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Global FX Monthly
US-China tensions make a comeback

05/20

May 2020

FX forecasts		Q220	Q420
G10	EURUSD	1.09	1.11
	USDJPY	105	103
	EURCHF	1.05	1.05
	GBPUSD	1.23	1.28
	EURGBP	0.89	0.87
EM	USDCNY	7.08	7.03
	USDINR	76.4	75.6
	USDIDR	14844	14629
	USDMXN	23.8	23.5
	USDBRL	5.83	6.01
	USDRUB	72.7	72.7
	USDZAR	18.70	19.30

Key highlights

- We have lowered our EURUSD forecasts to reflect on the recent messy constitutional challenges the euro area is facing. However, some progress on the coordinated Covid-19 fiscal response (recovery fund) poses upside risks to our new forecasts
- EURCHF is likely to trade close to the 1.05 level, as demand for Swiss francs will likely be offset by SNB intervention
- Although we maintain our GBP forecasts for now, downside risks to the currency are rapidly increasing
- As things stand, the JPY remains our favoured play against the USD across the main G10 currencies, while gold should be in any balanced portfolio to counter the materialisation of an adverse scenario
- In EM, we reiterate our view for Asia to outperform other regions. However, we have increased our USDCNY forecasts to reflect a higher risk premium due to the comeback of US-China tensions. BRL, ZAR, and TRY will remain at the bottom of the performance pile.

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

At a glance

Introduction

There have been four important developments in global markets relevant for the FX world, which have been working in opposite directions.

On the positive side, the Covid-19 infection curve has plateaued allowing the gradual re-opening of most main economies, which should pave the way to a growth recovery in H2 2020. In addition, the EU looks closer to an agreement on a recovery fund, though this is by no means certain yet. On the negative side, US-China frictions have come to the forefront again with the US administration accusing China of mishandling the virus outbreak and threatening with retaliatory measures. Moreover, the German court ruling on the ECB's PSPP has created a messy constitutional challenge in the euro area that is likely to weigh on investors' sentiment and add a risk premium to the euro.

Our fundamental case for USD weakness in the second half of the year remains in place, however we now see EURUSD lagging, with our forecast for year-end trimmed to 1.11. The increase in Euro zone-related risks also implies a lower trajectory for EURCHF than the one we had pencilled in before: we now see the pair stable at 1.05 as ongoing demand for francs will likely be offset by continued SNB intervention. Turning to sterling, we maintain our base case of a deal being reaching with the EU at the end of the year, which should be fundamentally supportive. However, we acknowledge that there is lack of progress and the limited time available suggests risks are to the downside. Within the main G10 currencies, our preference remains for the JPY. It screens as deeply undervalued on multiple metrics while it continues to exhibit global safe haven properties. Yen and gold, remain two of the best hedges against a resurgence of risk aversion.

Turning to emerging markets, since the sharp decline in energy prices in March, the GBIEM FX index has largely been range bound despite the modest recovery in energy prices. However, there has been a big divergence in terms of performance: currencies of North Asia and Central Eastern Europe as well as the CLP in LatAm have held in quite well; supported by stronger external balances, lower starting levels for government debt and their status as net-energy importers. On the other hand, higher-yielding, commodity-sensitive currencies have underperformed.

Within this latter group, currencies having lower debt levels and relatively hawkish central banks (IDR and RUB) have recovered nicely while both the MXN and COP- having more manageable debt burdens - have also stabilized.

However, currencies like TRY and BRL have been the clear underperformers given weak external balances (Turkey) and elevated debt levels and growing fiscal risks (Brazil). We expect these divergences to become more pronounced and have further raised our forecasts for USDBRL to reflect additional risks related to the unstable political situation.

Meanwhile, while the CNY has been amongst the most stable EM currencies, the recent rise in US-China tensions has been a noteworthy and unwelcome development. We have adjusted our USDCNY forecasts, now expecting 7.08 and 7.03 for Q2 and Q4, respectively. Even while our base case scenario is for large new tariffs to be averted, we believe US-China tensions will remain elevated in the months leading to the November US election. This should see the CNY incorporate some risk premium.

Back to cover page

FX forecasts – G10 and gold

	Current spot	Q2 20	Q3 20	Q4 20	Q1 21	Estimates of long-term fair value[1]
EURUSD	1.09	1.09	1.10	1.11	1.12	1.17
GBPUSD	1.22	1.23	1.26	1.28	1.30	1.40
EURGBP	0.89	0.89	0.87	0.87	0.86	0.84
EURCHF	1.06	1.05	1.05	1.05	1.06	1.04
USDCHF	0.97	0.96	0.95	0.95	0.95	0.89
USDJPY	107	105	104	103	102	94
EURJPY	117	114	114	114	114	109
EURSEK	10.55	10.70	10.65	10.65	10.60	9.95
USDSEK	9.65	9.82	9.68	9.59	9.46	8.58
EURNOK	10.96	11.00	10.90	10.85	10.80	9.24
USDNOK	10.02	10.09	9.91	9.77	9.64	7.96
AUDUSD	0.65	0.65	0.66	0.67	0.68	0.73
NZDUSD	0.61	0.61	0.62	0.63	0.63	0.64
USDCAD	1.40	1.40	1.38	1.37	1.36	1.26
Gold	1732				1600	

1 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 X for a more detailed explanation.

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

FX forecasts – EM

Asia

	Current spot	Q2 20	Q3 20	Q4 20	Q1 21
USDCNY	7.12	7.08	7.06	7.03	6.98
USDHKD	7.75	7.75	7.75	7.75	7.75
USDIDR	14710	14844	14814	14629	14475
USDINR	75.8	76.4	76.5	75.6	74.5
USDKRW	1237	1231	1225	1213	1201
USDMYR	4.37	4.38	4.34	4.30	4.26
USDPHP	50.7	50.8	50.8	50.7	50.6
USDSGD	1.42	1.41	1.41	1.40	1.39
USDTWD	30.0	30.0	29.8	29.5	29.2
USDTHB	31.9	32.0	31.8	31.7	31.5

LatAm

	Current spot	Q2 20	Q3 20	Q4 20	Q1 21
USDMXN	23.0	23.8	23.7	23.5	23.1
USDBRL	5.55	5.83	5.92	6.01	6.10
USDCOP	3 770	3 891	3 920	3 950	3 979
USDCLP	803	819	818	811	804
USDPEN	3.41	3.42	3.41	3.39	3.37

CEEMEA

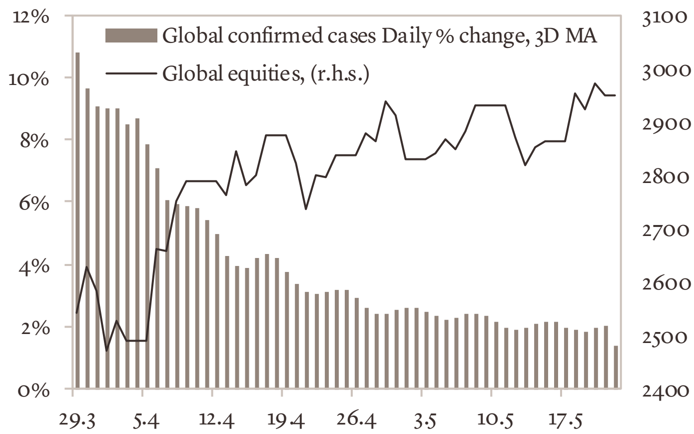
	Current spot	Q2 20	Q3 20	Q4 20	Q1 21
USDRUB	71.0	72.7	73.0	72.7	72.3
USDTRY	6.79	6.98	7.12	7.30	7.45
USDZAR	17.7	18.7	19.0	19.3	19.6
USDILS	3.53	3.52	3.49	3.46	3.43
EURPLN	4.52	4.58	4.57	4.56	4.52
EURCZK	27.1	27.6	27.8	27.9	27.8
EURHUF	348	352	354	355	355

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

G10FX: Three key charts

The Covid-19 infection rate has decreased substantially and this has fuelled a rally in risk assets.

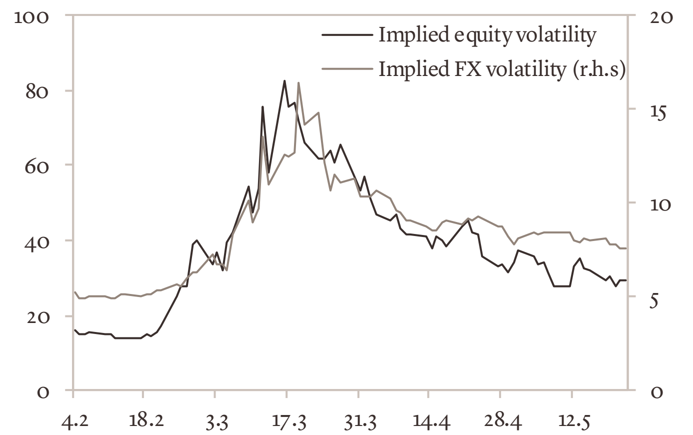
1. Covid-10 global confirmed cases and global equities



Sources: Bloomberg, Lombard Odier.

Implied volatility has declined significantly from its peak in mid- to late March, and is approaching more normal levels.

