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Investment Strategy
Private Clients

1/4

December 2019 · 1st quarter

Key highlights

- Our base case for the new year assumes only a laborious recovery from 2019's depressed levels of activity – that is, unless US and Chinese negotiators were to reach a truly convincing and durable trade deal.
- In the US, solid consumption should keep the spectre of recession away, but not prevent growth from continuing to trend down towards potential.
- External factors should allow for some upturn in Europe, but the process will likely be gradual – in the absence of a clear catalyst.
- With an orderly Brexit now in the cards, UK growth should also finally pick-up in 2020 – a more expansionary fiscal stance providing added support.
- In Japan, the fall-out from the consumption tax hike has been worse than anticipated, suggesting forthcoming aggressive and meaningful fiscal stimulus, with the Bank of Japan in a supporting role.
- Lower rates across much of the emerging world helped partially offset the trade drag in 2019 – with the full impact of this monetary easing still to materialise.
- Valuations now being less attractive, carry should be the core strategy in multi-asset portfolios – and nimbleness will be key. Looking beyond traditional sources of income, our preference goes to EM hard currency debt, global high yield, real estate and infrastructure.
- Favourable dollar winds are fading as we move towards the new year, suggesting that its overvaluation is set to recede.

Quarterly publication of
Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 2 December 2019

Post-trade shock hangover

As 2019 comes to a close, the good news is that global economic growth is bottoming out – thanks to much easier monetary policies across the globe and a modest reduction in geopolitical risk. But while a world recession has been dodged, just what type of recovery can be expected next year?

With most of the indicators that we monitor still at levels consistent with below-trend GDP growth, hoping for the world economy to revert back to its post-Great Financial Crisis (GFC) pace appears a tad optimistic. It is true that consumers have remained resilient across the globe, on the back of tight labour markets, but manufacturing – and the Chinese economy more generally – will likely continue to feel the brunt of the trade dispute.

On this subject, the prospect of a "phase 1" truce between US and Chinese negotiators is of course good news, but it is only that: a first step. Some tariffs might be rolled back, and uncertainty recede to a certain extent, but trade flows cannot be expected to bounce back to where they were before President Trump began levying duties on Chinese (and other) goods (see chart 1, page 04). Odds of a viable longer-term agreement, involving a major removal of tariffs and some reassurance that they will not be reinstated in the future, remain limited in our view.

Moreover, over the past decade, every economic slowdown and subsequent recovery has been characterised by relatively significant stimulus from China. On three occasions, in 2008 (GFC), in 2012 (European sovereign debt crisis) and 2015 (US dollar/oil shock), Chinese policymakers took substantial measures to boost credit. This time round, in comparison, their actions on this front appear quite limited – which is of course good news for the country's debt profile but comes at the expense of future growth. Although Chinese activity data will most certainly improve over the next quarters, we are unlikely to experience the kind of recovery that followed the afore-mentioned slowdowns.

In Europe, German authorities' unwillingness to make bold use of their fiscal leeway will preclude the largest Euro area economy from fully recuperating from the trade and auto sector shock (see chart 3, page 4). Significant public investment to finance the necessary energy and economic transition would make a huge difference, but budget orthodoxy seems unlikely to be abandoned anytime soon.

All told, our base case – or should we say main investment constraint – for the new year assumes only a laborious recovery from 2019's depressed levels of activity. Global growth can be expected to strengthen during the first quarters of 2020 but will remain in hangover mode: 1.8% in the US, 0.9% in the Euro area, 0.4% in Japan and 5.9% in China. In turn, this means that easy money (aka low rates) will continue to prevail. While currently on hold by its own admission, the Federal Reserve (Fed) may actually be brought to cut rates twice more as the year progresses.

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculations.

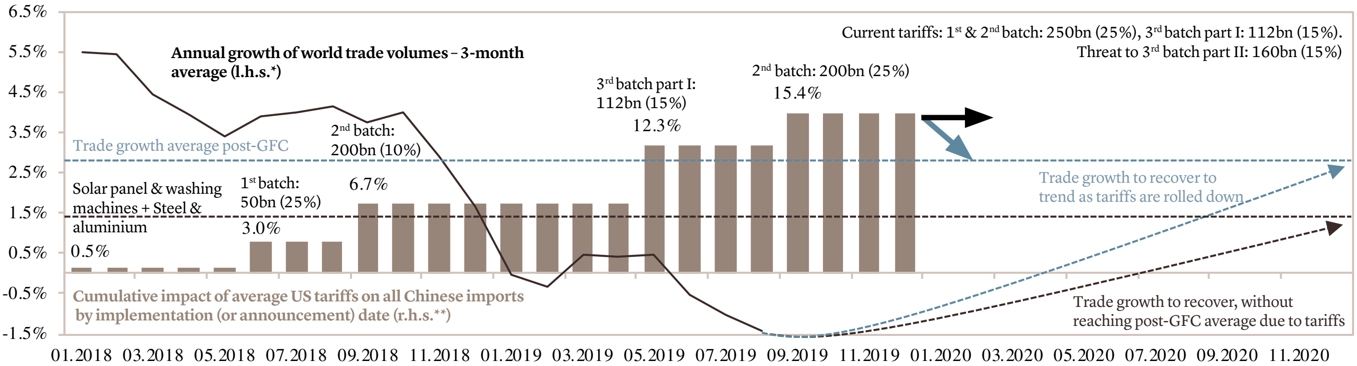
But what if, this time round, the US and China manage to reach a trade agreement that is both convincing and durable? This factor is clearly the pivotal element to our 2020 scenario and the upside "risk" to our base case. Capital spending and trade flows would pick up markedly, and growth rates across the globe revert back towards their longer-term trend. Which would of course make the Fed much less liable to ease policy further.

