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FX Monthly
Implications of Russia-Ukraine geopolitical conflict

02/12

March 2022

Key highlights

- The major development since our last publication has been a significant escalation in the Russia-Ukraine conflict
- Energy prices – and hard and soft commodity prices in general – are set to remain under upward pressure over the coming months. Global growth will likely be somewhat lower and inflation higher
- A wide range of oil price outcomes is possible, from USD 95/barrel to US D150/barrel and above
- Gold will remain supported in the short term by haven flows and investors looking for inflation hedges, with a downward trend resuming only once the market environment allows central banks to pursue monetary policy normalisation
- European currencies that are dependent on energy imports and/or in close proximity to the conflict will remain vulnerable. This includes the EUR, GBP, and SEK (in G10), and the PLN, HUF, and TRY (in EM). The US dollar will by default hold up better, aided by the US's energy independence. We revise down our EURUSD assumption for 2022 to 1.06 from 1.09 previously
- Over time, if broader risk sentiment stabilises, better support should materialise for those commodity currencies that are geopolitically distant from the conflict – such as the CAD and even the AUD (in G10), as well as LatAm FX (in EM)
- After the US dollar, the Swiss franc remains our second-favourite FX haven – given Switzerland's strong external balance, limited dependence on fossil fuels and natural gas, and a greater tolerance from the SNB of a stronger CHF. The Japanese yen would require a rally in US Treasuries to perform, and may lack some of the qualities of an optimal haven.

FX forecasts		Q222	Q422
G10	EURUSD	1.08	1.06
	USDJPY	116	117
	EURCHF	0.99	0.97
	GBPUSD	1.30	1.27
	EURGBP	0.828	0.835
EM	USDRMB	6.35	6.46
	USDINR	76.8	77.0
	USDIDR	14 300	14 450
	USDMXN	21.1	21.0
	USDBRL	4.93	4.81
	USDRUB	139	160
	USDZAR	15.5	15.8

At a glance

Monthly publication of Lombard Odier Investment Solutions – Investment Strategy department

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

Data as of 9 March 2022

Introduction

The major development since our last publication has been a significant escalation in the Russia-Ukraine conflict, with large-scale Russian military intervention extending deeper into Ukrainian territory. We have already seen significantly broader sanctions imposed in order to isolate Russia from access to financial markets; for now, though, Russian gas flows have continued to Europe. Energy prices are likely to remain higher given the supply shock, and we have made downward revisions to global growth forecasts (foremost for the eurozone) as well as upward revisions to inflation. We would make the following points regarding commodity and currency markets.

First, with both Russia and Ukraine significant producers of commodities, the ongoing conflict may result in supply disruptions and higher commodity prices. While a significant disruption to Russian supply of natural gas has so far been averted, the situation remains fluid. In oil markets, investors are weighing the potential impact of further sanctions or disruptions to Russian supply. This comes at a time when inventories are low and spare capacities stretched. We see a wide range of possible price outcomes this year. (see Commodity corner). However, Ukraine is also a systemically important producer of a number of agricultural commodities, including wheat and corn, and of industrial commodities and alloys (like aluminium), which suggests upside risks to inflation.

Second, while the immediate currency market response to Russia's invasion has been clouded by position adjustment and risk reduction, once risk sentiment stabilises as we assume it will at some point, we believe that over time there will be greater divergence in currency reactions regarding several parameters. European currencies dependent on energy imports and/or in close proximity to the conflict will remain vulnerable. This includes the EUR, GBP, and SEK (in G10), and the PLN, HUF, and TRY (in EM). The US dollar will hold up better, aided by the US's energy independence. We revise down our EURUSD assumption for 2022 to 1.06 from 1.09 previously. Assuming broader risk sentiment stabilises, commodity currencies geopolitically distant from the conflict may outperform. This includes the CAD and AUD in G10, and the CLP, PEN, BRL, IDR, and MYR in EM. The RMB should remain stable and track the broader US dollar.

Third, CEEMEA FX will retain their status of 'most vulnerable' given recent developments. Having already downgraded the RUB to 'cautious', we further downgrade the currency to EMFX underperformer. We also downgrade the PLN by one notch, to 'cautious'. Recent sanctions aimed at preventing Russia's central bank from accessing FX reserves will increase the risk of default, and prevent the country from protecting the Russian rouble. Further outflows are likely by both foreign investors and Russian residents, and this should keep the rouble under depreciation pressure against the US dollar. With the exception of ILS and ZAR, all other currencies will face weakening pressures in view of their high dependence on energy prices, proximity to the conflict (PLN and HUF), as well as potential loss of tourism (TRY; see CEEMEA section).

Finally, our preferred haven currencies remain the USD, CHF, and JPY – in that order. We believe a still-robust trade surplus as well as a small dependence on fossil fuels and natural gas in Switzerland (under 3% of total energy consumption) will ensure the franc remains very well supported. On the other hand, a much smaller trade surplus and dependence on fossil fuels and natural gas (near 70% of total energy imports) will prevent the JPY from functioning effectively as a haven currency. We expect the EUR vs CHF pair to reach below parity in 2022.

FX forecasts – G10 and gold

	Current spot	Q1 22	Q2 22	Q3 22	Q4 22	Estimates of long-term fair value[2]
EURUSD	1.10	1.09	1.08	1.07	1.06	1.17
GBPUSD	1.315	1.31	1.30	1.28	1.27	1.40
EURGBP	0.836	0.832	0.828	0.832	0.835	0.84
EURCHF	1.020	1.002	0.990	0.979	0.97	1.02
USDCHF	0.928	0.92	0.92	0.92	0.92	0.88
USDJPY	116	115	116	117	117	95
EURJPY	127	125	125	125	123	111
EURSEK	9.76	9.99	10.21	10.14	10.00	9.61
USDSEK	10.73	10.89	11.00	10.80	10.60	8.24
EURNOK	8.91	9.08	9.14	9.20	9.20	9.86
USDNOK	9.80	9.90	9.85	9.80	9.75	8.46
AUDUSD	0.73	0.73	0.73	0.73	0.74	0.79
NZDUSD	0.69	0.68	0.67	0.67	0.68	0.67
USDCAD	1.28	1.27	1.26	1.25	1.25	1.23
Gold (USD/Oz)	2 001	- [1]	- [1]	- [1]	- [1]	
Oil (Brent, USD/bl)	124	- [1]	- [1]	- [1]	- [1]	
Copper (USD/mt)	10 209	- [1]	- [1]	- [1]	- [1]	

1 Forecasts under review (see commodity corner)

2 The estimates of long-term (LT) fair values are calculated as the average value estimated using FEER and BEER models. The FEER (fundamental equilibrium exchange rate) model calculates the exchange rate required to bring macroeconomic balance, i.e. full-employment, low inflation and a sustainable current account balance. The BEER (behavioral equilibrium exchange rate) model uses econometric methods to estimate equilibrium FX rates based on a set of macroeconomic variables (our model uses terms of trade, investment as a share of GDP, and real rates within a panel data set across G10 FX). Please refer to page 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	Q1 22	Q2 22	Q3 22	Q4 22
USDRMB	6.32	6.35	6.35	6.41	6.46
USDHKD	7.82	7.79	7.79	7.80	7.80
USDIDR	14 348	14 268	14 300	14 400	14 450
USDINR	76.6	76.5	76.8	77.2	77.0
USDKRW	1237	1 219	1 216	1 212	1 200
USDMYR	4.19	4.17	4.17	4.17	4.14
USDPHP	52.2	52.2	52.6	53.1	53.2
USDSGD	1.36	1.36	1.37	1.37	1.37
USDTWD	28.4	27.9	27.8	27.8	27.6
USDTHB	33.1	33.1	33.3	33.4	33.3

LatAm

	Current spot	Q1 22	Q2 22	Q3 22	Q4 22
USDMXN	21.1	21.1	21.1	21.2	21.0
USDBRL	5.02	4.97	4.93	4.89	4.81
USDCOP	3 745	3 913	3 942	3 991	4 098
USDCLP	804	790	777	763	750
USDPEN	3.74	3.72	3.71	3.69	3.68

CEEMEA

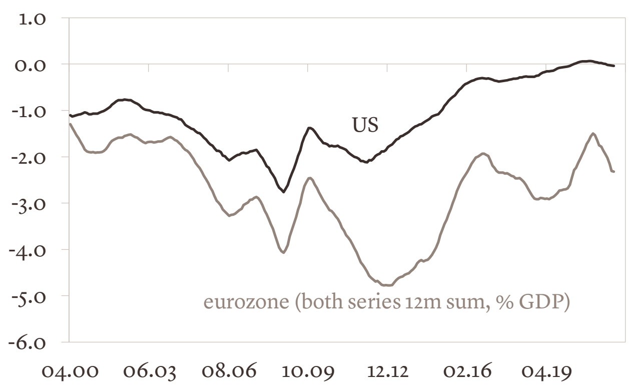
	Current spot	Q1 22	Q2 22	Q3 22	Q4 22
USDRUB	118.1	128.5	139.0	149.5	160.0
USDTRY	14.7	14.20	15.20	16.20	17.20
USDZAR	15.1	15.3	15.5	15.6	15.8
USDILS	3.27	3.25	3.22	3.20	3.16
EURPLN	4.82	4.80	4.77	4.73	4.70
EURCZK	25.4	24.5	24.6	24.8	24.9
EURHUF	379	380	377	373	370

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

G10FX: Three key charts

Energy dependence and terms of trade will matter more: Given the recent geopolitical conflict and resultant higher energy prices, terms of trade and energy dependence will matter greatly for currencies. The US's energy independence and lower energy trade deficit stand in stark contrast to large energy deficits seen for many currencies in the EU as well as Asia. This should further underpin our positive USD bias against the EUR.

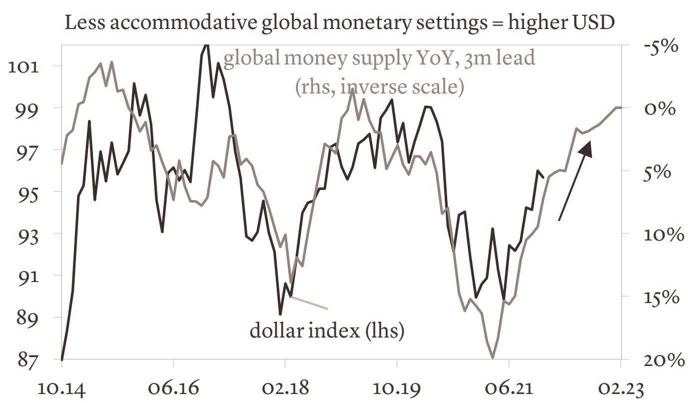
Petroleum products trade balance : US vs Eurozone



Sources: Bloomberg, CFTC, Lombard Odier

Tighter global liquidity to support the USD in 2022: With several central banks (Fed, ECB, BOE) having signalled an earlier end to asset purchases, we believe the USD dollar will see a natural level of support especially against relatively low-yielding currencies such as the EUR and JPY. Global liquidity – which we proxy as global money supply growth, has a stronger link to the dollar (over 40% correlation) than to interest rate differentials (about 20%). This is why we believe that even if the ECB turns less dovish, the US dollar could remain strong against the euro.

