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FX Monthly

Fed's hawkish tilt may not fetter the euro

06/12

June 2021

Key highlights

- The dollar strengthened across the board following a surprise hawkish tone from the Fed. We expect this strength to remain in place near term; medium term, however, we expect USD downside bias to resume due to the strong global growth dynamics
- The rise in US yields at the short end of the curve will likely cause soft trading in EURUSD for now. Further out, we still expect some appreciation to re-emerge as euro-area growth gathers pace
- EURCHF should reach 1.12 by year-end. Meanwhile, we are turning more neutral on the USDJPY. We maintain a neutral stance on GBP
- While recent months have been characterised by supportive EMFX conditions, we believe the remainder of the year could be more challenging for EMFX. The RMB remains our top pick
- This month, in EMFX preferences, we upgrade PEN from "cautious" to "modest performer".

FX forecasts		Q321	Q421
G10	EURUSD	1.23	1.22
	USDJPY	109	109
	EURCHF	1.11	1.12
	GBPUSD	1.40	1.38
	EURGBP	0.88	0.88
EM	USDRMB	6.29	6.22
	USDINR	74.4	74.5
	USDIDR	14 540	14 593
	USDMXN	20.0	19.8
	USDBRL	5.18	5.28
	USDRUB	73.3	73.7
	USDZAR	14.6	14.8

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

Data as of 20 June 2021

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Introduction

The Federal Open Market Committee (FOMC) now projects two 25-bps hikes in 2023 ...bringing its forecast more in line with market pricing.

The Federal Reserve (Fed)'s June meeting was the highlight of the month. As the central bank maintained its monetary policy, the hawkish surprise came from its interest rate projections. The Federal Open Market Committee (FOMC) now projects two 25-bps hikes in 2023 (vs none previously), bringing its forecast more in line with market pricing. However, this move represented a somewhat hawkish shift, since it portrays a central bank that is no longer pushing back against market expectations.

The immediate market reaction therefore saw the dollar surge against G10 and EM currencies. Equities fell, US 2Y yields rose, and the yield curve flattened.

The Fed's move upset our FX views, and we thus now expect USD upside pressure to persist in the near term. Medium term, however, we still think the path of least resistance is for the dollar to gravitate somewhat lower under the strong impetus of global growth.

Regarding EURUSD, we maintain our forecasts unchanged, although in the near term we expect downside pressures to persist as USD bullish sentiment builds up. However, for the medium term we would not throw in the towel on EUR appreciation just yet. The currency tends to perform very well in periods of cyclical growth upswings, similar to the one currently underway. EURCHF is likely to reach 1.12 by the end of the year, in our view.

Turning to sterling, we maintain a neutral stance. We still expect structural Brexit-related headwinds to keep pressure on the GBP. The main risk to this view is an earlier tightening of monetary policy by the Bank of England.

We have raised our USDJPY forecasts, as the hawkish Fed and sizeable outward Japanese M&A activity will weigh on the JPY for the time being.

The Nordics are likely to sustain losses in the short term, but growth rotation towards Europe should allow appreciation in H2 21. A similar pattern should occur in the core commodity FX G10 bloc (AUD, CAD, and NZD), which should find some support further out on rising commodity prices.

For EM currencies, while conditions had been supportive given stable US real yields and positive EM data surprises, we are likely entering a more challenging period. Accordingly, caution is warranted for EMFX exposure, but we continue to favour the RMB as our top pick (see FX ISB - Stress-testing our constructive renminbi view). This month, we upgrade PEN from "cautious" to "modest performer" because of extremely cheap valuations.

In terms of the EMFX path ahead, we believe the 2013 "taper tantrum" playbook may not work given better global trade growth and commodity price momentum in 2021 as well as improved EM external balances. However, in recent years, we do find a number of currencies that are more sensitive to US yields. These include the TRY and HUF (CEEMEA), IDR and INR (Asia), and CLP and COP (LatAm).

Main risks to our view: The main upside risk to our forecasts comes from a stronger recovery in global trade that could 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 yields (a US "yield tantrum"). **Second**, the Fed gradually turning more hawkish. **Third**, a premature withdrawal of global fiscal support.

FX forecasts – G10 and gold

	Current spot	Q3 21	Q4 21	Q1 22	Q2 22	Estimates of long-term fair value[1]
EURUSD	1.19	1.23	1.22	1.21	1.21	1.18
GBPUSD	1.40	1.40	1.38	1.37	1.37	1.46
EURGBP	0.85	0.88	0.88	0.88	0.88	0.82
EURCHF	1.10	1.11	1.12	1.12	1.11	1.02
USDCHF	0.92	0.90	0.92	0.93	0.92	0.87
USDJPY	111	109	109	108	108	94
EURJPY	132	134	133	131	131	111
EURSEK	10.12	9.95	9.95	9.90	9.90	9.69
USDSEK	8.48	8.09	8.16	8.18	8.18	8.24
EURNOK	10.17	9.90	9.80	9.80	9.80	9.84
USDNOK	8.52	8.05	8.03	8.10	8.10	8.37
AUDUSD	0.76	0.80	0.80	0.79	0.79	0.72
NZDUSD	0.73	0.73	0.73	0.73	0.73	0.67
USDCAD	1.23	1.20	1.21	1.22	1.22	1.24
Gold	1782	1 750	1 600	1 600	1 600	
Oil (Brent)	76	68	68	64	60	

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

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

Please read important information at the end of the document.

FX forecasts – EM

Asia

	Current spot	Q3 21	Q4 21	Q1 22	Q2 22
USDRMB	6.48	6.29	6.22	6.25	6.30
USDHKD	7.77	7.75	7.75	7.75	7.75
USDIDR	14433	14 540	14 593	14 647	14 700
USDINR	74.3	74.41	74.47	74.54	74.60
USDKRW	1138	1 119	1 109	1 100	1 090
USDMYR	4.16	4.13	4.11	4.10	4.08
USDPHP	48.8	49.2	49.3	49.5	49.7
USDSGD	1.35	1.33	1.32	1.32	1.31
USDTWD	28.0	27.7	27.5	27.4	27.2
USDTHB	31.9	31.6	31.5	31.3	31.2

LatAm

	Current spot	Q2 21	Q3 21	Q4 21	Q1 22
USDMXN	20.3	20.0	19.8	19.7	19.5
USDBRL	4.96	5.18	5.28	5.39	5.50
USDCOP	3 782	3 869	3 913	3 956	4 000
USDCLP	742	741	741	740	740
USDPEN	3.98	3.83	3.75	3.68	3.60

CEEMEA

	Current spot	Q3 21	Q4 21	Q1 22	Q2 22
USDRUB	72.6	73.3	73.7	74.0	74.0
USDTRY	8.6	8.96	9.13	9.30	9.40
USDZAR	14.2	14.6	14.8	15.0	15.2
USDILS	3.25	3.24	3.21	3.18	3.18
EURPLN	4.52	4.53	4.53	4.54	4.54
EURCZK	25.4	25.3	25.2	25.1	25.2
EURHUF	349	356	359	363	366

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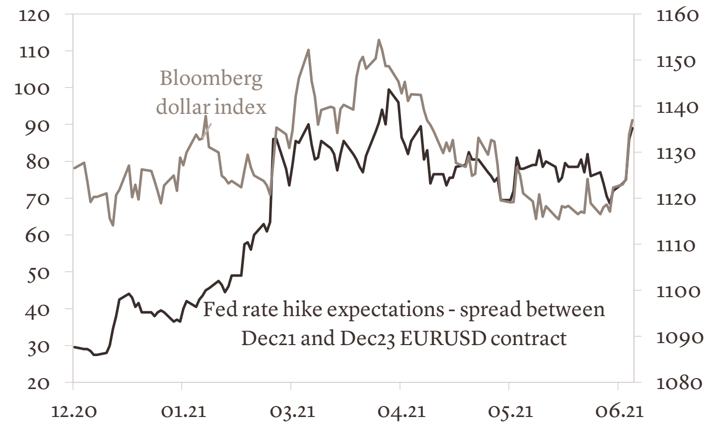
G10FX: Three key charts

The surprise hawkish move by the Fed has resulted in a repricing higher of Fed rate expectations and a stronger dollar. We now expect this strength to remain in place in the near term.

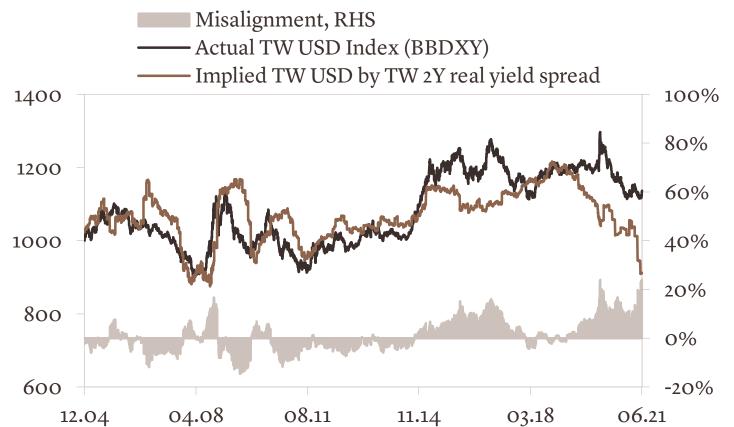
1. A significant repricing in Fed rate expectations...



Sources: Bloomberg, CFTC, Lombard Odier

However, from a medium-term fundamental perspective, the trade-weighted (TW) USD remains significantly overvalued, as higher inflation is "eating into" US real yields. Although, the US 2Y nominal yield broke out of its narrow range following the Fed meeting, we think it unlikely that it will manage to rise sustainably from here, maintaining pressure on real yields.

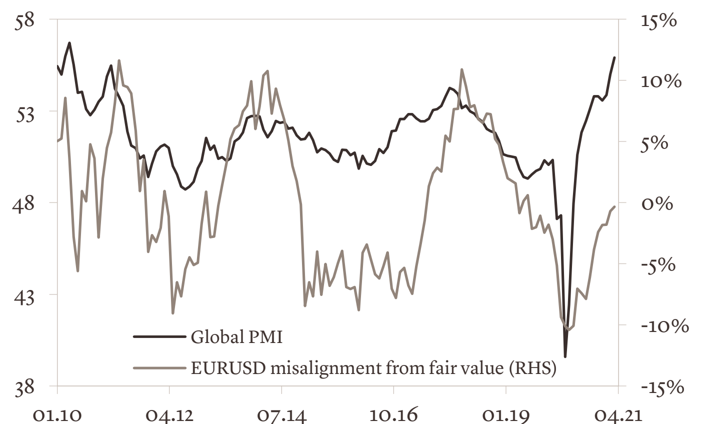
2. The dollar remains overvalued



Sources: Bloomberg, Lombard Odier

The EUR is likely to be pressured in the near term – a natural consequence of a hawkish Fed. However, over the medium term, global and European growth will matter, as strong cyclical upswings have in the past resulted in EURUSD appreciating, even in the face of rising Fed rates (consider 2017).

3. Global growth matters for the EUR
EURUSD current estimate of fair value is 1.18



Sources: Bloomberg, Lombard Odier

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FX majors

EUR (euro): The Fed turns hawkish, but don't write the EUR off just yet

- **The hawkish Fed has been the highlight of the month...**
- **... and has amplified pressures on the euro that are likely to remain in the near term**
- **Medium term, however, we still expect EURUSD appreciation due to the gradual growth rotation towards Europe**

The euro has traded softer so far in June as the dollar strengthened, especially following the surprise hawkish outcome of the FOMC meeting on 16 June. Nonetheless, EURUSD has maintained some gains so far this quarter, to the tune of 1.7%.

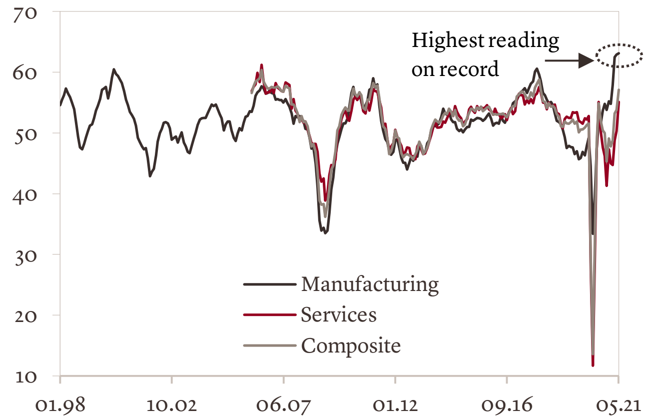
The upward revision in the median interest rate projection by the Fed in 2023 is 0.5%, i.e. it envisages two full 25-bps hikes. While this brought the Fed more in line with market expectations, it is hawkish in itself as it portrays a central bank that is no longer trying to the push back against market expectations. Consequently, market pricing moved even higher, now seeing 90 bps of hikes between December 2021 and December 2023, vs 75 bps previously. This Fed outcome has irrefutably removed an element of support for our bearish USD thesis, at least for the near term. Medium term, however, we would not "write the EUR off", and still expect the currency to resume appreciating following a period of weakness.