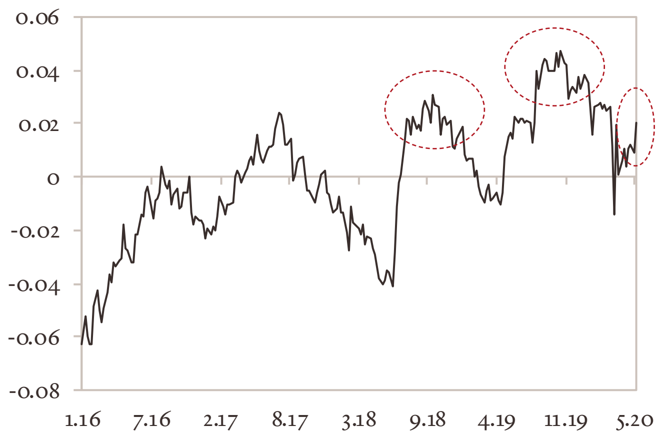
2. Equity and FX implied volatility



Sources: Bloomberg, Lombard Odier.

USDCNY and the trade-weighted dollar tend to move together in relative terms. In other words, there is a close relationship between the two. The chart to the right shows the deviation of the current USDCNY spot price from that implied by the relationship with the TW USD. In periods when US-China tensions flared up, the currency traded higher than its implied level – incorporating various trade war-related risk premia. Although tentative, this divergence has re-emerged as frictions between the US and China have made a comeback. This requires close monitoring.

3. Deviation of USDCNY from its implied level (based on trade-weighted dollar)



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

EUR: The recent euro-area constitutional challenges present another hurdle to EUR appreciation

- We have cut our EURUSD forecasts to 1.09 for Q2 2020 and to 1.11 for Q4 2020
- The change in our (constructive) view is based on the recent euro-area constitutional challenges arising from the German court ruling
- The possibility of an EU agreement for a recovery fund could help lift the euro higher, but is by no means a done deal.

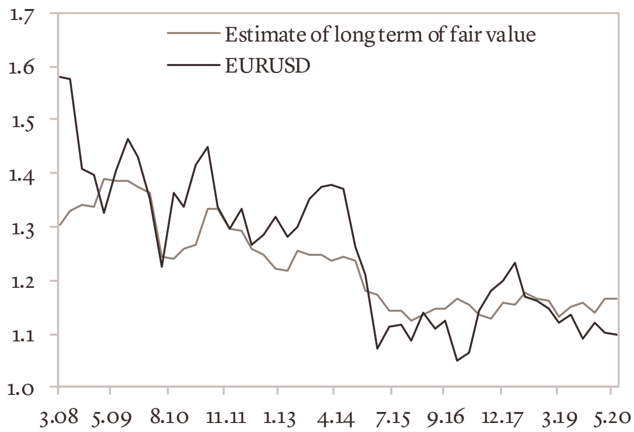
The 5 May German court (GCC) ruling on the ECB's Public Sector Purchase Programme (PSPP) represents a significant headwind for the EUR. The GCC ruled that the Central Bank of Germany (Bundesbank) may no longer be allowed to participate in the PSPP unless the ECB demonstrates that "monetary policy objectives are not disproportionate to the fiscal and economic policy effects of the programme", and gave the ECB three months to provide said proof. We discussed what this implies for EURUSD extensively in our recent Investment Strategy Bulletin, and below we give a summary of these views.

First, the decision is unlikely to generate a full-blown constitutional crisis (the Bundesbank should be able to provide a justification for the PSPP along the lines of what is required), but it will depress already-fragile investor sentiment towards euro-area assets. It causes confusion about the primacy of the ECJ to interpret EU law and – to a certain extent – undermines the independence of the ECB. **Second**, it is likely to keep euro-area peripheral spreads elevated, which would be an additional source of pressure on the euro. **Third**, although we do not doubt the ECB's resolve to expand its Pandemic Emergency Purchase Programme (PEPP) further amidst the virus-related risks, there is now a higher risk that the German court ruling could affect future decisions on the size and composition of additional asset purchases. **Fourth**, the move has set a precedent that increases the risk of similar legal battles between national courts and their national central banks across member states. **Fifth**, it is possible that the decision could pave the way for the PEPP to come under similar legal scrutiny.

We do not believe that EURUSD will collapse, as undervaluation is meaningful (see charts 1 and 2), the euro area's current account (C/A) surplus is high, and fiscal stimulus has been enacted by individual member states to stem off the pandemic outbreak. **However, this constitutional-related uncertainty means that there is now a higher risk premium embedded in the euro, and that the bar for material appreciation has risen.**

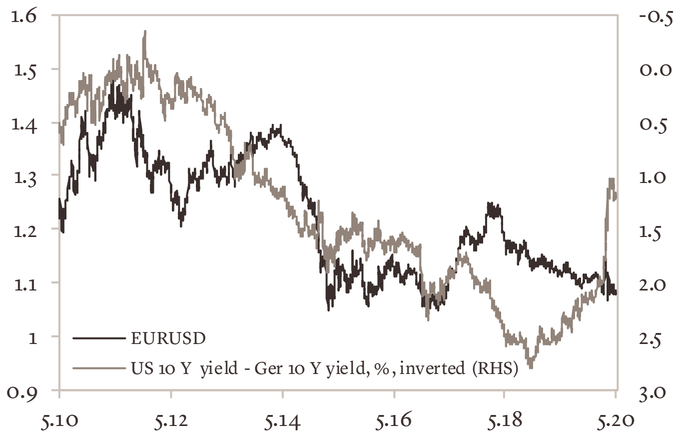
Risks to this view: We see both upside and downside risks.

4. EURUSD trading around 6-7% below our estimate of long-term fair value...



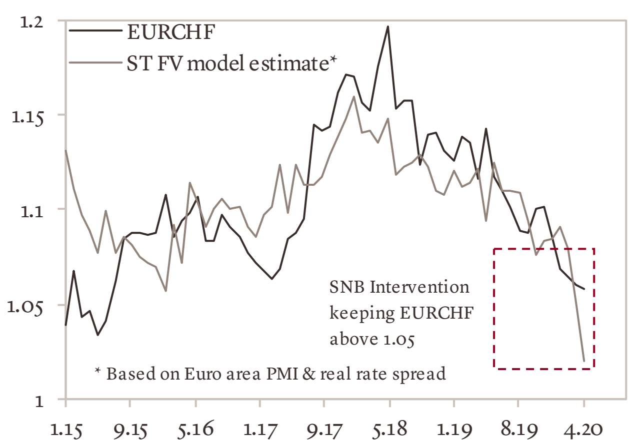
Sources: Bloomberg, Lombard Odier.

5. ... and considerably below the GE-US yield differential



Sources: Bloomberg, Lombard Odier.

6. EURCHF held higher due to SNB FX intervention



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

On one hand, the recent agreement between Germany and France to back a EUR 500 bn recovery fund is an important development, especially since it would be funded by EU borrowing, and the proceeds then distributed via budget transfers (i.e. in a way that would not impact the economies' debt profiles). However, such a proposal still requires the agreement of all 27 EU members, and Austria, Denmark, Netherlands, and Sweden are already resisting (they prefer disbursement via loans), Therefore, this may turn out to be a lengthy process, at a time when the pandemic-induced economic damage in several EU countries is currently being felt. **Nonetheless, it is a significant breakthrough, and if it leads to a swift agreement and implementation, then our EURUSD view would again become constructive.**

On the other hand, we would turn outright EURUSD bearish if 1) the constitutional challenge morphs into a full-blown constitutional crisis; 2) EU leaders fail to agree on a common fiscal support measure or the process drags on for too long; and/or 3) the improvement in the infection curve in Europe reverses.

CHF: We have lowered our EURCHF trajectory for this year

- We now see EURCHF trading flat around 1.05 for the rest of the year mainly due to increased euro-area risks
- Our assumption of a flat EURCHF profile rests on the SNB maintaining FX intervention. Should the central bank decide to step back from these operations, EURCHF could gravitate closer to parity.

Alongside the adjustments to our EURUSD forecasts, we have lowered our EURCHF targets for this year. We did so for two reasons. **First**, the increased euro-area risks (as outlined above) generate an additional source of pressure for EURCHF. In periods of higher risk aversion, the pair tends to be inversely correlated with IT-Bund yield spreads, suggesting that as long as the latter remain wide, then EURCHF will find it extremely difficult to recover. **Second**, yields in both the US and euro zone have fallen or remained exceptionally low, leading the real yield differential between the EMU (and the US) and Switzerland to compress, and exerting upward pressure on CHF crosses (see chart 6).

That said, we still expect the SNB to keep intervening in the market to ensure that EURCHF does not fall substantially and sustainably below 1.05 – which appears to represent the new "line in the sand" for the Swiss central bank.

Risks to this view: We discussed both upside and downside risks to this view in our Investment Strategy Bulletin. To summarise, we would turn mildly constructive on EURCHF if euro-area risks abate, but would expect a move towards parity if 1) there were an increase in euro-area risks (relating to the region's constitutional challenges and/or EU's coordinated fiscal response to the pandemic); and/or 2) the SNB decided to step back from FX intervention in view of its already exceptionally large balance sheet.

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FX majors and gold

GBP: The sterling rally takes a breather

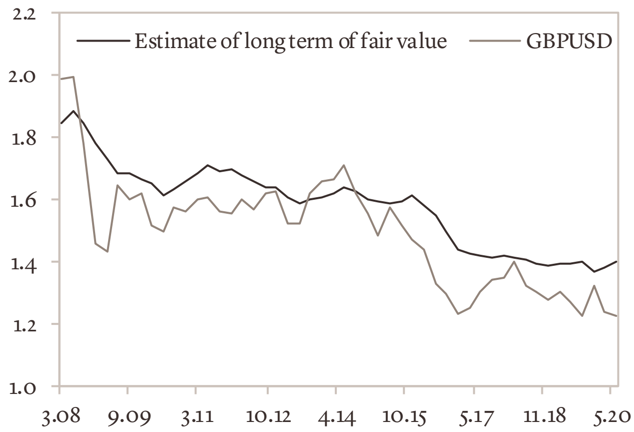
- Following the strong GBP rally, sterling has gravitated lower
- We maintain a medium- to long-term constructive view for now...
- ... but downside risks are increasing quite rapidly

Our medium- to long-term constructive view on sterling rests on three assumptions. **First**, there is the broad USD downside we envisage for the second half of the year. **Second** is the GBP's ongoing undervaluation from a long-term perspective (see chart 7). **Third** is our view that the UK will avoid a no-deal Brexit at the end of the year.

