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FX Monthly

Balancing global reflation with higher US yields

02/12

February 2021

Key highlights

- The January USD rally was due to positioning adjustment and the rapid rise in US nominal yields. However, we are currently in a global upswing, which has historically mattered more and pushed the USD lower. We reiterate our forecast of some further trade-weighted USD depreciation this year
- EURUSD should continue to benefit from the global trade recovery but the pace of regional vaccination rollout programmes should be monitored carefully
- We have revised our USDJPY trajectory higher but maintain our bias for JPY appreciation
- CHF should lag the EUR, and we see EURCHF moving up modestly to 1.10.
- We see recent sterling outperformance somewhat stretched and expect a correction
- Upward emerging market GDP revisions for Q1, stronger energy prices, and a higher EURUSD point to GBIEMFX gains over Q1. We prefer to remain selective in EMFX, and favour the CNY, KRW, CLP, CZK and ILS.

FX forecasts		Q221	Q421
G10	EURUSD	1.27	1.26
	USDJPY	102	103
	EURCHF	1.10	1.10
	GBPUSD	1.38	1.37
	EURGBP	0.92	0.92
EM	USDCNY	6.26	6.22
	USDINR	72.0	71.0
	USDIDR	13 970	14 160
	USDMXN	20.3	20.1
	USDBRL	5.40	5.25
	USDRUB	73	75
	USDZAR	15.5	16.2

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Contributors:

Vasileios Gkionakis, Head of FX Strategy

Kiran Kowshik, Global EM FX Strategist

Homin Lee, Macro Strategist Asia

Sophie Chardon, Senior Cross-Asset Strategist

Contact: is-fxstrategy@lombardodier.com

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

Data as of 23 February 2021

At a glance

Introduction

Despite sterling's outperformance this year, we are reluctant at this stage to chase the rally and keep our forecasts unchanged.

The trade-weighted (TW) dollar strengthened in January, coinciding with reductions in large speculative USD short positioning and the very rapid (as well as unexpected) rise in US 10Y yields on the back of the reflation theme. We do not expect this will provide lasting support to the dollar – indeed gains have fizzled out in February – for the following reasons.

First, the reflation theme is global as activity and trade are picking up worldwide. In periods like this, global improvements in GDP growth prospects (USD-negative) are more important than the rise in US nominal yields (USD-positive). **Second**, despite the spike in US10Y nominal yields, real US yields, which are more closely correlated with USD movements, remain severely supressed and negative. **Third**, the TW dollar index is still overvalued and should come under some pressure in the months to come. **Consequently, we maintain expectations of further modest USD depreciation this year. However, we note that if US nominal rates keep rising too fast, too soon, then this would put our forecasts at risk.**

More specifically, we keep our EURUSD forecast at 1.27 at Q2 2021, but closely monitor developments in the European vaccination rollout programme. At the same time, we maintain our modest upward bias for EURCHF, given solid risk appetite and an acceleration in Swiss portfolio outflows. As things stand, we see the pair peaking around 1.10.

Despite sterling's outperformance this year, we are reluctant at this stage to chase the rally and keep our forecasts unchanged. This is based on our expectation of structural headwinds due to Brexit and our anticipation of only a gradual lifting of the Covid-19 related restrictions. However, we will monitor closely development on the latter. Turning to the JPY, the upward move in USDJPY can be explained by the trimming of speculative USDJPY shorts and the rapid rise in US yields. We raise the pair's forecast trajectory but maintain a bias for JPY strength on fundamental grounds.

In the Nordics, we reiterate our preference for the NOK and expect further NOKSEK upside. In the core commodity FX bloc, we expect moderate gains but upside is likely to be capped, mostly on less attractive valuations.

Solid expectations for EM Q1 growth and a stronger energy prices suggest EMFX can appreciate in the coming months; that said, we reiterate our preference for a select subgroup of EM currencies. Our top pick remains the CNY, which should continue to receive medium-term support from strong underlying growth, accelerating flows to China and a gradual shift of the People's Bank of China towards hawkishness. The possibility of lifting some of the 301 section tariffs by the US could also underpin the currency.

Main risks to our views: The main upside risk to our forecasts comes from a stronger recovery in global trade, which will send the USD into an even steeper decline and support bigger and broader rallies in the G10 and emerging markets. On the downside, we see the following risks: **First**, further rapid increases in US nominal yields. **Second**, the Federal Reserve (Fed) turning less dovish and so triggering a market reaction like 2013's "taper tantrum". **Third**, a delay in the distribution of Covid-19 vaccines that would increase the risk of new restrictions and economic disruption. **Fourth**, a premature withdrawal of fiscal support.

FX forecasts – G10 and gold

	Current spot	Q1 21	Q2 21	Q3 21	Q4 21	Estimates of long-term fair value[2]
EURUSD	1.21	1.25	1.27	1.27	1.26	1.20
GBPUSD	1.40	1.36	1.38	1.38	1.37	1.43
EURGBP	0.87	0.92	0.92	0.92	0.92	0.85
EURCHF	1.09	1.09	1.10	1.10	1.10	1.03
USDCHF	0.90	0.87	0.87	0.87	0.87	0.86
USDJPY	106	104	102	102	103	91
EURJPY	128	130	130	130	130	110
EURSEK	10.06	10.00	9.95	9.90	9.95	9.68
USDSEK	8.28	8.00	7.83	7.80	7.90	8.07
EURNOK	10.29	10.10	10.00	9.90	9.95	9.92
USDNOK	8.47	8.08	7.87	7.80	7.90	8.27
AUDUSD	0.9	0.78	0.79	0.79	0.78	0.75
NZDUSD	0.73	0.73	0.73	0.73	0.73	0.66
USDCAD	1.26	1.26	1.24	1.24	1.25	1.25
Gold	1795	1850	1750	1600	1600	
Oil (Brent)	63	50	55	55	50	

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 25 for a more detailed explanation.

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

FX forecasts – EM

Asia

	Current spot	Q1 21	Q2 21	Q3 21	Q4 21
USDCNY	6.47	6.37	6.26	6.15	6.22
USDHKD	7.75	7.75	7.75	7.75	7.75
USDIDR	14 093	14 080	13 970	14 070	14 160
USDINR	72.47	72.30	71.97	71.42	71.00
USDKRW	1 111	1 094	1 077	1 061	1 044
USDMYR	4.04	4.02	4.00	3.98	3.96
USDPHP	48.65	48.65	48.65	48.65	48.65
USDSGD	1.32	1.31	1.29	1.28	1.26
USDTWD	28.1	27.88	27.53	27.18	26.82
USDTHB	30.0	29.88	29.73	29.58	29.43

LatAm

	Current spot	Q1 21	Q2 21	Q3 21	Q4 21
USDMXN	20.7	20.5	20.3	20.1	20.1
USDBRL	5.47	5.40	5.40	5.30	5.25
USDCOP	3 598	3 625	3 652	3 679	3 706
USDCLP	707	705	702	699	697
USDPEN	3.65	3.65	3.63	3.60	3.58

CEEMEA

	Current spot	Q1 21	Q2 21	Q3 21	Q4 21
USDRUB	74.3	72.0	76.0	74.0	75.0
USDTRY	7.07	7.21	7.35	7.49	7.63
USDZAR	14.7	15.2	15.5	15.8	16.2
USDILS	3.44	3.23	3.20	3.17	3.13
EURPLN	4.50	4.50	4.50	4.50	4.50
EURCZK	25.9	25.8	25.8	25.7	25.6
EURHUF	358	360	362	364	366

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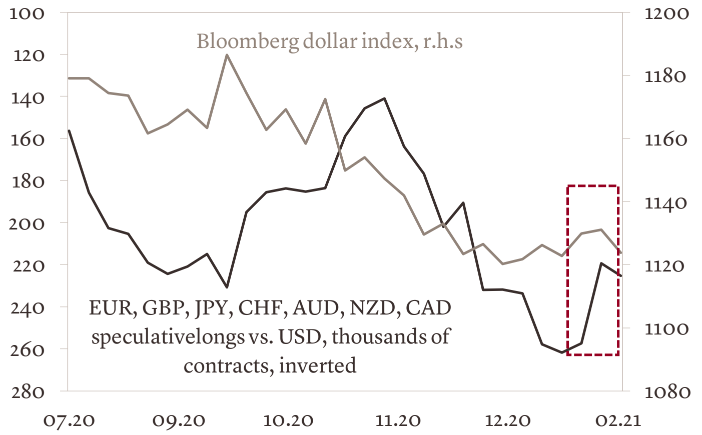
G10FX: Three key charts

The January rally in TW USD was due to some paring of extreme speculative dollar shorts, as well as the very rapid increase in US nominal yields; with the latter fuelled by the reflation theme.

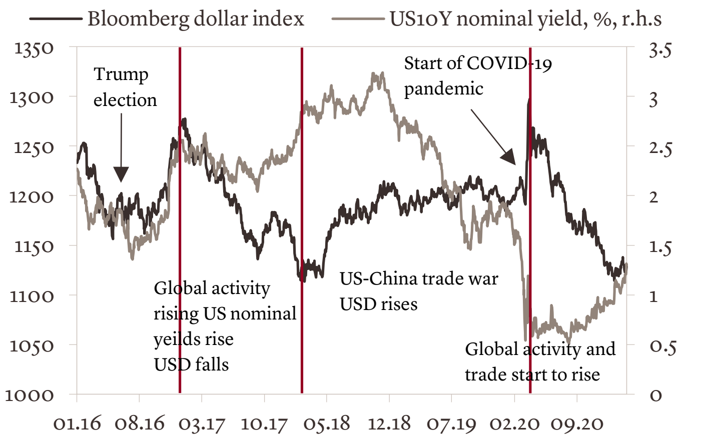
1. Part of the USD up move in January due to paring of shorts



*r.h.s: right hand scale
Sources: Bloomberg, CFTC, Lombard Odier

However, the reflation theme is global, as world activity and trade have started recovering swiftly. Despite rising US nominal yields, the environment is conducive to some further USD weakness due to better global GDP growth prospects (reminiscent of 2017).

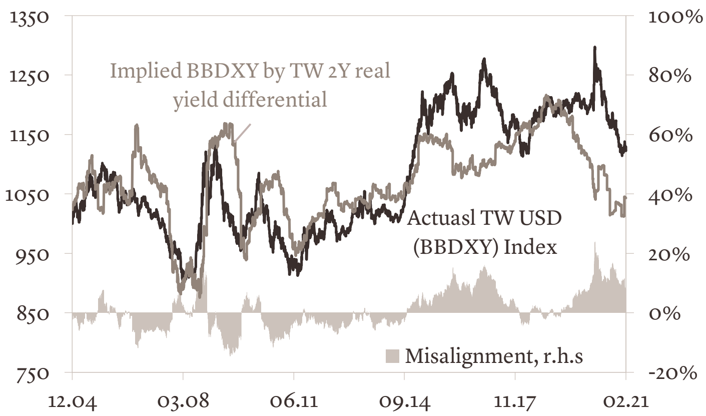
2. Uptrend in global activity coincides with a weaker dollar despite higher US nominal yields



Sources: Bloomberg, Lombard Odier

Moreover, the TW USD index remains overvalued when contrasted with the trade-weighted US2Y real yield differential, by around 8%. Hence, fundamentally the path of least resistance remains to the downside.

