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# FX Monthly
## A change in market narrative: from inflation fear to growth scare

07/12

July-August 2021

### Key highlights

- A change in market narrative towards a more defensive stance owing to growth concerns has allowed the dollar to hold onto its post-FOMC gains.
- However, we still believe that growth momentum in Europe will be sustained and that this should ultimately prove EUR-positive
- If so, EURCHF weakness should revert in the coming months. At the same time, we maintain a neutral stance towards GBP and JPY for now
- We had said H2 would be more challenging for EMFX, and loss of momentum in commodity prices adds to this view
- The RMB remains our top pick, but we have slightly revised up our year-end target for USDRMB to 6.30 (from 6.22 previously) as we pare the odds of material progress on the US-China trade dialogue in 2021.

| 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 | 6.42 | 6.30 |
| | 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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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 22 July 2021

### At a glance

# Introduction

The confluence of slowdown signs in China, rising Covid-19 cases due to the Delta variant, and OPEC+'s initial failure to agree on a production increase has shifted the market narrative from "inflation fear" to "growth scare".

Following the Federal Open Market Committee (FOMC) meeting in mid-June that saw the dollar rise across the board, market sentiment appears to have changed markedly. The confluence of slowdown signs in China, rising Covid-19 cases due to the Delta variant, and OPEC+'s initial failure to agree on a production increase has shifted the market narrative from "inflation fear" to "growth scare".

Defensive and growth stocks have started outperforming respectively cyclical and value equities, while emerging market spreads have widened. Nominal and real yields have declined, especially at longer tenors, and commodity prices have struggled. This defensive turn in the market has helped the dollar to hold onto its post-FOMC gains.

Although growth momentum has lost some steam (most evident in the US and China), we think the market is mispricing the rotation of growth towards Europe. Survey data suggests still very robust activity in the region despite ongoing Covid-related restrictions. In our view, the vaccination rollout will allow restrictions to be lifted further, which should in turn sustain the economic momentum.

As a result, we maintain our constructive stance on EURUSD and EURCHF.

On the other hand, we remain neutral on sterling and the yen. In both cases, we see a lack of catalysts to spur sharp moves in either direction.

Growth concerns are likely to maintain some pressure on the Nordic and commodity currencies due to their high beta-to-risk nature. However, further out, we still expect some reversal as growth concerns dissipate and certain central banks either tighten outright or begin to send tightening signals.

For EM currencies, we are likely entering a more challenging period as growth slows versus the US in H2 and commodity prices lose momentum. We make no changes to our relative preferences.

We continue to favour the RMB but have raised our year-end forecast to 6.30 (from 6.22) as we lower expectations of any significant progress on the US-China trade dialogue in 2021. That said, a still-solid balance of payments – driven by several contributing factors – should offer support.

**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**, renewed virus-related restrictions and lockdowns. **Second**, the Federal Reserve 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** | 1.18 | 1.23 | 1.22 | 1.21 | 1.21 | 1.18 |
| **GBPUSD** | 1.38 | 1.40 | 1.38 | 1.37 | 1.37 | 1.46 |
| **EURGBP** | 0.86 | 0.88 | 0.88 | 0.88 | 0.88 | 0.82 |
| **EURCHF** | 1.08 | 1.11 | 1.12 | 1.12 | 1.11 | 1.02 |
| **USDCHF** | 0.92 | 0.90 | 0.92 | 0.93 | 0.92 | 0.87 |
| **USDJPY** | 110 | 109 | 109 | 108 | 108 | 94 |
| **EURJPY** | 130 | 134 | 133 | 131 | 131 | 111 |
| **EURSEK** | 10.24 | 10.20 | 10.20 | 10.15 | 10.15 | 9.69 |
| **USDSEK** | 8.67 | 8.29 | 8.36 | 8.39 | 8.39 | 8.24 |
| **EURNOK** | 10.48 | 10.00 | 9.95 | 9.90 | 9.90 | 9.84 |
| **USDNOK** | 8.88 | 8.13 | 8.16 | 8.18 | 8.18 | 8.37 |
| **AUDUSD** | 0.74 | 0.78 | 0.78 | 0.77 | 0.77 | 0.72 |
| **NZDUSD** | 0.70 | 0.72 | 0.71 | 0.71 | 0.70 | 0.67 |
| **USDCAD** | 1.26 | 1.21 | 1.21 | 1.22 | 1.22 | 1.24 |
| **Gold** | 1 801 | 1 750 | 1 600 | 1 600 | 1 600 | |
| **Oil (Brent)** | 72 | 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.

# FX forecasts – EM

**Asia**

| | Current spot | Q3 21 | Q4 21 | Q1 22 | Q2 22 |
|---|---|---|---|---|---|
| **USDRMB** | 6.46 | 6.42 | 6.30 | 6.32 | 6.35 |
| **USDHKD** | 7.77 | 7.75 | 7.75 | 7.75 | 7.75 |
| **USDIDR** | 14 494 | 14 540 | 14 593 | 14 647 | 14 700 |
| **USDINR** | 74.4 | 74.4 | 74.5 | 74.5 | 74.6 |
| **USDKRW** | 1 150 | 1 126 | 1 112 | 1 115 | 1 120 |
| **USDMYR** | 4.22 | 4.17 | 4.14 | 4.15 | 4.17 |
| **USDPHP** | 50.2 | 49.9 | 49.6 | 49.7 | 49.7 |
| **USDSGD** | 1.36 | 1.33 | 1.32 | 1.32 | 1.31 |
| **USDTWD** | 28.0 | 27.7 | 27.4 | 27.4 | 27.4 |
| **USDTHB** | 32.9 | 32.6 | 32.4 | 32.4 | 32.3 |

**LatAm**

| | Current spot | Q3 21 | Q4 21 | Q1 22 | Q2 22 |
|---|---|---|---|---|---|
| **USDMXN** | 20.1 | 20.0 | 19.8 | 19.7 | 19.5 |
| **USDBRL** | 5.19 | 5.18 | 5.28 | 5.39 | 5.50 |
| **USDCOP** | 3 854 | 3 869 | 3 913 | 3 956 | 4 000 |
| **USDCLP** | 752 | 741 | 741 | 740 | 740 |
| **USDPEN** | 3.95 | 3.83 | 3.75 | 3.68 | 3.60 |

**CEEMEA**

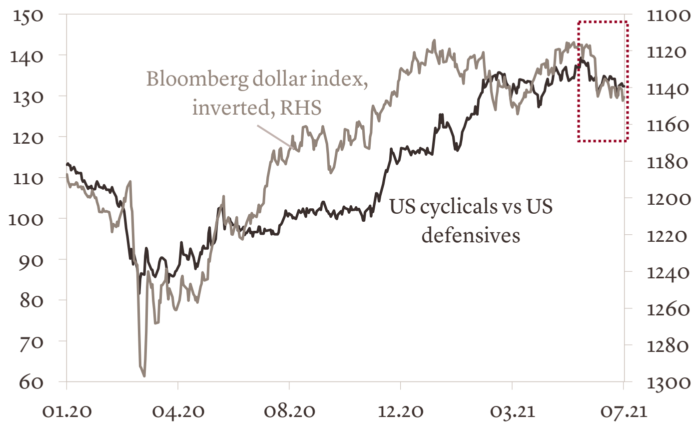
| | Current spot | Q3 21 | Q4 21 | Q1 22 | Q2 22 |
|---|---|---|---|---|---|
| **USDRUB** | 73.6 | 73.3 | 73.7 | 74.0 | 74.0 |
| **USDTRY** | 8.5 | 8.96 | 9.13 | 9.30 | 9.40 |
| **USDZAR** | 14.5 | 14.6 | 14.8 | 15.0 | 15.2 |
| **USDILS** | 3.27 | 3.24 | 3.21 | 3.18 | 3.18 |
| **EURPLN** | 4.58 | 4.53 | 4.53 | 4.54 | 4.54 |
| **EURCZK** | 25.6 | 25.3 | 25.2 | 25.1 | 25.2 |
| **EURHUF** | 359 | 356 | 359 | 363 | 366 |

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

# G10FX: Three key charts

Market narrative has turned defensive, as growth concerns have drawn attention. This has enabled the dollar to hold on to its post-FOMC gains...

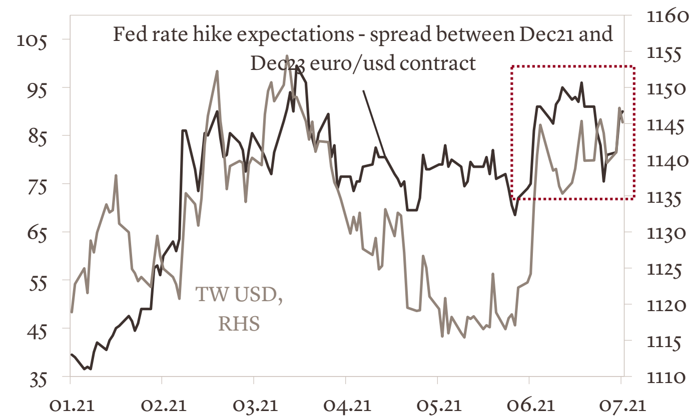
1. Dollar holds gains as market turns defensive




Sources: Bloomberg, CFTC, Lombard Odier

... despite a significant pricing out of Fed rate hike expectations

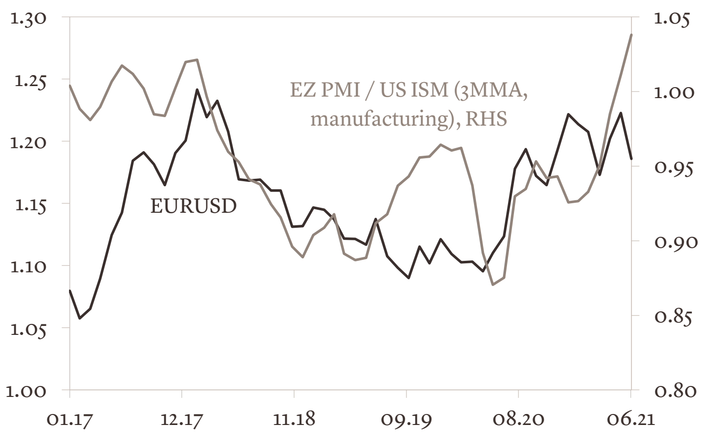
2. The change in market narrative has triggered a pricing out of Fed rate hike expectations




Sources: Bloomberg, Lombard Odier

However, activity momentum in the euro area is strong and the lifting of restrictions should offer support. This should enable EURUSD to climb higher over the course of H2 21.

3. Euro area activity momentum suggests upside for EURUSD




Sources: Bloomberg, Lombard Odier

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# FX majors

## EUR (euro): A mispricing of growth rotation

- **EUR has depreciated over the last month...**
- **... due to the FOMC's hawkish tilt in June and the emergence of the "growth scare" narrative in the market**
- **In our view, such a market response ignores the growth rotation in favour of the euro area that is likely to prove supportive for the currency.**

Since the FOMC meeting in mid-June, EURUSD has lost just around 2% in spot terms. The bulk of the decline occurred in the three days that followed the Federal Reserve (Fed) outcome; however, pressures on risk appetite emanating from the recent "growth scare" market narrative have been weighing on the currency. For example, the rotation out of cyclical stocks into defensives, characteristic of a rise in risk aversion, has correlated quite well with EURUSD moves (see chart 4).