First, soft coincident indicators of activity (Purchasing Managers' indices/PMIs) in the euro area have surprised on the upside. The manufacturing PMI registered its highest reading on record in May (see chart 4), while the services component appears to be recovering swiftly. The flash PMIs for June rose even further. Importantly, this is happening as the lifting of Covid-19 restrictions has only just started, suggesting that further improvement in business activity should be expected during H2 21. The disbursement of NextGenerationEU funds is also likely to support confidence and growth. In sum, we expect a growth rotation towards Europe in H2 21 that should ultimately support the currency.

Second, recent US employment data – although very solid – shows it will take time for the economy to return to maximum employment (see chart 5). If data in the US manufacturing sector also shows further signs of levelling off, it is reasonable to expect that the market may start pricing out Fed rate hike expectations.

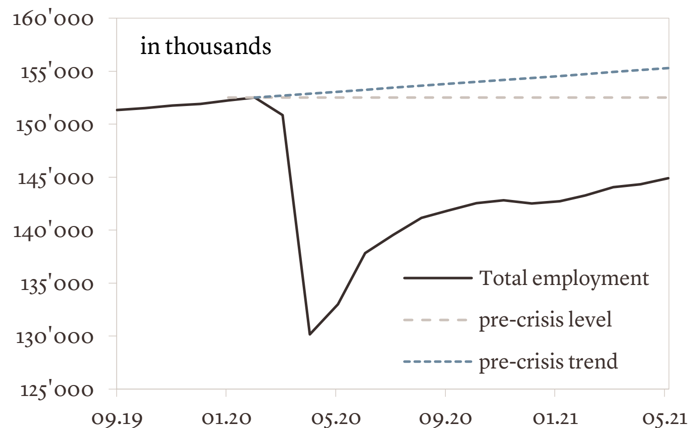
Third, momentum in Chinese imports from Germany has kept accelerating, with the annual growth rate at 47%, its highest since February 2012. As illustrated in chart 6, this has

4. A repricing lower in US rates



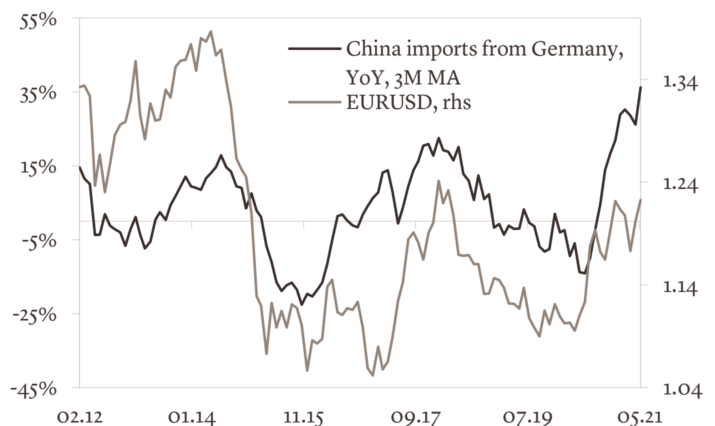
Sources: Bloomberg, Lombard Odier

5. Solid US employment gains not enough to close the employment gap near term



Sources: Bloomberg, Lombard Odier

6. Chinese imports from Germany suggest further EURUSD gains



Sources: Bloomberg, Lombard Odier

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FX majors

historically provided a good yardstick for the direction of EURUSD, and now suggests further upside in the months ahead.

Finally, euro-area equities are currently outperforming their US counterparts substantially (the MSCI EMU index has "beat" the MSCI US index by 2 ppts so far this year), and prospects remain good for this to continue in H2 21. With the eurozone having experienced large equity portfolio outflows since the flaring up of the pandemic, we think stock-related inflows are likely to return to the region, supporting the euro.

Main risks to our view: *Downside risks*: a "yield tantrum" that results in exaggerated US yield increases; the Fed gradually turning even more hawkish. *Upside risks*: An even stronger economic and trade recovery, as well as an even more efficient EU rollout of Covid-19 vaccines

CHF (Swiss franc): Target 1.12 for EURCHF by year end

- **EURCHF trades weaker so far in June**
- **However, we judge this to be only temporary**
- **We have nudged our EURCHF forecast higher to 1.12 (from 1.11) by the end of the year**

In our previous FX monthly, we argued that the CHF was approaching maximum strength and that we expected EURCHF to start rising gradually again. Challenging our view, EURCHF has dropped from near 1.10 to just below 1.09. We consider this only temporary, and reiterate our view of gradual EURCHF gains. In fact, we have nudged our forecast higher to 1.12 (from 1.11) by the end of this year. Below we explain why.

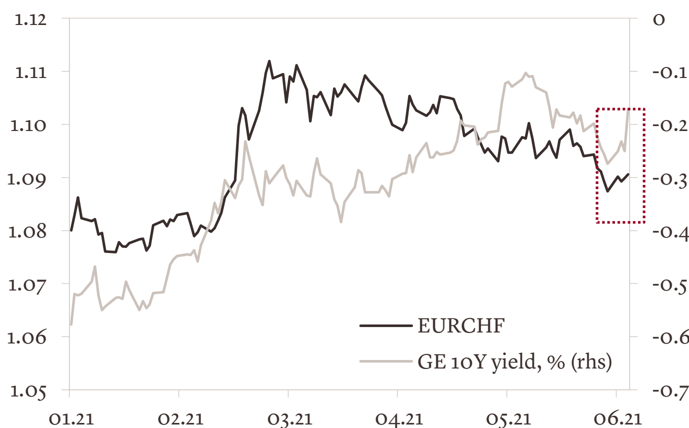
First, the move lower in EURCHF appears to be related to the move lower in Bund yields (see chart 7), which has compressed the Germany-Switzerland yield spread. However, German yields have declined in response to lower US yields rather than euro area-specific factors; we do not judge the European Central Bank (ECB) meeting to have been a game-changer. In that respect, we would make two points: 1. if indeed global factors are at play, then the narrowing GE-SZ yield differential should re-widen, as global yields move higher following the Fed outcome. 2. Euro-area growth prospects suggest that euro core yields should rise again, as Covid-19 related restrictions are being lifted in the euro area.

Second, risk assets should hold up well, even facing a hawkish Fed, as rates remain exceptionally low and liquidity is ample. Good risk appetite alongside gradually improving sentiment towards the common currency area (significant pick-up in the vaccination rollout, lifting of restrictions as well as disbursement of the NextGenerationEU funds) should support EURCHF over the coming quarters.

Finally, and as we have shown in previous articles, Swiss residents have started directing portfolio investment abroad, something that historically has been associated with appreciating pressure on EURCHF (see chart 8).

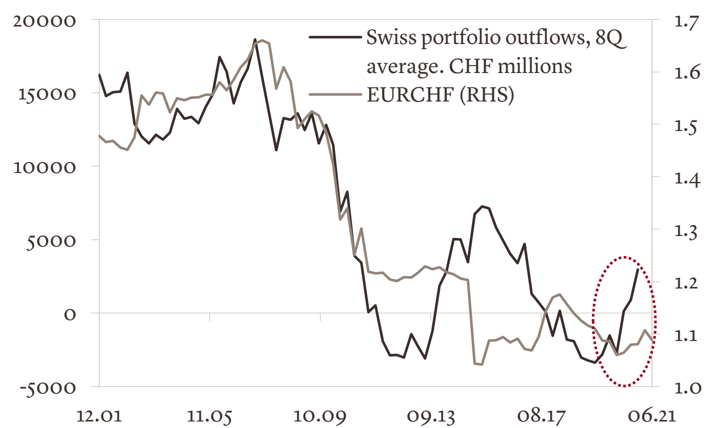
Main risks to our view: *Upside risks* to EURCHF: an acceleration of Swiss outflows, especially if the vaccination rollout in Europe gathers even more pace; a much stronger trade and growth recovery, underpinning carry trades and weighing on the franc. *Downside risks* to EURCHF: currently we see them as largely concentrated in eurozone developments. More specifically, risks are associated with a slowdown in activity and/or significant dovish turn by the ECB.

7. Decline in EURCHF related to drop in Bund yields



Sources: Bloomberg, Lombard Odier

8. Swiss residents directing portfolio flows abroad



Sources: Bloomberg, Lombard Odier

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FX majors

GBP (pound sterling): Remaining neutral on sterling

- **We remain neutral on sterling...**
- **... as we think a number of factors will set a speed-limit for currency gains**

In recent weeks, calls for a higher sterling have increased; we beg to differ. Although we do not expect any material depreciation over the medium term, we do not think GBP is likely to make substantial and sustainable headway from here.

For starters, the swift opening of the economy due to the successful vaccination programme is now largely in the price (the recent delay in the final stage of lockdown lifting is unlikely to affect the economy materially). This is evidenced by GBPUSD being the only G10 currency to appreciate against the dollar in Q1 21, i.e. in a period of USD strength.

Furthermore, Brexit-related headwinds remain in place and are unlikely to fade any time soon. The recent rift between the UK and the EU on the implementation of the Northern Ireland protocol is a reminder of the difficult road ahead. While we do not expect similar headlines to have much near-term impact on sterling, we believe they will set a speed limit on GBP gains.

Moreover, from a technical standpoint, TW GBP is now trading at the upper end of its post-Brexit referendum range (see chart 9), suggesting that a new catalyst may be needed for appreciation to gain momentum from here.

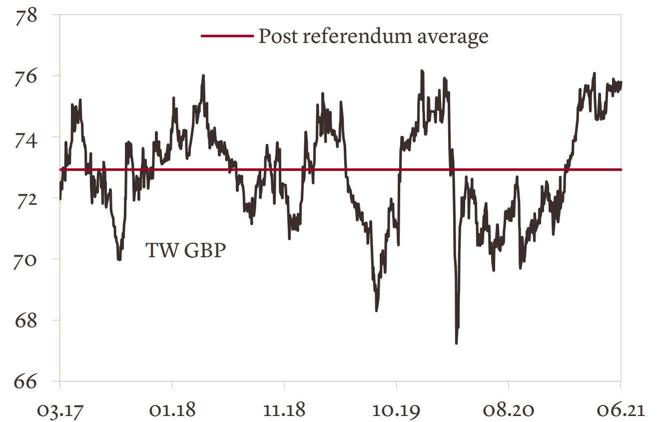
That catalyst would take the form of a hawkish shift by the Bank of England (BoE). However, recent price action shows that the market has already moved in that direction and the risk appears tilted towards disappointment (see chart 10). In fact, we find it difficult for the bank to signal tighter monetary policy ahead before allowing the economy to run unrestrainedly and assess the macro environment. Nonetheless, we stress that the BoE stance currently represents the biggest upside risk to our sterling view.

Main risks to our view: We see three *upside risks* to our forecasts: BoE tightening expectations rising; UK economic activity surprising significantly on the upside in the **Second** half of the year; and a faster dollar depreciation than we currently envisage. *Downside risks* relate to a shallower-than-expected UK rebound, and the Fed gradually turning even more hawkish.

JPY (Japanese yen): Turning more neutral

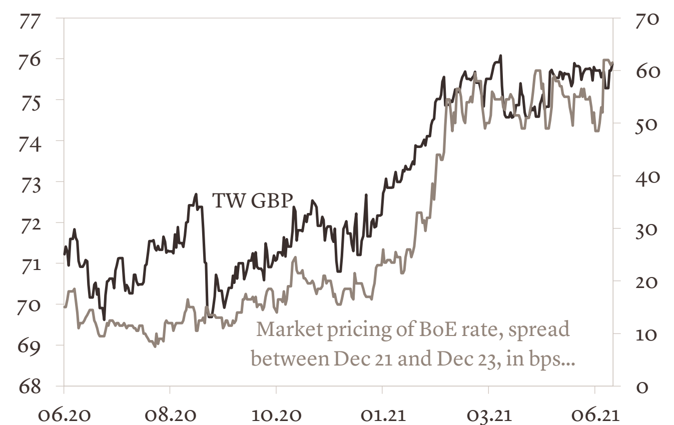
- **We are turning more neutral on the JPY**
- **While fundamental drivers still argue for USDJPY downside...**
- **... near term, the upside pressure from outward M&A activity in Japan is taking its toll on the currency**

9. TW GBP now at the upper end of this post-referendum range



Sources: Bloomberg, Lombard Odier

10. BoE rate hike expectations may prove difficult to sustain



Sources: Bloomberg, Lombard Odier

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FX majors

We are turning more neutral on USDJPY and have revised our forecasts higher, although we still maintain a very small downside bias.

