money into foreign stocks, and lower demand for safe haven assets. However, we would strongly urge investors to look through these short-term dynamics and focus on the underlying fundamentals. More specifically:

First, USDJPY is substantially dislocated from the US-JN yield differential, an important driver of the currency pair's mid-term prospects. The current differential suggests ample room for downside (see chart 10,p.9). **Second**, our medium- to long-term fair valuation framework (which, aside from rate differentials, takes into account trends in terms of trade and private investment) continues to flag a sizeable USDJPY overvaluation, to the tune of nearly 15%.
Third, episodes of dollar-depreciating cycles historically have been accompanied by substantial USDJPY declines, even as equities rallied strongly (see chart 11, p.9). **Fourth**, with the BoJ having reached the limits of its monetary policy accommodation, JPY downside risks due to further easing appear to be significantly contained.

We maintain a constructive JPY view and expect USDJPY to depreciate closer to 100 by the end of the year.

Risks to this view: Risks to our bullish JPY view include first, a very fast global growth recovery in the second half of the year that could restrain JPY upside against the dollar, especially if US rates reprice higher; and, second, finding and widely distributing a Covid-19 vaccine fairly soon, which would lead to a strong rally in risk assets and depress demand for JPY, at least for a certain period.

Nordic currencies: Some further upside

- NOK and SEK have stabilised recently following their big rally
- We expect some further gains in H2 20, mostly for the Norwegian krone.

EURNOK and EURSEK have stabilised recently, taking a breather from their rapid depreciation since March, despite risk assets continuing to gain and oil prices rising further. This likely relates to short-term positioning adjustment and profit-taking, as technical indicators were flashing oversold signals in early June. Over the medium term, our view remains constructive, mostly for the Norwegian krone.

First, improvement in market sentiment towards the euro area and the bottoming-out of regional and country confidence surveys bode well for both the NOK and the SEK (see chart 12, p.9). **Second**, NOK and SEK are pro-cyclical currencies that tend to appreciate against the EUR and the USD when equity prices rise or remain well supported. **Third**, valuations remain highly compelling. **Fourth**, in Norway, core (underlying) inflation remains at a high 3%. Although the Norges Bank will very likely look through this in the near term, the bottoming out of domestic activity coupled with ongoing underlying price pressure could force the market to price in earlier hikes relative to the Fed and the ECB. This will be NOK-positive against the USD and the EUR. At the same time, some idiosyncratic factors may limit the upside (especially for SEK). In Sweden, the fundamentals were weak before the virus wave. Hence, the bottoming-out in activity is unlikely to see a significant economic impetus building – especially since the initial virus impact was smaller relative to other countries due to the light lockdown measures. In Norway, the recent rise in oil prices (helped by the OPEC+ decision to deepen supply cuts) may start losing momentum because of extremely elevated inventory levels.

Risks to our views: Regarding our long-term fundamental constructive view, the clear risk here is a hit to the global potential growth rate (perhaps emanating from a flaring up of virus infections and/or a significant re-escalation of the US-China trade war). This would deliver a longer-lasting blow to currencies of small open economies.

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

FX majors and gold

Commodity currencies: The rally has legs

- Commodity currencies have strengthened since late March, with AUD leading the rally
- Recently, the rally has lost some steam, but we view this as a technical breather
- We expect further gains in the commodity FX bloc and reiterate our preference for the AUD.

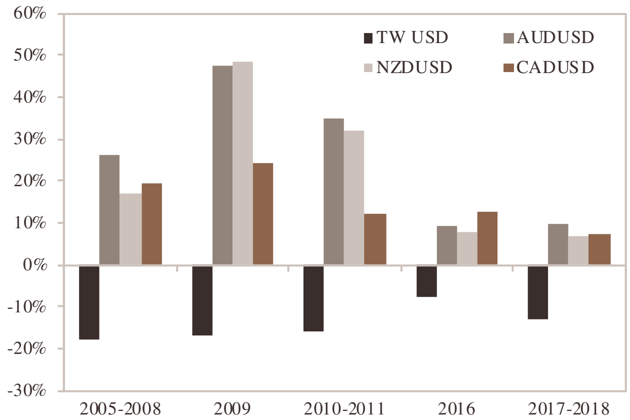
Commodity currencies have rallied strongly these past few months, led by the AUD, which has risen by nearly 20% against the USD since late March. Recently, however, more "two-way" price action has brought this rally to a halt, largely because the price moves had become far too stretched from a short-term perspective. This matches our expectations discussed in our previous FX monthly.

Following a period of consolidation (or even modest losses), we expect a resumption of the uptrend, although differentiation will be important.

First, valuations remain compelling for AUD and CAD (less so for NZD). **Second**, the global economic recovery in the second half of the year will be supportive of commodity prices, which are certainly low by historical standards. Here, our preference remains for the AUD: normalisation of Chinese economic activity (now nearly at the same level as in previous years) will push industrial raw material prices higher and support the exchange rate. At the same time, oil inventory levels at all-time highs are likely to prevent significant oil price increases and restrain CAD appreciation (though CAD's valuation is very favourable). **Third**, previous cycles of USD weakness have coincided with significant gains in all commodity FX (see chart 13). **Fourth**, despite the sizeable rally over the last three months, positioning is very light. In fact, Commodity Futures Trading Commission data shows that speculators are short all of the currencies against the dollar. A confirmation of the global recovery is likely to see money shift from shorts to longs, supporting the upside further.

Risks to our view: If we are wrong about the global growth recovery in H2 2020, it would be difficult to argue in favour of commodity FX appreciation, and our stance would turn neutral (or even bearish if global activity significantly undershoots our expectations). In Australia, the ongoing virus-related frictions with China (Australia is calling for an investigation into the origins of the pandemic) represent a downside risk for AUD, especially if Chinese retaliation starts targeting iron ore imports.