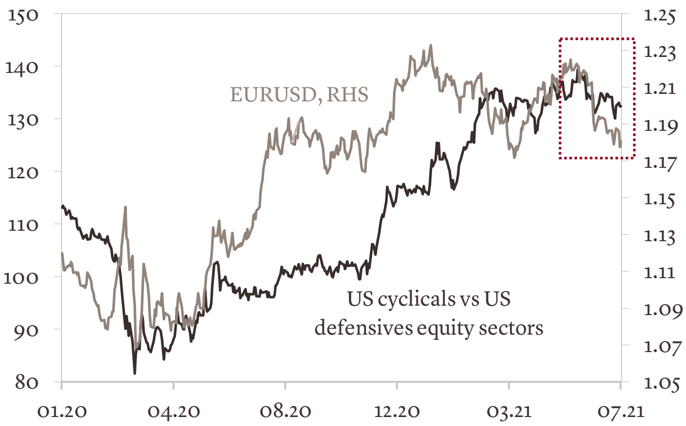
That said, we are not ready to throw in the towel on the euro just yet. In fact, we think that levels close to 1.18 offer attractive long opportunities.

The crux of our argument lies with what we consider to be a mispricing of growth rotation. Although it is true that there is evidence of growth momentum loss (in the US and China, mostly), we believe the market is not correctly positioned for a period of solid activity in the eurozone.

Soft survey data (purchasing managers' indices - PMIs) suggests that the euro area has already built a strong momentum relative to the US. We note this is taking place despite Covid-related restrictions being higher in Europe (see charts 5 and 6). In our view, as these restrictions are lifted and pent-up demand in the region is unleashed, the growth momentum is likely to be sustained. Disbursement and gradual absorption of Next Generation EU funds should also help.

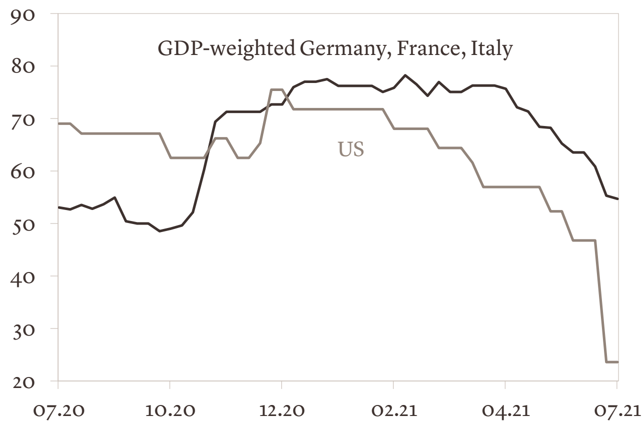
Of course, the Covid Delta variant poses risks, as can be seen by the sharp increase in confirmed cases. However, we believe this will not prevent governments from facilitating a return to normalcy. The available evidence suggests a significant weakening of the link between cases and hospitalisations/ deaths. The example of the UK makes this point clear: in the previous winter/spring wave, 2% of confirmed cases would lead to death while currently this figure has dropped to 0.3%. Furthermore, with vaccinations well underway, we suspect that the sizable economic/social lockdown fatigue has increased the hurdle for either maintaining or re-imposing quite stringent measures that continue to impede activity significantly.

4. Defensive market narrative has weighed on the euro



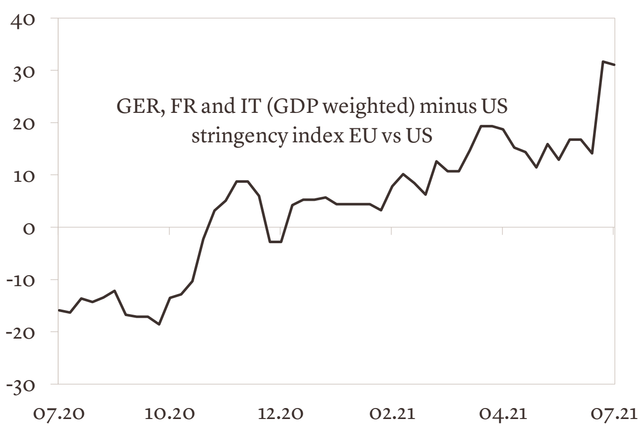

Sources: Bloomberg, Lombard Odier

5. Government stringency (Covid-related) indices




Sources: Bloomberg, Lombard Odier

6. Core Europe is lagging behind in restriction relaxation




Sources: Bloomberg, Lombard Odier

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

# FX majors

Finally, **a word** on the recent ECB review of its mandate and implications for FX. In summary, the ECB will now target symmetrically an inflation rate of 2% while inflation dynamics may imply a transitory period of above target inflation. We do not see any tangible currency market implications. **First**, the outcome was broadly expected and second, the review's conclusion is quite vague on the period and size of inflation overshooting. In this respect, it is less binding and allows the ECB plenty of discretion when compared with Fed and Bank of Japan announcements. **Third**, with the central bank already using multiple unconventional tools in recent years, it is debatable what the ECB could do to make monetary policy even more accommodative and so pressure the euro further.

**Main risks to our view:** At this stage, we see mainly downside risks to our views and forecasts. **First**, there is always the possibility that a new and more vaccine-resistant virus strain could develop, which would trigger a sharp rise in risk aversion and support the dollar. **Second**, the Fed could gradually turn even more hawkish, following ongoing upside surprises in inflation. However, we still expect the central bank will treat these as transitory (the majority of the surprise is coming from sectors mostly hurt by the pandemic) and not change its course.

### CHF (Swiss franc): Still constructive on EURCHF

- **The drop in Bund yields has led to a modest EURCHF depreciation**
- **We expect this to reverse as euro area restrictions are lifted...**
- **... helped also by the acceleration in Swiss portfolio outflows.**

In our last FX Monthly, we argued that the Swiss franc was approaching maximum strength. The flaring up of risk aversion due to growth concerns has certainly challenged this view, with EURCHF dropping below 1.09.

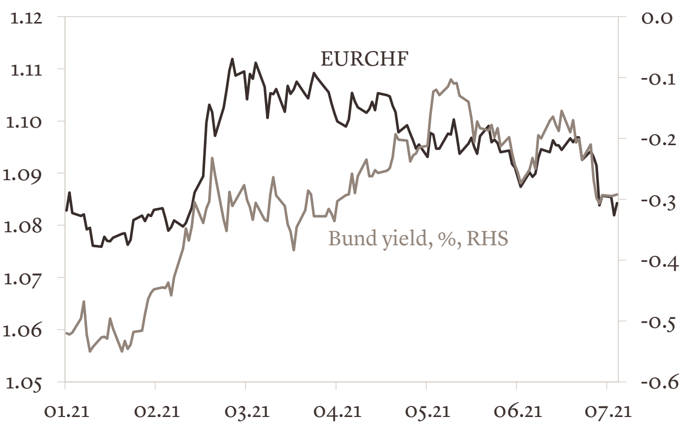
In that respect, CHF has responded in a typical risk-off fashion: EURCHF has declined in tandem with the drop in bund yields (see chart 7). In our view, this is only a temporary reaction.

We expect bund yields to start rising again, a direct consequence of a solid growth outlook for the second half of the year for the euro area. At the same time, even at current levels of Bund yields, our short-term fair value model (see chart 8) suggests that EURCHF should already be trading higher than it is at present.

Moreover, Swiss portfolio outflows accelerated in Q1 21, bringing the Q4 moving average to CHF 7.6 bn, the highest reading since December 2015. Although the recent risk-off episode might have enticed some retracement, the overall upward trend in portfolio outflows suggests upside pressure for EURCHF in the quarters ahead.

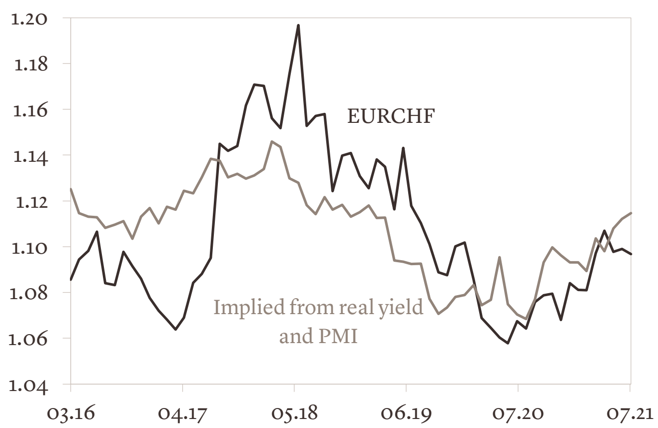
**Main risks to our view:** *Upside risks to EURCHF*: an acceleration of Swiss outflows, especially if the vaccination rollout in Europe continues to gather pace; a reacceleration in global growth recovery, underpinning carry trades and weighing on the franc. *Downside risks to EURCHF*: currently we see them as largely concentrated in eurozone developments. More specifically, risks are associated mostly with a virus-induced slowdown in regional activity.

7. EURCHF declines with Bund yields




Sources: Bloomberg, Lombard Odier

8. Short-term fair value model suggests EURCHF should be higher




Sources: Bloomberg, Lombard Odier

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# FX majors

## GBP (pound sterling): Still neutral

- **In the absence of a growth or monetary policy catalyst…**
- **… we find it difficult to expect GBPUSD to break out of the recent narrow range.**

We would reiterate our neutral stance on GBPUSD that reflects three factors.

**First**, the market has started pricing out some of the rate hike expectations for the Bank of England (BoE – see chart 9). This conforms to our view and suggests that sterling is likely to lack a major catalyst for upside.

**Second**, TW (trade-weighted) GBP is still hovering at the upper end of its post-referendum range (see chart 10). Consequently, in the absence of a major growth impulse, it is unlikely that the currency will be able to gain traction and rally further, and break strong resistance levels.

**Third**, the furlough scheme expires in September, something that induces an element of uncertainty in labour market prospects. Additionally, we think the BoE would want leave some time post expiry in order to have a clean reading of the job market before communicating a clearer signal on future monetary policy.

**Main risks to our view:** We see *three upside risks to our forecasts*: BoE tightening expectations rising again; 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, new virus-related lockdowns, and the Fed gradually turning even more hawkish.

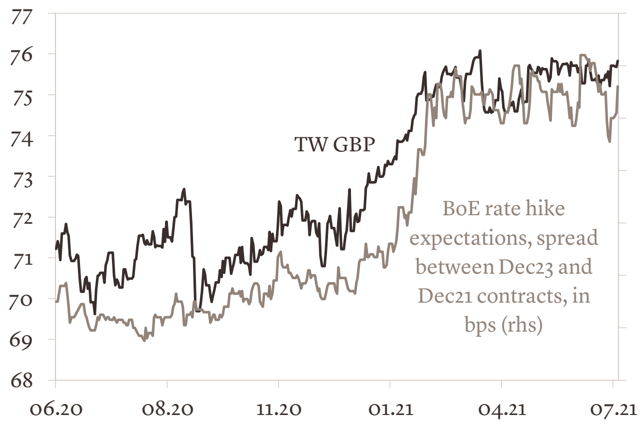
## JPY (Japanese yen): On the side-lines

- **Growth concerns have ignited demand for JPY…**
- **… especially following the widening of yen shorts after the FOMC meeting**
- **We see USDJPY trading in a range and eventually settling at around 109.**

Following the defensive stance in markets, USDJPY has seen some notable moves recently. From a peak of 111.66 at the beginning of July, USDJPY dropped heavily to the edge of 108. It has since stabilised around the 110-109 level, roughly -1% for the month.

