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FX Monthly

Biden win unravels Trump risk premium

11/12

November 2020

Key highlights

- Improved risk appetite is weighing on the dollar, and will likely continue to do so in the months ahead
- We keep our EURUSD forecast at 1.21 by year-end
- EURCHF should gradually gain, as Swiss outflows pick up
- The EU and the UK inch closer to a deal, which should underpin GBP
- Higher risk appetite poses a near term risk to USDJPY downside, but the medium-term downtrend remains in place
- We further lower our USDCNY downside, with Chinese authorities showing increasing ease with a stronger currency. We expect 6.55 at year-end and 6.40 at the end of 2021. However, a future reduction in tariffs under a Biden Presidency presents downside risk to these forecasts.
- Upgrades to H1 EM GDP consensus estimates and the emergence of a vaccine could see some modest GBI EMFX gains in Q1, but we are cautious thereafter, and prefer to remain selective
- We stay constructive on CNY, TWD, KRW, and CZK, but cautious on ZAR and BRL. This month, we upgrade CNY and downgrade PLN and CLP.

FX forecasts		Q420	Q221
G10	EURUSD	1.21	1.23
	USDJPY	101	100
	EURCHF	1.11	1.12
	GBPUSD	1.33	1.37
	EURGBP	0.91	0.90
EM	USDCNY	6.55	6.48
	USDINR	73.3	73.0
	USDIDR	13 900	13 950
	USDMXN	20.1	20.1
	USDBRL	5.25	5.35
	USDRUB	75	76
	USDZAR	15.0	15.60

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Important information: Please read important information at the end of the document.

Data as of 20 November 2020

At a glance

Introduction

Despite a split US Congress, Joe Biden's presidency will help alleviate trade-related risk premia and allow the flow of global trade to pick up.

The result of the US election, together with positive news on the virus vaccine, is helping unravel the Trump risk premium that was embedded in the price of the dollar. Despite a split US Congress, Joe Biden's presidency will help alleviate trade-related risk premia and allow the flow of global trade to pick up. Furthermore, a gradual return to normality thanks to vaccine breakthroughs will see the market pricing a lower risk of further restrictions, and therefore higher growth. All this should be USD-negative; to some extent, however, it has been priced in – mostly in the G10 FX universe. Consequently, we maintain the view of further dollar weakness. However, we believe that a rotation away from G10 and into select EM currencies is brewing.

We keep our target of 1.21 by year-end for the euro/US dollar (EURUSD), and see some further modest gains in 2021. EURCHF should also move higher, supported by improved risk appetite and Swiss residents' outflows.

We maintain our overweight in GBPUSD. The UK and the EU are inching closer to a deal, which should underpin the British currency for a move towards 1.35-1.37. At the same time, the sharp rally in risk prices has interrupted the downtrend in USDJPY but has not changed the medium-term dynamics. Positive news is already in the price, while the dollar trend has historically been more important for USDJPY direction than have equities. Nonetheless, we acknowledge some upside risks to our forecasts.

The Nordic currencies should remain underpinned by their pro-cyclical nature; we reiterate our call for NOK outperformance. Finally, in G10 FX, the commodity FX bloc will continue to receive support from improved risk appetite, although gains may be modest due to less compelling valuations.

We further revise down our already bearish USDCNY view, now forecasting 6.55 and 6.40 on three- and twelve-month views. Beyond superior macro fundamentals and much improved balance of payments flows, the increasing tolerance of authorities for a stronger CNY is a key reason. With Mr Biden winning, we assume some reduction in trade uncertainty, but do not bet on an automatic or rapid reduction in Section 301 tariffs on China goods. Still, a reduction is plausible, and would introduce further downside risks to our current forecasts.

Using modest energy price assumptions (USD 45 per barrel 12M out) and inputting consensus EM vs US growth forecasts for H1 2021, our GBI EMFX model suggests that the index could see some gains over H1. We are always guarded when making an index call given the great heterogeneity among the 18-19 countries. However, factors driving some stabilisation of the weakest EM currencies (like TRY and ZAR – see CEEMEA section) – in addition to the potential for improving sentiment on a vaccine – point to some possible gains in Q1 2021. However, low-for-longer energy prices and still-high debt loads will constrain further gains in H2 2021. We maintain our preference for CNY, TWD, KRW, CZK, and PLN. This month, we further upgrade CNY and downgrade the PLN and CLP.

Main risks to our views:

First, a delay in the development/distribution of virus vaccines could increase the risk of new restrictions and economic disruption. **Second**, a premature withdrawal of fiscal support. **Third**, the US Federal Reserve (Fed) turning less dovish.

FX forecasts – G10 and gold

	Current spot	Q4 20	Q1 21	Q2 21	Q3 21	Estimates of long-term fair value[2]
EURUSD	1.19	1.21	1.22	1.23	1.23	1.18
GBPUSD	1.33	1.33	1.35	1.37	1.38	1.38
EURGBP	0.90	0.91	0.90	0.90	0.89	0.86
EURCHF	1.08	1.11	1.12	1.12	1.12	1.03
USDCHF	0.91	0.92	0.92	0.91	0.91	0.88
USDJPY	104	101	100	100	100	91
EURJPY	123	122	122	123	123	106
EURSEK	10.23	10.25	10.25	10.25	10.25	9.95
USDSEK	8.62	8.47	8.40	8.33	8.33	8.51
EURNOK	10.76	10.40	10.35	10.30	10.25	9.49
USDNOK	9.06	8.60	8.48	8.37	8.33	8.11
AUDUSD	0.73	0.73	0.74	0.74	0.74	0.74
NZDUSD	0.69	0.70	0.71	0.71	0.70	0.65
USDCAD	1.30	1.28	1.28	1.27	1.27	1.28
Gold	1880		1 850-2 000		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 26 for a more detailed explanation.

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

FX forecasts – EM

Asia

	Current spot	Q4 20	Q1 21	Q2 21	Q3 21
USDCNY	6.58	6.55	6.51	6.48	6.44
USDHKD	7.75	7.75	7.75	7.75	7.75
USDIDR	14 165	13 900	13 950	13 950	14 106
USDINR	74.1	73.3	73.3	73.0	72.42
USDKRW	1 114	1 106	1 097	1 089	1 081
USDMYR	4.09	4.08	4.07	4.06	4.04
USDPHP	48.2	48.5	48.7	48.9	49.2
USDSGD	1.34	1.32	1.30	1.29	1.30
USDTWD	28.7	28.30	28.09	27.88	27.66
USDTHB	30.3	30.22	30.13	30.04	29.95

LatAm

	Current spot	Q4 20	Q1 21	Q2 21	Q3 21
USDMXN	20.2	20.1	20.0	20.1	20.2
USDBRL	5.31	5.25	5.30	5.35	5.52
USDCOP	3 649	3 570	3 645	3 719	3 794
USDCLP	758	753	749	744	740
USDPEN	3.58	3.65	3.68	3.65	3.62

CEEMEA

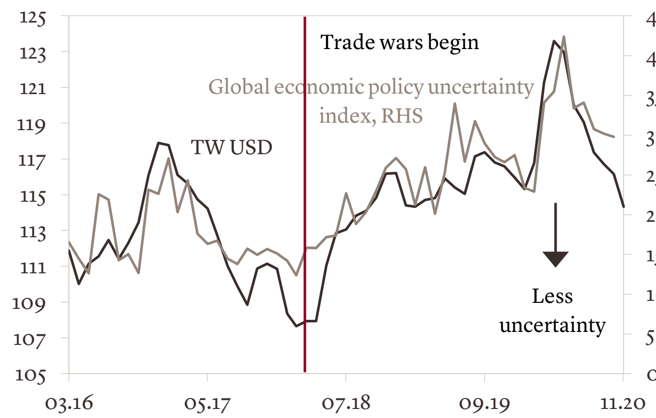
	Current spot	Q4 20	Q1 21	Q2 21	Q3 21
USDRUB	76.1	75.0	76.0	76.0	77.5
USDTRY	7.60	7.45	7.81	8.18	8.54
USDZAR	15.4	15.0	15.3	15.6	16.3
USDILS	3.44	3.32	3.29	3.26	3.23
EURPLN	4.47	4.56	4.53	4.53	4.50
EURCZK	26.3	26.8	26.6	26.6	26.3
EURHUF	359	370	371	375	375

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

G10FX: Three key charts

Mr Biden's victory in the US election and the breakthrough in Covid-19 vaccines are working in tandem to supress the dollar further. This is leading to an unravelling of the "Trump risk premium", which has farther to go...

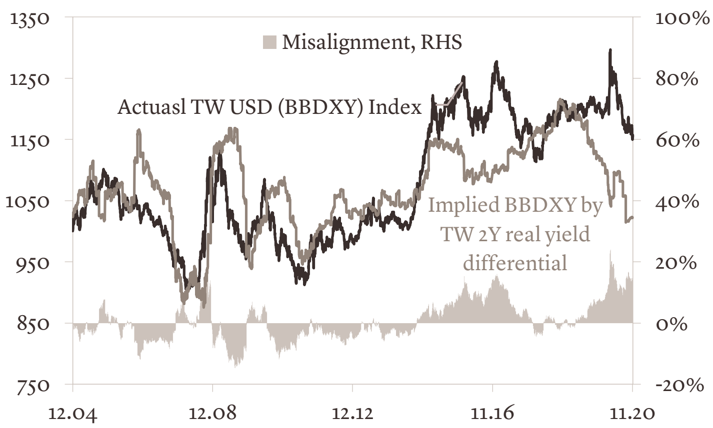
1. The unravelling of the Trump risk premium



Sources: Bloomberg, Lombard Odier.

... especially since the USD remains dislocated for real yield differentials

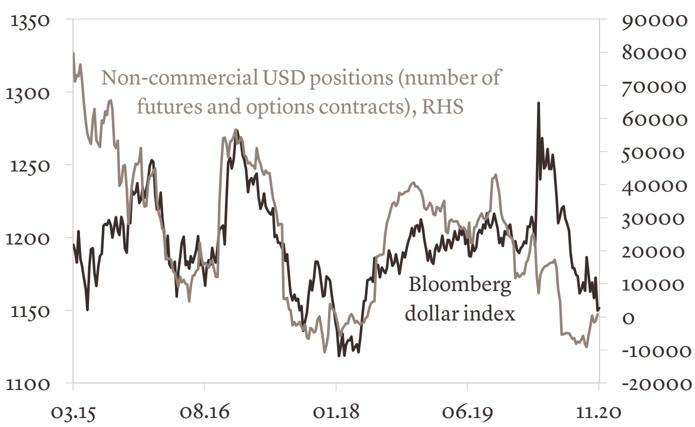
2. USD still rich relative to yield differentials



Sources: Bloomberg, Lombard Odier.

However, USD positioning is still quite short, which could induce more two-way price action in the near term and slow the pace of depreciation.

3. Despite some covering, USD shorts are still stretched



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

EUR (euro): Likely to break the 1.20 level, but moderate gains thereafter

- **Mr Biden's win and progress on Covid-19 vaccines flag a gradual return to normality**
- **Risk appetite will be supported and global trade will recover**
- **Both will underpin the EUR in the months ahead.**

EURUSD has strengthened this month due to [Joe Biden winning the US presidency] and news that the [Pfizer vaccine trials] have shown a 90% efficacy rate, higher than expected. All this has fuelled a strong rally in risk assets and weighed on the dollar. Our core view on EURUSD remains unchanged. We believe further appreciation is in store, with the currency breaking above 1.20. Gains are likely to moderate in 2021. More spevifivally:

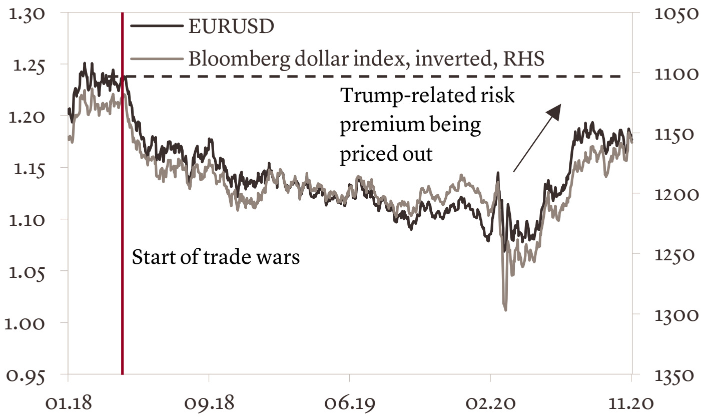
First, Mr Biden's victory represents a return to normality. This allows currencies to price out any Trump-related risk premia (see chart 4) and trade more on fundamentals. Importantly, Mr Biden's policies will promote an easing in trade tensions, which should be positive for trade-sensitive currencies such as the euro. **Second**, EURUSD is still low relative to the real yield differential (see chart 5). **Third**, progress on a Covid-19 vaccine means that the likelihood of additional economic disruptions in 2021 is falling, while prospects of economic recovery are rising. As global trade picks up, EURUSD should benefit. **Fourth**, European-related risk premia have structurally declined following [the agreement on the EU's recovery fund].