For now, from an investment perspective, we retain a prudent asset allocation overall – albeit having slightly upped our risk exposure to reflect the recent positive developments on both the market and macro fronts. More specifically, our stance on emerging market equities has been upgraded to neutral, and our global high yield allocation to overweight. We continue, however, to view gold as an essential and effective portfolio hedge, as well as a good diversification tool.

Samy Chaar, Chief Economist

1. Trade growth to recover to trend if tariffs are rolled down materially

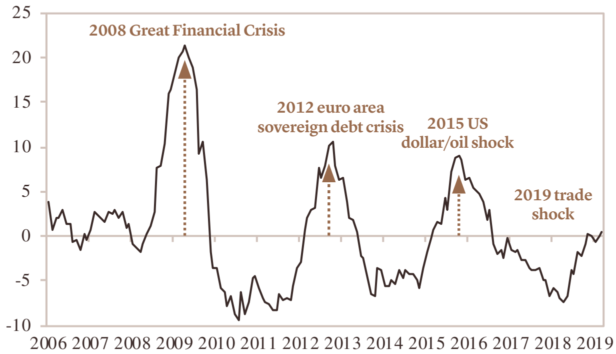
Substantial and systematic tariffs have been implemented



* left hand scale, ** right hand scale
Sources: USTR, Lombard Odier calculations

2. Chinese credit impulse

12-month change (in %)

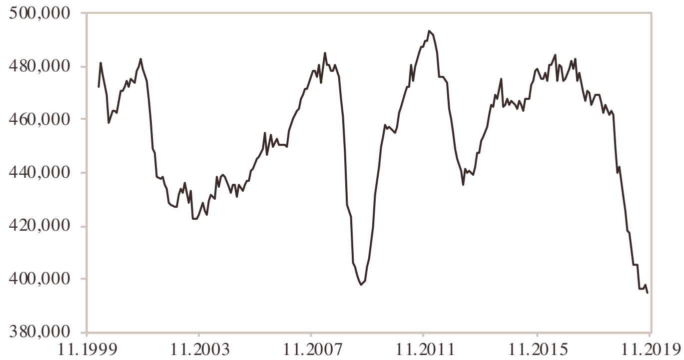


NB: The Chinese credit impulse is computed as the 12-month rolling sum of incremental Chinese credit divided by the 4-quarter rolling sum of nominal GDP

Sources: Bloomberg, Lombard Odier

3. German production of new passenger cars

12-month rolling volume (in millions)



Sources: Bloomberg, Datastream, Lombard Odier calculations

United States
The recession-less slowdown continues

In a nutshell

- Solid consumption should keep the spectre of recession away, but not prevent growth from continuing to trend down towards potential.
- The Fed is on hold for now, but rate cuts later in 2020 are a distinct possibility, depending largely on international developments.
- Domestic politics will be the focus of 2020: Congress is set to remain divided but much does hinge on the outcome of the Presidential race.

In the US, the picture remains very much the same as we head towards the new year. Although job creations are flattening out, real income growth should remain relatively stable which, together with the high savings rate, should keep consumption strong enough to steer the economy clear of recession, but not able – particularly now that the effects of fiscal stimulus have completely faded – to avoid further GDP slowdown towards the long-term potential rate.

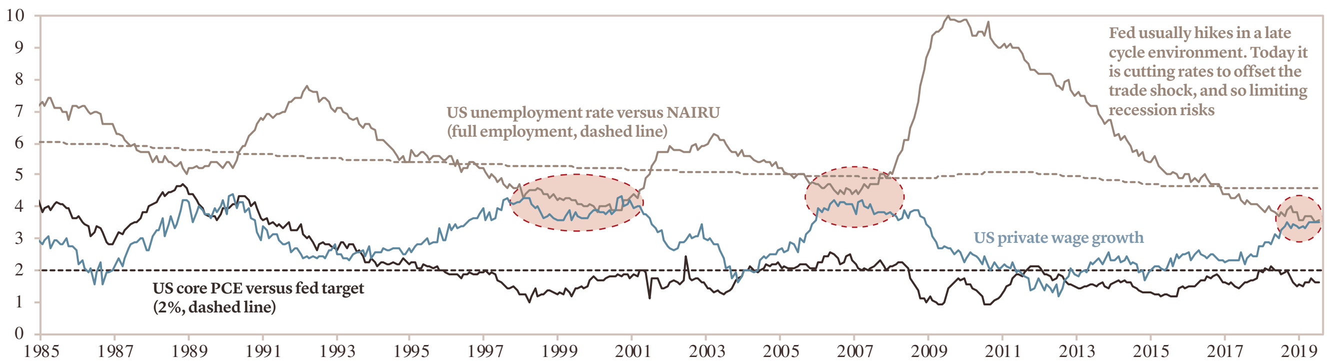
Having reversed gear abruptly during the course of 2019 (with three rate cuts that can be considered an economic insurance policy), the Fed has now said that it intends to remain on pause for an extended period. It is, however, the sole major central bank that still has sizeable room to cut rates and, with no signs of inflationary pressures, we would expect it to make use of this leeway later in 2020, when it becomes apparent that the global/manufacturing recovery is only mediocre. That is, unless meaningful surprises occur on the trade front, or Chinese and German policymakers decide on aggressive stimulus programs.

Of course, domestic politics will be very much in the spotlight during 2020. As far as Congress is concerned, division should continue to prevail, making the passing of any major legislation highly difficult. For President, the current leading Democratic contenders are Joe Biden and Elizabeth Warren – with Pete Buttigieg in close trail and Michael Bloomberg having just joined the fray. We would posit a Biden, Buttigieg or Bloomberg victory as a form of return to normalcy, for instance in terms of a more multilateral approach and greater respect of Fed independence. Should Warren become the first woman to head the US, policy priorities would be in for a general shake-up, whether in terms of business and financial regulation, tax policy or healthcare programs - despite her signature proposals probably not being able to pass a divided Congress. And if Trump is re-elected? Well, we now know what it means to live in a very uncertain world. Trade tensions would likely flare up at regular intervals, and pressure on the Fed would not disappear. In fact, a second mandate would mean that President Trump gets to pick the next Fed Chairman, with Powell's term ending in 2022.