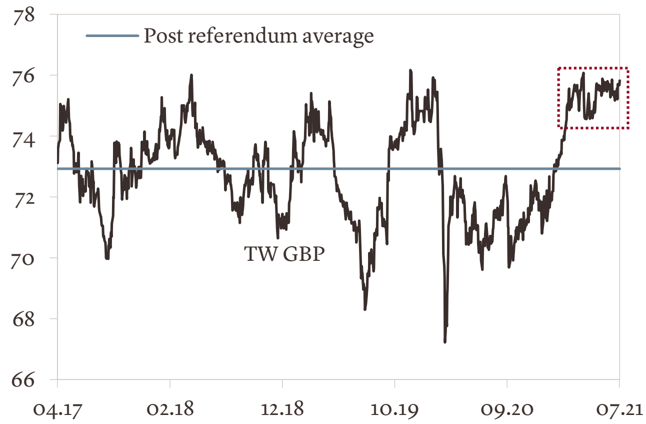
As chart 11 shows, the repricing of US yields lower due to growth concerns fueled USDJPY's recent depreciation. However, the move was amplified by the very abrupt widening of JPY shorts in the immediate aftermath of the FOMC meeting on 16 June (see chart 12), triggering a short squeeze.

9. BoE rate hike expectations being priced out




Sources: Bloomberg, Lombard Odier

10. TW GBP at the upper end of its post-referendum range




Sources: Bloomberg, Lombard Odier

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# FX majors

The move may have farther to run as speculative yen shorts remain extended, but we suspect that once the dust settles and growth concerns diminish, USDJPY is likely to settle around the 1.09 level. On one hand, a still-good growth outlook in tandem with large M&A-related outflows from Japan should exert upside pressure. On the other hand, a resumption of dollar weakness should suggest limited upside.

As discussed in our last FX Monthly, we prefer to stay on the side-lines for now, as we see no major catalysts for a big move in either direction.

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

### Nordic currencies: Bending under growth worries

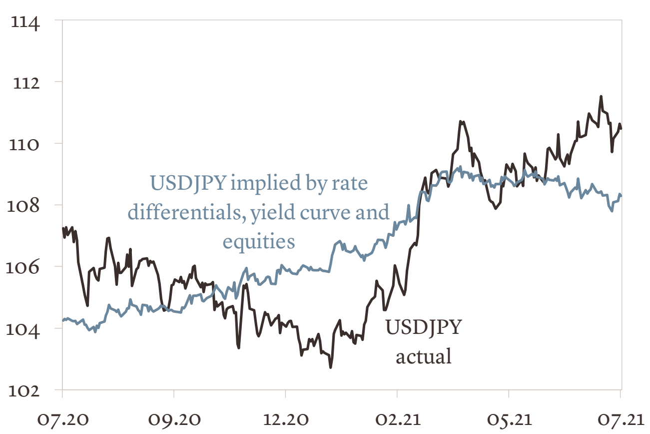
- **NOK and SEK come under pressure as risk sentiment changes**
- **We expect NOK to find support, but are no longer expecting material upside in the SEK.**

**NOK (Norwegian krone)**: USDNOK has lost 5% since the FOMC meeting (EURNOK down by 2.5%), and has been the main underperformer among G10 currencies. This has surprised us considering the robust domestic fundamentals, high oil prices, and the Norges Bank signalling the start of the hiking cycle in September. The price action can probably be explained by crowded positioning, since USDNOK fell by nearly 40% between late March 2020 and the FOMC meeting this June. Data has not changed enough to restrain the Norges Bank from delivering its first rate hike in September; if anything, mainland GDP for May came in significantly above expectations. Based on our short-term models that take into account rates and oil prices, EURNOK should be trading closer to 10.10 now and USDNOK closer to 8.45 (see chart 13). Consequently, there seems to be a weighty element of NOK undershooting at play. We believe that as we draw closer to the Norges Bank meeting in September and assuming concerns over growth subside (especially as European data remains firm), NOK should be able to bounce back.

**SEK (Swedish krona)**: SEK has had a similar response to that of NOK, although recent communication by the Riksbank suggests that the room for SEK upside is virtually non-existent, even if we indeed see a rotation of growth towards Europe. The central bank's minutes of its 30 June meeting revealed that 1) the Riksbank has adopted an implicit framework within which it will allow inflation to overshoot its target; and 2) it will maintain the current policy rate unchanged for three years after Sweden's GDP has recovered to pre-pandemic levels. This makes the Riksbank the most dovish G10 central bank, and highlights an important element of monetary policy divergence. This is the reason we no longer see any material downside in EURSEK from here. Our USDSEK forecast is thus almost entirely dictated by our EURUSD forecast.

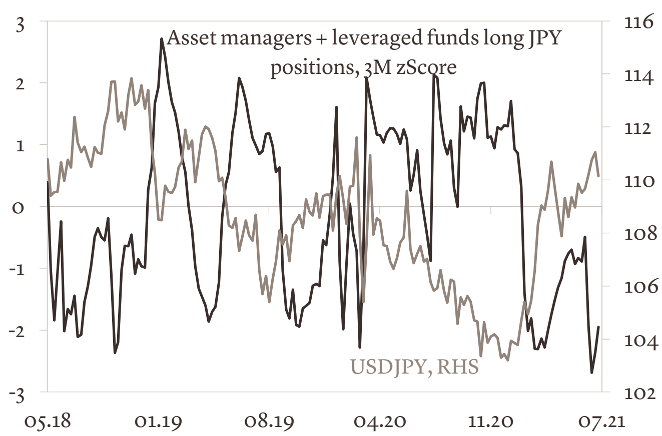
**Main risks to our view:** In the case of NOK, there are three main risks: euro-area recovery faltering, renewed oil price declines, and/or risk sentiment deteriorating. In the case of the SEK, our neutral stance could be challenged if euro area activity surprises on the upside (EURSEK downside) or if risk sentiment worsens (EURSEK and USDSEK upside).

11. Lower US yields have triggered a decline in USDJPY




Sources: Bloomberg, Lombard Odier

12. JPY shorts widened abruptly after the FOMC meeting




Sources: Bloomberg, Lombard Odier

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# FX majors

### Commodity currencies: Central banks turn hawkish

- **Commodity FX has naturally been penalised by the shift in market narrative**
- **However, there is still room for some recovery, especially in AUD.**

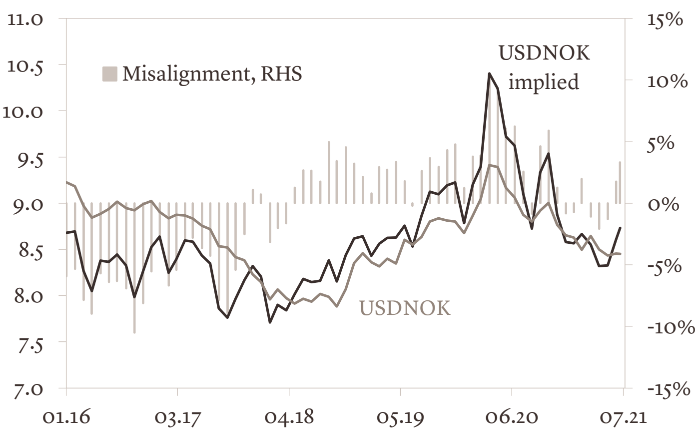
**AUD (Australian dollar)**: AUDUSD has come under pressure recently from the "growth scare", as well as from China's slowdown and the stronger dollar. From a recent peak above 0.78 in mid-May, it now trades close to 0.74. However, we expect consolidation in the near term and some appreciation further out. This is because despite the short-term headwinds from risk sentiment and China's slowdown, there is now a distinctive shift towards the hawkish spectrum in the RBA's stance. Employment growth has picked up notably this year and the unemployment rate has fallen back to pre-pandemic levels. Granted, inflation is low relative to target but this is likely to change as the labour market becomes tighter (see chart 14). As a result, the RBA has clearly acknowledged that these developments were better than expected, effectively making a hawkish turn. This is likely to lead to a faster pace of tapering. The market is pricing about 12 bps of hikes for the next year, so there is some room for upside surprise over the next few quarters. Balancing all these factors, we think some consolidation in the near term is likely, followed by AUDUSD appreciation as the market re-prices higher the rate trajectory.

**CAD (Canadian dollar)**: USDCAD has appreciated in line with global market developments, now trading around the 1.27 level. For some time now, the Bank of Canada has displayed a slightly more hawkish tone, given progress in the labour market and a pick-up in core inflation measures. As a result, the market is now pricing in about 40 bps of tightening over the next year and a total of 100 bps of hikes over the next two years. For as long as growth concerns remain at the forefront, CAD is unlikely to make a significant reversal but we think once these worries subside, then some headway is still possible, contingent on the price of oil. At the same time, we are aware that there is very little room for rates to re-price higher form here, at least over the next quarter or so. Consequently, we expect consolidation here too, and some modest CAD appreciation later. Although we maintain our USDCAD target of 1.21 by the end of the year, we would highlight that this is now subject to upside risks.

**NZD (New Zealand dollar):** For most of last month, NZD remained under pressure. However, recently it seems to be receiving some support due to a clear shift in tone by the country's central bank, which announced that it would halt its asset purchase programme by 23 July. The main factor underlying this decision is the sharp increase in house prices. The rate market has re-priced higher, seeing the first 25 bps hike this year and another two in 2022. That provides an element of support to the NZD, although the currency is still above where it should be based on the level of 2Y nominal yields. We maintain a relatively neutral stance.

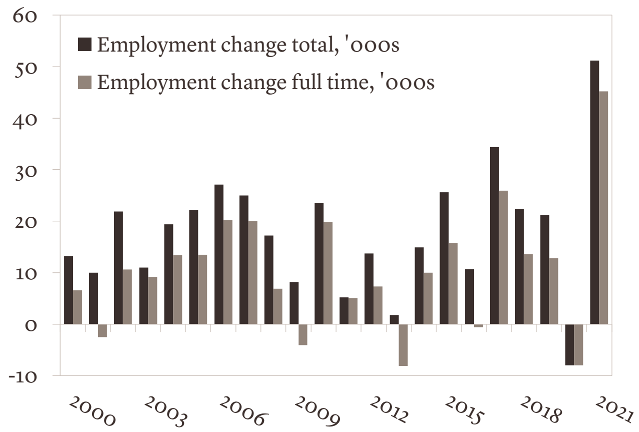
**Main risks to our view:** *Upside risks* to our forecasts could materialise if the growth recovery is sharper and the dollar depreciation deeper than we currently envisage. *Downside* surprises stem mostly from further hawkish surprises by the Fed that would put pressure on cyclically sensitive currencies,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

13. At current levels, USDNOK is overpriced




Sources: Bloomberg, Lombard Odier

14. A significant improvement in the Australian labour market
Average monthly employment gains, in thousands




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 (targeting USD 1,600/oz by year-end, and reiterate our recommendation to alleviate exposures in portfolios that still embed material positions.**

The slightly more hawkish FOMC in June triggered a 7% sell-off in gold prices despite the muted reaction on real rates. Later, as market sentiment changed swiftly from fears of an overheating economy and inflation to growth concerns, US interest rates declined. Indeed, The Fed's changed tone in June did not result in a steeper yield curve. Rather, defying expectations, it flattened and the long end of the curve erased half of the moves from the first quarter of the year, taking real rates back to -1% and close to their post-Covid crisis lows. Markets seem to agree with our view that these inflationary effects should remain transitory, as illustrated by the muted reaction to the impressive June inflation data release. In fact, a close look shows that inflationary pressures remain mainly limited to specific sectors such as autos and hotels. The fact that they have not spread to other sectors confirms our scenario; inflation should peak in the coming months, allowing real rates to trend higher.