3. TW USD still overvalued, albeit less so



Sources: Bloomberg, Lombard Odier

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

FX majors currencies

EUR (euro): stay constructive

- **The EURUSD decline in January was due to the rally in the dollar, a result of positioning adjustment and the rapid rise in US yields**
- **We reiterate our EURUSD constructive stance...**
- **...but vaccine rollout developments in Europe should be monitored closely, alongside developments in US yields.**

EURUSD started the year weakly, driven by the USD rally between 6 January and 4 February. We would look through this temporary strength in the dollar, which was largely due to positioning adjustment and the rise in US nominal yields (see below). Indeed, since early February the TW USD has unwound about half of its previous appreciation while EURUSD has risen, back above the 1.21 level, having fallen to below 1.20 earlier.

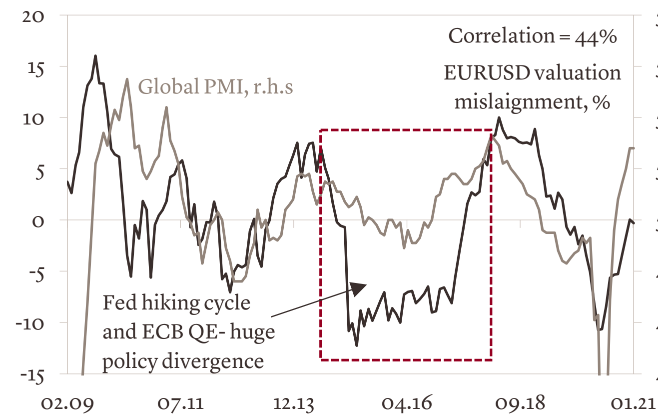
We maintain a constructive view on the currency, based on the following:

First, empirical evidence suggests that during periods when global trade and global activity rebound noticeably, EURUSD tends to overshoot its fair value (now at 1.20 in our estimates) by between 5% and 10% (see chart 4). **Second**, and despite US nominal yields rising at the longer end of the curve, US real yields remain significantly depressed, depriving the dollar of any sustainable support. **Third**, the rebound in Chinese imports from Germany – a good yardstick for EURUSD moves (see chart 5) – has been sharper than most expectations. With the Chinese economic rebound being firm and broad-based, this tailwind is likely to prove robust and enduring.

What about the vaccination rollout in the eurozone? Despite a slow start to the program, our macro team still expects (under very conservative assumptions) that herd immunity in the region will be reached in late summer, as the euro area approves and gains access to more vaccines. This should facilitate the gradual re-opening in the economy in the months to come. That said, renewed bottlenecks in vaccine distribution is currently one of the main risks to our EURUSD forecast.

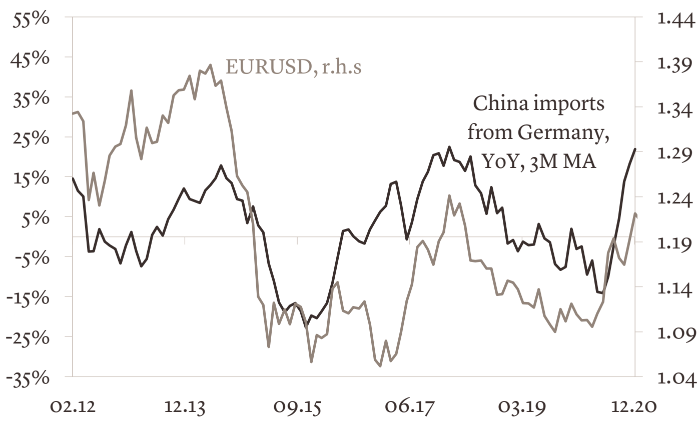
What about the US fiscal stimulus? The boost to US growth due to the anticipated fiscal stimulus (which has sent US 10Y nominal yields to 1.38%) should not be considered dollar-friendly. US growth should not be seen in isolation, but rather in the context of global developments. As illustrated in chart 6, EURUSD is actually inversely related to the ratio of eurozone PMI / US ISM (manufacturing) but it has a firmly positive correlation with the global manufacturing PMI since 2015, which is currently in expansion territory.

4. Global PMI matters for EURUSD valuation misalignment



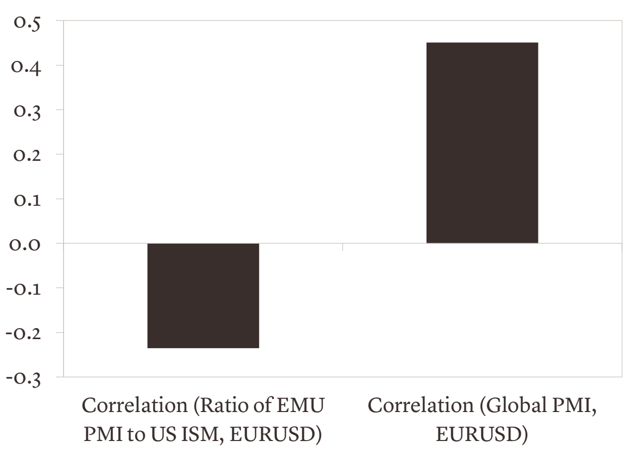
Sources: Bloomberg, Lombard Odier

5. Sharp rebound in Chinese imports to drive euro higher



Sources: Bloomberg, Lombard Odier

6. EURUSD more positively correlated with Global PMI



Sources: Bloomberg, Lombard Odier

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

FX majors currencies

Risks to our views:

Upside risks: An even stronger economic and trade recovery as well as a more efficient roll out of the Covid-19 vaccines. **Downside risks**: Further rapid increases in US yields. The Fed turning less dovish and potentially causing a "taper tantrum" akin 2013's. Recovery losing steam due to bottlenecks in vaccine distribution or other black swans.

CHF (Swiss franc): EURCHF in limbo

- **EURCHF is directionless around 1.08**
- **A catch up with EURUSD and Swiss portfolio outflows should push it higher...**
- **...but upside is limited towards 1.10.**

EURCHF remains in limbo, having traded just above the 1.08 for most of this year. At the same time, its unusually large gap with EURUSD persists (see chart 7).

We still expect modest upside towards 1.10. **First**, there should be (even a limited) catch up with EURUSD. **Second**, the recent and ongoing pick-up in portfolio flows (see chart 8) suggests that the fundamental case for EURCHF upside remains in place.

However, it seems that this increase in portfolio outflows is insufficient, at least so far, to recycle enough of Switzerland's current account surplus (now at 7.6%) to generate material upside pressure on EURCHF.

Consequently, we maintain our view for a slight upward trend, towards 1.10.

Main risks to our view: Delays to worldwide vaccine distribution could drive the CHF higher, threatening renewed restrictions and a halting the global economic recovery.

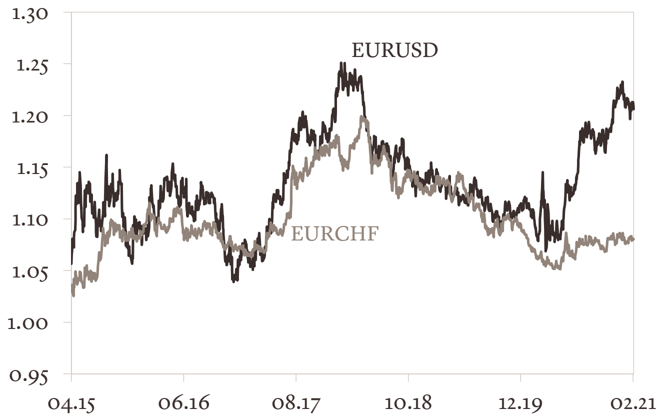
GBP (pound sterling): Looking for a correction lower

- **GBP has been boosted by the rapid progress on Covid-19 cases**
- **However, we think the market has "jumped the gun" and expect the currency to correct.**

Last month we argued that ongoing dollar weakness should continue to underpin sterling but upside should be limited. So far, we have been proven wrong. GBPUSD has been one of the best performing currencies in G10, having risen by nearly 2% year-to-date while EURGBP has depreciated by 2.5%. **However, we are still reluctant to ride the rally** and feel that the market has "jumped the gun" on sterling.

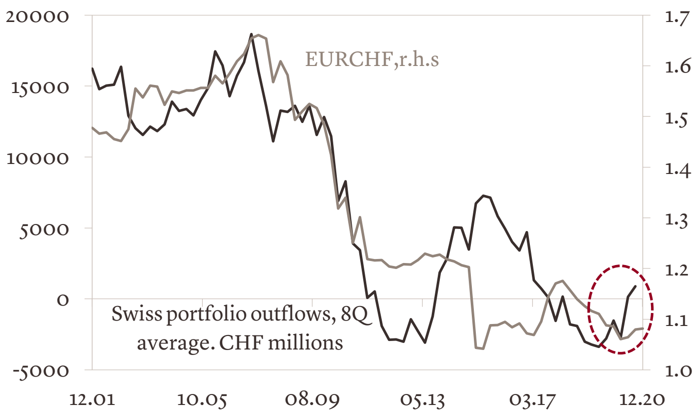
The data shows that an important driver of sterling's outperformance has been the sharp drop in Covid-19 confirmed cases/deaths/hospitalisations alongside the success of the vaccination program (see chart 9).

7. Still a big wedge between EURUSD and EURCHF



Sources: Bloomberg, Lombard Odier

8. Swiss portfolio outflows accelerate, but it may not be enough to push EURCHF materially highe



Sources: Bloomberg, Lombard Odier

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FX majors currencies

However, we would note the following: **First**, positioning is becoming stretched while GBPUSD appears overbought in the near term. Both of these suggest that a correction may be imminent. **Second**, it seems that the market is translating the marked improvement in Covid-related numbers to expectations of near-term economic outperformance via the lifting of restrictions. To be clear, this is a very logical and intuitive connection to make but we fear that government rhetoric does not corroborate this. Having been one of the laggards in implementing measures in the spring of 2020, the UK government is likely trying to reclaim political capital by moving to the other extreme i.e. being very cautious in relaxing restrictions. Effectively, we suspect that the rollback of the measures currently in place will take time and will not translate into the economic revival that markets seem to expect. After all, the UK currently has the most stringent Covid-related measures in place amongst developed countries, especially in tourism and hospitality, two industries that have been badly damaged over the last year. It is estimated that under normal conditions, tourism contributes over GBP 200 bn annually to the economy, i.e. around 11% of GDP.

Finally, we should not discount the structural headwinds from Brexit, which are bound to have negative implications for portfolio flows and the financing of the UK's current account.

Consequently, we expect GBPUSD to start retreating closer to the 1.35-1.37 range while EURGBP should start rising somewhat. Historically, EURGBP depreciations have been linked to UK economy's outperformance versus the eurozone (see chart 10), which is clearly not the case now.

