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FX Monthly

It's all about Sterling

10/12

October 2019

Key highlights

- We have trimmed our year-end EURUSD forecast, but as global activity stabilises and bottoms out the currency is likely to gain more traction and shrug off some of the external risks that were priced in.
- We stay neutral on CHF, forecasting EURCHF at 1.10 over the foreseeable future.
- Brexit developments and GBP undervaluation suggest upside sterling pressures over the next few quarters.
- USDJPY likely to consolidate in a range of 106-109.
- The US-China ceasefire supports our view of a stabilization in USDCNY around 7.10 for the time being.

FX Committee targets

	Q4 19	Q2 20
EURUSD	1.12	1.15
GBPUSD	1.30	1.34
EURGBP	0.86	0.86
EURCHF	1.10	1.10
EURSEK	10.85	10.95
EURNOK	10.00	9.90
USDCHF	0.98	0.96
USDJPY	106	107
USDCAD	1.32	1.29
AUDUSD	0.68	0.70
NZDUSD	0.63	0.63
USDCNY	7.10	7.00

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Contributors:
Vasileios Gkionakis, Head of FX Strategy
v.gkionakis@lombardodier.com

Kiran Kowshik,FX Strategy
k.kowshik@lombardodier.com

Homin Lee, Macro Strategist Asia:
ho.lee@lombardodier.com

Contact: is-strategy@lombardodier.com

Important information: Please read important information at the end of the document. Data as of 18 October 2019

It’s all about Sterling

What a month. While we have held a defensive bias in recent quarters (via JPY longs), Q3’s two major pressure points – fears of a no-deal Brexit and an escalating Sino-US trade war - appear to have eased over these past two weeks. While still early days, we think this presents some opportunities in the FX markets. We take these in turn.

First, the ongoing Brexit bruising has been enough to give anyone a nosebleed. But last week, the UK and the EU finally managed to reach a new deal at the EU summit of 17-18 October. This has propelled sterling crosses significantly higher, with GBPUSD up by 5% on a month-to-date basis and EURGBP lower by around 3%. As of the time of writing, the House of Commons has not yet approved the deal. However, a number of safeguards put in place to avoid the UK crashing out of the EU suggest that the probability of a no-deal Brexit is fading. As discussed in our Investment Committee Update, this has shifted us to a more positive view on the GBP: indeed, the pricing out of the “no-deal” Brexit premium alongside GBP’s significant undervaluation suggested to us that the risk-reward was in favour of sterling appreciation. We maintain this view and look for a gradual GBPUSD appreciation towards 1.35 with the risk skewed towards more upside.

Second, turning to China, the ceasefire achieved with the US on their trade disputes in early October supports our view of USDCNY stabilisation around the 7.10 level in the near term. If we are right in thinking that the admittedly modest Chinese credit stimulus helps commodity FX, this will present opportunities for AUD and CAD to gain.

Given the discussion above, we decided to take profit in our long-held long JPY exposure in our portfolios. USDJPY remains overvalued but a stabilisation in US yields, renewed Japanese equity outflows and negative JPY Q4 seasonality suggests the pair could hold up better for the remainder of the year.

Third, elsewhere, some things have remained the same. We retain the view that the dollar remains subject to opposing forces in the near term (headwinds to global activity vs. USD’s overvaluation). However, the risks that seemed to have underpinned the greenback these past few months (trade war escalation and a disorderly Brexit) are abating. This reinforces our view of USD weakness on a medium term horizon.

On EURUSD, we have trimmed our year-end EURUSD forecast, as the industrial woes – up until Q3 19 - are likely to make it difficult for the currency to make convincing headway in the near term. However, as the global economy stabilises and bottoms out, the currency is likely to gain more traction and shrug off some of the externally driven, priced-in risks. We keep our neutral stance on the Swiss franc and forecast a rather flat trajectory of around 1.10 against the EUR. Risks are for some EURCHF upside.

Finally turning to Nordic currencies, we have lowered our SEK forecast, as the currency will likely be undermined further by the extremely weak domestic data and a likely dovish shift in Riksbank’s stance.

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FX forecasts

	Current spot	Q4 19	Q1 20	Q2 20	Q3 20	Estimates of long term fair value[1]
EURUSD	1.11	1.12	1.13	1.15	1.17	1.15
GBPUSD	1.29	1.30	1.32	1.34	1.35	1.40
EURGBP	0.86	0.86	0.86	0.86	0.87	0.82
EURCHF	1.10	1.10	1.10	1.10	1.10	1.13
USDCHF	0.99	0.98	0.97	0.96	0.94	0.99
USDJPY	108.50	106	106	107	107	99
EURJPY	120.70	119	120	123	125	114
EURSEK	10.79	10.85	10.90	10.95	10.90	9.44
USDSEK	9.70	9.69	9.65	9.52	9.32	8.21
EURNOK	10.22	10.00	9.95	9.90	9.85	8.99
USDNOK	9.18	8.93	8.81	8.61	8.42	7.82
USDCAD	1.31	1.32	1.30	1.29	1.28	1.28
AUDUSD	0.68	0.68	0.69	0.70	0.70	0.76
NZDUSD	0.64	0.63	0.63	0.63	0.63	0.66
USDCNY	7.08	7.10	7.05	7.00	6.95	

[1] The estimates of long-term (LT) fair values are calculated as the average value estimated using FEER and BEER models. The FEER (fundamental equilibrium exchange rate) model calculates the exchange rate required to bring macroeconomic balance, i.e. full-employment, low inflation and a sustainable current account balance. The BEER (behavioral equilibrium exchange rate) model uses econometric methods to estimate equilibrium FX rates based on a set of macroeconomic variables (our model uses terms of trade, investment as a share of GDP, and real rates within a panel data set across G10 FX).
Please refer to page 18 for a more detailed explanation.

Note: Past performance is not a reliable indicator of future performance.

EUR
Further upside but likely slow for now

- **EUR has managed to stage a recovery in October...**
- **...but global industrial woes may keep the appreciation in check in the near term**
- **Medium term we still see potential for EURUSD upside.**

Since our last monthly (20 September), EURUSD has followed a U-shaped trajectory, leaving it 1.4% higher for the period. The weakness in late September – driven in large part by a strengthening of the US dollar as markets gave a hawkish interpretation to the FOMC meeting – gave way to a rebound in October.