13. Episodes of USD sell-offs and commodity FX performance



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Gold: Ongoing support by real yields

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

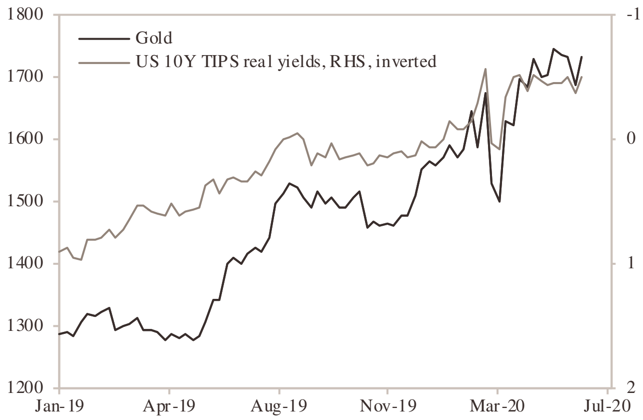
Gold has been trading sideways over the past month, mainly in the USD 1,700-1,750/oz range.

Short-term, some residual uncertainty and a weaker USD should maintain prices above USD 1,700/oz.

The Fed's balance sheet is a strong support, but its impact is likely to fade as the recovery materialises. We maintain our 12M gold forecast at USD 1,600/oz, as real yields will remain in negative territory for an extended period (no Fed hikes in the next two years). This limits the downside (see chart 14) in an environment where alternative safe-haven assets are scant.

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 – especially when the hedging capacity of traditional safe havens is limited.

14. Gold underpinned by low real yields



Sources: Bloomberg, Lombard Odier.

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EMFX: Three key charts

Since the bottoming of asset prices in early April, EM assets have recovered. However, in the grand scheme of things, the returns in both local currency debt and EM credit have been far stronger. This suggests that EMs' still decent balance sheets and the accommodative Fed have helped. On the other hand, both FX and equity markets – arguably more dependent on growth, have recovered, but less so (chart 15).

After having been in a range among the lows from end-March, the GBIEMFX index[1] rallied 7% between mid-April and 8 June. The support came from energy prices, which increased the aggregate terms of trade for EM – an input into our model. EMFX now screens as fairly valued (chart 16).

From here, we would maintain a neutral bias on the currency complex as a whole: while growth differentials could improve a bit 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 have also become increasingly correlated with global equity markets.

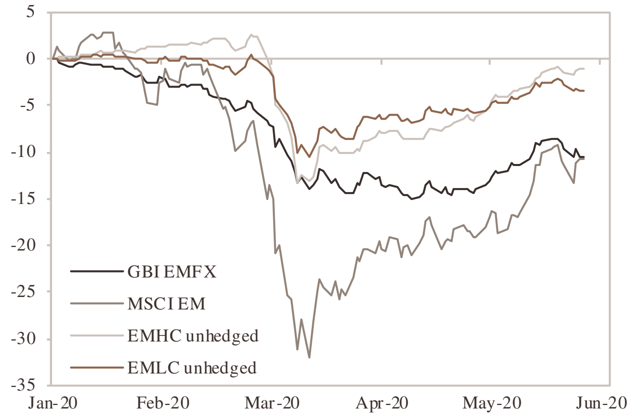
A much weaker base of USD weakness accompanied by a stronger recovery in global trade could see GBIEMFX overshoot, however. However, we would prefer currencies of countries with manageable debt levels that would benefit from stronger Chinese stimulus (North Asia FX and CLP in LATAM) as well as a stronger rebound in EURUSD (CZK, PLN and ILS).

The chart alongside 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 (proxied by the global manufacturing PMI) has been preceded by a rise in China`s credit impulse. We are seeing a big shift up in the latter, though admittedly in response to the negative growth shock seen because of the lockdowns in response to Covid19.

The National Peoples Congress (NPC) called for the stance of monetary policy to remain "prudent", but they did also call for a "notably increase in money and credit growth". While this should broadly support growth sensitive FX (including in EM), the likes of AUD in G10 and CLP and PEN in EM tend to have a higher beta

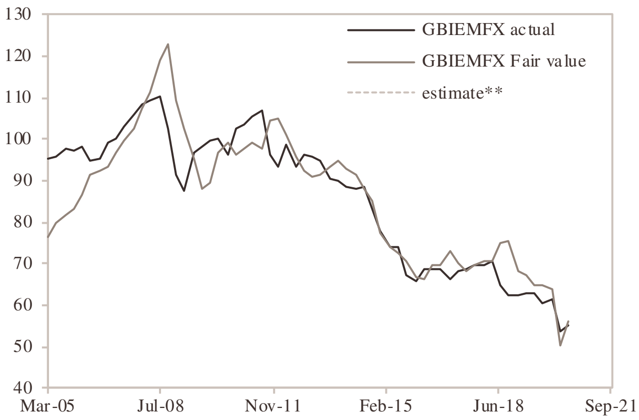
[3] The GBIEMFX index (Bloomberg ticker: EMCS index) is an index of local currencies (vs. USD) based on the JP Morgan GB EM global diversified index, a benchmark for EM local currency debt.

15. GBIEMFX and EM equities lag behind recovery in EM debt and credit



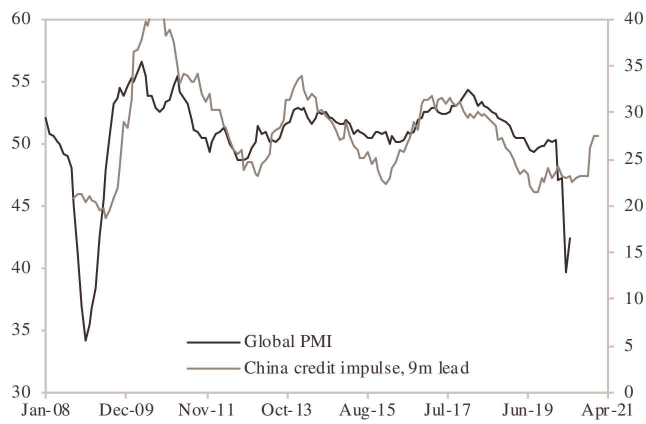
Sources: Bloomberg, Lombard Odier

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



Sources: Bloomberg, Lombard Odier

17. Chinese credit impulse could benefit some parts of EM



Sources: Bloomberg, IMF, Lombard Odier

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

Asia FX
Steady beneath the noisy geopolitical headlines

- While geopolitics has re-emerged as a key theme for emerging Asia in the past few weeks, its impact has been rather limited as the region's fundamentals remain solid
- After a decent rebound, Asian currencies as a whole will appreciate modestly against USD in the remainder of the year. We like MYR, KRW, and TWD, i.e. cyclical currencies
- We are neutral on CNY, IDR, and THB, and relatively cautious on PHP and INR. The lack of strong public health infrastructure will be key risks for the latter group.

