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FX Monthly

Tentative USD divergence, continued EUR weakness

08/12

August 2022

Key takeaways

- Two months ago, we articulated our view that dollar strength would broaden out on global growth slowdown concerns and a sharp decline in commodities. This view largely played out.
- However, with the Fed potentially flagging a slowing pace of rate increases and commodity markets stabilising, dollar gains could narrow somewhat. We could see dollar strength against European currencies, but more sluggish price action against pockets of the commodity bloc and emerging markets.
- Within the commodity bloc, we would expect the Australian dollar to begin to show some stability, while the Canadian dollar – until now one of our preferred currencies – potentially beginning to lag behind.
- Pockets of emerging market currencies, such as the Mexican peso and South African rand, could benefit from any further decline in volatility of US Treasuries.
- On the other hand, we believe European currencies, including the euro, sterling and Swedish krona, will begin to display independent weakness for several reasons.
- With our 1.02 EURUSD target met, we lower our three month and 12 month targets to 1.02 and 0.98 respectively, with risks to the downside. Fragilities in euro area growth, external balances and the political outlook are likely to become more of a driver.
- We continue to favour further strength in the Swiss franc and remain neutral on the Japanese yen, pencilling in a broad 133 – 138 range for USDJPY. A sharp decline in fossil fuel prices and US yields would lead us to lower our USDJPY assumptions.

Introduction

p.03

Monthly publication of Lombard Odier - Investment Strategy department

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

Data as of 03 August 2022 unless otherwise stated.

At a glance

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Euro (down)trend still your friend

Introduction

Market focus has shifted from factoring in weak growth and high inflation, to weak growth and moderating inflation

Following a rally over April and May, the dollar trend is getting somewhat fractured, meaning that USD strength has not only paused but is not as broad-based as it was previously.

The mood change appears to be a switch in markets: from factoring in weak growth and high inflation, to rising prospects of weak growth and moderating inflation. US 10-year yields have declined by nearly 80 bps, with all of it coming from real yields. US interest rate markets still see rates moving higher this year, but have now pencilled in 75bps of rate cuts in H2 2023.

While acknowledging this tentative change in mood, we are not altering our broader dollar outlook for several reasons.

Firstly, it remains far from clear whether a mild US recession will bring inflation down to satisfactory levels for the Federal Reserve (in turn allowing them to cut rates in 2023).

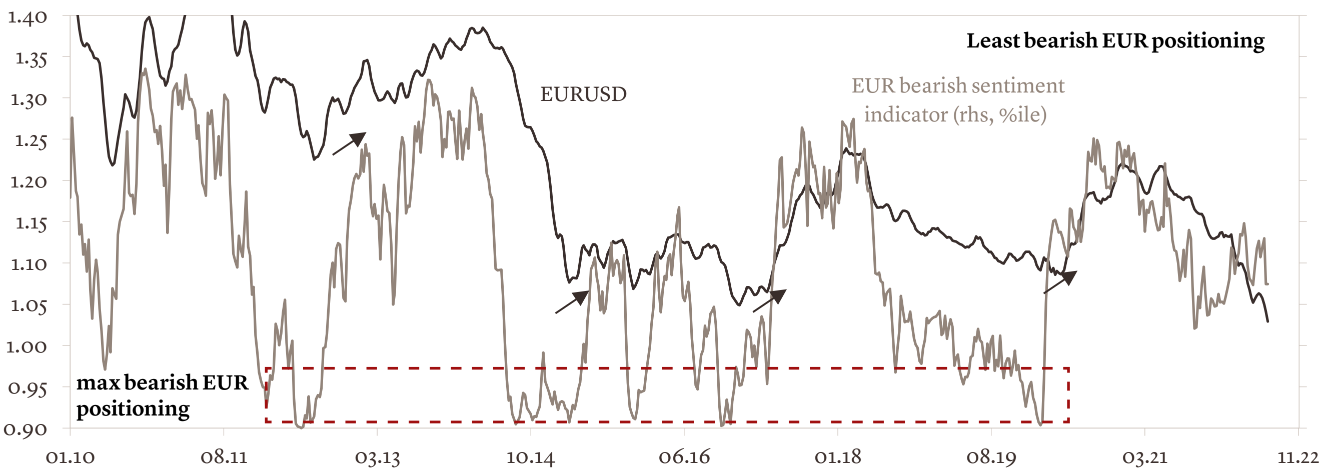
Secondly, global growth forecasts continue to be marked down. Europe's gas supply risk, continued intermittent Chinese lockdowns with relatively modest policy stimulus, and softer US growth are all contributing. Historically, the USD (along with the JPY and CHF) have performed well in global recessions.

If we also throw in still elevated inflation and hawkish central banks, then the 1980's experience showed us that the dollar can remain persistently strong and defy gravity (please see the introductory chart in June's FX monthly: [Weak growth, elevated inflation to support dollar)](#).

Thirdly, our EURUSD 12-month target of 1.02 has already been achieved. Still, sentiment remains unusually neutral despite the strong declines in the pair (see chart below). This suggests we are far from a "bearish capitulation" which would suggest a EURUSD bottom. With fundamentals still bearish, we revise our 12-month EURUSD target down to 0.98, with risks to the downside, while 1.02 becomes our new three-month assumption.