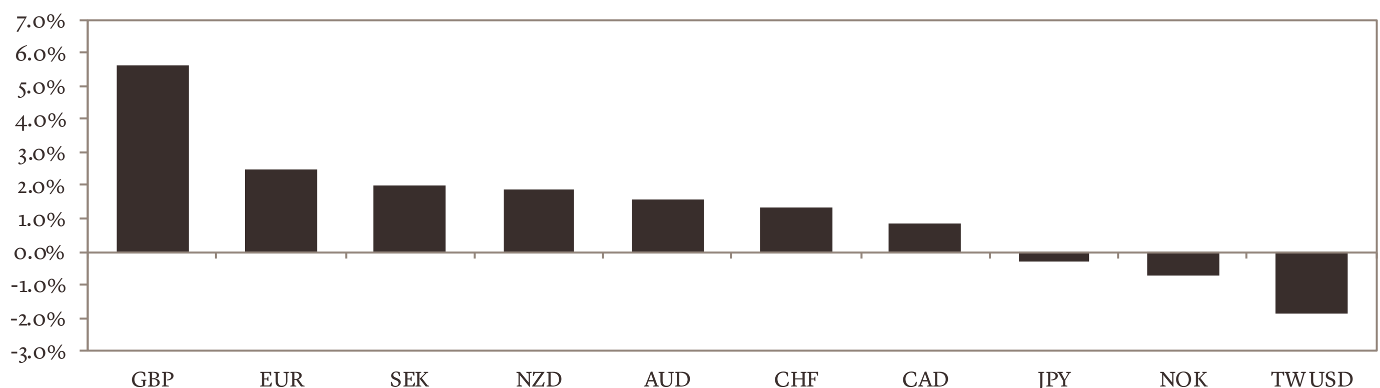
In our view, there have been three drivers behind this rebound. First, US data has disappointed overall. The latest US manufacturing ISM fell to a ten-year low, signalling a deeper contraction in the industrial sector, while the non-manufacturing ISM registered a much bigger-than-expected decline to 52.6 from 56.4 in August. The latter suggests further spillovers from manufacturing to the services sector. The non-farm US payroll report for September was not upbeat either: although the unemployment rate fell further to 3.5%, jobs and wage growth disappointed expectations. A monthly decline in US retail sales highlighted the risks for the consumer, which so far, has been the strongest part of the economy.

Second, the release of the ECB's contentious September meeting minutes (when the central bank announced a comprehensive package of easing measures), confirmed that the governing council was very divided on several stimulus measures. This reinforces the view that the ECB has reached its limits as far as the easing cycle is concerned, triggering further upward pressure at the short-end of core European yields, underpinning the EUR.

Third, some market optimism on US-China trade negotiations has resulted in improved risk appetite and weighed on the dollar, which is now nearly 2% down for the month (see chart 1). Naturally, this has lifted most G10 FX against the greenback, including the euro. The currency has also been underpinned by renewed optimism on Brexit developments (see next section).

We expect this upward EURUSD pressure to last on a multi-quarter horizon, albeit at a slow pace. On one hand, we have decided to trim our forecast trajectory (to 1.12 by the end of this year) to reflect the impact of the externally trade-related shock, which – admittedly – we previously underestimated (see chart 2). Despite the recent somewhat positive news on US-China negotiations, the reality is that trade channels remain disrupted (relative to the pre-tariff era) and the recovery in the industrial sector will be slow. This is likely to keep any EUR appreciation in check in the short term. On the other hand, our fundamental views about 1. USD overvaluation and 2. EUR having priced in plenty of "doom and gloom," remain in place. Initially, EURUSD upside will be slow (hence our trimming of the 2019-end forecast), but once more signs emerge that the manufacturing slump is bottoming out, we expect to see valuations start falling into place and upside to gain more momentum.

1. An unfriendly October for the USD
MtD spot returns (as of close of 18 October 2019)



Sources: Bloomberg, Lombard Odier.

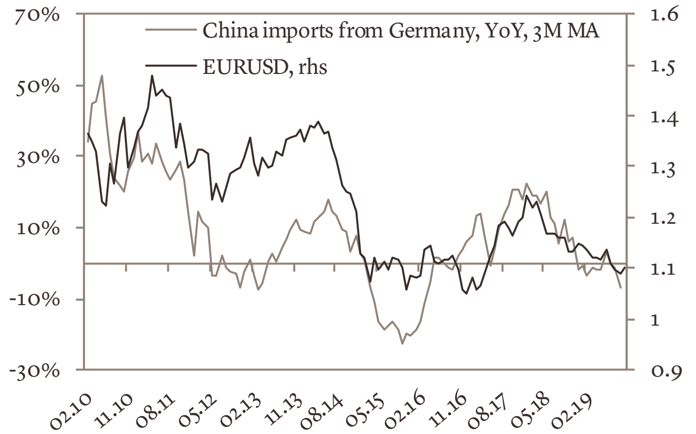
Note: Past performance is not a reliable indicator of future performance.

EUR
Further upside but likely slow for now

Regarding portfolio allocation for medium term investors, we remain neutral in EURUSD for the time being. Any modest near term upside is likely to be offset by the negative carry. Over the next few months, we will be monitoring two main factors to time our entry into EUR longs. First, we will watch for a stabilisation and bottoming-out of the manufacturing slowdown. Second, any potential German fiscal stimulus should generally be bullish for all European assets, including the currency. This is admittedly still very uncertain, but if it happens, would be euro-positive. An orderly Brexit would affect the euro positively, but for gains to become sustainable, the global economy needs to recover.

That said, more tactical investors will still find value in EURUSD option structures to position for potential appreciation. Implied volatility still hovers around multi-year lows, while EURUSD risk reversals (reflecting the difference in the pricing of call relative to put options – see chart 3) suggest that market participants have started dipping their toes into EURUSD upside.

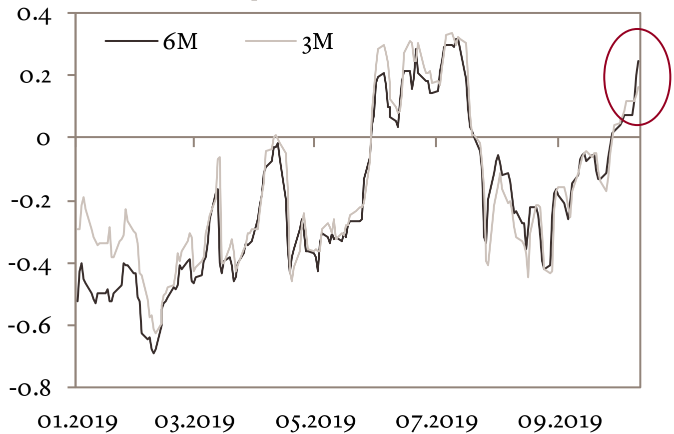
2. External factors still weigh on the EUR



Sources: Bloomberg, Lombard Odier.

3. EURUSD risk reversals

Unit of measurement is the difference of implied volatility between a call and a put of similar (25) delta



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

CHF
Under some pressure

- **CHF under some pressure recently due to improved risk appetite**
- **However, a number of global uncertainties may prevent a sustained rise in EURCHF for now**
- **We keep our EURCHF forecast path at 1.10, although there are some risks to the upside.**

Following a U-shaped path in September, the trade-weighted CHF has so far come under pressure in October. It is down about 1.0%, with EURCHF rising 1.1%.

In our last FX monthly, we argued that the Swiss franc is likely to remain subject to opposing forces. Upside pressure may stem from the uncertain global growth and fragile risk appetite but this would be offset by the SNB's monetary policy response, either through FX intervention, rate cuts or a combination of both.

