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Investment Strategy
Private Clients

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December 2020 · 1st Half 2021

2021 economic and market outlook

- Vaccines will prove the best of stimulus measures for the global economy in 2021. The growth recovery will allow also for a normalisation of inflation, albeit only to moderate levels.
- The current situation in the US may certainly look problematic in many respects, but it is by no means indicative of the country's – much brighter – 2021 economic prospects.
- Having been hard hit by the pandemic, the Euro area is set to rebound in 2021, although not yet fully to its pre-crisis output level. This applies to the UK economy too – even if the challenges of Brexit will limit the upside.
- While Japan will also experience a strong rebound in 2021, a temporary swoon is likely in the 1st quarter due to the ongoing third wave and possible partial suspension of GoTo programs during winter.
- We expect relative calm for much of 2021 on the China-US strategic competition front: a stronger yuan and further market liberalisation could be a mutually beneficial compromise.
- 2021 should see a recovery in emerging economies too, mainly driven by sharply rebounding global trade – albeit skewed to the latter part of the year due to lagged and more complex vaccine deployment.
- Better economic prospects should lead to above-average returns on cyclical assets and a normalisation of bond yields across developed markets – rewarding portfolios that stay invested and broadly diversified, while gradually adding exposure to some of 2020's laggards.

Biannual publication of
Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 30 November 2020

Macro Insights
2021: the year when the COVID crisis ends

Vaccines are truly a game changer. Most candidates have proved far more effective than expected in clinical trials and they will be produced in much greater quantities than hoped. In turn, the light at the end of the crisis tunnel is becoming increasingly visible. Assuming that the vaccines are approved and authorised for emergency use, frontline workers should start to be inoculated before year-end, with broader distribution possible by mid-2021, alongside sharply ramped-up production.

Let us begin our annual outlook with a bold statement: 2021 will be the the year when the COVID crisis ends. More precisely, it is now clear that the right set of tools will be available by the middle of next year to definitively control the pandemic. And one lesson of the past months is that when virus-related restrictions are lifted, the economic catch-up can be violent – as experienced during the third quarter of 2020. The examples of China and other Asian economies are also telling.

For sure, before vaccines are fully deployed, the pandemic will remain a challenge to the outlook. Still, it should prove easier to navigate and less economically damaging than during the first half of 2020. Better knowledge of the virus and of the measures necessary to combat its spread allow for much more targeted restrictions. Also, regional divergences put global demand less at risk of a generalised collapse. Finally, policy support measures are in place and continue to be rescaled, which constitutes a significant safety-net. So, while we do expect growth to remain under some pressure in the final quarter of 2020 and first quarter of 2021, the progress made over the past few months is unlikely to be reversed.

If all goes to plan, a resolution of the pandemic through safe, effective, and widely available vaccines would enable economies to recover lost output after their shutdowns and deep 2020 downturn. The relief should be palpable to the global population, potentially inducing a late spring/early summer rush to return to activities that support those sectors most affected by lockdowns (see chart 1, page 4).

And, with loose financial conditions, consumer spending should be lifted by lesser precautionary savings. At the same time, a great amount of fiscal stimulus should continue to buttress the recovery. Our baseline scenario thus sees the US economy return to its pre-crisis output level sometime during the second half of 2021, while the euro area will likely have to wait until early 2022.

Such a rebound in activity should also drive a recovery in inflation, but only to moderate levels (see charts 2 and 3, page 5). Firmer consumer demand and some supply shortages, with inventories having been depleted, should push up price growth. But the large output gap, labour market slack, and subdued private sector credit demand means that this normalisation process on the price front is unlikely to hinder central banks in their interventions. The recent changes to their monetary policy framework, with the adopting of Average Inflation Targeting (AIT), will also allow them to keep rates close to zero even as the unemployment rate continues to move down (see charts 4 and 5, page 5).

An important characteristic of the coming – strong – recovery is how uneven it is likely to be, with some countries and industries moving faster than others. Activity in still-depressed sectors such as food services, travel and accommodation can be expected to return to pre-pandemic levels, helping bring the unemployment rate down further. Still, these sectors, as well as general merchandise, clothing and accessory stores sales (indeed perhaps even grocery store sales), continue to face long-term challenges.

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

Meanwhile, housing and manufacturing are doing just fine. But it is mainly on the global trade front that we expect to see a sharp rebound (see chart 6, page 5). This improved trade outlook stems not only from the expected recovery from the COVID-19 shock, but also from an improvement in international business conditions once the new US administration takes office. Global demand should support exports, which is also encouraging for the economic outlook, particularly in the manufacturing space. After all, with the goods sector constituting the bulk of trade, manufacturing activity should improve in sync with exports. This is a net positive for trade-sensitive economies, especially in Asia and parts of Europe.

All that being said, our constructive scenario, in which significant hurdles have been and continue to be progressively removed (US elections, Brexit, COVID-19), is not free of risks. First and foremost, lingering uncertainty on vaccines makes for significant downside risk. Safety issues, secondary effects, duration of immunity, potential virus mutation: any of these could result in hopes of a return to normalcy being disappointed. Indeed, our base case rests on a gradual but permanent relaxing of economic restrictions. Were vaccines not to prove the decisive tool in containing the pandemic that we expect, downside risks will be material.

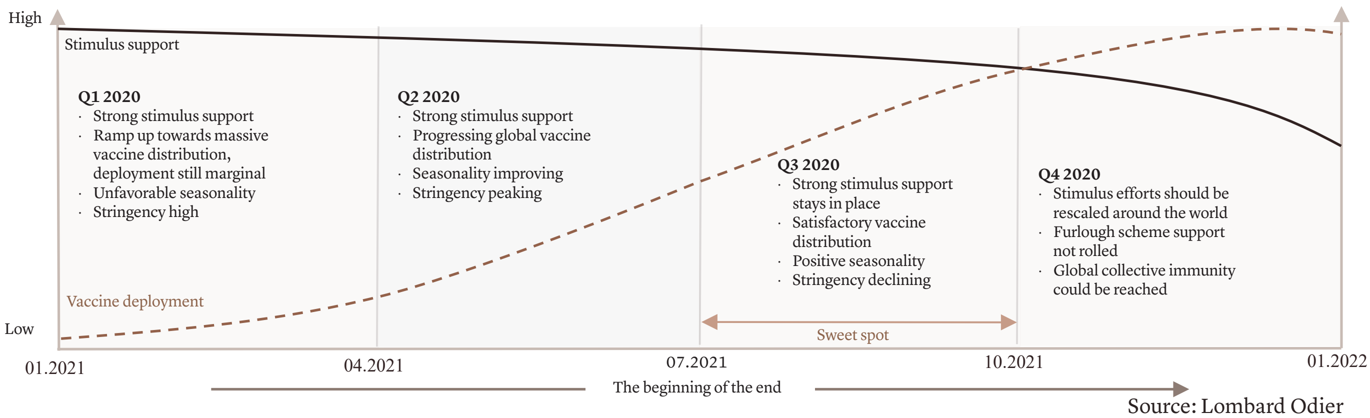
Second, anything that would lead to a higher cost of capital and a tightening of financial conditions should be cautiously monitored. This could prove damaging to the valuation of financial assets, as well as make the financing of debt much more challenging. Financial stress, sharply accelerating inflation or a policy mistake paring stimulus back too soon are key risks to monitor in that respect. Although we remain convinced that authorities will strive to remove support gradually and in a measured way, "taper fears" could emerge during the latter half of 2021 – when the global economy has regained a stronger footing.

Finally, a key problem – only made worse by the pandemic – remains the level of overall debt in the system. But although this will need to be monitored over the long run, interest rates are likely to stay near zero for a number of years, keeping interest payments at historical lows. At this point in time, debt levels can therefore be considered sustainable. In fact, rather than the sheer size of the debt pile, what concerns us more is how it is used. We have high hopes for productive investment targeting innovation, infrastructure and inequalities. Should spending not move in this expected direction, disappointment could be significant.