Elsewhere, we maintain a neutral JPY stance and would not chase the recent rapid appreciation. In emerging markets, we downgrade the Indonesian rupiah (IDR) and expect some near term recovery in the Indian rupee (INR). Following the recent Chilean peso (CLP) rally, we also downgrade the CLP to cautious, given worrying trends in the current account deficit.

Still neutral EUR sentiment suggests further scope for EURUSD decline



Sources: Bloomberg, Lombard Odier

FX majors

We (further) lower our 12-month target to 0.96 US dollars versus the euro. The EURUSD pair has already achieved our prior 12-month target of 1.02. We believe the downtrend remains intact, but that future moves could be more contingent on the EUR weakening, rather than the USD continuing to appreciate. When targets are met, we review both fundamentals and sentiment for the currency in question, to see if there has been a marked shift. For EURUSD, the aforementioned factors suggest further downside ahead.

As far as sentiment is concerned, we have not yet seen extreme pessimism for the EUR that previously provided a contrarian bullish signal for the currency (see chart in Introduction). On fundamentals, in chart 1, we reproduce a figure from the May FX monthly: Dollar strength broadens out. It shows a multi-month model that uses relative central bank balance sheets and real yield differentials to explain EURUSD movements. Based on our assumptions as to how central bank balance sheets are evolving, and plugging in market pricing on rates and consensus forecasts on inflation, the model suggests EURUSD could decline below parity to 0.98. Factoring in elevated FX volatility, an even stronger as well as faster decline cannot be ruled out.

The model indicates that EURUSD could rebound to 1.08 sometime in H2 2023. However, this is based on expectations that inflation in the euro area normalises to 2.5% year-on-year in 2023 and that the European Central Bank (ECB) can continue to shrink its balance sheet. The continuing energy shock, as well as worsening of political risks (Italy), suggest these assumptions should be taken with a pinch of salt. **Taken together, we pencil in 0.98, with risks to the downside, for our 12-month view, while keeping 1.02 (our prior 12-month target) as our new three-month target.**

What about July's more aggressive 50bps hike from the ECB?

Our existing EUR view was always more about the negative terms of trade shock from the Russia-Ukraine conflict, than the ECB outlook per se. Our reasoning was that the euro – as a freely floating currency – would need to depreciate to accommodate the negative terms of trade shock. This, in turn, would exacerbate inflationary pressures and make the ECB more hawkish. More important for us would be any change to our view that the eurozone faces slowdown risk because of higher energy prices and high dependence on Russian gas.

With our EURUSD forecasts being marked lower, forecasts for both EURCHF and EURGBP have also moved lower.

Sterling has managed to consolidate recently as markets attempt to draw inferences on what the change of leadership would mean for the macro and political backdrop. At the time of writing, Liz Truss has the upper hand on Rishi Sunak to become the next Prime Minister. The read through to the currency is more nuanced on the macro side. Fiscal loosening would likely imply a more hawkish Bank of England (GBP positive) but would prevent the current account deficit from correcting (GBP negative). A more hard-line stance on post-Brexit negotiations could inject greater political uncertainty (GBP negative). For now, we note the pace of deterioration in external balances (chart 2) and maintain our negative stance.

We stay bullish on the Swiss franc and keep a close eye on intervention trends. The Swiss National Bank (SNB) appears to have signalled a move from an asymmetric intervention bias (buying EURCHF to slow the pace of CHF appreciation) to a symmetric bias (also considering selling EURCHF to ensure the CHF appreciates in real terms). This would be quite a departure from history (chart 3) and increases our positive bias on CHF. We will be monitoring the SNB's weekly sight deposit data to inform our views, although in recent months this data has been distorted by the central bank`s money market operations (to ensure yields were in line with the policy target).

The currency where there is the greatest likelihood of a potential shift in our view is the Japanese yen. After USDJPY hit our 135 target, in June **we turned neutral and flagged two-way risks in a broader 133-138 range**. Three factors remain key to our yen view: movements in US Treasury yields, the path of Japan's energy trade deficit, and the Bank of Japan's (BoJ) policy outlook. In recent weeks, developments on the first and second fronts have gone in a more negative USDJPY direction. US 10-year yields have declined 80bps from their June peak as markets price in a mild US recession that succeeds in bringing inflation under control. Japanese Prime Minister Fumio Kishida has ordered the re-starting of nuclear power plants (though with questions on timing and how long this will take). If energy prices were to decline, it would help Japan`s trade situation to recover. Finally, the BoJ has indicated continued patience, suggesting possible delays to any hawkish shift in policy. Overall, for now **we pencil in a 133 – 138 trading range. We would turn more bearish on USDJPY if energy prices decline**, which, in turn, would improve Japan`s external balances (chart 4).

As far as the high-beta (higher-risk) peripheral G10 currencies are concerned, as long as markets are seriously contemplating an imminent recession risk, the current risk backdrop will likely keep all currencies on the back foot against the USD, but also against the EUR. We have long stated a preference for the **Canadian dollar (CAD)**, however, given elevated positioning, it is possible the currency will give back some of its gains. We are generally cautious on both the Australian dollar (AUD) and **New Zealand dollar (NZD)** but are more negative on the latter. We expect **AUDNZD** to remain well supported.