On the other hand, there are a number of headwinds, namely: first, speculative EUR long positioning has contracted, but remains high (see chart 6). **Second**, the move in the EURUSD higher has been quite abrupt in the past few months, suggesting that plenty of optimism is in the price already. **Third**, the European Central Bank (ECB) may continue verbally intervening in the market. However, its impact on the euro is likely to be moderate, given the depletion of available tools. That said, a significantly higher-than-expected expansion of QE in December could put some pressure on the euro for some time.

Main risks to our view:

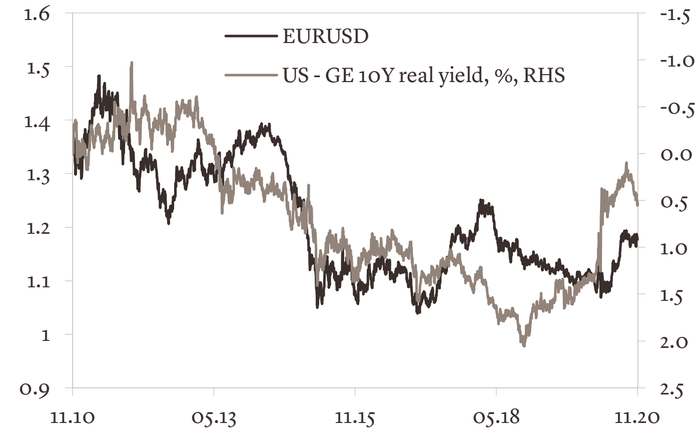
1. The ECB cutting rates into further negative territory (unlikely);
2. delays in vaccine distribution (or other bottlenecks) accompanied by renewed economic disruption;
3. the Fed turning less dovish because of inflation picking up.

4. Still some Trump-related premium to be priced out



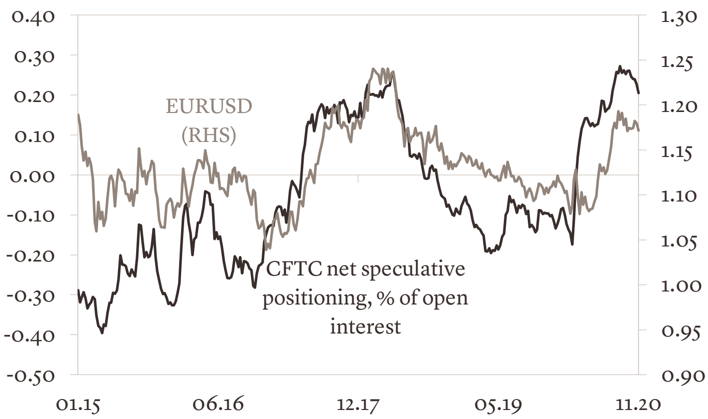
Sources: Bloomberg, Lombard Odier.

5. EURUSD still low relative to the real yield differential...



Sources: Bloomberg, Lombard Odier.

6. ... but long EUR positioning may be a headwind



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

CHF (Swiss franc): Risk appetite and Swiss portfolio outflows will be key

- **EURCHF is still lagging EURUSD significantly**
- **The improvement in risk appetite, however, is important**
- **Assuming this does not change, Swiss residents' portfolio outflows should pick up, weakening the franc.**

In our last FX Monthly, we made two points regarding the Swiss franc. **First**, we observed that there was an unusually wide wedge between EURUSD and EURUCHF (see chart 7), meaning that the latter was lagging the former. **Second**, we expressed the view that the gap would close by means of the EURCHF moving higher. This would be consistent with historical experience, although in the absence of Swiss portfolio outflows the move would be very gradual. These outflows are a prerequisite for sustained CHF weakness. That said, we also highlighted that the latest Swiss balance of payments data showed tentative evidence of rising appetite by Swiss residents for foreign assets (see chart 8).

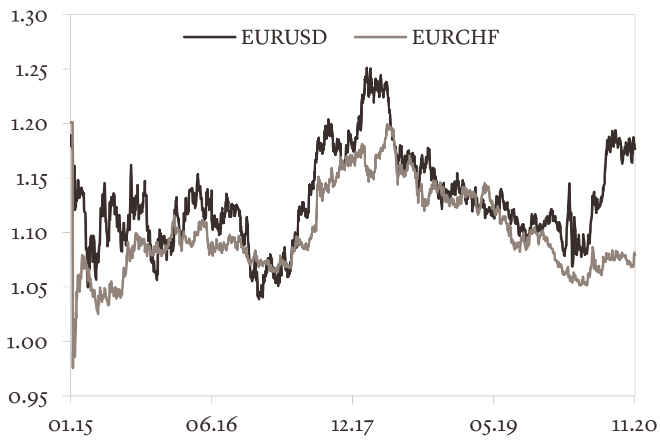
Since then, EURCHF first drifted lower ahead of the US election but has recently spiked above the 1.08 level, which has been a very strong resistance area (see chart 9). Although there are now downside risks to our 1.11 call for the end of the year, we believe the time is ripe for Swiss residents to direct money abroad. **First**, Joe Biden's victory in the US is forcing the market to price out trade-related risk premia that could otherwise reignite risk aversion. **Second**, progress on the Covid-19 vaccine (relating to the Pfizer/Moderna news) argues in favour of investors pricing out pandemic-related risk premia, especially in the euro area.

Main risks to our view:

CHF could rise if

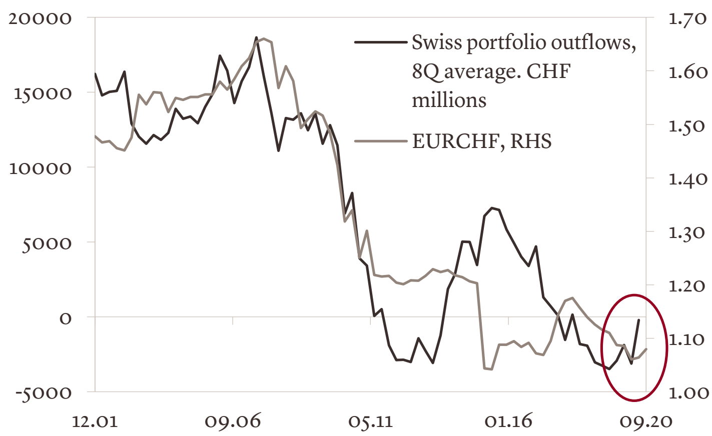
1. vaccine progress and/or distribution is delayed, threatening renewed restrictions; and
2. the ECB surprises the market negatively with a QE announcement below expectations, leading investors to anticipate a slower pace of regional economic recovery.

7. A big and unusual wedge between EURUSD and EURCHF



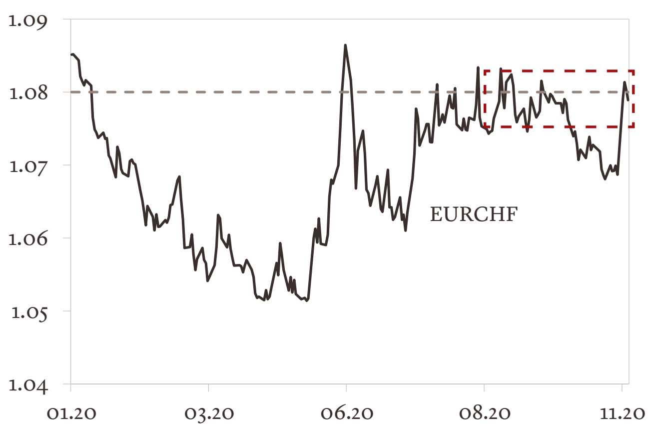
Sources: Bloomberg, Lombard Odier.

8. Tentative evidence that portfolio outflows are picking up



Sources: Bloomberg, Lombard Odier.

9. 1.08 has been a strong resistance level for EURCHF



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

GBP (pound sterling): On the road to 1.35

- **The UK and the EU are inching closer to a (basic) Brexit deal**
- **This should support GBPUSD further, alongside the weak dollar**
- **We remain overweight in our portfolios.**

In our last FX Monthly, we fleshed out four reasons we had turned positive on sterling and had decided to overweight GBPUSD in our portfolios. **First**, there was evidence that progress was being made in the negotiations. **Second**, we felt that, as time was running out, pragmatism would prevail, especially under the economic hardship imposed by the pandemic-related restrictions. **Third**, positioning in sterling was rather clean, suggesting that the market was not pricing in a “deal” Brexit. Finally, the weak USD would be an additional factor driving GBPUSD higher.

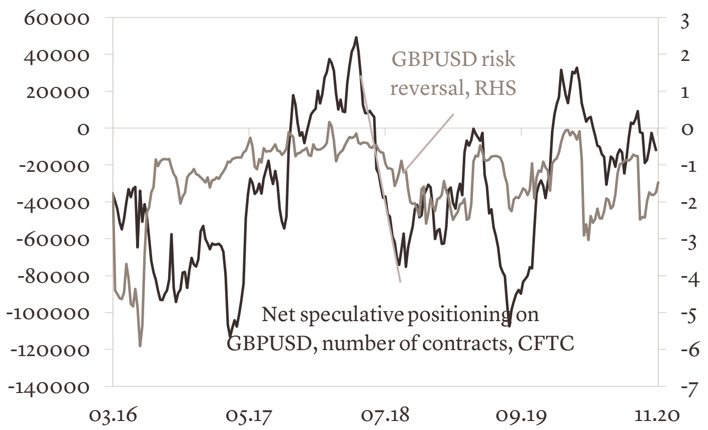
Fast-forward one month and all these reasons remain valid, in our view. The two sides keep sending positive signals and have become more pragmatic; for example, a compromise seems to be in the making on the issue of fisheries. What really remains for the EU and the UK is to draft the agreement in such an ingenious manner that both can promote it to their respective audiences as a political success.

Speculative positioning in sterling remains clean (see chart 10), whereas the Biden victory alongside the progress on the virus vaccine are fuelling risk appetite and weighing on the dollar. Moreover, the Biden presidency will add further pressure on the UK government to reach a deal if it wants to reinvigorate its relationship with the US. Joe Biden has made no secret that he opposed Brexit; he is pro-EU; and has been adamant that any resolution should ensure the peacekeeping of the Good Friday agreement in Northern Ireland.

GBPUSD is now trading around the 1.32 level. More importantly, EURGBP has started weakening, which effectively shows that the market has only recently started to price out the “no deal” Brexit premium (see chart 11). We expect GBPUSD to rise towards 1.35 and potentially higher in 2021. However, we would not chase the currency much above 1.37. Even a “deal Brexit” would result in a structural hit to the UK economy, which is also struggling with the second wave of the pandemic against a ballooning fiscal deficit.