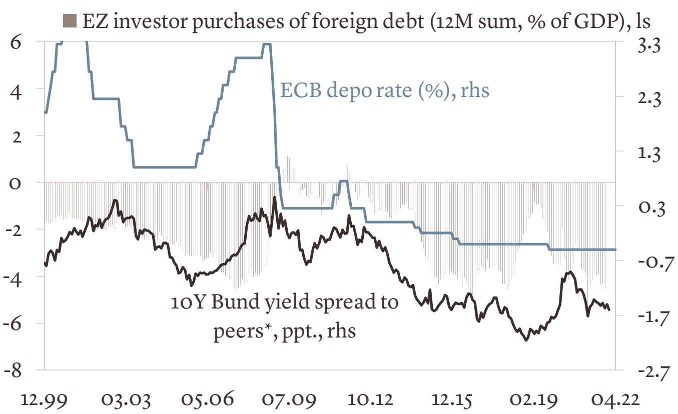
USD to stay strong as global liquidity growth normalises



Sources: Bloomberg, CFTC, Lombard Odier

A shift away from negative rates is unlikely to be a big game changer for the euro: We believe that alongside such a move, the ECB would also need to be more hawkish than peers in order to allow the yield advantage of German Bunds (versus US Treasuries and gilt) to improve. Our analysis shows that the substantial capital outflows from the eurozone (as domestic investors made large acquisitions of foreign debt) can be traced more to yield differentials than to the deposit rate per se. Yield differentials also explain movements in flows even before 2009.

Yield differential, not deposit rate level, governs bond outflows
Correlation of debt flows to yield spread is 48%, vs 4% to deposit rate



Sources: Bloomberg, Lombard Odier
* for peers, we use average of 10Y US Treasury and 10Y UK gilt yield

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

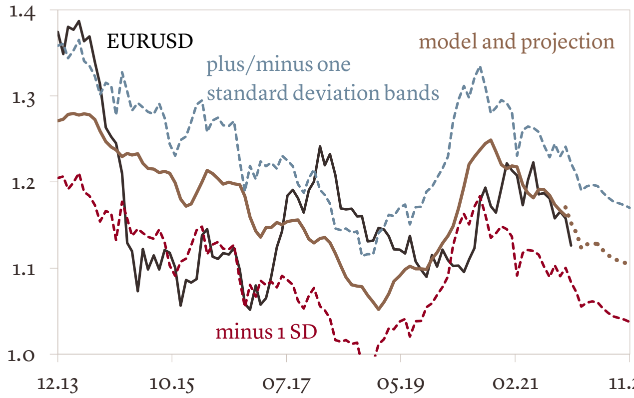
FX majors

EUR (euro): A further downgrade given negative terms of trade effects

- **We further downgrade our EURUSD forecast, and lower our year-end target to 1.06 (from 1.09 US dollars per euro previously)**
- **The eurozone's large dependence on Russian oil and gas poses downside risks to growth and will keep the bloc's balance of payments flows weak**
- **We do not believe a shift to non-negative deposit rates will influence the EUR, as large debt capital outflows since 2014 have coincided more with the relative yield between German Bunds and global peers (US Treasuries, UK gilts).**

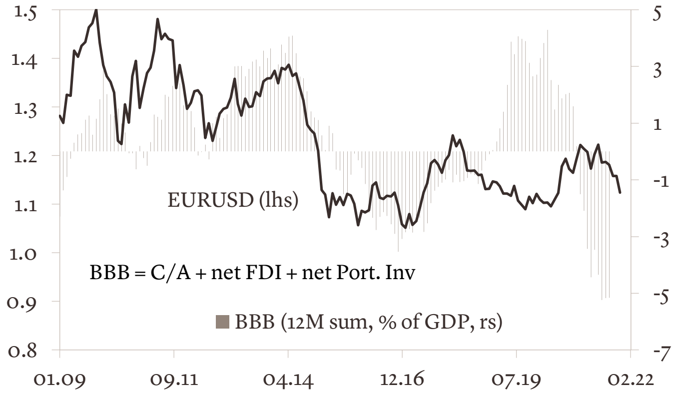
First, we downgrade our EURUSD forecast and lower our year-end target to 1.06 (from 1.09 US dollars per euro previously). This represents an undershoot scenario relative to the existing assumption of fair value (see adjacent chart). However, a weaker euro seems likely given the negative terms of trade shock the eurozone will face due to higher energy prices and the risk of disruption to Russian gas supply (on which the eurozone is extremely reliant). On the other hand, the US economy is relatively closed and energy-independent, which should keep the USD well supported. **Second**, ultimately we believe the ECB will be unable to tighten policy very much. We assume a 25-bps hike by the end of 2022 to -0.25% (although this view may be challenged by recent developments). However, we see rates eventually rising only to 0.75% on a longer-term view. We assume that the Fed, by contrast, can raise rates to higher levels eventually, up to 2.75% on a longer-term view. We stress again that the crux of our positive USD for 2022 was based on global growth and liquidity slowing to trend, rather than policy divergence and interest rate differentials. Global liquidity has been a more reliable explanatory factor (see G10FX: Three key charts). **Third**, we believe balance of payments flow dynamics will keep the EUR soft. The region's broad basic balance of payments (12-month sum of current account plus foreign direct investment plus equity and debt portfolio investment) has been running at a pace of minus 5% GDP. Debt outflows may well remain in place as Bund yields will likely maintain their yield disadvantage compared to global peers (US treasuries and UK gilts). This matters more than the level of the ECB deposit rate per se (see G10FX: Three key charts). Hence, we do not believe a return to a positive deposit rate will be a game-changer for flows, and thus for the EUR. **Fourth**, we assume that the French presidential elections (first and second rounds set for 10 and 24 April) are unlikely to be a big driver for the EUR.

EURUSD fair value estimate projection based on Lombard Odier's monetary policy assumptions & consensus inflation and yield forecasts



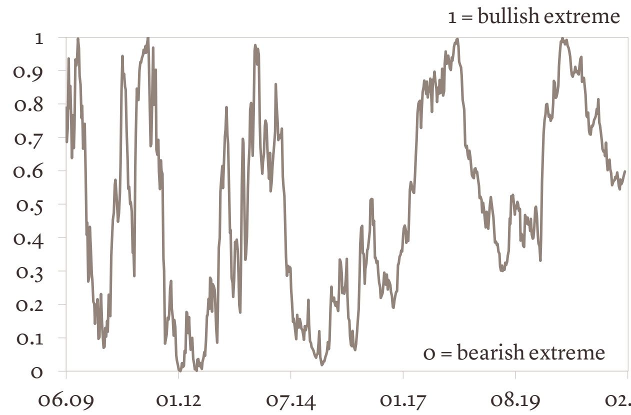
Sources: Bloomberg, Lombard Odier

EURUSD to weaken on worsening eurozone balance of payments flows



Sources: Bloomberg, Lombard Odier

EURUSD sentiment relatively neutral after large decline in spot



Sources: Bloomberg, Lombard Odier

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

FX majors

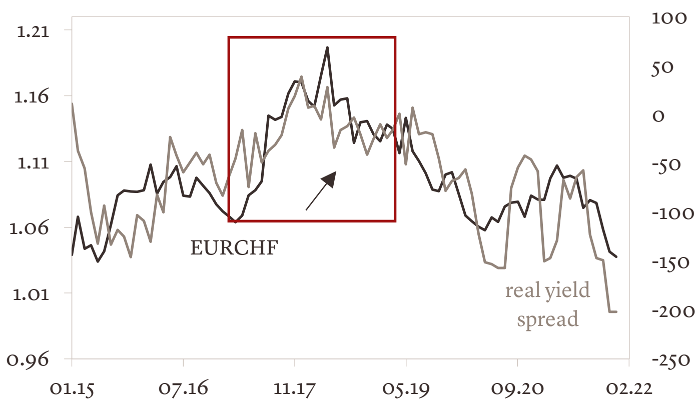
Key events: French elections (first half of April), FOMC meetings (16 March, 4 May, 15 June, 27 July), ECB meetings (10 March, 14 April, 9 June, 21 July), and eurozone core CPI figures (2 March, 1 April and 29 April).

CHF (Swiss franc): EURCHF to decline below parity

- **We assume CHF will remain flat against the USD, which should see EURCHF track EURUSD. Given our downward revision to EURUSD, we now expect EURCHF to reach 0.97 by end-2022, with risks to the downside**
- **We believe valuation, relative balance of payments pressures, as well as increased tolerance for a lower EURCHF from the Swiss central bank will drive EURCHF lower.**

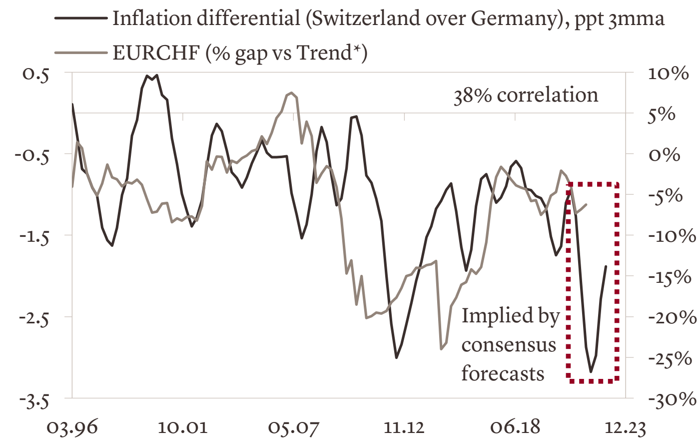
First, we believe the direction of the EUR vs CHF pair will be dictated largely by the relative real yield differential between the eurozone and Switzerland, which currently remains deeply negative. Since the Swiss National Bank (SNB) removed the EURCHF 1.20 floor in 2015 and allowed the cross to be driven more by market forces, the real yield differential between the eurozone and Switzerland has proven to be a strong determinant for the currency. Strong rises in both US Treasury and German Bund yields could lead to retracements higher in the EUR vs CHF pair, but these should be limited. **Second**, Switzerland's balance of payments remain supportive of currency appreciation. The country's trade balance stands at 12% GDP on annual rolling sum basis, the strongest since at least the early 1990s. At the same time, Switzerland is once again seeing net foreign direct investment inflows (after strong outflows over 2018-20). Coupled with a strong 'home bias' among Swiss domestic investors (evident in their preference for CHF deposits and hedging on foreign asset holdings), the Swiss franc should remain under appreciation pressure, in the absence of SNB intervention. **Third**, while Switzerland is also a net energy importer, it is far less vulnerable than the eurozone or even Japan. Much of the country's energy comes from hydro and nuclear sources, with under 3% coming from fossil fuels and natural gas (vis-à-vis 40% and 70% for the eurozone and Japan, respectively). **Fourth**, barring smoothing intervention in the event of abrupt CHF appreciation, we assume the SNB will take a more hands-off approach towards intervening to support the EUR vs CHF pair. Just as other central banks are tapering their balance sheets by reducing bond purchases, the SNB will likely taper its own balance sheet, the largest in the developed world relative to the size of the economy. Real exports and core inflation, two metrics that the SNB monitors, are both

EURCHF vs EUR-CHF real interest rate differentials



Sources: Bloomberg, Lombard Odier

Inflation differential suggests downside risks to EURCHF



Sources: Bloomberg, Lombard Odier
* Trend = preceding 8Y (32 quarter) average

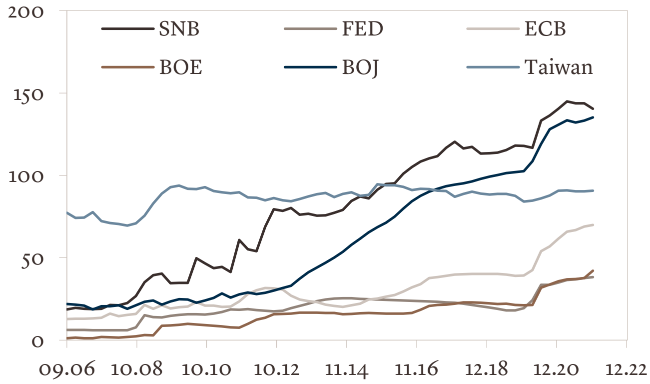
Note: Past performance and forecasts are not a reliable indicator of future performance.

stronger than historical averages. Indeed, it is plausible that if core inflationary pressures turn out to be stronger, the central bank will consider actively selling EUR in order to reduce the size of its FX reserves (and hence its central bank balance sheet). The SNB appears to be relatively comfortable with lower levels of EURCHF given that, on an inflation-adjusted basis, the real exchange rate has actually declined. The trend in inflation differentials for the eurozone vis-à-vis Switzerland suggests EURCHF should remain under downward pressure.