Samy Chaar, Chief Economist

1. Covid-19 recovery trends by quarter

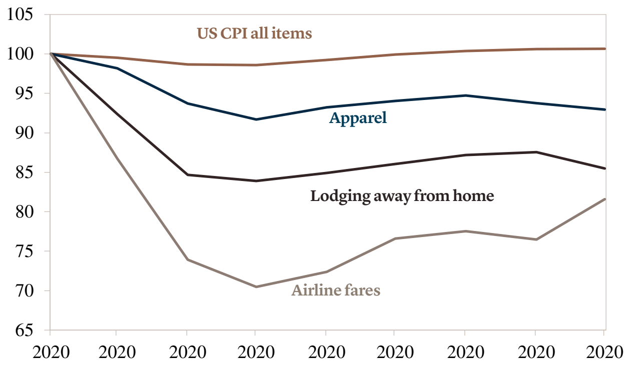
Stimulus and vaccine deployment should be the key indicators of 2021



Source: Lombard Odier

2. Categories like lodging, apparel or airfares will recover...

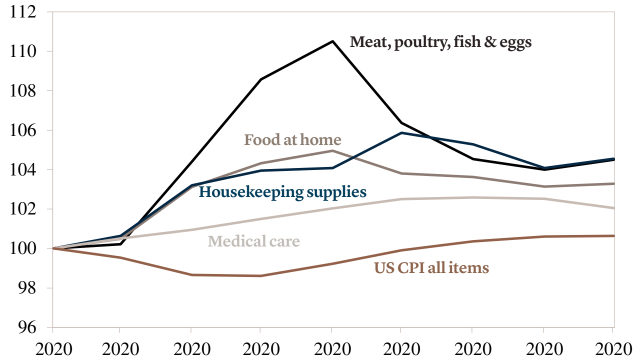
... but gradually, and probably not shift towards persistently higher inflation



Sources: DataStream (BLS), Lombard Odier calculations

3. Supply pressures in other categories will fade...

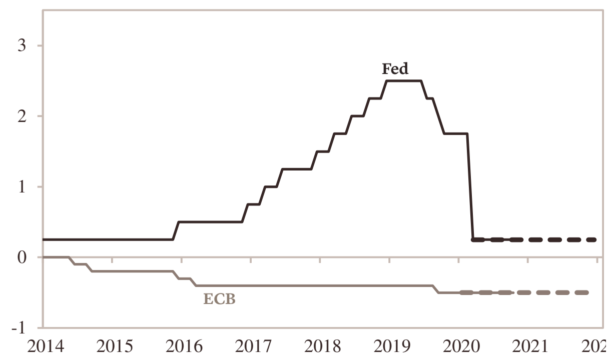
... allaying fears of typical post crisis inflationary pressures



Sources: DataStream (BLS), Lombard Odier calculations

4. Key policy interest rates

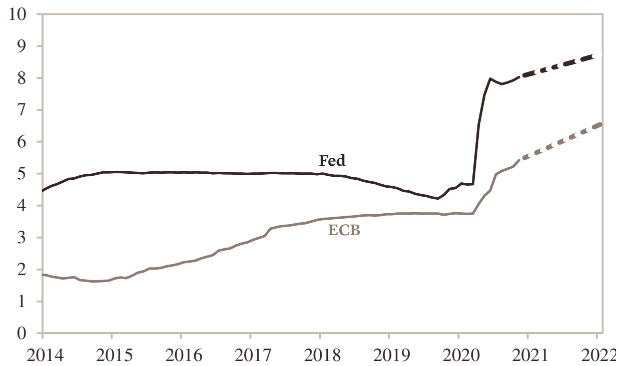
Fed & ECB to keep rates at lower bound until 2023 and possibly longer



Sources: Federal Reserve, ECB, Bloomberg, Lombard Odier calculations

5. Fed and ECB balance sheet size

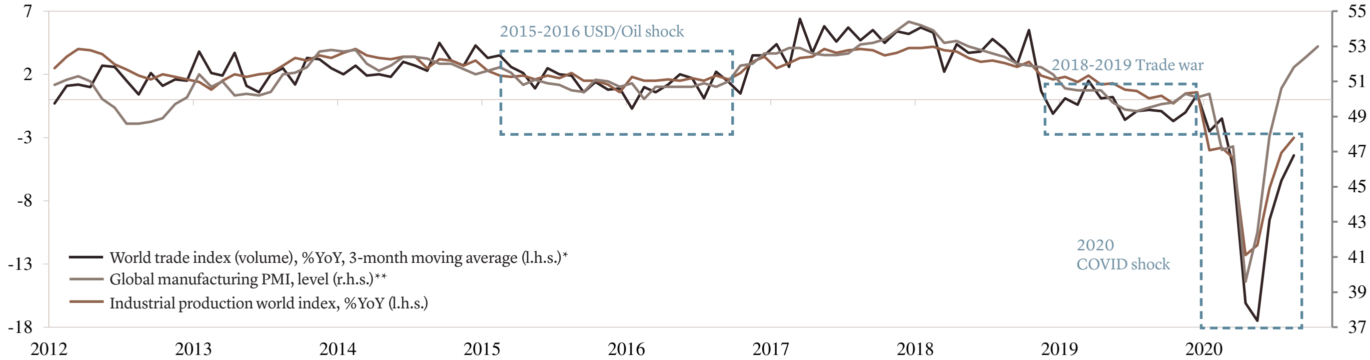
In USD trillions



Sources: Federal Reserve, ECB, Bloomberg, Lombard Odier calculations

6. Global trade flows contracted due to US tariffs and COVID shock, hurting production and manufacturing confidence

Trade volumes & industrial production in % YoY growth, PMI in level



* left hand scale, ** right hand scale
Sources: Bloomberg, Lombard Odier

How "green" is the COVID stimulus?

A rather eye-watering USD 11.8 trillion of fiscal support have been mobilised during the COVID-19 pandemic as per September 2020 (World Resources Institute). Approximately one third, or nearly USD 4 trillion, are to be spent on sectors that concern the environment. Indeed, investing in clean, sustainable infrastructure can be one of the most effective ways to boost economic activity short-term and build sustainability and resilience long-term.

While that sounds very positive, it really merits closer scrutiny. Energypolicytracker.org has surveyed the G20 countries and found that the spending on energy in the COVID recovery packages, thus over and above any previously existing policies, is mostly allocated to fossil energy, to the height of 52%. Clean energy receives 36% and other energy measures represent 12% of the total. No public money has been identified for hydrogen based on fossil fuels. This is a staggeringly incoherent public policy, given that 197 countries have signed the Paris Agreement but continue to subsidise fossil energy production and consumption.

The European Union (EU) is emerging as the world's foremost spender on green initiatives. It has a EUR 750 billion Recovery Fund and a EUR 1.1 trillion budget for 2021-2027, and 37% of the former will be dedicated to climate measures[1]. Within the EU, Germany and France have the most ambitious climate-friendly plans.

It should be noted, however, that the EU continues to support the aviation sector through unconditional bailouts and free carbon allowances in its Emissions Trading System. Some EU-member countries have introduced conditions though. Sweden imposed upon Scandinavian Airlines its goal of reducing carbon dioxide emissions by 25% by 2025 – five years ahead of schedule. France allotted USD 7.7 billion to Air France while stipulating that the airline must cut its emissions by 50% and reach a minimum standard of 2% renewable fuel by 2030. Austria made the bold move to require that plane routes that can be reached by train in less than three hours be abolished.

The US is at the other end of the spectrum with most of its spending benefitting the fossil energy industry (see chart 7). The country has also rolled back environmental protection regulation over the past four years. The UK's spending too is overwhelmingly in favour of fossil energy. At least regarding the US, this can be expected to evolve now that Joe Biden will become president. His Clean Energy Revolution legislative package includes USD 1.7 trillion federal spending on climate measures over 10 years, funded by the rolling back of some of the Trump-era tax cuts. He also intends to ban new oil and gas projects on public lands and waters, and pledges to achieve net-zero emissions by no later than 2050. Importantly too, he promises to re-enter the Paris Agreement, and to demand a worldwide ban on fossil fuel subsidies.