Main risks to our view:

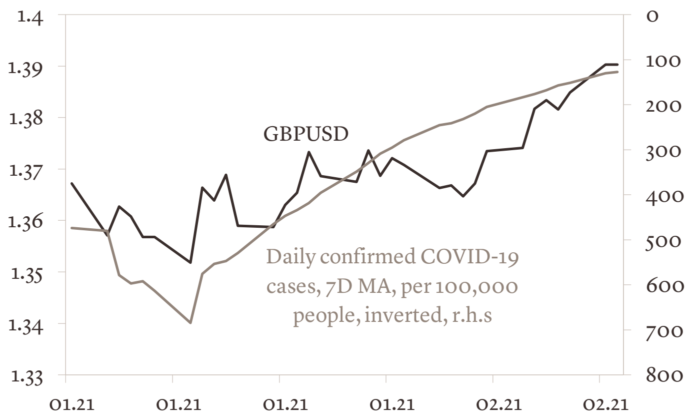
We see **two upside risks** to our forecasts:

1. **The UK government lifts lockdown restrictions faster than we expect resulting in improving economic activi**ty; and
2. A faster dollar depreciation than we currently envisage.

Downside risks are related to:

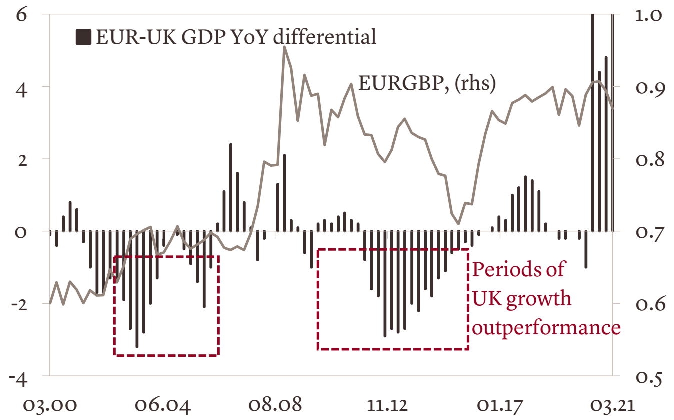
1. The UK rebound being even shallower than expected, and
2. the Fed turning less dovish.

9. Sterling outperformance due to falling Covid-19 cases



Sources: Bloomberg, Lombard Odier

10. EURGBP vs eurozone-UK growth differential



Sources: Bloomberg, Lombard Odier

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FX majors currencies

JPY (Japanese yen): Curbing JPY enthusiasm but maintaining JPY upside bias

- **Most of the USDJPY upward move this year is due to speculative positioning adjustment and...**
- **...the very rapid (and unexpected) rise in US10Y yields**
- **We adjust our USDJPY forecast higher but maintain a downward bias.**

Despite the TW USD resuming its decline since early February, the JPY has not managed to capitalise in any meaningful way. In fact, it has weakened further, with USDJPY now close to the 106 level. Clearly, on a mark-to-market basis, our USDJPY forecast of 100 by the end of Q121 now seems out of reach. We adjust the pair's forecast path higher but maintain a bias for JPY strength. Below we summarize our reasoning.

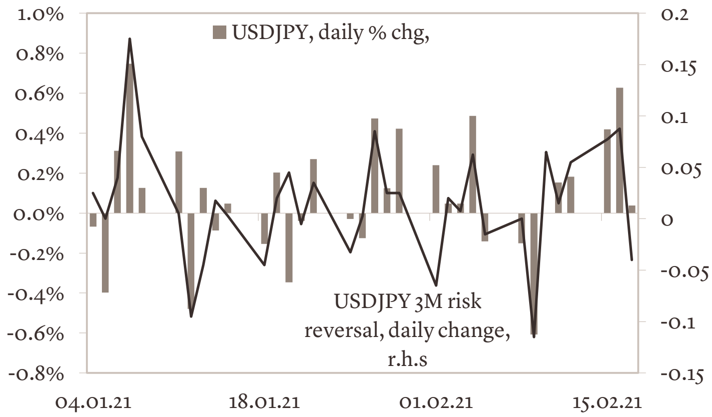
First, an important driver of the move in USDJPY this year has been the reduction in USDJPY shorts (see chart 11). This may have some further room to run, keeping the pair in close proximity to current levels. However, we view this factor as only temporary. **Second**, and although USDJPY is dislocated from US-JN yield differential on a long term basis (see chart 12), the near-term price developments have been associated with the very rapid (and unexpected) rise in US10Y yields, which now stand at 1.30%. This has been the main reason behind shifting our USDJPY forecast trajectory higher. **Third**, on a fundamental and medium term basis the dislocation with yield differentials still suggests USDJPY downside (again, see chart 12). **Fourth**, Japanese investors have stopped acquiring foreign equities and are now sellers, meaning that unloaded FX-denominated stocks will likely be converted back to JPY, adding to currency demand. Fifth, there is now a clear trend in the Japanese current account balance improvement that historically has been associated with JPY strength (see chart 13).

All that said, the main risk to our forecast in the near term stems from further rises in US nominal yields. This requires close monitoring.

Main risks to our views:

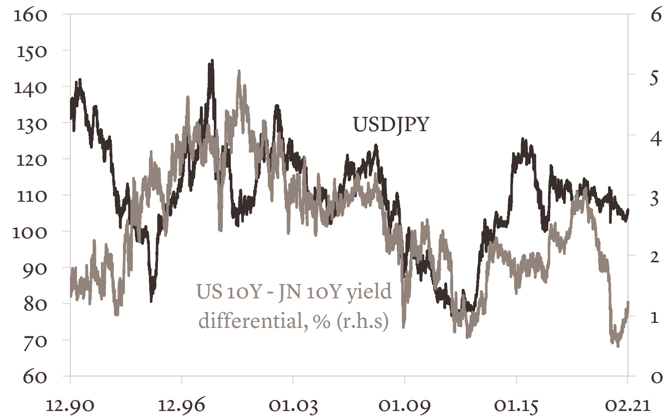
1. A further rapid rise in US nominal yields would put some additional pressure on the JPY;
2. A stronger global economic recovery could slow JPY appreciation.

11. USDJPY daily moves highly correlated with changes in positioning



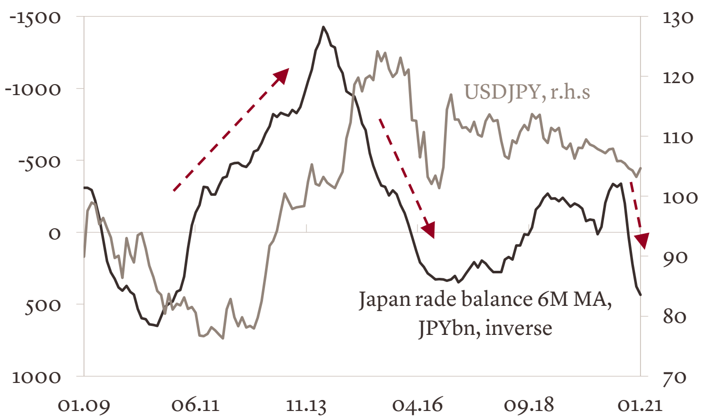
Sources: Bloomberg, Lombard Odier

12. Still a big gap between USDJPY and yield differentials



Sources: Bloomberg, Lombard Odier

13. Significant improvement in Japan's trade balance



Sources: Bloomberg, Lombard Odier

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FX majors currencies

Nordic currencies: Further NOK gains

- **We expect the Nordic currencies to perform well amid solid risk appetite...**
- **...but we have a clear preference for NOK outperformance.**

NOK (Norwegian krone): So far this year, the NOK has been one of the outperformers in the G10, rising 2.5% against the dollar and 3% against the EUR. We see further strength, predominantly for the following three reasons:

First, risk appetite remains solid and NOK has one of the highest correlations with risk assets. **Second**, global trade continues to power ahead: YoY growth registered its highest reading in its latest (November) data point since October 2018. Both, EURNOK and USDNOK have a high correlation to trade, given Norway's current account surplus and the economy's exports, which stand at 38% of GDP. **Third**, in the near-term, the NOK should remain underpinned by higher oil prices.

SEK (Swedish krona): The SEK has lagged behind the NOK in line with our expectations some months ago. This is mainly due to anticipation that the Riksbank will not tighten policy for a very long time. We believe the recent NOKSEK move higher has further legs, as corroborated by the current interest rate differential between the two countries (see chart 16).

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.

Commodity currencies: Treading water

- **Core commodity currencies remain supported due to the cyclical recovery and renewed dollar weakness**
- **However, valuations and loose monetary policies at home represent headwinds**
- **CAD and AUD should see some further strength while NZD should lag.**

AUD (Australian dollar): AUDUSD is now trading around 0.78 , close to levels of about a month ago. We reiterate our view that the sharp recovery in global trade and the upswing in Chinese activity should maintain support for the currency but we expect gains to be capped at around 0.79. This is due to the Reserve Bank of Australia remaining in very accommodative stance for "as long as needed" and the currency's somewhat unattractive valuation (our estimates suggest a small overvaluation of 3.5%).

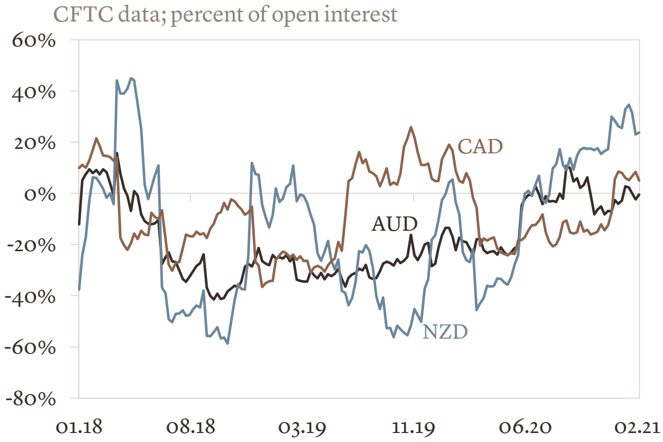
CAD (Canadian dollar): In line with the upswing in global trade, CAD should continue to strengthen. The weakness seen in late January due to the dollar rally has washed out, and the pair is now back around 1.26. This, alongside higher oil prices, should maintain support and drive USDCAD towards 1.24 by mid-2021.

NZD (New Zealand dollar): Similar to the AUDUSD, NZDUSD remains close to the 0.72/0.73 mark. We reiterate our view that the NZD is our least preferable commodity currency. While dollar downside and the growth recovery will act as tailwinds, a dovish central bank, overvaluation (we estimate it at 9%) and high speculative long positioning (albeit less so than a couple of months ago – see chart 14) should act as headwinds, keeping the NZD in check.

Main risks to our view: Upside risks to our forecasts could materialise if the growth recovery is sharper and the dollar depreciation deeper than we currently envisage. Downside surprises could manifest in case of delays or other bottlenecks in the distribution of the Covid-19 vaccine that could dampen growth expectations and weigh on risk sensitive assets

14. Commodity FX speculative positioning

CFTC data; percent of open interest



Sources: Bloomberg, Lombard Odier.

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Commodity corner

The bond market sell-off hints at a materialization of our base case for gold: we turn underweight.

- **Gold has passed its cyclical peak.**
- **A combination of bear factors, such as risk-on sentiment, recovering global economy, both aided by the eventual rollout of a Covid-19 vaccine, and a rise in bond yields will weigh on prices over the course of the year.**

The past few weeks seem to indicate that the path for a global economic recovery is set, supported by substantial US fiscal stimulus and reassuring earnings season. After months of trading in a range since the lows seen at the worst of the crisis, rates have started to catch up with other markets. That acknowledges that there may be an end to this crisis and that the upcoming recovery may be stronger than initially thought.