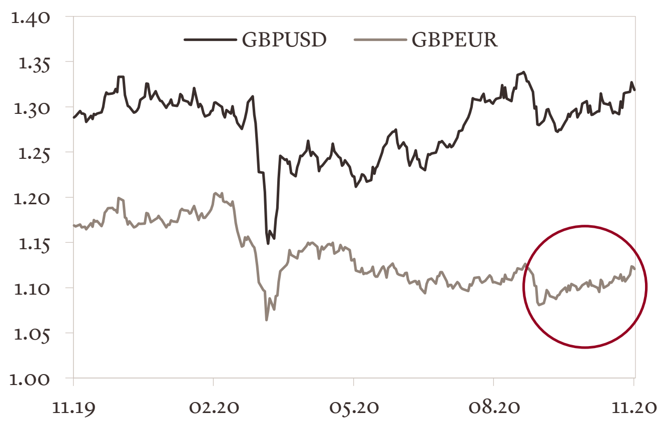
Main risks to our view: Clearly, the main risk to our constructive sterling view comes from a “no deal” Brexit. An additional risk stems from a resurgence in demand for dollars in case of another severe risk-off episode.

10. GBPUSD positioning still very clean



Sources: Bloomberg, Lombard Odier.

11. GBP has only recently started pricing out a “no-deal” Brexit



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

Japanese yen: No change in medium term view for now

- **Vaccine news interrupted the move lower in USDJPY…**
- **… but has not halted the medium-term downtrend**
- **We still expect USDJPY downside, although the adjustment lower** may take more time.

For most of the last four weeks, USDJPY remained in a downward trend. Shortly after the US election result, it managed to break below the 104 level, trading as low as 103.18. However, following the announcement of the Pfizer vaccine (which reported a 90% efficacy rate), USDJPY shot up by 2% on the day.

We have received many questions about this move, and whether our degree of conviction in our USDJPY underweight has changed. In short, we still think USDJPY will trend lower from here, although the approach towards the 100 level may be slower now. That said, an important level to watch is 106-106.50, as a break above this area could signal the beginning of a reversal in trend. Below we make the following points:

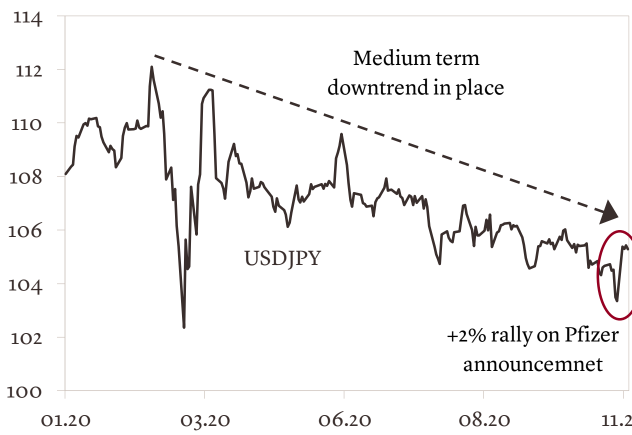
First, The 2% daily appreciation on 11 November was predominantly driven by market euphoria following positive vaccine news, and was in sync with the sharp rise in equity prices. However, we feel that this is now largely in the price. **Second**, historically, USDJPY's beta to the dollar dominates its beta to equities (see chart 13). This means that the broad dollar trend is more important for USDJPY medium-term fluctuations than the trend in risk assets. In that respect, a weaker dollar should eventually lead to a lower USDJPY. **Third**, the US-JN yield differential still suggests potential USDJPY downside (see chart 14). Although the correlation between the two has fallen recently, the gap is too wide to be dismissed. Furthermore, a split US Congress is likely to result in less fiscal stimulus, which implies that the rise in US yields will be limited.

In summary, we maintain the view that USDJPY will return to a depreciating path. At the same time, the rise in equity prices may partly offset the impact from the weaker dollar, which may result in a more gradual decline. We maintain our forecasts unchanged, but acknowledge some upside risks.

Main risks to our views:

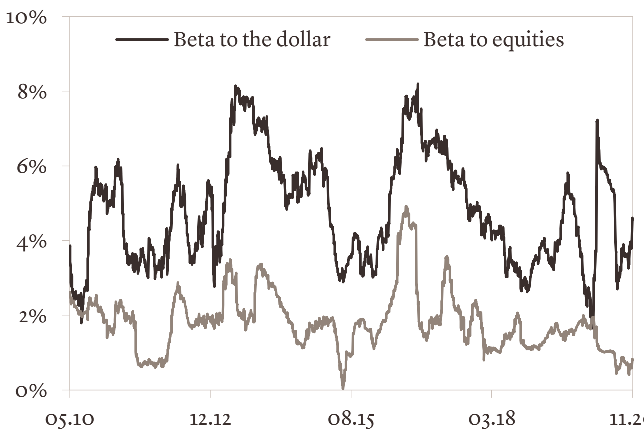
1. Further positive news on other Covid-19 vaccines currently under trial could improve risk appetite and weigh on JPY;
2. a stronger global economic recovery than we expect;
3. verbal intervention by Japanese officials to stem JPY appreciation;
4. large fiscal stimulus in the US could raise US yields and pressure the yen for some time.

12. USDJPY downtrend in place



Sources: Bloomberg, Lombard Odier.

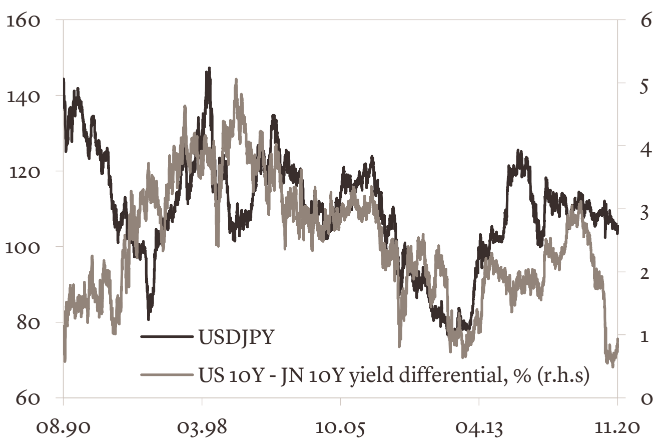
13. Dollar trend more important than equities for USDJPY



The "beta" is the estimated impact on USDJPY of a hypothetical 5% rise in the TW USD/hypothetical 5% rice in global equity prices. Calculated using daily returns on a 90D rolling window

Sources: Bloomberg, Lombard Odier.

14. USDJPY still dislocated for the real yield differential



Sources: Bloomberg, Lombard Odier.

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FX majors and gold

Nordic currencies: Risk appetite is key; we still favour the NOK

- **On the back of improving risk appetite, both NOK and SEK have rallied…**
- **… but there is now evidence that the NOK has started outperforming the SEK**
- **We expect this outperformance to amplify over the coming months.**

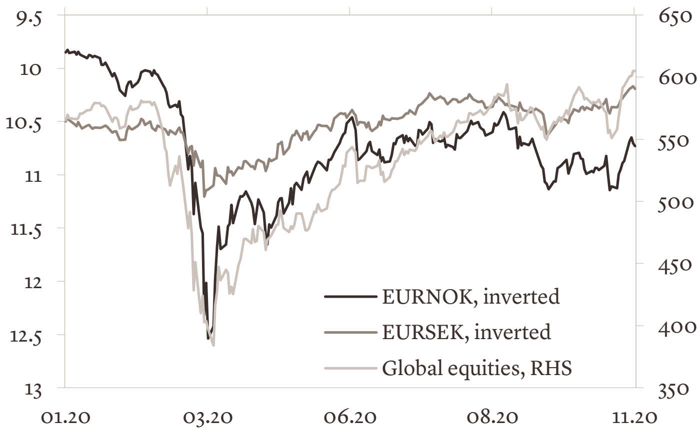
NOK (Norwegian krone): Having spent October in a range around 10.90, the improved risk environment led to a sharp drop in EURNOK from 11.12 to near 10.60; similarly, USDNOK has depreciated so far this month and is now close to 9.00. The news on the progress of the virus vaccine played an important role, as NOK is a highly pro-cyclical currency, moving in line with risk sentiment and expectations for global growth. We maintain our constructive view on the NOK, against both the EUR and the USD, based primarily on the following two factors. **First**, in a period of normalising global growth where risk premia are being priced out, cyclically sensitive currencies like the NOK should trend higher. Positive news on the vaccine front is very likely to act as a catalyst for this move. **Second**, with inflation running above the central bank's target zone, Norwegian yields should remain supported. This should lend additional support to the currency. That being said, oil price increases appear to be limited for now, which suggests that the pace of NOK appreciation is likely to slow.

SEK (Swedish krona): The Swedish krona has continued strengthening, with EURSEK now close to its lowest point for the year, at 10.20, and USDSEK at 8.63. That said, the SEK has started underperforming the NOK, with EURNOK down by more than 3% in November vs 1.2% for EURSEK. Similar to the Norwegian krone, risk appetite will dictate moves for the near future (chart 15). In that sense, there is now a downside risk to our year-end forecast of 10.25, but on balance, we still expect the SEK to underperform the NOK (chart 16).: Swedish inflation remains extremely subdued, allowing the Riksbank to maintain an accommodative stance for longer.

Main risks to our view:

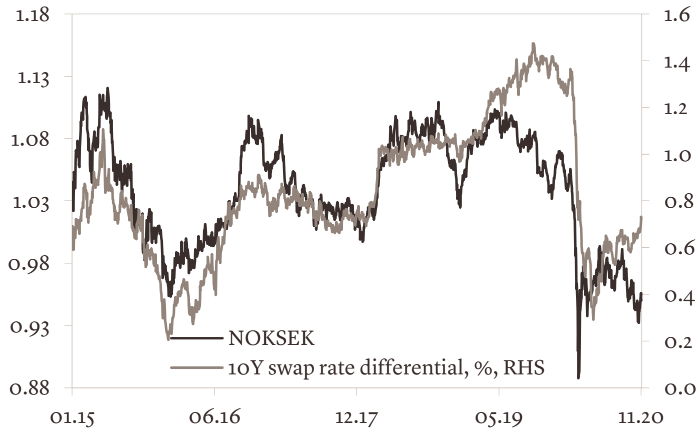
In the case of NOK, there are two main risks: euro-area recovery faltering, and/or renewed oil price declines. In the case of the SEK, the main risk relates to external factors that could disrupt the global recovery and weigh on pro-growth currencies.

15. Risk appetite key for the Nordics…



Sources: Bloomberg, Lombard Odier.

16. …but fundamentally, the NOK should outperform the SEK



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

Commodity currencies: A battle between risk appetite and valuations

- **USD downside will continue to support commodity currencies...**
- **... but valuations are now less appealing than before.**

AUD (Australian dollar): In our last FX Monthly, we suggested that tactically the AUDUSD should be bought on any dip below 0.72, with a target of 0.74. We maintain this view. On one hand, the AUD will continue to receive support from first, better risk appetite due to the Biden victory and vaccine developments; second, robust recovery in Chinese growth; and finally, buoyant iron ore prices. On the other hand, a number of headwinds are likely to prevent substantial appreciation. **First**, valuation is not as compelling as before (see chart 17). **Second**, the RBA recently cut the cash rate to 0.1%, increased its asset purchase programme, and strengthened its forward guidance by pledging not to increase interest rates for at least three years. Finally, the ongoing spat with China will remain a risk for the Australian dollar. There is little doubt that expectations of a vaccine breakthrough and higher growth will support the AUDUSD, but for now, we think it unlikely that the 0.74 level will be broken.

CAD (Canadian dollar): Turning to Canada, last month we expressed the view that the CAD had the potential to outperform the rest of the core commodity FX bloc. Since then, USDCAD has moved close to its lowest level for the year (1.30), and we believe there is further room for depreciation. **First**, the currency will continue trading in line with risk appetite, with valuation somewhat more compelling (albeit not by much) than that of the AUD or NZD. **Second**, the speculative community remains short CAD (see chart 18). We have lowered our forecast to 1.28 for the end of the year and to 1.27 for Q3 21. It is true that low oil prices and uncertainty on Biden policies over oil production may raise some headwinds, but for now, we feel that the recent positive CAD momentum will more than offset them.