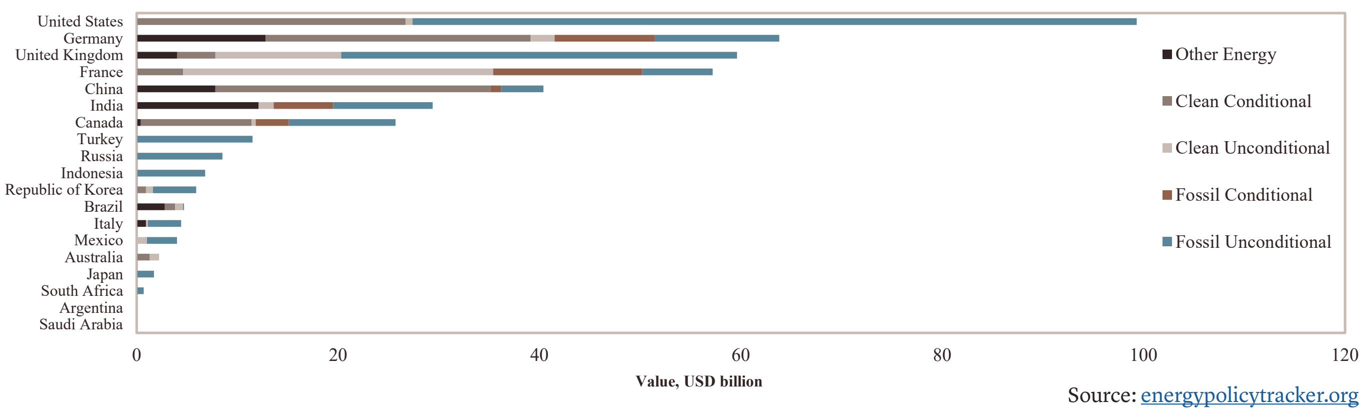
Other countries fall somewhere in between on the scale from brown to green spending. China and India, for example, are boosting green projects but simultaneously provide support for coal as part of their economic recovery plans.

The overall assessment is, unfortunately, that in spite of increased green investments, the net effort remains mostly climate negative[2].

Marie Owens Thomsen, Head of Global Trends

[1] https://www.vivideconomics.com/casestudy/greenness-for-stimulus-index/
[2] https://www.vivideconomics.com/wp-content/uploads/2020/10/201028-GSI-report_October-release.pdf

7. COVID-19 policy response allocated to energy projects



Source: energypolicytracker.org

United States
All the right ingredients

In a nutshell

- The current situation in the US may certainly look problematic in many respects, but it is by no means indicative of the country's 2021 - much brighter - economic prospects.
- Rather, activity is set to rebound strongly on the back of vaccine distribution, the release of pent-up demand, and strongly supportive financial conditions.
- The new administration that has started to take shape points to more predictable policymaking and improved international business conditions.

It is difficult to be particularly optimistic when looking at the current situation in the US. The ongoing wave of COVID-19 is worse there than in virtually any other advanced economy, and Thanksgiving traveling may only have aggravated the picture. The messy political aftermath of the November election raises some profound institutional questions, and the prospects of near-term fiscal stimulus remain uncertain given inconclusive multi-month negotiations between the two parties.

But being overly focused on current conditions may be a completely wrong approach when building 2021 projections. Indeed, the macro picture is set to brighten materially over the course of the year. Widely available vaccines will not make the virus disappear instantly, but they will prevent another wave. Restrictive measures will thus undoubtedly be reduced significantly. At which point, pent-up demand of an unprecedented scale will be released – given the excess savings accumulated in 2020 (see chart 9).

President Trump's refusal to concede the election and his numerous legal challenges continue to make the news but, here again, the picture will look very different in two months' time. An orderly transition is in fact under way, with a new administration starting to take shape. The nominees announced so far invariably point to a more predictable, less volatile policymaking environment, with the US likely to re-engage with the world through multilateral institutions – heralding improved international business conditions.

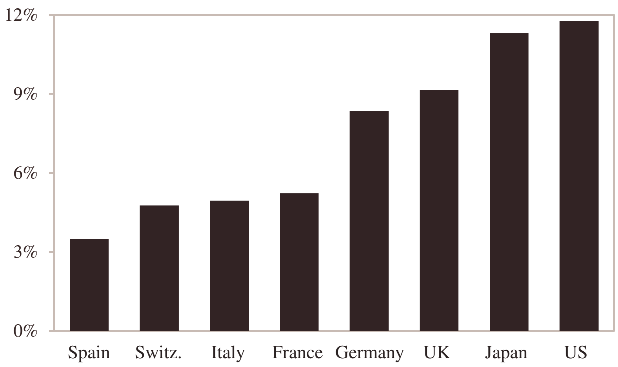
A fresh multi-trillion fiscal package does indeed seem unlikely under a divided government. But the scale of the CARES Act was such (see chart 8) that it has left the economy in a strong enough position to withstand the absence of renewed stimulus, especially with the end of the health crisis in view.

Finally, but crucially, strong monetary support remains a key pillar of our positive outlook. The Federal Reserve (Fed) has already provided a substantial boost to the economy during this critical phase. One needs just look at the US housing market to see how potent its action has been. Unlike fiscal policy, an extremely accommodative monetary stance can be taken for granted in 2021, and probably beyond. The Fed's recent framework change, towards Average Inflation Targeting, removes the risk of pre-emptive rate hikes and commits the central bank to the pursuit of full employment.

Bill Papadakis, Macro Stategistt

8. The USD 2.2 trillion CARES Act has been a strong support for the US economy...

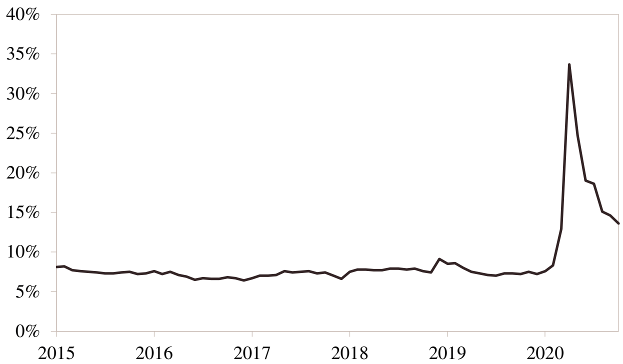
Government spending increase and tax reductions, in % of GDP



Sources: IMF, Lombard Odier

9. ...leaving a large cushion - even in the absence of a new package

Personal savings rate, as a % of disposable income



Sources: Bloomberg, BEA, Lombard Odier

Euro area
Lifting the constraints

In a nutshell

- Having been hard hit by the pandemic, Europe is set to rebound in 2021, although not yet fully to its pre-crisis output level.
- State support has been and will continue to be crucial: getting the Recovery Fund up and running is a key 2021 challenge for EU leaders.
- The ECB is also playing its part, with a significant expansion of asset purchases likely to be announced at its December meeting.

The COVID-19 pandemic has taken a large human toll on Europe this year, and the measures implemented to contain its spread have strongly impacted economic activity across the continent. Strong policy support limited the damage, crucially containing job losses and bankruptcies via generous schemes. While 2021 is bound to be better, we expect pre-crisis outputs levels to be reached only in 2022. In the meantime, keeping policy support in place will be necessary – but we are hopeful that European leaders will avoid their past mistakes in that respect.

The second wave of infections has led governments to reinstate restrictive measures, but of a more "flexible" nature this time round (see chart 10). Lockdowns are not as broad-based, with workplaces and schools staying open. Thanks probably to an improved understanding of the virus, they also seem to be producing results sooner. In fact, falling new infections and some rebuilding of hospital capacity have allowed first steps in loosening restrictions. Still, although it will nothing like the spring experience, we expect a double-dip 2% contraction of euro area GDP in the 4th quarter (see chart 11).

As we saw during the 3rd quarter, once lockdowns are eased the bounce-back can be extremely sharp: Italy's economy expanded at a near 16% quarterly (non-annualised) rate, and France by 19%. Similar dynamics will play out again in 2021. In fact, the vaccine roll-out will allow a normalisation of activity even in high-contact sectors.

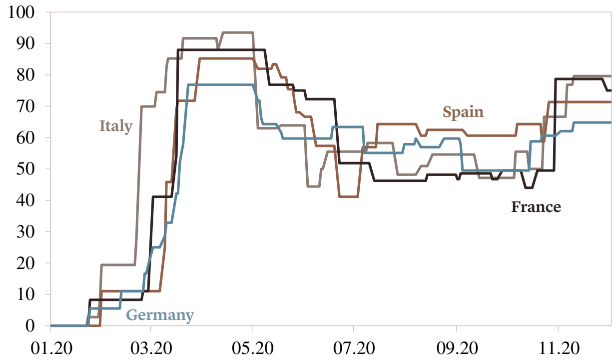
The external picture will also improve, with global trade set to grow strongly in 2021 and an incoming US administration likely to take less of a confrontational approach vis-à-vis European trade partners.