Since then, the modest progress in the US-China trade negotiations has recently improved risk sentiment somewhat (see chart 4), which explains why the franc has been among the worst performers since late September. Is this renewed optimism sufficient to propel EURCHF significantly and sustainably higher?

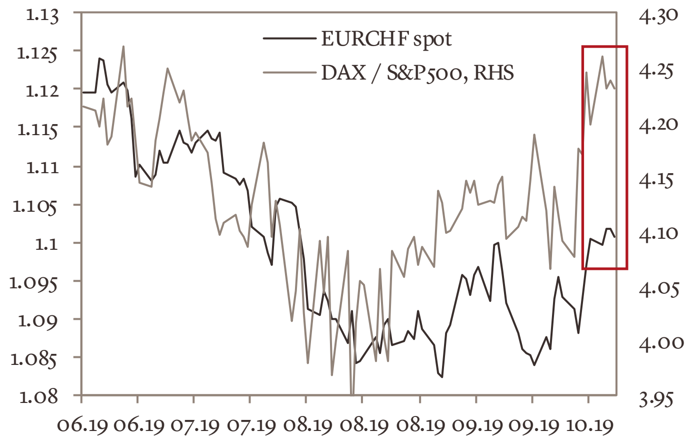
We do not yet think that there is enough justification to change our core view i.e. relative stability around the 1.10 level. Although we acknowledge that there are some upside risks to this forecast, we argue that the recent US-China developments amount to a ceasefire rather than a complete solution. The avoidance of further escalation and implementation of new tariffs will certainly be a "shot in the arm" for sentiment. However, existing tariffs remain in place and China's fiscal stimulus – though adequate to stem a sharp slowdown – is smaller than before. Consequently, the global manufacturing sector stills faces a number of challenges.

In that respect, global growth is unlikely to stage a quick recovery. Some stabilisation can be expected (indeed some data point to tentative signs of stabilisation), which will prevent the CHF from appreciating. But equally, the global backdrop does not look likely – at least so far – to spur a big sell off in safe haven assets.

In terms of domestic economic dynamics, the KOF leading indicator remained in a downward trend in September – now at its lowest level since mid-2015 - while inflation keeps on disappointing, coming out at 0.1% year-on-year last month. While all this may be interpreted as strengthening the case for further easing, it is likely that the SNB will remain on hold. Rates are negative and at historical lows and pressures on the franc are abating (hence there is no urgency for the central bank to adjust monetary policy). In that sense, the central bank is likely to want to keep a rate cut as the option of last resort i.e. in case of a sharp and sustained rise in risk aversion.

For the time being, we maintain a neutral EURCHF stance in our portfolios.

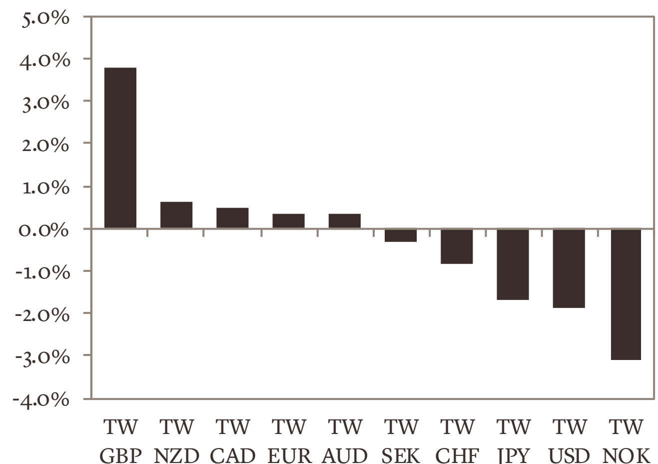
4. Improved risk appetite lifts EURCHF



Sources: Bloomberg, Lombard Odier.

5. TW CHF has been one of the underperformers in October

MtD spot returns (as of close of 18 October 2019)



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

GBP
Odds of a no-deal Brexit are fading

- **We analyse the recent Brexit developments in the form of a Q&A**
- **The risk of a no-deal Brexit is fading. We reiterate our view that sterling is likely to rally further.**

What was the outcome of the EU/UK negotiations?

During the European Summit of 17 and 18 October, the UK and the EU reached a revised Withdrawal Agreement (WA). This would allow the UK to enter a transition period during which the longer-term trading arrangements with the EU will be discussed and decided. The contentious Irish backstop was removed. Under the revised deal, Northern Ireland will be aligned to the EU single market while simultaneously remaining part of the UK's customs territory. It will be able to participate in any future UK trade deals with other countries. Customs checks on goods transported between mainland UK and Northern Ireland will be performed in the Irish Sea, removing the need for a border on the island of Ireland (which was a significant stumbling block because of the risk it posed to peace on the Irish island). The Northern Ireland Assembly - suspended since January 2017 - will vote every four years on whether to continue with the new trading arrangements. Importantly, any decision would be based on a simple majority i.e. not requiring a majority of both unionists and nationalists (a point that triggered the Democratic Unionist Party's – DUP - opposition to the deal).

Naturally, sterling has rallied sharply these past ten days, when signs emerged that an EU-UK deal was in the making. GBPUSD is up more than 5% on a month-to-date basis, EURUSD is down by 3% while GBPCHF – which has been hovering around its all-time lows – has gained 4%.

What was the reaction of the UK's House of Commons, and what has been decided so far?

Before delving into the very recent developments in the UK parliament, we should remind our readers of the Benn Act. This is a bill that was voted and passed into law in October 2019. It requires the UK Prime Minister to request an extension to the Article 50 deadline if the UK parliament is not able to approve a Brexit deal before the end of the current 31 October deadline. Boris Johnson repeatedly said that he would not apply for such an extension, although the Benn Act legally requires him to do so.

Following the revised EU-UK agreement, the UK government scheduled an extraordinary parliamentary session this past Saturday 19 October with the intention of bringing the new WA for approval. There was plenty of speculation as to whether the parliament would support the deal given the DUP's refusal to back it, and the government's struggle to gather the required support (at least 320 votes).

However, things did not even get to this point. Some MPs who sought to avoid a no-deal Brexit expressed concerns that even if the parliament approves the EU-UK agreement, the legislation process to pass it into UK law might turn up to be time consuming, resulting in the UK accidentally crashing out of the EU without a deal by 31 October. To safeguard against such an eventuality, Sir Oliver Letwin – currently an independent MP, following his whip removal from the Conservative party earlier in September – tabled an amendment that defers any deal approval until the appropriate legislation to enact the Withdrawal Agreement has been passed. The House of Commons voted for the motion on Saturday 19 October, and the Letwin Amendment was passed with 322 votes in favor and 306 against. Combined with the Benn Act (see above), this required the UK Prime Minister to write a letter to the EU requesting an extension to the Article 50 deadline. Despite his initial resistance, Boris Johnson confirmed that an extension-request letter was sent to the EU – alongside a letter stating that the UK Prime Minister does not really want an extension to be granted.