NZD (New Zealand dollar): The NZD has moved significantly higher than we expected. Aside from the rally in risk assets, the New Zealand dollar is also benefiting from expectations of an improved tourism outlook due to the vaccine breakthrough. This can indeed provide a tangible source of support, which is why we have decided to raise our forecasts to 0.70 for the end of this year. Nonetheless, a dovish RBNZ alongside overvaluation should restrain any material upside.

Main risks to our view:

1. Delays (or other bottlenecks) in the creation/distribution of the Covid-19 vaccine could dampen growth expectations and weigh on commodity currencies;
2. if US President-elect Joe Biden moves forward with his promise to scrap permits for the Keystone XL pipeline project (a project that would facilitate the flow of oil barrels from Canada to the US Midwest), then we would expect upside pressure on USDCAD.

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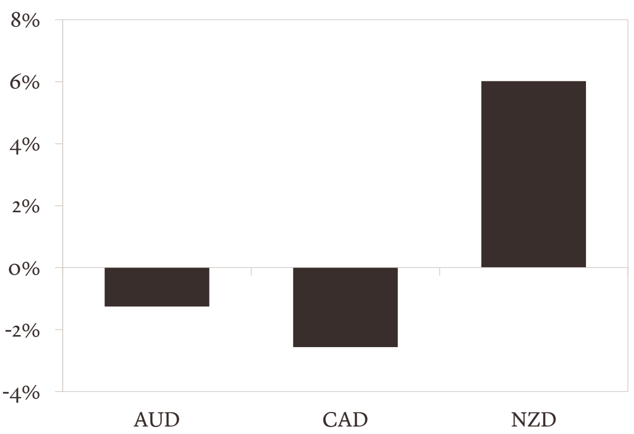
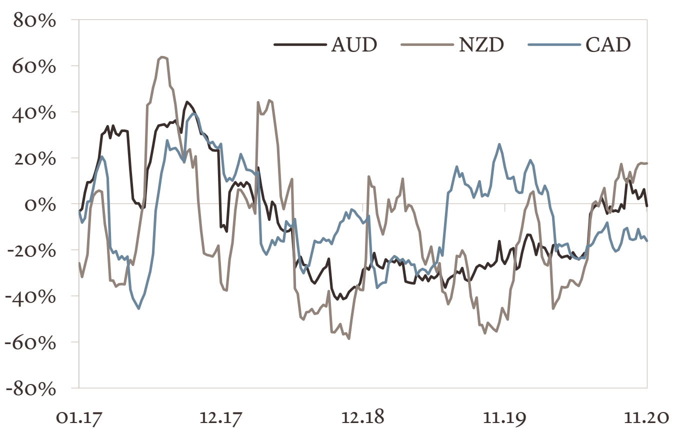
17. Commodity currencies' over/under valuation
CFTC data, % of open interest



Sources: Bloomberg, Lombard Odier.

18. CAD positioning is still the lightest among commodity FX



Sources: Bloomberg, Lombard Odier.

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

FX majors and gold

Gold: Fed's policy remains supportive of gold prices in the near term

- **Fed's policy is capping yield normalisation and continues to offer support to gold**

Gold has benefitted from strong positive momentum since late July, reaching an all-time high above USD 2050/oz in early August. The combination of real rate compression, TINA (There Is No Alternative for investors), and expansionary fiscal and monetary policies has lifted both equity markets and gold. In these conditions, we took partial profits on our long gold position. Indeed, gold can be a defensive asset to shield portfolios in a low-yield environment, but its inherent volatility (which is close to equity volatility) begs tactical management and discipline.

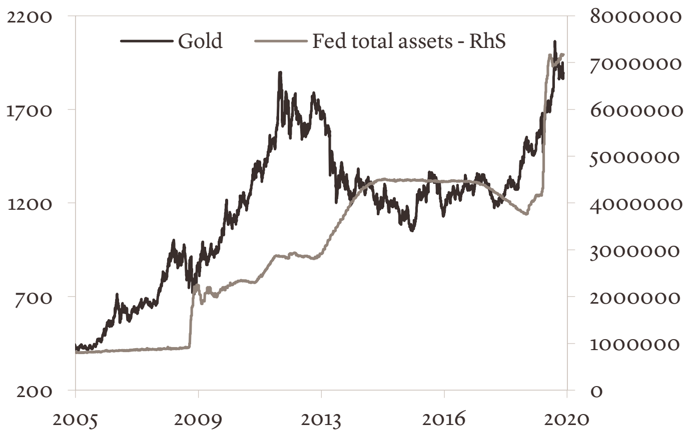
Still, the Fed's policy is capping the potential of yield normalisation for now. Taking into account the high level of uncertainty surrounding the Covid-19 pandemic in the near future, we believe that gold is likely to continue to overshoot our medium-term target, trading in the USD 1,850-2,000/oz range. Hence, material upside seems limited.

The impact of the Fed's balance sheet should fade as the recovery materialises further – once a vaccine is widely distributed. Our base case remains one where gold trades lower in the medium term (our 12-month target is USD 1,600/oz) once the recovery is well established and real rates can start normalising from their historically depressed levels. Specifically, US 10Y real yields rebounding towards -0.5% would be consistent with a gold price around USD 1,600/oz.

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

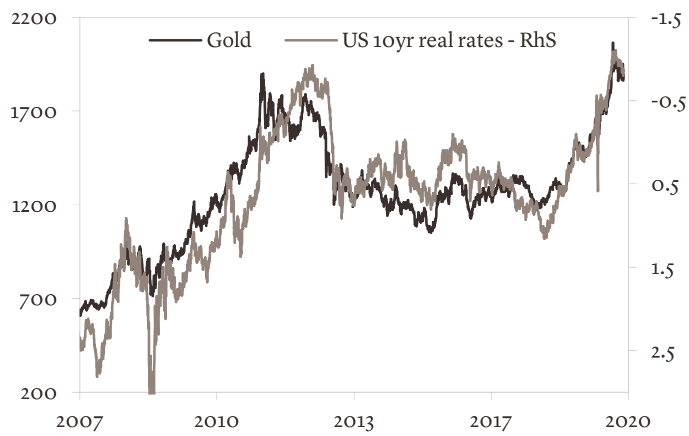
Main risk to our view: a fiscal cliff in the US that triggers additional expansionary monetary policy measures – potentially the Fed adopting a negative interest rate policy.

19. Unprecedented Fed balance sheet expansion offers a strong support to gold...



Sources: Bloomberg, Lombard Odier

20. ...However, interest rate normalisation will eventually weigh on gold outlook



Sources: Bloomberg, Lombard Odier

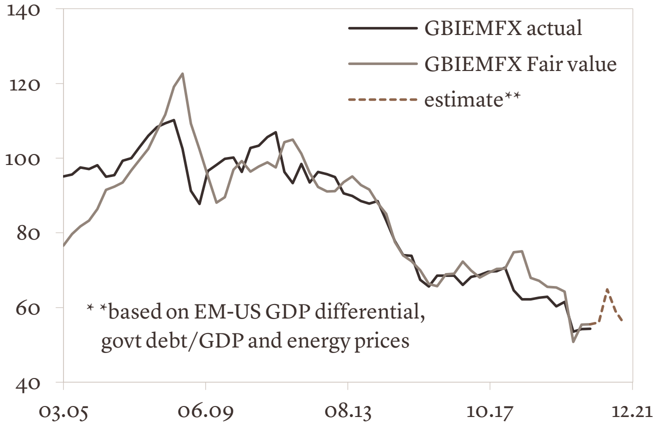
Note: Past performance and forecasts are not a reliable indicator of future performance.

EMFX: Three key charts

GBIEMFX – what the model suggests:

Using modest energy price assumptions (USD 45 per barrel 12M out) and inputting consensus EM vs US growth forecasts, our GBI EMFX model suggests that the index could see some gains over H1 (chart 21). The gains, in particular, are driven by the consensus forecast for a sharp recovery in EM growth over Q1 and Q2. Better news on the vaccine will certainly frontload EMFX gains. Near term, a better short-term outlook for some of the weakest links in EMFX (like TRY and ZAR – see CEEMEA section) suggests the time for a rise in GBIEMFX would be in the next one to three months. However, further out, high debt loads and still low-for-longer energy prices suggest gains may not be sustained in H2.

21. GBI EMFX: Case for some gains on a 1-3M view, but cautious further out



Sources: Bloomberg, Lombard Odier

EMFX buckets: from best to worst:

Chart 22 shows our division of the liquid EMFX universe into four buckets – from our top favourites to our least liked currency picks. We continue to prefer currencies with low debt, exposure to Chinese infrastructure spending (KRW and CLP), EURUSD upside (PLN and CZK), and tech sector exposure (TWD). Changes this month: We upgrade CNY to "EMFX outperformer" from "modest performer" previously, as well as RUB to "cautious" (changes in green) On the other hand, we downgrade both PLN and CLP to modest performers (red). We remain cautious PEN and believe risks are to the downside on political risk.

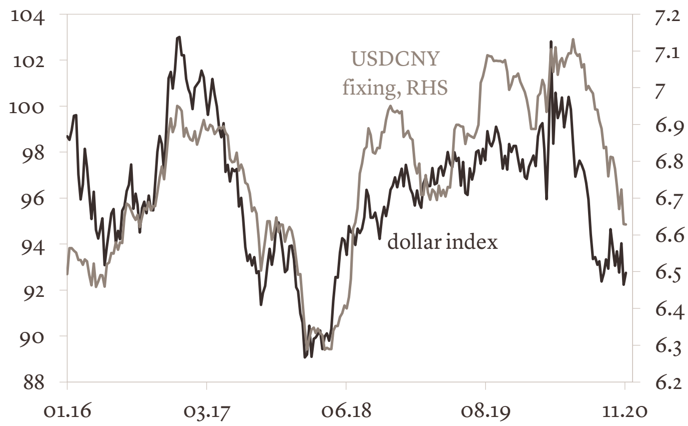
22. EMFX – four buckets of EM currencies

The outperformers	• Asia (TWD, KRW and CNY) • LATAM (N/A) • CEEMEA (CZK)
Modest performers	• Asia (SGD, INR and THB) • LATAM (CLP, MXN) • CEEMEA (ILS and PLN) • GBIEMFX index
Cautious	• Asia (PHP, MYR and IDR) • LATAM (BRL and PEN) • CEEMEA (HUF and RUB)
Underperformers	• LATAM (COP) • CEEMEA (TRY and ZAR)

Sources: Bloomberg, Lombard Odier

Chinese FX liberalisation could mean USDCNY has a higher sensitivity to the USD: We revise our USDCNY forecasts, assuming 6.55 and 6.40 on a 3M and a 12M view. In September, we moved from a cautious CNY to a more constructive view based on an improvement in Chinese FX fundamentals (the better growth and balance of payments noted above). We assumed a Biden win would reduce some trade uncertainty. However, we did not and do not expect that a Biden win will automatically and immediately bring a reduction in tariffs on Section 301 Chinese goods. What has changed in the past month is an increasing tolerance on the part of the Chinese authorities for USDCNY to trade with a higher beta to the dollar. Through FX liberalisation measures – like removing the countercyclical factor – we think USDCNY fixings could gradually converge to a lower USD (chart 23). Should there be a reduction in Section 301 tariffs at some point, we would likely have to revise the USDCNY forecast lower.

23. PBOC's FX liberalisation could see USDCNY close gap with the broader USD trends



Sources: Bloomberg, Lombard Odier

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

Asia FX
Biden and vaccine lift all boats

- Joe Biden's victory in the US presidential election has brightened the outlook for Asian currencies
- We raise our forecast for the renminbi, as Beijing's latest liberalising moves for the FX market create an upside risk for the medium-term path of the currency's value versus the official basket
- The upside for THB, IDR, SGD, and KRW could increase if an effective vaccine arrives. The Biden administration's stance on currency manipulation could push KRW, TWD, and THB higher.