Policy response was crucial in 2020 and will continue to play a key role next year. With EU fiscal rules suspended for both 2020 and 2021, governments have been able to run as large a budget deficit as their circumstances call for. The July agreement on the launch of EU-wide Recovery Fund also boosted market confidence, although risks remain as to its implementation. As for the European Central Bank (ECB) , its support has been crucial, keeping rates low, narrowing spreads, and providing ample liquidity. If anything, with inflation sharply negative and large hits to output, further easing is called for going forward and the December ECB meeting should lead to a significant expansion of asset purchases.

Bill Papadakis, Macro Strategist

10. Europe has tightened measures in response to the second wave, but by a much smaller degree than the first time ...

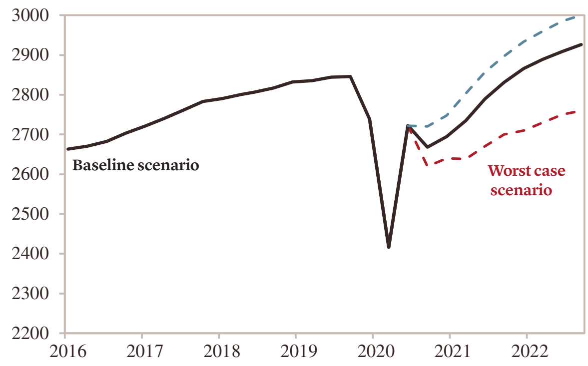
Stringency index (100 = maximum stringency)



Sources: Blavatnik School of Government, Lombard Odier

11. ...resulting in a small contraction in the final quarter of 2020

GDP in EUR millions (LO forecast after Q3 2020)



Sources: Eurostat, Lombard Odier

United Kingdom
The year it all gets real

In a nutshell

- Having suffered the worst downturn of all advanced economies, the UK can expect a particularly strong recovery in 2021, as the COVID-19 crisis subsides.
- On the Brexit front, we continue to expect a deal before the 31 December deadline.
- But even if a UK/EU free trade agreement is indeed signed by year end, Brexit will weigh on economic activity, particularly in the all-important services sector.

Like much of the world, the UK will also see a huge improvement in its economic prospects as it puts the COVID-19 crisis behind thanks to widely available vaccines. The country was hit particularly hard by the pandemic, suffering the worst contraction among advanced economies in the first three quarters of 2020 (see chart 12). Mechanical catch-up dynamics alone should make for a sharp recovery as restrictions on activity are lifted.

Still, the UK economy will have to deal with a shock of a different nature in 2021: Brexit. Unlike the impact of the virus, profound but short-lived, Brexit effects will play out over time and persist for longer – resulting in lower potential growth as the UK's ties with its largest and closest trade partner become weaker.

The form that Brexit takes will determine its overall impact. If no EU/UK trade agreement is in place by the time the transition period ends on 31 December, the resulting disruption would certainly prove particularly damaging (see chart 13). Our view continues to be that the two sides will reach an agreement before this deadline, despite negotiations that remain inconclusive at this late stage. Economic incentives on both sides, the scope for compromise in the key areas of negotiation (fishing, state aid, governance), the UK's own domestic political dynamics (including the May 2021 Scottish election), as well as Joe Biden's recent victory in the US, make a deal more likely than not.

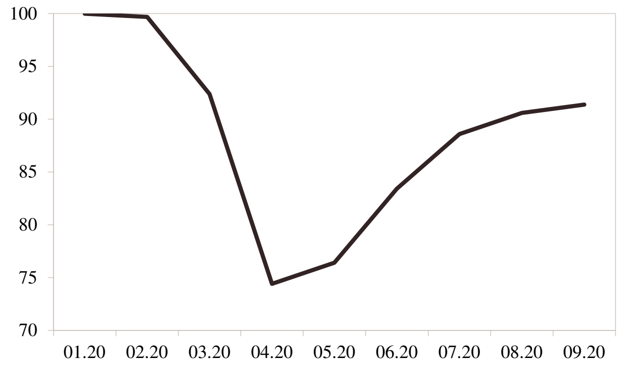
But while a deal will limit disruption, it will not solve the more fundamental issues caused by Brexit. In fact, our expectation is only for a "skinny" trade deal, which would ensure no tariffs in goods traded between the UK and the EU. Non-tariff barriers would nonetheless have a negative economic impact as the UK leaves the EU single market and customs union, especially during the early stages of necessary adjustment to new processes.

Of greater importance to the UK's services-based economy is the impact on the services sector. Even with a "deep" free trade agreement, frictions in services trade would be substantial. Crucially, the loss of "passporting" rights for financial services providers will mean reduced access to EU markets. The sector will now have to rely on the granting of EU "equivalence", which can be retrieved at short notice – making for an uncertain business environment.

Bill Papadakis, Macro Strategist

12. A large hit from COVID left UK GDP almost 10% below pre-crisis levels - despite a sharp 3rd quarter bounce

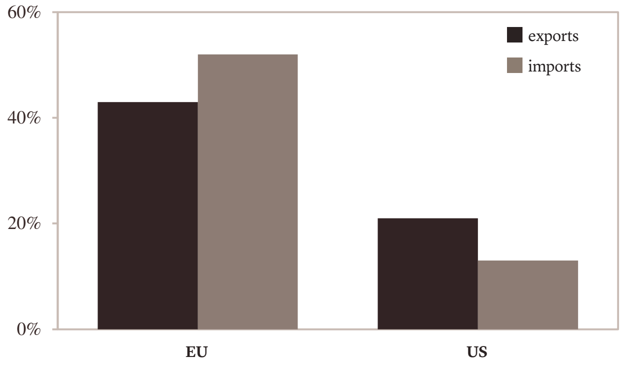
GDP level (January 2020 = 100)



Sources: ONS, Lombard Odier

13. The EU is by far the UK's largest trade partner, accounting for approximately half of its total trade

Share of UK trade in goods and services, in %



Sources: ONS, Lombard Odier

Japan
Bank of Japan playing second fiddle

In a nutshell

- While Japan will experience a strong rebound in 2021, a temporary swoon is likely in the 1st quarter due to the ongoing third wave and possible partial suspension of GoTo programs during winter.
- Inflation is unlikely to approach the 2% target anytime soon, but the BoJ seems content to play second fiddle to both Suga's cabinet and other central banks.
- With time running out on its current mandate in the Diet, the ruling party will actively look for opportunities to call a new election – pointing to continued fiscal activism in 2021.

Like most of its industrialised peers, Japan will experience a strong GDP rebound in 2021 (which we currently estimate at 3.5%) – thanks to good access to (and acceptation of) vaccines, a sharp recovery in global trade and continued policy support (see chart 14). Olympics, crowded bars and traditional festivals are no longer impossible prospects for next summer.

The months leading to the vaccine roll-out will, however, be more of a gentle slog. While Japan has been able to maintain an extremely flat infection curve so far, even without blanket restrictions, the recent spikes in cases have led Prime Minister Suga to make the government's GoTo program of subsidised travel contingent on the state of the pandemic in each prefecture and the traveller's age. Since this program likely accounted for a part of recent domestic consumption strength, growth will be capped during the 1st quarter of 2021.

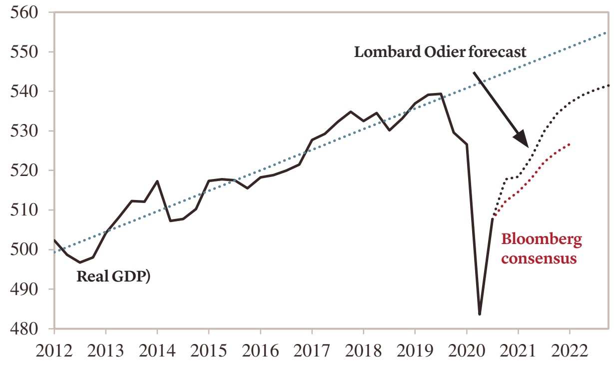
Notwithstanding the positive medium-term outlook, Japanese inflation will be weighed down by multiple factors, hence our year-end projection of 0.3% only (see chart 15). The slack in the labour market will not disappear overnight, businesses have strong incentives to be conservative about pay raises and the government is likely to extend consumption subsidies – pressuring service sector inflation.