Key events: SNB meetings (24 March, 16 June, 22 September, 15 December).

SNB has the largest balance sheet in the DM central bank world

Central Bank total assets % GDP



Sources: Bloomberg, Lombard Odier
* Trend = preceding 8Y (32 quarter) average

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FX majors

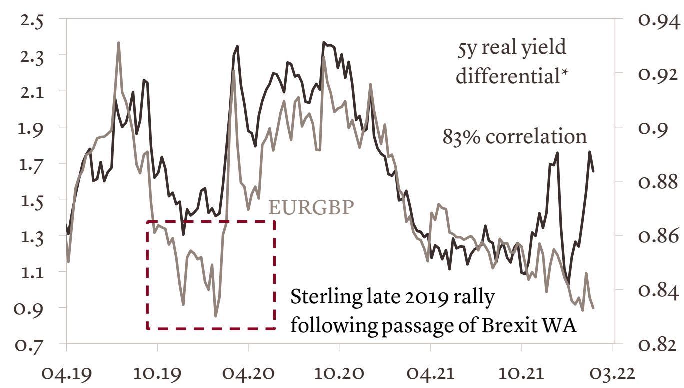
GBP (pound sterling): Weaker against the USD and CHF, but well supported against the EUR

- **We now expect the euro to remain weaker against sterling beyond H1. The EUR vs GBP pair will stay near 0.83, or even potentially dip lower in the months ahead**
- **However, we believe sterling will depreciate against both the US dollar and the Swiss franc given its relative vulnerability to higher energy and gas prices**
- **Political risks have become more prominent, but should be secondary to the outlook for the economy and broader monetary policy.**

First, our starting point for thinking about and forecasting the path of sterling is to form a view on the EURGBP. This is because the EURGBP best describes sterling on a trade-weighted basis given that the eurozone is still very much the UK's biggest trading partner (the eurozone accounts for 40% of total goods exports and imports from the UK). We now expect the euro to remain weaker against sterling beyond H1. While the GBP is vulnerable to higher energy and gas prices given a sizeable energy trade deficit, the EUR is even more exposed given European dependence on energy notably from Russia. Hence, we assume the EUR vs GBP pair will stay near 0.83, or even potentially dip lower in the months ahead. **Second**, taking into account our reduced forecasts for EURUSD and our assumptions on EURGBP, we expect GBPUSD to decline to 1.27 by year-end (unchanged from prior forecast). **Third**, domestic and Brexit-related political risks will need to be monitored for sterling, but will likely take a back seat as the focus shifts to geopolitical developments surrounding Russia and Ukraine. In the event that Mr Johnson loses his party's leadership at some point given the scandal over senior government members breaking Covid rules, we assume that sterling volatility would increase as the process of electing a successor may take time (the 2019 leadership contest took a full month). In terms of potential impact on sterling, it is unclear whether a change in leadership would have ramifications for UK domestic or foreign policy. The potential for less confrontational negotiations with the EU (sterling-positive) would have to be weighed against the likelihood of a successor to Mr Johnson tightening fiscal policy more (sterling-negative). We will have to wait and see how the situation develops and which theme retains the markets' attention. **Fourth**, in the longer run, we believe sterling is overvalued in the context of likely structural changes occurring because of Brexit – particularly a continued decline in the UK's share of global trade. As the eurozone on the other hand continues to gain share, this should result in weaker sterling on a five-year view, and higher EURGBP. However, this is likely less relevant for the quarters ahead, as developments around a likely energy supply shock dominate.

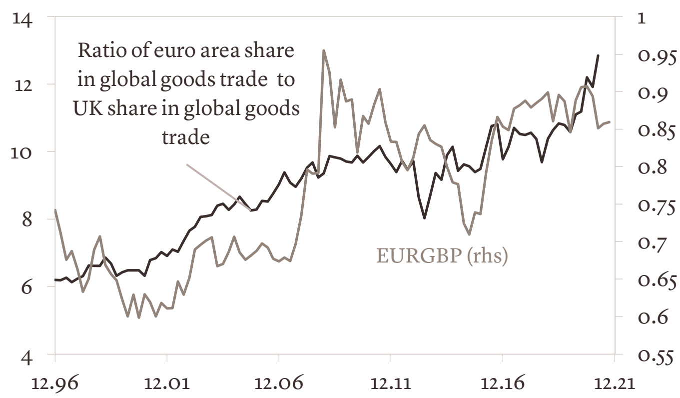
Key events: BOE meetings (17 March, 5 May, 16 June, 4 August).

Real yield differential* no longer providing a clean EURGBP bearish signal



*adjusted for inflation and credit risk
Sources: Bloomberg, Lombard Odier

Declining footprint of the UK in global trade suggests EURGBP should move higher on a long-term view



Sources: Bloomberg, Lombard Odier

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FX majors

JPY (Japanese yen): A sub-optimal safe haven

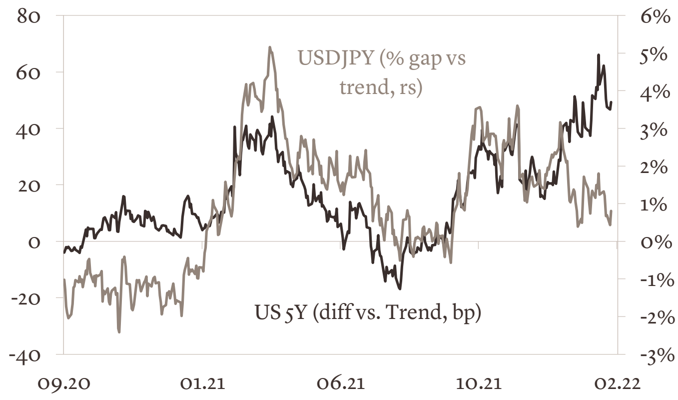
- **USDJPY has remained range-bound within 113-116 in recent months, with no clear trend**
- **If US yields remain under upward pressure, then we believe USDJPY will eventually move higher, with the BOJ likely to cap Japanese yields**
- **However, recent geopolitical developments may cloud the picture for US yields and could keep USDJPY in a 114-116 range for longer**
- **Given a smaller trade surplus and a large dependence on fossil fuels and natural gas, we believe the JPY will function suboptimally as a haven against the evolving energy supply shock. USD and CHF are our preferred havens in FX.**

First, we believe the Japanese yen will weaken over the coming year, with any risk aversion-related support likely to remain shallow. We assume that the Bank of Japan will maintain its yield curve target in place, while US 10Y yields will continue to grind higher (although there are some two-way risks around this scenario given geopolitical developments). This assumption was reinforced in February when the Bank of Japan (BOJ) conducted unscheduled bond buying operations in order to keep 10Y government bond yields within the trading bands, as per the central bank's yield-curve control (YCC) policy. This yield divergence should keep USDJPY under upward pressure. **Second**, we believe that the Japanese yen is performing sub-optimally as a safe-haven currency. One reason is that the recent source of risk aversion has been a hawkish Fed (and higher US yields), something that tends to keep the JPY on the back foot. An external event that makes the Fed dovish and sees US treasuries rally may result in a lower USDJPY. However, beyond the source of risk aversion, another major reason for the poorer performance of the Japanese yen in times of stress is weakening in balance of payments support. On a stock basis, Japan's creditor status (holding large foreign assets) implies that repatriation flows could support the JPY, but on a month-by-month flow basis, flows are not as supportive for the Japanese yen as they used to be. The aggregation of Japan's trade balance and net foreign direct investment flows turned deeply negative after 2011. **Third**, in the longer term, USDJPY is overvalued, albeit likely less than traditional models such as purchasing power parity imply. When we factor in Japan's falling share of global trade (from 7.5% in 2005 to ~3.5% at present), we estimate that USDJPY's fair value is likely closer to 110 than to 100. An overvaluation to the tune of 5-10% – as seen over the past decade – would suggest that USDJPY could remain in a 115 to 120 range. **Fourth**, a risk to a positive USDJPY view would be if US treasuries saw a sharp rally, and/or if the BOJ turned more hawkish. It is possible that the central bank may slowly move towards normalising policy by widening the bands on its yield curve target to allow for more two-way movement. However, this prospect appears some time away and is likely a story for H2 2022. The debate on changes to policy could emerge closer to Q3 2022 as the market anticipates possible changes in policy linked to the end of BOJ Governor Kuroda Haruhiko's tenure in April 2023. However, this is a risk for later in the year, in our view, and should not alter the USDJPY trend over the coming six months.

Key events: BOJ meetings (18 March, 28 April, 17 June, 21 July).