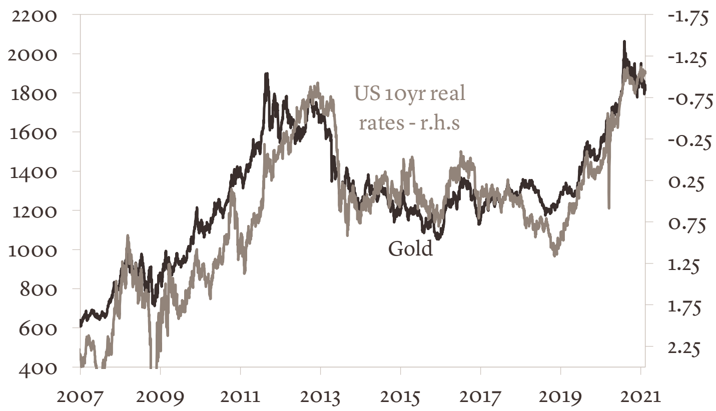
We expect this positive tone to persist and gain traction throughout the year. Rising yields and ongoing healthy risk appetite should continue alongside the cyclical upturn, worsening the risk/reward of holding the precious metal. The pressure on gold has already started; indeed, gold posted its worst first month of the year since 2011. On a year-to-date basis, gold is down more than 4.50%, in-line with liquidation seen on the yellow metal as higher US yields dampened the appeal of the non-interest bearing asset.

Medium term, once the recovery is well established, investors will switch their attention to the next steps in terms of monetary policy. Generally, this is not good news for gold. Since the Fed reintroduced quantitative easing policies in 2008, major sell-offs have typically been triggered by a change in expectations for the Fed's bond purchases and the subsequent effect on longer-duration yields. The best example is the taper tantrum of 2013. Even if we believe Fed officials will be able to avoid such a volatile episode, the direction of travel for real rates is higher, thus lower for gold prices. **In this context, we expect our USD 1,600/oz target to be reached by mid-year.**

Strategically, gold should remain in investors' portfolio allocations as one of the best alternatives to government bonds in periods of zero rates. But its inherent volatility (which is close to equity volatility) demands tactical management and discipline, especially in periods of recovery. In such a context, **we have reduced our exposure to gold as we expect the metal to suffer with these conditions prevalent in the coming quarters**. At a portfolio level, we are thus now underweight versus the benchmark, with an allocation ranging from 1% to 2.5% depending on the risk profile and currency of the portfolio.

Main risk to our view: inflation expectations running out of control while the Fed caps nominal rates, Covid-19 vaccines struggle against variants of the disease.

15. We expect gold to suffer from higher US yields
and thus reduce our exposure accordingly



Sources: Bloomberg

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

Commodity corner

Oil market rebalancing is well advanced; the future path of prices is in OPEC's hands.

- **OPEC+ is back in the driving seat for oil prices after its December meeting. At January's meeting, Saudi Arabia proved determined to act to avoid oversupply**
- **Demand for oil will be boosted in Q2/Q3 thanks to a progressive removal of travel bans earlier than initially thought. Combined with lower inventories, this will create a supportive environment for oil prices by mid-year.**

Since the OPEC+ agreement on 3 December 2020 to co-manage their exit strategy with orderly production increases, prices are already up more than 30% (+50% since November and the US elections). In our view, this shift in OPEC+ strategy to accommodate the relapse in US and European transportation fuel demand created by the third Covid-19 wave brought needed visibility to market participants.

Fundamentals are improving. The monthly nature of this taper points to OPEC+ targeting higher production without derailing the ongoing market rebalancing. OPEC production cuts are efficient in the sense that global demand outpaced supply in H2 2020. With the market now back in deficit, there is space for a decline in inventories from the historical levels seen in May/June. This decline has been surprisingly rapid and relentless, helped more recently by colder winter in Asia and supply disruptions in Texas.

For now, mobility remains constrained by lockdowns but slowing Covid-19 infection rates point to better prospects in the coming weeks.

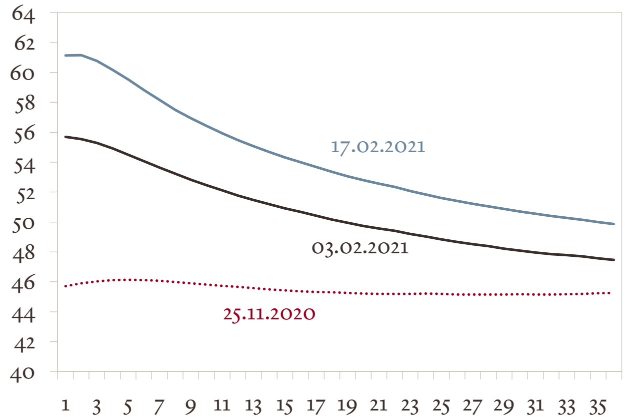
We have been surprised by the sharp fall in inventories and the strong rally seen since the beginning of November. With prices now back to levels likely to incentivise the restart of US shale production, we believe the next OPEC meeting in early March will be crucial for Saudi Arabia's determination to ensure both OPEC's cohesion and oil market rebalancing. Despite the strong momentum, we would not chase the rally from current levels as we believe that risks of a dysfunctional OPEC+ are rising.

Long-term, the low oil price environment is here to stay. Looking beyond this short-term catch-up dynamics in demand trends, we believe the picture is broadly unchanged. **With peak demand becoming a reality, OPEC and its allies cannot afford permanent losses in their market share.** This means that they have to maintain future prices at levels that discourage US shale producers from increasing capacity. So far, the strategy is proving successful.

Main risk to our view: diverging interests leading to dysfunctional OPEC+ and another supply glut.

16. Spot prices are back above pre-crisis levels, futures above US shale production costs

Futures curves on WTI at different dates in USD/bbl



Sources: Bloomberg, Lombard Odier.

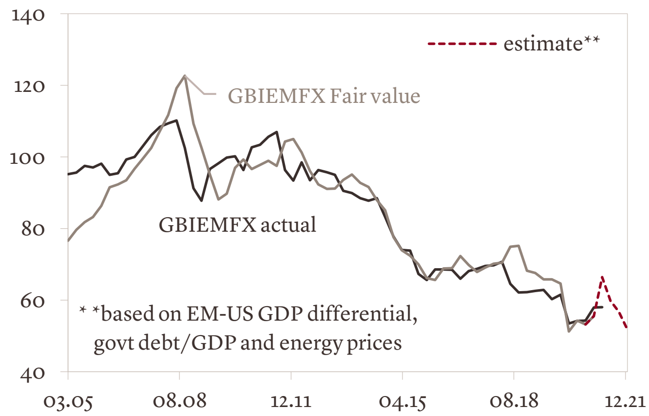
Note: Past performance and forecasts are not a reliable indicator of future performance.

EMFX: Three key charts

GBI EMFX – what the model suggests:

Using our energy price assumptions (around USD 55 per barrel in Q2) and inputting consensus EM vs US growth forecasts, our GBI EMFX model suggests that the index could see decent gains over H1 (chart 18). 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 side will certainly frontload EMFX gains. Upside risks to energy prices will result in more EMFX upside. However, further out, high debt loads and still lower-than-average energy prices suggest gains may not be sustained in H2.

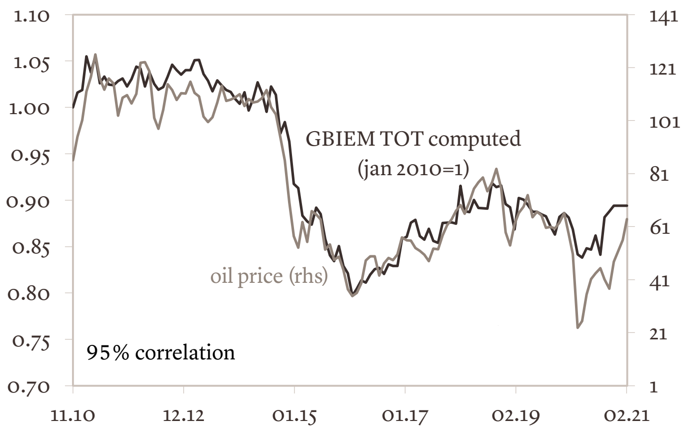
17. GBI EMFX: Model signals best period for EMFX will be Q1



Sources: Bloomberg, Lombard Odier

Upside risks to energy prices will result in more EMFX upside. Despite only about 30% of the weight of the GBIEMFX index being represented by energy exporters, GBIEM terms of trade are highly correlated to energy price movements (chart 18). Hence, upside risks to energy prices would prove more supportive for EMFX gains. Currencies that are especially responsive to energy prices include the MXN, COP, MYR, and IDR. While the RUB is an energy exporter, beyond a point energy price movements have a diminished impact because of the country's budget rule (whereby the authorities sterilise via FX operations the difference between market energy prices and the price assumed in the budget).

18. Energy prices remain key risk for the GBI EMFX



Sources: Bloomberg, Lombard Odier

EMFX buckets: from best to worst:

Chart 19 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 (CZK and PLN), and tech sector exposure (TWD and ILS).

19. EMFX – four buckets of EM currencies

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

Sources: Bloomberg, Lombard Odier

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

Asia FX

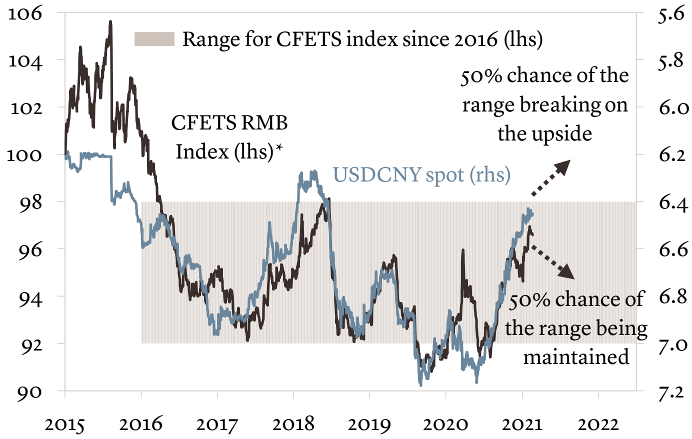
- **Rising global yields driven by improving global growth prospects should be supportive ultimately for further appreciation of Asia's trade- and growth-sensitive currencies. We look past their recent softness**
- **We see CNY, KRW, TWD, and SGD as the best currencies for a global reflationary rebound in spring. We see some limited gains for INR and THB, and are neutral on IDR and MYR. We remain slightly bearish on PHP**
- **Vaccine availability and rollout, the US-China strategic competition, and intermittent scares about premature monetary policy tightening will be key risks for the currencies.**

CNY: Asymmetric scenarios pointing to further appreciation

We maintain our bullish forecasts for the yuan (CNY) as macro and policy scenarios remain skewed to the currency's further appreciation in 2021. **First**, gradual shift in the People's Bank of China's (PBoC) policy stance will be a key factor. Now confident of the country's public health capabilities and the sustainability of ongoing domestic recovery, Beijing's policymakers are shifting their stances on monetary and macro-prudential policies to the hawkish side. We still do not expect outright rate hikes or equivalent liquidity measures in the near term, but we do see tightening chatter or guidance surfacing later this year should growth remain solid as we currently anticipate. This alone might be sufficient to shield the yuan from any pressure from rising global yields. **Second**, tariff-related scenarios also appear asymmetrically favourable to the yuan. Our macro team currently ascribes 50% probability to the scenario that the Biden administration will start reducing at least some of the widely disliked Section 301 tariffs on Chinese exports before the 2022 midterms. Meanwhile, the macro team judges that the risk of an unexpected rapid re-escalation of tit-for-tat tariffs is very low, even though the two countries' strategic competition could preserve non-tariff barriers or investment restrictions for the near future. This creates an upside risk for the currency, since any lowering of the tariffs or serious signals thereof would reduce the need for the currency to play a cushioning role for US tariffs. We thus incorporate the likelihood that the value of the currency vs the official basket would break out of its five-year-long range and start a new upward trajectory (see chart 20). **Third**, capital inflows remain solid, as foreign investors continue to flock to the country's onshore markets for their recent outperformance, attractive underlying fundamentals, and higher returns.