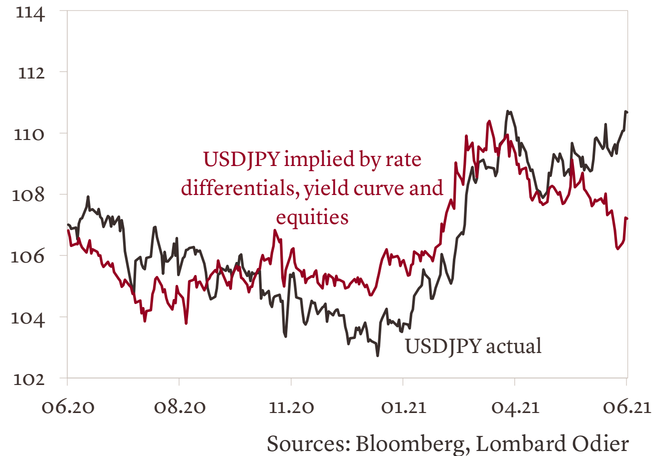
USDJPY is certainly dislocated from underlying fundamentals. Our long-term fair value model estimates an overvaluation of close to 20%, while our shorter-term model (see chart 11) suggests that the currency pair should be trading closer to 107.

However, the solid backdrop of strong global trade and GDP growth has resulted in a flurry of outward M&A activity in Japan. So far this year, the total volume of M&A deals agreed by Japanese firms for acquiring foreign companies stands at more than USD 56 bn, an increase of 85% compared to the same period last year. JPY selling by Japanese corporates has certainly weighed on the yen, and will likely remain a source of downside pressure for the near future.

Consequently, we prefer to stay on the sidelines for the time being, especially since USDJPY has a very high sensitivity to US yields that are currently on the rise. Medium to long term, we still expect USDJPY to revert somewhat lower because of strong fundamental drivers.

Main risks to our view: *Downside risk to USDJPY*: Outward M&A activity subsiding. *Upside risks to USDJPY*: further pick-up in outward M&A activity; the Fed gradually turning more hawkish.

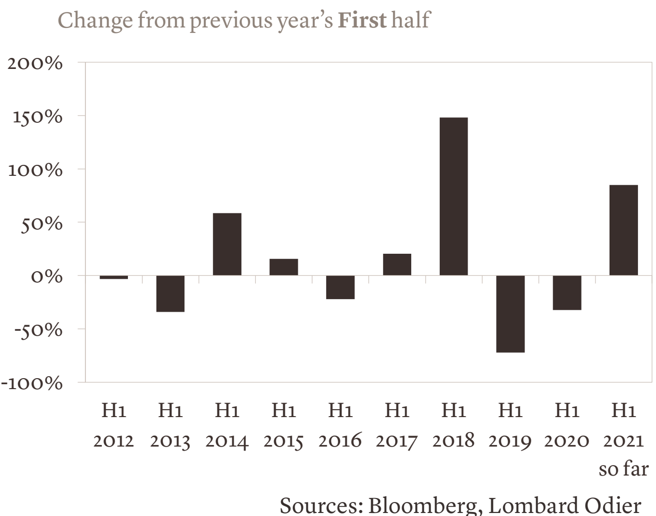
11. A notable discrepancy between USDJPY and underlying fundamentals...



Sources: Bloomberg, Lombard Odier

12. ... which however may persist due to the sizeable outward M&A related flows

Change from previous year's **First** half



Sources: Bloomberg, Lombard Odier

Nordic currencies: To drift higher still

- **NOK and SEK to suffer near term due to the hawkish Fed**
- **Medium term, however, the global backdrop argues for some modest appreciation**

NOK (Norwegian krone): NOK appreciation has stalled recently: following the June Fed meeting, USDNOK rose back to 8.50 from 8.30. Pressures are likely to persist in the near term as US yields rise. That said, we still expect some modest appreciation until the end of the year. This medium-term constructive view on the currency is based on the following. **First**, the Brent crude oil price has risen further, and is now in excess of USD 75 p/b; strong global demand should maintain support going forward. **Second**, risk sentiment should hold up well. **Third**, the NOK is a highly cyclical currency and dependent on European growth. With the growth cycle in full upswing and euro-area growth ready to take off, the krone should find renewed support. Finally, the Norges Bank in its latest meeting flagged that the **First** rake hike is likely to take place in September, earlier than expected by the market. This decision largely reflects the strong momentum, exhibited by house price increases (see chart 13). All this should support the krone in the medium term.

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FX majors

SEK (Swedish krona): Similarly, the SEK has fallen victim to the recent dollar rally. Pressures are likely to remain in the short term, perhaps to a higher degree than NOK given a still-dovish Riksbank. However, the pick-up in euro-area growth that we anticipate in H2 21 suggests the probability of positive spillovers to the currency, which is highly geared to European growth.

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 risk appetite. The Fed gradually turning more hawkish is also a risk for both currencies, which are quite risk-sensitive.

Commodity currencies: Near-term pain; medium-term more constructive

- **Nera term commodity FX is likely to face headwinds...**
- **... but absent a further hawkish Fed surprise, further modest appreciation is likely**

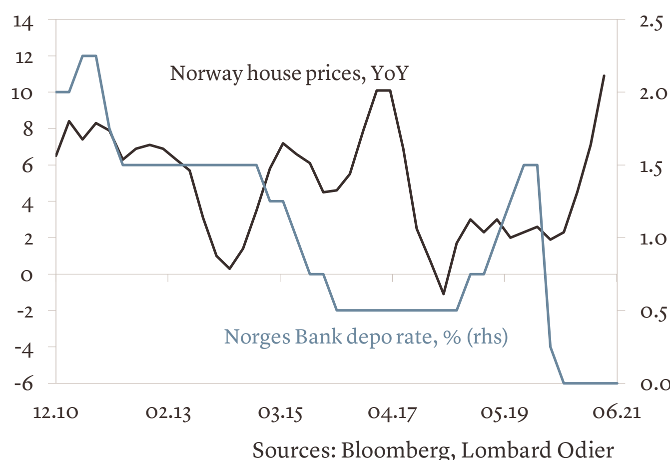
AUD (Australian dollar): AUD has naturally suffered from the hawkish result of the Fed meeting, and AUDUSD is now trading at 0.76. We expect these pressures to remain as US yields re-price higher. At the same time however, global dynamics remain strong and should offer support in the medium term. These supportive factors include increasing base metal demand, the upswing in trade volumes, and risk sentiment holding up well. Finally, recent labour market data shows a material pick-up in employment gains, which, further down the road, could temper the Reserve Bank of Australia's current dovishness.

CAD (Canadian dollar): Despite oil prices rising, USDCAD has appreciated from near 1.20 towards 1.23. Near-term USD strength could push the pair even higher. That being said, the trade and commodity price upswings are likely to provide some additional support. We maintain our USDCAD forecast at 1.20 by the end of Q3 21.

NZD (New Zealand dollar): The mixture of recent NZD downside due to USD strength and the hawkish tone by the Reserve Bank of New Zealand in its late-May meeting suggest that NZDUSD is caught between opposing forces. We maintain our forecast unchanged at 0.73 as valuation is already somewhat stretched; we estimate NZD to be overvalued by around 8% presently.

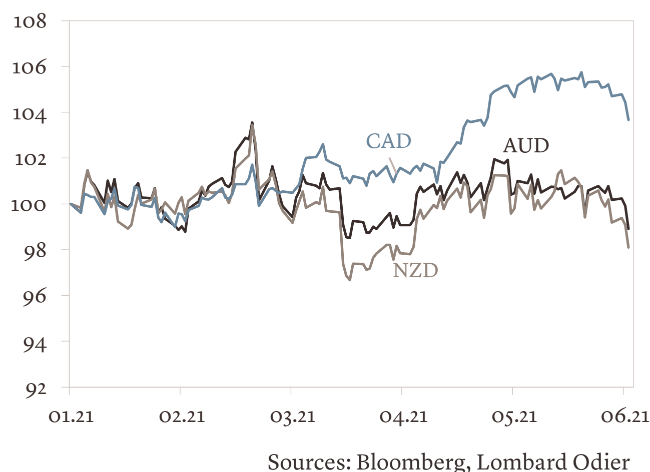
Main risks to our view: *Upside risks* to our forecasts could materialise if the growth recovery is sharper and the dollar depreciation deeper than we currently envisage. Downside surprises stem mostly from further hawkish surprises by the Fed that would put pressure on cyclically sensitive currencies.

13. Momentum in house price rises implies a high risk of an earlier rate hike by the Norges Bank



Sources: Bloomberg, Lombard Odier

14. Recent USD strength is weighing on commodity currencies
Spot vs the USD; normalised at 100 on 1 January 2021



Sources: Bloomberg, Lombard Odier

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Commodity corner

Gold back to year highs: all eyes on the Fed's next move

- **Gold continued to benefit from lower real rates and higher inflation expectations at end-May and in early June. But the slight change in Fed tone at the June FOMC meeting suggests that we have the seen the lows in real rates**
- **As we advance in the recovery, real rates should take over inflation expectations as the main driver for gold prices.**
- **We maintain our bearish view (target USD 1,600/oz by the end of the year, and reiterate our recommendation to alleviate exposures in portfolios that still embed material positions.**

Growing inflation fears have carried gold prices back into positive territory year to date. Since the release of the May job report, however, these inflation concerns have eased somewhat, reflecting the realisation that a key channel for transitioning from a transitory to a more sustained inflationary regime – namely a buoyant labour market – is so far missing (see Investment Strategy Bulletin: Risk scenarios on inflation>what can go wrong?). The downward-sloping inflation breakeven curve also corroborates our call in favour of a transitory phenomenon.

It is clearly very difficult to time when gold's downward trend will resume, but history shows that as we advance in the recovery, real rates should take over from inflation expectations as the main driver of gold prices (chart 15). While real yields may have hit their lows in the **Second** quarter of 2021, we will probably have to wait for the announcement of the asset purchase tapering to see a sustained rise in real rates. True, the Fed has been particularly active in TIPS (Treasury inflation-protected securities) and now owns more than 25% of this market. In addition, the cost of carry yield associated with holding short TIPS positions is prohibitive, since monthly CPI prints are still substantial and likely to exceed expectations. Only a rapid move higher on real rates would mitigate these losses. As experienced in the past, a clear shift in the monetary stance can spur such a move.

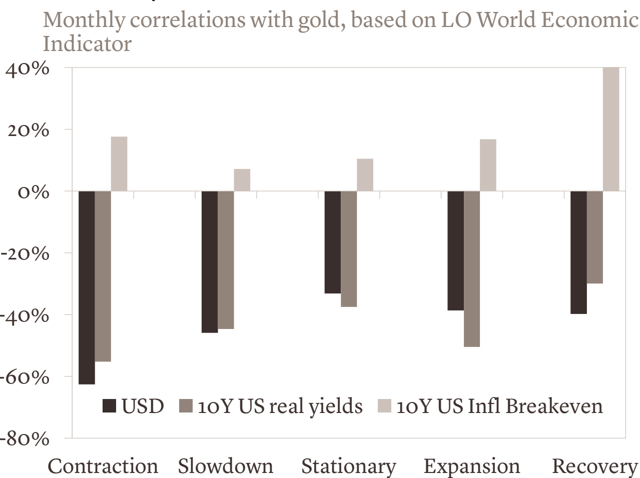
Still, the June FOMC taper tantrum of 2013 is on every investor's mind – and also on the minds of Fed officials. We believe the latter should be able to avoid such a volatile episode, and the latest FOMC communication might be the **First** step in the Fed's change in tone. Even if the move may be more gradual this time, medium term, the direction of travel of real rates is clearly higher, and thus lower for gold prices. In this context, we expect our USD 1,600/oz target to be reached by the end of the year (chart 16).

Strategically, gold can be considered in investors' portfolio allocation as one of the best alternatives to government bonds in periods of zero rates. But tactically, in a rising real rate environment, it might prove unable to act as a hedge. For this reason, we are currently underexposed to gold, and consider current levels as opportunities to alleviate positions in excess.