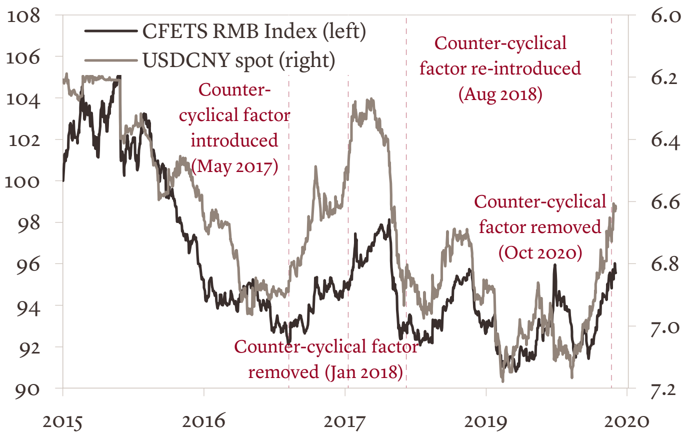
CNY: Raising the forecasts, as Beijing shows tolerance for CNY strength

We raise our forecasts for the yuan in light of Mr Biden's victory in the US presidential election and the latest Covid-19 vaccine developments. **First**, the new regime in Washington D.C. will likely reduce the risk of unexpected trade-related shocks for the yuan. In fact, a weaker US dollar could offer the easiest path to a tacit compromise between the US and China under the Biden presidency. China, will probably accept the yuan's appreciation as it helps the leadership's plan to boost domestic consumption. Markets may also have to price in the outside chance of a reduction in tariffs between the two countries. **Second**, the People's Bank of China's recent tweaks in its currency management demonstrate that Beijing is willing to let markets drive the value of the yuan. In October, the PBOC removed the reserve requirement ratio for FX forward transactions, and did the same with counter-cyclical factors in the fixing of the yuan (see chart 24). We disagree with commentary that these measures signal that the PBOC is beginning to lean against the market strength. Rather, they create the risk that the PBOC may let the yuan rise past the range that the bank has been maintaining since 2016, as that would also be a market-driven event. **Third**, China offers one of the strongest combinations of macroeconomic fundamentals, in the world, and will attract more inflows in the coming months. The country has established firm control of the Covid-19 virus even without vaccines (see chart 25), thus allowing a significant recovery of the service sector. China has its own indigenous Covid-19 vaccines that are close to broad deployment. For foreign investors, the country has an outperforming stock market and a higher-yield bond market. These factors will continue to drive inflows and support the currency's upward trajectory.

Main risks to our view: Unexpected serious geopolitical flare-ups vs the US in the neighbouring areas (e.g. Taiwan, South China Sea, other maritime borders) could fuel expectations of the Biden team's aggressive hawkish turn and create risks for our scenario. There is also an upside risk for the currency that could arise from Beijing's policy tightening in 2021.

24. China is letting markets drive the renminbi's value again

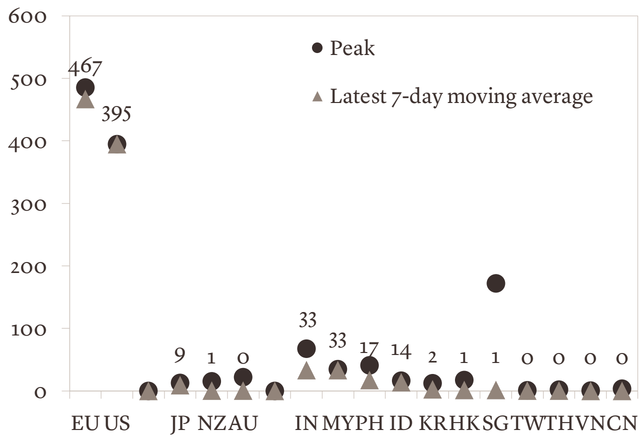
CFETS RMB index estimate, 31 Dec. 2014 =100 (lhs), USDCNY spot (rhs)



Sources: CEIC, Bloomberg, Lombard Odier

25. Asia-Pacific region still ahead in the Covid-19 fight

Number of Covid-19 cases per million people, 7-day moving averages



Sources: CEIC, Bloomberg, Lombard Odier

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

Asia FX
Biden and vaccine lift all boats

KRW: Best Asian currency for global trade recovery in 2021

We still expect the Korean won to strengthen further in next 12 months. **First**, the country will benefit strongly from synchronised global recovery in 2021 due to its relatively diversified export sector, and its currency indeed shows the highest positive correlation among its Asian peers to global trade volume growth (see chart 26). We note that South Korea's merchandise export basket is rather unique in the region due to its competitive positions in both the technology and industrial sectors. **Second**, the Moon administration enjoys a high degree of flexibility in fiscal policy thanks to the ruling party's sizable majority in the National Assembly (176 seats out of 300 after a blowout victory in April) and the country's sufficient fiscal space. This adds to the government's ability to contain the virus in the pre-vaccine period, since targeted fiscal support can enhance the efficacy of calibrated public health measures. **Third**, the Bank of Korea faces political pressure not to ease its policy dramatically due to the widespread public discontent on rapidly appreciating urban home prices. We believe that the BOK has entered a period of extensive policy pause for this reason.

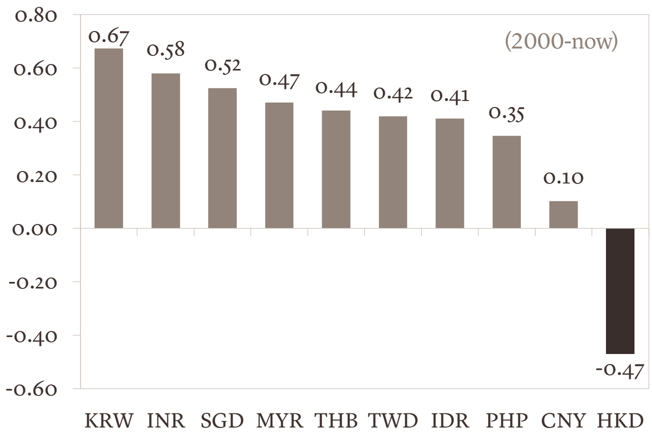
Main risks to our view: Geopolitical risks surrounding China and North Korea will remain a key risk for the Korean won. The Biden administration's stance towards Asian currencies will be another risk to watch as the country has been closely monitored by the US treasury for its semi-annual reports on FX manipulation.

TWD: Our favourite pick

The New Taiwan dollar remains our favourite pick in Asia due to its well-known sources of strength. **First**, the currency is underpinned by one of the most solvent systems in the world, with net claims on foreign assets and FX reserves, and is set to face structural appreciation pressures. **Second**, Taiwan's policymakers have been signalling their comfort with the market-driven strength of the TWD: CBC Governor Yang recently described the trade-weighted value of the currency as "not expensive" on a trade-weighted basis. We note that Mr Yang also hinted at the CBC's shift in focus to financial stability issues in the medium-term. **Third**, Taiwan's economy will likely avoid outright contraction in 2020 due to its world-leading virus containment efforts, while the cyclical upturn outside the country and new smartphone product cycle will boost its already strong exports. This in turn will keep the external surpluses high and support the TWD's value. Life insurance companies that have been very aggressive with unhedged investments outside Taiwan have sufficient capital to withstand further TWD strength as well.

26. KRW has the highest correlation with global trade growth

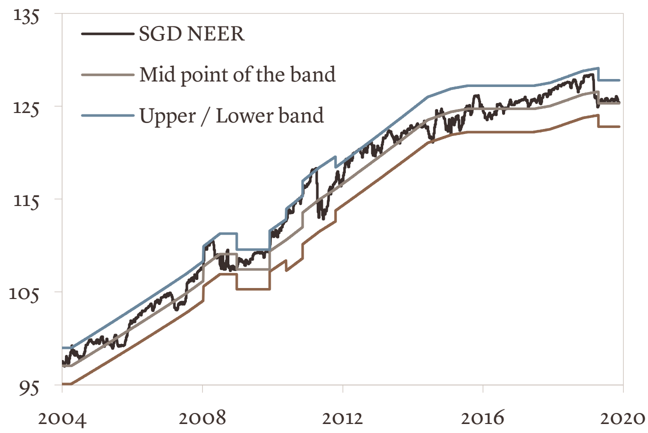
Correlation of currency appreciation (vs USD) to global trade growth



Sources: CEIC, Bloomberg, Lombard Odier

27. MAS will likely keep SGD NEER flat for another year

SGD NEER curve and estimated MAS policy bands



Sources: Bloomberg, Lombard Odier

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

Asia FX
Biden and vaccine lift all boats

Main risks to our view: Main risks are a 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.

SGD: Flat SGD NEER curve points to further gains vs USD

We expect SGD to appreciate modestly vs USD in the next 12 months. **First**, the Monetary Authority of Singapore (MAS) is unlikely to ease its policy again as the domestic public health condition has improved significantly, and growth is set to rebound strongly from Q3 onwards. Indeed, the MAS confirmed this in its October policy decision by putting the policy on hold. As a result, the SGD nominal effective exchange rate curve will likely move sideways in 12 months (see chart 27). This outlook is consistent with the appreciation of SGD vs USD, as we expect other currencies in the basket to strengthen as well. **Second**, weaker USD trends create a modest upside risk for the currency as it is trading near the midpoint of the MAS band and could move to the upper end in a favourable market environment. **Third**, vaccine deployment would provide an outsized boost to the currency, as it would improve both local service sector activities and the external service balance.

Main risks to our view: Main risks are the impact of Q4 deceleration in the US and Europe, vaccine-related news flows, and public health and macroeconomic conditions in the surrounding South-Asian economies.

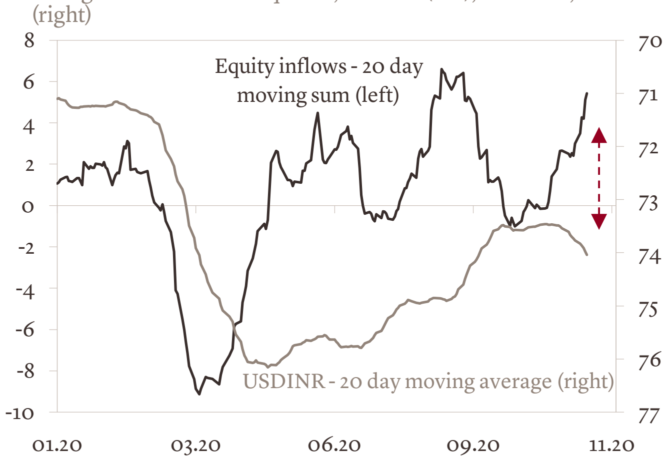
HKD: Gradual reversion to the linked rate after Ant Group IPO surprise

We expect the HKD peg to remain in place for the near future, but we believe that USDHKD will gradually move from the strong-side convertibility of 7.75 to the linked rate of 7.80. **First**, the temporary scarcity of liquidity related to Ant Group's mega-IPO is easing already due to the unexpected suspension of the listing. **Second**, the city's economic and political news flows remain uneven, and medium-term concerns could motivate steady shifts in the FX allocation of the city's residents, especially since the strong-side convertibility of 7.75 reduces the risk and reward of such adjustments. **Third**, a major change in the USD peg is still extremely unlikely, as HK does not have a logical alternative to the current system.

Main risks to our view: Main risks are the magnitude of the IPO boom including the renewed attempt to list Ant Group, and domestic political developments related to the Legislative Council elections.

28. RBI keeping the lid on INR despite strong equity inflows

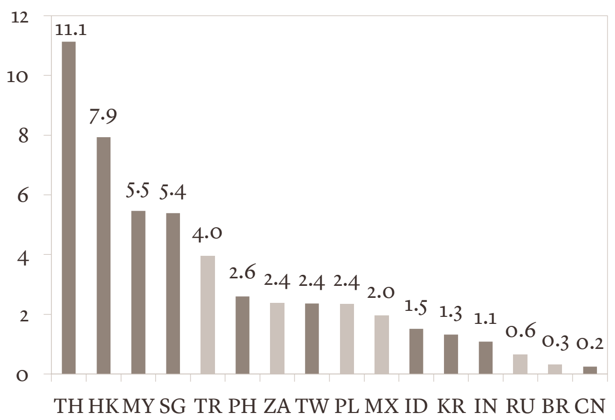
Foreign investments in equities, USD Bn (left), USDINR, inverted (right)



Sources:Bloomberg, Lombard Odier.