CNY

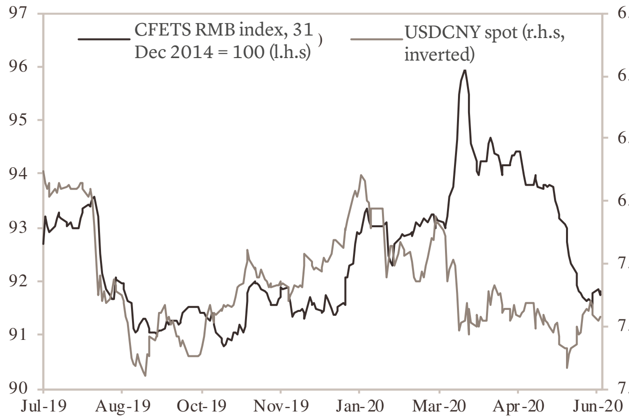
We are neutral on the yuan, but we still see slight upside vs USD in the next twelve months. **First**, after the sharp correction in May, the value of the yuan relative to the official basket of trading partners' currencies (i.e. renminbi index) is at the level where a rebound is more likely in the medium term (see chart 18). We note that the wild roundtrip in the renminbi index between March and June was mostly due to the inertia of the USDCNY pair. **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 recent noises on US technology export restrictions and Hong Kong. The tension will certainly cap upside for the yuan, but we expect solid fundamentals to offset some of this pressure in the medium term.

Events and risks to the view: 1. Any escalation of tension with the US that leads to punitive restrictions on China's trade and investments would be the most important risk to monitor before the US presidential elections. 2. **Second**-wave infections (e.g. the new cluster in Beijing) will also be a risk, but China has shown its ability to control the epidemic curve thus far.

INR

We believe that the worst might be behind the Indian rupee, but the currency's recovery path will be brimming with dangers. We expect a slight appreciation vs USD before the end of the year. **First**, India has not yet succeeded in controlling the Covid-19 epidemic curve, despite a national lockdown lasting over 70 days since March. The struggle will likely continue – especially since the country has begun to ease restrictions on activities. **Second**, the RBI has shown its clear dovish bias on multiple occasions since March, by cutting benchmark rates, launching large-scale refinance operations (TLTROs), and announcing loan moratoriums (see chart 19,p.14). **Third**, the good news is that state governments have

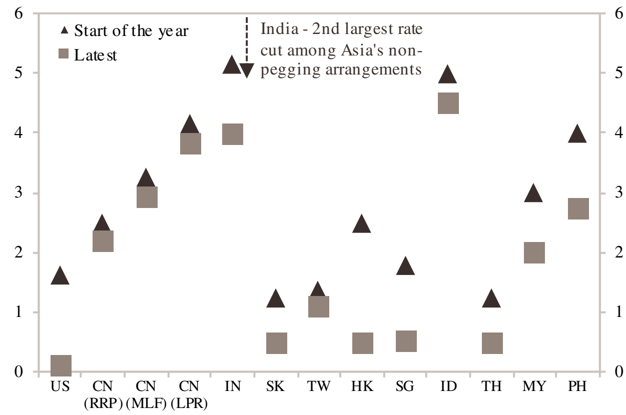
18. Mini-correction in the renminbi index is likely over



Sources: Bloomberg, Lombard Odier

19. RBI's dovish bias remains clear

Benchmark interest rates, latest vs start of the year, %-points



Sources: Bloomberg, Lombard Odier.

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

Asia FX
Steady beneath the noisy geopolitical headlines

begun to implement consequential reforms in the labour market and land acquisition laws. Moreover, commodity prices will remain low in the near term, and exceptional global USD liquidity will reduce the pressure on the rupee.

Events and risks to the view: 1. Second-wave infections will be the most important risk for INR's trajectory in H2 20. 2. The banking sector's fragility (especially post the loan moratoriums) and commodity prices will remain key risks.

KRW

We maintain our relatively constructive view on the Korean won despite multiple geopolitical risks on the horizon, i.e. US-China tensions, North Korea's return to provocation, and simmering trade disputes with Japan. **First**, the latest North Korean provocations are unlikely to escalate to incidents more severe than the shelling of a South Korean island near North Korea's coastline or the sinking of South Korea's patrol ship in the past. We note that these past events did not trigger significant market reaction (see chart 20). **Second**, South Korea's fundamentals remain quite strong, with the Covid-19 epidemic curve under control, the ruling party with a newly won large majority in the National Assembly to pass needed fiscal packages and other support measures, and global home-office build-out anchoring tech exports. **Third**, while the Bank of Korea is likely to bring the benchmark domestic rate down to zero this year, the bank will be relatively cautious due to worries about the limits of interest rate policy and the government's strong preference for tight controls on the real estate market.