Main risks to our view: an external shock leading to another rise in inflation while the Fed sticks to its 'average inflation targeting' framework (surge in inflation expectations, collapse of real rates)

15. As recovery advances, real rates should become the main driver

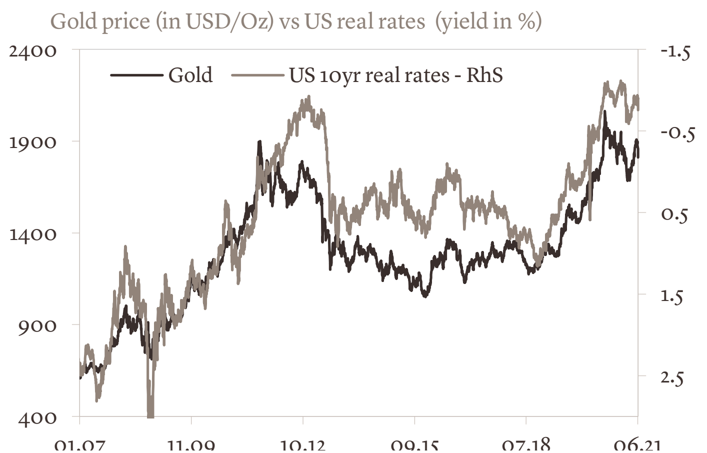
Monthly correlations with gold, based on LO World Economic Indicator



Souces: Bloomberg, Lombard Odier calculations

16. Gold is less useful as a hedge in multi-asset portfolios when real rates normalise

Gold price (in USD/Oz) vs US real rates (yield in %)



Sources: Bloomberg

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

Commodity corner

The reopening generates strong demand for oil. Yet we are very far from a shortage situation

- **The risk of overshooting we identified for the reopening period is materialising**
- **Demand for oil is accelerating, and the OPEC+ continues to increase production gradually**
- **High prices and improved balance sheets challenge the capital discipline advocated among the US shale producers**

Optimism fuelled by the reopening and its consequences in terms of acceleration in oil demand recovery has lifted oil prices beyond the 60-70/bbl range in place since the beginning of the year (chart 17).

Even if mobility data continues to hint at improved outlook for oil demand, the OPEC+ is maintaining its gradual increase in production. Officials have clearly stated that, "There will always be a good amount of supply to meet demand, but we'll have to see demand before you see supply". This validates our pre-existing view that temporary overshoots above USD 70/bbl like the one we are currently experiencing were likely.

Still, we are far from a situation of shortage on oil markets. OPEC+ spare capacities are large enough to offset the incremental demand forecast by the IEA (+5.4 Mb/d). This was also the message conveyed by oil major managements.

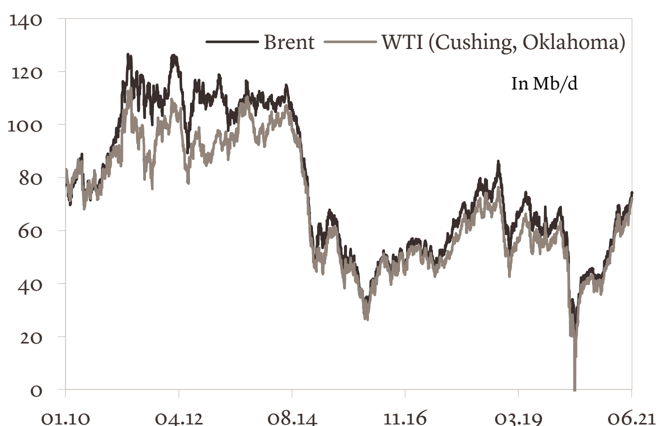
We understand that in the context of Covid-related extraordinary spending, the governments of oil-producing countries are enjoying current price levels. But the recent decisions also suggest that the members do not fear a return of US shale production in the near future.

Even though the US shale industry keeps on advocating capital discipline, it is becoming obvious that some producers will have the capacity to increase production as their balance sheets are improving rapidly. The record lows reached on high-yield financing rates and very active primary markets makes a future rise in US production capacity quite inevitable (chart 18).

We thus believe that the current overshoot should prove short-lived, such that the risk/reward of long positions looks very limited from current levels. However, we believe that other oil-linked assets in the credit or equity universe – not to mention specific currencies – should perform well on prices trading above USD 60/bbl in the near future.

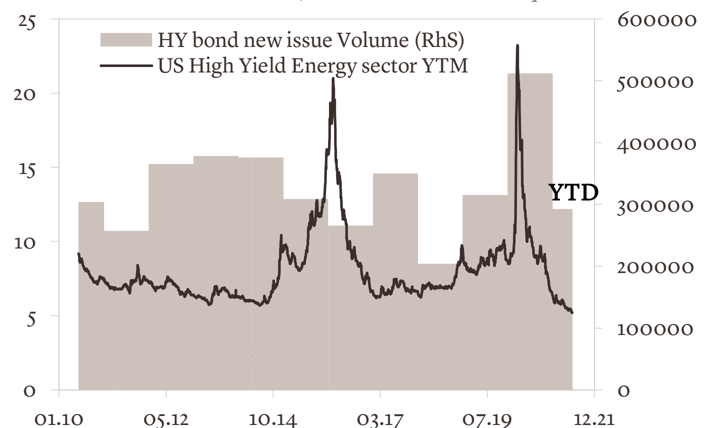
Main risk to our view: diverging interests leading to a very dysfunctional OPEC+ when the market is back at equilibrium and the return of Iranian production requires some adjustments by other members.

17. Oil prices broke their recent range
Brent and WTI prices in USD/bbl



Source: Bloomberg

18. Very accommmodative financial conditions helped US shale producers
HY bond new issue volumes, face values (USD mn equivalents)



Source: BofA ML, Bloomberg

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

EMFX: Three key charts

GBI EMFX – downside risks in H2, but data surprises still suggest support in place for now: Our GBI EMFX model has flagged decent gains over H1, driven notably by the consensus forecast for a sharp recovery in EM growth over Q1 (up to five percentage points from a prior-decade average of two percentage points). However, in H2, a narrowing of EM-US growth differentials and higher US yields will mark a more challenging backdrop for GBI EMFX. While some countries (e.g. Brazil) are seeing major growth upgrades and better fiscal metrics than thought just a few months ago, when we look at bottom-up estimates and aggregate them to the index level, we still find that the EM-US GDP differential narrows after Q3. That should lead our model to signal a more challenging backdrop for EMFX.

The caveat here is that while 2021 GDP forecasts are being revised, those for 2022 have been largely unchanged. We will continue to monitor this situation.

EMFX sensitivity to US yields: We do not expect a 2013-type tantrum given strong global growth, higher commodity prices, and better internal and external balances compared to 2013. EM central banks are also more proactively hiking policy rates, and have had, for the most part, inflation within target until recently. Hence, we do not think the 2013 template will apply for EMFX.

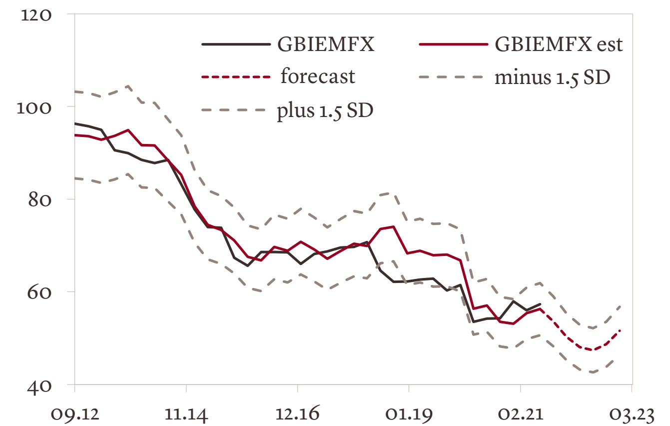
Instead, we gauge the sensitivity of various EMFX by calculating the beta of 3M volatility-adjusted spot returns to 3M volatility-adjusted changes in both US 10Y nominal as well as real yields.

Chart 20 shows that INR, IDR, MYR, and KRW (in Asia); CLP, PEN, and COP (in LatAm); and HUF, PLN, and TRY (in CEEMEA) show the highest sensitivity to a move in US real yields on a volatility-adjusted basis. Betas to simple 10Y yields are less reliable, hence the tracking of US real yields remains of key importance for EMFX.

EMFX differentiation: In LatAm, we upgrade the PEN (from 'cautious' to 'modest performers'). The trigger is cheap valuations and markets likely already pricing in a worse political scenario than is plausible.

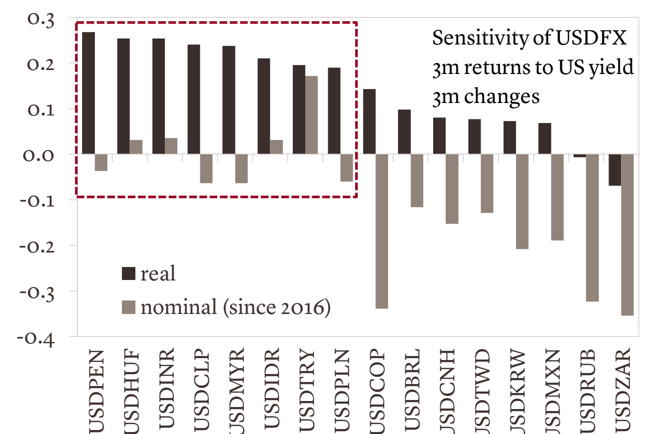
In CEEMEA, we leave our preferences unchanged and continue to favour the RUB, PLN, CZK, and ILS. In Asia, we retain our preferences as well, with RMB still our top pick as the currency has a lower beta to US rate volatility.

19. GBI EMFX model signals decline from Q3 onwards



Sources: Bloomberg, Lombard Odier

20. EMFX sensitivities to higher US yields



Sources: Bloomberg, Lombard Odier

21. EMFX – four buckets of EM currencies

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

(unchanged, upgraded and downgraded from prior month)
Sources: Bloomberg, Lombard Odier

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

Asia FX

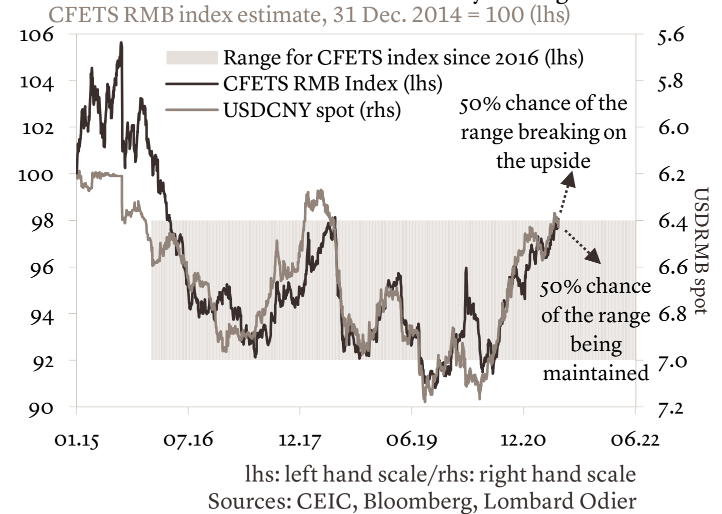
- **CNY, KRW, TWD, and SGD remain the best Asian currencies for navigating the market's gradual transition to the Fed's policy normalisation, thanks to their robust fundamentals**
- **We are neutral on IDR, THB, and MYR, but we acknowledge modest tailwinds from the rally in industrial commodities. We remain slightly bearish on PHP**
- **The vaccine roll-out, the US-China strategic competition, and intermittent scares about premature monetary policy tightening will be key risks for the region's currencies**

RMB: Beijing's stability focus provides an anchor for investors

We maintain our constructive forecasts for the yuan renminbi (RMB), as macro and policy scenarios point to the currency's further appreciation in 2021. **First**, we believe that trade-related scenarios remain asymmetrically favourable to the yuan. Strong global growth should be positive for the currency due to China's competitive export sectors. More importantly, our macro team sees the yuan strength as the most expedient pathway for a bilateral compromise on trade between China and the US, as it would accelerate economic transitions that both Beijing and Washington D.C. desire in the medium term. For this reason, we still designate a 50% probability to the yuan breaking out of its five-year range at some point over the next 12 months – despite recent noises about other geopolitical issues between the two countries (see chart 22). **Second**, the recent hawkish shift in Beijing's policy stance will be a key anchor for the currency. Given Beijing's continued focus on medium-term financial stability, we expect the ongoing steady credit tightening to be maintained for the remainder of the year. We note that the yuan tends to strengthen in episodes of credit growth deceleration (see chart 23). **Third**, capital flows will add to the currency's strength and stability. Foreign investors' presence in China's onshore bond market has been expanding steadily thanks to the inclusion of RMB bonds in key global indices. Beijing's widening of relevant quotas for foreign institutional investors has also contributed to this trend. Recent accumulation of USD deposits by domestic corporates does not seem sustainable, and points to eventual conversion to RMB.