Samy Chaar, Chief Economist

4. A strong consumer may prevent a recession in 2020 but not a slowdown

The unemployment rate, inflation and wage growth are moving sideways while the Fed eases, arguing for an extension of the cycle (in %)



Sources: Bloomberg, Datatsream, Lombard Odier calculations

Europe
The worst may be over, but don't expect a sharp recovery

In a nutshell

- Some improvement is pending in Europe, thanks to external factors.
- But the process looks likely to be gradual – in the absence of a clear catalyst.
- Fiscal policy will make just a small contribution, while there is only so much that easier monetary conditions can achieve.

Our one-word 2020 outlook for the euro area is "stability". This may sound like an improvement compared to the sharp – almost relentless – slowdown experienced since late 2017 (see chart 5). But it is hard to find GDP growth exciting.

External factors may offer some support, in the event of a US-China trade truce and a reduction in Brexit-related uncertainty (see next section). But their impact will be slow and partial, unless we get abundant clarity on both fronts. Meanwhile, Europe's persistent issues of deficient domestic demand, low potential growth, and insufficient policy response will continue to weigh.

The lack of effective policy response is proving a major constraint. Monetary firepower looks largely spent. Having implemented a tiered reserve system to limit the side effects of negative rates on the banking system, the European Central Bank (ECB) may proceed with another small deposit rate cut. But, with a starting point of -0.50%, namely one of the world's most negative policy rates, this would be unlikely to have meaningful impact. In fact, as we expected at the time, this was also the case for last September's package.

Despite its ambitious scope and scale, the ECB only managed to avoid a tightening of financial conditions, with no noticeable boost to growth.

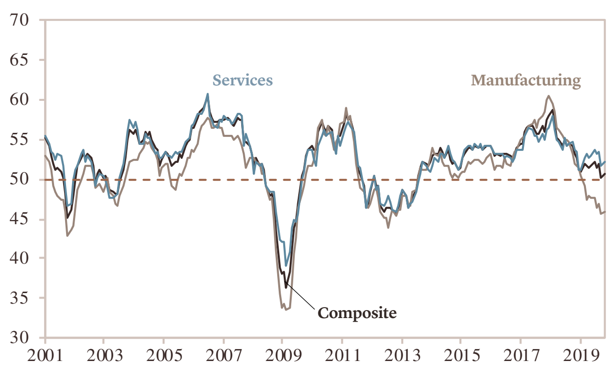
The ECB has repeatedly asked for fiscal policy support which, by boosting demand directly, could indeed move the needle significantly. But, for all the talk, such help remains elusive. As shown in chart 6, current budget projections suggest that governments are, in the aggregate, only marginally easing their fiscal stance. Germany, the country with the most leeway (and Europe's largest economy) remains unwilling to enact sizeable measures – at least so long as recession is not an imminent risk. The debate in German politics is moving towards fiscal easing, but only very slowly.

All told, the outlook is rather balanced for 2020. Some help from an improved external environment, combined with domestic demand that is sustained by tight labour markets, low inflation and easy financial conditions, will prevent a collapse in growth. But risks remain, including a protracted Brexit saga, the tough adjustment underway in the auto sector, or even the risk of EU-US trade tensions. With limited ability for policy to respond, stability may be the best we can hope for.

Bill Papadakis, Macro Strategist

5. Euro area PMIs: two years of non-stop slowdown

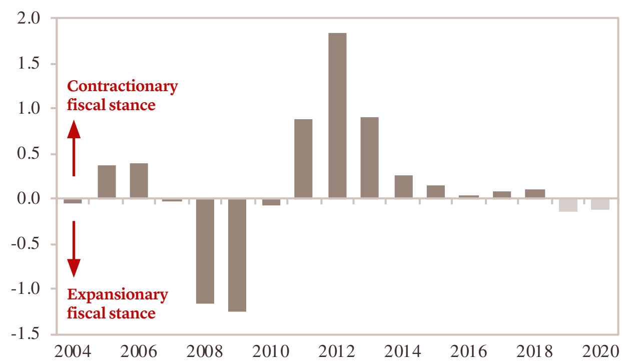
Services, Manufacturing and Composite Purchasing Managers Indices for the euro area



Sources: Markit, Bloomberg, Lombard Odier calculations

6. Fiscal easing? Way too limited to make a difference

Change in government budget structural balance (as a % of GDP)



Sources: IMF, Lombard Odier calculations

United Kingdom
A little less uncertainty, a little more growth please

In a nutshell

- With an orderly Brexit now in the cards, the UK growth picture should finally start to improve in 2020 – helped also by a more expansionary fiscal stance.
- Still, crucial negotiations about the future relationship with the EU lie ahead, notably on the complex trade front.
- To this effect, an extension of the "transition period" (due to end in December 2020) will be necessary, despite Boris Johnson's publicly stated opposition.

Having experienced slower growth every year since the 2016 referendum, the UK economy may finally be set to pick-up somewhat in 2020 (see chart 7) – conditional on an orderly Brexit process, which now clearly appears to us as the most likely scenario. This contrasts with several episodes in 2019 when concerns regarding a no-deal exit were legitimate.

With polls currently widely favouring the Conservative Party (see chart 8), it also looks likely that Boris Johnson will return as Prime Minister with a comfortable parliamentary majority. This should allow the Withdrawal Agreement bill to be passed in short order, most likely before the end of 2019. The UK would then cease to be a full European Union (EU) member by January 2020, setting off the "transition period", during which it will remain a part of most EU structures (including the single market and the customs union).

Given the relative stability of the transition period, the environment will likely be less uncertain than that of the past few years. Combined with a short-term boost from increased fiscal spending, at the heart of both major parties' campaign promises, this makes for an improved backdrop in 2020.