We expect the Bank of Japan (BoJ) to refrain from introducing major new catalysts to fight this trend. It is difficult to imagine the central bank suddenly starting to cut rates in the midst of a strong post-vaccine recovery. And any aggressive quantitative measures that weaken the yen could invite critical responses from Washington, at a time when the dollar is probably the only stimulus lever left for the incoming Biden administration. Rather, the BoJ should continue to play a passive supporting role, with which it seems content.

Having taken pragmatic steps toward reforms (e.g. digitalisation of bureaucracy and banking sector consolidation), Prime Minister Suga is beginning to experience gravity in his approval ratings due to the third wave of COVID-19. With less than a year left before the current mandate in the Diet runs out for the ruling coalition – a front on which we will be keeping a close eye – he will be strongly incentivised to use fiscal levers to stabilise economic conditions.

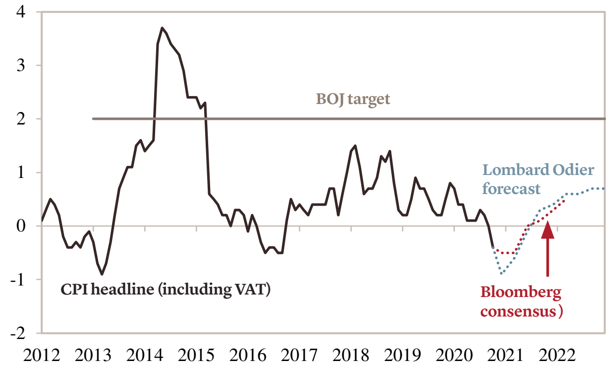
Homin Lee, Macro Strategist – Asia

14. **Strong growth ahead, but only recovering pre-COVID GDP level in early 2022**
Japanese quarterly real GDP, in JPY trillion (seasonally adjusted)



Sources: Bloomberg, Lombard Odier

15. **Inflation will remain weak for the foreseeable future**
CPI inflation, in %YoY



Sources: Bloomberg, Lombard Odier

China
Biding time

In a nutshell

- China is set to experience above-8% growth in 2021 on the back of pent-up domestic demand for services and a strong global trade recovery.
- Domestic inflation will decelerate modestly due to idiosyncratic food price developments – leading the central bank to adopt a neutral "wait and see" approach throughout the year.
- We expect relative calm for much of 2021 on the China-US strategic competition front: a stronger yuan and further market liberalisation could be a mutually beneficial compromise.

One of the rare economies that managed to expand in 2020, China has established a firm control on the COVID-19 pandemic. This will allow the country to enjoy a relatively uninterrupted recovery – even in the lead-up to national vaccination. We thus expect China to post above-8% growth in 2021, followed by more trend-like growth (low 5%) in 2022. Household consumption, domestic services and private sector capex will lead the way, with a sharp recovery in global trade also helping. The catch-up in services will have a particularly large impact, as the sector accounts for 53% of GDP (see chart 16).

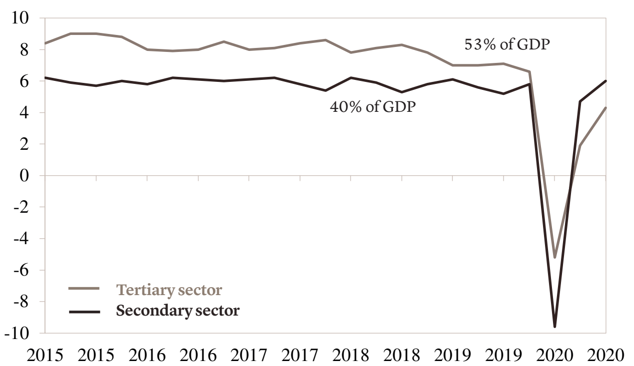
Inflation should remain relatively muted, however. Food prices, which we estimate to account for some 20% of the overall consumer basket, will continue to trend down well into 2021. The impact of the African swine fever is fading rapidly, pushing pork prices lower. Still, sometime later in the year, the nascent stabilisation in the services sector and producer prices will eventually be echoed in headline inflation. Despite the lack of obvious price pressures, the People's Bank of China (PBOC) is already focused on financial stability. Worries about excessive debt in the real estate sector have led it to temper market expectations of additional easing since the summer. In our view, the PBOC is just adopting a "wait and see" approach, with economic strengths balancing out fragilities for now. We expect all benchmark rates to be kept at their current levels in 2021 (see chart 17). Monetary policymakers will fight any sign of imbalances with targeted curbs, such as the USD bond issuance restrictions imposed on property developers.

Even after the White House change, the strategic competition with the US will remain a challenge for China. Restrictions on technology and individual sanctions related to Hong Kong and other sensitive issues will stay, Joe Biden being surrounded by many well-known foreign policy hawks. Still, 2021 likely heralds a period of relative calm as the new US administration plots a more multilateral rule-based approach. China's 14th 5-year economic plan also creates interesting possibilities, with numerical growth targets having officially been ditched. As the US will probably rely heavily on FX policy to stabilise its economy, would a stronger yuan and market liberalisation not offer a win-win for both countries?

Homin Lee, Macro Strategist – Asia

16. Services recovery is key to 2021 growth outperformance

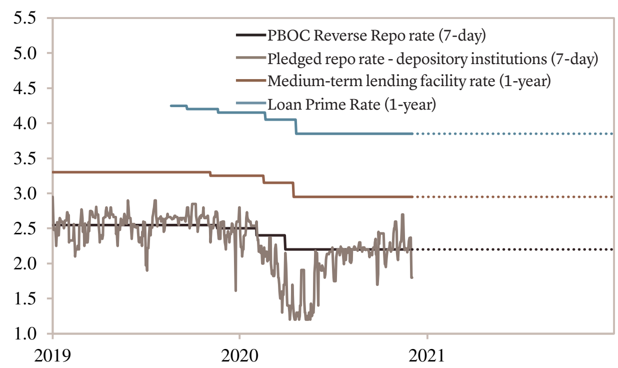
Chinese real GDP growth rate by sector



Sources: Bloomberg, Lombard Odier

17. PBOC will keep its policy rates on hold for all of 2021

Key Chinese onshore money market rates



Sources: CEIC, Lombard Odier

Emerging Markets
Timing of recovery very much dependent on access to vaccines

In a nutshell

- 2021 should see a recovery in emerging economies too, mainly driven by sharply rebounding global trade – albeit skewed to the latter part of the year due to lagged and more complex vaccine deployment.
- Supporting the upturn are also the very accommodative financial conditions and much improved current account balances – limiting external vulnerabilities.
- That said, mounting debt is a concern and suggests that, over the next few years, growth in emerging markets will no longer far outpace that of developed markets.

In 2021, we expect the emerging complex ex-China (which we treat separately, see p.11) to recover most of the output lost during the pandemic. But a return to pre-COVID trend levels will take several years (see chart 18). Brazil, Russia, India, Indonesia and South Africa should pick-up by 6% (weighed by the size of their economy) in 2021, after a 6% drop in 2020. Our projections are above consensus for Russia, India and Indonesia, and below consensus for Brazil and South Africa, in both cases mainly due to fiscal concerns (see chart 19).

A normalisation of global trade, thanks to the lessening – and eventual disappearance – of COVID-related constraints on mobility, and to somewhat toned-down US rhetoric, should deliver a major boost to growth.

Emerging markets also enjoy very accommodative financial conditions, be it on the external front, with a cheap US dollar and low US rates, or on the domestic front, with central bank policy rates at historical lows. The lack of inflationary pressure, which should persist in 2021 given the large amount of slack in these economies, means that most central banks should not be forced to raise rates significantly next year.

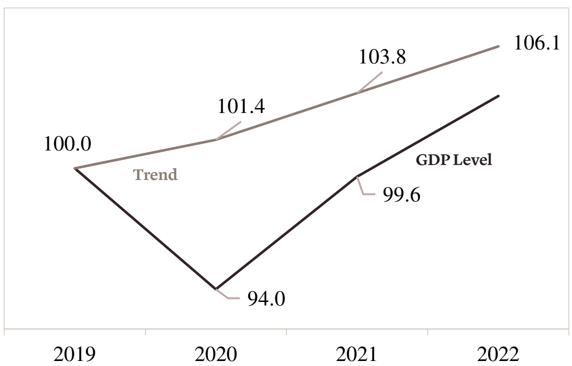
Finally, external vulnerabilities are limited, thanks to improved current account balances (over half of the largest emerging countries are now actually in surplus) – greatly reducing the risk of balance of payment crises.