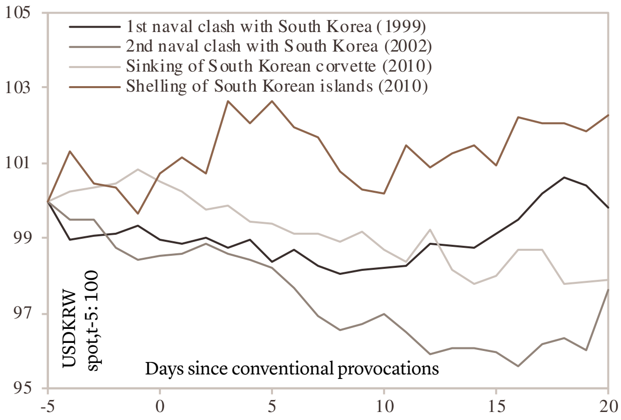
Events and risks to the view: 1. While currently manageable, geopolitical risks surrounding China and North Korea will remain critical for the Korean won. 2. The arrival of new members on the BOK policy board could trigger a shift in the bank's internal debates on long-term monetary strategy.

TWD

TWD remains our favourite 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 spectacularly successful, and the country can contemplate full normalisation of economic activities unlike most of its peers. **Second**, the currency is underpinned by one of the most solvent systems in the world, with net claims on foreign assets, FX reserves, and the external balance all very high as percentage of GDP (see chart 21). **Third**, the country could see the combination of life insurance companies' repatriation flows and equity flow recovery in H2 2020 if global growth resumes as we predict.

Events and risks to the view: Main risks are potential direct confrontation with China on President Tsai'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.

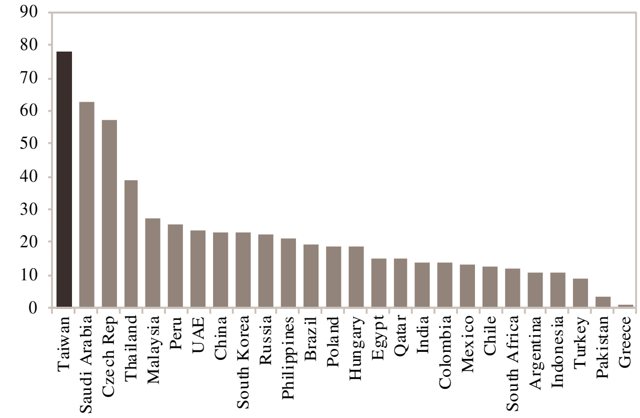
20. KRW somewhat indifferent to past North Korean provocations



Sources:Bloomberg, Lombard Odier.

21. Taiwan has the strongest solvency metric in emerging markets

FX reserves as % of GDP (2018 data)



Sources: CEIC, Bloomberg, Lombard Odier

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

Back to cover page

Asia FX
Steady beneath the noisy geopolitical headlines

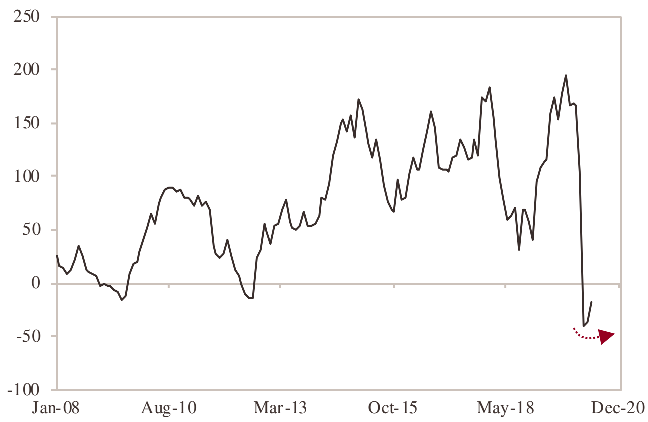
IDR

The rupiah has rallied more than 18% from its low point in at the start of April, and it is back at the pre-Covid-19 level. We remain constructive on the currency even though gains will be more limited in the remainder of the year. **First**, foreign flows to Indonesia's bond market are beginning to recover amidst the easing of acute USD funding stress. The US Federal Reserve's launch of the repo facility has been a major boon to Bank Indonesia's ability to manage USD liquidity. **Second**, Indonesia's real interest rate remains relatively attractive due to Bank Indonesia's somewhat conservative stance on monetary policy. The bank's recent bond purchases are part of liquidity management and are not particularly larger than regional peers'. **Third**, the Widodo administration has been treading carefully after raising the fiscal deficit target, and we expect the administration to maintain this preference for targeted measures and relative restraint for some time, unless the Covid-19 epidemic worsens substantially.

Events and risks to the view: 1. The country's steadily rising Covid-19 epidemic curve (with over 1,000 cases per day) will be a key risk. Any material change to BI's overall stance on bond purchases could weaken the rupiah, but this is not our base case. Prices of bulk commodities will also be a key risk.

22. Foreign demand on IDR bonds stabilising after historic collapse

12-month change in foreign ownership of Indonesian gov't bonds, IDR trillion



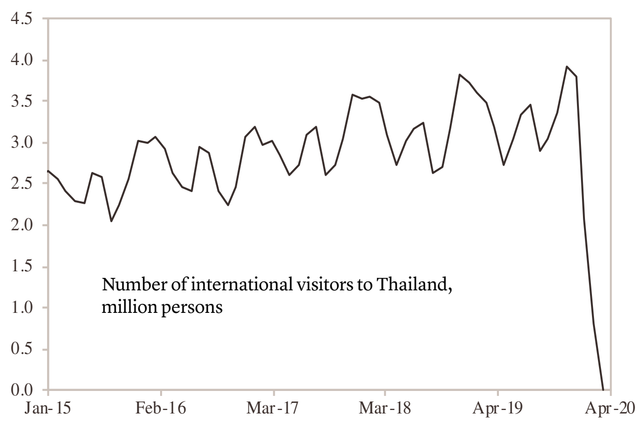
Sources: CEIC, Lombard Odier

THB

We are neutral on the baht, and we maintain our scenario of a slight rebound in the currency before the end of the year. **First**, the country will benefit from the easing of the national lockdown that began in early May. Thailand has been one of the successful cases of epidemic control in Asia, despite its earlier exposure to the risk. The high-frequency indicators suggest that domestic growth has been rebounding after a sharp slowdown between March and April. **Second**, the Bank of Thailand might not be able to fight the modest appreciation of the baht, with its interest rate ammunition almost tapped out and the US closely watching its currency policy. **Third**, the negative shift in the country's vital tourism sector will prove durable over the next few years due to the changing perception of risks in international travel (see chart 23). This will weigh on the country's medium-term growth prospects and the upside potential for the baht.