Still, we would be remiss not to underline the remaining risks. First, the possibility of a hung Parliament and renewed Brexit-related uncertainty cannot be excluded. UK polls have been widely off the mark in the past, while it is also possible that the Conservative lead narrows over the coming days.

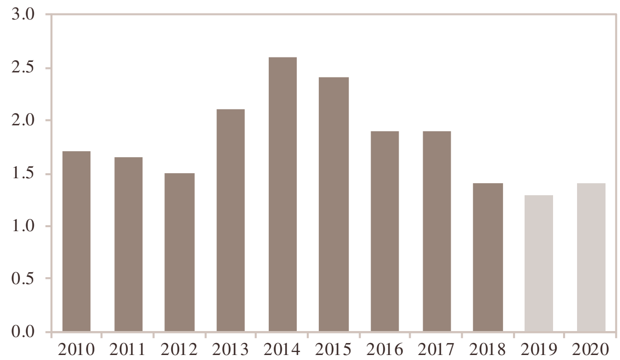
Also, while a smooth exit process is certainly better than an abrupt crash-out, it does not solve all the issues. Negotiations regarding the future relationship are only about to begin, and a trade deal that significantly weakens the links between the UK and its largest trade partner would severely hurt the country's long-term growth prospects.

Finally, and crucially, the aforementioned reduction of uncertainty is conditional on a transition period that runs beyond its December 2020 set date. Indeed, it will be virtually impossible to conclude a complex trade agreement in just a few months. An extension will thus be needed to avert exit on simple "WTO terms". We think that such a request will (once again) be granted, but lack of such intention is a risk worth monitoring, given Boris Johnson's public opposition to the very idea.

Bill Papadakis, Macro Strategist

7. Looking for a small improvement after years of slowdown

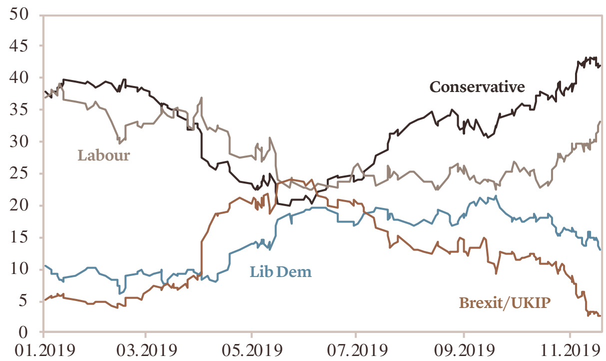
UK real GDP growth, post-crisis period (in %)



Sources: IMF, Lombard Odier

8. A conservative majority looks likely based on recent poll data

Average of the five most recent polls



Sources: Financial Times, UK polling companies, Lombard Odier calculations

Japan
Injecting fiscal "fresh water"

In a nutshell

- The fall-out from the consumption tax hike has been worse than anticipated, despite Japanese policymakers' meticulous preparations.
- The Abe cabinet will likely introduce aggressive and meaningful fiscal stimulus to ensure a quick rebound at the start of the new year – with the Bank of Japan to play a supporting role via additional tweaks.
- Assuming no new external shocks from US-China trade and Northeast Asia geopolitics, Japan has a chance of maintaining positive, albeit low, growth in 2020.

Japanese policymakers continue to focus on containing the negative impact of the October consumption tax hike. The sharp deterioration in recent data (such as retail sales and new car registrations) suggests that this might require more aggressive measures by both the Abe cabinet and the Bank of Japan (BoJ) than initially anticipated. There are also signs that the labour market is loosening. Deeply negative growth is thus a foregone conclusion for the final quarter of 2019, even though the full-year figure should reach ca. 0.9% thanks to healthier previous growth.

As we expected, the Abe cabinet has begun to push for a large supplementary budget to engineer a quick recovery. Local media reports suggest that such additional stimulus will amount to at least JPY 10 trillion (see chart 10) – which is quite possible given the majority enjoyed by the ruling party. In fact, we believe that the cabinet will also consider extending the temporary consumption boosting measures included in the budget for the current fiscal year (ending in March 2020). If we are correct, the government should be able to deliver sufficient "fresh water" (mamizu) to maintain 2020 headline growth in positive territory.

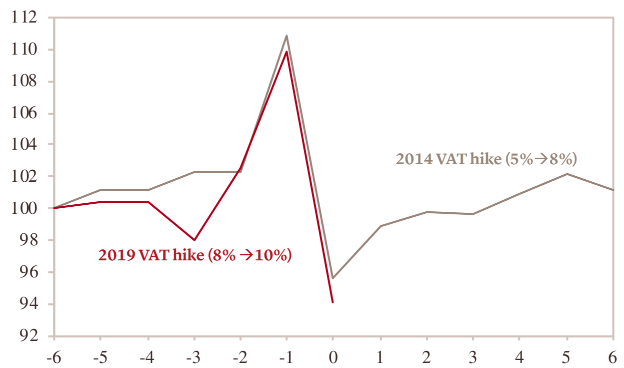
On the monetary front, however, the modest policy tweak that we anticipated in October did not occur. Yet, with headline inflation suggesting little "pass-through" from the consumption tax to final prices, the BoJ has many good reasons to coordinate its policy response with the Abe cabinet. Its continued restraint hints at political discomfort with aggressive rate cuts and an eagerness to keep some dry powder. Still, we do see it as highly likely that it will take at least an initial symbolic step toward the ECB-style monetary policy framework of modestly lower short-term rates with a "tiered" system as regards the application of these punitive rates to bank reserves.

All told, as 2020 progresses, we expect quarterly growth figures to improve, thanks to both a modest global recovery and the soon-to-be implemented monetary and fiscal easing. The Tokyo Olympic games could also be a modest positive for growth and inflation, but offsetting risks lie in a possible deterioration of the Northeast Asia security environment, after North Korea's self-imposed deadline for denuclearisation talks. Abe's push for constitutional revision also remains a key domestic political risk.