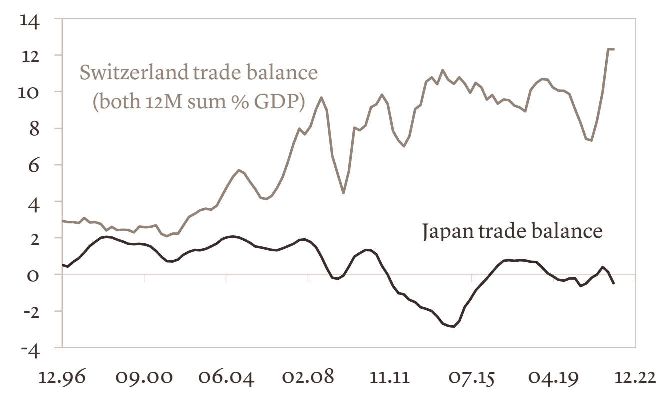
USDJPY spot vs US 5Y yield detrended

Trend = 100 day moving average



Sources: Bloomberg, Lombard Odier

An evolving trade deficit has undermined JPY safe haven properties after 2011



Sources: Bloomberg, Lombard Odier

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FX majors

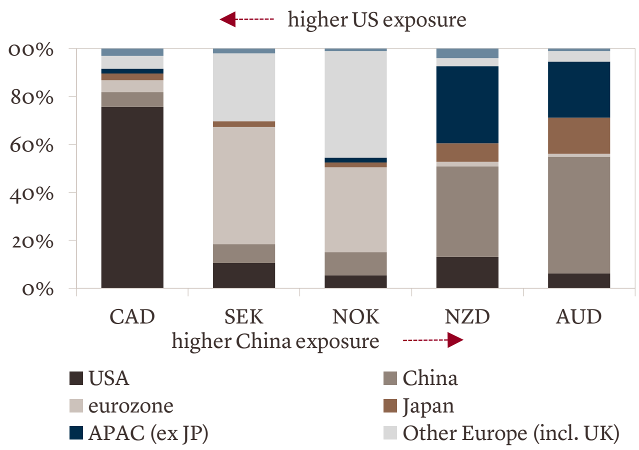
Nordic currencies and commodity bloc

- **Within this currency group, we shift our relative preferences in light of recent geopolitical developments**
- **We turn bearish on SEK and relatively cautious on NOK, with the latter's sensitivity to eurozone risk sentiment potentially capping gains on higher energy prices**
- **We prefer the CAD and AUD, as both currencies could benefit from higher energy prices and are more distant from the conflict.**

First, we believe that in the current environment of geopolitical conflict in Russia-Ukraine and resultant higher energy prices, both the Canadian dollar and the Australian dollar could benefit. Both currencies benefit from higher gas prices and are also geopolitically distant from the conflict. It is worth noting that in recent years, the AUD has become more of an oil currency than the CAD, with a strong export exposure to energy (30%), and has become one of the largest global exporters of liquid natural gas. **Second**, we are more cautious on Scandinavia given its high risk sensitivity to stress in the eurozone. We have turned more bearish on the Swedish krona given its low yield, with Sweden's Riksbank pursuing its persistently over-dovish bias; in February it ruled out an imminent balance sheet run-off while keeping forward guidance for eventual rate lift-off in place for 2024. The EURSEK already appears extremely overvalued, but this could worsen in the months ahead as the SEK will remain a preferred funding currency. **Third**, we believe that while the Norwegian krone will outperform the Swedish krona (see chart), gains in NOK could be capped by geographically distant CAD and AUD as better choices. Norway does benefit from strong external balances and a very large exposure to the energy sector (natural gas and crude oil together account for close to 55% of Norway's total exports). However, higher sensitivity to the euro will cap gains, in our view. **Fourth**, it is worth reviewing the degree of exposure of these countries to the major economies. Canada is exposed to the US economy (particularly via housing and autos), while Australia and New Zealand are more geared towards China, Japan, and the Asia-Pacific region generally, which accounts for more than 75% of exports. Norway and Sweden are more heavily exposed to the eurozone and other European countries (over 75% of total exports). A softening in eurozone growth against the US and China should favour CAD, AUD, and NZD over NOK and SEK, as also discussed above.

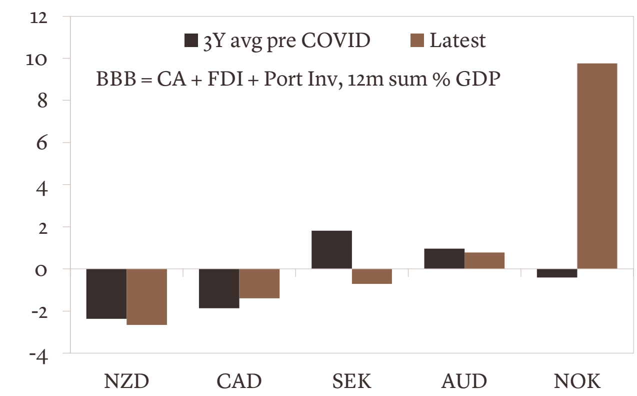
Key events: BOC meetings (2 March, 13 April, 1 June, 13 July), RBA meetings (1 March, 5 April, 3 May, 7 June, 5 July), RBNZ meetings (23 February, 13 April, 25 May, 13 July), Norges Bank meetings (24 March, 5 May, 23 June, 18 August), Riksbank meetings (26 April, 30 June, 20 September, 24 November).

Main export destinations for the Scandies and commodity bloc



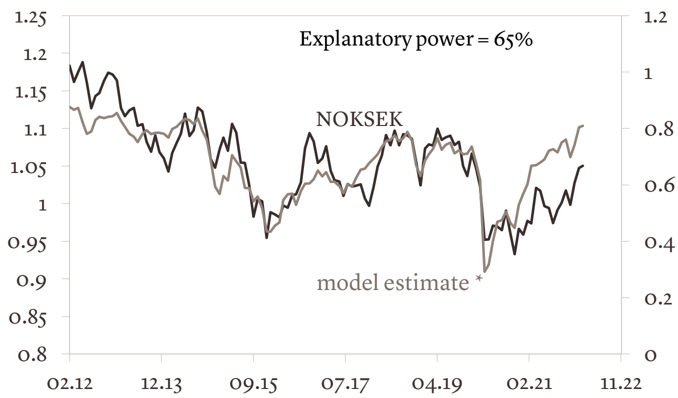
Sources: Bloomberg, Lombard Odier calculations

External balances for Nordic and commodity FX bloc



Sources: Bloomberg, Lombard Odier calculations

Model points to NOK outperforming the SEK



* model uses energy proces and 5Y interest rate differential
Sources: Bloomberg, Lombard Odier calculations

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

Commodity corner

Safe haven flows support gold

- **Financial demand remains the main driver of gold and safe haven flows should support prices for some time. We foresee prices remaining above USD1,800/oz in Q2**
- **In the second half, gold could trend lower, if the Ukraine situation does not worsen and central banks are able to normalise monetary policy.**

Gold prices spiked at USD 1,974/oz on 24 February, the day Russia invaded Ukraine and have since moved higher. They remain over USD 2,004/oz at the time of writing, as investors worry about the prospect of further sanctions damaging growth and raising inflation, and any potential escalation in the conflict. We have revised our price forecast to above USD 1,800/oz in Q2, as gold remains a safe haven asset of choice for investors during periods of instability, and particularly those concerned about a possible stagflationary and/or currency debasement scenario.

That said, higher real rates and a strong USD should both act to curb gold's rise as we move beyond the second quarter. While we are certainly expecting central banks to review policy normalisation in the light of risks to growth and market liquidity, we still believe the US will soon start the process of raising interest rates, with a 25-bps hike in March and four to five hikes this year in total. With its more closed economy, strong domestic demand, and greater energy independence than Europe, we expect the US to be less affected by the Ukraine conflict, and thus more able to tighten policy to curb persistent inflationary pressures.

We assess the current implied geopolitical premium above USD 200. It will not disappear rapidly, and volatility in gold prices could also remain high. We therefore expect gold to trend below USD 1,800/oz in the second half, assuming that the Ukraine scenario does not worsen and central banks are able to normalise policy. Our tactical commodity exposure in client portfolios favours a basket of commodities, and we favour industrial metals for clients looking specifically for a long-term inflationary hedge. Our longer-term model points to gold's fair value at around USD 1,720/oz.

Main risks to our scenario: Escalation in Ukraine conflict leading to worsening growth/inflation mix and deteriorating investor sentiment; delays to Fed's policy tightening.

Wide range of price outcomes possible

- **A US ban on Russian oil, and the possibility of further disruption/sanctions is high, at a time when inventories and spare production capacities are stretched, sending prices and volatility higher**
- **We see a wide range of possible price outcomes this year, depending on possible additional sanctions/retaliatory measures/disruption. These range from USD 95-150+ per barrel.**

Russia's invasion of Ukraine has pushed oil prices sharply higher; Brent crude was trading at over USD 120 a barrel (/bbl) at the time of writing. Investors are hedging for geopolitical risk using oil markets and weighing possible further disruption to Russian supplies, after the US banned Russian oil imports. The UK has also announced it is phasing out all Russian oil supplies by end-2022. Russia is responsible for around 10% of global oil supply, producing around 10mn barrels per day (mbd) and exporting more than 7mbd of these. Western sanctions, including cutting some banks off from the SWIFT international payments system, are already causing some disruption to oil exports.

Some of Russian oil supplies to the US and UK can be re-routed elsewhere. For now, the EU has not imposed such bans. But wider sanctions on Russian oil and gas could cause huge damage to Western economies, as well as to Russia. Even throughout the Cold War, the Soviet Union continued to supply the West with oil and gas. Yet the risk of a further supply shock, either through disruptions related to military operations, new sanctions, or Russian retaliatory measures on the West, remains. Furthermore, the crisis is happening in a context of low inventories, and limited spare production capacity from the Organization of the Petroleum Exporting Countries (OPEC). As well as causing heightened volatility, this could lead to further price appreciation.

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

Back to cover page

Commodity corner

In a more extreme scenario, assuming the same sanctions were imposed on Russia as are currently imposed on Iran, almost all Russian exports would be at risk, leading to a 5-6 mbd deficit on oil markets. Here we could see prices move into uncharted territory (USD 150/bbl and above). In this context, the only rebalancing force would be demand destruction, i.e. a sharp slowdown of economic activity. Hence such price levels would only be short-lived, as recessionary expectations would rapidly weigh on oil prices. The chart below attempts to summarise some of the potential supply and price implications of different scenarios.

In summary, a high risk of supply disruption in a context of low inventories and limited OPEC spare capacities leads to a wide range of near-term price outcomes, with risk clearly skewed to the upside.

Main risks to our scenario: Ukraine conflict escalates, with sanctions/Russian retaliatory measures affecting oil supply; US shale industry not adding production capacities; deal with Iran fails to materialise.

Market pricing has moved closer to the worst case scenario

In our scenario analysis, an exposure to Global commodities is preferable to gold only

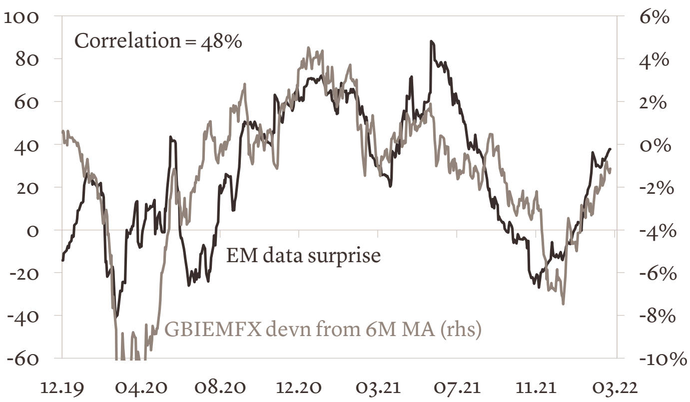
	Fundamental Fair Value	Ceasefire / end to the war	Sanctions on US/EU energy imports	Maximum level of sanctions on exports (Iran case)
Oil / Energy	USD 80-90/bbl	= USD 100/bbl Sustained geopolitical premium	++ USD 120/bbl 2 mbd Russian production removed from global oil markets, price stabilize at high level to incentivize additional output	+++ then -- USD 150/bbl then back to below USD 60/bbl 4-5 mbd Russian production removed from global oil markets but demand destruction (ie recession needed to rebalance)
Industrial Metals (copper)	USD 11000/mT Chinese demand accelerates on easing fiscal & monetary policies	++ USD 11000/mT Domestic nature of Chinese support offsets risk-off sentiment	= USD 9-10000/mT	- USD 9000/mT
Gold	USD 1700/oz	- USD 1800/oz **Sustained geopolitical premium** but gradual return to Fed overtightening fears	+ USD 2000/oz Sustained geopolitical premium + rising inflation expectations	++ then +++ USD 2400/oz Collapse of economic activity / Hedge against currency debasement
Global Commo		=/+	++	+++ **then** =

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

EMFX: Three key charts

GBI EMFX – downside risks are receding: Higher-frequency EM data surprises had flagged downward pressure for EM currencies in H2 2021. However, the surprises are now bottoming out, and point to some stabilisation higher in Q1 2022.