Events and risks to the view: Main risks are 1. deterioration of the Covid-19 outbreak among Thailand's neighbours, 2. US stance on the country's currency policy, and 3. the BoT's stance on widening fiscal deficits.

23. Thailand's tourism sector undergoing a historic shock



Sources: Bloomberg, Lombard Odier.

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

Asia FX
Steady beneath the noisy geopolitical headlines

MYR

The ringgit's performance has stabilised, and we continue to see a modest appreciation of the currency in the remainder of the year. **First**, the formation of the new coalition government under Prime Minister Muhyiddin Yassin ends weeks of political intrigue, and creates some scope for policy stability in the coming quarters. We do not believe that a snap election is likely in 2020 since the current parliament has a mandate extending to 2023. **Second**, the government's record supplementary budget will ease the pressure on Bank Negara Malaysia to cut its benchmark rates aggressively, which the bank is likely reluctant to do given its usual focus on currency stability. **Third**, the country has been able to bend the epidemic curve substantially with more disciplined testing and a contact-tracing programme on par with those of better-known success cases such as South Korea. This enhances the credibility of the government's gradual re-opening strategy.

Events and risks to the view: Main risks are 1. unexpected snap election decision by the ruling coalition, 2. trajectory of local confirmed cases of Covid1-9, 3. oil price trends and their impact on the government's fiscal balance, and 4. global demand for its industrial commodities and mid-end manufactures.

PHP

The peso has been a surprising outperformer in Asia due to its low sensitivity to China and its 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 when visibility about global recovery materialises in H2. **First**, the Philippines has just begun to flatten its epidemic curve after a substantial spike between mid-May and early June, and the situation remains fragile despite punitive lockdowns in key metropolitan areas. **Second**, the Bangko Sentral ng Pilipinas (BSP) has been the most aggressive rate-cutting central bank in the region, and we expect it to maintain this dovishness for the remainder of the year to ensure strong recovery amidst the lingering epidemic challenges. **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.

Events and risks to the view: Main risks are 1. the trajectory of local confirmed cases of Covid-19, 2. investor pricing for the likely period of political uncertainty ahead of the 2022 presidential election, and 3. industrial commodity price trends.

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

LatAm FX
Continue long standing preference for MXN over BRL

- Over the past month, LatAm currencies all rallied given the recovery in energy prices and improvement in risk sentiment
- We maintain our cautious view on the BRL and the COP, and continue to prefer the MXN beyond any near-term correction
- Both PEN and CLP should hold their value better on a brighter outlook for copper, thanks to China's infrastructure push, and lower debt levels.

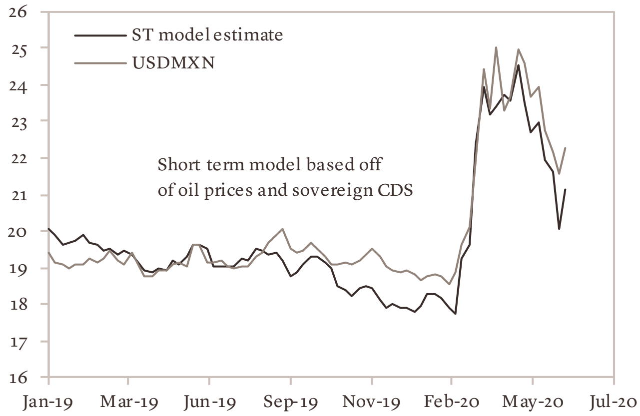
MXN: Modestly better performance in the months ahead

MXN falls into our category of "modest outperformers". Provided rating downgrade risks do not materialise in the coming three to six months, we believe the currency could perform reasonably well, and better than both COP and BRL. We would make the following points regarding the currency.

First, our longer-term USDMXN model (based on oil prices, growth differentials and projected government debt) suggests that the cross will likely hover on either side of 21 for now, however a projected rise in government debt will take fair value to 23.00 by year-end. However, USDMXN could well undershoot in the months ahead given improving global risk-sentiment and better supported energy prices, beyond near-term stabilisation (chart 24) **Second**, unlike other central banks in LatAm, real rates remain relatively elevated (above +250bp) and the central bank has been more cautious in easing policy than others. Similarly, the fiscal response has also been more conservative in the country. The more cautious approach should hold the currency in good stead. **Third**, FX carry stands close to 5%; while this is below the 8% seen 12 months earlier, it scores favourably compared to the 3% and 1.7% offered by COP and BRL, respectively. **Fourth**, external balances are supportive. The country's non-commodity balance has been improving sharply in recent quarters. This should see the external balance further improve, in turn capping USDMXN (chart 25). **Fifth**, the main risk for Mexico is a worse fiscal deterioration. While in comparison to Brazil, government debt/GDP is relatively low, gross government debt/GDP is projected by the IMF to rise to 61% (end-2020) from 54% (end-2019), but is expected to decline modestly to 59% (end-2022). However, a worse fiscal deterioration driven by even weaker growth and/or a rise in contingent liabilities (if the government takes on the debt of PEMEX) pose risks of a downgrade. This will keep a check on any gains in MXN.

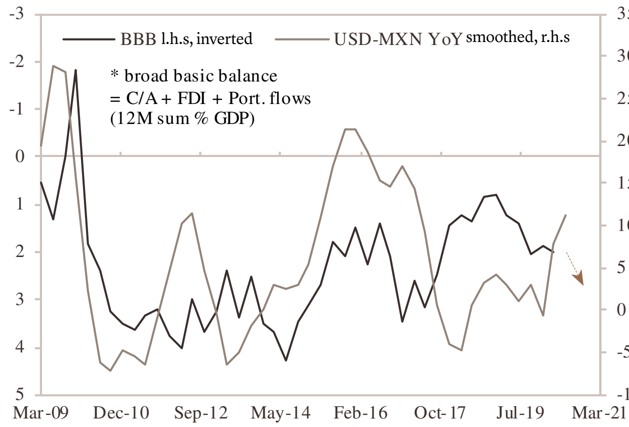
Risks to our view: Downside risks include 1. a surge in virus cases and further downward revisions to growth that, in turn, lead to further rating downgrades and a loss of investment grade (IG) status. 2. Further weakness in the US economy, compressing demand for unskilled workers, would be another risk.