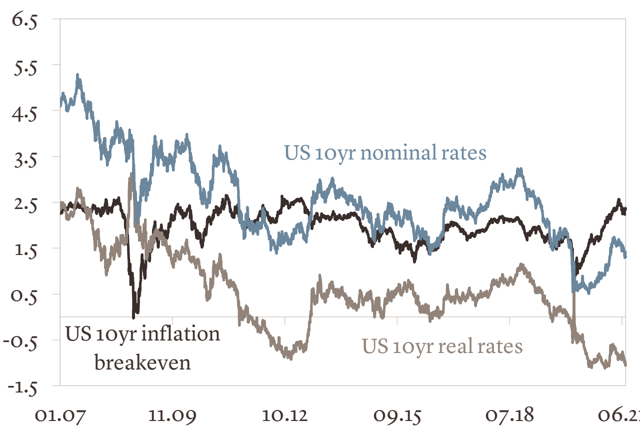
While confusing, these technical pauses in rate normalisation are not at odds with historical patterns, and we reiterate our target of 2.25% for 10-year US treasuries on a 12-month horizon. If, as we expect, macro data remains solid, the policymakers' guidance on its asset purchase programme is likely to evolve over time (most likely between Jackson Hole late August and the end of the year).

In this context, we reaffirm our bearish view on gold. History shows that when the recovery advances and we shift to a stationary phase of the cycle, inflation expectations are less correlated to gold prices, and real rates become the main driver. The upcoming shift in Fed policy outlook should be the trigger.

We maintain our target at USD 1,600/oz by year-end, and see current levels as an opportunity to alleviate exposures in portfolios that still embed material positions.

**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. A pause in US interest rates normalisation




Souces: Bloomberg, Lombard Odier calculations

16. Real rates will remain the key driver


Souces: Bloomberg, Lombard Odier calculations

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

# Commodity corner

**The outlook for oil prices is definitely in OPEC+ hands**

- **OPEC+'s recent disagreement over increasing oil supplies to meet recovering demand has ushered prices to a three-year high**
- **OPEC+ eventually agreed on the need to raise production, which demonstrates the organisation's willingness to preserve the alliance**
- **Nonetheless, the deal compelled some members to limit their production further – and Iranian production is still waiting in the wings.**

A disagreement over the pace of restoring post-Covid oil supplies has pushed prices to a three-year high. As OPEC and its allies look to reverse production cuts, demand from recovering economies continues to outpace supplies, challenging oil price stability.

The United Arab Emirates, with the world's sixth-largest oil reserves, had invested in its oil infrastructure before the Covid crisis dramatically changed the outlook. The country therefore objected that its recent investments were not visible in the proposals to raise OPEC+ production. Specifically, it wanted its reference level of production increased as its production recovery certainly trails others': in May, its crude output was still 30% lower than 13 months earlier, while Russian production stood 8% lower over the same period.

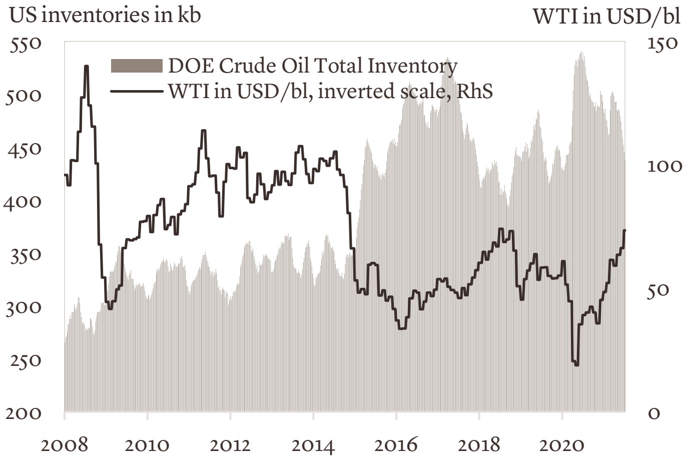
The absence of an agreement to manage supply rises would have been bullish for oil prices in the short run as OPEC+ members were to continue to pump oil at current levels, which already fall short of rising demand.

As chart 17 shows, inventories are decreasing and the market is rebalancing rapidly because of the OPEC+ strategy to adjust to demand trends rather than anticipate them, as any supply disruption is likely to fuel volatility in the short term. Still, the organisation managed to find an agreement on July 18, whereby members will adjust to the rise in the reference level of production in the UAE as well as in Iraq and Kuwait. The deal points to a 0.4 mb/d monthly production increase from August until the cuts are phased out (tentatively by September 2022, see chart 18).

In the medium term, we are not facing an oil shortage risk and it is in all members' interest to produce more, such that any spike in prices due to undersupply should prove short-lived. In addition, the extension of the OPEC+ agreement through to end-2022 could bring more supply discipline next year, and it demonstrates the willingness of the organisation and of the Saudis in particular to preserve the alliance. Nonetheless, the deal came at a cost to some members, which had to agree to limit their production further; moreover, Iranian production is still sidelined.

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

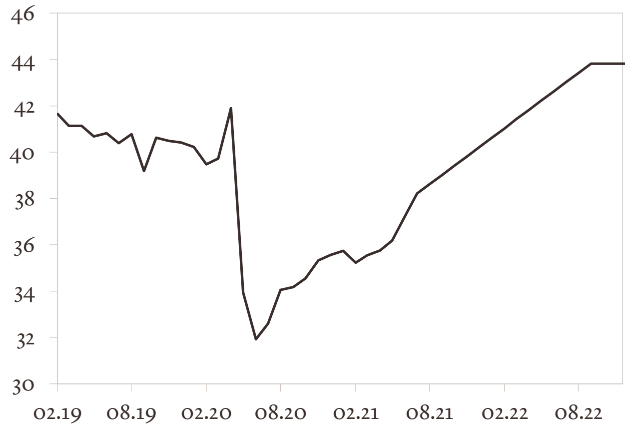
17. Oil market rebalancing accelerates with economic reopening and US driving season




Source: Bloomberg

18. OPEC+ agrees on a gradual rise in production to return to pre-Covid levels

OPEC + Russia crude oil production in Mb/d




Source: Datastream, Lombard Odier estimates

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

# EMFX: Three key charts

**GBI EMFX – downside risks in H2:** Our GBI EMFX model had flagged decent gains over H1 (chart 19), 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 (potentially_) higher US yields will mark a more challenging backdrop for GBI EMFX. We note that flows to EM have also lost some momentum.

While certain countries (e.g. Brazil) are seeing major growth upgrades and better fiscal metrics than anticipated 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 remain largely unchanged. We will continue to monitor this situation.

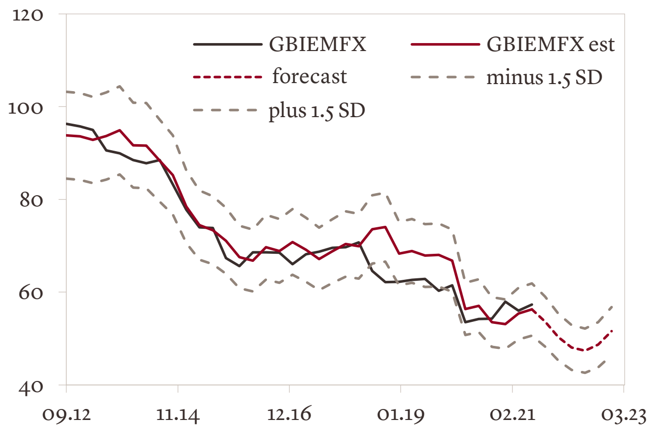
**RMB FX flows supported from several angles**: A robust balance of payments position has been a key assumption in our strong RMB scenario. Aggregating the current account, foreign direct investment (FDI), and portfolio investment, China's broad basic balance of payments stands at 4.4% of GDP. This is three times as strong as the average from 2016 to 2019 (chart 20).

The reasons for the strength have been broad based. Compared to the 2016-19 average, portfolio investment inflow is ten times stronger, and FDI five times higher. Interestingly, the current account is twice as strong, but this increase mostly reflects a smaller services trade deficit, which in turn is due to Covid-related restrictions on outbound tourism.

The goods trade balance is marginally stronger, but is not the main driver. Some of these drivers could soften in 2022, but will likely remain robust for the rest of 2021.

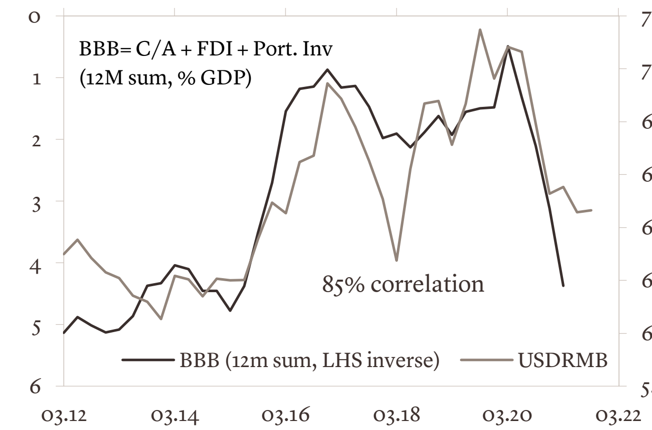
**EMFX differentiation:** Chart 21 opposite shows our preferences across the EM currencies we cover, to which we make no changes this month.

19. GBI EMFX model signals decline from Q3 onwards




Sources: Bloomberg, Lombard Odier

20. RMB FX flows continue to flag a lower USDRMB




Sources: Bloomberg, Lombard Odier

21. EMFX – four buckets of EM currencies

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

- **We tweak our forecasts for Asian currencies in response to the recent policy signal from China and on a lower chance of progress in the US-China trade dialogue in 2021**
- **However, we maintain our appreciation views for RMB, KRW, TWD, and SGD**
- **We remain neutral on IDR, THB, and MYR, as the positive impact of robust global trade is offset by fragile public health conditions. We are slightly bearish on PHP**
- **Vaccine rollout, the US-China strategic competition, and intermittent scares about premature monetary policy tightening will be key risks for the region's currencies.**

## RMB: Appreciation still the base case despite a modest forecast change

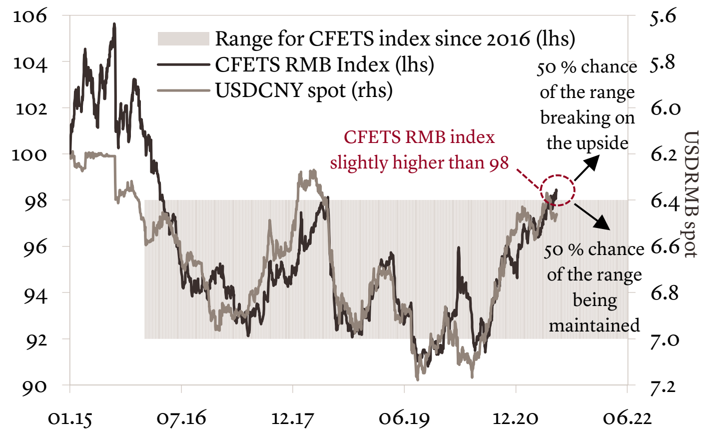
We are lowering our expectations slightly for the Chinese renminbi (RMB) in response to the recent policy tweak by the People's Bank of China (PBOC), as well as on lower odds than previously assumed of seeing progress made in the US-China trade dialogue in 2021. However, our base case remains the currency's further appreciation vs the US dollar in the next six to twelve months.