20. Will CFETS RMB index break out of its 5-year range in 2021?

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

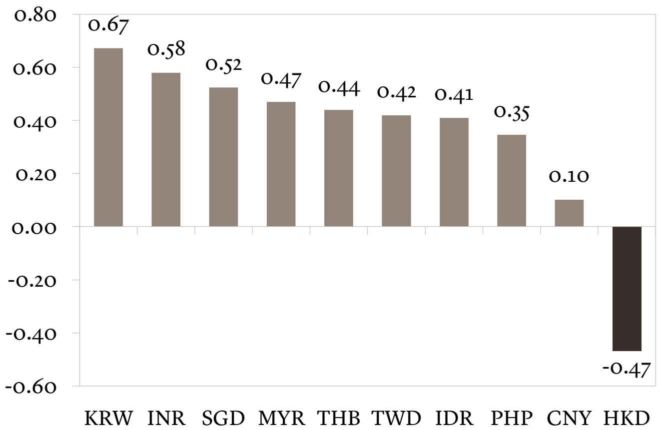


*left hand scale

Sources: Bloomberg, Lombard Odier

21. KRW has the highest correlation with global trade growth

Correlation of currency appreciation (vs USD) to global trade growth (2000-now)



Sources: CEIC, Bloomberg, Lombard Odier

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

Asia FX

We see a rather limited mid-term impact from Mr Trump's restrictions on US citizens' trading of blacklisted Chinese securities.

Main risks to our view: Unexpected serious geopolitical flare-ups between China and the US (e.g. Taiwan, South China Sea, other maritime borders) or re-escalation of tit-for-tat tariffs will be a key risk for the yuan. We do not believe that the pandemic or rising global yields pose significant risks to the currency for the time being.

KRW: Still the best Asian currency for global reflation trade in 2021

Despite the Korean won's slightly wobbly start to the year, we see further appreciation for the currency vs the USD in next 12 months. **First**, the country will benefit strongly from synchronised global recovery in 2021 due to its relatively diversified export sector (high tech and cyclical industries); the KRW indeed shows the highest positive correlation among its Asian peers to global trade volume growth (see chart 21). South Korea's robust economic fundamentals will underpin steady inflows into the country's equity sector, especially since Korea has long been an underweighted market among institutional investors. **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 (currently 174 seats out of 300 after a blowout victory in April) and the country's low debt levels. We also note that South Korea has access to a diversified portfolio of Covid-19 vaccines that it can distribute efficiently through its national healthcare system. We expect a high level of vaccinations by Q3. **Third**, the Bank of Korea faces political pressure to refrain from easy monetary policy due to the widespread public discontent on rapidly appreciating urban home prices.

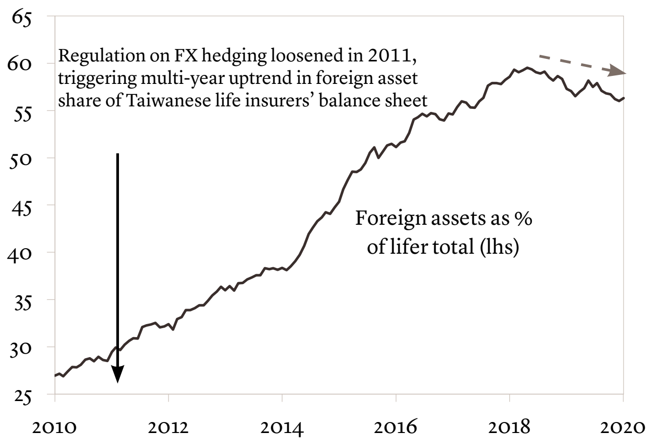
Main risks to our view: Geopolitical risks surrounding China and North Korea will remain a key risk for the Korean won. The Biden administration's stance towards Asian currencies will be another risk to watch as the country has been closely monitored by the US treasury for its semi-annual reports on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

TWD: Structural appreciation in its early innings

The New Taiwan dollar (TWD) remains one of the most under-valued emerging market currencies, and we see the currency steadily appreciating in the medium term. Fighting the structural appreciation pressure for TWD might become rather difficult for the Central Bank of China (CBC) in the future, due to evolving economic and geopolitical circumstances for Taiwan. **First**, macro fundamentals for Taiwan are exceptionally robust thanks to the country's

22. Taiwanese lifers' turn from foreign assets could boost TWD

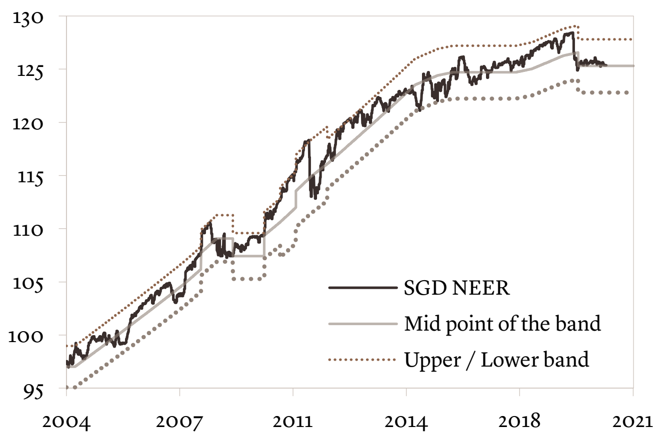
Foreign assets as a % of total, for Taiwan's life insurers



Sources: CEIC, Lombard Odier

23. 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

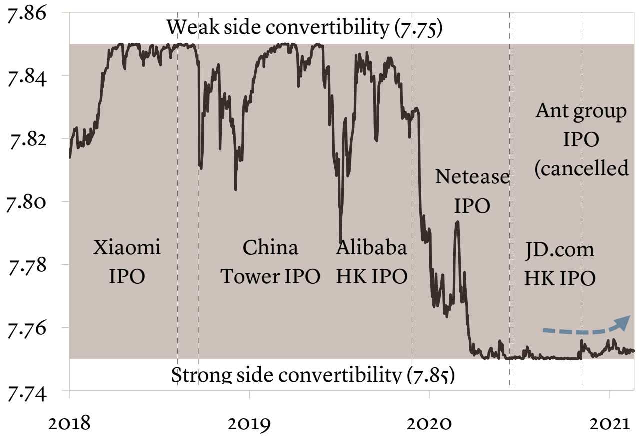
world-beating virus containment efforts and sovereign solvency metrics. Furthermore, booming high tech exports will lift the domestic capex cycle and make this year the best growth year since 2014.
Such sustained growth outperformance alone should be a compelling reason for TWD to appreciate. **Second**, the CBC faces the delicate task of coping with TWD strength, as the chronic undervaluation of the currency could become a source of friction with the Biden administration. Taiwan's inclusion in the US Treasury Department's "monitoring list" of potential currency manipulators in December could thus narrow the wriggle room for the CBC significantly this time, unlike past instances of inclusion. **Third**, Taiwan's life insurance companies, key players in the FX market, are beginning to refrain from adding more foreign assets to their balance sheets after a period of TWD strength (see chart 22). The turn in life insurance companies' investment behaviour removes an important unofficial channel for Taiwan's policymakers to lean against TWD appreciation, as their large unhedged foreign bond portfolios have been a key conduit for capital outflows.

Main risks to our view: Main risks are potential direct confrontation with China, further escalation of tension between the US and China, and a shift in the US stance on Taiwan's currency policy. Risks from the Covid-19 epidemic (infections and vaccine rollout) and a significant rise in global yield are rather limited for TWD given Taiwan's safe-haven status among emerging markets.

SGD: Eventual testing of the upper bound

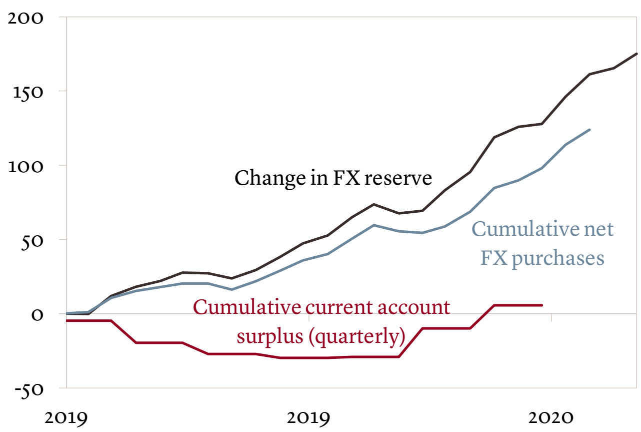
We expect the Singapore dollar (SGD) to appreciate solidly in the next 12 months. **First**, the Monetary Authority of Singapore (MAS) is unlikely to ease its policy again since domestic public health conditions have improved and growth is rebounding. The MAS confirmed this neutrality in its October policy decision by maintaining the current stance on the SGD's benchmark nominal effective exchange rate (NEER) curve, which has been moving sideways for the whole of 2020 (see chart 23). This outlook is consistent with the appreciation of SGD vs USD, as we expect other Asian currencies likely in the basket to strengthen. **Second**, global recovery tends to create a modest upside risk for the SGD NEER curve and keep it in the upper half of the MAS's target band, as markets begin to expect the monetary authority to eventually return to its policy of long-term nominal appreciation for SGD. If so, the possible testing of the upper band of the SGD NEER curve would create 1.5-2.0 percentage points of additional downside for the USDSGD spot rate. **Third**, markets' medium-term expectation on the SGD NEER curve could start shifting up towards the end of this year when the country's relatively advantageous position in vaccine

24. Post-IPO reversion in progress for HKD
USDHKD spot, HKMA's convertibility zone, key IPOs



Sources: Bloomberg, Lombard Odier

25. RBI to step back from FX markets after relentless intervention
Cumulative change since January 2019, USD billion



Sources: CEIC, Bloomberg, Lombard Odier.

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

Asia FX

procurement and global trade will be clearly evident in public health and economic data.