At the time of writing, the EU has simply declared that the request will be examined. A formal response may take a few days, potentially also requiring the UK to provide a formal explanation setting out the reasons the extension is needed. It is also likely that since the request is being made on technical grounds (time required for legislation to enact the WA), the EU may offer a short extension rather than the three-month extension formally requested. Furthermore, the EU is not obliged to respond positively. However, we consider it very unlikely that the EU will refuse another prolongation, and risk a chaotic no-deal Brexit on 31 October.

In parallel, the government said that it will bring the WA before the parliament again this week and, subject to approval, will begin the legislation process to pass it into UK law.

Note: Past performance is not a reliable indicator of future performance.

Please read important information at the end of the document.

GBP
Odds of a no-deal Brexit are fading

What's next, and what is the outlook for sterling?

Despite setbacks to PM Johnson's plans to get his deal approved by the House of Commons last Saturday 19 October, the outlook remains constructive, the probability of a "no-deal" Brexit is fading and - given sterling's undervaluation- prospects for GBP strengthening from here remain for the following reasons:.

1. Three and a half years after the Brexit referendum, different UK PMs and government cabinets, the EU and the UK have managed to reach a new, revised deal. Both sides – and mostly the UK - have crossed some of their "red lines" in doing so. This unequivocally demonstrates a very strong willingness and commitment from both sides to avoid the worst scenario – the UK crashing out of the EU.
2. While the UK parliament may disagree on what comes next – general elections, a new referendum or a deal Brexit – one thing is clear. UK MPs have implemented a number of safeguards against a no-deal Brexit. This is sterling-positive in its own right.
3. While still not a done deal, the UK parliamentary arithmetic suggests that the odds are shifting towards the deal being approved by the House of Commons. A number of MPs who voted in favor of the Letwin amendment are very likely to support the deal (indeed, Sir Letwin himself said that he will support the agreement, and Amber Rudd, who surrendered her conservative whip in September in protest to Boris Johnson's policies, also confirmed she will support the deal). In parallel, there seems to be a dynamic forming within a group of Labour MPs, mostly from Brexit constituencies, to back the WA. In other words, as long as the parliament votes on Mr Johnson's deal in the next few days, the odds seem to be gradually shifting towards an approval.
4. With a deal agreed between the EU and the UK, even potential general elections are unlikely to result in a "no-deal" Brexit Parliament. Conservatives (who mostly support the current agreement) seem to be consolidating their lead of about 9-10 percentage points ahead of the Labour Party, while support for the Brexit Party seems to be declining. Early in the summer, the Brexit Party was polling at around 16%-17% while now this has declined to around 11%-12%. While the prospect of a fresh parliamentary deadlock remains, the odds of the UK crashing out of the EU are fading, and this is what matters most for sterling.
5. If a new referendum is held, the choice that will likely be put to the vote is to revoke the Article 50 or proceed with a Brexit under the current terms of the Withdrawal Agreement.

It is difficult to predict the exact path that will bring us to a deal-Brexit, or even no Brexit at all. But the odds of the UK crashing out of the EU (i.e. without a Withdrawal Agreement in place) are diminishing. This should lend further support to the undervalued sterling. While our GBPUSD target is 1.35, we see a risk that the pair overshoots 1.40 in 2020. When the process of convergence to fair value begins (we estimate it to be around 1.40), it rarely stops at equilibrium, and usually extends beyond that. That said, we do not foresee a return to its pre-Brexit referendum range of 1.50-1.60. Exit from the EU, even under a deal, implies a terms-of-trade shock for the UK with its most important trading partner. This is bound to affect growth structurally, and suggests that GBPUSD fair valuation is unlikely to be lifted materially in the near future. Of course, if Brexit does not happen at all, GBP upside would turn out to be more pronounced.

Note: Past performance is not a reliable indicator of future performance.

JPY
Taking profit on our bullish view

- **Long JPY has been our favoured trade since Q318. That said, there are forces for potential consolidation, following tentative signs of progress on US-China trade and Brexit talks**
- **For the remainder of the year, several factors argue for USDJPY stabilisation including steady US yields, renewed Japanese equity outflows and negative November seasonality**
- **We modestly raise our USDJPY forecasts to 106 for Q419 (104 previous) and 107 for Q220 (105 previous). We would consider re-engaging in USDJPY short positions above 110.**

While we have liked the JPY medium term, given valuation and the global backdrop (it has been our "favoured long" since Q318), we believe it currently makes sense to move to the sidelines.

Longer term, the JPY offers value as a hedge. First, our valuation models suggest the JPY is still cheap: our long-term fair-value places USDJPY at 99.00, while short-term models based on yield differentials, equity markets and the US yield curve also suggest USDJPY should probably be closer to 107 (against 109 currently). Furthermore, in the risk scenario of a global manufacturing recession (not our base case), JPY tends to perform well.

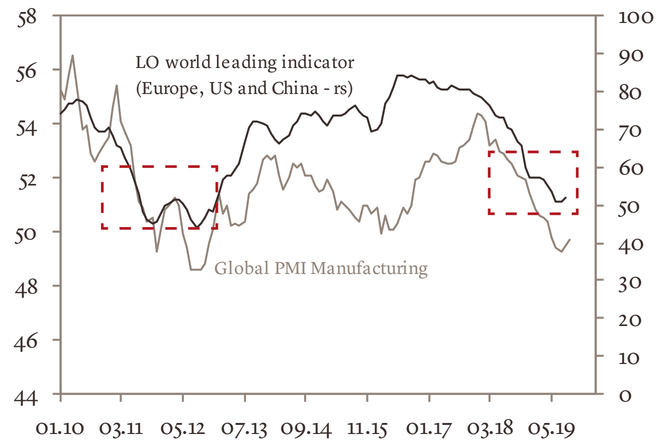
That said, there are a number of reasons for suggesting taking profit and watching the evolution.

First, following recent developments, there is a reasonable chance that Q3's two main risks – US-China trade tensions and a "no-deal" Brexit – will be priced out.
In late August, US 10Y yields hit a low close to 1.45%, and USDJPY traded below 106. Since then, yields and USDJPY have risen. Stabilisation in US yields is likely to result in some USDJPY consolidation.

Second, there are some signs of activity stabilisation in August and September (see chart 6). While still early, lower political uncertainty may help this stabilisation to persist and improve global PMIs. Even if activity stabilises at a low level, history shows that the JPY requires meaningful declines in global PMIs to thrive. However, stabilisation at a low level may only lead to modest USDJPY losses (chart 7) that are unlikely to compensate for the negative carry in play.

Third, in the past we have seen that foreign equities purchases by Japanese investors tended to influence USDJPY. The latest data show that following a period of repatriation over Q3, Japanese investors have started buying foreign equities again. This trend, which often tends to front-run USDJPY, suggests that USDJPY may see more support from unhedged equity portfolio outflows (see chart 8).