29. THB's sensitivity to vaccine development is not surprising

Trade-related service export as a % of GDP



Sources:Bloomberg, Lombard Odier.

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

Asia FX
Biden and vaccine lift all boats

INR: Modest gains against economic recovery

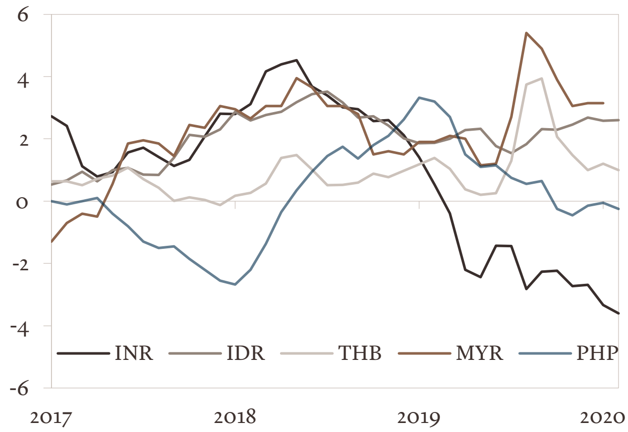
The Indian rupee has experienced a modest setback in the past four weeks, but we see a somewhat better performance vs USD in the next few months. **First**, INR's recent gains have been rather limited despite the significant improvement in India's overall balance of payments and its strong foreign inflows (see chart 28). This is likely due to the Reserve Bank of India's continued buying of FX. We suspect that the RBI will be somewhat less aggressive in its FX market intervention as domestic growth and inflation stabilise. **Second**, the economy has been finally bouncing back from the extreme contraction in Q2 amidst nationwide re-opening. India's public health situation looks modestly better, with a steady flattening of the Covid-19 epidemic curve (albeit still elevated) and strong coordination with vaccine suppliers. Any additional easing measures by the RBI will likely be seen as the last due to these developments. **Third**, the ruling coalition's victory in the recent Bihar election – in spite of the painful economic downturn this year – hints at many more years of policy continuity. The Modi cabinet has been relatively cautious in its use of fiscal policy thus far, and this will likely help India maintain its investment-grade rating after Moody's downgrade (to Baa2 from Baa1) in January 2020.

Main risks to our view: Although we still expect the country's investment-grade rating to be maintained this year, it will be crucial to watch sovereign ratings as Moody's downgrade could continue or be echoed by other rating agencies. The country's slowly worsening Covid-19 epidemic will also be a key issue for the currency.

IDR: Omnibus bill anchoring the currency for now

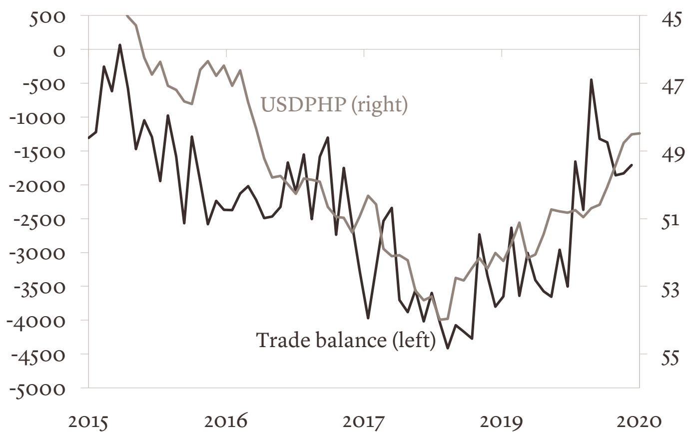
Contrary to our earlier expectation, the rupiah has performed rather solidly in the past few weeks due to the market's positive response to the passage of the Omnibus bill, which eases various key restrictions in the economy. The currency also seems to have benefitted from the weaker USD environment and vaccine news. We believe that much of the boost from these catalysts is behind us. **First**, the government will have to demonstrate to foreign investors that it can apply the new law effectively to the affected industries. It is still possible that the law may be diluted upon implementation due to trade union opposition. We do not believe that this law, while modestly positive for the long-term growth, will be a game-changer for the country's direct investment inflows in the near term. **Second**, excess domestic liquidity will cap the upside for the currency. Foreign investors' demand for local bonds remains fragile, leading Bank Indonesia to pick up the slack in a market that has been hit with increased supplies of deficit financing bonds. Bank Indonesia its likely to cut its benchmark rate one

30. Real rate still attractive in Malaysia
Benchmark policy rates minus CPI inflation, %



Sources: CEIC, Lombard Odier

31. Widening deficit would increase PHP depreciation pressure
Trade balance, USD mn (left), USDPHP, inverted (right)



Sources: Bloomberg, Lombard Odier

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

Asia FX
Biden and vaccine lift all boats

more time to ensure sustained economic recovery and to put a little pressure on the rupiah. **Third**, stable policy outlook (no election until 2024), better access to USD liquidity, and the post-US election boost to emerging markets will provide some support for the currency.

Main risks to our view: The country's lax approach to Covid-19 containment will be a key risk given its fragile healthcare system. The results of clinical trials involving China's unique inactivated virus vaccines could be an interesting variable, as Indonesia's vaccine portfolio depends heavily on that prospect.

THB: Vaccine news more impactful than political uncertainties

While the baht has staged an impressive rally in the past few weeks, the triggers for this rally entirely match our risk scenarios for the currency. **First**, Thailand's macro outlook is most sensitive to vaccine developments due to its tourism sector, and the announcement of a highly effective Covid-19 vaccine from the Pfizer-BioNTech-Fosun group was bound to boost the THB substantially. No emerging market comes close to Thailand in terms of dependence on tourism for USD earnings (see chart 29). **Second**, Thailand's macro fundamentals remain resilient. The country will still post substantial current account surpluses for 2020 despite the collapse in tourism. This reflects the exceptional rebound in the region's manufacturing sector. The country has been able to keep a lid on Covid-19 cases with strong public health measures. Recent street protests are not expected to spiral out of control given the ruling party's structural advantages and scope for eventual compromise. **Third**, the Bank of Thailand is unlikely to cut its rates further, as policymakers have shown extreme aversion to a zero interest rate policy and unorthodox monetary programmes. That said, the BOT will prefer to intervene directly in the FX market to lean against the THB's excessive strength.

Main risks to our view: Main risks are the evolution of the ongoing street protests and vaccine developments.

MYR: Caught between a snap election risk and recovering trade

The relative softness of the ringgit in past few weeks is in line with our modified outlook for the currency, and we expect it to appreciate only modestly vs the USD in the next 12 months. **First**, the fragility of the new governing coalition, clearly revealed by the recent confusion over the opposition party's no-confidence vote attempt, points to the high likelihood of a snap election in 2021. While we do not expect the opposition to disrupt the budget released on 11 November, we believe that political intrigue will dominate policy outlook in the near term and weigh on MYR. **Second**, Malaysia's solid fundamentals will continue to favour the MYR's stable performance. The ongoing boom in the global goods trade will boost the country's exports and underpin another year of current account surplus. **Third**, Bank Negara Malaysia has begun to signal the end of its easing cycle, and we expect the central bank to remain on hold for the next 12 months in the absence of a new external shock. The real interest rate should be a draw for foreign investors, especially since it is substantially lower outside the country (see chart 30).

Main risks to our view: Main risks are unexpected failure to pass the new budget in November; the trajectory of local confirmed cases of Covid-19; oil price trends and their impact on the government's fiscal balance; and global demand for the country's industrial commodities and mid-end manufactures.

PHP: Countercyclical outperformance likely to reverse

We believe that the period of outperformance for the peso is coming to an end, even though we do not see significant depreciation in the next twelve months. **First**, the stabilisation of the Covid-19 epidemic curve in the country has led to the re-opening of the economy and an exceptional rebound in its activities in Q3, but the Philippines' full-year GDP will contract by 7.5-8.0% instead of growing. The country will also face significant logistical challenges in the nationwide deployment of Covid-19 vaccines. **Second**, the country's external balance will begin to deteriorate with the resumption of economic activity and with government spending that will push the deficit to 7-8% of GDP (chart 31). **Third**, the Bangko Sentral ng Pilipinas (BSP) may not cut rates further, but it will continue to support growth via liquidity operations and adjustments in reserve requirements for the banking sector. We note that the BSP's holding of government bonds has risen by roughly PHP 1.3 trillion since February (~5% of 2019 GDP). Stable remittance flows and better access to USD liquidity, however, will limit the downside for the currency.

Main risks to our view: Main risks are the trajectory of local confirmed Covid-19 cases and investor pricing for the likely period of political uncertainty ahead of the 2022 elections.

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

LatAm FX
Preference for MXN and CLP vs COP and PEN maintained

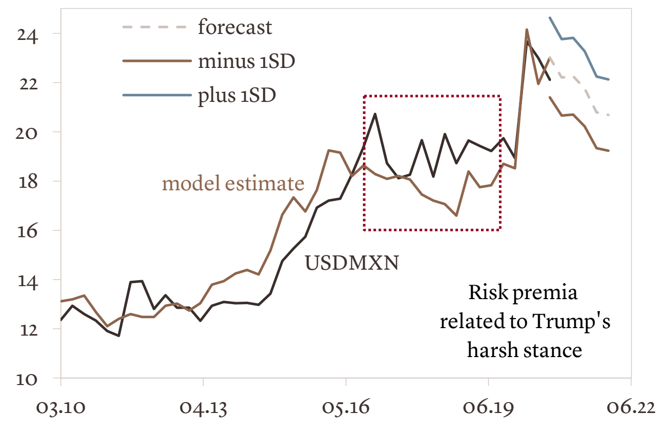
- **MXN benefits from positive fundamentals and more cautious macro policy backdrop. However, the second half of 2021 should be more challenging.**
- **We maintain a neutral view on the BRL for the coming months assuming the debt ceiling remains intact. However, any fiscal slippage would make us negative**
- **With CLP having performed well in line with our views, we downgrade the currency from "outperformer" to "modest performer", but still expect gains**
- **We stay cautious on the COP and turn more negative on the PEN as political** risks rise.

MXN (Mexican peso): Solid momentum, but now turning expensive

The Mexican peso falls into our category of "modest outperformers". Taking into account the government's unique conservative fiscal stance for 2020, still positive real rates and assuming rating downgrade risks materialise only in H2 2021, USDMXN could stay heavy. Despite the very conservative macroeconomic policy response to COVID lockdowns (and in stark contrast to Brazil), Mexico could still register growth rates of over 3% in 2021 (following a near 13% contraction in 2020). A higher exposure to manufacturing and leverage to the US economy (where stimulus remains strong) offer support. Hence, while USDMXN is already near the bottom of a 20.30-23.70 range based on our estimate of fair value of 22 (chart 32), further downside is plausible. However, we have opted to keep the currency as a modest performer (rather than an outperformer) for a few reasons. External balances have been strong, overall, they are a bit less supportive than before. Similarly, while still positive, real rates have declined in recent months (to just +20 bps from around +300 bps in May). Banco de México has suggested a likely pause in the easing cycle for the remainder of the year. The government has been even more conservative in its fiscal stance than previously assumed. Increasing market pricing of rating downgrade risks and create a more challenging MXN backdrop for H2 2021.

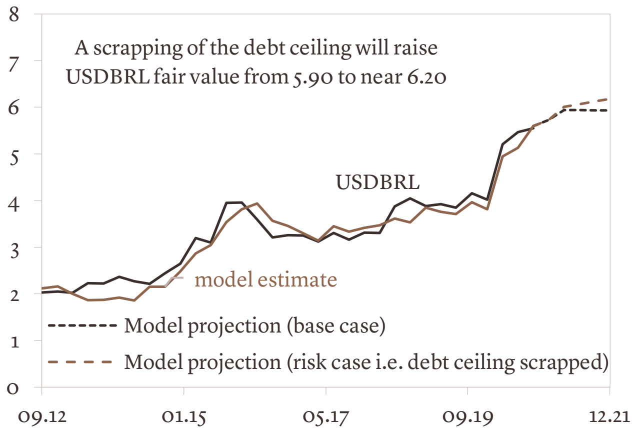
Main risks to our views: Shorter term, as the MXN is the EM currency most correlated to equities, a sell-off in global equities could result in an unwind of long MXN positions. Longer term, the main risk for Mexico is fiscal deterioration, although this is more likely a risk for 2021 ahead of the legislative election in July next year.