For the Scandinavian currencies, both the **Norwegian krone (NOK)** and the **Swedish krona (SEK)** are sensitive to eurozone risk aversion. Of the two, we would be more cautious on SEK given Sweden's higher dependence on weaker German growth, as well as emerging signs of a sharp slowdown in the Swedish housing market. The **NOKSEK** cross could move higher.

Forecast table

The table provides information on our 3M and 12M targets, the risks to our views in the near term, as well as the crucial signposts and risks we will be monitoring.

	Current spot	ST bias	3M	12M	Key drivers of our view
EURUSD	1.02	↓	1.02	0.98	Russian natural gas imports, ECB meetings and anti-fragmentation tool, eurozone balance of payments, trade data
GBPUSD	1.21	↓	1.18	1.16	By-product of EURUSD and EURGBP movements. Activity and inflation data, BoE meetings, political developments
EURGBP	0.84	→	0.86	0.85	Supported when focus is on weaker global growth. Under pressure when market driver is eurozone growth hit by RU-UKR conflict
EURCHF	0.98	↓→	0.97	0.93	SNB intervention/sight deposits, Swiss inflation data, EUR and USD real yields, ECB anti-fragmentation tool
USDCHF	0.96	↑→	0.95	0.95	By-product of EURUSD and EURCHF movements. Prone to upside risk on sharp EURUSD declines with SNB EURCHF intervention
GBPCHF	1.16	→	1.12	1.10	By-product of EURGBP and EURCHF movements
USDJPY	135	→	135	135	US 10Y yields, energy prices, BoJ meetings/bond purchases, govt commentary on JPY and intervention, 10 July upper house elections
EURSEK	10.40	↑	10.70	10.45	Eurozone growth and risk sentiment, auto sector, global capital goods demand, Riksbank meetings, housing market
EURNOK	9.97	↑→	10.25	9.90	Global risk appetite and market volatility, terms of trade, Norges Bank budget FX operations, housing market
AUDUSD	0.69	↓→	0.68	0.68	China sentiment, terms of trade, housing market, RBA meetings
NZDUSD	0.62	↓	0.61	0.60	Risk sentiment, China sentiment, terms of trade, housing market, RBNZ meetings and AUDNZD developments
USDCAD	1.29	↑→	1.30	1.28	Terms of trade, BoC meetings, US growth, housing market

↑↑ = Higher conviction bullish/possibility of sharp move up

↑→ = Modestly bullish/spot grinding higher

→ = Sideways/spot range-bound

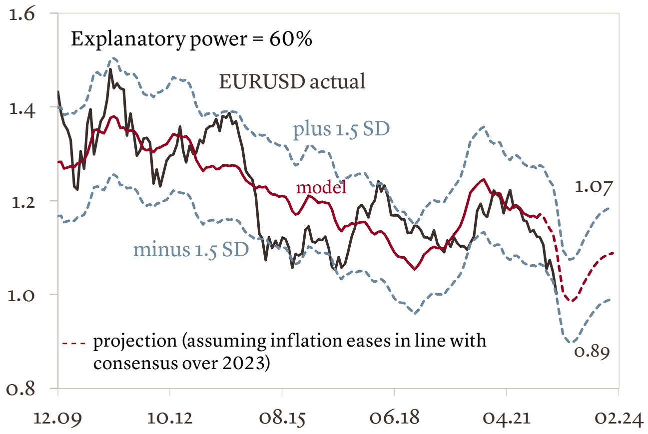
↓→ = Modestly bearish/spot grinding lower

↓↓ = Higher conviction bearish/possibility of sharp move down

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

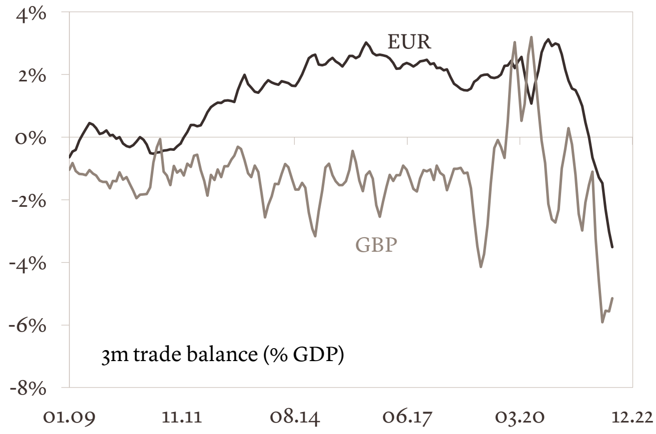
G10 key charts

1. EURUSD decline below parity based on fundamentals



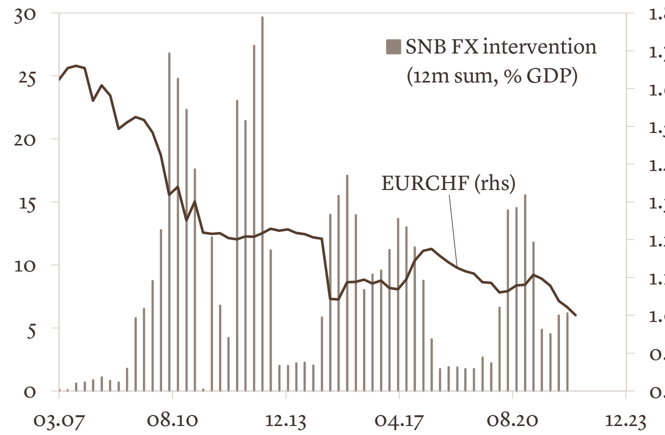
Sources: Bloomberg, Lombard Odier calculations