However, downside risks are increasing. **First**, we are quickly approaching the July deadline for the UK to request an extension of its transition period. Although the virus-related disruption would make it logical (and easily defensible) for the UK to ask for an extension, Boris Johnson has insisted that no such request will be made. This implies that the time to sort out numerous and complicated differences with the EU has become extremely tight, raising the risk of a no-deal Brexit at the end of the year. **Second**, we are concerned about the very slow envisaged lifting of the lockdown. The UK economy contracted by 2% QoQ in the first quarter of the year, and the hit in the second quarter will surely be much more dramatic. The current plans to ease restrictions extend to early July, which would imply that the economy would have remained partly idle for nearly four months, longer than other economies in Europe (based on current planning). Plans to introduce a 14-day quarantine in international arrivals would bring the aviation industry to its knees (currently contributing around GBP 52 bn on an annual basis), and would cripple many other segments of the hospitality sector. **Consequently, we fear that the recovery may lag expectations, something that would be a clear negative for sterling.** For the moment, we maintain our GBPUSD forecast, i.e. of 1.23 for Q2 2020 and 1.28 for the end of the year – but we will be monitoring developments very closely.

Risks to this view: The risks are mostly to the downside and include 1) a very sluggish recovery due to a very slow lifting of the lockdown; 2) failure by the UK to make progress with the EU on significant Brexit matters during the second half of the year; and 3) a move by the Bank of England (BoE) to bring interest rates into negative territory. The BoE's chief economist Andy Haldane suggested in a recent speech that emergency measures including negative rates are on the cards. This opinion is shared by Silvana Tenreyro – an external MPC member – who stated that she felt negative rates had had a positive effect on the euro area.

7. GBPUSD more than 10% undervalued relative to long-term fundamentals



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

JPY: Adding JPY exposure to our portfolios

- Renewed US-China frictions add tailwinds to the (already) undervalued JPY
- We have increased JPY exposure in our portfolios.

On a number of occasions, we have made two points regarding our preference for the JPY. **First**, the pair is substantially dislocated from a number of metrics including the US-JN yield differential and the relative growth rates of the two respective central banks' balance sheets (see charts 8 and 9). **Second**, we have repeatedly said that JPY remains the most effective hedge (alongside gold) against global risks, such as a worsening of the pandemic, renewed US-China tensions and/or a very sluggish global growth recovery.

We maintain all these views, and have recently decided to add another 2% of JPY (against the USD) to our portfolios on account of substantial undervaluation and risks of renewed US-China frictions (mostly related to the US administration blaming China for poorly communicating and handling the severity of the Covid-19 spread in a timely manner and threatening to impose various penalty measures).

One question we have received in the last few weeks is why the pace of USDJPY depreciation has slowed recently. We believe this is related to very sizeable equity outflows from Japan (essentially buying foreign currency and selling JPY). However, we note that this pace of foreign equity acquisition is quite abnormal and unlikely to be sustainable. There is in fact recent evidence that these purchases are slowing down, and we think that the latest news on US-China frictions will act as an additional brake.

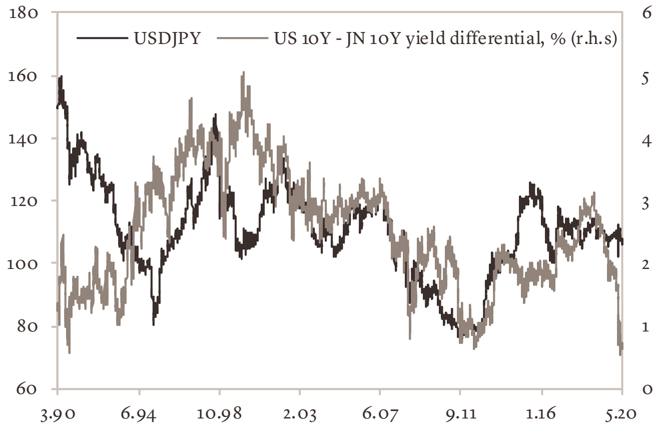
Risks to this view: Risks to our bullish JPY view include these. **First**, Trump abandoning his harsh China rhetoric as an anchoring point for his pre-election campaign. **Second**, a very fast global growth recovery in the second half of the year following the improved virus outlook. We assign relatively low probabilities in both events. **Third**, 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 for a certain period.

Nordic currencies: Undervaluation narrows, but a bit too rapidly

- **The Nordic FX bloc reprices significantly higher...**
- **... but near-term risks of a correction loom.**

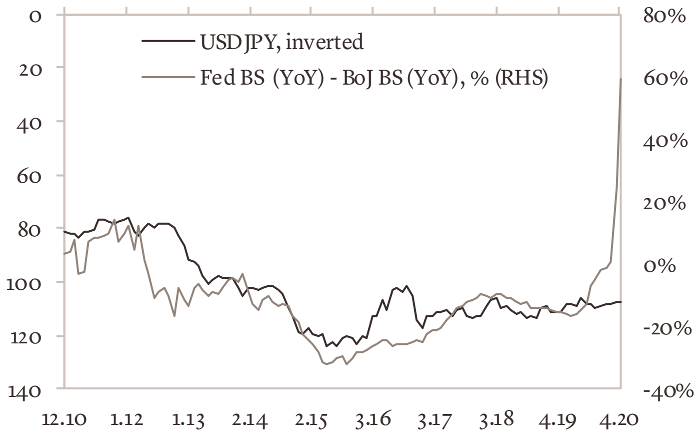
The Nordic currencies (NOK and SEK) have rallied strongly in the past couple of months, against both the USD and the EUR (even though the Norwegian central bank lowered interest rates to zero on 8 May). The appreciation can be attributed mainly to two factors. **First**, the rise in oil prices, and **second**, the normalisation of risk appetite (equities gaining).

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



Sources: Bloomberg, Lombard Odier.

9. ... and relative growth of central banks' balance sheets will add more pressure



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

That said, the correction appears to have been a bit too abrupt, with EURNOK and EUSEK now trading below our Q2 2020 targets. This may be due to the possibility that the market is already re-pricing a return to global normality quite aggressively. Although the decline in Norway's infection rate is clear and unquestionable, the global outlook still poses a number of risks – including a second virus wave and a resurgence of US-China trade tensions that could negatively affect small open economies. And while the market may be willing to reward Sweden for keeping its economy running, the rest of global activity is still under severe strain, which should result in negative spill-overs into the (already fragile) domestic economy.

We believe that in the near term, cyclical currencies should still incorporate some risk premium due to this abundance of uncertainties – unless a Covid-19 vaccine is found soon. We would therefore not be surprised to see a correction lower in NOK and SEK over the next few weeks. From a medium to long-term perspective, however, we retain our constructive view, largely based on sizeable undervaluation.

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

Commodity currencies: Is the rally sustainable?

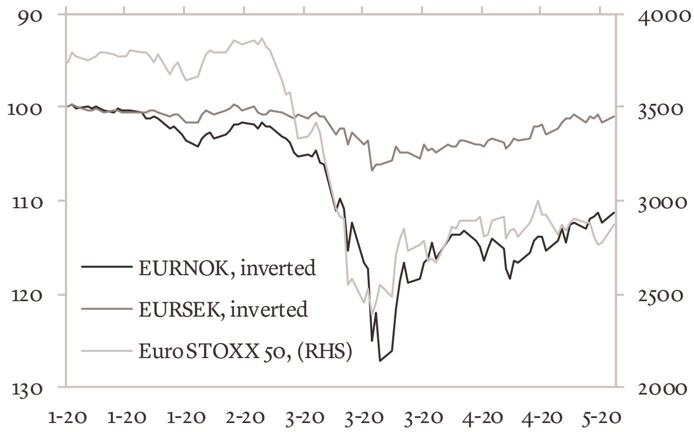
- **The commodity FX bloc has pared back a great deal of the losses seen in Q1 2020**
- **Although we remain fundamentally constructive, near-term risks of a correction are rising.**

Since the equity rally in mid- to late March, the core commodity FX bloc (AUD, CAD, and NZD) has rebounded, led by the AUD that has risen by over 12% against the USD (see chart 11). As with the Nordics, this recovery reflects improved risk appetite, higher (to varying degrees) commodity prices, and pressure on the USD (mainly against high-beta G10 FX). But is it sustainable?

First, in the near term, we see a number of potential hurdles, with the US-China frictions posing a renewed threat to global sentiment and trade. **Second**, in Australia's case, the recent fraying of its relationship with China (Australia has been a fierce critic of China's handling of the Covid-19 crisis, while China has just imposed an 80% tariff on barley imports from Australia) could act as an additional headwind to further AUD appreciation. So we would advise a more neutral approach to the core commodity FX bloc over the next few weeks.