Homin Lee, Macro Strategist – Asia

9. Worse than expected initial impact from the 2019 VAT hike

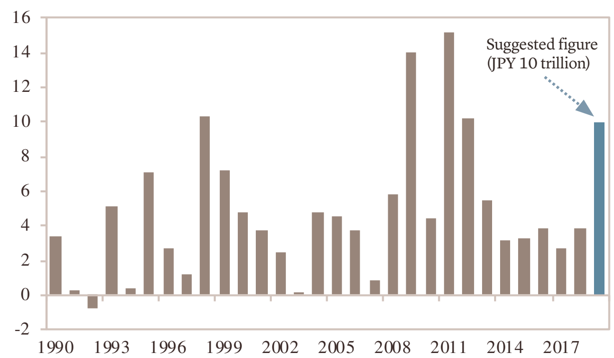
Real sales level (value) around the initial month (T=0) of VAT hikes



Sources: CEIC, Lombard Odier calculations

10. Suggested supplementary budget could provide a substantial boost

Supplementary budget by fiscal year (actual and suggested) - in JPY trillion



Sources: Minstry of Finance, Lombard Odier

Emerging Markets
A tepid recovery in 2020

In a nutshell

- Lower rates across much of the emerging world helped partially offset the trade drag in 2019 – with the full impact of this monetary easing still to materialise.
- The record debt burden is, however, a concern; emerging economies should take advantage of lower rates to lengthen maturities and repair balance sheets, if they want to retain their hard-won improved credibility.
- A close eye should also be kept on the social tensions that have erupted in a number of countries, lest they come to trigger a negative economic cycle.

In the emerging complex, the massive and unprecedented wave of rate cuts is certainly what history will remember of 2019. Within our universe of 18 large emerging countries, a full 15 saw their central bank lower rates – Hungary and Poland (where rates were already at record lows) as well as Colombia being the exceptions. And the scope of this easing was substantial, averaging ca. 100 bp versus 75 bp in the US (see chart 11).

Still, emerging economies experienced quite a significant slowdown, with real GDP growth falling back from 4.9% in 2018 to an expected 4.5% in 2019. Trade tensions took an immediate toll on emerging economies, because of their deep integration in long and complex supply chains – whereas the rate cuts need time to filter through to the real economy.

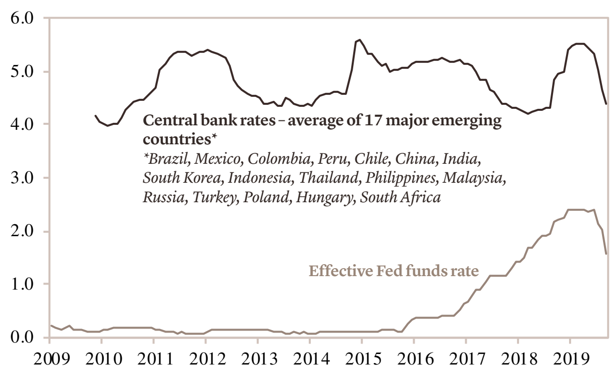
Turning to 2020, two pieces of good news should be highlighted. First, the lagged effect of monetary easing means that some of its benefits have yet to materialise. Second, central banks are not completely done. Even though the Fed is on hold for now, we continue to see two rate cuts as possible in 2020, to support gradually slowing US growth. Often forgotten, but very important too, is the fact that domestic inflation is low across the emerging complex (see chart 12), thanks to the lack of global price pressures of course, but also to improved fundamentals – narrower current account deficits, alongside stronger and more credible policy-making institutions.

But while the long-term growth potential of emerging markets is intact, we do note several headwinds. At USD 71.4 trillion, or 220% of GDP (IIF data), total emerging debt stands at a record high, a substantial part being short-term for non-financial firms. The lower Fed funds rate should be used as an opportunity to lengthen debt maturities and repair balance sheets. If, instead, emerging countries continue to take advantage of easy financial conditions to increase their debt burden, at a time when the full independence of some central banks could come under question (e.g. Turkey, India to a lesser extent), they risk losing their hard-won improved credentials. More immediately, the biggest obstacle to growth upside in 2020 continues to be the trade dispute. A partial deal would obviously provide some relief, but more will be needed to fully unlock the growth potential. Finally, rising social unrest (e.g. Chile, Peru, Bolivia, Ecuador, Hong-Kong, Lebanon) should be monitored as it could lead to less reforms, greater deficits, and thus a vicious circle of higher inflation, tighter monetary policies and slower growth.

All told, we expect some pick-up of emerging growth ex-China in 2020, offsetting part of the slowdown in the US or Japan.

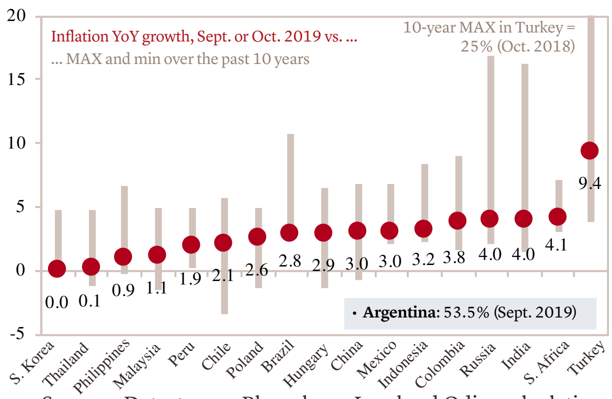
Stéphanie de Torquat, Macro Strategist

11. Emerging central banks in the Fed's footsteps
In %, as of 31 October 2019



Sources: Datastream, Bloomberg, Lombard Odier calculation

12. Inflation close to a 10-year low in many countries
In %



Sources: Datastream, Bloomberg, Lombard Odier calculation

Asset Allocation
More of the same in 2020 – but with lesser returns

In a nutshell

- 2019 returns well exceeded expectations across most asset classes, thanks notably to the pivotal shift in central bank policy.
- Turning to 2020, with valuations now less attractive, carry should be the core strategy in multi-asset portfolios – and nimbleness will be key.
- Persistently low yields will also force investors to look beyond traditional sources of income: our preference goes to EM hard currency debt, global high yield, real estate and infrastructure.
- Negative yielding government bonds are no longer an effective diversification tool – making exposure to gold a necessity today rather than just an option.