32. USDMXN fair value near 22.0, justifying 20.3-23.7 range



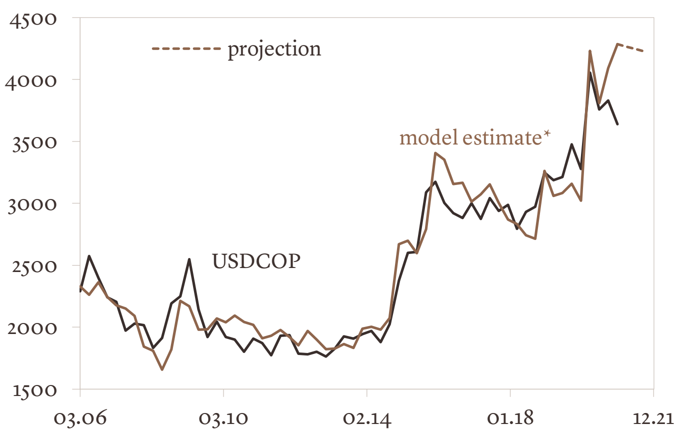
Sources: Bloomberg, Lombard Odier.

33. USDBRL fair value under 6.00, but removal of debt ceiling would take cross above 6.00



Sources: Bloomberg, Lombard Odier.

34 USDCOP should gravitate higher towards our fair value estimate over 4,000



Sources: Bloomberg, Lombard Odier.

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

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LatAm FX
Preference for MXN and CLP vs COP and PEN maintained

BRL (Brazilian real): Debt ceiling removal would compromise stability

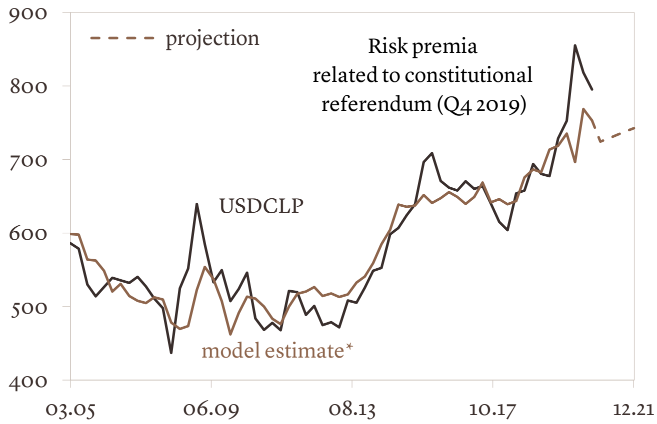
In September, we upgraded our view for the BRL – tor the longest time on our list of "underperformers" given rising political risks and extremely elevated debt levels, -- to "modest underperformer". We believe a wide 5.10-6.10 range remains appropriate for the USDBRL. However, this assumes the debt ceiling remaining in place. **First**, economic indicators have shown strong advances in recent months, suggesting that the government's Covid strategy – initially criticised for being lax – is helping. Generous cash handouts are likely also helping. **Second**, the slight recovery in the balance of payments suggests that USDBRL gains will remain capped, unlike just a few months ago when such flows gave a bullish USDBRL signal (see chart 33). **Third**, our longer-term fair value model for USDBRL shows that, once we take into account the worsening fiscal trajectory and still-weak growth forecasts, USDBRL will be anchored within a wide range of 5.10-6.10 around our fair value estimate of 5.60 (chart 33). **Fourth**, fiscal deliberations will be key. We assume the negotiations for the 2021 budget will remain noisy and a source of headline risk, yet assume that the debt ceiling (95% of GDP) will remain intact. However, in the risk scenario where the ceiling is scrapped, debt/GDP assumptions will rise, in turn feeding into a higher USDBRL forecast. **Fifth**, the BRL's low carry is a break from history for the currency, and has likely changed the hedging behaviour of local and foreign investors. Corporates are finding it attractive to issue debt in local currency and swap into USD, while local and foreign investors who deem Brazilian equities and bonds attractive may find it worthwhile to hedge via being long USDBRL. These flows will prevent BRL from experiencing a stronger rebound, in our view.

Main risks to our views: One downside risk is if the imposed debt ceiling of 95% GDP is removed. This would lead to further BRL depreciation and raise our estimate of USDBRL fair value. Another risk is if reformist economic minister Guedes and his entire team leave.

COP (Colombian peso): An overvalued LatAm currency

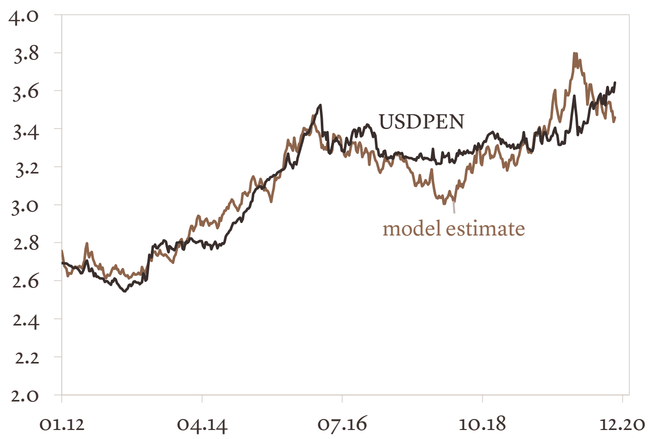
The COP falls into our category of EMFX "underperformers". With the currency overvalued, the country having the deepest twin deficit problem, and our view for only a modest increase in energy prices (12M target of USD 45 p.b.), COP remains our preferred bearish view in among liquid LatAm FX. On our models, USDCOP screens as being 7% undervalued – the most since 2016. Using IMF projections for government debt, fair value may rise above 4,000 by the end of 2020, suggesting rising odds of a move up in USDCOP (chart 34). In recent

35. USDCLP still overvalued in the grand scheme of things



Sources: Bloomberg, Lombard Odier.

36. USDPEN could overshoot towards 370 on political risk where it could present value



Sources: Bloomberg, Lombard Odier.

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

LatAm FX
Preference for MXN and CLP vs COP and PEN maintained

months, COP has held up better than we had expected because of government USD sales (conversion of FX issuance to local currency). However, these supportive drivers should prove temporary and lessen in intensity in the months ahead. Fiscal risks will likely remain and flare up in Q4. Similar to the Mexican case, a continued deterioration in public finances would pose rating downgrade risks. However, Colombia's situation is more challenging, as there could be more political opposition to fiscal consolidation. Colombia's sovereign rating is on thin ice: it has the lowest investment-grade rating from all three rating agencies, two of which have a negative outlook.

Main risks to our views: On the positive side, a more bullish outlook for energy prices than our base case should help. On the negative side, shorter-term, a halt of USD sales by the Ministry of Finance could see USDCOP move higher. Longer term, the continued twin deficit problem will likely come into focus as rating downgrade risks comes into view in 2021.

CLP (Chilean peso): Still positive, but downgrading to "modest performer" following gains

The CLP has been the only LatAm FX to fall into our EMFX "outperformer" category in recent months. Since the beginning of the year, CLP (along with MXN) has held its value far better than peers, registering under 2% losses during a troubling period for EMFX. With the hope of strong US infrastructure-centred fiscal stimulus having faded and with China's credit cycle mature, we believe that gains for the CLP could moderate somewhat from here. Hence, we opt to downgrade the CLP by one notch to "modest performer". Valuation remains compelling: the CLP screens as undervalued against longer-term macro fundamentals, even allowing for some modest weakness on the fiscal side. Our model, based on variables like copper prices, government debt, relative growth (vs. US) and real interests, signals fair value moving from 750 down to 720, with a range of 700-800 (chart 35). As for most LatAm countries, political risk remains. As largely expected by the polls ahead of the event, the constitutional referendum (25 October) resulted in strong popular approval of a new constitution (78% in favour) to be drafted via a constitutional convention of 155 newly elected members (79% in favour). While this is significant, we would stress that the whole process of changing the constitution could take until at least mid-2022 to complete. The more sensitive period for Chilean assets could come in H2 21, when markets will scrutinise the profile of members to gauge the likely changes to macroeconomic policymaking (they have nine months from April to draft and vote in the new constitution). At the same time, let us stress that a shift to "more populist" policymaking would likely have less of a negative impact (than in other countries). This is because Chile has among the lowest government debt levels in LatAm. Gross government debt for Chile is expected to rise from 28% (end-2019) to a still relatively low 35% (end-2021).

Main risks to our views: Following the referendum, the next event risk data will occur on 11 April, 2021, when the members of the constitutional convention will be appointed. A more populist make-up of the convention could begin to impact CLP assets in H2 2021.

PEN (Peruvian sol): Hostage to FX hedging and messy politics

The PEN falls into our category of EMFX "modest underperformers". With FX carry extremely low and FX hedged Peruvian local bonds offering the most attractive yields in mainstream LatAm, short PEN hedging flows by investors have had a large impact on USDPEN movements in recent years. A higher frequency model using the copper prices, an FX hedging flow indicator and the Chilean Peso (an important trading partner) suggest USDPEN is already near 5% overvalued, with spot near 3.65. However, in early 2016, USDPEN became as overvalued as 8% (chart 36). With political risk in the next three quarters (ahead of the 2021 election) set to become much more prominent, USDPEN will likely remain an outlier, continuing to grind higher. The domestic political climate remains polarised, with the opposition party having succeeded in impeaching President Vizcarra over corruption allegations. Local commentators believe political uncertainty may be reaching its worst since 2000, and far worse than during the shutdown of Congress in Q3 2019. With the new interim President, Manuel Merino, having populist inclinations, the PEN will likely trade with an even higher risk premium in the next few months, before undervaluation gets extreme.

Main risks to our views: The major risk remains on the positive side, i.e. a decline in political risk as well as short PEN positioning would see the currency aligning with better FX fundamentals, seeing a return closer to fair value near 350.

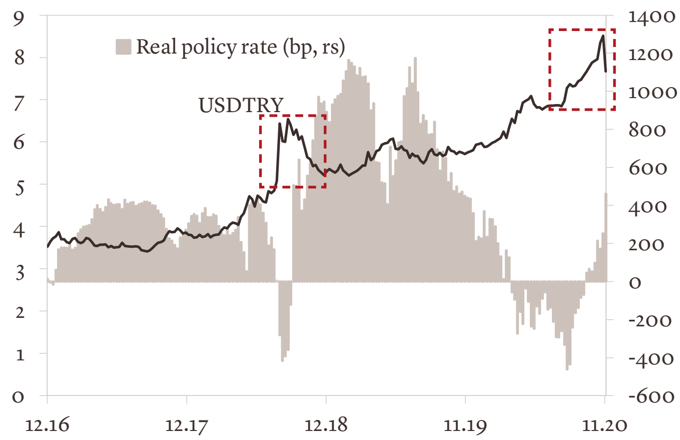
CEEMEA FX
Authorities signal response to disorderly TRY depreciation

- **TRY remains the most vulnerable mainstream EM currency. Further geopolitical tensions add downside risks**
- **Even though the RUB has cheapened in line with our view, risk premia under a Biden administration may rise further**
- **For now, external rebalancing is keeping ZAR relatively stable and at relatively overvalued levels. We stay cautious longer term**
- **CEE FX remains hostage to a second virus wave, but represents value. We are bearish on HUF relative to PLN and CZK.**