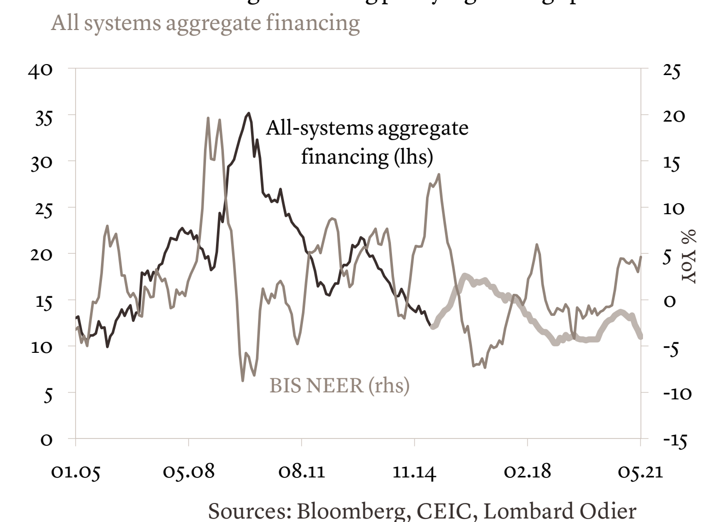
Main risks to our view: We do not believe that China's recent adjustment in FX reserve requirements signals a substantial turn in the People's Bank of China's FX policy stance. Unexpected serious geopolitical flare-ups between China and the US (e.g. Taiwan, South China Sea, other maritime borders)

22. Will CFETS RMB index break out of its 5-year range in 2021?
CFETS RMB index estimate, 31 Dec. 2014 = 100 (lhs)



lhs: left hand scale/rhs: right hand scale
Sources: CEIC, Bloomberg, Lombard Odier

23. RMB tends to strengthen during policy-tightening episodes
All systems aggregate financing



Sources: Bloomberg, CEIC, Lombard Odier

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

Asia FX

or a re-escalation of tit-for-tat tariffs would be key risks for the yuan. We do not believe that the pandemic or rising global yields pose significant risks to the currency for the time being. Beijing's action on the possible debt restructuring of large asset management companies and property developers should be monitored closely given their sizes.

KRW: Upside risk as the Bank of Korea readies for a rate hike

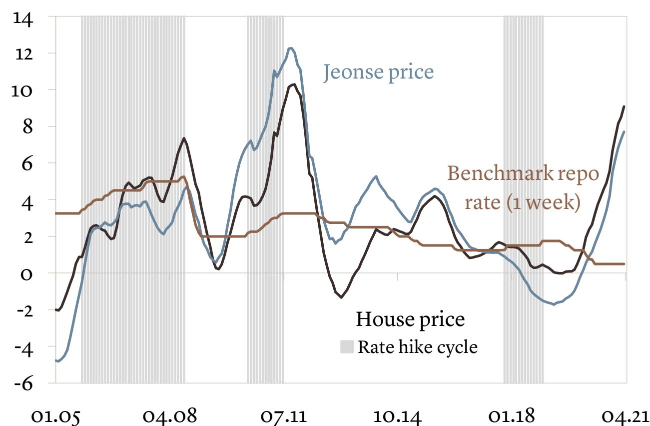
The Korean won (KRW) has performed poorly vs the USD year to date, but we expect the currency to regain its momentum in the remainder of the year. **First**, the policy elite are now primed to favour the use of monetary policy to counter the rally in real estate prices and strong growth in household debt after the ruling party's crushing defeats in April municipal by-elections. The elections were widely seen as the public verdict of the government's housing policy, and the Bank of Korea (BOK) will be under pressure to play its part in fighting real estate speculation ahead of its leadership change in April 2022. Two of the BOK's last three rate hike cycles coincided with a sharp rise in housing prices (see chart 24). **Second**, the country will benefit strongly from global recovery in 2021 thanks to its relatively diversified export sector (both high-tech and cyclical industries). We note that KRW shows the highest positive correlation among its Asian peers to global trade volume growth. **Third**, the KRW was the best-performing Asian currency during the 2013 "taper tantrum" episode, as it benefits from both strong macroeconomic fundamentals consistent with the Fed's normalisation and the Bank of Korea's floor for KRW value in volatile FX market environments.

Main risks to our view: Geopolitical risks surrounding China and North Korea will remain a key menace 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. Pronounced JPY weakness could be a risk for KRW as it is KRW's main regional rival.

TWD: Global growth and "Stimulus 4.0" to boost TWD further

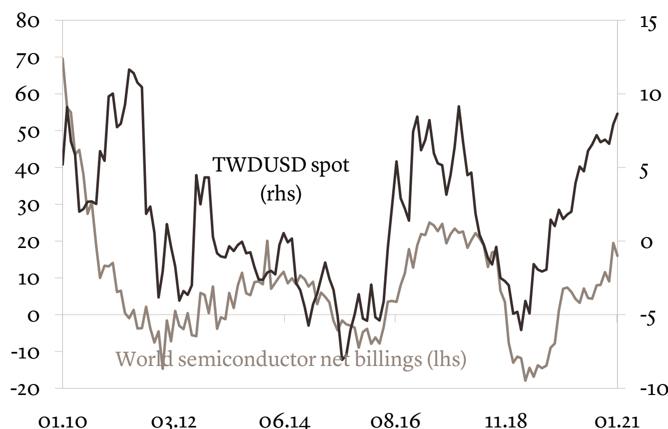
Now that Taiwan has begun to bring the recent Covid-19 outbreak under control, we believe that the New Taiwan dollar (TWD) will resume its structural appreciation vs. USD. **First**, TWD benefits from one of the world's most resilient economies. After 92 consecutive quarters of current account surpluses, Taiwan's net accumulated financial claim on the rest of the world (i.e. net international investment position) is more than twice the country's nominal GDP. Moreover, the country's FX reserves are large enough to cover its external

24. Housing price appreciation tends to trigger BOK's rate hikes
Housing and rental price appreciation for 6 major cities, % YoY, policy rate, %



Sources: Bloomberg, CEIC, Lombard Odier

25. Strong semi cycle means strong TWD
Semi net billing growth, % YoY (lhs), Change from 1 year ago, % YoY (rhs)



Sources: CEIC, Lombard Odier

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

Asia FX

debt nearly three times over and its imports for 22 months. **Second**, the cyclical backdrop for Taiwan remains robust despite the expected modest hit to domestic demand in Q2. The country is benefitting from the ongoing boom in semiconductor exports, and TWD will be well supported as long as the global dash for chips continues (see chart 25). Domestic demand will recover as vaccinations and mobility improve together, and the effects of the government's "Stimulus 4.0" relief package filter through the economy. **Third**, the Biden administration's discomfort with Asian countries' currency management practices will create some pressures for Taiwan's central bank to tolerate TWD strength, and this has indeed been the signal from Governor Yang. The prospect of a stronger TWD is also discouraging Taiwan's life insurance companies from adding more foreign assets to their balance sheets.

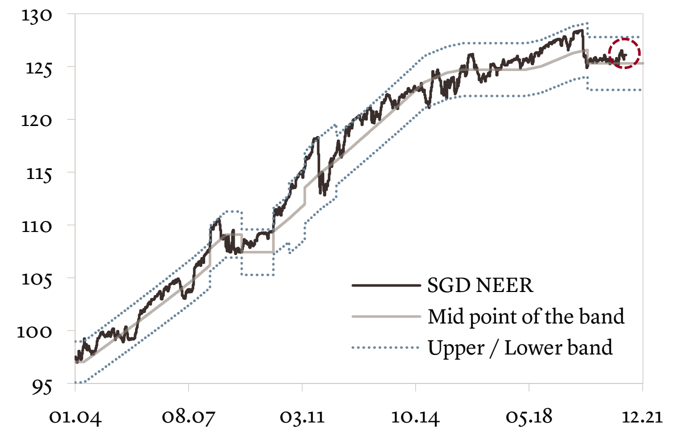
Main risks to our view: Main risks are an unexpected sharp deterioration in public health conditions and negative spillover to semiconductor production; potential direct confrontation with China; further escalation of tensions between the US and China; and a shift in the US stance on Taiwan's currency policy.

SGD: Eventual testing of the upper bound despite the new small wave

We expect the Singapore dollar (SGD) to appreciate in the next 12 months as the recent virus outbreak begins to stabilise under the government's effective mobility restrictions. **First,** we expect the Monetary Authority of Singapore (MAS) to start guiding the markets towards policy normalisation later this year. While there was no change in the MAS's April meeting, it began to introduce a temporal dimension to its current "accommodative stance". This supports our view that the SGD nominal effective exchange rate (NEER) curve will test the upper bound of the current target range (see chart 26). If so, the possible testing of the upper band of the SGD NEER curve would create 1.5-2.0 ppts of additional downside for the USDSGD spot rate. **Second**, growth recovery will add to markets' confidence that the MAS will return to its policy of long-term nominal appreciation for the SGD. The country has been enjoying a strong rebound in economic activity since the **Second** half of 2020, and buoyant external demand has been supporting double-digit growth in domestic non-oil exports. **Third**, as one of Asia's large surplus countries with competitive positions in high value-added exports, Singapore will provide a firm fundamental anchor for the SGD's performance through the possible market volatility related to the Fed's policy normalisation announcement.

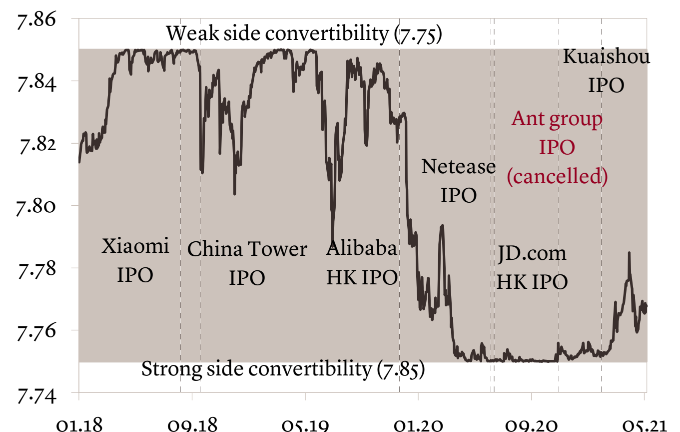
Main risks to our view: Main risks are further tightening of social distancing restrictions, performances of major currencies in the SGD NEER basket, the US stance on

26. SGD NEER curve starting to show some movement
SGD NEER curve and estimated MAS policy bands



Sources: Bloomberg, Lombard Odier

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



Sources: Bloomberg, Lombard Odier

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

Asia FX

Singapore's unique FX policy framework, and public health and macroeconomic conditions in the surrounding South-Asian economies.

HKD: Gradual reversion to the middle of the convertibility zone

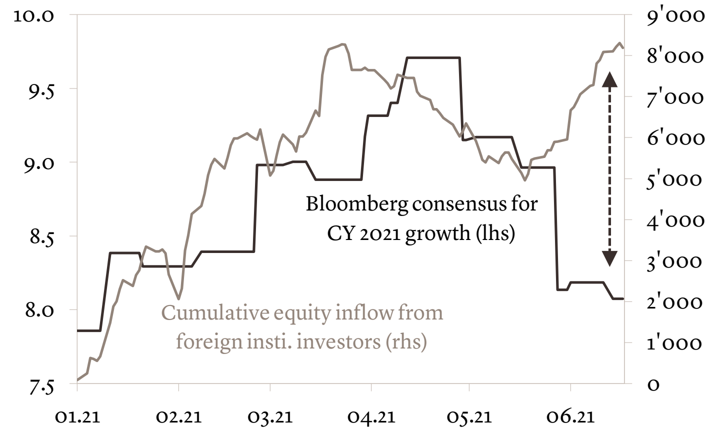
We expect the HK dollar peg to the US dollar to remain in place for the foreseeable future, but we believe that USDHKD will gradually move to the middle of the Hong Kong Monetary Authority (HKMA)'s convertibility zone, i.e. 7.80. **First**, the temporary scarcity of liquidity related to various IPOs will eventually ease towards year-end, when the bulk of expected marquee listings are complete (see chart 27). This is so even though additional listings of large tech companies could introduce intermittent episodes of temporary strength in the currency. **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. **Third**, HKD tends to soften slightly vs the USD in times of strong global trade growth, as local investors look for investment opportunities elsewhere.

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. We do not believe there is a high risk of another unexpected tax hike like the stamp duty on trading.