2019 proved a better year for financial markets than we and most investors had anticipated. Twelve months ago, very few were those forecasting 20%+ returns in global equities, 10%+ returns in corporate credit, alongside a 10%+ return for gold. The reasons underpinning this strong performance are two-fold. First, the year began with attractive valuations in many asset classes: US equities were trading at a price-to-earnings ratio of 14x, US investment grade credit spreads stood at ca. 140 bp, etc. And second, we witnessed a pivotal change in central bank policy, notably that of the Fed, from a tightening to an easing interest rate cycle. Still, 2019 was no smooth ride, with escalation/de-escalation of US-China trade tensions (and the resulting downturn in global trade), tensions in the Middle East, Brexit negotiations and other geopolitical events swaying investor sentiment from bullish, to bearish, and back to bullish again.

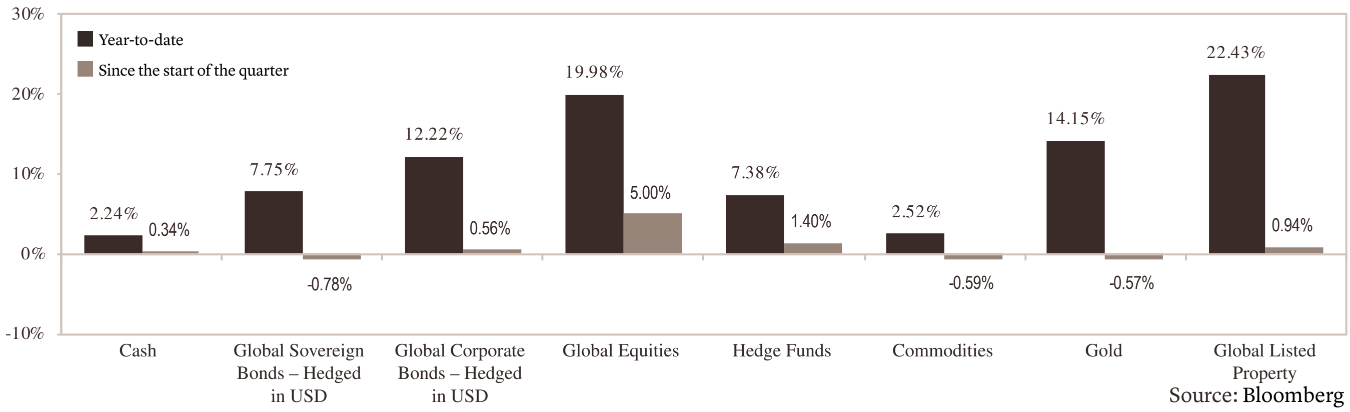
Where does this leave us as we look to 2020? We would start by noting that:

- We remain in a late cycle market. This means that valuations of the various asset classes are not particularly attractive, and meaningful market catalysts will be necessary for returns to be anywhere close to those of 2019.
- With value unattractive, carry should be the core strategy in multi-asset portfolios – and is where we anticipate the best risk-adjusted returns. The current low yield environment, which we expect to persist during 2020, means that one needs to look beyond traditional sources of income. We have a preference for EM hard currency debt, global high yield (see chart 14, page 11), real estate and infrastructure.
- Negative-yielding core government bonds are less effective as safe havens. Not only do they not generate income, but their potential for price appreciation during times of stress is capped by investors' limited appetite for ever-more negative yields (bond prices move in the opposite direction to yields). In turn this makes less traditional safe havens, such as gold, take on a renewed importance in a well-diversified portfolio.

Keeping the above in mind, we intend to position our asset allocation according to the following investment themes:

- Central banks will remain accommodative, keeping government yield curves anchored at low levels.
- Although still weak, growth will be sufficient to prevent a pick-up in defaults and allow for some earnings growth.

13. Global asset class performances
Total return



Source: Bloomberg

Indeed, gradual improvement/bottoming-out of economic data will provide increasing support to earnings as the year progresses.

- Portfolios should balance carry strategies with a cautious equities positioning. Nimbleness will be key, taking advantage of volatility episodes to adjust overall risk exposure.
- Option strategies are a good, asymmetric means of managing equity exposure tactically.
- Uncertainty around trade negotiations and other geopolitical risks will continue to prevail throughout the year.

Investors' relatively defensive positioning in 2019 provides a reasonable starting point for 2020 from an expected return perspective. We forecast low- to mid-single digits returns in 2020 across most asset classes. In equities, performance should be driven by topline (i.e. revenue) growth and dividend payments. Margin expansion will most likely be limited and current valuations do not call for a material re-rating. Credit should primarily be a carry play. This means that expected returns will likely be close to current yields, minus expected losses specific to the high yield segment. Spreads should broadly remain flat. As for government bonds, the current environment and central bank policy will persist in 2020, which implies range-bound yields and returns similar to the yields now prevailing in each government bond curve.

Overall, in our base case, we would expect 2020 balanced portfolio returns to range from 3% in EUR and CHF, 3.75% in GBP to 4.5% in USD. But they could be as low as -7% and as high as 6% in our downside and upside scenarios, respectively. While our base case for next year does call for some caution, we will stay nimble and reactive in our portfolio allocation, ready to adjust our equity vs. credit mix and our duration exposure, as events unfold.

Carolina Moura Alves, Head of Asset Allocation
Sophie Chardon, Senior Cross-Asset Strategist

Why own gold?