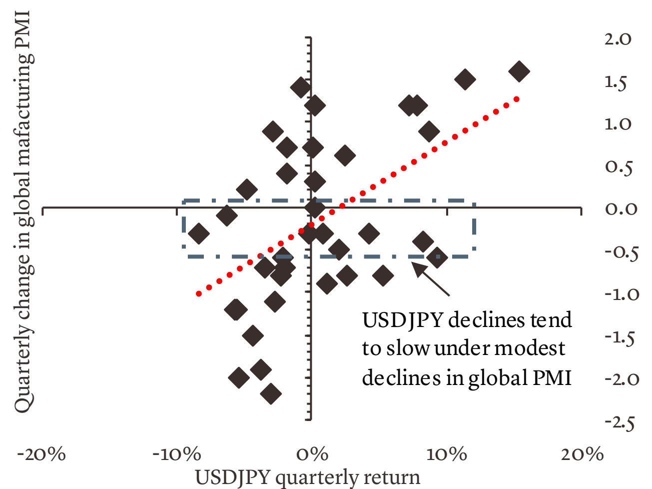
6. Lombard Odier's world economic indicator points to signs of tentative stabilisation in global PMI



Sources: Bloomberg, Lombard Odier.

7. JPY a good hedge against a "sharp" global manufacturing slowdown. However, gains moderate as pace of contraction slows

All in spot terms



Sources: Bloomberg, Lombard Odier.

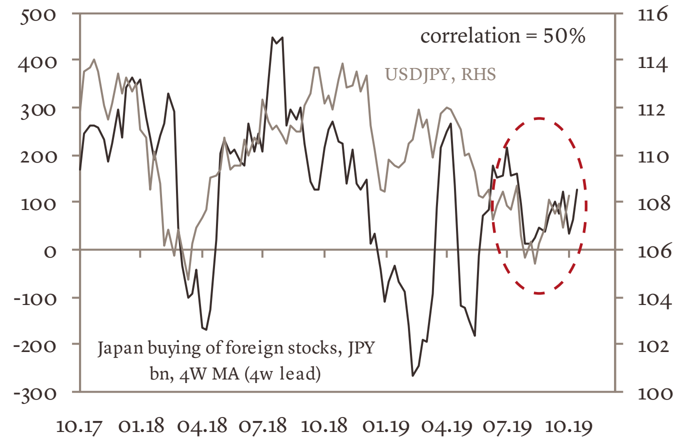
Note: Past performance is not a reliable indicator of future performance.

JPY
Taking profit on our bullish view

Fourth, we see positive seasonality for USDJPY over Q4, and specifically the month of November. Looking at the past five years (2014-18), we find that – on average – USDJPY has appreciated 2.8% cumulatively over the months of November and December with gains recorded in November (3.3%). Even excluding the possible distortion of the November 2016 US election (when US yields spiked and the USDJPY rallied some 9%), we find this seasonal November effect. USDJPY rose 0.7% over November-December, with average November gains (+1.8%) outpacing declines in the months of December (-1.1%). In short, there is some potential for USDJPY to rise in the next month.

On balance, we have decided to marginally lift our forecast USDJPY trajectory to 106 for Q419 (104 previously) and to 107 for Q220 (from 105 previously). From a portfolio-construction perspective, we think it makes sense to book profits on short USDJPY exposure and move to the sidelines. That said, given we still believe the JPY is cheap on a long-term view, any notable gains (above 110) could well provide opportunities to reinstate shorts in USDJPY.

8. Following repatriation, Japanese investors have returned to buying foreign equities in recent weeks



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

CNY
A new ground?

- **Baseline scenario of a trade truce between the US and China would support our existing forecast for the yuan**
- **Any significant depreciation of the yuan will occur only if trade talks collapse.**

For the third time in less than a year, the US and China have agreed to a cease-fire in their trade dispute. The Trump administration has suggested that a "phase one" of the bilateral compromise has been struck. China has made few concrete commitments (e.g. large purchases of US agricultural products) in exchange for the suspension of additional tariffs scheduled on 15 October. Investors are rightly cautious about the durability of this compromise. After all, there is no written document with the details to count on, and the US government has already reversed previous accords.

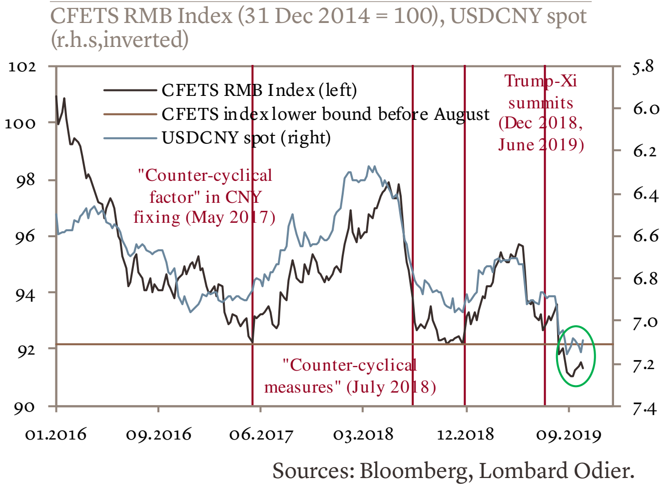
Our baseline scenario is for both sides to maintain a fragile status quo until the US presidential election at the end of next year. Concretely this means that most of the newly introduced restrictions on trade (tariffs, entity list, etc) will not see any meaningful reversal in the near future. However, the threat of renewed escalation has fallen, as neither side is motivated to make new destabilizing provocations, especially if there is a scope for limited truce.

In that respect, it is interesting that instead of targeting an immediate game-changing compromise on the global treatment of China's unique economic system (e.g. state-owned enterprises and industrial policy), the Trump administration has begun to split the negotiation into parcels of varying expediency. This indicates some willingness to focus on a feasible near-term truce. US sensitivity to China-related turmoil in financial markets and the farm sector should also be clear. Meanwhile, China has made its macro policy conditional on US action, as its monetary policy stance, outside US-driven volatility, clearly favours yuan stability. Indeed, after offsetting the impact of the new US tariffs on 1 September, the yuan's benchmark index seemed to be settling above a new floor around of 90 (see chart 9).

If both the US and China can somehow find a way to refrain from additional provocations, then we believe that our existing forecast of USDCNY slightly below the 7.0 level (later in 2020) is still reasonable, even if markets don't get a diplomatic breakthrough. With gridlock in Washington and continued slowdown in the economy, the onus of economic stabilization will fall on the US Fed, which will likely cut two more times in the next 6 to 12 months. In this case, China's onshore rates, which are now higher than US rates, could be a sufficient draw for global investors (see chart 10). Indeed, foreign inflows seem to have continued in September despite trade-related noises, possibly helped in part by China's inclusions in key bond indices.