24. USDMXN likely to consolidate near term before declining



Sources: Bloomberg, Lombard Odier.

25. Improving external balance should cap USDMXN



Sources: Bloomberg, Lombard Odier.

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

LatAm FX
Continue long standing preference for MXN over BRL

BRL: To come under renewed pressure

Along with TRY and ZAR, BRL remains in our group of "fragile" EM currencies given rising political risks and extremely elevated debt levels. We forecast a further 6% depreciation by March 2021.

First, while the BRL appears undervalued, we believe it will continue to underwhelm. The country was slow to contain the virus, with President Bolsonaro resisting the 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 on offer 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 1.80% 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 CB remaining dovish (and even entertaining QE), 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 26) suggest that USDBRL overshoots are a possibility.

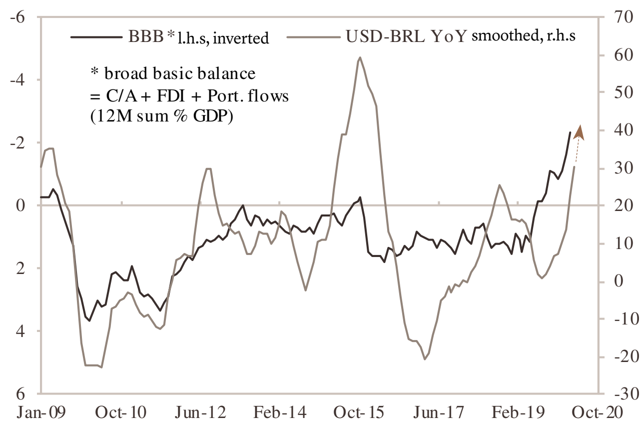
Risks to our view: 1. A critical risk remains an uncontrolled virus breakout with Brazil – which, unlike its neighbours, refrained from adopting a coherent national strategy on the lockdown. 2. Growing risk of Bolsonaro being impeached should warrant an additional risk premium, though this is more likely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

CLP and PEN: Look to buy CLP on dips

Both PEN and CLP fall into our respective categories of "neutral" and "modest outperformers". We pencil in 1.5-2.5% gains for both until June 2021. Our year-end targets for USDCLP and USDPEN stand at 780 and 3.44, respectively.

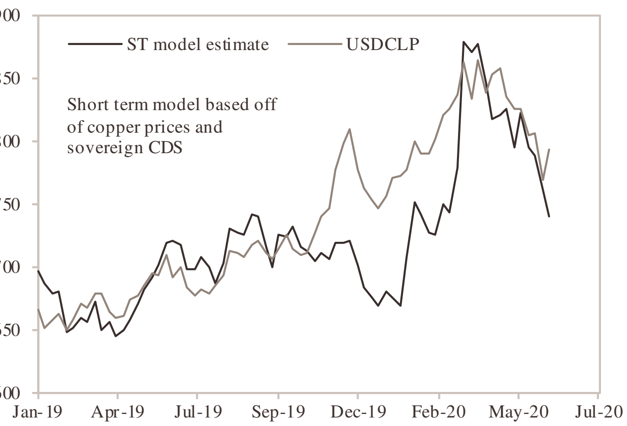
First, we believe both the CLP and PEN, being copper-exporters, have an exposure to a China recovery in H2. Increased fiscal stimulus in China, especially a loosening of property restrictions would be a positive for both currencies. **Second**, valuation is compelling: both the CLP and PEN screen as undervalued against longer-term macro

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



Sources: Bloomberg, IMF, Lombard Odier

27. USDCLP sell-offs may have longer to run



Sources: Bloomberg, IMF, Lombard Odier

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

LatAm FX
Continue long standing preference for MXN over BRL

fundamentals. Even on higher-frequency models using market-determined variables, CLP may have further room to rally (chart 27). **Third**, both Chile and Peru have amongst the lowest government debt levels within LatAm (see chart 28). Gross government debt for Chile is seen rising from 28% (end-2019) to 35% (end-2021), still relatively low. Gross government debt for Peru is seen rising from 27% (end-2019) to 37% (end-2021). Hence, for both countries, 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 to 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 IMF 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) would present an event risk for the currency and could cause some volatility heading into the vote.

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

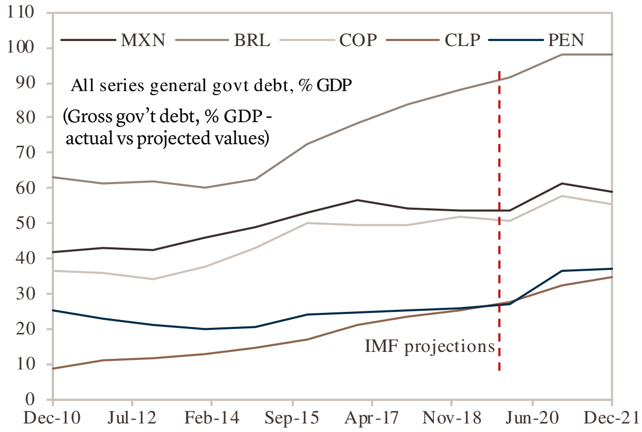
COP: Surprisingly resilient, but fundamentally less secure

COP falls into our category of "fragile currencies" alongside the likes of BRL, ZAR, and TRY. That said, we believe the COP will be the relative outperformer within this group. We forecast spot depreciation of 3% by June 2021, with USDCOP likely to end the year closer to 3,820. We would make the following points regarding the currency.