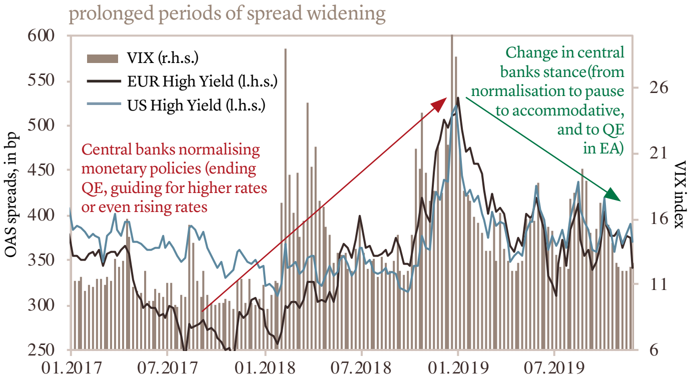
Historically, government bonds have been the safe-haven or risk-free asset of choice to ensure portfolio diversification. Negative government bond yields in Europe and Japan have, however, fundamentally altered the relative merit of government bonds vs. gold as a safe haven. In these economies, government bonds no longer have an income advantage over gold. There is also a limit as to much further into negative territory bond yields can go, while still attracting investors. This fact was highlighted by the global bond market rally that occurred during the summer of 2019: the US 10-year yield collapsed by more than 130 bp, from 2.8% to below 1.5%. Meanwhile, the German and Swiss benchmarks dropped only 100 bp, reaching historical lows of respectively -0.71% and -1.12% in August. Interestingly, Japanese bonds underperformed their peers due to the yield curve targeting implemented by the Bank of Japan, aimed at anchoring the 10-year yield around 0%.

Since gold has no limit to the upside and benefits from the growing share of negative-yielding bonds, we see scope for the yellow metal to outperform significantly (upside of almost 14%) in an adverse environment, concurrently with US real rates moving significantly into negative territory (see chart 15). In our base case, we keep our 12-month target for gold unchanged at USD 1,450/oz, expecting the Fed to remain on hold for the next couple of quarters.

We believe that the negative yield environment will persist for EUR and CHF government bonds in the near future. This has profound implications for long-term portfolio construction. Expected government bond returns in the event of a stress scenario are capped – making gold a necessary rather than optional allocation.

14. We overweight high yield bonds to gain further exposure to carry strategies

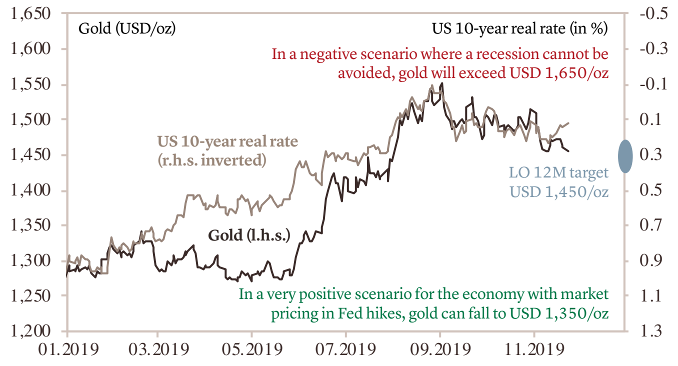
Change in central bank stance and associated search for yield prevent prolonged periods of spread widening



Source: Bloomberg

15. Gold in our multi-scenario analysis

As the probability of a recession is falling, we would wait for gold to trade meaningfully below our target to increase our overweight (as a value, not a risk-reduction, trade)



Sources: Bloomberg, Lombard Odier estimates

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

Forex
2020 outlook: is the dollar heading for a secular decline?

In a nutshell

- Favourable dollar winds are fading as we move towards the new year, suggesting that its overvaluation is set to recede.
- A less uncertain global environment and positive Brexit developments should support the euro and sterling.
- The (safe haven) yen may lose some ground initially but should recover later in the year, on the back of its undervaluation and greenback weakness.
- A normalisation of global trade, as well as domestic stimulus and improving EM growth, will underpin the CNY.
- EM currencies look cheap in aggregate, with the RUB, MYR, PEN and MXN being our top picks for 2020.

In 2019, the dollar managed to hold on to its prior year gains, bolstered by the flaring up of political/trade uncertainty and the concomitant deceleration in world growth (see chart 16). But, as we head into 2020, these factors appear to be dissipating.

First, US-China trade talks have taken on a modesty better tone, which should unclog trade channels somewhat and, importantly, improve market and business sentiment. In parallel, global manufacturing activity is bottoming out and likely to recover, albeit at a sluggish pace. Finally, a disruptive no-deal Brexit appears to have become a very low likelihood scenario. Although uncertainties remain, the decline in tail risk premia is thus likely to trigger a correction of fundamental misalignments in the currency market.

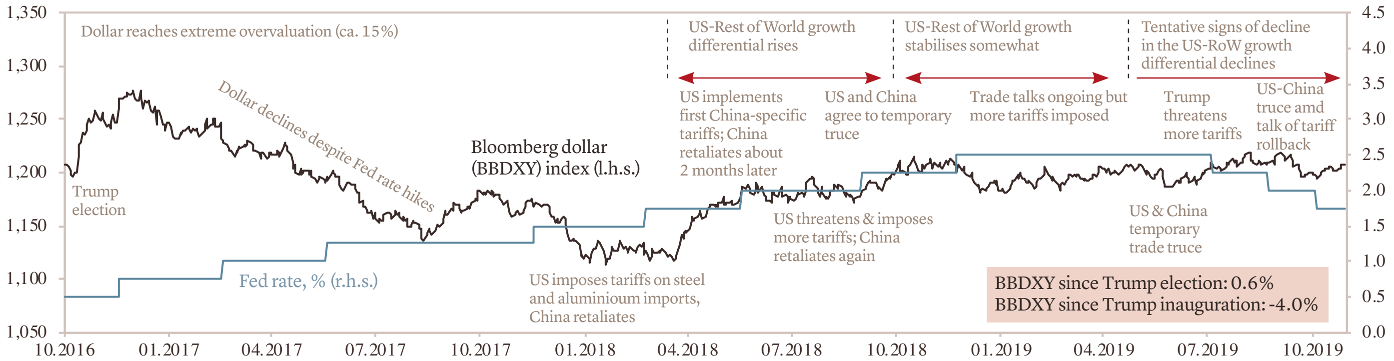
More specifically, we expect the overvalued dollar to adjust lower. Relative to interest rate differentials, we estimate that the trade-weighted (TW) USD is currently overvalued by some 9%. This misalignment was sustained during a period of rampant global trade/growth concerns (see chart 17, page 13) and US exceptionalism. Going forward, however, a stabilisation in the world outlook and the now-faded US fiscal impulses will likely serve as catalysts for the greenback to converge closer to fair value.