INR: Growth forecast revision and Fed's shift being priced in

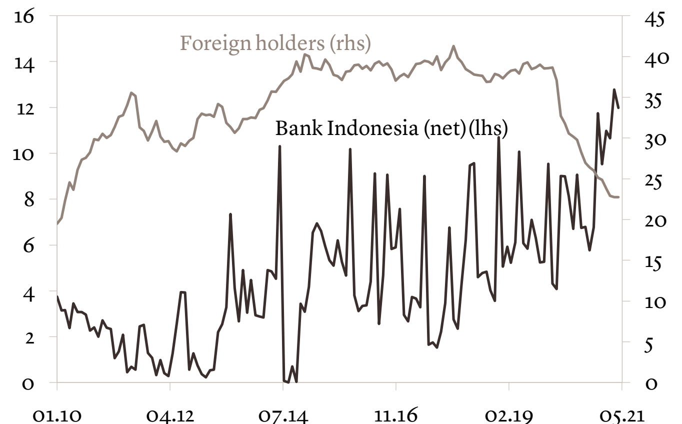
We now see the Indian rupee (INR) registering only a limited recovery vs the USD in the remainder of the year, despite the ongoing stabilisation of India's public health conditions. **First**, equity markets have probably frontloaded the H2 2021 rebound somewhat excessively, while the country is heading into a tricky summer season of possible Monsoon disruption of the vaccine roll-out, on top of the Fed's taper discussions. Although we expect a strong rebound in H2, an argument can be made that the positioning for INR and Indian stocks is heavy at this juncture and vulnerable to negative catalysts (see chart 28). **Second**, the Reserve Bank of India (RBI) will have no choice but to maintain its support for domestic liquidity while the country faces the dormant threat of another large Covid-19 outbreak without sufficient progress in vaccination. We expect the RBI to keep its benchmark rates on hold for an extended period and launch another secondary market support measure for the government bonds (G-SAP 2.0). **Third**, another positive catalyst is unlikely in fiscal policy after the passage of the new budget at the end of January and the Modi cabinet's likely reluctance to test the patience of

28. Surprisingly resilient equity inflows at the risk of reversal?
Net equity inflows, USD mn (lhs), Bloomberg implied CY consensus (rhs)



Sources: CEIC, Bloomberg, Lombard Odier

29. Dramatic change in the bond market ownership in Indonesia
Outstanding tradeable IDR bonds by ownership, % of total



Sources: Bloomberg, CEIC, Lombard Odier

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

Asia FX

credit rating agencies that must be watching the ongoing outbreak with concern.

Main risks to our view: We do not believe 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 infection wave. 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

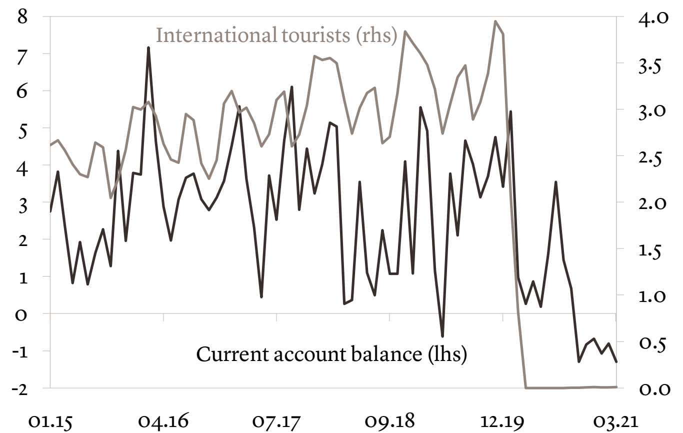
We expect only modest appreciation for the Indonesian rupiah (IDR) in 2021 vs the USD. We see three reasons for the currency's limited gains. **First**, the latest government bond auction revealed that Bank Indonesia (BI) remains the essential buyer in the primary market, filling in the gap left by more hesitant foreign investors (chart 29). While foreign investors' misgivings regarding the burden-sharing agreement between BI and the government have faded somewhat, the wall of new bond issuances will require significant excess domestic liquidity from the BI. This makes IDR relatively vulnerable to the market gyrations over the Fed's normalisation plans. **Second**, Indonesia is unlikely to make a quick escape from the Covid-19 epidemic – even if the overall infection rate is somewhat better than those in the US, Europe, and other emerging markets. The logistical challenges of pre-vaccine containment efforts and vaccine roll-out are substantial, and the country will not be able to return to its GDP trend until 2022 due to this fragility. **Third**, the currency's downside is also limited due to a relatively higher real rate trajectory in 2021 and its sensitivity to the global cyclical upturn and bulk commodity prices.

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, especially after the Fed's hawkish signal.

THB: Headwinds persisting

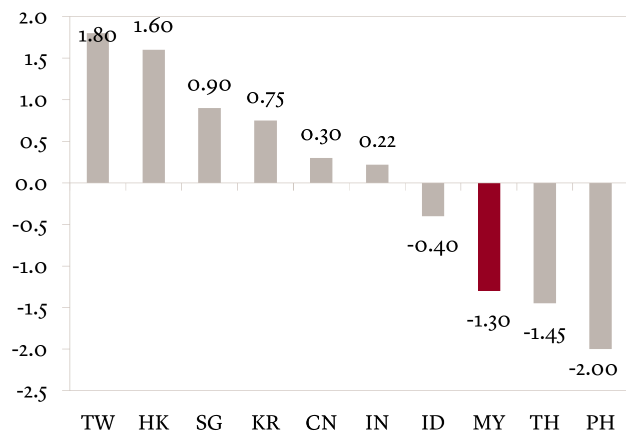
We lower our forecast for the Thai baht (THB) even though the currency is still likely to appreciate slightly vs USD in the remainder of the year. **First**, Thailand's macro outlook will be extremely sensitive to vaccine developments due to its tourism sector, but relatively slow vaccination roll-out in major emerging markets will likely push back the timing of full

30. Thailand could register current account deficit in 2021
Current account balance, USD bn (lhs), Foreign visitors, million (rhs)



Sources: Bloomberg, Lombard Odier

31. Malaysia has seen the worst growth forecast revision for 2021
Change in consensus outlook for 2021 real GDP growth, ppts



Sources: Bloomberg, Lombard Odier

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

Asia FX

recovery in tourism until 2022 or even 2023. Thailand registered six consecutive months of current account deficit until April this year due to the lack of recovery in international tourism (chart 30). **Second**, the local epidemic curve does not seem to be flattening easily, and the resulting delay in re-opening will likely cap Thailand’s 2021 growth. **Third**, the Bank of Thailand is unlikely to cut its rates further, but is keen to keep the THB as competitive as possible to help the country maximise the ongoing recovery’s benefits. Domestic investors have reacted to the Bank of Thailand’s relaxation of FX regulations by snapping up foreign assets, creating significant portfolio outflows.

Main risks to our view: Main risks are the government’s response to the new infection wave, political stability after the street protests, and retail-driven portfolio outflows.

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

We expect the Malaysia ringgit (MYR) to post only a modest gain against the USD in 2021. **First**, the fragility of the new governing coalition points to the material risk of a snap election in 2021. Although the declaration of a public health 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 the MYR. That said, the impact of these developments is not yet visible on the currency. **Second**, the ongoing boom in the global goods and industrial commodity trades will boost the country’s exports, but Malaysia has suffered a major negative revision of its growth outlook due to Asia’s worst Covid-19 wave (chart 31). **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. In sum, the currency will neither gain nor lose significantly as positive and negative factors offset each other.

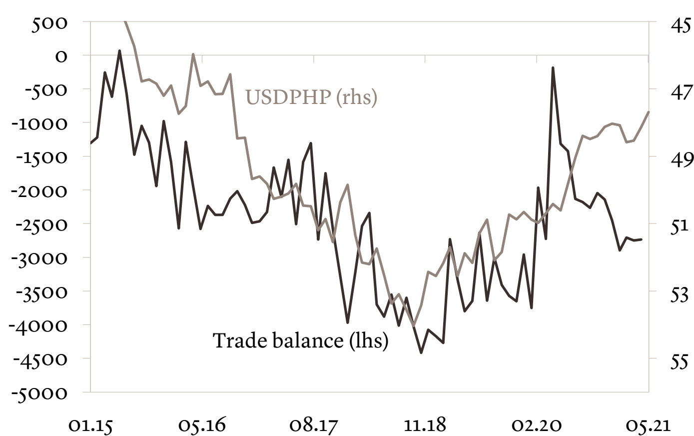
Main risks to our view: Main risks are the break-up of the current coalition government and a snap election; the trajectory of local confirmed cases of Covid-19; oil price trends and their impact on the government’s fiscal balance; and global demand for the country’s industrial commodities and mid-end manufactures.

PHP: Countercyclical outperformance likely to reverse

We believe that the end of the period of surprising outperformance for the Philippine peso (PHP) is near, even though we do not see significant depreciation in the next twelve months. **First**, the country has not been able to stabilise its Covid-19 epidemic curve completely, and continues to face significant logistical challenges in the nationwide deployment of vaccines. **Second**, its 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 32). **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.

32. 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.

LatAm FX

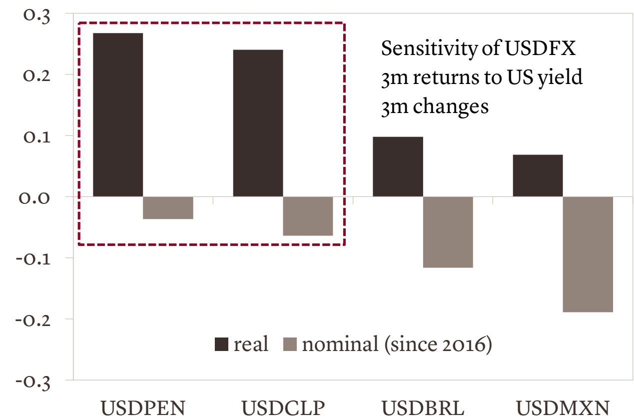
- **This month, we upgrade the PEN to "modest performer" on valuation and potential ebbing in political uncertainty**
- **We revise up our BRL forecasts given an abrupt fundamental upward re-rating on both 2021 growth and fiscal numbers. Risks are to the upside.**
- **We continue to like the MXN, given its still-attractive valuation and positive spillover from US growth**
- **By contrast, we are more negative on the CLP and COP given extended positioning and scope for negative political news**

BRL (Brazilian real): Revising forecasts on abrupt growth upgrades

We had already upgraded our BRL view in April (shifting it up from "EMFX underperformer" to the "cautious" category), as tail-risk fiscal outcomes for 2021 had been averted (i.e. emergency fiscal policy use and spending cap breach). However, over the past few weeks, there has been a more fundamental upward re-rating on the economy reflecting data surprises. Our economists have revised up their 2021 GDP forecast to 5.2% (from 3.2%). However, consensus forecasts still stand lower, and we should expect upgrades to persist in the weeks ahead (chart 34). Coupled with higher inflation, government debt (as a percentage of GDP) is also being revised down substantially, to around 85% for 2021 (from near 90% previously). This is an important part of our USDBRL valuation model, and we now see USDBRL fair value for year-end at 5.00 (down from 5.60 – chart 35). Assuming slower growth in 2022 and a slow creep higher in debt ratios, our projected 2022 fair value would stand at 5.60 (down from 6.0 previously). The extension of emergency Covid aid is now being actively discussed. That said, in an environment where growth estimates are being sharply revised higher, we believe negative fiscal noises will have less of a detrimental impact in the coming few months. However, assuming the positive growth trend peters out in 2022, markets will likely shift their focus to the presidential elections that could be polarised (a potential clash between current President Bolsonaro and former President Lula). This period could be challenging for the BRL. In the months ahead, though, we would expect the currency to hold up reasonably well. In terms of ranges, we would pencil in a broad 4.40-5.60 (one standard deviation on either side of fair value).

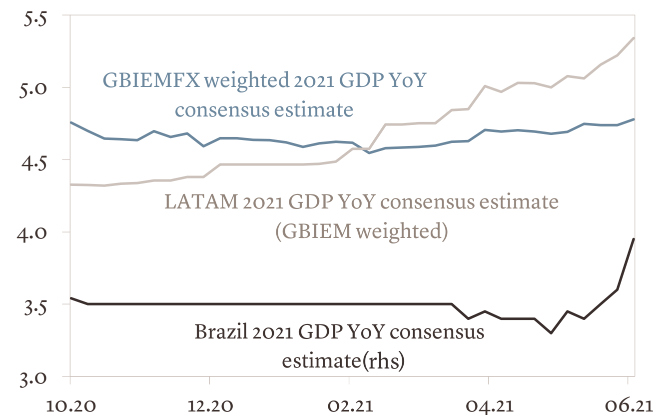
Main risks to our view: A downside USDBRL risk would be if 2022 GDP is revised higher also, and the debt profile is seen further improving in 2022. This is not our base case, but should not be ruled out. An upside USDBRL risk, more likely

33. CLP and PEN have highest volatility-adjusted sensitivity to US yields



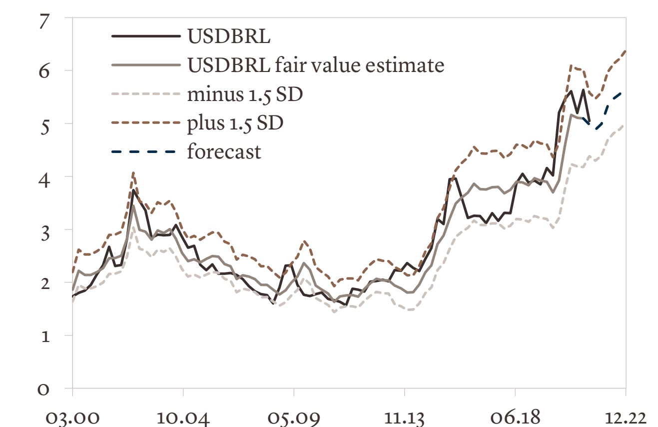
Sources: Bloomberg, Lombard Odier

34. Brazil has seen the most abrupt growth upgrades in EM in recent weeks



Sources: Bloomberg, Lombard Odier

35. USDBRL fair value estimate lowered 10% given improved fiscal projection for 2021



Sources: Bloomberg, Lombard Odier

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

LatAm FX

to materialise in 2022, would be a move towards populist fiscal policy in the run-up to the presidential elections.