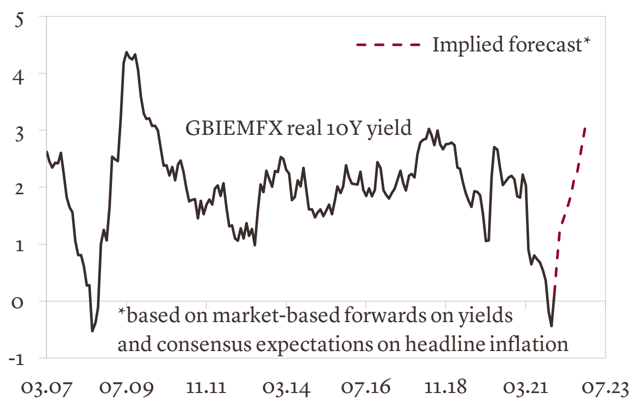
Recovering EM data surprises support EMFX stabilisation



Sources: Bloomberg, Lombard Odier

Real yield cushion set to improve for GBIEMFX: The real yield cushion was sharply in focus over H2 2021 given the upside inflation surprises seen across countries, and several EM central banks in LatAm and CEEMEA raised interest rates. Inputting the relevant forwards on local bond yields and consensus inflation projections, GBIEM weighted real yields are set to improve in the coming quarters.

GBIEMFX real yields projected to turn positive in months ahead
10Y yield forwards minus consensus CPI expectations, GBIEM weighted



Sources: Bloomberg, Lombard Odier

As regards our EMFX preferences, this month we upgrade the Thai baht (THB) to the cautious category, but downgrade the Russian rouble (RUB) and Polish zloty (PLN) to respectively the underperformer and cautious categories.

EMFX relative ranking

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

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

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

Asia FX

- **After its relative stability among EM currency regions over 2021, we expect Asia FX to lag LatAm peers in the months ahead**
- **Asia, as a largely net energy-importing region whose central banks have been slower to normalise policy than other EM peers, should see its currencies lag in the present scenario of a supply shock to energy prices**
- **That said, there will be differentiation. We expect IDR, MYR, RMB, and SGD to likely hold up better than the INR, PHP, and THB**
- **We maintain our lower USDRMB 6.35 assumption over H1 2022 to reflect a stronger RMB. Balance of payment flows are likely to remain stronger for longer than previously assumed.**

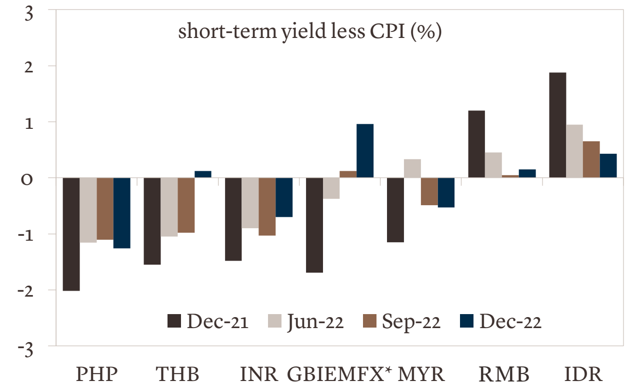
RMB (Chinese renminbi): Stable in H1 2022

The RMB remains on our list of EMFX outperformers, but this owes more to its relative stability and decent carry rather than expected appreciation. The renminbi will see a tug-of-war between two opposing forces in 2022: a dovish People's Bank of China (PBoC) and stronger external balances. We assume the latter will dominate and keep USDRMB below current forwards over the next six months, anchoring the RMB along with capital flows. China's merchandise export growth remains solid, and Beijing's 'dynamic clearing' strategy for Covid-19 suppression should keep the service deficit low, as strict quarantine requirements deter outbound tourism. This should remain in place until the National Party Congress towards year-end, i.e. longer than we had previously assumed. Foreign portfolio investments in China's onshore markets should be robust, as institutional investors diversify and passive flows arrive following onshore bonds' inclusion in global indices. On the other hand, macro policy is becoming a headwind, with the PBoC gradually easing its stance in response to substantial downside risks to the economy. Nearly all of the PBoC's recent actions hint at the bank's discomfort with the strength of the RMB. In addition to benchmark rate cuts, the central bank has raised the FX reserve requirement ratio and continued accumulating foreign currencies. Should the headwinds to growth persist, the expectation of more aggressive dovish action could spread and weigh on portfolio inflows that have been partially unhedged to benefit from RMB's strength. We assume that a relaxation in Covid restrictions closer to Q4 should result in USDRMB moving gradually higher.

Main risks to our view: Unexpected geopolitical tensions between China and the US (e.g. Taiwan, South China Sea, other maritime borders) or re-escalation of tit-for-tat tariffs

Asia short-term real yields

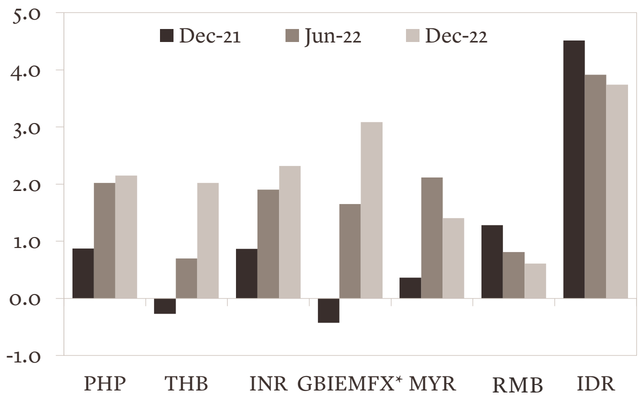
Current yield minus consensus CPI forecasts



Sources: Bloomberg, Lombard Odier

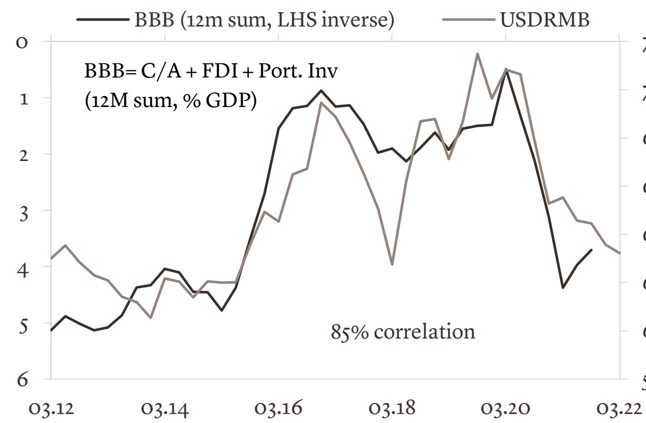
Asia 10Y real yields

10Y forwards minus consensus CPI forecasts



Sources: Bloomberg, Lombard Odier

Lower USDRMB driven mostly by strong balance of payments



Sources: Bloomberg, Lombard Odier

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

Asia FX

would be key risks for the RMB. Beijing's handling of the property sector's turmoil may accelerate capital outflows and add pressure on the RMB. Our base case is that this issue will be contained, even if it leads to intermittent volatility.

KRW (Korean won): Screening as cheap versus fundamentals

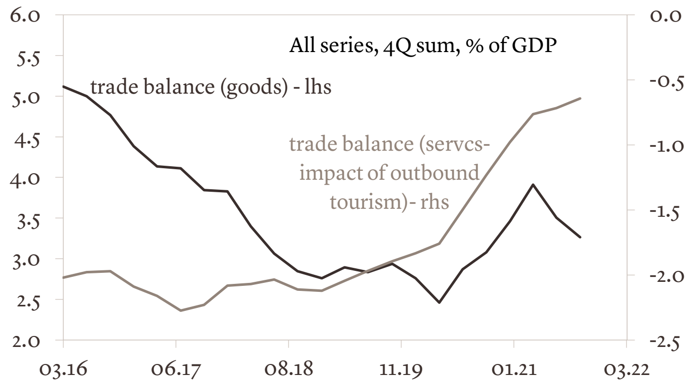
The Korean won remains on our list of EMFX "modest performers". While USDKRW has remained well supported around the 1200 level, we expect the dollar to gradually decline against the won. A major reason for KRW underperformance has been a weakening in balance of payments-related support linked to a strong trend of outward equity investments from the domestic investor base. South Korea has been seeing close to 5% GDP in annual outflows on net equity portfolio investments. We assume that this trend is likely to moderate somewhat as the recent volatility in foreign equity markets begins to dampen their enthusiasm. KRW's current valuation looks too cheap versus the country's macroeconomic fundamentals, and we believe it will recover modestly against the USD in 2022. As the flows improve, the KRW should begin to gain some support. At the same time, the Bank of Korea (BoK) will remain the most hawkish central bank in Asia due to strong pressure from the electorate to counter the recent real estate price rises. The BoK has already hiked its policy rate by 75 basis points since the summer of 2021, and we expect the central bank to follow up with at least two additional rate hikes in the next six months, despite the likely leadership change in April this year.

Main risks to our view: Geopolitical risks surrounding China and North Korea will remain a key risk for KRW. The presidential election in early March is a risk with stark consequences for fiscal and monetary policy. Pronounced JPY weakness could be a risk for KRW, as Japan is Korea's main regional rival.

TWD (New Taiwan dollar): Still a solid Asian currency

The currency remains in our list of EMFX "outperformers". **First**, TWD benefits from one of the world's most resilient economies. 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 approximately 16 months. **Second**, the cyclical backdrop for Taiwan remains robust as the country is benefitting from the ongoing historic boom in semiconductor exports. With growth set to exceed

Strong balance of payments driven by smaller services deficit on Covid restrictions



Sources: Bloomberg, Lombard Odier

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

Asia FX

3% for the fourth year in a row and CPI inflation to be close to 2%, Taiwan's monetary authority is quite likely to signal interest rate normalisation in the second half of 2022. **Third**, the prospect of a stronger TWD is also discouraging Taiwan's life insurance companies – the key conduit of capital outflows – from adding more foreign assets to their balance sheets. Reshoring and supply chain diversification away from China will also add support for TWD as the country's manufacturers gradually change their direct investment patterns. That said, the large negative carry for TWD will keep some scope for an intermittent reversal in institutional hedging behaviour, with investors engaging in FX carry when USDTWD valuation looks extremely low.