Yet, in these economies too, vaccines are a necessary condition for the recovery to take hold, and one that might prove more complex to achieve. In a base case scenario, herd immunity in most emerging markets will likely not be reached before late 2021 or even mid-2022, delaying the stronger part of the recovery to the second half of 2021.

Beyond a negative surprise on the vaccine front, mounting debt is our main medium-term concern. The large fiscal stimuli that were rightly implemented in order to survive the pandemic have put some countries, Argentina, Brazil and South Africa in particular, on unsustainable debt trajectories. At some point, fiscal retrenchment will be necessary – thwarting growth. More generally, rising debt service burdens will be a headwind over the next few years, meaning that the era of high growth differential between emerging and developed markets is over.

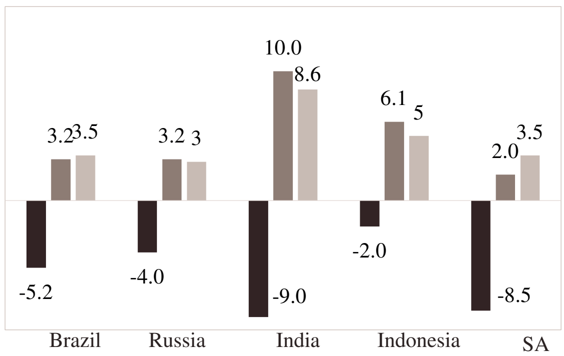
Stéphanie de Torquat, Macro Strategist

18. Strong GDP recovery in 2021...
... but not yet back to long-term trend



Sources: Bloomberg, Lombard Odier calculations

19. Lombard Odier forecast vs consensus for some of the major emerging economies



Sources: Bloomberg, Lombard Odier calculations

Asset Allocation
Time for some of 2020's laggards to shine?

The outcome of the US elections, combined with substantive progress towards the development of an effective COVID-19 vaccine, has improved the medium-term economic and market outlook, driving a rally in risk assets and a strong sector rotation. Both have potential to continue in our view. Given the ongoing uncertainty surrounding the recovery, central banks are committed to remain accommodative, while further fiscal support is likely in the US and EU. We expect broad vaccine availability by the first half of 2021 and the US dollar to weaken further, and maintain a pro-risk positioning – expressed through a combination of global equities, real estate and corporate credit.

2020 challenged us all. The most severe economic contraction in decades triggered an event-driven bear market that few could have been prepared for. Still, swift monetary accommodation and massive fiscal support packages managed to avoid an entrenched recessionary spiral, underpinning both investor confidence and risky assets. Quite fittingly, the fastest bear market in history was followed by the fastest recovery (see chart 20, page 14). As such, portfolio performances are positive in all currencies – even exceeding our expectations in the case of USD portfolios – after having flirted with double-digit losses at the worst of the crisis.

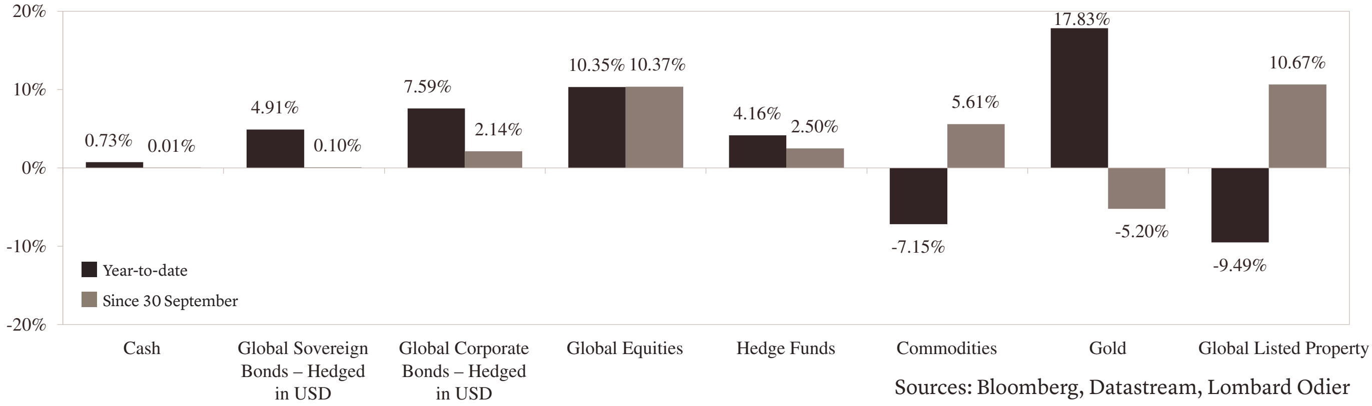
Now, as we move towards 2021, the promise of effective COVID-19 vaccines is a game-changer. Despite the current dire situation, with high levels of new infections in Europe and the US, it encourages us to anticipate a return to pre-pandemic activities. The combination of mass vaccinations, public health measures, extraordinary government spending and monetary policy support should accelerate the economic recovery. From a financial market standpoint, that prospect should lead to above-average returns on cyclical assets and a normalisation of bond yields across developed markets – rewarding portfolios that stay invested and broadly diversified, while gradually adding exposure to some of 2020's laggards.

Starting with global equities, we see further upside potential on recovering earnings, fiscal stimulus and loose monetary policy. On the earnings front, the third quarter provided a positive surprise, and we expect pre-COVID levels to be reached in 2021 in the US, by early 2022 in the EU. With markets having rallied ahead of earnings, valuation multiples currently stand at multi-year highs. We consider this partly justified by low rates (see chart 21, page 14), as well as being a typical early cycle phenomenon. We now expect a reverse situation, in which earnings do the heavy lifting and multiples remain broadly stable or contract somewhat. This should see the S&P 500 index advance to around 3800, with high single digit returns possible in the other regional equity markets.

Within the indices, vaccine hopes have triggered a rotation towards value and cyclically oriented sectors. Given the substantial degree of underperformance suffered by these sectors during the past months, we think this rotation still presents an opportunity in the coming months and recommend that investors complement their holdings in tech-dominated mega-caps with some of the beaten-down stocks of 2020. We expect cyclical and global trade-exposed sectors such as industrials or materials to continue to do well, while the more challenged value-oriented energy and financials could offer some partial catch-up potential. Rising yields would be a condition for a more sustained rally. We also see strong return potential in the small-cap arena, to which we recently increased exposure.

A change in the US/China dialogue under the Biden presidency should enable a revival in global trade and an improved business climate for sectors that depend on complex production and logistic chains. This should encourage a strong upturn in emerging economies, after two years of contraction. China's

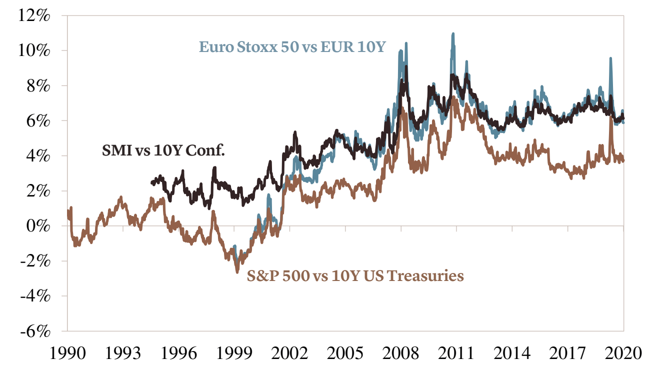
20. Total returns by asset class in 2020



Sources: Bloomberg, Datastream, Lombard Odier

21. Accommodative monetary policies support valuations

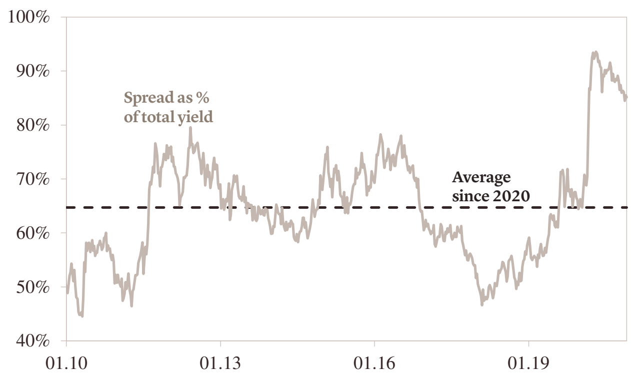
Differential between earnings yield and 10-year bond yield