2. Sharp trade balance deterioration seen for EUR and GBP



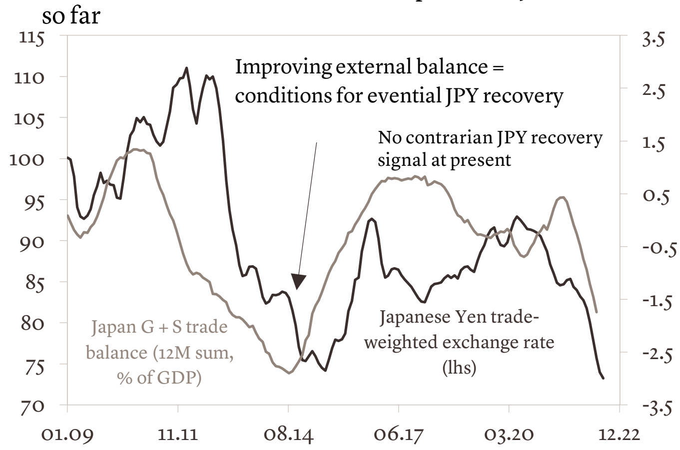
Sources: Bloomberg, Lombard Odier calculations

3. EURCHF vs. SNB FX intervention



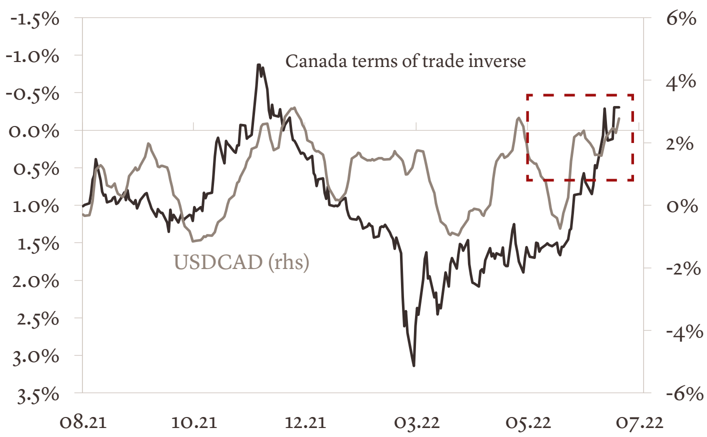
Sources: Bloomberg, Lombard Odier calculations

4. Trend in external balance does not point to a JPY bottom so far



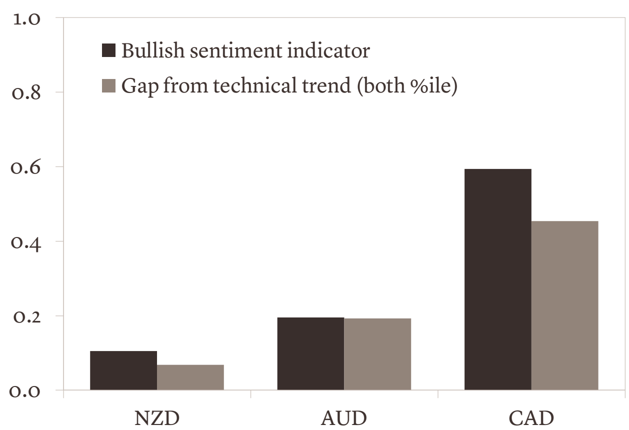
Sources: Bloomberg, Lombard Odier calculations

5. USDCAD vs Canada terms of trade (both vs. Trend)



Sources: Bloomberg, Lombard Odier calculations

6. Momentum and sentiment relatively positive for CAD



Sources: Bloomberg, Lombard Odier calculations

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

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Commodity corner

Oil markets remain tight

Brent crude averaged USD 105/bbl in the month of July, but declined below USD 100/bbl towards the end of the month. The decline from the June peak now stands at 223%, as markets increasingly price in slowing demand and the risk of a US and European recession in 2023.

Supply looks constrained, and oil markets tight. While strategic oil reserve releases from the US and International Energy Agency (IEA) are helping short term, their impact should fade in the third quarter. The Organization of Petroleum Exporting Countries (OPEC) has little capacity to expand production, and many of its members are struggling to meet current targets. US shale producers have not stepped into the breach – the industry has not regained pre-Covid production levels. The IEA estimated initially three million barrels a day of supply could be lost from Russia in the second half. Yet the impact of Western sanctions looks to be limited so far, with exports diverted to other countries, including China, India and Turkey. A price cap mooted by the G7 to incentivise further cooperation from these remaining Russsian oil importers would be difficult to enforce.

On the demand side, China's gradual economic reopening from Covid lockdowns is among the few positive dynamics, as is travel in Europe, which has now regained pre-pandemic levels. Yet taking a broader view, slowing global growth is reducing demand for oil. Financial conditions are tightening, high inflation and fuel prices are pushing consumers to rethink unnecessary purchases and car journeys. Still, we estimate it would take a major US recession to offset the loss of Russian supply – and our base case for 2023 is for a more mild contraction. With the oil market still in structural deficit, we expect prices to average above USD 100/bbl for the rest of the year, before gradually falling in 2023.