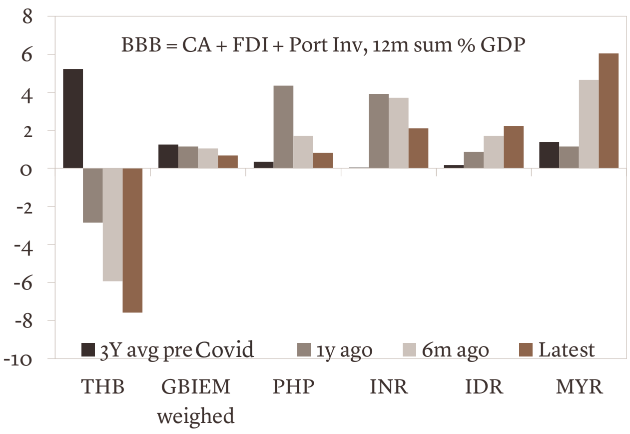
Main risks to our view: Unexpected sharp deterioration in public health conditions and negative spill-over to semi-conductor production, potential direct confrontation with China, and further escalation of tensions between the US and China.

SGD (Singapore dollar): Central bank actions confirm our appreciation view

The currency remains in our list of EMFX "outperformers". We expect the SGD to appreciate further in the next 12 months in light of the Monetary Authority of Singapore (MAS)'s decision to resume its long-term appreciation guidance for SGD in its October policy meeting. In our view, the MAS's tightening decision is consistent with the improving macroeconomic prospect for Singapore. We believe the country should enjoy strong growth of around 5% in 2022, due to the government's adoption of its 'living with the virus' strategy, as well as neighbouring countries' ongoing rebound. The US Federal Reserve's policy normalisation will have limited impact on SGD, as Singapore has one of the largest current account surpluses among Asian countries, with competitive positions on high value-added exports. The MAS's current guidance on SGD means that the currency should remain at least stable versus USD while appreciating against other G10 currencies that we expect to soften against the greenback.

Main risks to our view: 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.

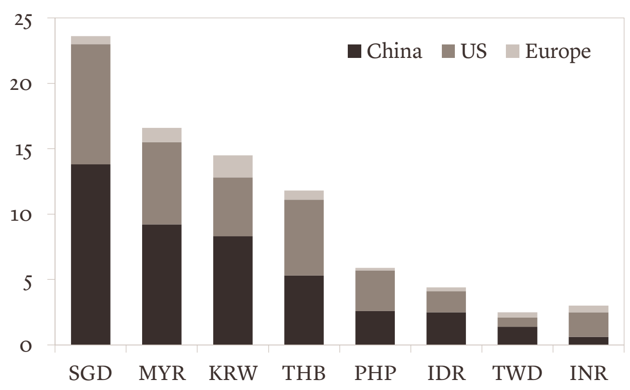
Asia external balances



Sources: Bloomberg, Lombard Odier

Asia export exposure to China, US, and euro area

Exports to destination as % of GDP



Sources: Bloomberg, Lombard Odier

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Asia FX

HKD (Hong Kong dollar): Likely to hover around 7.80

We expect USDHKD remain close to 7.80, which is the middle of the Hong Kong Monetary Authority's (HKMA's) convertibility zone. The temporary scarcity of liquidity related to various IPOs will no longer be the main driver for the currency – even though Beijing's recent data sovereignty measures could bring more overseas-listed firms to the HK market in the medium term. The city's near-term growth will take significant hits from the ongoing wave of Covid-19 infections and aggressive suppression efforts, and medium-term concerns could motivate steady shifts in the FX allocation of the city's residents. Although the HKMA will adjust HK rates in response to the US Fed's policy normalisation to maintain the peg, the central bank could attempt to soften the blow by pursuing a slightly slower rate hike path and maintaining modest excess liquidity. The result of these moves would be the softening of HKD past the middle of the convertibility zone.

Main risks to our view: Listing plans of various Chinese tech companies, and domestic political developments related to the Legislative Council elections. We do not believe there is a high risk of another outflow catalyst such as an unexpected stamp duty hike on stock trading. The city's virus suppression efforts could affect HKD negatively if they drag on for the remainder of the year.

INR (Indian rupee): Likely to underperform, barring periodic IPO-related support

We downgraded the INR to EMFX "underperformer" in January, and expect the currency to soften somewhat in the next six to twelve months despite the country's consensus growth forecast upgrades and buoyant equity market environment. The recent upward pressures in industrial commodity prices create risks for India, given the country's chronic energy deficit. That said, the INR could receive support periodically thanks to inflows related to initial public offerings, with such flows likely even for the month of March. It could be argued that investor positioning in INR and Indian stocks looks vulnerable to negative catalysts as the Fed's policy normalisation starts. Recent developments support our assumption that the Reserve Bank of India (RBI) will keep its benchmark rates on hold over H1 2022 before starting the rate hiking cycle in H2.

Main risks to our view: Higher industrial commodity prices, geopolitical tensions with China, and global government bond yields will be key risks. While the public health situation remains stable, vaccination rates are not fast enough to ensure the systematic avoidance of another debilitating Covid-19 wave over the next six to twelve months.

IDR (Indonesian rupiah): Better insulated against higher US rates

We maintain the IDR in our list of EMFX "modest performers". Unlike prior episodes of tightening in US financial conditions (2013 taper tantrum, 2015 and 2018 Fed rate hikes), the country's balance of payments are in a much better place. The broad basic balance (current account plus net foreign direct investment plus equity and debt portfolio investment) stands at a near 3% GDP surplus (in prior US tightening regimes, Indonesia ran a deficit). We expect Indonesia's current account deficit to be kept in a narrow range of 1.5-2.0% of GDP in 2022. In terms of capital inflows, Indonesia's own tech IPOs have reinvigorated foreign investors' interest, and portfolio inflows could remain steady as more companies consider tapping the local market. Real rates remain supportive. We expect Bank Indonesia (BI) to start its rate hike cycle in Q2. It has sent a clear hawkish signal by announcing an increase in commercial banks' reserve requirement ratio by 300 basis points in 2022. While domestic inflation is well-anchored, the central bank will try to pre-empt any FX market volatility by aligning its policy moves with the US Fed's, while making efficient use of macroprudential measures (by providing adequate FX liquidity as and when needed).

Main risks to our view: The country's lax approach to Covid-19 containment will be a key risk given its fragile healthcare system. The local bond market's sensitivity to global yields will also be a risk, especially after the Fed's hawkish signal in the past few weeks.

THB (Thai baht): Bad news mostly in the price

With increasing signs that much of the bad news is in the price, we opt to upgrade the THB to the "cautious" EMFX category. A delay in the full recovery of tourism to 2023 appears to be the consensus view at this point, and the country has begun to take incremental steps to prepare the industry for re-opening. Thailand's annual current account deficit in 2021 is old news, and the external balance is unlikely to get materially worse. The Bank of Thailand is unlikely to raise its benchmark rates in the near term due to the remaining fragility in the economy, but it has been actively leaning against THB's weakness to anchor the country's market against potential volatility related to the US Fed's tightening.

Main risks to our view: Domestic Covid-19 outbreaks and the government's public health responses, policy stability in light of the ruling party's poor performance in recent by-elections, retail-driven capital outflows, and the impact of the Fed's rate hiking cycle.

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

MYR (Malaysian ringgit): Beneficiary of buoyant energy commodity prices

The Malaysian ringgit remains in our "modest performer" category. USDMYR has continued to trade in the 4.17 to 4.20 range in 2022 so far. We expect MYR to post a modest gain versus USD in the next few months. The boom in global goods and industrial commodity trades will boost the country's exports, and local Covid-19 outbreaks have been controlled with better vaccination efforts. Bank Negara Malaysia (BNM) has begun to signal the end of its easing cycle, but we expect it to remain on hold for the next six months in the absence of a new external shock. The BNM will likely start its rate hikes in H2 2022 if the economy rebounds strongly as we expect. We believe Malaysia's 2022 growth rate will approach double-digit due to its belated re-opening process and improving terms of trade from better commodity prices. Political uncertainty would need to be monitored and, although the new governing coalition remains somewhat fragile, a new snap election looks unlikely due to the lack of an immediate path for the Pakatan Harapan coalition to regain its parliamentary majority.

Main risks to our view: Main risks are the break-up of the current coalition government and snap elections; 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 manufacturing.

PHP (Philippine peso): Expect modest depreciation

We believe that PHP will depreciate further versus USD in the next few months, and the currency remains in our EMFX "underperformer category". The country has not been able to stabilise its Covid epidemic curve completely, and the government continues to face significant logistical challenges in the nationwide deployment of vaccines. The Philippines' low standing in Asia's vaccination rankings clearly illustrates this fundamental difficulty. The country's external balance has deteriorated sharply on rising commodity import prices, the resumption of domestic economic activities, and government spending that will push the deficit to 7-8% of GDP. While the Bangko Sentral ng Pilipinas (BSP) will start its rate hike cycle in H2 2022, the market's outlook on the country's policy is unlikely to change significantly until after the new government is elected in May. A period of calibration might be needed for markets to gain confidence in the new government's economic policy, as incumbent President Rodrigo Duterte's preferred successors are no longer the favourites in the presidential race.

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

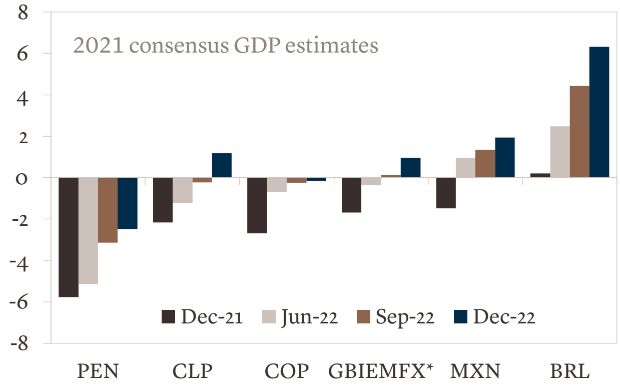
- **We assume H1 2022 should be calmer for Latin American currencies compared to 2021, with the BRL, CLP, and PEN likely to perform better**
- **Most LatAm currencies should hold up better than peers in Asia and CEEMEA, in an environment of broad-based rises in commodity prices**
- **With somewhat lower political uncertainty and central banks having hiked interest rates, LatAm FX could also benefit from an improving real rate profile assuming downside surprises on the inflation front.**
- **In January, we decided to upgrade the PEN, CLP, and BRL while downgrading both the COP and MXN. In this edition, we notably further revise down our USDBRL assumptions to under 5.00.**