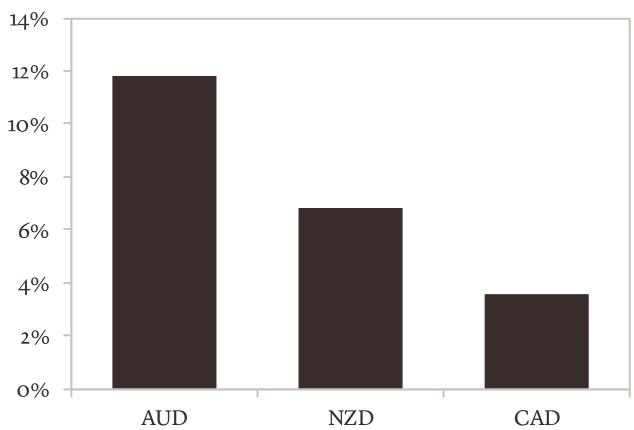
10. Nordic currencies recover as risk appetite normalises

EURNOK and EURSEK normalised at 100 (1 January 2020)



Sources: Bloomberg, Lombard Odier.

11. Returns of the commodity FX bloc since dollar peak (23 March 2020)



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

On CAD, we would add that it currently seems in line with oil prices, so one would have to see a material rise towards USD 40 per barrel for USDCAD to break its recent range of between 1.39-1.42 sustainably.

Medium term and assuming our central scenario of a global growth recovery in H2 2020 plays out, we expect appreciating pressure mostly for the AUD, which will likely benefit from additional fiscal stimulus in China.

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).

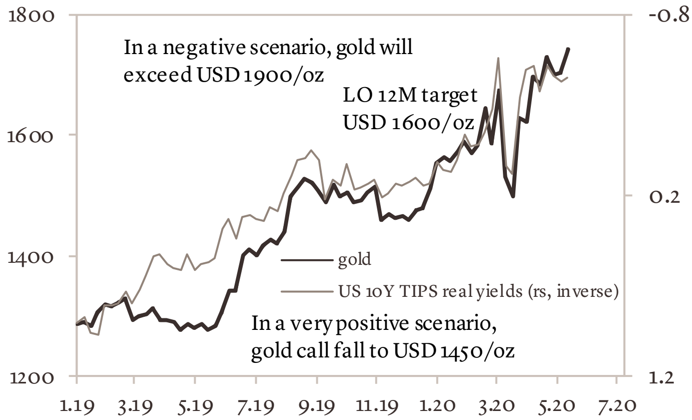
Gold: Underpinned by low real yields

Gold has been supported lately by the central banks' balance sheet expansion. Medium term, as we have argued many times, the key variable to watch in order to gauge the present and future direction of the gold price is real yields.

With US Fed Fund rates at near zero for the foreseeable future, US real yields will likely remain suppressed, which reduces any potential downside. We therefore stick to our medium-term target of USD 1,600/oz, but maintain the position in portfolios as a hedge against the materialisation of an adverse scenario (namely a prolonged recession).

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.

12. Gold underpinned by low real yields



Sources: Bloomberg, Lombard Odier.

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EMFX: Three key charts

Over the past two months, currencies of countries with firm external balances, low debt, and less reliance have outperformed – i.e. currencies of countries in Asia and Central and Eastern Europe. That said, over the past three weeks, a handful of currencies have managed to eke out noticeable gains. First off are the RUB and IDR, with strong gains of 5%, effectively recovering nearly half their sharp losses encountered during March when oil plunged. The next-best performers have been the MXN and ZAR, with more modest gains of 1-3%.

We believe that the RUB and IDR – while both dependent on energy prices – have been helped by central bank intervention and by strong fiscal fundamentals, with government debt to GDP of under 35%. To some extent, the MXN also falls into this category, with a central bank more cautious than others in LatAm in cutting interest rates, though the country faces rising fiscal risk (see chart 13).

On the other hand, we think the recovery in ZAR is likely linked to a "sell the facts" response following the much-feared local currency rating cut to below investment-grade (IG) in March. The forced selling of South African bonds, given the country's exclusion from the WGBI bond benchmark, may have been positioned for ahead of the event. That said, we believe the ZAR, along with the BRL and TRY, will remain vulnerable.

Currencies of countries having a weak fiscal position to start with and real yields in excess of projected growth are at risk. Chart 14 compares the projected government debt-GDP ratio relative to the difference between projected growth and real bond yields. For GDP, we have used the average of the IMF growth forecasts for 2020 and 2021. For CPI, we have used the IMF projection for 2020.

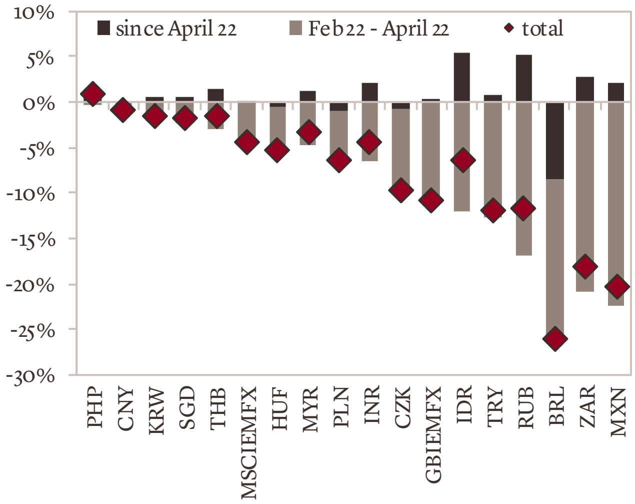
Both Brazil and South Africa, in the bottom right quadrant, are vulnerable. Both countries have very large fiscal burdens to begin with (over 65% of GDP). Furthermore, the ability to service the debt will be extremely low, with projected average growth over the next two years likely to fall short of the cost of financing the debt.

Since 2018, the trade war and the imposition of tariffs have been by far the strongest drivers of USDCNY. A shorter-term USDCNY model for USDCNY utilising the effective tariff rate on Chinese goods (currently 13.4%), interest rate differentials, and the China manufacturing PMI now suggests that fair value stands around 7.04 (see chart 15).

Back in February when we favoured short USDCNY expressions, the fair value had fallen down to almost 6.90. In recent months, it has backed up to 7.04. If one assumes that the US-China tensions intensify sharply and tariffs are raised to their November levels of 15.40% (not our central scenario), then fair value would rise further to 7.10.

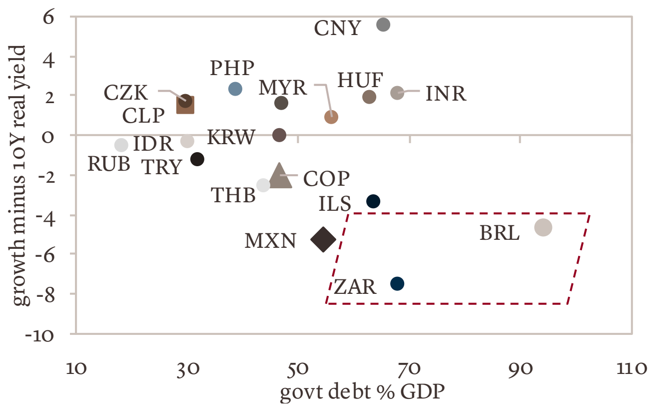
Accordingly, in our view, the most recent escalation in trade tensions suggests that USDCNY could stay higher for longer, heading into the November US elections. A 7.05 -7.10 level now appears increasingly likely.

13. North Asia and Central & Eastern Europe have held up quite well



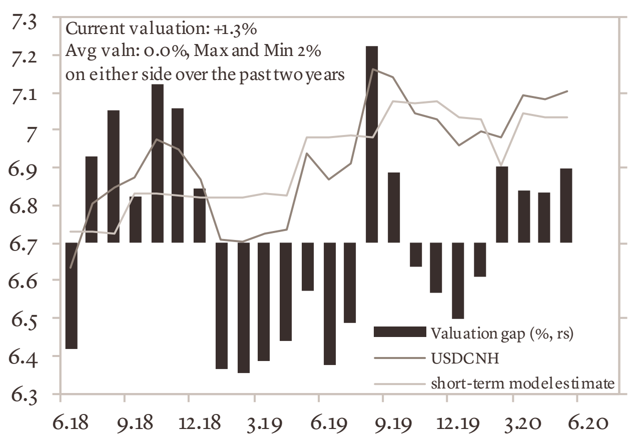
Sources: Bloomberg, Lombard Odier.

14. ZAR and BRL face rising fiscal risks



Sources: Bloomberg, Lombard Odier.

15. Tariff risk likely to keep USDCNY elevated for longer



Sources: Bloomberg, Lombard Odier.