MXN (Mexican peso): Near-term volatility, but stronger US growth exposure

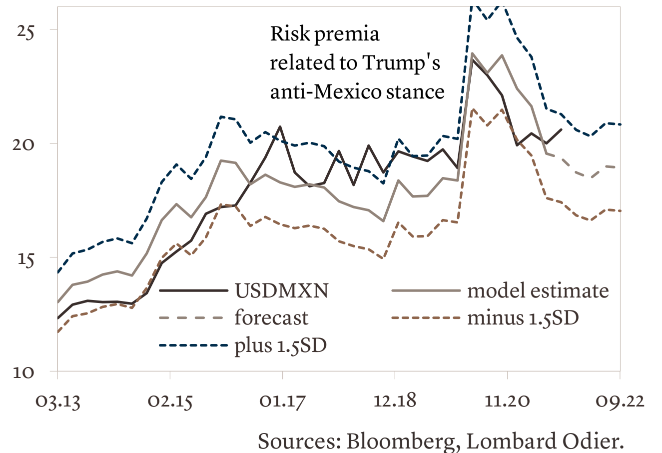
Having been bullish on MXN for H2 2020, we downgraded the currency to "cautious" in the January edition of the Monthly. However, following cleaner positioning and exposure to improving US growth, we upgraded the currency to "modest performer" in May. While MXN has seen some correction following the more hawkish June FOMC, we believe the currency should be well placed to perform, and levels closer to 21 will provide a good opportunity to enter long exposure. We would point out that of all LatAm FX pairs, USDMXN is the only one for which fair value is seen moving lower this year (chart 36). At the same time, over 80% of the country's exports go to the US, which should continue to see healthy growth. Furthermore, while carry in the likes of Brazil are improving from historically low levels, that for MXN has remained supportive. Carry in MXN remains attractive and not far from historical averages (5.05% post-Great Financial Crisis average vs 4.8% at present). However, real rates are now flat, and here, a more hawkish central bank turn could offer further MXN support – but this is still not a given (the central bank sees the rise in core inflation as likely to reverse in Q3). The June mid-term elections resulted in a status quo: President 'AMLO' retained a simple majority in Congress, but fell short of the two-thirds majority required for more radical constitutional changes.

Main risks to our view: The main *upside risks* to USDMXN relate to US 10Y yields, any downward revisions to US growth, and potential clashes between US President Biden and the Mexican President on Mexico's energy agenda.

CLP (Chilean peso): Staying cautious in the months ahead

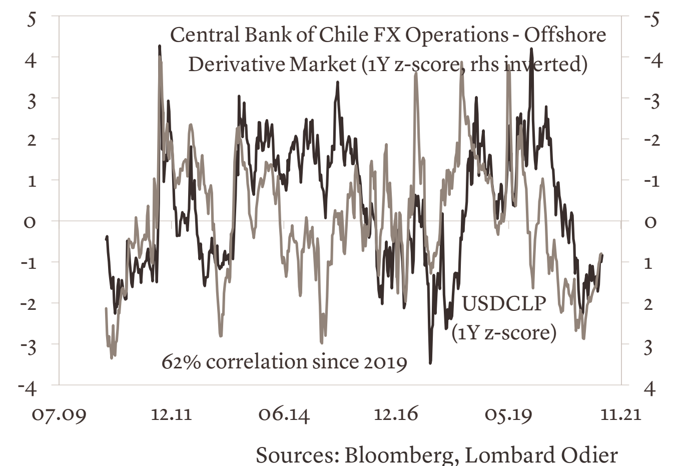
The CLP had long been our top pick in LatAm FX, but we chose to downgrade our stance to "cautious" in May. The rationale was political risks and positioning amid already fair valuations. On political risks, the outcome of the constitutional assembly election came in on the more negative side and points to a turn towards more populist policies and potential constitutional changes. Left-leaning factions gained strength, and the centre-right coalition is no longer a source of "checks and balances" on policies, having failed to gain a blocking minority of 52 seats. Markets will likely price in a higher risk of changes to the constitution in the months ahead. While USDCLP is not really that undervalued (we see valuation around 710 as fair), non-resident investor

36. USDMXN to have more downside potential, with fair value seen grinding lower for the rest of the year



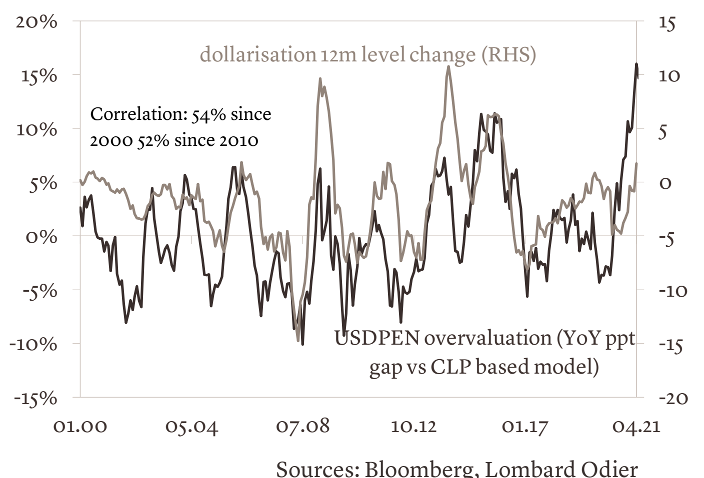
Sources: Bloomberg, Lombard Odier.

3. USDCLP susceptible to short covering of large positions



Sources: Bloomberg, Lombard Odier

38 USDPEN now overstretched, even accounting for political risk



Sources: Bloomberg, Lombard Odier

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LatAm FX

positioning remains quite stretched (chart 37). Moreover, in recent years, positioning actually preceded moves in the currency. We hence believe that USDCLP is vulnerable to short covering pressure, and would see USDCLP as presenting better value closer to 740-750. If we see a correction, we would consider upgrading the CLP at some point. Nevertheless, for now, the focus will very much be on political risks. A number of political events in the next five months will keep headline risks high (presidential and parliamentary primaries in mid-July, presidential and congress elections in November). The social mood in other countries in the region (Colombia and Peru) suggests support for a radical shift towards more socialist policies (for example, pertaining to healthcare and education, higher state interventionism, and so on). Even if the policies decided turn out to be conservative, it could spark greater social unrest.

Main risks to our view: Negative risks come from politics and possible rating downgrade risks. Still, relatively low government debt should imply limited fallout for the CLP. A sharp decline in copper prices is another risk.

PEN (Peruvian sol): Upgrading the currency to "modest performer" as valuations are cheap

USDPEN remained extremely volatile through the elections, and is oscillating in a wide 3.75-3.95 range. The currency has been in our "cautious" category, but we now opt to upgrade it to "modest performer". We believe that the PEN remains cheap, with USDPEN fair value closer to 3.50 given strong terms of trade, firm growth, and still-low government debt. However, political uncertainty surrounding elections has led to local dollarisation, and we believe this has been a big driver of the USDPEN rising. FX deposits rose 20% after September 2020. That said, we believe that USDPEN levels currently already account for substantial political risk. Historically, we find that the premium of USDPEN (to USDCLP, a pair with similar fundamental characteristics) can be explained by trends in FX deposit dollarisation in Peru (chart 38). However, the current rate of the USDPEN rise seems to already factor in a fast pace of dollarisation. This means a lot of bad news is already in the price. At the same time, we would emphasise that left-leaning Mr Castillo faces a divided Congress that could limit the scope for sweeping policy changes. Accordingly, we believe levels of USDPEN above 3.80 present value, and we are warming up to short USDPEN exposure. **Main risks to our view**: USDPEN *downside risks* would come from locals unwinding sizeable long USD positions should political uncertainty decline (see the 20% FX deposit rise after September 2020). USDPEN *upside risks* would come from ongoing FX hedging by foreign investors (who own 50% of the local bond market).

COP (Colombian peso): Still at the bottom of the LatAm pack

The COP is now the only LatAm currency in our group of EMFX underperformers. On the fiscal side, back in May, the tide had already turned in a more negative direction. With a change in leadership at the Finance Ministry and local protests, fiscal reform efforts will likely face growing uncertainty, increasing the risk of a ratings downgrade, weighing on the currency. Fundamentals support COP under performance. Our long-term model suggests USDCOP equilibrium of between 3,800 and 4,000. The COP is a clear twin-deficit currency in EM – an outlier. External balances should remain weak: the current account deficit will likely remain wide at near 3.8% of GDP, with the trade deficit still intact and widening (despite weaker growth last year). Foreign direct investment (FDI) flows could also slow. It is worth emphasising how weak Colombia`s external balances are compared to peers: on a 12m sum basis (% of GDP), Colombia`s broad basic balance (C/A plus FDI) stood at -0.6% GDP, lower than 6%, 3%, 3% and 2% for CLP, MXN, BRL and PEN respectively. This suggests that the COP is more dependent on hot-money flows (hence EM risk appetite) to perform. **Main risks to our view**: A faster ratings downgrade should hurt COP given high foreign participation in the bond market. A renewed push towards reform would make us less bearish on the currency.

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

CEEMEA FX

- **RUB has performed well in recent months, justifying our upgrade. Seasonality turns negative in the latter half of July**
- **We remain bearish on the TRY, but expect a more controlled depreciation in ZAR**
- **Near term, CEE currencies could face some downward pressure following the more hawkish FOMC. However, growth suggests the region's FX should perform better**

RUB (Russian rouble): RUB has performed. Looking for better re-entry levels

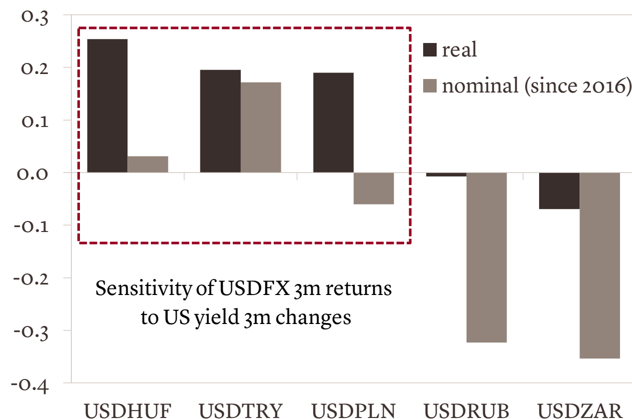
We used the correction in RUB over the end of Q1 to upgrade our view on currency up to "modest performer" from "cautious" EMFX. The rationale for the move was a decline in sanctions risk pricing, because of lower Ukraine-Russia tensions as well as some thawing in the US-Russia relationship. However, we would look for opportunities to re-enter long RUB exposure. This is because the currency is now back towards the bottom of a 72-76 range, while USDRUB tends to see a seasonal rise from mid-July that reflects dividend payments. Fundamentals remain strong given the country's twin surpluses (current account and budget), a more hawkish central bank, as well as the RUB's lower sensitivity to US, yields (chart 39). Our fair value remains around 74-75 (chart 40), suggesting USDRUB should trade within a broad 72-76 range.

Main risks to our view: Risks remain two-way dependent on politics, but the recent meeting between US President Biden and Russian President Putin points to some thawing in tensions.