**First**, we acknowledge the need to adjust our expectation for the currency – in light of the PBOC's first sweeping cut in reserve requirement ratios (RRR) for commercial banks in 18 months. The move likely signals a shift in Beijing's macro policy from a somewhat hawkish setting to a neutral one, as China's economic growth enters a more nuanced phase of deceleration to its potential path. For this reason, we now see the PBOC keeping the onshore benchmark rates (7-day reverse repurchase rates, medium-term lending facility rates, and loan prime rate) on hold for the remainder of the year. This assumption dictates our new forecast, as market-implied rates suggest some residual expectation for 20-25 basis points of rate hikes over the next 12 months. Still, we do not believe that this marks the start of any outright easing cycle in China (e.g. rate cuts), especially since the H2 growth rate will exceed China's trend growth rate – and Beijing's policy elite continue to express their commitment to medium-term policy discipline.

**Second**, the PBOC seems to be rather tolerant of the RMB's strength if it is primarily market-driven. This was demonstrated on 14 July when, even in the aftermath of the RRR cut, the PBOC quietly let the CFETS RMB index breach the upper bound of its five-year range (see chart 22). In our view, this indicates that the PBOC's main objective is to maintain sufficient onshore liquidity amidst rising

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

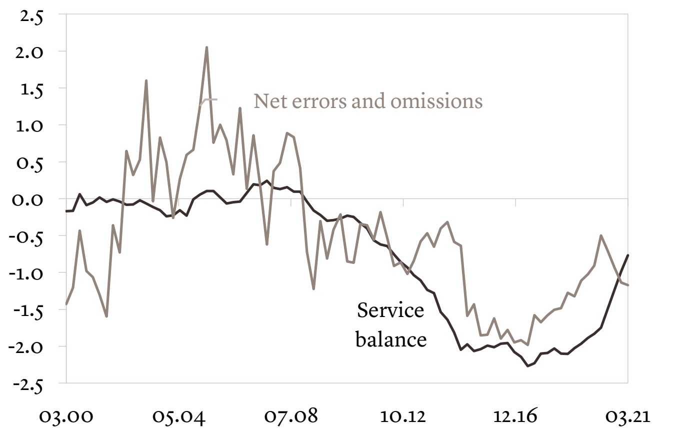
CFETS RMB index estimate, 31 Dec. 2014 = 100 (lhs)




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

23. Service deficit likely to remain narrow in the near term

Q4 rolling sums of China's service and net errors and omissions as a % of GDP




Sources: Bloomberg, CEIC, Lombard Odier

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

# Asia FX

government bond issuance and maturing medium-term lending facility transactions, rather than an all-out fight to arrest currency strength.

**Third**, we expect China's balance of payments to remain robust due to the likely extension of tight border controls and thus low service deficits. The Delta variant risk and widely divergent global opinions on the efficacy of China's own vaccines mean that the number of China's outbound tourists is unlikely to rise in the next six to twelve months. This prospect implies that the main channels of overseas spending and informal outflows will remain shut, and the recent compression of service deficits persist (see chart 23).

**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. Beijing's action on the possible debt restructuring of large asset management companies (AMCs) and property developers should be monitored closely given their sizes.

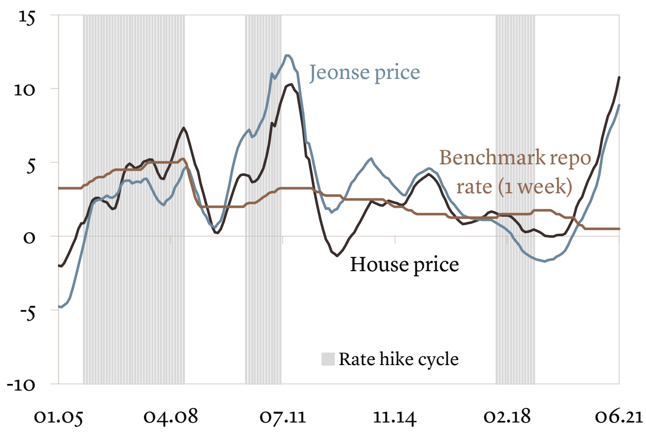
## KRW: Upside risk as the Bank of Korea readies for a rate hike

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 on 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 sharp rise in housing prices (see chart 24). We note that the BOK has mandates for financial stability and inflation targeting, but not for full employment. **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**, KRW was the best-performing Asian currency during the first "taper tantrum" episode in 2013 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 a volatile FX market environment.

**Main risks to our view**: Geopolitical risks surrounding China and North Korea will remain a key risk for the Korean won.

24. Housing price appreciation tends to trigger BOK's rate hikes

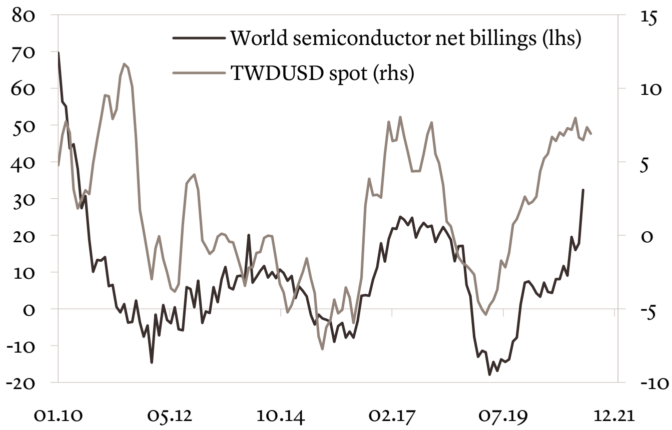
Housing and rental price appreciation for 6 major cities, % YoY, policy rate, %




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

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 the yen is KRW's main regional rival.

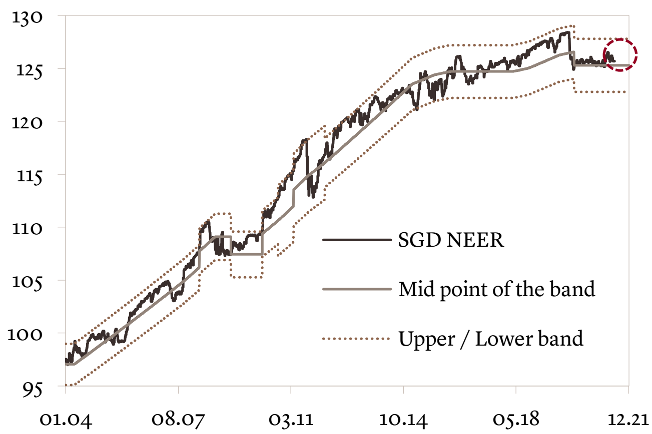
## TWD: Global growth and "stimulus 4.0" to boost TWD further

Now that Taiwan has begun to bring the recent Covid-19 outbreak under control, we believe the New Taiwan dollar (TWD) will resume its structural appreciation vs the 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 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 impact of the government's "stimulus 4.0" filters 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 been indeed the signal from Governor Yang Chin-long. 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.

26. SGD NEER curve starting to show some movement

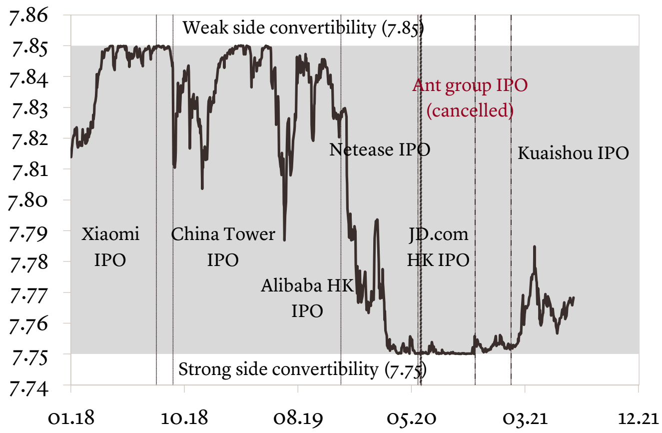
SGD NEER curve and estimated MAS policy bands




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

### 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 despite intermittent Delta cluster scares and 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 introducing 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 market 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 on 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.

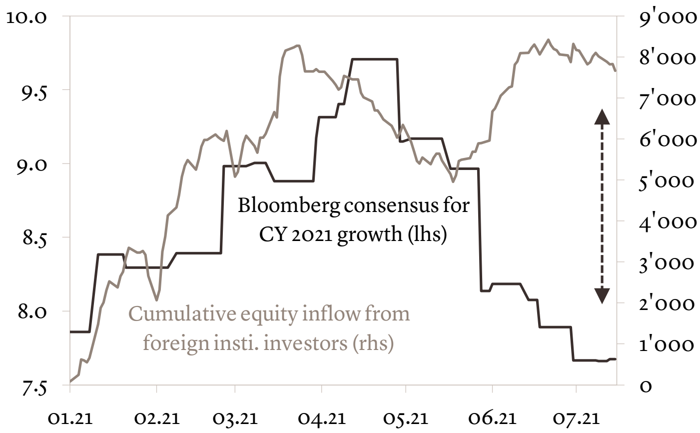
**Main risks to our view:** Main risks are further tightening of social distancing restrictions, performances of major currencies in the SGD NEER basket, the US stance on Singapore's unique FX policy framework, and public health and macroeconomic conditions in the surrounding South-Asian economies.

### HKD: Gradual reversion to the middle of the convertibility zone

We expect the peg of the HK dollar (HKD) 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 has been gradually easing after the completion or suspension of large marquee listings in 2020 (see chart 27). Additional large listings in Hong Kong could introduce intermittent episodes of temporary strength in the currency, but this has become a more uncertain prospect in the near term due to Beijing's ongoing crackdown on Chinese tech platforms. **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

28. INR equity inflows somewhat excessive vs fundamentals

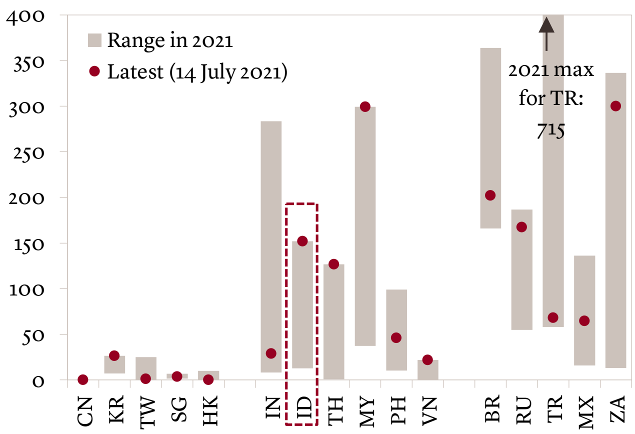
Net equity inflows, USD million (left), Bloomberg implied CY consensus (rhs)




Sources: CEIC, Bloomberg, Lombard Odier

29. Indonesia currently has Asia's second-worst Covid-19 wave

Covid-19 infections per million, 7-day moving averages




Sources: Our World in Data, Lombard Odier

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

# Asia FX

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: Pricing in growth forecast revision and the Fed's shift

We now see the Indian rupee (INR) registering only a limited recovery vs the USD in the remainder of the year, despite the recent 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 for vaccine rollout and 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 currently heavy 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 as long as the country faces the dormant threat of another large Covid-19 outbreak without sufficient progress in vaccinations. 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 credit rating agencies that are still keeping the country on the lowest rung of the investment grade ladder.