BRL (Brazilian real): Upgraded to modest performer for Q1 2022

We upgraded the currency to "modest performer" in January and believe there is a window of opportunity for the BRL to perform better over Q1. Our longer-term fair value model now pencils in USDBRL at 5.00 (from 5.60 previously), given a downward revision to expectations of government debt (to around 85% GDP for end-2022 from closer to 90% previously). Moreover, given the large initial USDBRL undervaluation, undershoots are plausible that could see USDBRL below 5.00 in the months ahead. Government debt features as an important variable in our long-term USDBRL valuation. While debt levels will eventually move higher again, suggesting the USDBRL could rise at some point in the future, we believe this is more likely a story for 2023 and beyond. The strong improvement in the country's terms of trade (following a rally in the prices of energy and agricultural products since Q4 2021) should help the currency in the months ahead. The real rate profile for the currency may begin to improve from here onwards. While inflation reached over 10% at the end of 2021, consensus estimates foresee a moderation in price pressures in the coming quarters. Assuming the central bank remains cautious in easing monetary policy, this should result in a substantial improvement in real yields, making the BRL the highest real-yielder in mainstream EM. Another validating signal comes from a real rate comparison with peers: real yield differentials have begun to suggest BRL's multi-year underperformance versus the MXN could be ending. As ever, political risks will need to be monitored. While there was intense focus on fiscal risks in Q4 2021, these could abate over Q1 following the approval of the 2022 budget (which should remove concerns around any breach of the spending cap). We assume that markets are likely to look through headlines concerning a number of policy initiatives under

LatAm short-term real yields

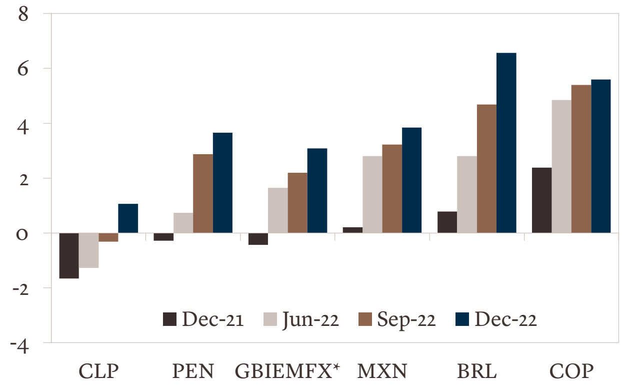
Current yield minus consensus CPI forecasts



Sources: Bloomberg, Lombard Odier

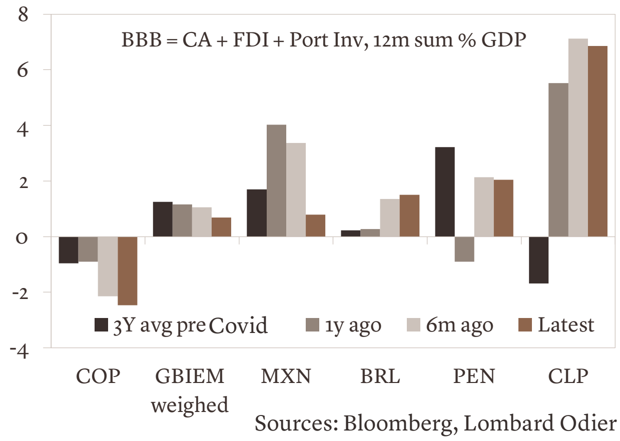
LatAm 10Y real yields

10Y yield forwards minus consensus CPI forecasts



Sources: Bloomberg, Lombard Odier

LatAm external balances



Sources: Bloomberg, Lombard Odier

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

LatAm FX

President Jair Bolsonaro (like increasing the minimum wage and reducing fuel taxes). We assume election risks could curb the BRL rally, but this is unlikely until after July when pre-election campaigning will begin.

Main risks to our view: An upside USDBRL risk, more likely to materialise from June onwards, is markets pricing in the election event risk. A higher pace of gains in US Treasury yields also presents ongoing risks for the BRL.

MXN (Mexican peso): Downgraded to cautious EMFX category

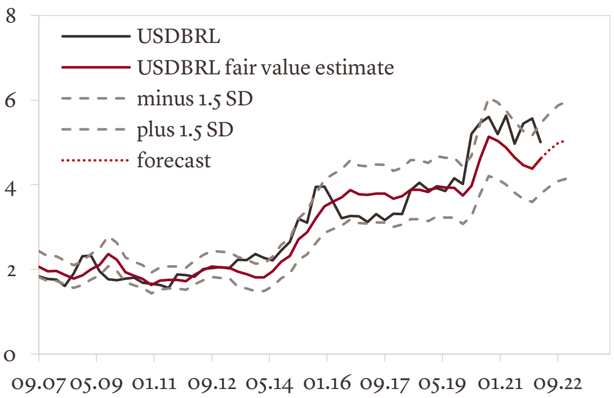
The peso remained our top LatAm pick in 2021, but we opted to downgrade the currency to the "cautious" category in January. While USDMXN valuations remain stable, the dollar looks modestly undervalued versus the peso, in our view. That said, the relative political stability seen over 2021 should no longer be a feature, and we believe political headline risks could increase going into Q2. President Andrés Manuel Lopez Obrador's revocation referendum (10 April), a likely vote on an energy bill (likely after the referendum), and six governor elections (June) are all coming up in the months ahead. Furthermore, there could be a discussion of constitutional reforms in Congress (H2). On the more positive side, still resilient US growth should support the currency, while real rates should also improve as the new central bank governor appears to be more hawkish than expected. Over a longer-term period, we believe the MXN can perform well and trade with lower volatility compared to peers (BRL, CLP, and PEN). However, for the months ahead, we believe that these latter peers could show a stronger relative performance after having underperformed over 2021. The MXN should offer value on corrections in USDMXN above 21.0.

Main risks to our view: The main upside risks to USDMXN relate to the political event risks mentioned above for Q2, a sharp re-pricing in US 10-year yields, any downward revisions to US growth (which has negative implications for Mexican GDP projections).

CLP (Chilean peso): Upgraded to EMFX outperformer for Q1

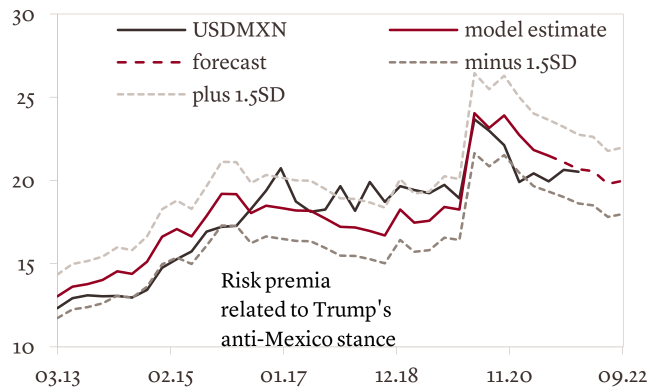
We decided to upgrade the CLP to "EMFX outperformer" in January following signs of moderation in macro policies by new President Gabriel Boric. Our analysis shows that the currency is still rather undervalued even following the recent rally. A big driver for the currency's undervaluation in 2021 was linked to political risks, but the newly-elected president's cabinet has signalled a more pragmatic and moderate fiscal stance. This should help reduce political risk premia, benefitting the currency. While real rates are still projected to

USDBRL valuation



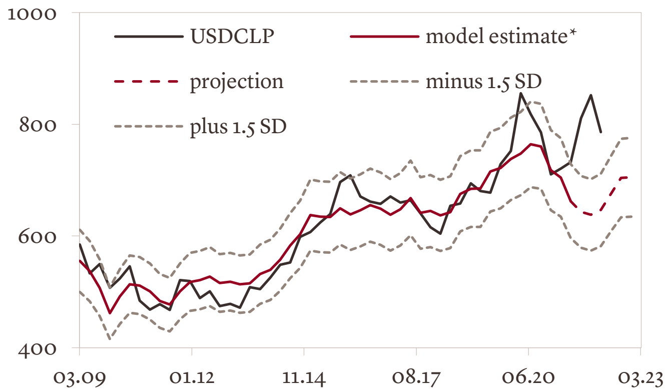
Sources: Bloomberg, Lombard Odier

USDMXN valuation



Sources: Bloomberg, Lombard Odier

USDCLP valuation



Sources: Bloomberg, Lombard Odier

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

LatAm FX

be negative in 2022, the central bank has turned hawkish, having hiked rates substantially and flagging a faster pace of tightening. This could help reverse the local dollarisation flows that weighed on the CLP in H2 2021. Together with the current account deficit being financed by foreign direct investment flows (which so far have not been interrupted by political uncertainties), we believe there is scope for the CLP to continue to recover.

Main risks to our view: Positive USDCLP risks come from politics and possible rating downgrades. While political risk may diminish, headline risks will remain, given frictions between the Presidency and the Constitutional Convention, and could generate some volatility. CLP is also sensitive to US yields and to the slowing in China's housing market. Negative USDCLP risks could come from a watering down of policy proposals (for example on the mining tax), something that seems more likely over Q1.

PEN (Peruvian sol): Upgraded to modest performer for Q1

We decided to upgrade the PEN to "modest performer" in January given very cheap valuations, reduced political uncertainty, and the central bank having turned more responsive to inflation concerns. The central bank has now raised rates by a cumulative 325 bps since August 2021, with further moves possible. Short-term real rates will remain negative, however, and with the bonds providing good risk premium, there may be a tendency for foreign investors to buy bonds on an FX hedged basis. This could slow any appreciation of the PEN from current undervalued levels. Political risk was rife in 2021 and caused dollarisation trends to take hold. However, market concerns could decline as there are signs that the executive body is moderating its stance, and President Pedro Castillo will be re-shuffling his cabinet in October 2022. This could lead to improved relations with Congress and a moderation in policies (as the President will have to seek support from other parties), which could ease market concerns.

Main risks to our view: USDPEN upside risks would come from the central bank pausing in its policy normalisation campaign, in turn leading to further local dollarisation trends. PEN also has a high negative sensitivity to rising US real rates.

COP (Colombian peso): Downgraded to EMFX underperformer

We downgraded the COP to our group of EMFX underperformers in January. Markets are likely to re-focus on political risk events in the months ahead: the key periods to keep in mind are the congressional elections (March 2022), the first round of the presidential election (May 2022), and the potential second round (June 2022). The main reason for our longer-term negative view on COP is weak external balances, an expensive valuation, and a loss of reform momentum that led both S&P and Fitch to downgrade the sovereign debt to sub-investment grade in 2021. President Ivan Duque's presidential approval ratings remain at historic lows. It is also possible that once the candidates for the elections are announced, the campaign may turn towards more suboptimal policies.

Main risks to our view: A retreat in EMFX risk appetite, as well as in energy prices, would make us less positive on the currency. A renewed push towards reform would make us more positive.

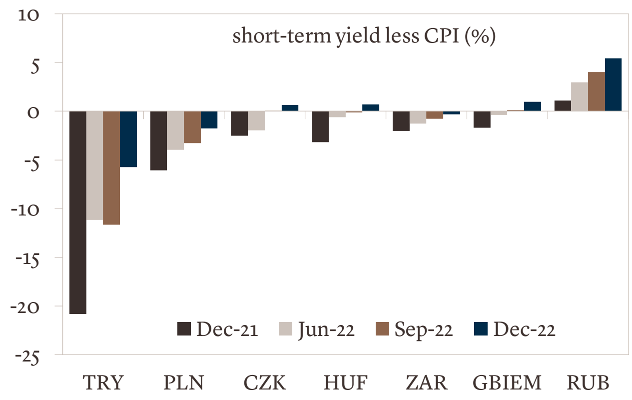
Note: Past performance and forecasts are not a reliable indicator of future performance.