Main risks to our view: Main risks are the impact of Q1 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 middle of the convertibility zone

We expect the HK dollar peg to the US dollar to remain in place for the near future, but we believe that USDHKD will gradually move to the middle of the monetary authorities (HKMA)'s convertibility zone, i.e. 7.80. **First**, the temporary scarcity of liquidity related to various IPOs will eventually ease towards the end of the year when the bulk of marquee listings are complete (see chart 24). **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**, the HKD tends to soften slightly vs USD in times of strong global trade growth, as discussed earlier (see chart 21).

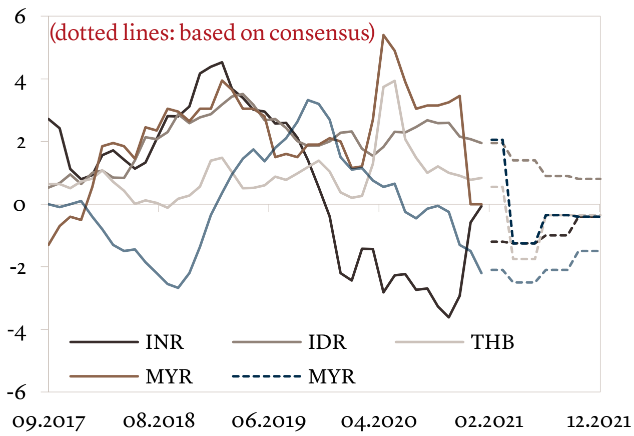
Main risks to our view: Main risks are the magnitude of the IPO boom including the new attempt to list Ant Group, and domestic political developments related to the Legislative Council elections.

INR: New budget to lead to modest appreciation

The Indian rupee (INR) has been resilient to rising oil prices and global yields in past few weeks, and we see some scope for modest appreciation vs the USD in the rest of 2021. **First**, the new aggressively expansionary budget from the Modi cabinet should boost growth outlook for the country and reduce the pressure on the Reserve Bank of India (RBI) to ease further in 2021. The equity market's reaction to the unveiling of the new budget was strongly positive, and we believe there is scope for the foreign equity inflows to accelerate in coming months. **Second**, the RBI will likely see reduced presence in the FX market as the most convenient path to deal with the dilemma of simultaneously supporting local bond markets (amidst large increases in government bond issuance) and sterilising steady foreign inflows. The RBI been relentlessly bidding for USD, limiting INR's gains in H2 2020 and early 2021 (see chart 25). By simply stepping back from the FX market, the RBI can avoid introducing new complications to the onshore rates market, while mitigating the impact of the rising oil prices. **Third**, the ruling coalition's victory in the recent Bihar election – in spite of the painful economic downturn this year – hints at the underlying political strength of the Modi team

26. Real rates to remain positive for IDR in 2021

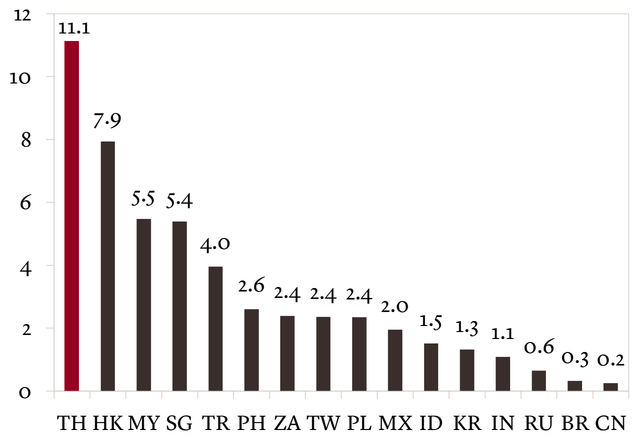
Benchmark policy rate minus CPI inflation, %



Sources:Bloomberg, Lombard Odier.

27. Real rate still attractive in Malaysia

Trade-related service exports as a % of GDP



Sources: CEIC, Lombard Odier

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

Asia FX

and thus policy continuity. We do not expect the recent farmers' protests to have a lasting impact on Modi's incremental reforms in 2021 and 2022.

Main risks to our view: We do not believe that there will be additional downgrades in India's investment grade rating, but it will be important to monitor the rating agencies' assessment of the country's medium-term fiscal risks in light of the new expansionary budget. Industrial commodity prices, geopolitical tensions with China, and global government bond yields will be other key risks.

IDR: Cyclical upside capped by excess domestic liquidity

We expect only modest appreciation for the Indonesian rupiah (IDR) in 2021 vs. USD. In line with our expectations, IDR's rally began to peter out in December after the passage of the Omnibus Bill. We see three reasons for the currency's modest gain. **First**, the latest government bond auction revealed that Bank Indonesia (BI) is still the essential buyer in the primary market, filling in the gap left by more hesitant foreign investors. While foreign investors' fears over the burden-sharing agreement between BI and the government have quietened somewhat, the wall of new bond issuances will require significant excess domestic liquidity from the BI. **Second**, Indonesia is unlikely to achieve a quick escape from the Covid-19 epidemic – even if the overall infection rate is somewhat better than those of the US, Europe, and other emerging market peers. The logistical challenges of pre-vaccine containment efforts and vaccine rollout are substantial, and the country will not be able to return to its GDP trend until 2022. **Third**, the currency's downside is also limited due to a relatively higher real rate trajectory in 2021 and its sensitivity to global cyclical upturns. Indonesia's real interest rate in particular will likely be higher than its regional peers', albeit declining somewhat from 2020 levels due to the BI's recent dovish signal (see chart 26).

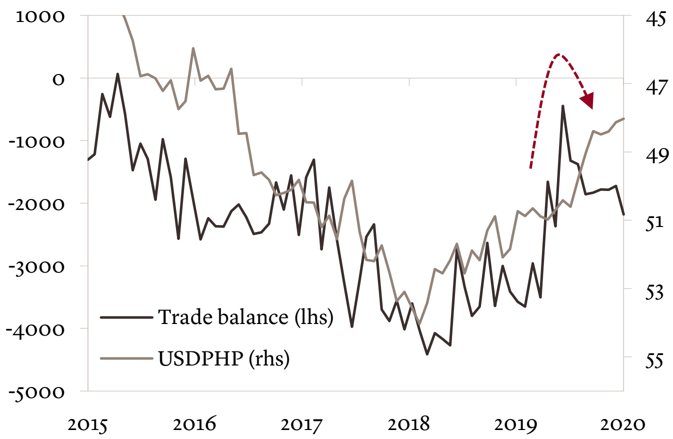
Main risks to our view: The country's lax approach to Covid-19 containment will be a key risk given its fragile healthcare system. Somewhat disappointing and unclear efficacy data for Chinese vaccines will be an issue since Indonesia's vaccine strategy depends heavily on them. The local bond market's sensitivity to global yields will also be a key risk.

THB: Vaccine news more impactful than political uncertainties

We continue to see a modest upside for the Thai baht (THB). **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 was bound to boost the

28. Widening deficit would increase PHP depreciation pressure

Trade balance, USD mn (lhs), USDPHP, inverted (rhs)



Sources: Bloomberg, Lombard Odier

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

Asia FX

THB substantially. No emerging market comes close to Thailand in terms of dependence on tourism for USD earnings (see chart 27). **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 sustained rebound in Thailand's merchandise exports. The country has been able to keep a lid on Covid-19 cases with strong public health measures. Street protests that began in H2 2020 seem to be losing their momentum, and the ruling party's structural advantages are unlikely to be dented by the protests. **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.

Main risks to our view: Main risks are the evolution of the ongoing street protests and vaccine developments. The Biden administration's stance on Asian currencies could create an upside risk for THB, as Thailand is rather closely monitored by the US Treasury Department due to its persistent surpluses.

MYR: Trade boost undermined by uncertain politics and Covid-19 waves

We expect the Malaysia ringgit (MYR) to post a modest gain against the USD in 2021. **First**, the fragility of the new governing coalition makes a snap election in 2021 highly likely. Although the declaration of emergency gives the ruling party some time to fend off no confidence votes and snap elections, we believe that political intrigue will dominate policy outlook and weigh on MYR. That said, the impact of these developments is not yet visible on the currency. **Second**, the ongoing boom in the global goods trade will boost the country's exports, but Malaysia also suffers from Asia's worst epidemic curve – although the latest wave has been stabilising in recent weeks. **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.

Main risks to our view: Main risks are an 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 Philippine peso (PHP) is ending, 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 will face significant logistical challenges in the nationwide deployment of Covid-19 vaccines and thus rapid virus containment. **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 (see chart 28). **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 significantly since the start of 2020. Stabilising 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.

LatAm FX

- **We have a cautious long-term outlook on the BRL, but fiscal risks have now reduced chances of BRL participating in an EMFX rally in coming months.**
- **MXN could remain well supported by better fiscal data and a stronger US growth outlook. However, the currency appears expensive already. Negative headline risks and/or a more dovish central bank may provide setbacks**
- **With CLP having performed well in line with our views, the currency could consolidate. We remain negative on both the COP and the PEN.**

BRL (Brazilian real): Fiscal risks back to the forefront

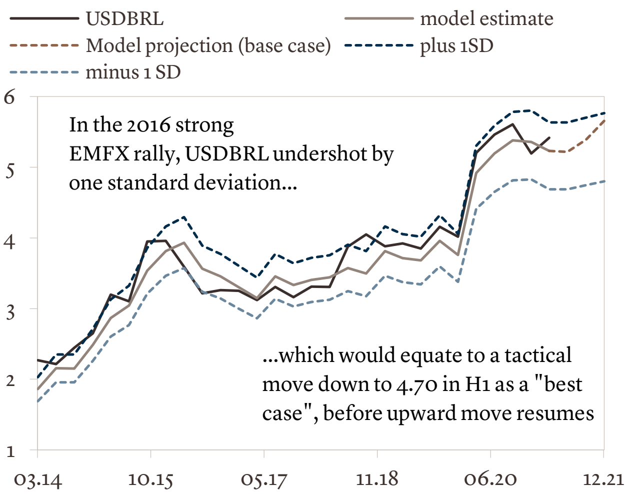
Despite having been a laggard already in 2020, the BRL remained the underperformer in January as the USD gained a bid. While we had in January assumed that positive developments on three fronts (fiscal, monetary and vaccine), would help USDBRL decline in Q1, the currency has now missed its chance. On fiscal policy, there is uncertainty over whether any further emergency aid put forth will come alongside reforms that stabilise the debt ratio. However, recent events include signs of greater intervention from Bolsonaro in government matters, including management of state-owned enterprises, hints at a move towards populist policies. On balance, this increases the chances that the country could breach its self-imposed debt ceiling in Q3. The move to looser fiscal policy has seen markets increased their expectation of rate hikes from the central bank. While the BCB removed its forward guidance for lower rates at its most recent meeting, we believe a failure to deliver on the rate hikes would further unsettle the BRL. Consequently, we have abandoned our earlier expectation for a short-term decline in USDBRL towards 5.00, now expecting the pair to hover around current levels (around 5.40) in coming quarters, with risks to the upside. Our longer-term trajectory (5.25 by end-2021) is being re-assessed. Currently, the BRL remains in the “cautious” EMFX category, but risks a downgrade back to “underperformer” status.