9. Is 90 the new floor for the CFTES index?

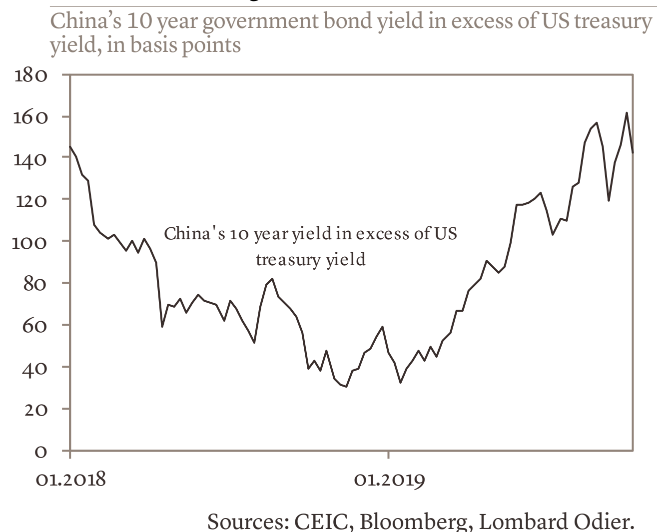
CFETS RMB Index (31 Dec 2014 = 100), USDCNY spot (r.h.s,inverted)



Sources: Bloomberg, Lombard Odier.

10. CNY returns no longer unattractive vs. USD returns

China's 10 year government bond yield in excess of US treasury yield, in basis points



Sources: CEIC, Bloomberg, Lombard Odier.

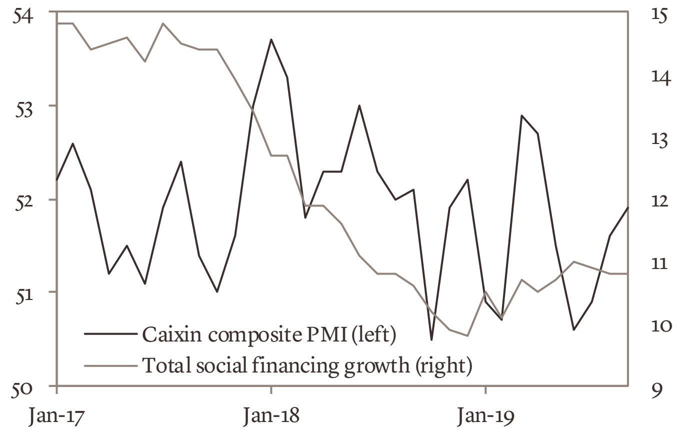
Note: Past performance is not a reliable indicator of future performance.

CNY
A new ground?

Our view also finds modest support from September's macro data, which seem to be pointing to some stabilization after a tricky start to Q3 (visible in the lower-than-expected GDP growth of 6.0% YoY). Growth in credit aggregates is tracking around 11% YoY and activity appears to be picking up despite the new tariff shock at the start of the month (see chart 11). This newfound peace could of course end if the US applies more tariffs to China's exports and China retaliates. In that scenario of new tariffs threats (5% on USD 250 billion, and 15% on USD 160 billion), USDCNY could rise to 7.50. Given more encouraging news flows, we assign only 15% probability to this scenario.

11. Stabilization in macro data could also anchor the yuan in Q4

Markit composite PMI, diffusion index (left), Growth in total social financing, % Y/Y (right)



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

Nordic currencies
SEK depreciation to remain in place

- **SEK has been undermined by weaker global growth, weak German growth and the Riksbank`s balance sheet expansion**
- **Undershooting inflation should see the Riksbank on hold and willing to maintain accommodative policies. This creates additional downside risks on a 3-month view and so we have revised our EURSEK forecasts higher**
- **A mixture of tailwinds and headwinds are likely to result to some gradual NOK outperformance. However, still weak global growth theme and negative Q4 seasonality may weigh for now. We have made some small adjustments to our EURNOK forecast trajectory.**

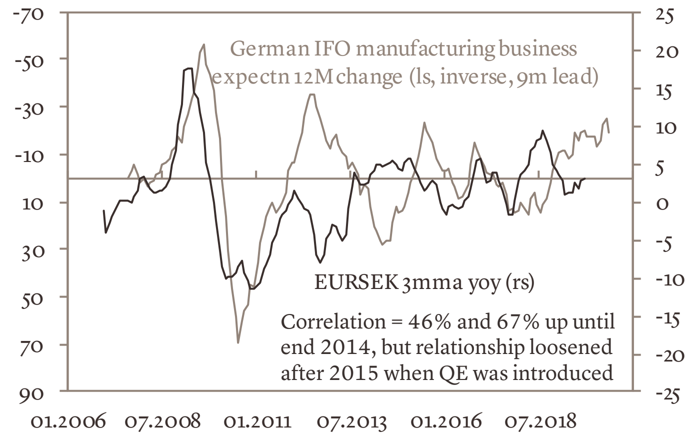
Over the month of September, global trade dependent and cyclical currencies have underperformed, with the SEK and NOK at the forefront. This suggests that FX markets have continued to price downside risks to global trade. However, an additional concern comes from negative German growth, which has seen more euro-centric Nordic currencies underperform even the commodity bloc of AUD, NZD and CAD.

If we are right in assuming that we are unlikely to clarify trade uncertainty (though with a lower risk of escalation), then the push from German data may remain lacklustre. This will likely mean that both the SEK and the NOK (which we prefer on domestic fundamentals) will be unable to rally strongly – despite favourable valuations – against the EUR and the USD in the short-term.

We believe that SEK looks vulnerable despite its currently weak levels. We find that weaker German manufacturing business sentiment points to negative returns (chart 12). Domestic data has taken a turn for the worse: both manufacturing and services PMIs for Sweden fell below 50 this month, for the first time since 2013. While weakness in regional manufacturing can be reconciled with weak global manufacturing, the negative spill over to services (60% of production) is worrying. This is corroborated by the flagging labour market: the jobless rate has risen a percentage point over 2019, well above the Riksbanks' forecast trajectory. Should data remain soft, it is entirely possible that the central bank would change its modest tightening bias (so far, it has signalled its intention to raise the repo rate towards the end of 2019/beginning of 2020).

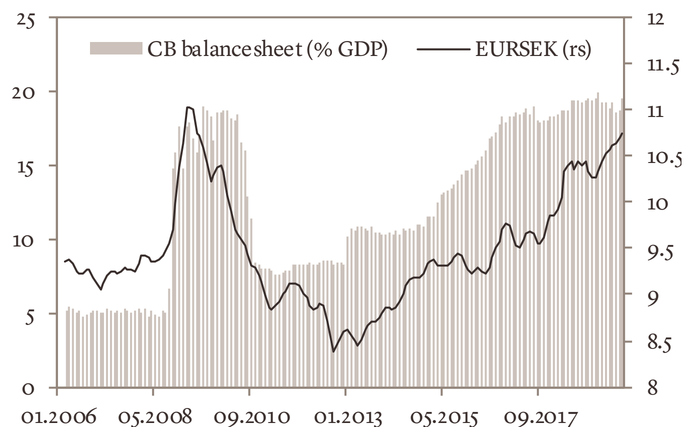
Aside from this, the SEK may still come under further pressure. The still-elevated central bank's balance sheet and low yields look enough to keep the SEK under pressure (chart 13). Thus, while on our long-term valuation models the SEK seems very cheap, the headwinds remain and further downside is likely before some stabilisation.