Gold still torn two ways

Gold prices have come off mid-April highs, falling from around USD 1985/oz to USD 1770/oz currently. In terms of price drivers, conflicting forces are at play and rising uncertainties are preventing a clear trend from materialising. We see little change from this status quo in coming months, and continue to prefer other haven investments, including the US dollar.

Factors arguing for higher prices include a sustained geopolitical premium related to the Ukraine war (which we currently estimate at just over USD 500/oz), rising recessionary fears and still-strong inflation, as US consumer and producer price pressures continues to surprise on the upside. Historically, haven flows have supported gold in this context.

Meanwhile, the overwhelming factor arguing for lower prices is rising real rates, as the Federal Reserve is under continued pressure to proceed with its rapid pace of monetary tightening. As long as this pressure remains, we see little chance of gold staging a rebound, meaning prices could struggle to make headway over the summer. In such a context, the US dollar acts as the safe haven asset of choice.

Our base case is for gold prices to remain around USD 1800-1900/oz. Signs of overtightening in real rates would likely see gold rise in a second stage, once the effects on economic activity allow the Fed to ease its stance; in the last economic contraction in 2020, gold rose as real rates declined. If the global economy were to see a policy-induced recession – and our base case scenario is a mild US contraction in 2023 – pressure would remain in the short term.

Alternative scenarios could include an intensification in the Ukraine war, with Western sanctions or Russian retaliation intensifying. This could see prices rise to USD 2000/oz, before economic activity collapsed. Our final alternative scenario is a more severe recession induced by Fed overtightening. In this case, we estimate that gold would fall below USD 1700/oz as it suffered from further portfolio de-risking and rising real rates before acting as a safe haven. As volatility is here to stay, active management should prevail.

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

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3. Recession scenarios – oil, gold and industrial metals prices

	Base case			Alternative scenario
	Mild recession	Mild recession	Mild recession	Severe Recession
	Prolonged supply disruptions on energy markets	**Ceasefire/end to war. Gradual EU energy independence**	**War intensifies, max level of sanctions/ Russian retaliation**	**... due to ultra-restrictive US Federal Reserve**
Oil	+ USD 120/bbl 2 mbd Russian production removed from global oil markets partly offset by OPEC/shale	- USD 100/bbl Sustained geopolitical premium adds to tight fundamentals	+++ then -- USD 150/bbl, then back to below USD 70/bbl 4-5 mbd Russian production removed from global oil markets but demand destruction (recession needed to rebalance)	=/- Below USD 100/bbl: demand collapse, decline in prices depends on supply scarcity
Industrial metals (copper)	++ USD 10000/mT Chinese demand accelerates European Union's REPowerEU plan	+++ >USD 11000/mT European Union's REPowerEU plan	=/- USD 7 000/mT Further de-risking from financial investors weighs on non-energy commodities	- USD 7000/mT Further de-risking from financial investors
Gold	+ USD 1900/oz	- USD 1800/oz Sustained geopolitical premium but gradual return to Fed overtightening fears	+ then ++ > USD 2000/oz Collapse of economic activity	- then ++ Gold below USD 1700/oz as market prices in additional rate hikes and gold suffers from portfolio de-risking
Global commodities	++	=/+	+++ then =	-- then OW gold

Source: Lombard Odier calculations
mbd= million barrels per day, mT= metric ton, OW= overweight
Data as of 11.07.22, see CIO Viewpoint of that date

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

Asia FX

After favouring Asia among emerging markets for much of 2021, we maintain our view for the next 12 months that the region's currencies will remain weak versus the USD.

For USDRMB, we maintain our 6.70-6.90 range assumption, but gains will likely be controlled. A widening USD-RMB interest rate differential, driven in part by China's public health and property sector challenges, will create upside risk for the pair. The Biden administration's possible decision to reverse Trump's tariffs could provide a negative catalyst. While we expect China to defend current account surplus this year, weaker-than-expected H2 merchandise exports would lead us to revise up our USDRMB assumptions.

A more mediocre outlook for RMB and JPY should keep the **Korean won (KRW)** and the **Taiwanese dollar (TWD)** on the back foot in the near term, but we are more neutral for the mid-term given their valuations. **USDKRW** will show an upward bias in the near-term due to equity market outflows, external balance deterioration, and the Bank of Korea's wavering on the inflation fight. The cheap current valuation, however, should allow the currency's recovery in the medium-term. **USDTWD** will also soften modestly due to weakening global growth, but we see Taiwan's solid fundamentals (e.g. current account surplus 10%+ of GDP) eventually reversing this trend in 12 months' time.

For USD pairs in South Asia, we have raised our forecast for **USDIDR** due to the Bank Indonesia's apparent dovish bias and more mediocre medium-term outlook for bulk commodities. We still believe that a stable inflation outlook and limited external deficit will anchor the currency's performance despite the Fed's rapid tightening. In contrast, we now see limited upside risk for **USDINR** after its rise in H1 as the Reserve Bank of India's accelerating policy tightening and stabilizing commodity prices should provide an offset for equity market outflows. Similar shifts should also cap the upside for **USDPHP**, but we suspect that the Philippines might see a larger trade deficit due to its excess demand conditions and higher food and energy import dependence.