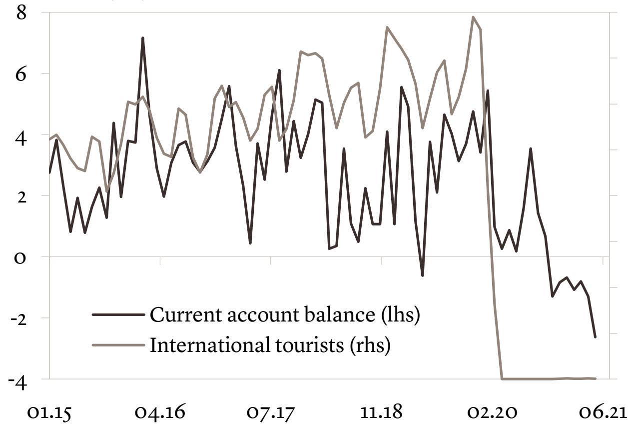
**Main risks to our view:** We do not believe there will be additional downgrades in India's grade rating, but it will be important to monitor the credit rating agencies' assessment of the country's medium-term fiscal risks. Industrial commodity prices, geopolitical tensions with China, and global government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

## 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 gain. **First**, Indonesia is unlikely to achieve a quick escape from the Covid-19 epidemic now that it has the second-worst infection wave in Asia (see chart 29). The logistical challenges of non-pharmaceutical interventions and vaccine rollout are substantial, and the country will not be

30. Thailand could register current account deficit in 2021

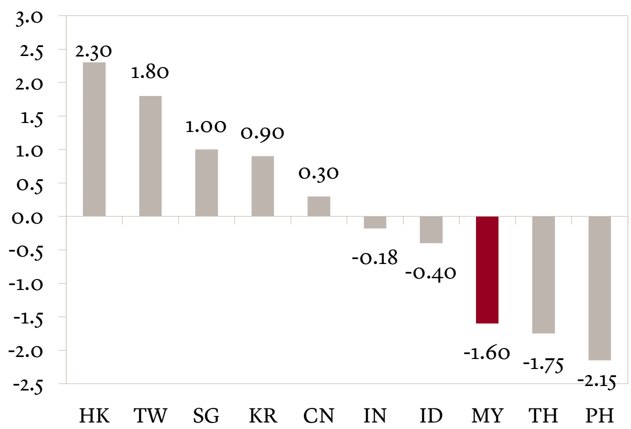
Current account balance, USD billion (left), Foreign visitors, millions (rhs)




Sources: Bloomberg, CEIC, Lombard Odier

31. Malaysia and its ASEAN peers have seen growth downgrades

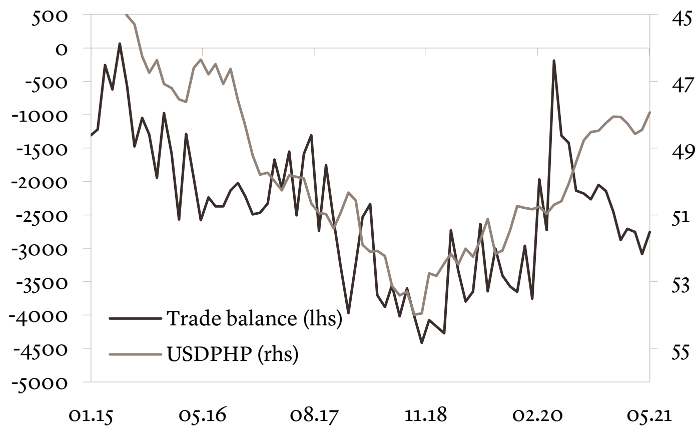
Change in consensus outlook for 2021 real GDP growth, ppts




Sources: Bloomberg, Lombard Odier

32. Widening deficit could create 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

able to return to its GDP trend until 2022 due to this fragility. **Second**, Bank Indonesia (BI) is still the essential buyer in the primary market, filling the gap left by more hesitant foreign investors. While foreign investors' fears over the burden-sharing agreement between BI and the government have abated somewhat, the government's new bond issuances will require significant excess domestic liquidity from the BI. This makes IDR relatively vulnerable to the potential market gyration over the Fed's normalisation plans. **Third**, the currency's downside is also limited due to relatively higher real rate trajectory in 2021 and its sensitivity to global cyclical upturn and bulk commodity prices.

**Main risks to our view:** The country's rising Covid-19 cases will be a key risk given its fragile healthcare system. Somewhat lower 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 the USD in the remainder of the year. **First**, Thailand's macro outlook will be extremely sensitive to news flows on virus variants and global vaccinations due to its crucial tourism sector, but relatively slow vaccination rollout in major emerging markets will likely push back the timing of a full recovery in tourism until 2022 or even 2023. Thailand registered seven consecutive months of current account deficit until May this year due to the lack of recovery in international tourism (see 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 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 MYR. That said, the impact of these developments has not yet been 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 alongside its ASEAN peers due to Asia's worst Covid-19 wave (see 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. All in, 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 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 peso is near, even though we do not see significant depreciation in the next twelve months. **First**, the country has not been able to completely stabilise its Covid-19 epidemic curve, and it continues to face significant logistical challenges in the nationwide deployment of vaccines. **Second**, the country's external balance will begin to deteriorate with the resumption of economic activity and with government spending that will push the deficit to 7-8% of GDP (see 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.

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

# LatAm FX

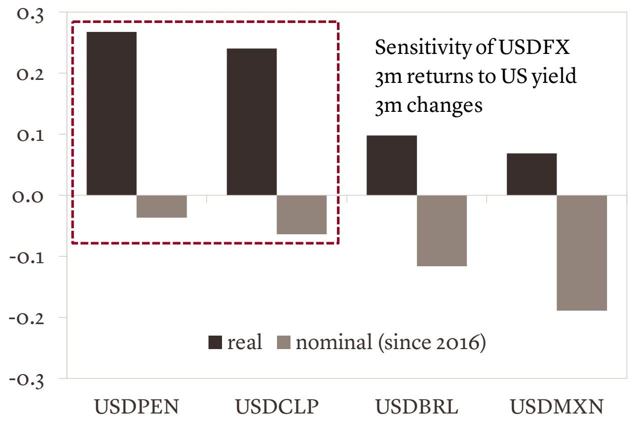
- **LatAm FX will face ongoing volatility from commodities, the global growth climate, US rates, as well as political stories. PEN and CLP are most sensitive to US real rates**
- **We maintain our preference for the MXN and PEN, but have a more cautious view on the COP and CLP. We are relatively neutral on the BRL.**

### BRL (Brazilian real): Should hold up in H2, though extreme positioning and end of growth upgrades could cap gains. Stay cautious for 2022

We have had a cautious view on the BRL for 2021 given the rising debt trajectory in recent years. That said, the 2021 view is now less bearish following strong growth upgrades after May, and government debt projections subsequently being revised down. We upgraded our BRL view in April (shifting it up from "EMFX underperformer" to the "cautious" category), and subsequently revised lower our USDBRL forecast to 5.28 (for end-2021). Still, we maintain an upward trajectory after 2021 as well as a mid-2022 target of 5.50 for the cross. The rationale for the shift in projections comes from our fair value model that saw a decrease in projection for end-2021 from 5.50 to 5.00. The main driver for this has been the downward adjustment in government debt projections (from 90% of GDP down to under 85%). That said, for 2022 we maintain a rising trend for USDBRL. 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 – chart 35). We assume this as over the longer term, we still have potential growth lower than the real cost of servicing debt (unlike other EM countries like India, for example). Two factors suggest BRL gains will be capped from here, and argue for more range-bound price action. **First**, the main driver of the BRL rally – i.e. the sharp pace of growth upgrades – is likely close to petering out. Consensus growth projections for 2021 now stand around 5.2%, having already converged with our own macro assumption (chart 34). **Second**, positioning has suddenly become stretched in the past few months, with CFTC net non-commercial long positions having been moved briskly to the 98th percentile of history since 2013 (vs 12% at the beginning of April). As always, political developments will need to be monitored, including the 2022 presidential election.

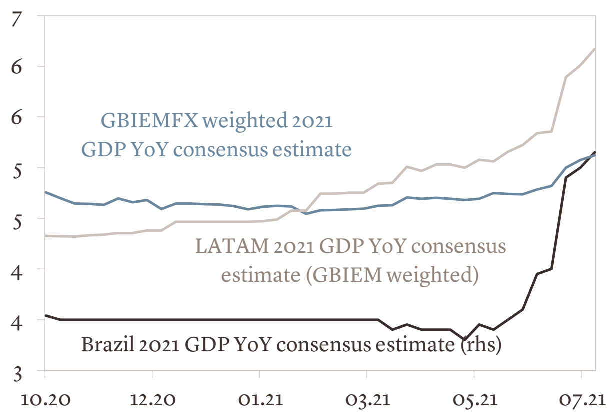
**Main risks to our view:** A downside USDBRL risk would be if 2022 GDP is revised higher also, and the debt profile is seen further improving in 2022. This is not our base case, but should not be ruled out. An upside USDBRL risk, more likely to materialise in 2022, would be a move towards populist fiscal policy in the run-up to the presidential elections.

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



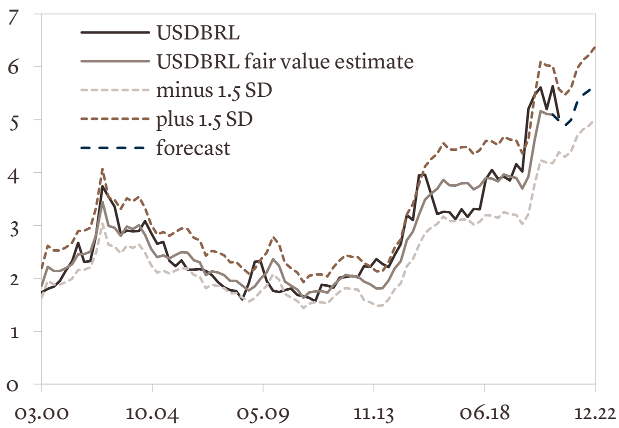

Sources: Bloomberg, Lombard Odier

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

### MXN (Mexican peso): More hawkish central bank and exposure to US growth to underpin the currency

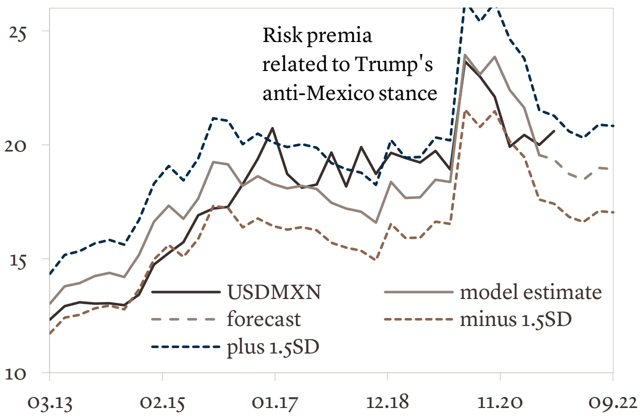
MXN has held up much better than other LatAm FX following the FOMC, and strong US growth as well as a more hawkish central bank turn may be providing support. The peso remains our top pick in LatAm (alongside the PEN). We would point out that of all LatAm FX pairs, USDMXN is the only one for which fair value is seen moving lower this year (chart 36). This is a function of the government running a relatively conservative fiscal policy after Covid, compared to peers. 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 is improving from historically low levels, carry in MXN has remained supportive and attractive – and not far from historical averages (5.05% post-Great Financial Crisis average, 4.8% at present). We did however have some reservations about the real rates profile that turned negative in March, following a rise in inflation. However, the more hawkish turn by the central bank could suggest this is less of a risk. The central bank hiked interest rates by 25 bps to 4.25%, and is indicating continued interest rate increases. Further interest rate normalisation, coupled with a decline in inflation (as very large positive base effects run off), could see real rates return to positive territory in the months ahead.