First, 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 the IMF projections for government debt, fair value is seen rising to 3,705 by the end of 2020, suggesting a limited scope for a sharp decline for USDCOP. **Second**, and in stark contrast to Brazil, Colombia has adopted one of the strictest lockdown strategies in LatAm, and hence may be less at risk than others to the virus. **Third**, gross government debt/GDP is projected by the IMF to rise to 58% (end-2020) from 51% (end-2019), but is expected to decline modestly to 55% (end-2022). Similar to Mexico's case, a continued deterioration in public finances would pose rating downgrade risks. Still, unlike Mexico, the external balances are weaker and this keeps us relatively bearish on the COP.

Risks to our view: A likely deterioration in growth and fiscal balances may increase the risk of a sovereign rating downgrade. We will keep a close eye on any comments from S&P, as the rating agency has set the sovereign just one notch above IG.

28. More fiscal space implies lower risks for CLP & PEN in crisis response



Sources: Bloomberg, IMF, Lombard Odier

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

CEEMEA FX
Favouring CEE currencies

- Amongst the high-yielders, we believe the RUB will remain stable, but both the TRY and ZAR will be unstable and under depreciation pressure
- Instead, we believe CEE currencies as well as the ILS will perform better against the USD.

RUB: Stable high-yielder

The RUB falls into our category of "modest underperformers". We forecast flat returns until March 2021, and would pencil USDRUB remaining in a range around the 70 mark.

First, we expect that USDRUB stay largely in a range around the 70 mark. 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 29). The main driver for this is government debt that is expected to rise, even though from low levels. **Second**, the government operates a budget rule based on an assumption of USD 42 per barrel. When energy prices were above this level, the central bank was buying USD on behalf of the Ministry of Finance, whereas when prices fell below after March, large FX sales have been noted (chart 30). The aim is to reduce the sensitivity of the economy to swings in energy prices. However, when COVID19 struck, our assumption was that the budget rule would be suspended and the exchange rate would be allowed to adjust, as was the case in previous crisis episodes (like after 2008). However, the continuation of the budget rule has supported the RUB. Since 11 March, the central bank has sold USD 10.8 bn of FX. This supportive factor will likely decline as oil prices go back above USD 42pb. **Third**, the central bank has been very cautious in its easing so far, cutting rates by only 50 bps since the beginning of the year. However, with inflation well below target (3% YoY vs 4% target) and real rates ample (at 250 bps), more easing appears likely going forward.

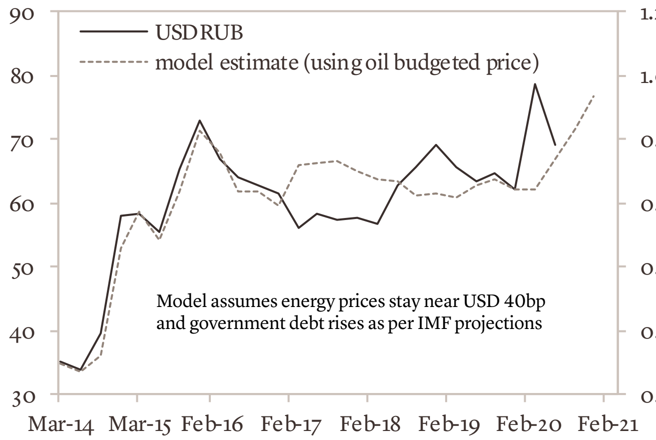
Risks to the view: Markets are no longer pricing in US sanctions risk as they did in 2018-19. Hence, any new developments should be seen as RUB-negative. On the other hand, a sharper energy price rally could support the RUB.

TRY: 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, with USDTRY going to 7.13 by year-end. We would make the following points regarding the currency.

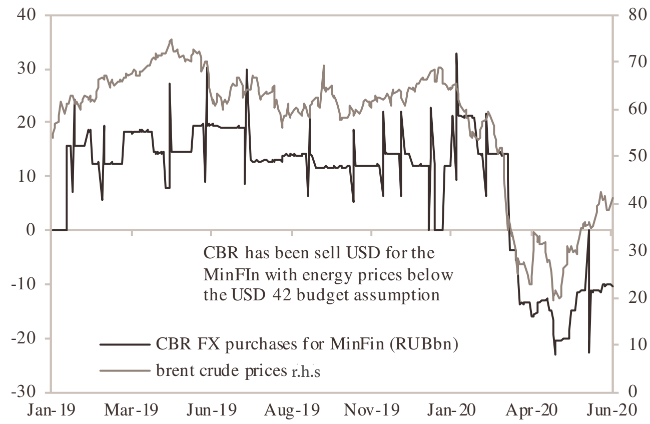
First, we are bearish on the TRY, but the rapid pace of Q2 weakening – likely on account of larger debt redemptions (USD 18 bn fall between April and June) – should give way to a slower decline in the weeks ahead. **Second**, given the sharp weakness in the economy, credit growth has been ramped up and now runs at extremely high levels not seen since 2006. This should result in the current account balance weakening

29. USDRUB downside potential from here likely limited



Sources: Bloomberg, Lombard Odier.

30. CBR FX sales likely to end when energy prices surpass USD 42 per barrel budgeted level



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX
Favouring CEE currencies

from here on. Coming at a time when citizens continue to accumulate US dollars (chart 31), this means TRY will remain under weakening pressure. **Third**, recent data showed inflation coming higher than expected in May, the first upside inflation surprise in a while. Real rates have now turned negative, and do not compensate investors for taking investment risk. **Fourth**, 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.

Risks to the view: Given the bearish outlook due to very low FX reserves, we would highlight a positive risk – the possibility of Turkey seeking assistance from the IMF to obtain an external backstop.

ZAR: Facing rising fiscal risks

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, with USDZAR going to 17.80 by year-end. We would make the following points regarding the currency.