Sources: Bloomberg, Lombard Odier calculations

22 Credit spreads are still attractive in this low yield environment

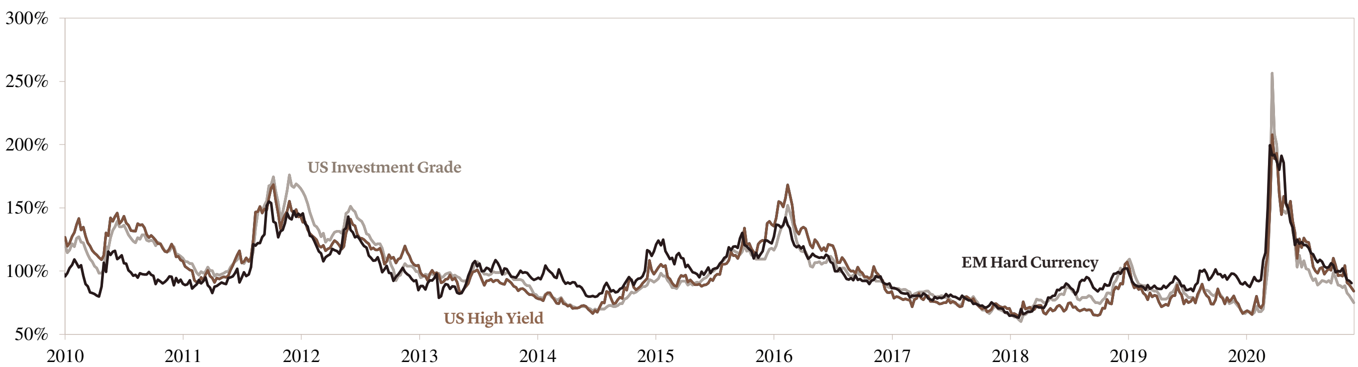
EM hard currency bonds spreads are back to their long-term average, but embed a high risk premium



Source: Bloomberg

23. A look at key credit segments

Current spread relative to the 10-year average



Source: Bloomberg

recovery in activity and more domestically driven economy makes its equity markets increasingly uncorrelated to those of the rest of the world. The country would of course also be one of the earliest beneficiaries of any thawing of trade relations with the US. Turning to fixed income, with interest rates at new lows globally and still ample output gaps in most economies, the inflation-normalisation process is unlikely to limit central bank accommodation. We continue to focus on carry strategies in order to generate attractive risk-adjusted returns. While the traditional portfolio hedging properties of government bonds may be reduced given the current low yield levels (see Box), corporate credit should continue to benefit from investors' quest for income. Granted, spreads have tightened swiftly, and more rapidly than after previous selloffs (see chart 22, page 14). However, in an environment of low inflation and anchored monetary policy, we think that this search-for-yield dynamic is set to persist. In this context, emerging market hard currency bonds look particularly attractive, given their still reasonable level of yields and potential for some further spread compression (see chart 23. page 14).

Finally, investors with appropriate liquidity buffers should continue to invest in the real economy. Putting capital to work in non-listed companies can help improve portfolio resilience. Investment activity in this area slowed during the pandemic. Lower valuations for many target companies and record levels of industry cash reserves are now opening significant opportunities. This capital should help businesses get back on track and generate sustainable growth. In addition, infrastructure assets are poised to benefit from massive levels of government pandemic spending linked notably to green initiatives to aid the economic transition towards more sustainable ways of production and transportation. In real estate markets, changing commuting and working patterns are shifting demand for commercial property in the short run.

All told, while 2020 will cast a long shadow, we expect next year to deliver a rapid and robust global recovery. This should translate into portfolio returns ranging between 3.5% (CHF) and 5% (USD) for a balanced profile, which are slightly above our long-term expectations. But they could be as low as -8% and as high as 7% in our downside and upside scenarios, respectively. While our base case for next year does call for risk taking, we will maintain portfolio ballast and stay nimble and reactive in our portfolio allocation, ready to adjust our equity and our duration exposure as events unfold.

Christian Abuide, Head of Asset Allocation
Sophie Chardon, Cross-Asset Strategist

Tactically managing portfolio hedges

A consensus is starting to form whereby 2021 will see a progressive fading of risk, be it on the economic, political or geopolitical fronts. A welcome return to greater visibility, after four years of a chaotic Trump presidency, particularly on the international scene, Brexit gyrations that date back even further, COVID stress for much of 2020 and six months of unprecedented monetary and fiscal stimulus (set to continue). That said, risk premia have already come down far more than would usually be the case at such an early stage of an economic rebound, leaving little margin for negative surprises.

Despite the promising news regarding vaccine developments, the vaccine-fuelled economic recovery is unlikely to be a linear process. Risks such as an early withdrawal of policy support, potential issues with production or delays in the distribution and administration of the vaccines, or a virus mutation, should not be downplayed.

As already discussed in the past, the low-yield environment makes traditional portfolio stabilisers, such as domestic government bonds, less efficient. With US yields approaching all-time lows, this statement is more relevant than ever, challenging the traditional 60/40 asset mix. Which in turn explains the significant changes made to our strategic asset allocation last September. Our recommendation at this juncture is to hold a diversified set of hedges. These can range from US or Chinese government bonds (the latter currently having more rallying potential than their developed market peers at large), to gold, the Japanese yen or put options (when volatility is low). That said, such assets can trade independently from the equity risk they are intended to cushion, and therefore need careful tactical management.

Fixed Income
Credit still favoured over government bonds

In a nutshell

- An economic pick-up in 2021 should push yields up somewhat and steepen yield curves – making government bonds little attractive given low starting yield levels.
- Credit should continue to be supported by spread normalisation, declining net issuance, investor need for income as well as official bond purchase programs.
- High yield and emerging debt in hard currency offer the highest potential from the current rate and spread levels.

Recent positive vaccine developments argue for a better macroeconomic outlook for next year, one in which the economic recovery continues and even gathers speed, despite the possible near-term challenges. This should lead to moderate upside on nominal (and real) yields. In turn, yield curves are likely to steepen, as central banks maintain policy rates unchanged while longer term rates move somewhat higher from their current multi-year lows. This diminishes the appeal of holding government bonds in portfolios and we are underweight the space.

An exception is Chinese government bonds, which we see as an interesting investment opportunity. Starting yields are attractive with a pick-up vs. those in the US and Europe (see chart 24), the market is underrepresented in foreign investors' portfolios (foreign ownership stands at only 2.7%, see chart 25) and the Chinese authorities' efforts to globalise and deepen their capital markets continue to bear fruit.

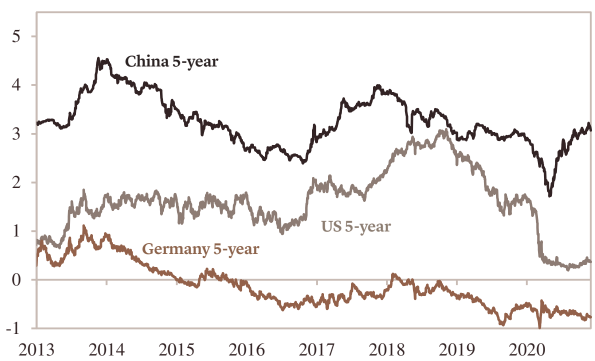
In addition, while US Treasuries are less attractive at current levels, we would consider scaling in for portfolio hedging purposes, if a more significant pick up in yields occurs during 2021.

We continue to favour corporate credit over government bonds going into the new year, still finding pockets of opportunity despite the significant spread compression that has occurred since March. We expect credit spreads to pursue their normalisation to pre-COVID levels as the recovery takes hold, supply falls from 2020 record levels and volatility continues to grind lower. Financial repression remains in vogue with 25% (or some USD 17 trillion) of the Bloomberg Global Aggregate index trading at negative yields. The need for income will thus likely continue to be a tailwind for credit even if yields do back up somewhat, as we expect, in response to stronger economic growth in 2021. All told, and factoring in also the support from official corporate bond buying programs, the technical picture remains positive for both investment grade and high yield credit.

But although the former is still well supported, its upside is constrained by current rate and spread levels. At this point, high yield corporate credit and emerging market debt in hard currency offer more potential in our view. As regards high yield more specifically, the earnings recovery that is under way should lead to defaults peaking earlier, and at lower levels, than previously anticipated.