Main risks to our views: One downside risk is the removal of the debt ceiling at 95% of GDP. This would lead to further BRL depreciation

MXN (Mexican peso): Well supported, but turning expensive

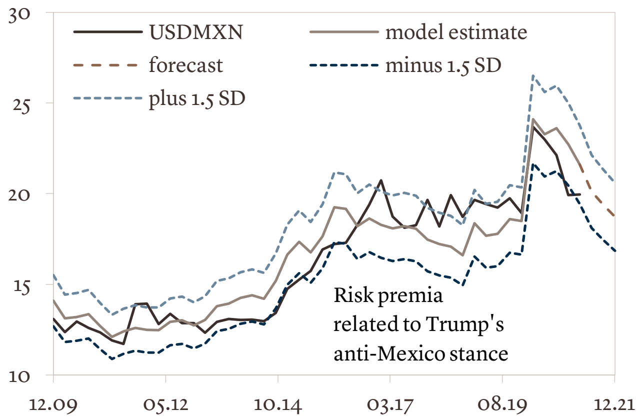
Having been bullish on MXN for the past six months, we downgraded the currency to “cautious” in the January edition of the monthly. That said, the MXN clearly has a number of positives going for it, and could remain a LatAm outperformer as the region’s only major currency still offering positive real

29. USDBRL to be in a 4.70-5.60 range around fair value



Sources: Bloomberg, Lombard Odier

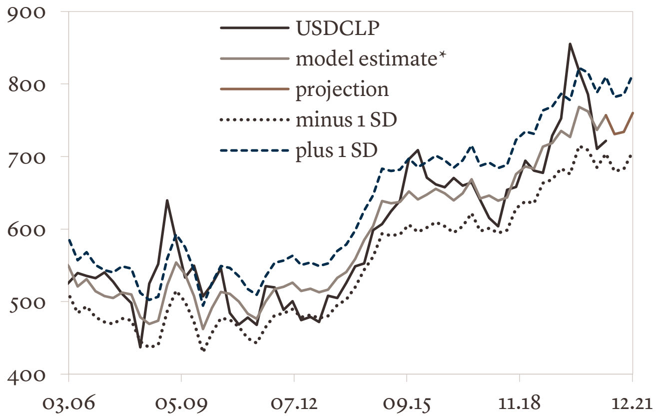
30. MXN appears already priced to perfection at current levels



Sources: Bloomberg, Lombard Odier

31. USDCLP screens as valued following recent sharp declines

SD = standard deviation



Sources: Bloomberg, Lombard Odier

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

LatAm FX

yields. **First**, a stronger US economic outlook given the coming fiscal stimulus would benefit the MXN the most among LatAm currencies, given that 80% of the country's exports target the US. **Second**, despite weaker growth, the fiscal deficit figures have been stronger than expected, helped by securing extra sources of revenues from the stabilisation funds. This could persist, pushing the risk of rating downgrades out further towards the end of 2021, or quite possibly 2022. **Third**, the relatively conservative monetary and fiscal stance holds the MXN in good stead. **Fourth**, despite the country now being a net commodity importer (due to gasoline imports), the MXN will be strongly supported by any upside risks to energy prices. Still, what concerns us is that the MXN, at current levels, appears priced to perfection (chart 30).

Hence, we believe that the currency could be prone to negative news, with the recent concerns over the manufacturing sector (in light of natural gas supply shortages from Texas) an example of this risk.A rise in political risk premia as we head closer to the mid-term elections in June could also make the MXN prone to retracements. However, as long as oil prices are well behaved and external balances remain strong, USDMXN rallies should be relatively contained to 21, in our view.

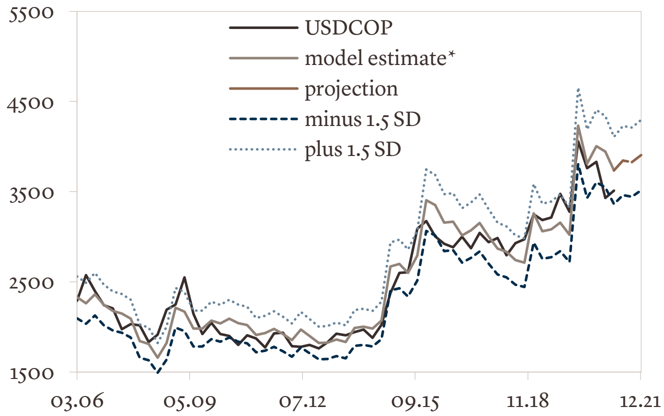
The central bank recently reduced rates by 25 bps to 4.00%. Another cut is quite likely, and after a point, reduced real carry (currently 45 bps, the only positive real yielder in mainstream LatAm FX) could lessen support for the currency.

Main risks to our views: Political uncertainty could weigh on MXN heading into the June mid-term elections. President AMLO's energy agenda may clash with incoming US President Biden's agenda for clean energy. Longer term, the main downside risk for Mexico is fiscal deterioration.

CLP (Chilean peso): Consolidation expected after solid performance

The CLP has been the only LatAm FX to fall into our EMFX "outperformer" category in recent months. Over 2020, CLP (along with MXN) has held its value far better than peers have. From here, we expect that gains for the CLP could moderate somewhat, but maintain the currency as a "modest performer". The easy gains have now passed. Indeed, one of the tailwinds for the CLP over 2020 i.e. large USD sales in the spot market linked to conversion from sovereign funds and fiscal spending (from issuance of FX bonds), will be likely be lower in 2021 (likely USD 7-8bn vs. USD 15bn in 2020). CLP no longer screens as extremely undervalued, unlike in H2 2020. Our model, based on variables like copper prices, government debt, relative growth (vs the US), and real interest rates, signals fair value of around 730, and reflects our more

32 COP is the most expensive LatAm currency at present



Sources: Bloomberg, Lombard Odier.

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

LatAm FX

optimistic view on copper prices. Still, with Chinese credit impulse still healthy and Chile the best-placed in the vaccine race among its LatAm peers, further declines in USDCLP are very possible. Working against the CLP, however, will be the announcement in mid-January of the launch of a USD 12 bn reserve accumulation programme (to occur via daily auctions of USD 40 mn over 15 months). We would pencil in a range of 695-725. At levels of under 690, USDCLP would screen as undervalued (chart 31). Politics will be in focus, but will more likely have a bearing in H2. Markets will likely scrutinise the profiles of the 155 members of the new constitutional convention body (to be elected in April), and begin to make inferences about the path of policymaking going forward. At the same time, there is an upcoming general election (November) and potentially a second-round presidential election (December).

Main risks to our views: Following the referendum, the next event risk date will be 11 April 2021, when the members of the constitutional convention are appointed. A more populist make-up of the convention could begin to impact CLP assets in H2 2021. Still, relatively low government debt should imply fallout remaining limited for the CLP.

COP (Colombian peso): Near-term support, but extreme overvaluation

In the months ahead, COP could gain somewhat in strength, supported by energy prices grinding higher, and by upward EM growth revisions and lower event risks. That said, we keep the currency in our category of EMFX “underperformers” because of the high degree of overvaluation as well as weak external balances. USDCOP screens as extremely undervalued (chart 32). The current account deficit will likely remain wide at near 3.8% of GDP, and foreign direct investment (FDI) inflows are likely to slow. Meanwhile, we believe that foreign debt holdings, which held up quite well in 2020, could be susceptible to negative news on the fiscal front. Finally, and somewhat similar to the case with the CLP, COP will benefit less in 2021 from USD sales. Private sector estimates suggests the USD selling flow from such operations could be in the region of USD 3-4bn in 2021 (vs. USD 7bn in 2020).

Main risks to our views: On the negative side, a failure to undertake fiscal reform would increase rating downgrade risks.

PEN (Peruvian sol): Our preferred short in LatAm

The PEN falls into our category of “cautious” EMFX, but remains our preferred short in LATAM FX over H1 given a combination of very low yields, elevated political risks and a central bank that is persistently intervening to keep the currency weak. With political risk (ahead of the April 2021 election) set to become more prominent, USDPEN will likely remain an outlier, unable to decline alongside the softer USD. Dollar-hedging demand could rise as polls for the presidential election reflect the polarised political climate. This could keep USDPEN relatively elevated compared to our model estimate in the coming three to six months. We assume a 3.55-3.65 range will hold. However, if political risks dissipate in H2, and taking into account a stronger growth trajectory and higher commodity prices, the PEN could perform better later in 2021.

Main risks to our views: On the positive side, a decline in political risk as well as short PEN positioning would see the currency aligning with better FX fundamentals, with a return towards fair value near 3.50. On the negative side, political uncertainty will keep USDPEN elevated and above 3.60.

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

CEEMEA FX

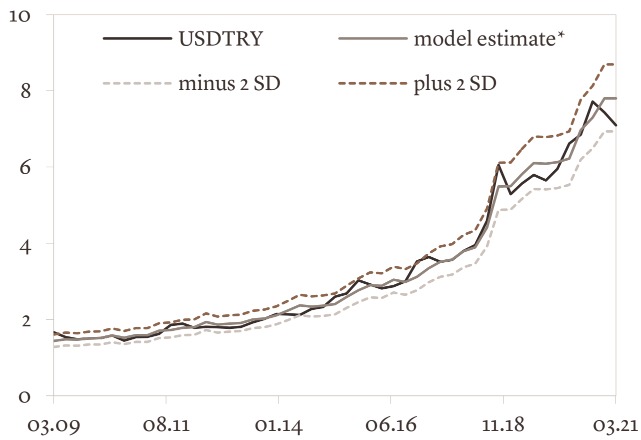
- **Signs of a turn towards more conservative macro policies have allowed the TRY recovery to extend. However, further gains may be harder to come by**
- **Our bearish ZAR view has been challenged in recent months by strong external rebalancing. Nonetheless, the currency appears expensive**
- **We remain constructive on the ILS, and believe the currency cold undershoot longer-term valuation metrics as the country appears set to achieve herd immunity earlier than others. In CEE, we prefer CZK to the HUF.**

TRY (Turkish lira): Better performance likely over January and February

We retain a cautious view on the TRY longer term, and believe the best period for the tactical rally may be behind us. We find that longer-term macroeconomic fundamentals such as relative core-CPI trends, relative productivity, FDI, government debt, and external debt can explain the trajectory of USDTRY. A model that uses these variables suggests that USDTRY fair value stands at 7.80, with a likely trading range of 6.90-8.70 (defined by two standard deviations). We are now approaching the bottom of this range, suggesting the move has already become stretched (chart 33). While authorities have in recent months sent all the right signals by tightening monetary and fiscal policies and adopting macro-prudential tightening measures, we sense that some damage has already been done to the public's faith in the currency. Compared to the 2018 crisis, we find that data shows that citizens have not reduced their hard currency deposits by much. At the same time, the widening current account deficit over 2020 was largely driven by strong gold imports - another sign of concern over the local currency's purchasing power (chart 34). Politics remain a wildcard: Turkish President Erdogan offered more conciliatory messages to the US and EU to resolve conflicts. While the country has been sanctioned by the US under CAATSA (due to its purchase of Russian missile systems), the sanctions could be minor, and still leave some room for dialogue with the new Biden administration. The EU has so far avoided stronger sanctions, and several issues will be evaluated at the European Council Summit on 25-26 March. Finally, we also note that as we enter March, redemptions of external debt will pick up to over USD 7 bn (from under USD 3 bn in each of January and February). This could help put a floor under USDTRY.