**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 Mexican President 'AMLO' on Mexico's energy agenda. A move to more radical constitutional changes remains a risk, but the June mid-term elections saw AMLO failing to receive the two-thirds majority required for such changes.

### CLP (Chilean peso): Staying cautious given elevated positioning and mixed drivers

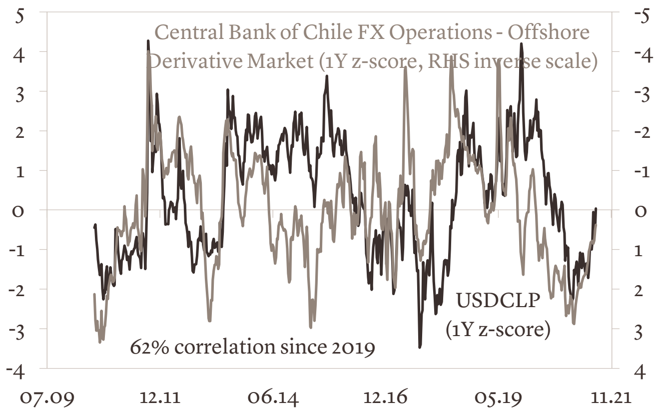
After a long stretch as our top pick in LatAm FX, we chose to downgrade the CLP to the "cautious" category in May. The currency subsequently did sell off, with USDCLP rising from 700 to close to 750 in recent months. While some value has been created with our fair value in the region of 710, at this point we would hold off on upgrading the currency. We remain concerned by positioning, which is very short USDCLP. Our USDCLP positioning indicator shows short covering has occurred, but the continued existence of short positions (chart 37) suggests the bias is still asymmetric, whereby negative news would affect CLP more than positive news. The months ahead bear competing drivers for the currency: political uncertainty (CLP-negative); and strong growth, higher interest rates, and still-supportive commodity prices (CLP-positive). On political uncertainty, the outcome of the constitutional

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



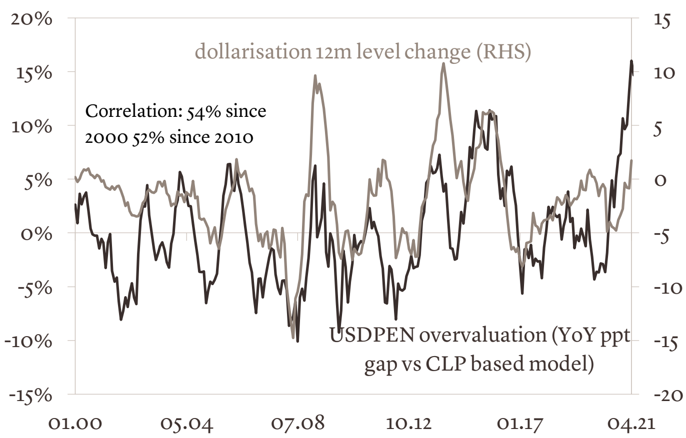

Sources: Bloomberg, Lombard Odier.

37. Short USDCLP positioning has decreased, but still remains




Sources: Bloomberg, Lombard Odier

38 USDPEN now overstretched, even accounting for political risk




Sources: Bloomberg, Lombard Odier

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

# LatAm FX

assembly election suggests a likely turn towards more populist policies and potential constitutional changes, as the centre-right coalition can no longer be relied on to perform "checks and balances". On fundamentals, Chile has also seen strong growth upgrades for 2021 (consensus 2021 GDP now at 7.5% vs. 5.0% in February), and the central bank has started normalising policy. Consensus expectations are for rates to rise to 1.25% by the end of 2021. Still, with inflation likely to remain above 3%, real rates should remain substantially negative.

**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. CLP has a high negative sensitivity to rising US real rates as well (chart 33, on previous page). Positive risks could come from a watering down of policy proposals (for example on the mining tax).

### PEN (Peruvian sol): Remaining rather constructive on good value and limited political risk

We upgraded the PEN to "modest performer" from "cautious" in June. The main reason is that the currency remains extremely cheap even after accounting for ongoing political risk. While political risk tends to result in a higher USDPEN as it leads Peruvian citizens to shift exposure from PEN to USD (dollarisation), we believe USDPEN levels currently already account for substantial political risk (chart 38). Furthermore, the scope for politics to spill over to negative macro policies appears limited, as left-leaning President-elect Castillo faces a divided Congress that could limit the scope for sweeping policy changes. The main risk remains that real rates are far too low (minus 300 bps) given the political uncertainty. Consensus expectations are for the central bank (BCRP) to keep rates unchanged in 2021, which means real rates will stay negative. In its most recent meeting, the BCRP made only minor tweaks to its dovish forward guidance (stating that policy would remain "expansionary" versus "strongly expansionary" previously).

**Main risks to our view:** USDPEN upside risks would come from the central bank staying too dovish for long, as well as political rhetoric (Peruvian Independence Day holidays over 28-29 July is an event risk). PEN has a high negative sensitivity to rising US real rates also. USDPEN downside risks would come from locals unwinding sizeable long USD positions.

### COP (Colombian peso): Still trailing the LatAm pack

The COP is the only LatAm currency in our group of EMFX underperformers. The main reason is weak external balances, an expensive valuation, a loss of reform momentum, and a central bank more dovish than its peers. External balances are indeed weaker than peers': on a 12M sum basis (% of GDP), Colombia's broad basic balance (C/A plus FDI) stood at -0.6% of GDP, lower than the 6%, 3%, 3%, and 2% of respectively Chile, Mexico, Brazil, and Peru. 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); this suggests a greater dependence on hot-money flows (hence EM risk appetite) to perform. Our long-term model shapes USDCOP equilibrium at between 3,800 and 4,000. On the fiscal side, a watering down of fiscal reform efforts resulted in a rating downgrade. The central bank has also been a laggard, continuing to signal a neutral bias in contrast to peers that have already begun policy normalisation. Real interest rates are negative (minus 200 bps), and are expected to remain so even after factoring in the possibility of a 25 bps hike by the central bank by end-2021.

**Main risks to our view:** A retreat in EMFX risk appetite as well as energy prices would make us more bearish. 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 corrected on specific flows and may offer an attractive entry point**
- **ZAR has seen a sharp fall from its 2021 outperformer status of last month. Expect further weakness, capped by a stronger current account**
- **Longer term, we remain bearish on the TRY, but USDTRY screens as overbought and may grind lower over the summer, aided by the tourism season**
- **The CEE FX correction may be over. We favour ILS and CZK.**

## RUB (Russian rouble): RUB closer to better re-entry levels for long exposure

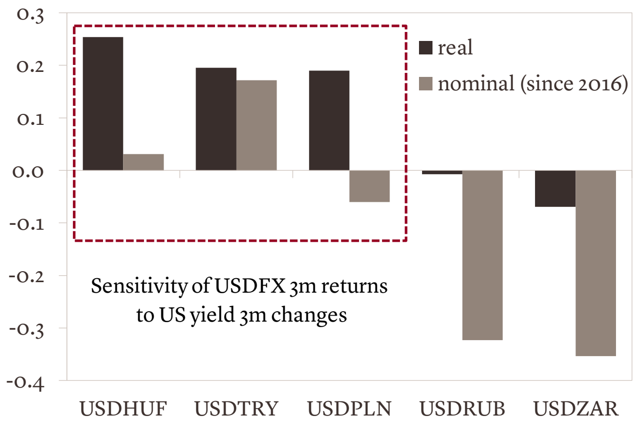
In early Q2, we upgraded our RUB view to "modest performer" (from "cautious"). We believe the recent correction in USDRUB towards the top of our assumed 72-76 range is an opportunity to sell USDRUB. Much of the dividend-related RUB outflows are likely behind us, whereas fundamentals remain strong. The currency has a unique position in EMFX as it not only offers high carry, but also operates twin surpluses (current account and budget). RUB also has a much lower sensitivity to US real yields than regional peers (chart 39). We did have two reservations for the RUB previously (financial sanctions risk and low real yields), but developments have moved in a more positive direction on both these fronts. On sanctions risk, there has been some thawing in Ukraine-Russia tensions as well as in the US-Russia relationship. With the passage of sanctions on primary OFZ issuance in early Q2, investors appear less concerned about follow-on action post the Biden-Putin summit in June. As for real rates, they still remain negative at minus 100 bps, but have improved following the more hawkish turn from the central bank (CBR) and should return to positive levels in Q4. The CBR has hiked interest rates by 125 bps (to 5.50%), and consensus median estimates anticipate rates will eventually rise to 6.25% and inflation peak in Q3. 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): Weakness likely due to political uncertainty, but capped by still strong external balances in 2021. Cautious in 2022

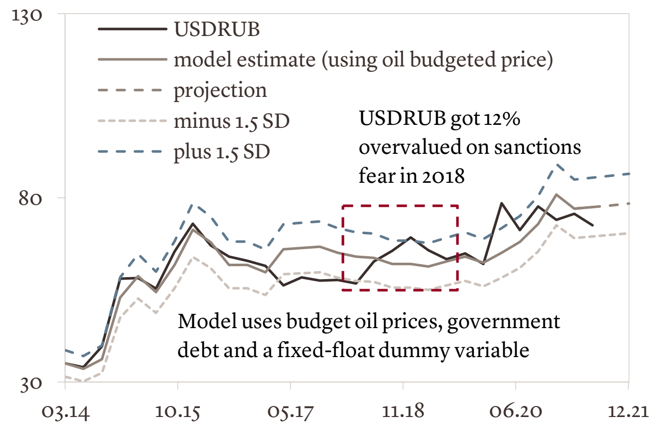
The South African rand had been the best-performing currency until mid-June (6.5% vs the USD, ahead of the 3% of