12. Weaker activity has historically weighed on future SEK prospects



Sources: Bloomberg, Lombard Odier.

13. The still large size of the CB balance sheet could keep SEK weak



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

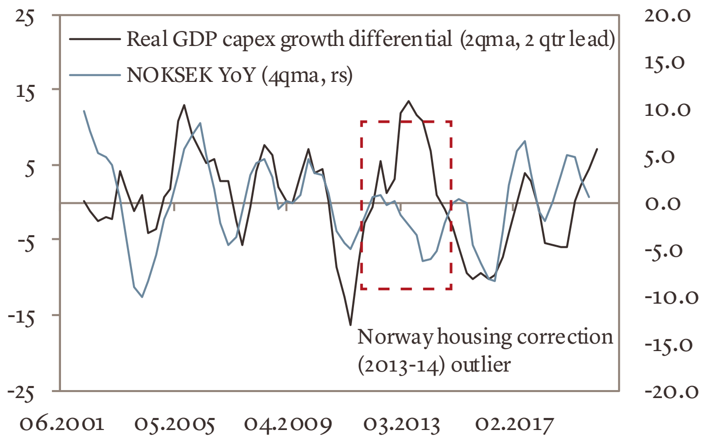
Nordic currencies
SEK depreciation to remain in place

Swedish inflation currently stands some way below the central bank's 2% target. This is far from the case for Norway, where both activity and inflation data have held up far better (core-inflation remains above the Norges Bank target of 2%). However, in an environment of soft global growth impulse, the risk in the coming three months is that Norwegian data starts to show cracks. It does not help that NOK has already navigated negative seasonality: over the fourth quarter in all of the past six years, the EURNOK has appreciated.

This said, from a long-term perspective – and even though both the NOK and SEK are undervalued - we think that domestic fundamentals favour the NOK holding its value better, compared with the SEK. Given its close links and relatively more open nature, the slowdown in external demand has resulted in a sharp decline in business investment growth in Sweden, which is now filtering through more broadly to weakening services and the labour market.
After averaging 5% yoy from 2014 to 2017, investment began declining in 2018 and entered contractionary territory in Q119.

In comparison, business investment has held up in Norway. Capex, by its very nature, tends to drive growth momentum and relative capex differentials suggest that Norway's expansion will likely hold up better. Historically this has tended to coincide with NOK outperformance (chart 14), barring a few exceptions (such as the Norwegian housing slowdown in 2013 when the relationship broke down).

14. Better capex growth points to a higher NOKSEK



Sources: Bloomberg, Lombard Odier.

Note: Past performance is not a reliable indicator of future performance.

Sources: Bloomberg, Lombard Od

Commodity FX
China's stimulus-inspired Q120 bump

- **The modest credit stimulus from China may help the commodity bloc over Q120**
- **From a valuation perspective, we prefer the AUD and CAD to the NZD. Domestic fundamentals appear strong for CAD.**

Year to date, the NZD and AUD have – along with the Nordic currencies – been the poorest performers in G10. They have declined 5% and 3% respectively against the USD, with a significant portion of these declines registered over the past three months. The primary driver for the weakness has been fears of global growth, intensified by higher US-China trade fears over August. While uncertainty may remain, the potential trade war cease-fire may allow sentiment to improve on a 3-month view.

At the same time, while Chinese policy makers have provided some stimulus over the past year, it has been more measured than before, e.g. in 2012 or 2015. The credit-to-GDP ratio has risen about 4 percentage points to just under 25% over H119, compared with the 8-10 percentage point rises (above 30%) seen in H113 or H116 (see chart 15). That said, from a timing perspective, it appears that commodities could get more support through to Q1 (see chart 15) filtering through to the commodity FX bloc as a whole.

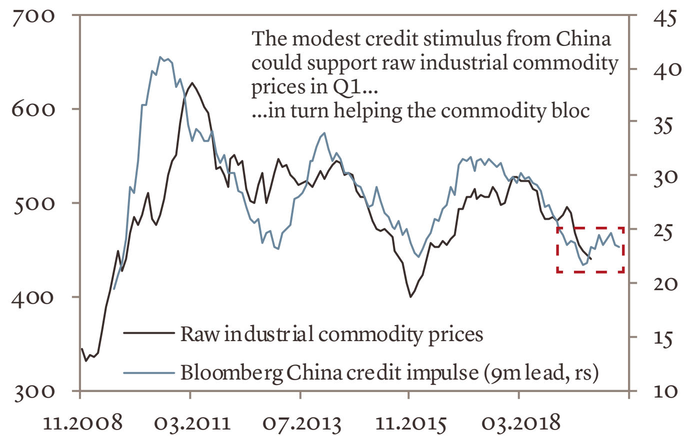
In terms of valuation, we find AUDUSD compelling: the cross is around 10% undervalued based on our estimates. CAD is also undervalued, although less so. On the other hand, NZDUSD is about 1% overvalued, compared with as much as 8% overvalued in Q1 2019. From a valuation perspective, we prefer both the AUD and CAD to the NZD.

In terms of fundamental drivers, the CAD has stood out with the Bank of Canada raising interest rates over 125bps to 1.75% since June 2017. In stark contrast, both the RBA and the RBNZ have cut rates by 75bp over the same period to 0.75% and 1.00% respectively. Looking ahead, the Bank of Canada appears poised to keep rates unchanged: both headline and core inflation remain near the central bank's 2% inflation target mid-point. With the labour market still tightening (chart 16) and wage growth at its fastest since 2009 (chart 19), CAD should remain underpinned by a relatively hawkish central bank.

Both the RBA and RBNZ hold meetings in November (5th and 13th respectively). Currently, markets are giving a 25% chance of a 25bp rate cut from the RBA and a near 100% chance of a 25bp cut from the RBNZ.

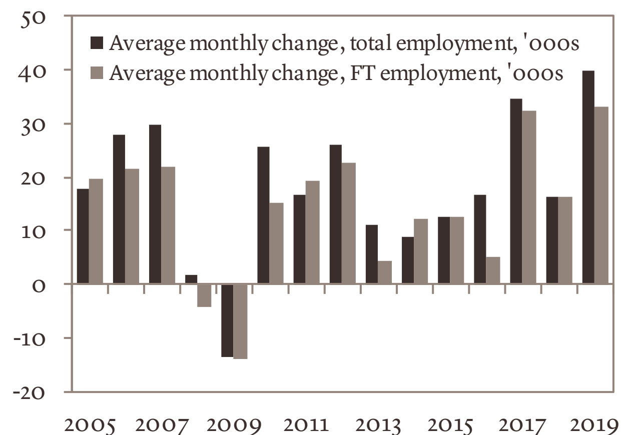
We believe that the risk, if anything, would be for the RBA to remain unchanged and the RBNZ to deliver on expectations. As far as the RBA is concerned, the central bank has taken a more dovish bias in recent months than suggested by the local data flow. This implies the central bank has put more emphasis on the global growth outlook and associated trade uncertainties, despite acknowledging that housing's downside risks have abated. A near-term lowering of trade-related uncertainties may see the central bank on hold, supporting the AUD.