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

Back to cover page

Asia FX
Navigating cross-currents

- **Emerging Asian currencies will outperform their non-Asian peers for the remainder of the year, but their absolute performance vs USD will be capped by the US-China trade noises**
- **While CNY will remain sensitive to recent trade-related news flow regarding the US and China, we believe Beijing will maintain a level of restraint on the currency's value**
- **We see most emerging Asian currencies gaining vs USD in H2 2020. Relative laggards will be INR and PHP, but we still see slight gains for these currencies in absolute terms.**

CNY: lower CNY forecasts

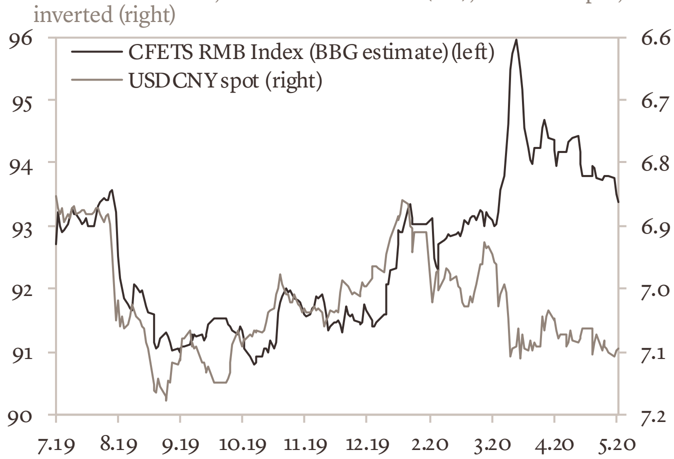
We have lowered our forecasts for the yuan to reflect the risk of rising tension between the US and China, but we still believe the currency is likely to appreciate modestly vs USD over the remainder of the year if the tensions do not morph into a new round of painful tit-for-tat in trade restrictions. **First**, China is already rebounding from its historic Q1 contraction thanks to its aggressive (and thus far successful) control of its Covid-19 epidemic curve. The re-opening of the country's economy is fully underway, with many key daily indicators for services and industry back at their 2019 levels. **Second**, both the US and China have shown a degree of restraint on trade-related restrictions targeting each other. The US has not re-introduced additional tariffs on China, although it has implemented new restrictions on specific companies such as Huawei. Meanwhile, China has been re-iterating its commitment to "phase 1" deal purchases, and has also kept the value of the yuan stable vs USD (see chart 16). **Third**, the country's newfound calm and relatively higher onshore rates have attracted foreign inflows recently, and Beijing has added a modest boost by scrapping quota systems altogether for foreign institutional investors.

Risks to the view: Any escalation of tensions 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 elections.

INR: Past its worst but path rife with danger

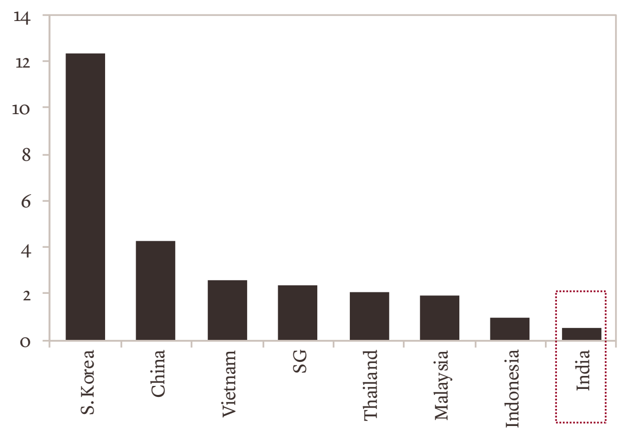
We believe that the Indian rupee might have passed the worst, but the currency's recovery path will be rife with danger. We expect a slight appreciation vs USD before the end of the year. **First**, India's ability to navigate the exceptional challenges of the Covid-19 pandemic is fundamentally constrained by its fragile public health infrastructure (see chart 17). While the country has begun to ease its punitive lockdowns on a district-by-district basis, it will take some time before the economy fully re-opens without incurring the risk of large second-wave infections. **Second**, the country will rely heavily on the

16. Yuan has actually been quite strong vs all non-USD currencies
CFETS RMB index, 31 Dec. 2014 = 100 (left), USDCNY spot, inverted (right)



Sources: Bloomberg, Lombard Odier.

17. India has unique vulnerabilities to Covid-19
Number of hospital beds per 1,000 people (latest available data)



Sources: World Bank, Lombard Odier.

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

Asia FX
Navigating cross-currents

Reserve Bank of India for the ongoing stimulus efforts, as the government's fiscal flexibility remains small. The government's caution, which is driven by concern over collapsing tax collection, would put the onus of economic stabilisation on the RBI. **Third**, India's banking sector remains vulnerable to further deterioration of its loan books in this context of the country's worst slowdown ever. Thankfully, persistently low commodity prices will provide some offsetting support for the rupee.

Risks to the view: Second-wave infections will be the most important risk for INR's trajectory in H2 2020. The banking sector's fragility and industrial commodity price swings will also remain as key risks for the currency.

KRW: Remain modestly constructive

We remain modestly constructive on the Korean won, although the US-China trade tensions could limit its strength in H2 2020. **First**, Korea has suppressed its Covid-19 epidemic rather effectively, and is now in a strong position to ease remaining restrictions on economic activities. This should allow Korea to start rebounding in Q2, unlike many of its OECD peers (see chart 18). **Second**, the National Assembly election in April provided a historic victory for President Moon's ruling party, thus brightening the prospects for more aggressive use of fiscal policy in the next two to four years.

Third, the Bank of Korea (BOK) could ease policy further, but its restraint thus far regarding additional rate cuts strongly suggests that the policy elite in Seoul prefers fiscal policy to monetary policy as a stabilisation tool. This caution likely reflects concerns about US pressure on the KRW's persistent weakness, the zero lower bound in rates, and real estate prices in key metropolitan areas. It all points to the BOK's continued relative restraint on monetary easing measures.

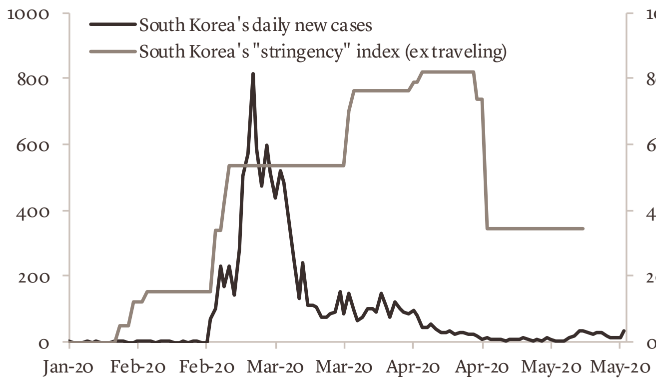
Risks to the view: An unexpected (if unlikely) shift in the policymakers' focus towards monetary easing could put pressure on a KRW that has been moving sideways recently. The country remains vulnerable to the US-China trade dispute and the geopolitical risk with North Korea.

TWD: In a good place

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 spectacularly successful, and the country can contemplate re-opening more comfortably than 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 external balance all very high as a percentage of GDP (see chart 19). **Third**, the country could benefit from the combination of life insurance companies' repatriation flows and the recovery of equity flows in H2 2020 if global growth resumes as we predict.

18. South Korea's re-opening is in full swing

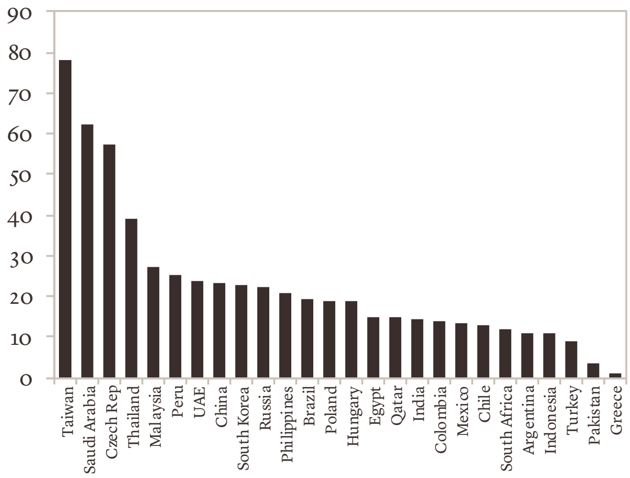
Oil and bulk commodity balance as % of GDP (2018 data)



Sources: KCDC, Lombard Odier.

19. Taiwan has the strongest solvency metric in emerging markets

FX reserve as a % of GDP (2018 data)



Sources: CEIC, Bloomberg, Lombard Odier.

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

Asia FX
Navigating cross-currents

Risks to the view: Main risks are the magnitude of the slowdown in the US and Europe in the next few quarters, further escalation of tensions with China, and a shift in the US stance on Taiwan's currency policy.

IDR: Some modest gains ahead

The rupiah has staged a significant rally since the end of March, thanks to the return of USD liquidity in the region. We believe that IDR will see a modest gain vs USD over the remainder of the year. **First**, the country's public health condition remains uncertain, as relatively high case fatality rates (mid-6%) point to the broader spread of Covid-19 than the headline case numbers suggest. **Second**, the arrival of the USD repo facility for foreign central banks has been a boon to the country's USD liquidity, but the currency might have seen the bulk of improvement tied to this development. The focus could shift to Indonesia's management of the economic fall-out from the disease in the next few weeks. **Third**, Bank Indonesia (BI) is beginning to play the role of disciplinarian, as the government has raised its deficit targets since its recent meetings led to a pause in rates despite the ongoing economic slowdown. BI's conservatism and the likely return of flows to the ASEAN region could support the currency's modest appreciation in H2 2020, but a large rally is unlikely.

Risks to the view: Main risks are the evolution of the Covid-19 epidemic in Indonesia's climate and demographic context, volatility of capital flows to emerging markets (the country's dependence on foreign investors is high), and the outlook for bulk commodity prices.

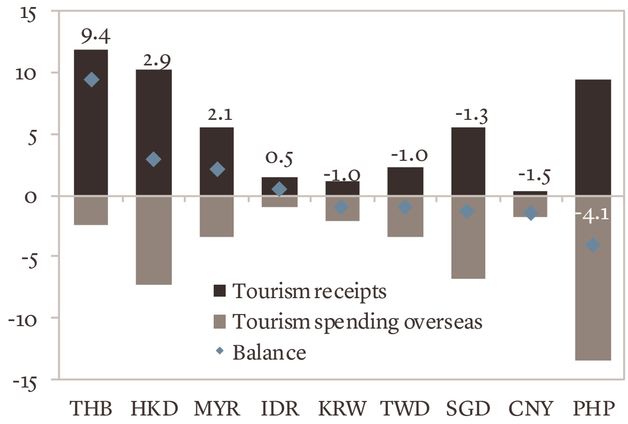
THB: A muted rebound

We now believe that THB could rebound modestly – but not significantly – before the end of the year. **First**, the country will benefit from the easing of the national lockdown that began in early May. The high frequency indicators suggest that domestic growth is bouncing back after a sharp slowdown between March and April. This will support the currency somewhat. **Second**, the hit to the country's important tourism industry has been exceptional, and the damage could last longer as global consumers exercise more caution on international travel (see chart 20). This fundamental shift will weigh on the country's growth in the next year or two, limiting the currency's upside. **Third**, the Bank of Thailand (BoT) will prefer to keep the baht on the weaker side to provide some cushion for the country's tourism and export industries, and the currency does not appeal strongly to foreign investors due to its very low rate.