39. CEEMEA FX: US yield sensitivities since 2016



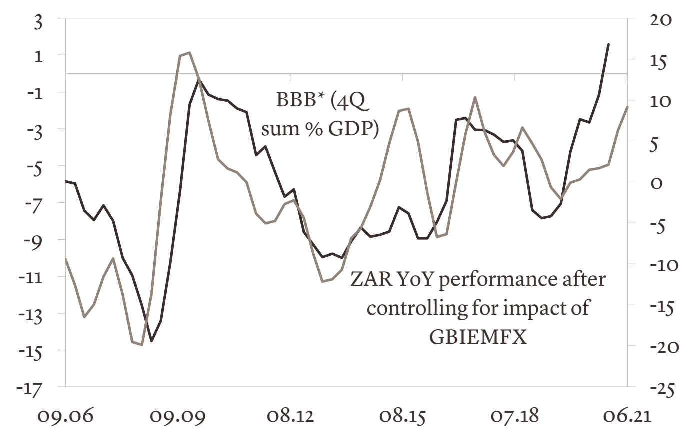

Sources: Bloomberg, Lombard Odier

40. USDRUB vs fair value estimate




Sources: Bloomberg, Lombard Odier

41. A still-strong external balance position could moderate USDZAR adjustment higher in 2021




Sources: Bloomberg, Lombard Odier

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

# CEEMEA FX

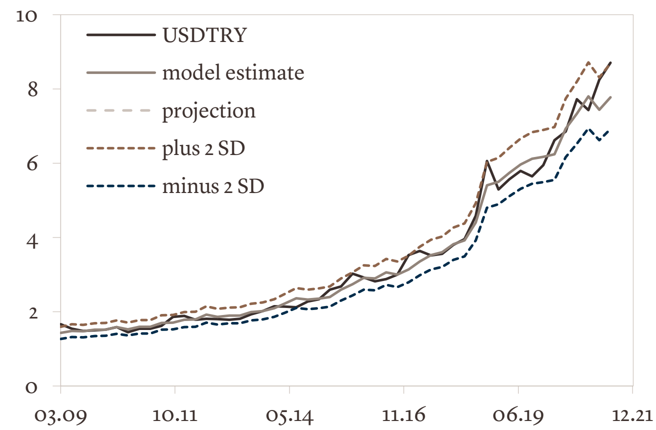
next-best performers RUB and BRL). However, the currency has erased most of those gains in the past month, falling 5% following widespread social unrest in the aftermath of the imprisonment of former President Jacob Zuma on corruption charges on 9 July. The riots have been the deadliest since minority rule ended in 1994. USDZAR has already rallied over 14.50, and headline noises will likely take the pair higher. However, we believe the move could slow closer to 14.80 (also our year-end forecast), at which the cross would appear overbought versus its short-term drivers. Another factor that could keep USDZAR from accelerating higher would be the still-strong current account, which has explained quite well the ZAR's relative resilience versus other EM currencies (chart 41). The current account is likely to remain near a surplus of 2% of GDP this year, and consensus expectations are still being revised higher (currently 1.50% of GDP). The main drivers for this have been both a record 8% trade surplus (courtesy of a strong rise in precious and base metals, as well as coal) and a narrower income deficit. These drivers could reverse in 2022, but should stop USDZAR from seeing a more aggressive rally in the months ahead. Furthermore, positioning still remains neutral. That said, 2022 will likely be more challenging for the currency, and we pencil in USDZAR rising next year to 15.20 and beyond. The ZAR looks expensive on our longer-term models, and has a poor fiscal profile and weaker growth compared to other EMs with high debt levels (like India and Brazil). Furthermore, real rates are likely to stay negative, with the central bank likely lagging peers in normalising policy.

**Main risks to our view**: On the bearish USDZAR side, a longer-than-expected spell of external rebalancing. On the bullish USDZAR side, the widespread rioting leading to economic damage, exacerbating an already snail's pace of vaccination.

### TRY (Turkish lira): USDTRY extremely overbought – and could see sideways consolidation helped by the tourism season

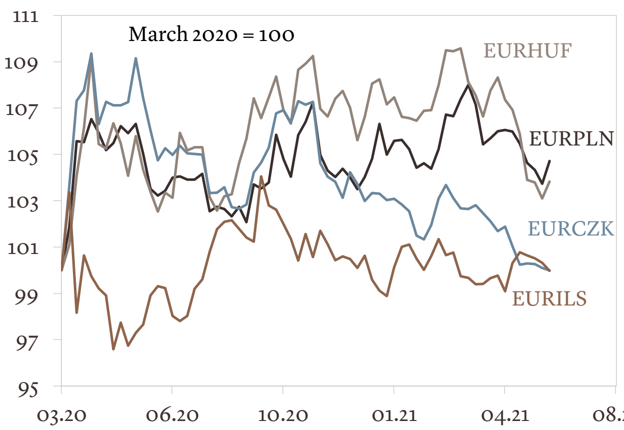
The Turkish lira is almost permanently on our list of EMFX underperformers given poor external balances, lack of clarity on monetary policy, as well as a trend of domestic dollarisation. That said, while the USDTRY has gained 10% since April, the cross could see some short-term consolidation around 8.50-8.80 over the summer. Our expected short-term summer respite mostly reflects the tourism season, which usually tends to see Turkey`s external accounts improve somewhat as the (tourism-driven) services balances increase strongly. Our long-term model, based on longer-term macroeconomic fundamentals such as relative core-CPI trends, relative productivity, foreign direct investment,

42. USDTRY now looking overbought versus fair value



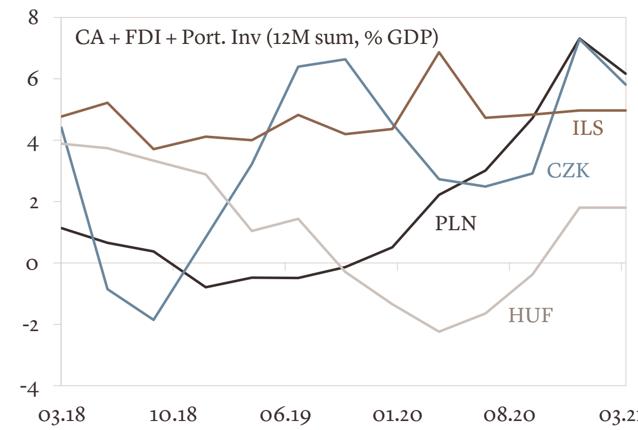

Sources: Bloomberg, Lombard Odier

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

government debt, and external debt, suggests USDTRY is now already near the top of the 6.90-8.70 range identified by our model, which highlights a central projection of 7.80 (chart 42). That said, we refrain from upgrading the currency on valuation grounds, as continued high inflation would suggest that the fair value itself will keep moving higher (as has been the case for the past decade). Otherwise, we believe we would need to see a clear hawkish shift and clarity on the direction of macro policies, which remain elusive. This uncertainty has led to diminished inflows from foreign investors in recent years, as well as to an increasing trend of local citizens shifting their savings away from the TRY to the USD. Furthermore, the TRY is the CEEMEA high-yielder that shows a great sensitivity to US yields, in contrast to the RUB or ZAR (chart 39, on previous page).

**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: Post-FOMC correction likely over

In June, we suggested that CEE currencies could face a setback driven by the less dovish-than-expected FOMC meeting. Over the past month, CZK, PLN, and HUF have declined by 3.3%, 3.7%, and 4.7% against the USD (underperforming the EURUSD that declined 2.5% over the same period). In contrast, the ILS has remained relatively stable, declining only 0.90% versus the USD over the same period. From here on, we would not expect the correction to continue, as we continue to anticipate a recovery in EURUSD (year-end target of 1.22), and assume that eurozone growth sentiment will remain positive (EZ manufacturing PMI is at all-time highs). Still, we would maintain a preference for the CZK, ILS, and PLN, but remain cautious on the HUF.

**CZK (Czech koruna):** We like the CZK for its historical response to stronger German growth sentiment, which tends to herald CZK gains and a relatively healthy debt trajectory. In recent months, Czech manufacturing PMI has outpaced regional peers, increasing the chances of imminent rate hikes. Markets are also under-pricing the pace of rate hikes signalled by the central bank.

**ILS (Israeli shekel):** We still like the ILS given its healthy balance of payments profile, and pencil in USDILS ending the year at 3.20. Israel's broad balance of payments (current account + foreign direct investment + portfolio investment) continues to track at a record high of 12% GDP on a 12-month basis. The central bank has been intervening aggressively, and has managed to fully recycle the surplus in recent quarters by 2% of GDP (reserve surplus over total trade and financial flows). Nonetheless, this is below the 5% reserve surplus that historically resulted in a reversal of the ILS appreciation trend. The CB has already executed on two-thirds of the 2021 FX intervention programme, which could be expanded further. Modest increases will only serve to slow the decline in USDILS.

**PLN**: The PLN benefits from strong balance of payments support, but has been undermined by the central bank's more dovish stance than peers, and by a preference for a slightly weaker PLN (the CB intervened some months ago). There will be many changes to the central bank board membership in H1 2022, with seven of the ten Monetary Policy Council members as well as the governor (in June 2022) due for replacement. This could constrain policy to some extent.

**HUF**: We maintain our more bearish view on the HUF given higher sensitivity to US real rates, as well as weaker external balances compared to peers (chart 44). While the central bank has moved to a normalising policy, we believe that its still-large balance sheet, historical preference for a weaker currency, and weak external balances will see the HUF underperform.

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

# Our Lombard Odier long-term FX fair valuation framework

| **BEER** Behavioural equilibrium exchange rate model | **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 buy 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

**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

**RMB**
Chinese Renminbi

**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 National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).*

### LONDON
**Lombard Odier (Europe) S.A.· UK Branch[2]**
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom ·
london@lombardodier.com
The Bank is deemed authorised in the UK by the Prudential Regulation Authority (‘PRA’). Subject to regulation by the Financial Conduct Authority (‘FCA’) and limited regulation by the Prudential Regulation Authority. Financial Services Firm Reference Number 597896. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority and regulation by the Financial Conduct Authority are available from us on request.
**Lombard Odier Asset Management (Europe) Limited**
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom ·
london@lombardodier.com
*Investment firm authorised and regulated by the Financial Conduct Authority (FCA register No.515393).*

### LUXEMBOURG
**Lombard Odier (Europe) S.A.**
291, route d’Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
*Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.*
**Lombard Odier Funds (Europe) S.A.**
291, route d’Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

### MADRID
**Lombard Odier (Europe) S.A. · Sucursal en España[2]**
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
*Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).*
**Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.**
Paseo de la Castellana 66, 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
*Management Company supervised by the Comisión Nacional del Mercado de Valores (CNMV).*

### MILAN
**Lombard Odier (Europe) S.A. · Succursale in Italia[2]**
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
*Credit institution supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d’Italia.*

### MOSCOW
**Bank Lombard Odier & Co Ltd · Representative Office Moscow**
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]**
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### BRASIL
Lombard Odier (Brasil) Consultoria de Valores Mobiliários Ltda.
Avenida 9 de Julho No. 3624, Torre DGN 360, 6° andar
Jardim Paulista · CEP 01406-000 · São Paulo · Brasil
sao.paulo.office@lombardodier.com
*Supervised by the Comissão de Valores Mobiliários of Brasil.*

### DUBAI
**Bank Lombard Odier & Co Ltd · Representative Office Dubai**
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE ·
dubai@lombardodier.com
*Under the supervisory authority of the Central Bank of the UAE.*

### ISRAEL
**Israel Representative Office · Bank Lombard Odier & Co Ltd**
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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### JOHANNESBURG
**South Africa Representative Office · Bank Lombard Odier & Co Ltd**
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
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### MONTEVIDEO
**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
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## ASIA - PACIFIC

### HONG KONG
**Lombard Odier (Hong Kong) Limited**
3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
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### SINGAPORE
**Lombard Odier (Singapore) Ltd.**
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
*A merchant bank regulated and supervised by the Monetary Authority of Singapore.*

### 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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