Turkish lira: Stability followed by renewed depreciation pressure

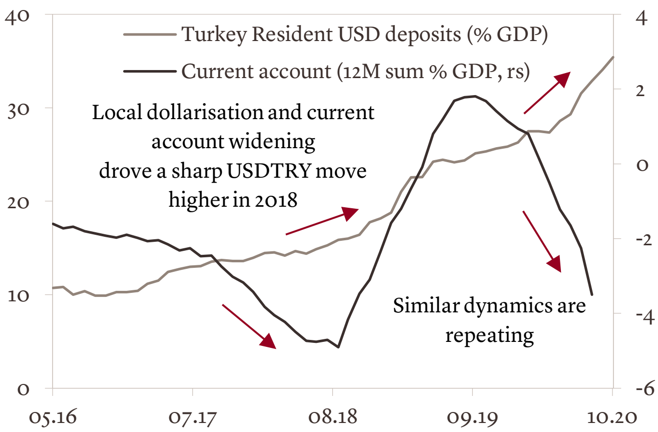
We remain bearish medium term on the TRY, but believe that a potentially more hawkish central bank reaction, as well as smaller external debt payments in the coming three months, could see USDTRY retreat lower towards a 7.20-7.50 range first. Very recently, changes at the top of the economic policy leadership (firing of the central bank governor and departure of the finance minister) suggests a push by President Erdogan towards more orthodox policy-making. In 2018, when Turkey suffered a currency collapse and had a similar worrying trend in external balances, it took a rise in TRY real rates of 600-800 bps for USDTRY to stabilise (chart 37). Hence, we believe a tightening of 500-600 bps would help USDTRY stabilise at somewhat lower levels on a 3M view, providing an attractive opportunity to gain the high carry on USDTRY forwards. However, we think any stability is unlikely to last beyond this tactical window for a few reasons. **First**, and unlike other EM countries, Turkey's current account has been widening while local citizens have been increasing their dollar holdings – keeping Turkey in just as vulnerable a position as in mid-2018 when there was a currency collapse (chart 38). **Second**, monetary tightening, in itself, will be insufficient to see the external balance improve (important for a TRY recovery). This is because much of the credit growth (which weakened Turkey's external balance in the first place) is attributed to fiscal expansion. **Third**, Turkey's extremely low FX reserves suggest that "high rates for longer" and "fiscal tightening" would be required to create a longer-lasting TRY stabilisation. This seems unlikely (especially under President Erdogan), with Turkey having historically favoured high growth over and above containing inflation. **Fourth**, geopolitical tensions, which we have not factored into our forecasts per se, remain an upside USDTRY risk. Recent reports that Turkey is

37. Material monetary tightening (500-600 bps) could work to keep USDTRY in lower ranges for a few months



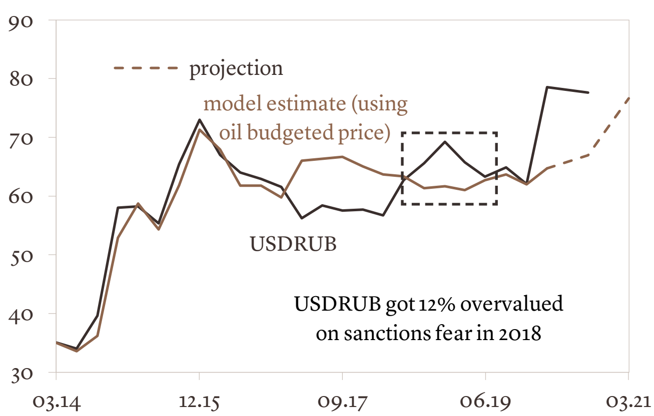
Sources: Bloomberg, Lombard Odier.

38. Local FX buying and a re-widening current account have been the force behind TRY depreciation (like in 2018)



Sources: Bloomberg, Lombard Odier

39. USDRUB likely to stay under 80, but unlikely to fall much below our fair value projections of 75-77



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX
Authorities signal response to disorderly TRY depreciation

planning to test parts of the Russian S-400 missile that it purchased from that country will be pressure points with a Biden administration.

Main risks to our views: The positive risk we mentioned in previous reports, i.e. a hawkish central bank, may be materialising. A further positive risk would be if this is coupled with strong fiscal tightening. A negative risk would be a more hawkish foreign policy stance from the US under a Biden presidency.

RUB (Russian rouble): Upgrading to "modest underperformer"

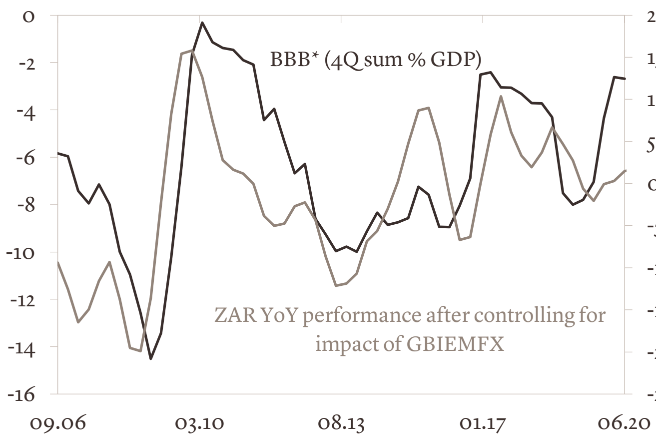
Following the US election outcome, which fulfilled our expectations only partly (Biden win, but no Democrat sweep), the risks for a move in USDRUB above 80 have fallen substantially. That said, in our view the risk of sanctions has not completely faded, hence we do not believe we should expect material RUB gains. As a result, we upgrade our long held bearish RUB view by shifting it from the list of "EMFX underperformers" up a notch to the group of "modest underperformers" EMFX. A move above 80 now appears quite unlikely, and some thawing in the sanctions risk premium could take USDRUB down closer to our 6M USDRUB fair value near 76.00 (chart 39). The reason we keep a cautious stance is that a harsher US policy stance towards Russia is still very plausible, even without a Democratic US Senate. Foreign policy is set by the executive much more than by Congress.

While specific sanctions in recent years were watered down as they went through the Republican Senate (perhaps to guard President Trump and his dealings with Russia), with Mr Trump gone, the Senate Republicans may have more of an incentive to push anti-Russia policies through under a Biden presidency.

On the other hand, one factor that could help cap USDRUB into year-end would be increased FX sales by the Russian central bank (CBR), linked to the sale of Sberbank shares to take place from October to December. Finally, we do not believe that the view on energy prices is overly important (unlike for other energy-exporting country currencies). This is because the Russian central bank sterilises oil revenues that deviate from the assumed budget oil assumption of USD 41-42 p.b (so deviations technically do not impact the currency market).

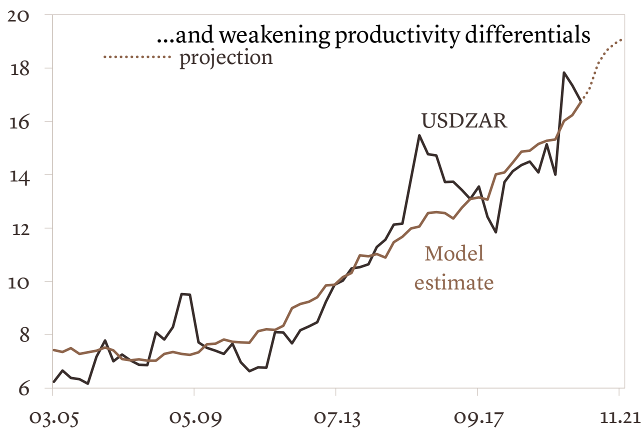
Main risks to our views: On the negative side, a change in tone – where Republicans voice more opposition towards Russia – could see the market pricing for a return of sanctions. On the positive side, we flag that seasonality tends to favour the Russian currency in the first quarter (January to April 2021), which could take USDRUB below 75 in Q1.

40. Current account adjustment supporting relative ZAR outperformance for now



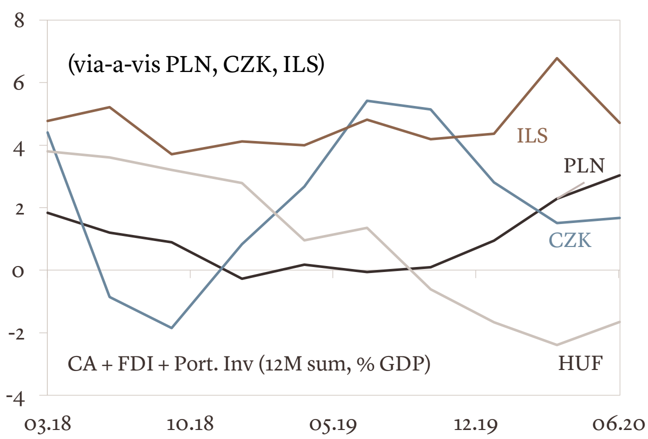
Sources: Bloomberg, Lombard Odier

41. Longer term, our model suggests USDZAR may trade higher on a worsening debt trajectory



Sources: Bloomberg, Lombard Odier

42 Despite a marginally more hawkish CB, HUF to face continued depreciation on weaker trend in flows



Sources: Bloomberg, IMF, Lombard Odier

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

CEEMEA FX
Authorities signal response to disorderly TRY depreciation

ZAR (South African rand): External rebalancing keeps USDZAR range-bound for now

ZAR is in our group of "fragile" EM currencies, but the currency has held up better than we assumed. We believe a key reason for this is the improvement in the country's balance of payments. We find this explains the relative performance of the ZAR against the broader GBIEMFX index (chart 40). This adjustment, driven by collapsing imports on weak domestic demand, could potentially continue for some time, keeping USDZAR in lower ranges. However, once this adjustment is mature and imports begin to increase, we believe USDZAR will re-align to fundamentals. Our projected fair value suggests that weakening productivity growth and higher debt levels will be offset only modestly by improved terms of trade. Hence, while spot could undershoot in the next few months, fair value will likely edge up towards 19 in the years ahead (chart 41). On the fiscal side, the October medium-term budget statement resulted in an upward revision to public debt (now seen peaking at 95.3% in FY 2025/26). However, debt levels will likely be higher than those assumed by the government for two reasons. **First**, the government's consolidation plan that relies on wage bill savings of 5.6% of GDP seems ambitious. It will depend on negotiations between the government and trade unions over a new three-year wage agreement. This will remain a source of headline risk. Indeed, there is a risk that the courts will force the government to implement a wage hike (the issue of the cancelled 2020-21 wage increase is still being battled in court). **Second**, the government has decided to provide additional financial support to state-owned enterprises, which will likely feed through to higher contingent liabilities.

Main risks to our views: On the positive side, a longer-than-expected spell of external rebalancing could keep ZAR somewhat supported. On the negative side, the fiscal trajectory looks set for ongoing deterioration with headline risk set to rise with labour unions over fiscal tightening in the months ahead.

CEE & ILS: Prefer CZK and ILS to HUF and PLN

In the group of CEE & ILS, we include the Czech koruna (CZK), Polish zloty (PLN), Hungarian forint (HUF), and Israeli shekel (ILS). A second wave of virus outbreak, first in Israel, then in the Czech Republic, has weighed on currencies. While all are highly correlated to EURUSD (and hence can gain automatically on our positive EURUSD view), we prefer the CZK and ILS to the HUF and PLN. Given the lack of an efficient test-and-trace system and a lower level of testing in these countries, some further tightening of social restrictions could be unavoidable. This could result in periods of FX depreciation.

ILS belongs to our group of "modest performers". This assumes continued good performance of the tech sector and low-for-longer US yields (which drive ILS), as well as a strong balance of payments position. The central bank's FX policy would also need to be closely monitored. A large FX intervention would likely only neutralise appreciation pressure. However, we believe that for the central bank to succeed in weakening the ILS, it would take a drastic measure like an FX peg (such as in Switzerland after 2011, or the Czech Republic after 2013).

CZK appears perfectly poised to perform, with support from a strong fiscal impulse and still-low debt. This should keep the CB relatively hawkish. At the other extreme, the HUF is our preferred short in the region: an important driver here is the trend of external balances: Hungary has seen its broad basic balance erode in trend terms over the past three years, in contrast with peers (chart 42). We are relatively neutral on PLN, but it should be a modest performer assuming EURUSD moves a bit higher from here. On one hand, the balance of payments situation is improving. However, this is offset by strong balance sheet expansion undertaken by the central bank, which will keep yields low.

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
- Investment as % of GDP
- Rate differentials
- 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
- Output gap
- Current account
- 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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