The **Thai baht (THB)** remains in our "cautious" EMFX category. The country is re-opening its border significantly to boost tourism, and we expect Thailand's growth to accelerate in the near-term. The Bank of Thailand's tolerance of high short-term inflation, however, will keep THB relatively unappealing for global investors. We are neutral on the **Malaysian ringgit (MYR)** given a stable macroeconomic performance and policymakers' preference for inaction. The **Singaporean dollar (SGD)** remains our favourite currency in Asia in light of the central bank's hawkish message. We expect the bank to steepen the path of SGD's nominal effective exchange rate path yet again in October as policymakers are determined to fight current high inflation.

	Current spot	ST bias	3M	12M	Key drivers of our view
USDRMB	6.77	↑→	6.78	6.90	Merchandise export trend, Biden's decision on Trump's Section 301 tariffs (likely in July), PBoC policy action, portfolio outflows
USDINR	79.60	↑→	80.45	80	RBI frontloading prospects, NRI deposit inflows, coal/seed oil/crude oil prices, Russia energy exports to India, summer rainfall
USDKRW	1'306	↑→	1,335	1'280	BoK's rate decisions vs consideration for impact on household debt service ratio, USDJPY directions, equity outflows, geopolitical risk
USDTWD	30.0	↑→	30.2	29.1	Semi-conductor/smartphone cycle, global macro conditions, equity flows, life insurers' hedging after global sell-off, CBC policy tightening
USDSGD	1.38	↓	1.36	1.34	MAS inter-meeting potential decision (for additional tightening), service sector inflation trend, regional growth (esp. of ASEAN)
USDIDR	14'920	↑→	14,950	14'900	Bulk commodity, coal, and seed oil prices, administered fuel price hike and its impact on BI policy, capital flows amidst US rate hikes
USDTHB	35.8	↑→	35.9	36.3	Near-term BoT tolerance of high inflation and dovish rate cycle to create residual depreciation pressures, re-opening for tourism
USDMYR	4.46	→↓	4.46	4.36	BNM hike cycle pricing, snap parliamentary election, commodity price cycle, resident portfolio outflows
USDPHP	55.6	↑→	55.8	56.4	Speed of deterioration in external balances, post-election fiscal policy, BSP rate hike cycle and inflation tolerance

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

LatAm FX

The Latin American (LatAm) currency complex broadly outperformed for much of H1, but performance peaked back in April in line with broader commodity markets. Thereafter, declining commodity prices on global (and China) growth concerns have led to weakness.

In terms of changes to our views this month, the largest revision applies to the Chilean peso (CLP), which we revise down to our "cautious" category. Even before the large 28% drawdown for CLP (from June to mid-July), we had downgraded the currency by a notch to "modest performer" category (see May FX monthly: Dollar strength broadens out). Valuation still appeared favourable at the time, keeping us optimistic over a 12-month horizon. However, valuation is now increasingly in question following the sharp sell-off in copper prices. That said, the central bank`s recently announced FX intervention program (USD 25bn until end-September) is sizeable and has seen the currency recover.

For now this prevents us from turning even more negative on the currency (rather than turning constructive). This is because Chile`s current account balance – one of the widest in mainstream EM – is likely to get wider. It is being driven by multiple sources, including a deteriorating services balance and income deficit. The goods balance, still in surplus, is moderating.  Historically, the trend in Chile`s external balance has driven the currency's relative performance against EM peers (charts 5 and 6). Ultimately, tighter fiscal policy would be needed for us to turn more positive (assuming this improves Chile's future current account position).

Elsewhere, our views largely remain unchanged (see table).

We prefer both the Brazilian real (BRL) and Mexican peso (MXN) and both currencies remain in our "modest performer" category. BRL benefits from favourable valuation and improving external balances. However, the currency could face volatility from August onwards (ahead of the October Presidential election). On the other hand, Mexico is modestly expensive and has seen some deterioration in external balances, being a net energy importer. Still, it benefits from limited political and fiscal uncertainties (in contrast to LatAm peers).

We expect a **5.10-5.40 range for USDBRL** on a three-month view, but see the cross eventually falling back under 5.0. Taking into account the positive re-rating for the 2022 government debt outlook, external balances and local investor positioning, we believe the BRL – while remaining volatile – should hold up well (see our June FX monthly : Weak growth, elevated inflation to support dollar).

The Colombian peso (COP) remains one of our EMFX underperformers, for its expensive valuation, as well as poor external and fiscal balances. Now that Gustavo Petro has won the Presidential election, markets will likely focus on the new cabinet's make-up. Appointments more towards the left of the political spectrum would be COP-negative, while a more centrist composition could see COP recover some ground. By contrast, **the Peruvian sol (PEN)** will likely remain more stable, with the central bank actively managing the currency to ensure stability.

	Current spot	ST bias	3M	12M	Key drivers of our view
USDMXN	20.4	→	20.5	21.0	Broader risk sentiment, US economic activity, Banxico meetings
USDBRL	5.16	→	5.15	4.80	Terms of trade, fiscal policy actions, pre-election campaigning (August) and elections (October)
USDCOP	4350	↑	4450	4300	Cabinet appointments and proposals of new government, trade/current account
USDCLP	917	↑→	915	900	Copper prices, dollarisation, local politics, trade/current account
USDPEN	3.90	→	3.75	3.70	Dollarisation, local politics, copper prices, CB intervention trends

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

CEEMEA FX

CEEMEA remains our least favourite EM region. Proximity to the Russia-Ukraine conflict, heavy reliance on Russian gas and oil, exposure to slowing eurozone growth, widening external imbalances, and sharply rising inflation are some of the main reasons. Our detailed views for this group of currencies remain relatively unchanged from June.