Risks to the view: Main risks are deterioration of the Covid-19 outbreak among Thailand's neighbours, and the BoT's response to the government's possible breach of the 2018 Fiscal Responsibility Act.

20. Hit to Thailand's tourism industry will last longer

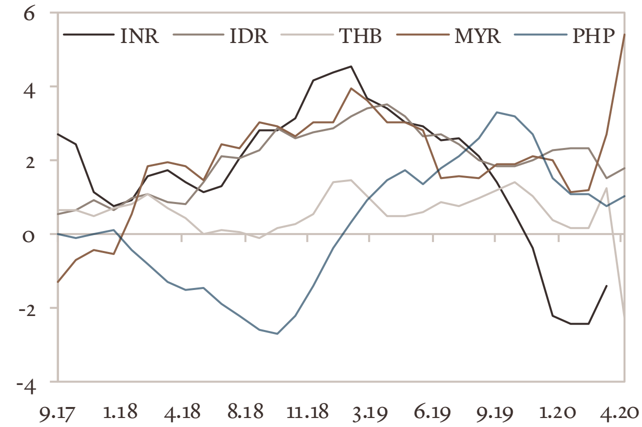
Tourism balance (latest available annual figures) as a % of GDP



Sources: CEIC, Lombard Odier.

21. Real rates declined in Philippines

Benchmark policy rate minus consumer price inflation, %



Sources: Bloomberg, Lombard Odier.

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

Asia FX
Navigating cross-currents

MYR: Political stability should be supportive

The ringgit's performance has stabilised, and we now see a modest appreciation for the currency over the rest 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 up 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 in any case is likely reluctant to do given its usual focus on currency stability. **Third**, the country has been able to bend the epidemic curve substantially after suffering the ASEAN region's largest outbreak of Covid-19 infections in March.

Risks to the view: Main risks are an unexpected snap election decision by the ruling coalition, the trajectory of local confirmed Covid cases, oil price trends, and global demand for Malaysia's industrial commodities and mid-end manufacturing.

PHP: Still expect underperformance

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, but believe that there will be better opportunities than the PHP when visibility on the global recovery in H2 improves. **First**, the Philippines has been rather aggressive in implementing sub-national lockdowns, and despite the recent relaxation of these measures, the cycle of lockdown substitution for more calibrated responses that are not feasible in the country's public health and administrative system could affect the growth rate. **Second**, we suspect that Bangko Sentral ng Pilipinas has maintained a dovish bias, even though it refrained from a rate cut in its latest meeting. **Third**, the peso tends to be an underperformer during more broad-based recoveries at the global level. We believe that it will underperform its North Asian peers in H2 2020.

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

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

LatAm FX

BRL depreciation dramatic, but can still undershoot on rising political risks

- **Over the past month, our expectations for the BRL undershooting and CLP outperforming came to fruition**
- **Following the recent rapid and sharp depreciation, the BRL undervaluation – while stretched – could become even more extreme given political risks**
- **MXN has held up better for good reason, but we see COP as vulnerable to downside risks**
- **PEN and especially CLP have been performing better because of lower sensitivity to energy prices and more fiscal space.**

BRL: Has undershot as expected, but political risks to keep currency volatile

Along with the TRY and the 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, with USDBRL going above 6.00. We would make the following points regarding the currency.

First, last month, we reasoned that the BRL would be prone to undershooting. It has done precisely that, declining by a large 12% over the past month even as other LatAm currencies remained relatively stable (see chart 22). Had the political news flow been less provocative, we would have expected some USDBRL consolidation. That said, political noises and debt reaching critically high levels keeps conviction low.

Second, according to our equilibrium USDBRL model, the currency is now getting closer to being historically overstretched: 19% is not far from the 23% overvaluation seen over 2014-15 (chart 23).

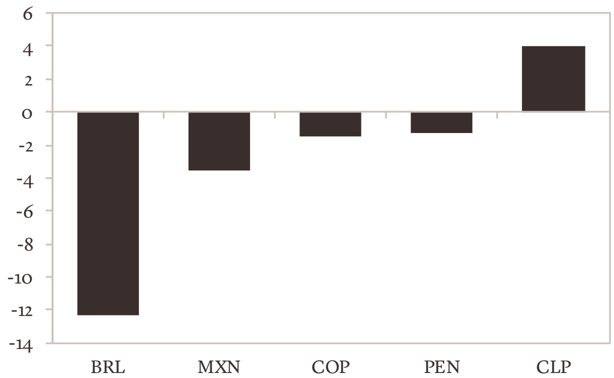
Third, using IMF projections on government debt and consensus expectations on growth, our model suggests USDBRL fair value will rise from 5.03 currently to 5.12 by year-end.

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 24) suggest that USDBRL overshoots cannot be ruled out.

Fifth, political risks remain high, with increased noises surrounding President Jai Bolsonaro's political overreach and interference in different areas of government, including the health and police departments fanning "impeachment risk" concerns.

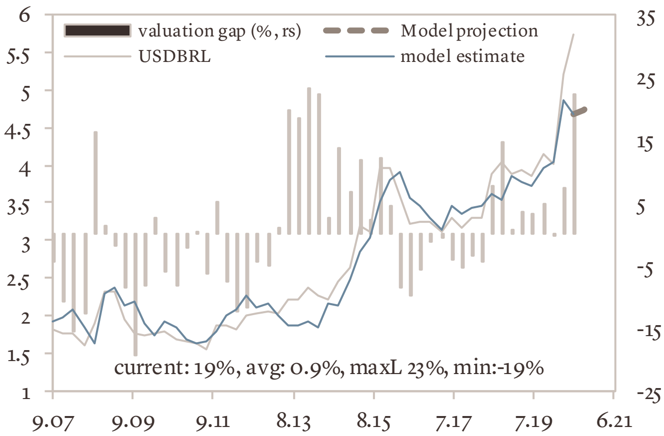
Risks to our view: A critical risk remains an uncontrolled virus breakout with Brazil, having, unlike its neighbours, refrained from adopting a coherent national strategy on the lockdown. Growing risk of Bolsonaro being impeached should warrant an additional risk premium, though this is more likely an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

22. Over the past month, BRL has been under severe depreciation pressure



Sources: Bloomberg, Lombard Odier.

23. At current levels, USDBRL overstretched but fair value itself likely to rise to 5.12 by year-end (from 5.03 at present)



Sources: Bloomberg, Lombard Odier.

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

LatAm FX

BRL depreciation dramatic, but can still undershoot on rising political risks

MXN: Should stabilize, even with fiscal deterioration

MXN falls into our category of "modest outperformers" alongside the likes of CNY and PEN. We would make the following points regarding the currency.

First, we would expect USDMXN to remain within the 23.00-25.00 range for now, before moving lower in H2. For the moment, USDMXN could remain relatively elevated, with the virus curve in Mexico appearing worrisome and news first likely to get worse.

Second, a model based on crude energy prices, growth differentials compared with the US, and government debt to GDP places USDMXN's fair value at 21, sharply above Q4 2019's 18.40. However, at 25.00 and above, USDMXN would begin to look historically overstretched (see chart 25).

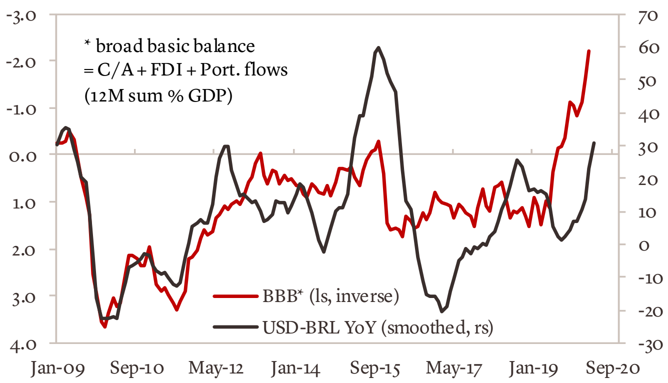
Third, using the IMF's projections for government debt and consensus growth forecasts, USDMXN's equilibrium is projected to rise modestly to 23.25 from 21.00 at present. This suggests that – even pencilling in fiscal deterioration – MXN looks undervalued at present and should recover from here on.

Fourth, as far as commodity dependence goes, Mexico actually scores better than either Brazil or Colombia, as the country is a net importer of energy (though fiscal revenue is dependent on oil). Moreover, the country's non-commodity balance has been improving sharply in recent quarters. This should eventually provide a cushion for the MXN.

Fifth, unlike other central banks in LatAm, real rates remain relatively elevated and the central bank has been more cautious in easing policy than others.