CEEMEA FX

- **CEEMEA currencies will remain most vulnerable to escalating geopolitical tensions**
- **We further downgrade the RUB to "underperformer", after having already lowered our assessment to 'cautious' in January**
- **USDRUB is still in the relatively early stages of overshoot territory with further gains likely on capital outflows**
- **All CEE currencies (PLN, HUF, and CZK) and the TRY should remain vulnerable given their proximity to Russia, dependence on energy imports as well as Russian tourism**
- **In comparison, both the ILS and even the ZAR could perform comparatively better.**

CEEMEA short-term real yields

Current yield minus consensus CPI forecasts



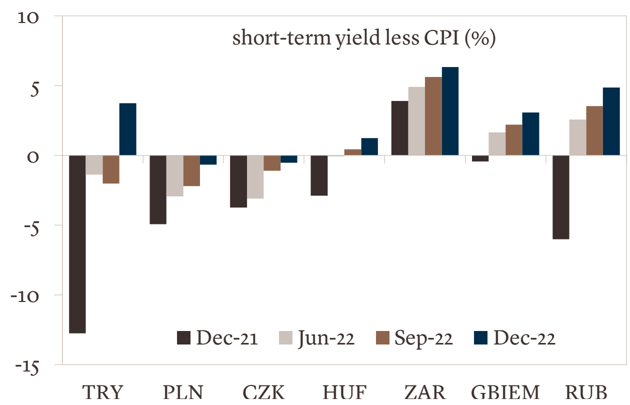
Sources: Bloomberg, Lombard Odier

RUB (Russian rouble): Downgrade to EMFX under-performer

In January, we had already downgraded the RUB to our list of "cautious" EMFX on the view that geopolitical tensions would dominate over otherwise sound macroeconomic fundamentals. However, given recent developments, we further downgrade the currency to EMFX "under performer". USDRUB is likely in the early stages of an overshoot, with further gains and volatility likely. **First**, with sanctions preventing the use of FX reserves to defend the currency and pay external creditors, the rouble could have further to fall. We believe conventional valuation models, which would otherwise have placed USDRUB at 85 as representing "extreme RUB undervaluation" are no longer reliable as they assume full access to policy tools, if required. That is not the case at present. Comparisons are difficult, with a lack of precedent for such a large economy integrated into global financial markets for reference. However, currencies of harshly sanctioned countries (like Iran) have seen their nominal value more than halve. Given high inflation, depreciation pressures remain in place, with the real exchange rate overvalued. Accordingly, we believe it is still too early to state that the worst of RUB depreciation is behind us. **Second**, further capital outflows are likely from both non-resident investors as well as resident citizens. Non-resident investors are likely to move to reduce exposure, and an exclusion of Russia from bond and equity benchmarks cannot be ruled out. For residents, the proportion of deposits held in roubles has increased over the past five years, as confidence in the macro economy and the purchasing power of the currency improved after 2015. Reduced confidence could lead to greater diversification away from the local currency, indicating scope

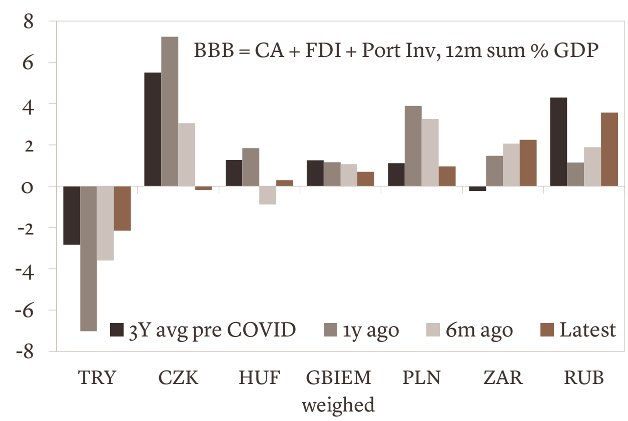
CEEMEA 10Y real yields

10Y yield forwards minus consensus CPI forecasts



Sources: Bloomberg, Lombard Odier

CEEMEA external balances



Sources: Bloomberg, Lombard Odier

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

CEEMEA FX

for further outflows from domestic residents. **Third**, while the central bank's recent large interest rate hike could temper the pace of domestic resident outflows, it is unlikely to prevent them. Furthermore, partial capital controls are unlikely to fully restrict such outflows. Overall, we believe further USDRUB gains are likely.

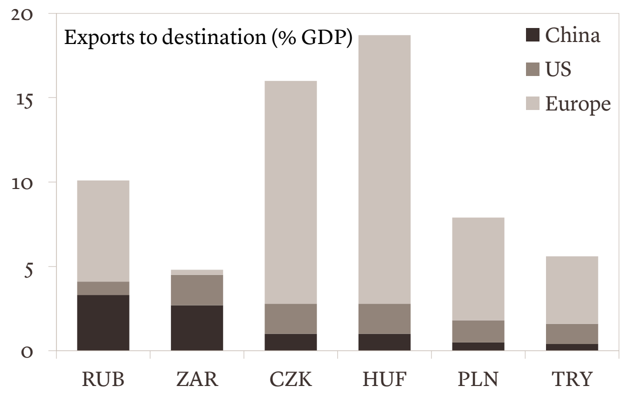
Main risks to our view: Downside risks on further capital outflows following escalation in geopolitical tensions and sanctions.

ZAR (South African rand): Largely a range trade until the current account peaks

The South African rand remains in our "cautious" EMFX category and will not be immune to risk aversion surrounding the geopolitical situation. However, recognising its location further away from the conflict and exposure to rising commodity prices, we believe ZAR could hold up relatively better compared to other CEEMEA currencies. For Q1, we would expect USDZAR to trade between 14.70 and 16.00, and would look to take offsetting exposures at either extreme of that range. In the months ahead, fiscal data should hold up quite well, with the budget deficit figures possibly coming in lower thanks to stronger-than-expected fiscal revenues. Furthermore, President Cyril Ramaphosa appears to be taking a conservative stance on macro policies despite the ANC party's poor performance in the 2021 local elections. Terms of trade have also been supportive for longer than we had assumed. By virtue of being the largest exporter of commodites also exported by Russia (like palladium and platinum), over time, South Africa may actually benefit from a diversion in demand away from Russia. The current account is likely to be kept in surplus for somewhat longer. Our analysis has shown for some time now that cycles in the country's balance of payments explain the ZAR's relative resilience versus other EM currencies quite well. This has been a major driver over the past 12-18 months. However, the currency does not look cheap in the longer run. The South African Reserve Bank (SARB) raised interest rates to 4.0% on 27 January, but the move was on the more dovish side as not all members were keen to tighten policy. This could leave the rand vulnerable in H2 once the Fed's tightening cycle reaches more advanced stages.

Main risks to our view: On the bearish USDZAR side, a longer-than-expected spell of external rebalancing. On the bullish USDZAR side, trade figures take a turn for the worse and/or US rates rise even faster, allowing USDZAR to move higher more swiftly.

CEEMEA exposure to China, US, and euro area



Sources: Bloomberg, Lombard Odier

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CEEMEA FX

TRY (Turkish lira): Forever fragile

The Turkish lira is almost permanently on our list of EMFX underperformers given poor external balances, lack of clarity on monetary policy, extremely low net FX reserves, as well as a strong trend of domestic dollarisation. Since mid-2021, Turkey has pursued monetary policy that is disconnected both from what is required for the domestic economy (with inflation rising) and from external requirements (with global central banks tightening their policies). By December 2021, the Central Bank of the Republic of Turkey (CBRT) had cut interest rates by a total of 500 bps, to 14%. It has since kept rates unchanged. The real policy rate remains deeply negative at -25%. With a relatively free capital account and limited FX reserves, this has led to the currency depreciating sharply. Instead of tightening policy to curb credit growth, the government introduced ad hoc measures to attempt to stabilise the exchange rate, such as an FX deposit scheme to reimburse citizens for losses incurred on their local currency savings deposits, while also requiring exporters to sell at least 25% of their FX revenues. While this has, for now, stabilised local demand for foreign currency, it is unlikely to be a longer-term solution and will only transfer the private sector risk to the sovereign side. With credit growth rising, the current account deficit should begin to widen once again. While USDTRY has found some equilibrium in a 13.50 to 14.10 range, we believe this calm will be short-lived and we expect the USD to appreciate against the TRY in the quarters ahead.

Main risks to our view: Positive risks would be if the CBRT reverses recent easing and hikes interest rates, as well as signs of less government interference in macro policies. Negative risks include a sharper increase in energy prices and US yields, and a renewal of tensions between Turkey and major allies (US/Europe).

Central Eastern Europe & Israel

ILS (Israeli shekel): After finding strong support in the 3.10 region over Q4 2021, we recommended downgrading the ILS by one notch in January to ‘modest performer’ given its extreme sensitivity to the path of US yields and the NASDAQ. USDILS has since risen above the 3.20 mark. Longer term, we like the ILS given its healthy balance of payments profile. Higher US yields and volatility in tech stocks would bias USDILS higher and keep it in a 3.20 to 3.30 range for a while. That said, if stabilisation in US yields results in the tech sector finding favour once again, USDILS could return down to a 3.10 – 3.20 range. Medium-term fundamentals remain strong and the central bank is less likely to intervene on a large scale (like the Swiss National Bank) given better macro fundamentals than in the past. Both headline CPI and inflation expectations are above 2% YoY, and GDP is expected to exceed 5.0% in 2022.

PLN (Polish zloty), HUF (Hungarian forint), and CZK (Czech koruna): We choose to downgrade the PLN back to “cautious” this month. All Central Eastern European currencies will be vulnerable given the geopolitical crisis, but the PLN and HUF more so. Both are highly sensitive to the euro, are dependent on gas imports from Russia, and are close to the conflict zone. Recent sharp rises in commodity prices suggest that both Poland and Hungary are likely to see their central banks not only pursue their hawkish policies, but initiate potential currency intervention as well. Fiscal measures to reduce energy costs are a third possibility. Such measures may slow the pace of depreciation, but are unlikely to reverse it until the geopolitical situation shows signs of stabilising. In comparison, the CZK is likely to fare better.

Our Lombard Odier long-term FX fair valuation framework

BEER
Behavioural equilibrium exchange rate model

Definition

Econometric model, which estimates FX fair values by "mapping" the exchange rate to a set of fundamental economic variables

Inputs

- Terms of trade
- Investment as % of GDP
- Rate differentials
- Inflation differentials

Output

Fair value estimates for major forex crosses
Updated 2 to 3 times annually
Weight: 50%

FEER
Fundamental equilibrium exchange rate model

Definition

Framework tries to identify the level of the exchange rate that would bring the economy into macroeconomic equilibrium (Current account balance sustainably financed by flows)

Inputs

- Price elasticity of trade
- Output gap
- Current account
- Capital flows

Output

Fair value estimates for major FX crosses
Updated 2 times annually
Weight: 50%

COMBINED OUTPUT – LO FX long-term fair value estimates

Usage (BEER)

Anchor for long-term forecast

Usage (FEER)

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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