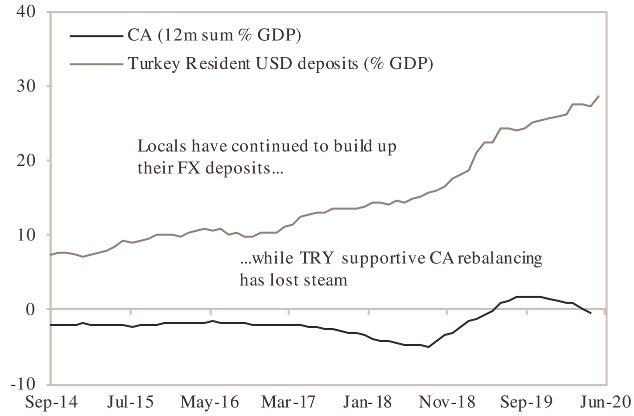
First, despite the profound losses, the ZAR is not cheap when we factor in longer-term drivers like government debt and commodity prices. **Second**, in our sample of EM countries, South Africa (along with Brazil) faces the worst fiscal position, having both high gross debt levels and growth likely to undershoot the real interest rate on debt (see chart 32). This means that beyond simply the effect of weak growth, the gross debt trajectory will continue to move higher. **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. **Fifth**, while in theory, South Africa should benefit from a Chinese growth recovery, we note that the share of South Africa in Chinese imports has continued to decline in recent years. This suggests the marginal benefit from a Chinese recovery will be lower for the ZAR compared to peers such as the CLP in LatAm.

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.

CEE FX: A preferred long against the USD

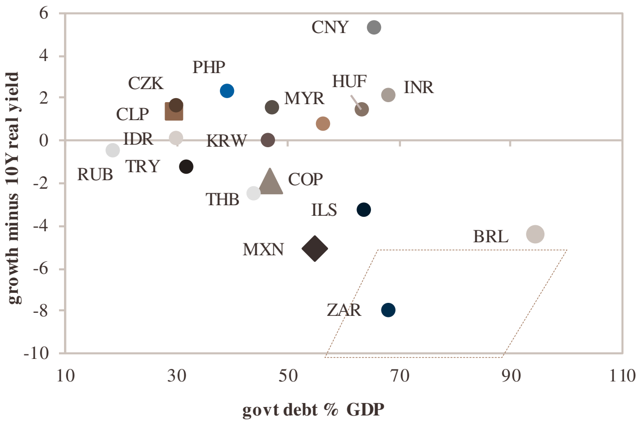
We believe that the currencies of Central and Eastern Europe may be among the best positioned to benefit against the USD. We forecast 4% to 6% gains for the CEE currencies against the USD by the end of June 2021, largely because of a more positive outlook on EURUSD.

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



Sources: WHO, Bloomberg, Lombard Odier

32. ZAR faces rising fiscal risks



Sources: Bloomberg, IMF, Lombard Odier

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

CEEMEA FX
Favouring CEE currencies

First, Central and Eastern Europe (CEE) appear to have already priced in the hit to global growth, and is now looking forward to a recovery, especially in the euro area (chart 33 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. **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 have, which could imply that growth downgrades will slow. Data has already begun to show signs of green shoots. **Fourth**, we prefer both the CZK and the PLN to the 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.

Risks to the view: A sharper slowdown in global growth and the auto sector is a negative risk for CZK and HUF. For the 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.

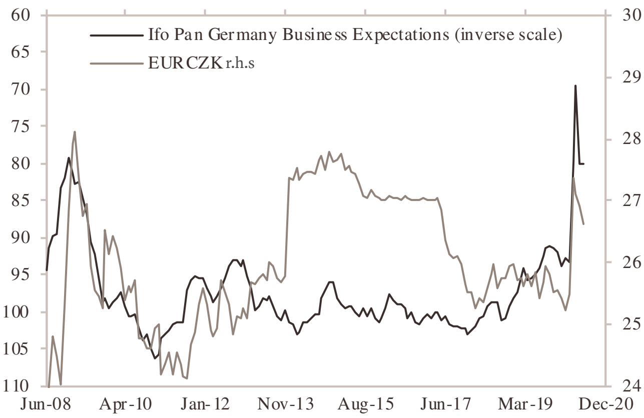
ILS: Dependent on tech sector and US yields

Along with the KRW, IDR, MYR, and CLP, the ILS is in our group of "modest 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 short- term fair value model suggests ILS is sensitive to US real yields and to the performance of the tech sector (proxied by the NASDAQ). USDILS has recently declined towards the lower 3.40-3.45 range implied by the short-term model (see chart 34). **Second**, Israel has strong balance of payments support with a strong current account as well as FDI inflow. The country has had robust investments from foreign tech names in recent years given its status as a regional "tech hub". This suggests there will be pressure on the ILS to appreciate that can be slowed only by FX intervention (somewhat similar to the Swiss National Bank). **Third**, we believe that the central bank (BOI) will begin intervening to ensure USDILS does not decline too fast. After having suspended interventions in March, the central bank has suggested it will step in once again to cap the ILS.

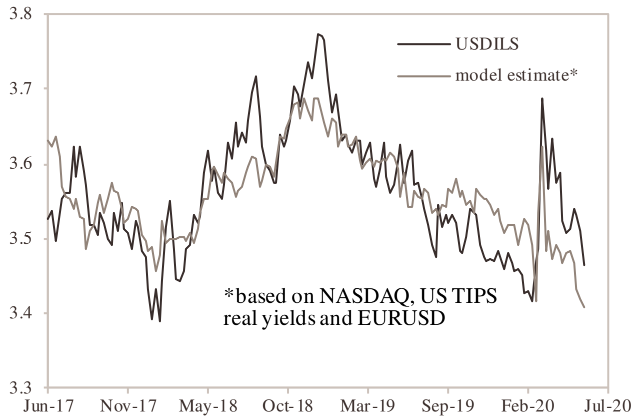
Risks to the view: A sharp slowdown in the global tech sector is a downside risk for ILS.

33. Chart 33: EURCZK decline consistent with recovery in German IFO



Sources: Bloomberg, Lombard Odier.

34 USDILS has declined towards short-term fair value



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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