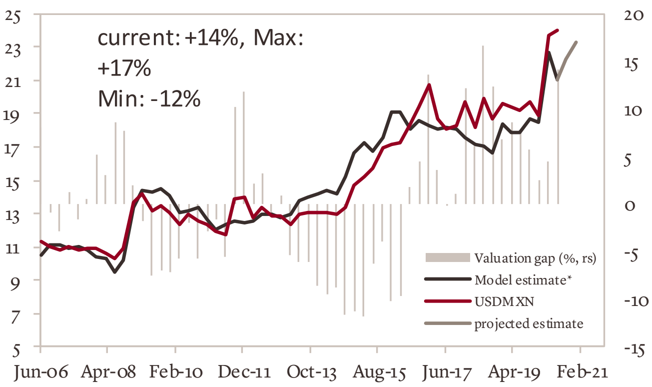
Risks to our view: Downside risks include a surge in virus cases and further downward revisions to growth that, in turn, lead to further rating downgrades and a loss of investment grade (IG) status. Further weakness in the US economy, compressing demand for unskilled workers, would be another risk.

24. Negative shift in overall FX flows suggests USDBRL overshoots cannot be ruled out



Sources: Bloomberg, Lombard Odier.

25. USDMXN currently overstretched versus fundamentals



Sources: Bloomberg, Lombard Odier.

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

LatAm FX
BRL depreciation dramatic, but can still undershoot on rising political risks

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 5% by March 2021, with USDCOP likely to end the year closer to 3950. We would make the following points regarding the currency.

First, despite heavy dependence on oil, the COP has held up quite well and outperformed both the BRL and MXN in recent months. Usually, Colombia is the fastest-growing economy in the region, and this has been associated with a wider current account deficit and softer FX. Accordingly, it is plausible that the slowdown in growth is lowering imports and hence demand for USD, keeping USDCOP heavier than should be the case.

Second, a model based on crude energy prices and government debt-to-GDP shows that USDCOP is 8% overvalued, not far from the 10% seen in 2015.

Third, using the IMF projections for government debt, fair value is seen rising to 3930 by the end of 2020, suggesting scope for USDCOP to move higher in H2.

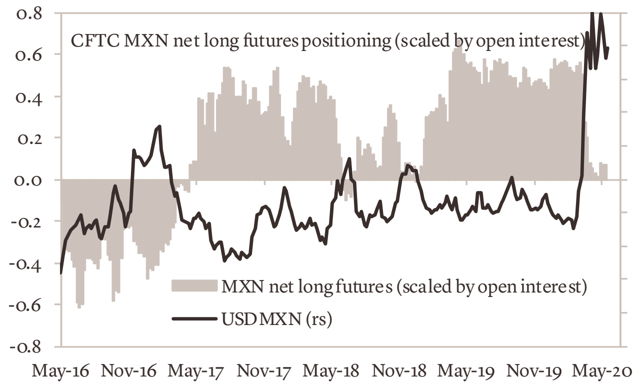
Fourth, and in stark contrast to Brazil, Colombia has adopted one of the strictest lockdown strategies in LatAm and hence may be less at risk compared to others to virus risk.

Fifth, Colombia is the LatAm country most dependent on energy as far as FX flows are concerned: the energy trade surplus stands at 7% of GDP, which compares with a net energy deficit of -2% of GDP for Mexico.

Sixth, Colombia's central bank (alongside that of Brazil) is among those of a handful of countries studying the feasibility of buying sovereign bonds or private assets from the primary market, somewhat akin to QE. While such actions could support the bond market, it could see their currencies facing increasing pressure.

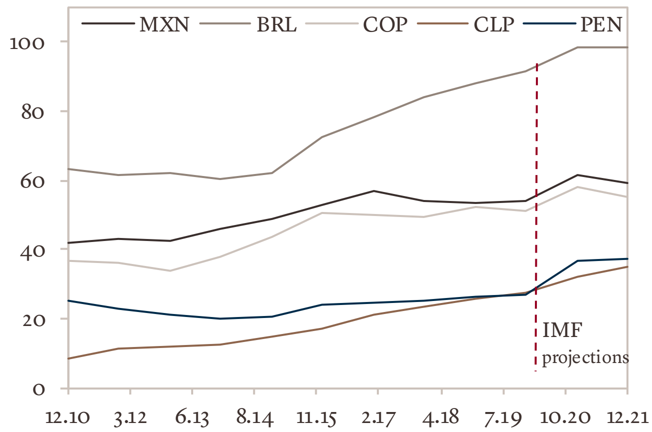
Risks to our view: A likely deterioration in growth and fiscal balances may increase the risk of a sovereign rating downgrade. We will keep a close eye on any comments from S&P, as the rating agency has set the sovereign just one notch above IG.

26. Positioning has already adjusted back to neutral for MXN



Sources: Bloomberg, Lombard Odier.

27. More fiscal space implies lower risks for CLP and PEN in crisis response (gross govt. debt, % GDP - actual vs projected values)



Sources: Bloomberg, IMF, Lombard Odier.

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

LatAm FX

BRL depreciation dramatic, but can still undershoot on rising political risks

CLP & PEN: Likely LatAm's relative outperformers given manageable debt

Both PEN and CLP fall into our respective categories of "outperformers" and "modest outperformers". Our year-end targets for USDCLP and USDPEN stand at 804 and 3.37, respectively.

First, we believe both the CLP and PEN are better placed to recover going forward given lower dependence on energy prices, healthier starting debt levels, and exposure to a potential China recovery in H2.

Second, valuation is compelling: both the CLP and PEN screen as extremely undervalued against longer-term macro fundamentals.

Third, both Chile and Peru have amongst the lowest government debt levels within LatAm (see chart 27). Hence, increased fiscal spending can support growth without undermining the currency.

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, in the case of Chile, the political risk event of the constitutional referendum has been postponed from 26 April to Q3.

Sixth, both Peru and Chile are major producers of copper and are actually net energy importers. Hence, both CLP and PEN are a cleaner play on an H2 recovery in China. Increased fiscal stimulus in China, especially a loosening of property restrictions (which would favour copper), would be a positive tail risk for both currencies.

Risks to our view: In terms of risks, both currencies have comparatively weaker medical infrastructure than other countries, hence there are risks for virus cases to increase. A significant escalation in US-China tensions and tariffs would likely weigh on both currencies.

CEEMEA FX
Offsetting factors argue for a range-bound RUB

- **RUB will likely remain stable on offsetting forces, with implied volatility creeping lower**
- **We remain bearish on both the TRY and the ZAR. TRY has behaved accordingly, but ZAR has been relatively calm**
- **ILS will be driven by a combination of tech sector performance, low US yields and CB intervention. In CEE, PLN should perform better than either CZK or HUF.**

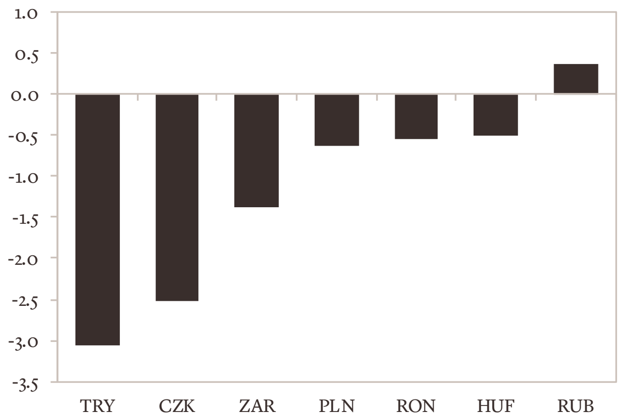
RUB: Likely stuck in a range on offsetting factors

RUB falls into our category of "modest underperformers" alongside the likes of CZK and PHP. Despite stellar fiscal and external balances, the projected increase in fiscal spending will likely raise the USDRUB's fair value, to be offset only partly by higher energy prices. We forecast flat returns until March 2021, and our year-end USDRUB target stands at 72.7. However, volatility for the currency should remain relatively low compared to other high-yielders. We would make the following points regarding the currency.

First, after having already gained some 6% in April, the RUB has made modest gains, and has been the outperformer within CEEMEA (see chart 28). Going forward, we believe RUB should hold its value, but should be range-bound. **Second**, it is extremely hard to ascertain the RUB's fair value since the currency went through a regime change – moving from a fixed to a free float after 2015. Moreover, the operation of the budget rule (where spending is aligned with a USD 42 bps assumption, with the gap between the actual and budgeted oil prices feeding into reserves) makes valuation difficult to estimate. If we use the actual energy price, USDRUB now screens as broadly in line (see chart 29). However, if we use the budgeted energy price, then USDRUB should – in theory – be trading below 65! We choose a more conservative approach of using the actual observed energy price, which yields a broadly aligned RUB. **Third**, while Russia has very low levels of government debt, when we plug in the IMF's forecasts, our projected USDRUB fair value moves higher towards 80. This suggests that USDRUB will more likely remain in a range around current levels, rather than trending in either direction. Indeed, higher energy prices by year-end could be offset by higher government spending. **Fourth**, Russia has fast become one of the coronavirus hotspots, recording the highest number of confirmed cases in major EM (see chart 30). While this reflects a much higher rate of testing in the country compared to other EM, the negative headlines should prevent RUB from appreciating from current levels.

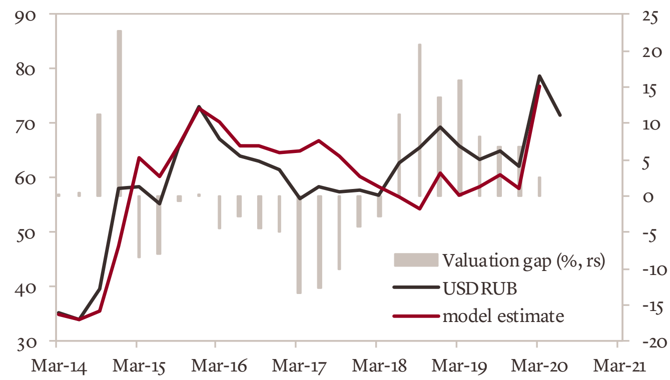
Risks to the view: Markets no longer price in US sanctions risk as they did in 2018-19 (see chart 29). Hence, any new developments should be seen as RUB-negative. On the other hand, a sharper energy price rally could support the RUB.