ZAR (South African rand): Still too early to expect trend depreciation; favour short TRYZAR

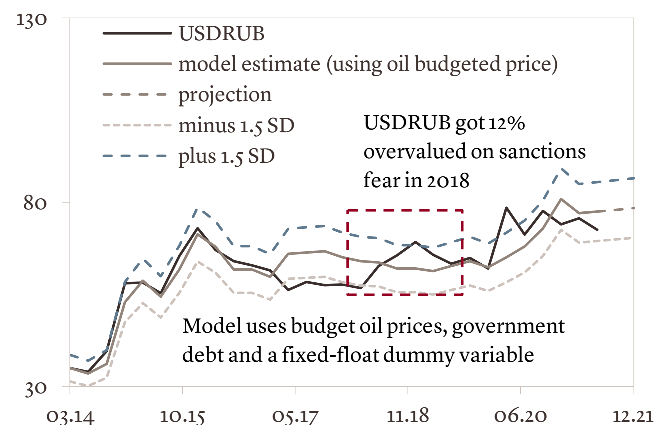
The South African rand has been one of the best-performing EM currencies in 2021. While we have pointed out the role of stronger external rebalancing in ZAR outperformance in previous Monthly editions (chart 41), we have adopted a cautious approach of not extrapolating ZAR outperformance due to valuation arguments. However, it seems that a negative turn in the current account would be a pre-requisite for the ZAR to weaken once again. The fiscal situation remains tenuous as, much like Brazil, a likely longer-term weaker growth profile will likely remain below the real cost of servicing debt, resulting in an ongoing upward drift in the country's government debt ratio. That said, recent better fiscal data as well as strong terms of trade suggest this could be more relevant for 2022. Furthermore, and despite the recent ZAR weakness, it is worth noting that ZAR shows a lower sensitivity to US real rates (than the TRY or even the HUF –

39. CEEMEA FX: US yield sensitivities since 2016



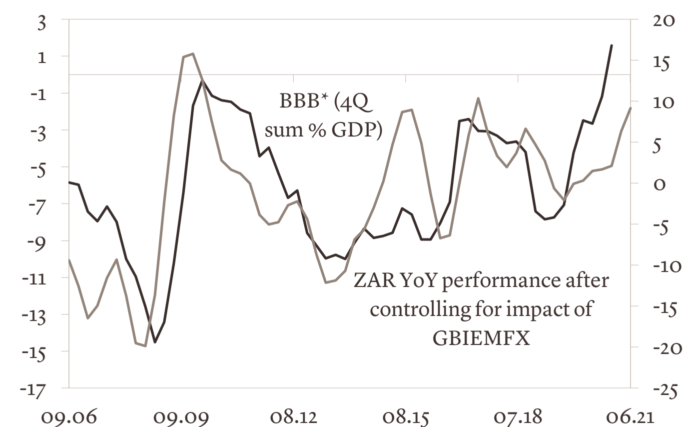
Sources: Bloomberg, Lombard Odier

40. USDRUB still within fair range



Sources: Bloomberg, Lombard Odier

41. ZAR resilience explained by external rebalancing



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX

chart 39), and positioning does not appear stretched (chart 42). We opt to lower our forecasts for year-end further, to 14.80 (vs 15.70 previously), albeit still pencilling in some depreciation that is likely to intensify in 2022.

Main risks to our view: On the bearish USDZAR side, a longer-than-expected spell of external rebalancing. On the bullish USDZAR side, negative news from the fiscal front, driven by worsening Covid trends (which remain well in control for now).

TRY (Turkish lira): Still the EMFX underperformer

The Turkish lira is on our list of EMFX underperformers. Our longer-term model continues to suggest that USDTRY will move higher. We find that longer-term macroeconomic fundamentals such as relative core-CPI trends, relative productivity, foreign direct investment (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). There remains considerable uncertainty as to the direction of macroeconomic policy following the recent changes, including the unexpected dismissal of orthodox central bank (CBRT) Governor Aqbal. Indicators suggest that local citizens may have already lost faith in the local currency: there was a sharp rise in gold imports over 2020 and limited evidence of locals reducing FX deposits following the Q4 2020 rally in TRY

This suggests that a cautious approach will still be required for the TRY, even considering very low non-resident positioning in Turkish assets.

Main risks to our view: Political ties between the EU and US will need ongoing monitoring given that markets assume some thawing in tensions.

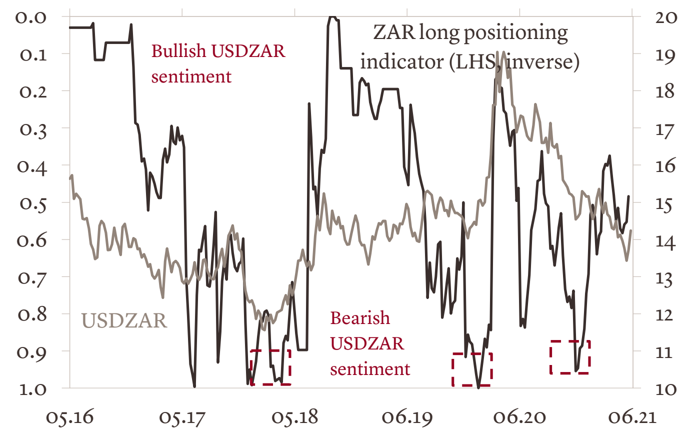
Central Eastern Europe & Israel: HUF and PLN to face near-term setback

Structurally, we have always maintained a preference for both the Czech koruna (CZK) and Israeli shekel (ILS), compared to the PLN (Polish zloty) and HUF (Hungarian forint). So far, the CZK as well as the ILS have held their value far better than the PLN or the HUF (chart 43).

However, in recent weeks both the HUF and PLN have gained against the EUR on the improved growth sentiment towards the eurozone, the sharp rally seen in EURUSD, as well as more hawkish noises from respective central banks, especially from that of Hungary.

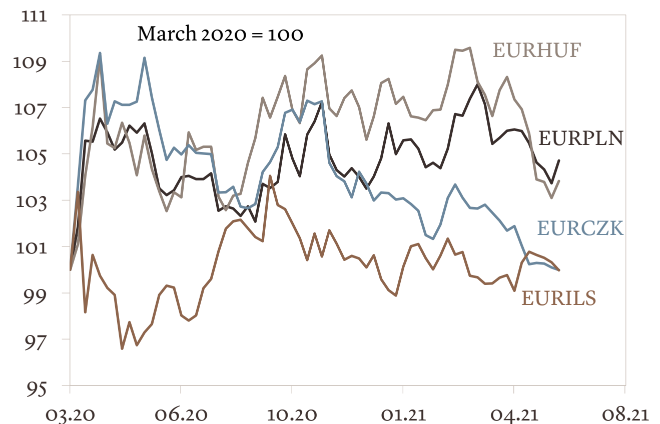
In the next few weeks, however, we would expect a setback for both the HUF and the PLN, with EURUSD likely to

42. ZAR sentiment remains moderate, and not exuberant like in early 2018 and late 2019



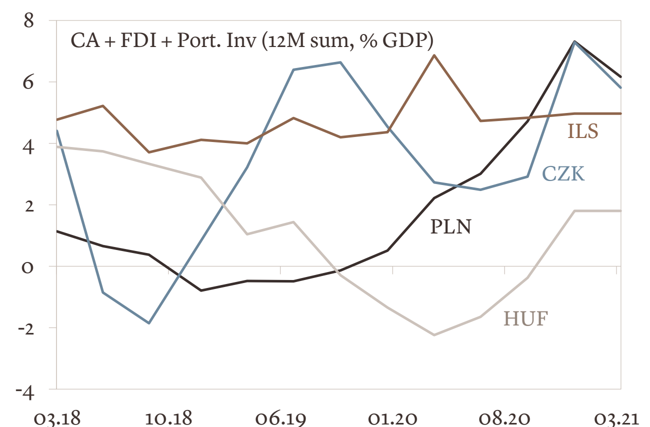
Sources: Bloomberg, Lombard Odier

43. Relative performance of EUR-CEEMEA crosses



Sources: Bloomberg, Lombard Odier

44. HUF FX flows improving, but still the weakest in the region



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX

consolidate in a lower range for the time being in the aftermath of the more hawkish FOMC. That said, given that we still believe the EURUSD will move higher (year-end target of 1.23) and assume that eurozone growth sentiment will remain positive (EZ manufacturing PMI is at all-time highs), we believe the HUF and especially the PLN should fare better.

Between the two, while the HUF could initially be better supported as the Hungarian Central Bank is flagging a series of interest rate hikes, Poland's balance of payments is far superior (chart 44). In addition, HUF has a higher sensitivity to US yields (chart 39). Hence, we maintain a preference for the PLN longer term. Recently, the PLN had weakened as markets built in a risk premium around the conversion of legacy CHF mortgage loans. However, the amounts involved are still unclear, as are whether resultant PLN sales (and CHF purchases) would occur in the open market or via the central bank. The deliberations are still fluid, but tentative evidence suggests that some banks have already pre-positioned, suggesting this should be less of a barrier to PLN performance.

We still like both the CZK and the ILS, but expect more volatility on the latter

We like the CZK because of its historical response to stronger German growth sentiment, which tends to herald CZK gains and a relatively healthy debt trajectory. In recent months, the Czech manufacturing PMI has outpaced regional peers, and has increased the chances of imminent rate hikes. Markets are also underpricing the pace of rate hikes signalled by the central bank.

In Israel, big political changes are taking place, with a coalition of right-wing and left wing parties succeeding Benjamin Netanyahu's government, following twelve years of its governance. The new government will be headed by Naftali Bennet, a former entrepreneur. While still early days, we would view the new government as positive for markets, with a potentially more coherent policy for stimulating growth, while being fiscally conservative. Some changes have already been made in this direction, such as curbing non-essential Covid benefits for citizens below the age of 45.

The ILS, while already arguably somewhat overvalued based on longer-term macro fundamentals, remains undervalued relative to its strong balance of payments position. Solid export growth in services, increasing gas exports, and firm FDI inflows suggest that Israel's balance of payments will remain robust. The central bank has been intervening and has already executed on two-thirds of the 2021 FX intervention programme. It is plausible that this may be further expanded, but we would expect intervention merely to slow the USDILS move lower. We still pencil in USDILS grinding down to the bottom of a 3.20-3.30 range.

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

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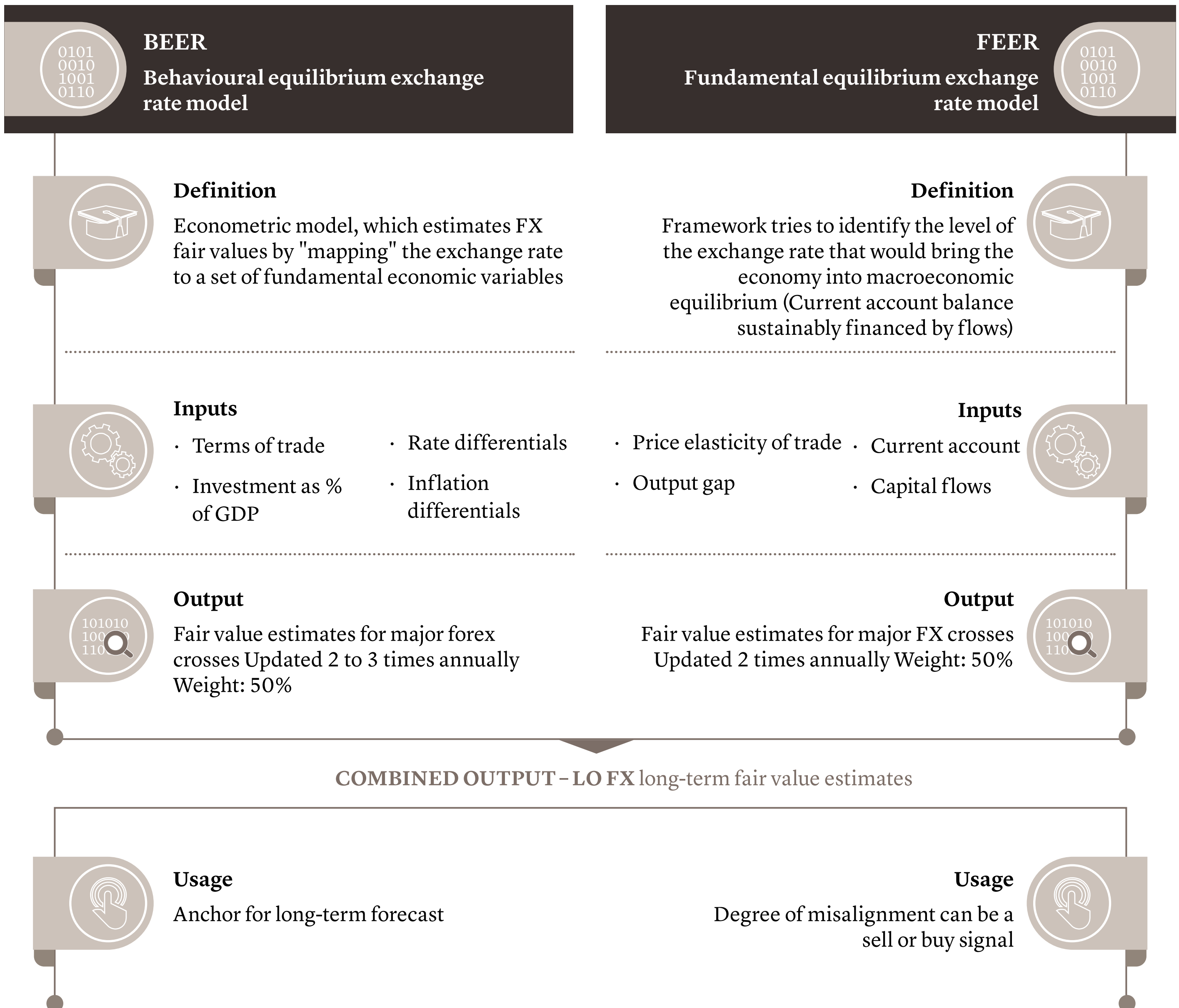
Our Lombard Odier long-term FX fair valuation framework



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

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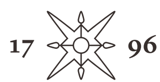

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