15. Chinese stimulus a small tailwind for the commodity FX bloc



Sources: Bloomberg, Lombard Odier.

16. The Canadian labour market is the strongest it has been for years



Sources: Bloomberg, Lombard Odier.

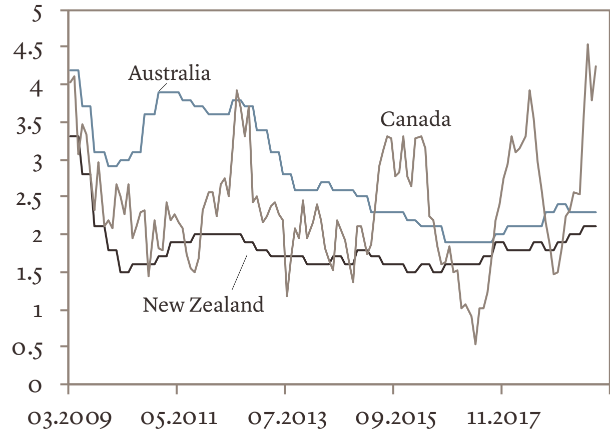
Note: Past performance is not a reliable indicator of future performance.

Commodity FX
China's stimulus-inspired Q120 bump

On the other hand, the RBNZ is focused on domestic fundamentals. Business sentiment indicators have dived in New Zealand in recent months, and this is likely to prompt the central bank to downgrade its growth assumptions at the November meeting. At the same time, 1Y inflation expectations have fallen to a two-year low of 1.7%, according to the RBNZ's own survey. The central bank was pre-emptive and cut interest rates by 50bp in August, more than forecasters had expected. Accordingly, it seems likely that it will cut rates by 25bp with a dovish message, with a slight risk of a 50bps reduction.

In conclusion, we believe these factors should see the commodity bloc performing better into Q120. In terms of preference, both valuation and the monetary policy outlook favour both the CAD and the AUD over the NZD.

17. Canada: signs of firming wage pressures



Sources: Bloomberg, Lombard Odier.

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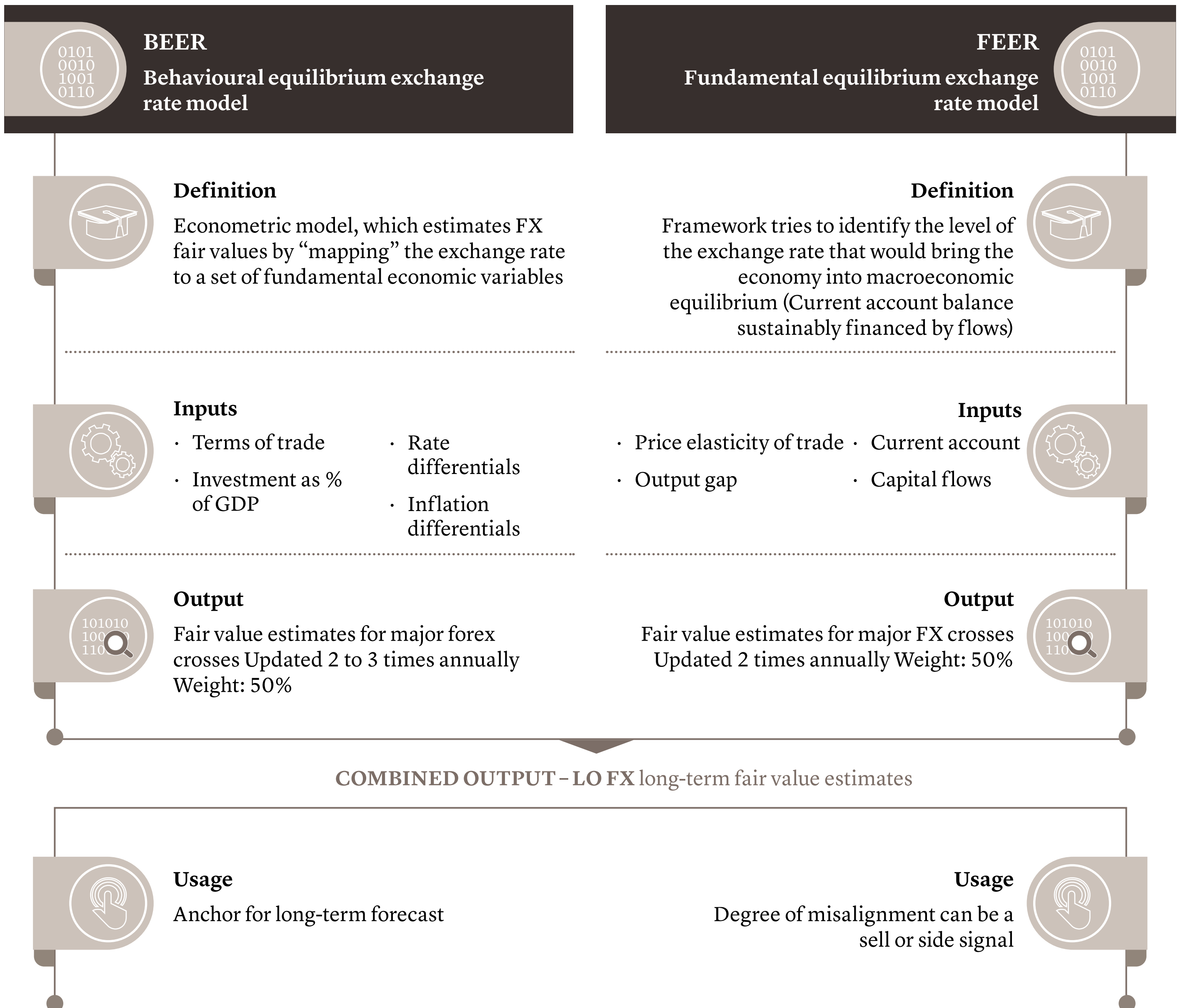
Our Lombard Odier long-term FX fair valuation framework



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Glossary

1W
1-week

BEER
Behavioural Equilibrium Exchange Rate – one method for evaluating the fair value of a currency.

BIS
Bank for International Settlements

C/A
Current account

CFETS
China Foreign Exchange Trade System.

CFTC
Commodity Futures Trading Commission

EM
Emerging market(s)

FEER
Fundamental-equilibrium exchange rate – rate consistent with a steady economy at full employment and a sustainable current-account balance.

RT
Real time

TW
Trade-weighted (dollar, etc.)

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
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140 West Street · Sandton
Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
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MONTEVIDEO
Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com
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Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
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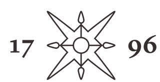

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