We expect EURUSD to appreciate (towards 1.15) driven by valuation, a stabilisation in trade flows as well as positive Brexit developments. We anticipate that the Swiss franc will weaken modestly against the euro (our 2020 year-end forecast stands at 1.12) as uncertainty reprices lower. This should also mean that USDJPY trades more firmly in the near term. That said, we expect JPY to regain some ground eventually, on the back of its undervaluation and USD weakness (year-end forecast of 107).

Sterling should benefit further, especially in the early part of next year. We think it is likely that the Conservative party will master a majority in the UK parliament, sufficient to ratify the EU/UK deal signed last October. This will pave the way for the EU/UK discussions on the future trade relationship to kick off. Our year-end forecast for GBPUSD stands at 1.35.

Our working assumptions regarding global developments in 2020 should, alongside valuations, also support the Australian and Canadian dollars. In the Nordic space, we expect NOKSEK upside to gain more traction as Norway's outperformance vis-a-vis Sweden becomes more evident.

16. The dollar's path over the past three years



Sources: Bloomberg, Lombard Odier calculations

Turning to China, we anticipate that some normalisation in global trade, the lagged impact of (modest) domestic stimulus, as well as the pickup in emerging market growth (attributable both to easing trade tensions and to significantly easier monetary policies), will underpin the CNY. We target USDCNY at 6.80 by the end of 2020.

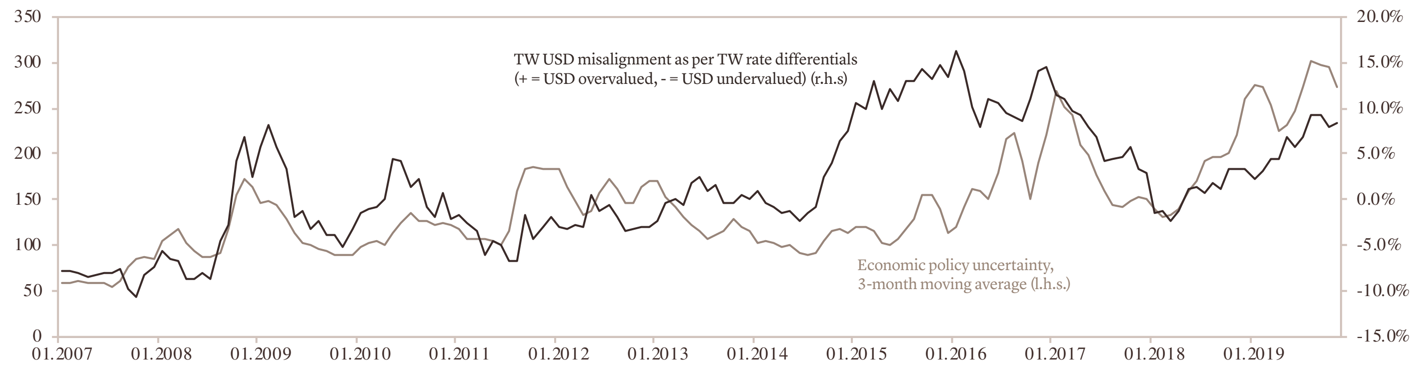
While dispersion remains high among emerging market currencies, they do appear cheap in aggregate. Much of the undervaluation since mid-2018 has coincided with the sharp rise in global political (and trade-related) uncertainty. Assuming tensions de-escalate somewhat, we believe emerging currencies could recover. We target a 3-4% return for the GBI EMFX index.

Our favoured emerging currency picks are the RUB in the CEEMEA region (Central & Eastern Europe, Middle East and Africa), the MYR in Asia, and the PEN and MXN in Latin America. These currencies all screen as undervalued and will likely benefit from idiosyncratic drivers in the year ahead. The Russian rouble should benefit from typical positive first-quarter seasonality, with any loosening of fiscal policy also a support. The Malaysian ringgit offers exposure to some pick-up in global trade volumes, strong external balances and a recovery in portfolio flows. The Peruvian sol could respond to a stabilisation of copper prices. Solid external balances, alongside low volatility and a decent yield (similar to that of the much more volatile BRL), make for an attractive carry trade. Finally, although the Mexican peso does face a number of headline risks, such as ratification of the US-Mexico-Canada agreement, the state-owned Pemex and the potential controversial turn in President AMLO`s reform agenda, it is cheap, government debt is relatively low and the anaemic pace of portfolio inflows likely already reflects many of these concerns.

There are both upside and downside risks to our 2020 forecasted currency trajectories. On the one hand, a more "abrupt" trade resolution – involving a significant rollback of existing tariffs – would likely push the greenback much lower. On the other hand, a complete US-China fallout would bring about the risk of global recession, with flight to safety flows triggering another sharp dollar appreciation.

Vasileios Gkionakis, Global Head of FX Strategy

17. USD's overvaluation can be explained by policy uncertainty



Sources: Bloomberg, Lombard Odier calculations

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