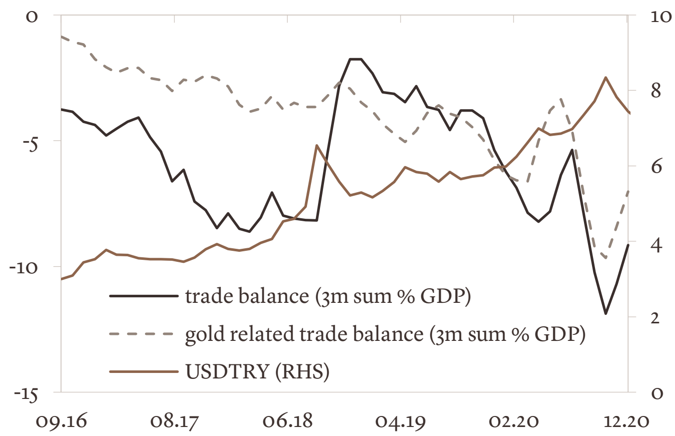
Main risks to our views: A negative risk could come from delayed vaccine deployment (that implies a slower recovery in tourism), or if the central bank is too early to begin easing.

33. USDTRY is now beginning to appear extended below the 7.00 level according to longer-term fair value



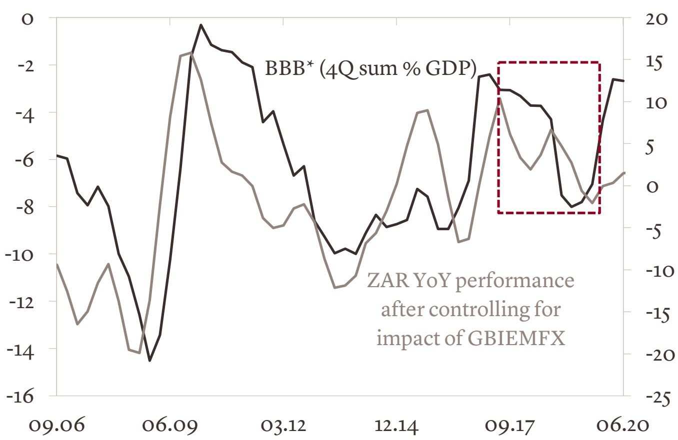
Sources: Bloomberg, Lombard Odier

34. Unlike the 2018 FX crisis, rapid increase in gold imports suggests public distrust for the Turkish lira



Sources: Bloomberg, Lombard Odier

35. A strong trend of external rebalancing helps explain recent ZAR outperformance



Sources: Bloomberg, IMF, Lombard Odier

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

CEEMEA FX

ZAR (South African rand): External rebalancing provides support for now

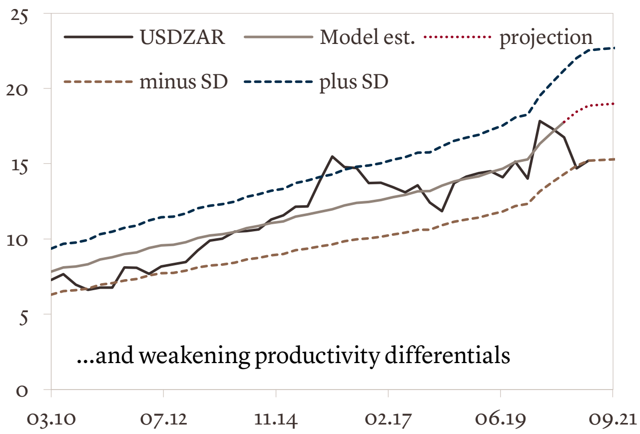
ZAR is in our group of "fragile" EM currencies, but it has held up better than we had assumed. We believe a key reason is the improvement in the country's balance of payments. Historically, this has coincided with periods of relative ZAR outperformance vis-à-vis the GBIEMFX index (chart 35). The recent improvement in the trade balance is coming not only from a decline in imports (because of weak domestic demand), but also an increase in exports. While export volumes have not risen much, export prices have, and this has contributed to the improved trade balance. Gold (8% of total exports), platinum (3% of total exports), and coal and iron ore (8%) have been the main drivers. With gold prices likely to taper off towards year-end, and assuming energy prices remain well supported, South Africa's trade balance could begin to soften over H2. At that point, we believe the South African rand will begin to adjust to a lower fair value. Our projected fair value suggests that weakening productivity growth and higher debt levels will be offset only modestly by improved terms of trade. It shows fair value will likely edge up towards 19 in the years ahead (chart 36). On the fiscal side, risks remain in place concerning wage agreements as well as the provision of additional financial support to state-owned enterprises.

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 projected to rise as labour unions protest fiscal tightening in the months ahead.

RUB (Russian rouble): Caught between good fundamentals and sanctions concerns

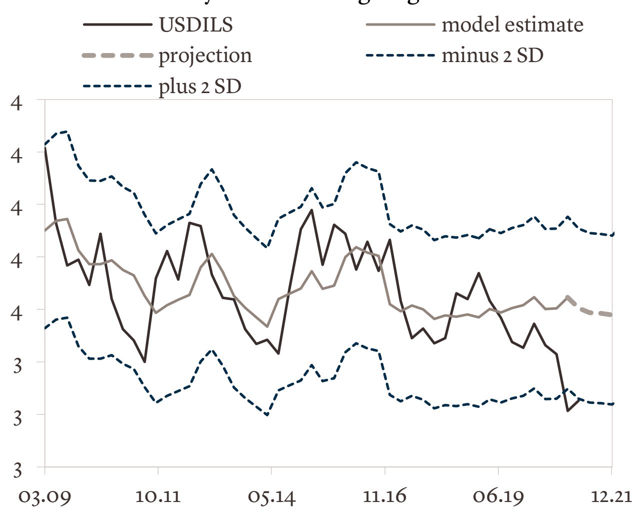
With incoming US President Biden likely to focus on areas other than international politics in his first 100 days, and with seasonality usually positive for the RUB in Q1, the currency could be well supported at the beginning of 2021. USDRUB could hence undershoot, but we would expect the 68-70 region to provide strong support. The reason for our continued cautious stance is twofold. **First**, we disagree with consensus views that USDRUB fair value is somewhere between 60 and 70. In our view, USDRUB fair value is elevated – near 75, driven by modest gains in debt and the budgeted energy price of USD 42 per barrel (rather than the market-traded energy price). Hence, we do not view rising energy prices as equating to a sharp decline in USDRUB with the budget rule (and FX operations by the Ministry of Finance) still in place. **Second**, a harsher US policy stance towards Russia is still very plausible,

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



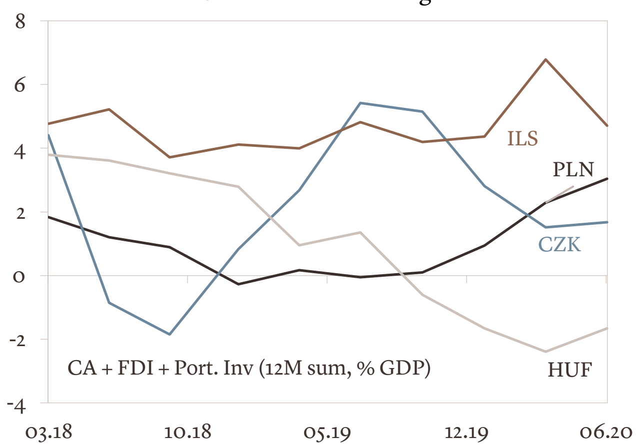
Sources: Bloomberg, Lombard Odier

37. USDILS currently undershooting long-term fair value



Sources: Bloomberg, Lombard Odier

38 ILS stands out in CEEMEA for its strong external balances



Sources: Bloomberg, IMF, Lombard Odier

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

CEEMEA FX

especially now with the Democrats having secured a Senate majority. We thus maintain RUB on our list of "modest underperformers" in EMFX, even though it could perform better in Q1.

Main risks to our views: On the negative side, an increase in sanctions rhetoric from US politicians towards Russia could hurt. However, US President Biden is likely to focus on areas other than international politics in his first 100 days. On the positive side, a change in budget rule or FX operations could sway our view on RUB, as it would suggest RUB can trade with a higher beta to market-observed energy prices.

Central Eastern Europe & ILS: Preference for ILS and CZK

In the group of CEE & ILS, we include the Czech koruna (CZK), Polish zloty (PLN), Hungarian forint (HUF), and Israeli shekel (ILS).

We maintain a constructive ILS view. One factor supporting gains is Israel being on track to approach "herd immunity" sooner, as well as more upbeat signalling from the Bank of Israel. Our longer-term view still assumes continued good performance of the tech sector and low-for-longer US real yields, as well as a strong balance-of-payments position. We find that in the longer term, macroeconomic variables such as the trend in government debt, real interest rate differentials (vs the US), growth differentials (vs the US), and trade and FDI flows explain the ILS. Such a model places fair value close to 3.60 with a likely range of 3.20-3.90 (chart 37). In recent months, we have undershot this range driven by more positive news on the vaccination front. That said, strong FX flows linked to Israel's emergence as being a tech hub, rising gas exports, as well as low US real yields have contributed to the strong ILS appreciation pressure (a dynamic seen in recent years). We assume this remains in place for the months ahead, with the central bank's FX intervention only likely to slow the move.

Elsewhere for the CEE, we maintain our prior preference for CZK and PLN over HUF: **CZK** appears perfectly poised to perform well, with support from a strong fiscal impulse and still-low debt. Core inflation remains elevated, and has kept the central bank relatively hawkish. Indeed, central bank assumptions pencil in three rate hikes in H2 2021. 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 to peers (chart 38). The central bank should turn more dovish as core inflation edges lower.

We are only slightly positive on the **PLN**: the renewed move of the National Bank of Poland towards FX intervention dents our enthusiasm; it suggests policymakers would prefer a weaker PLN. That said, with overall balance of payments support still strong, positive beta to EURUSD upside (our central view is for a peak at 1.27 in 2021), PLN will likely grind stronger. We pencil in an eventual decline to 4.40 on EURPLN.

Our Lombard Odier long-term FX fair valuation framework

BEER Behavioural equilibrium exchange rate model	FEER Fundamental equilibrium exchange rate model
Definition Econometric model, which estimates FX fair values by "mapping" the exchange rate to a set of fundamental economic variables	**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 · Terms of trade · Investment as % of GDP · Rate differentials · Inflation differentials	**Inputs** · Price elasticity of trade · Output gap · Current account · Capital flows
Output Fair value estimates for major forex crosses Updated 2 to 3 times annually Weight: 50%	**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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SWITZERLAND

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

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

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

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

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

EUROPE

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

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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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Paseo de la Castellana 66, 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
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MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
2 Letnikovskaya st.2, bld.1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France. RCS PARIS B 803 905 157 · paris@lombardodier.com
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4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
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Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com
Supervised by Banco Central del Uruguay.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Superintendencia de Bancos de Panamá.
Lombard Odier (Panama) Inc.
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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HONG KONG
Lombard Odier (Hong Kong) Limited
3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
A licensed entity regulated and supervised by the Securities and Futures Commission in Hong Kong.

SINGAPORE
Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
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TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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