28. TRY worst performer while RUB fares the best



Sources: Bloomberg, Lombard Odier.

29. USDRUB broadly in line with fair value



Sources: Bloomberg, Lombard Odier.

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

CEEMEA FX
Offsetting factors argue for a range-bound RUB

TRY: Undershoots, as expected, on large Q2 external debt payments

Along with the BRL, ZAR, and COP, the TRY is in our group of “fragile” EM currencies, and is the most vulnerable within that group given extremely low level of FX reserves. We forecast near 9% depreciation by March 2021, with USDTRY going to 7.30 by year-end. We would make the following points regarding the currency.

First, we are bearish on the TRY, and suggested last month that Q2 could be a delicate period for the currency. The currency has been the worst performer within CEEMEA over the past month (see chart 28).

Second, in the coming two months, Turkey faces larger debt redemptions that will likely put pressure on the TRY. Of the next twelve months’ private sector external debt repayments, 37% fall due between April and June (USD 18 bn in total).

Third, the sharp fall in energy prices should have helped to lower oil imports (and thus to narrow the trade deficit). However, the decline in tourism due to a rise in virus cases should largely offset gains from lower oil prices by lowering the services trade balance: Turkey receives 40-50% of its tourism revenues between May and August.

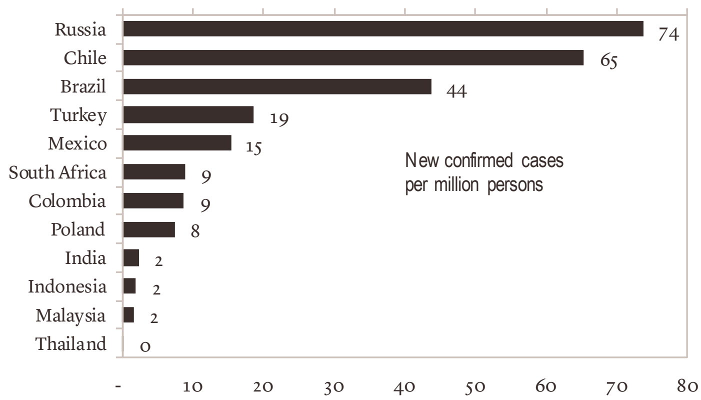
Fourth, net FX reserves are depleting fast and suggest that TRY would have fallen even more had authorities not intervened (see chart 31). This makes the currency vulnerable to an undershoot in the coming weeks.

Fifth, with still-large capital outflows, Turkey may require an external anchor in the form of IMF aid. However, President Erdogan continues to refuse to seek such aid and has, in turn, resorted to soft capital controls to try to stabilise the currency.

Sixth, and on the more positive side, Turkey’s virus curve appears to have been flattening in recent weeks, which should allow a gradual reopening of the economy.

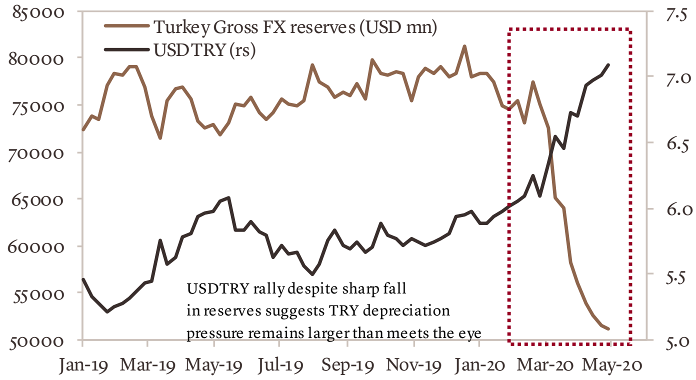
Risks to the view: Given the bearish outlook, we would highlight a positive risk – the possibility of Turkey seeking assistance from the IMF to obtain an external backstop. Net FX reserves appear dangerously low. A further negative risk would be if Turkey declines assistance and instead goes for strict or partial capital controls.

30. Russia has recently overtaken Turkey in showing the highest number of confirmed cases (per million persons) in our sample



Sources: WHO, Bloomberg, Lombard Odier.

31. TRY susceptible for an undershoot as reserves are depleted



Sources: Bloomberg, Lombard Odier.

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

CEEMEA FX
Offsetting factors argue for a range-bound RUB

ZAR: Beware of the false sense of calm

Along with the TRY, BRL, and COP, the ZAR is in our group of "fragile" EM currencies. We forecast near 9% depreciation by March 2021, with USDZAR going to 19.30 by year-end. We would make the following points regarding the currency.

First, after having risen 12% in March, USDZAR has been mired in an 18.30-18.80 range over the past month. However, we believe this reflects a "sell the facts" response following the much-feared local currency ratings to below IG in March. The forced selling of South African bonds given the country's exclusion from the WGBI bond benchmark may have been positioned for ahead of the event. That said, we believe the ZAR, along with the BRL and TRY, will remain the weakest links within major EM currencies.

Second, despite the profound losses, the ZAR is not cheap when we factor in longer-term drivers like government debt and commodity prices. **Third**, in our sample of EM countries, South Africa faces the worst fiscal position, having both high gross debt levels and growth likely to undershoot the real interest rate on debt (see chart 14 in the "Three key EM charts" section).

Fourth, 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 (see chart 32).

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.

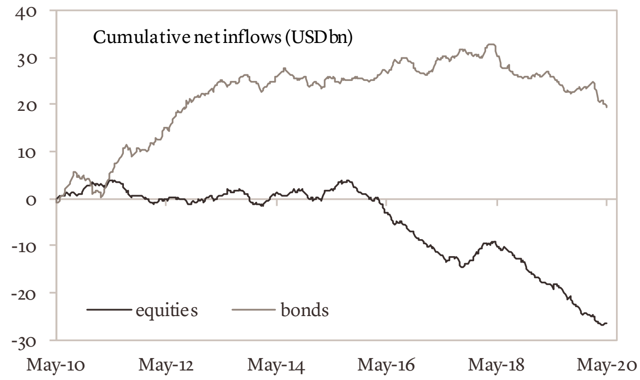
Risks to the view: Given the bearish view painted, we would highlight a positive risk: that of South Africa seeking assistance from the IMF to obtain an external backstop.

ILS: Underpinned by a resilient tech sector and low US yields

Along with the KRW, TWD, IDR, MYR, CLP, and PLN, the ILS is in our group of "outperformer" EM currencies. We forecast near 3% appreciation by March 2021, with USDILS expected to decline towards 3.45 by year-end. We would make the following points regarding the currency.

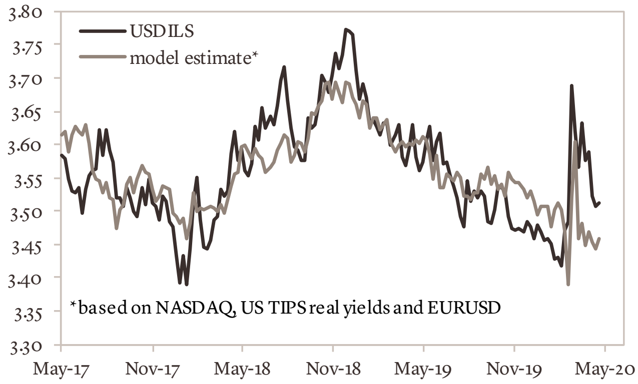
First, after having rallied sharply by 10% from 3.45 in early March to above 3.80 (mid-March), the shekel regained its composure in the latter half of March and has remained stable at around 3.55.

32. South Africa – unlike equities, bond position still elevated



Sources: Bloomberg, Lombard Odier.

33. USDILS to face downward pressure if tech sector recovers further and US yields remain low



Sources: Bloomberg, Lombard Odier.

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

CEEMEA FX
Offsetting factors argue for a range-bound RUB

A technical reason for the sharp and sudden USDILS rally appears to be linked to the sharp unravelling – an unwinding of long ILS positions linked to foreign equity swaps (which are apparently very popular in Israel). From here on, we would expect the ILS to remain relatively stable and to outperform CEEMEA peers given strong external balances.

Second, 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 should be trading in a lower 3.45-3.50 range compared to 3.53 at present (see chart 33).

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 CB has suggested it will step in once again to cap the ILS. **Fourth**, Israel has a strong balance of payments support with a strong current account as well as FDI inflow. The country has seen strong 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).

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

CEE FX: PLN likely to hold up better than CZK and HUF

We forecast 1% to 3% gains for the CEE currencies against the USD by the end of March 2021. We pencil in 4.56, 27.90, and 355 for respectively EURPLN, EURCZK, and EURHUF. We would make the following points regarding CEE FX.

First, we believe Central and Eastern Europe (CEE) is still in the process of pricing in a large negative hit to global growth. This will no doubt keep some downward pressure on the currencies of the extremely open economies of the Czech Republic and Hungary, but will also hurt relatively closed-economy currencies like the PLN. This has been evident in the underperformance of the CZK following a faster pace of monetary easing.

Second, and on the other hand, CEE external balances and fiscal policy ammunition are superior to those of other CEEMEA countries, which should hold the 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, which could imply that growth downgrades will slow.

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

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

Back to cover page

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