That said, **we highlight the potential for some recovery in the Israeli shekel (ILS) and South African rand (ZAR) in the coming month**. Both currencies are more isolated from vulnerabilities to European growth, dependence on Russia oil and gas, and weakening external balances when compared to the Hungarian forint (HUF) or Polish zloty (PLN).

Looking ahead, we believe ZAR could recover and pencil in the USDZAR pair declining to a 16.10 – 16.30 range. With markets beginning to accept a slower pace of Fed normalisation, lower US Treasury volatility and a continuation of the recovery in equities and commodities should help. Somewhat similar to the situation in Brazil (see LatAm section), South Africa continues to benefit from improved prospects for external and fiscal balances this year. A hawkish turn from the central bank also helps. Still, given valuations and a still challenging medium term fiscal outlook, we maintain ZAR in our "cautious" category.

A further relief rally in technology-centric US equities and stabilising US yields would also benefit the ILS. USDILS could edge lower towards the bottom of a 3.35-3.45 range. Despite a still stellar external balance, a key factor driving a weaker currency in recent months has been FX hedging related flows. Since the start of 2022, local institutional investors' purchase of close to USD 7 bn has supported USDILS. Any stability in US equity markets should allow these USDILS buying flows to ebb. The ILS remains in our EMFX '**modest performer**' category.

The HUF remains on our list of EMFX underperformers. Hungary's current account deficit is on track to widen further to nearly 5% of GDP (and this figure may well be understated given large unexplained flows in the balance of payments). EU fund payments, a key source of inflows, are at risk following the EU's decision in April to trigger the rule-of-law conditionality mechanism. Hungarian officials are currently in negotiations with the European Commission to try to unlock payments. Low FX reserves have made it more challenging for the central bank to slow the pace of currency depreciation, leading it to further intensify the pace of monetary tightening. The government has signalled tighter fiscal policy for H2, a positive step. Still, we remain cautious given the country`s large exposure to a slowing eurozone economy.

Meanwhile, the **Polish zloty (PLN) remains in our "cautious" category**. The country suffers from similar problems to Hungary, including a widening current account deficit and low real yields. That said, Poland's authorities have more FX reserve firepower, as well as readiness to contain any sharp movements in the currency.

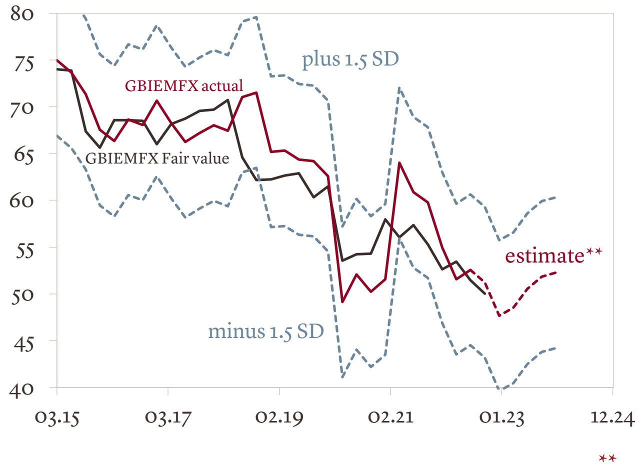
Finally, given intense volatility, as well as constraints on gaining exposure, we prefer to avoid both the Turkish lira (TRY) and the Russian rouble (RUB). **The Turkish lira (TRY) remains on our list of EMFX underperformers** and we see very little reason to change our stance

	Current spot	ST bias	3M	12M	Key drivers of our view
USDTRY	17.9	→	19.2	23.0	Dollarisation trends, credit growth, inflation, monetary policy, tourism
USDRUB	64	→	65	75	Exports of oil and gas, Russia-Ukraine conflict, energy prices, domestic capital controls
USDZAR	16.8	→	16.5	16.2	Trade figures, terms of trade, broader EMFX sentiment
USDILS	3.34	→	3.45	3.35	Israeli institutional investors' ILS hedging, NASDAQ trend
EURPLN	4.70	↑	4.80	4.70	Trade figures, inflation, activity data, EU fund flows and NBP intervention
EURHUF	394	↑	410	405	Trade figures, inflation, activity data and EU fund flows

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

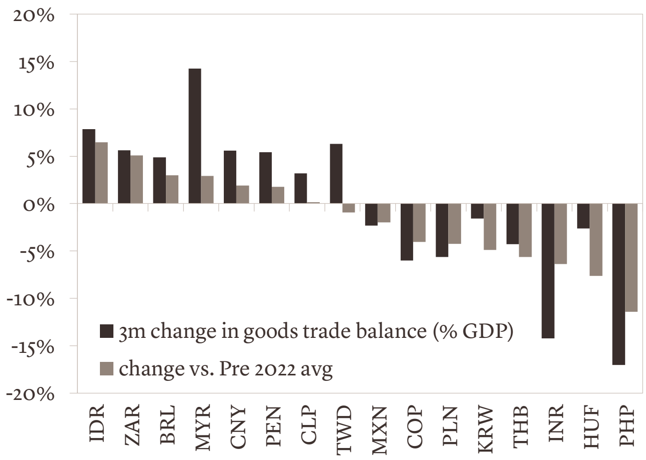
EM key charts

1. EMFX fair value seen moving lower following Q1 recovery



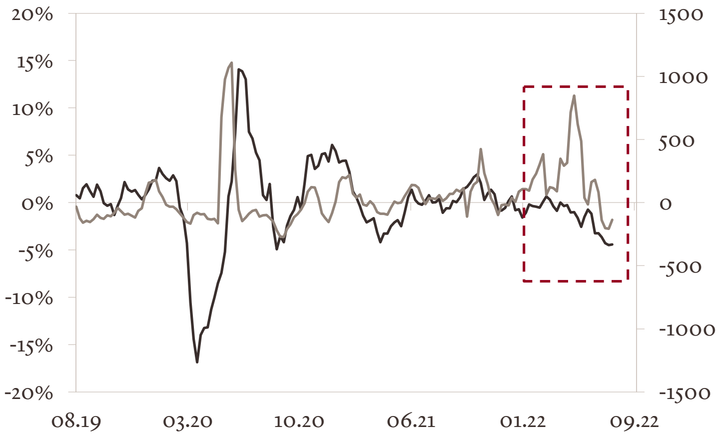
Sources: Bloomberg, Lombard Odier calculations

2. EMFX vs trade balance evolution



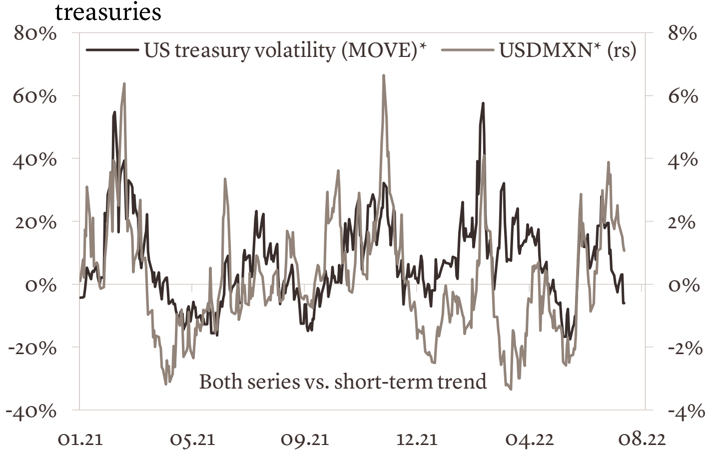
Sources: Bloomberg, Lombard Odier

3. IDR: H122 Equity flow support has come to an end



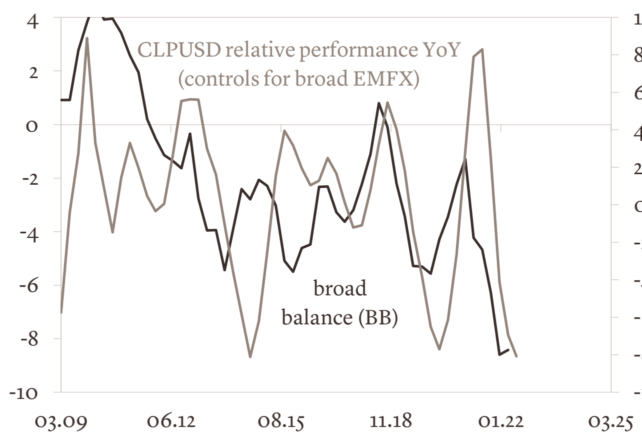
Sources: Bloomberg, Lombard Odier calculations

4. MXN could benefit from reduced volatility in US treasuries



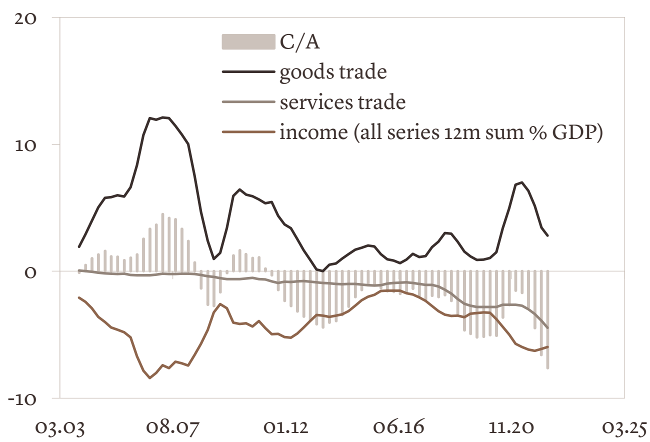
Sources: Bloomberg, Lombard Odier calculations

5. Weak current account explains CLP under performance



Sources: Bloomberg, Lombard Odier calculations

6. Widening CA deficit to keep CLP highly volatile



Sources: Bloomberg, Lombard Odier calculations

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

Our Lombard Odier long-term FX fair valuation framework

BEER
Behavioural equilibrium exchange rate model

Definition

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

Inputs

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

Output

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

FEER
Fundamental equilibrium exchange rate model

Definition

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

Inputs

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

Output

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

COMBINED OUTPUT – LO FX long-term fair value estimates

Usage (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 Rouble

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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