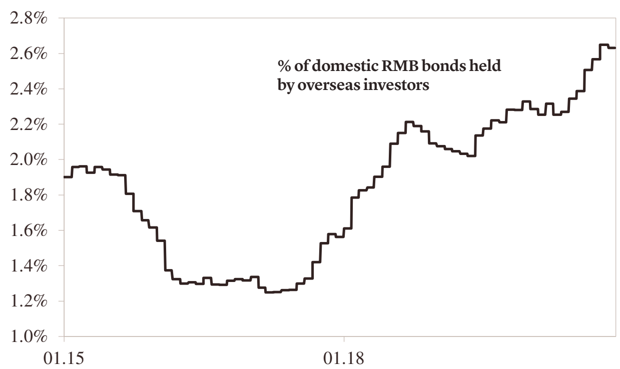
Christian Abuide,
Head of Asset Allocation

24. Chinese debt offers a significant yield pick-up vs US Treasuries...



Sources: Bloomberg, Lombard Odier

25. ... while the market is growing and underrepresented in foreign investors' portfolios



Sources: Bloomberg, Lombard Odier

Equities
Towards a more balanced market leadership

In a nutshell

- The US elections and, to a greater degree, the promising news on the vaccine front warrant higher one-year targets for the main equity indices.
- The sectors most hurt by the pandemic appear set for a catch-up: small-cap, energy and financials should be considered at this juncture.
- From a regional perspective, Chinese equities remain an interesting uncorrelated investment.

Two major known year-end catalysts have finally delivered their much-anticipated outcomes. Although both proved positive for equity markets, the effects of the US elections on sectors and regions varied greatly from those of the promising COVID-19 vaccine results that were announced. The latter factor should have a longer-lasting effect on markets, as an unexpected fast track to economic normalisation has just emerged.

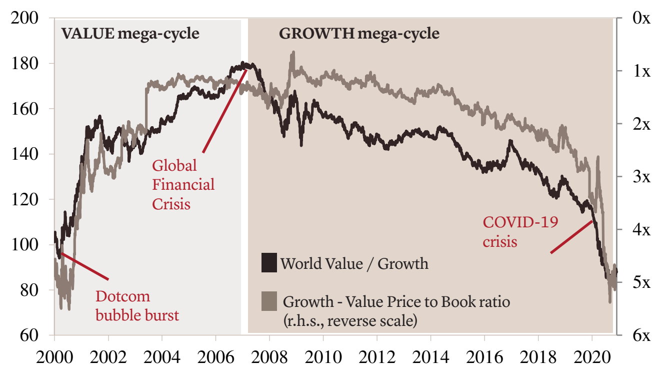
These developments have led us to raise our one-year targets for the main equity indices. We are factoring in a more rapid earnings recovery and assuming stable valuation multiples. The new targets for the S&P 500 and Stoxx Europe 600 stand at, respectively, 3,800 (up from 3,200) and 420 (up from 380).

Even if recent episodes of cyclical and, especially, value outperformance have been short-lived and would require a significant rise in rates to endure (which is not our base case), we see the vaccine discovery as enough of a catalyst to call for a partial catch-up of those sectors most affected by the pandemic. Their extreme starting point in terms of performance and valuation differentials relative to growth stocks (see chart 26), coupled with concerns about index concentration in the US, instil confidence that their downside risk is rather limited going forward. Low-valuation stocks tend to do well in periods of accelerating economic momentum, particularly in the early innings of the cycle. This trend is admittedly unlikely to be linear and should not last more than a couple of months, but leadership in the market will be forcibly more balanced going into 2021.

In asset allocation portfolios, we initiated this transition during the summer for two sectors, then continued in September with the Eurozone (see chart 27). We now think that exposure to small-cap, energy and financials should be considered, as they are just past trough earnings – with financials also offering 2021 dividend optionality. Looking further out, towards the latter part of 2021 when policy support might start to be withdrawn, it is fair to assume that quality and growth stocks could come back into fashion. Region-wise, China's strong and domestic-driven economy makes it a still interesting uncorrelated asset to own over the long run.

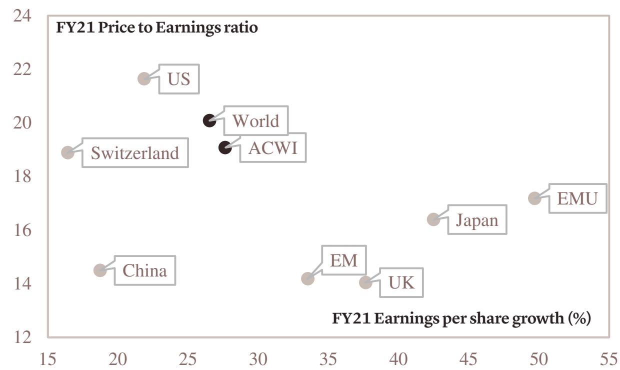
Mathieu Bellamy,
Head of Equity Strategy

26. Performance of value and growth stocks since 2000



Sources: Bloomberg, Lombard Odier calculations

27. 2021 consensus earnings growth vs valuation



Source: Datastream

Forex
Look for further dollar weakness in 2021

In a nutshell

- The USD is set to lose more ground next year, in a context of alleviated pandemic, economic and political concerns.
- Even absent a reduction in tariffs, superior fundamentals argue for CNY upside vs. the greenback, particularly since Chinese authorities now seem more tolerant of a stronger currency.
- The broader EM FX index – albeit heterogenous by nature – stands to make some gains during the first half of 2021, after which high debt loads will limit upside.

The result of the US elections, together with significant progress on COVID-19 vaccines, is helping unravel the Trump risk premium embedded in the dollar. Despite a potentially split Congress, Biden's presidency will alleviate trade-related concerns, while the gradual return to normality heralded by vaccine breakthroughs will see the market price in a lower risk of further restrictions on economic activity. Accommodative monetary policies also remain conducive of a global recovery. Finally, and despite its 12% drop since March, the greenback remains overvalued (see chart 28). All this suggests that 2021 is likely to see further dollar weakness.

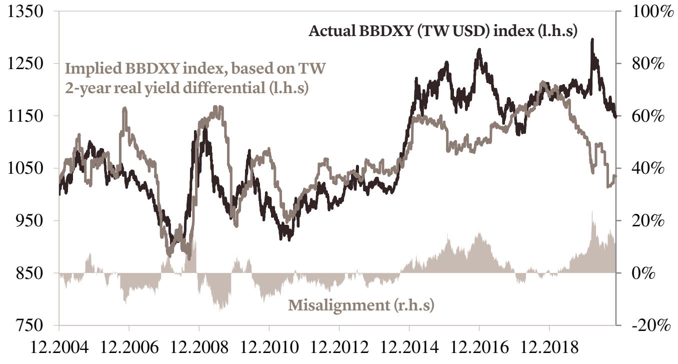
More specifically, we forecast EURUSD to rise towards 1.23 in 2021, with some risks to the upside. The dollar has lost much of its interest rate differential advantage vs. the common currency. EURCHF should also move higher and break the 1.10 level, supported by improved risk appetite and Swiss resident outflows. Sterling should benefit from USD weakness too, on top of a basic Brexit deal. We forecast GBPUSD to rise to 1.37, possibly overshooting towards 1.40. Still, we suggest not to "chase" the currency beyond 1.35/1.37, given the UK's continued struggle with Brexit and high debt ratios. The JPY is still undervalued by some 15% against the USD, warranting a constructive stance. Finally, the Nordic currencies should remain underpinned by their pro-cyclical nature; we reiterate our call for NOK outperformance.

Turning to the emerging space, we have further revised down our already bearish USDCNY view, now forecasting 6.40 by 2021-end (see chart 29). Beyond superior macro fundamentals and much improved balance of payments flows, the increasing tolerance of Chinese authorities for a stronger CNY is a key factor. A reduction in section 301 tariffs has become plausible (though by no means automatic) and would imply further downside to our forecast.

Regarding the broader EM FX index, our model suggests gains in the first half of 2021 – with even some stabilisation of the weakest currencies (like TRY and ZAR). Still-high debt loads will, however, limit upside later in the year for many EM currencies, requiring a selective approach. We maintain our preference for the CNY, TWD, KRW, CZK, and PLN. The main risks to our FX views are a delay in the development/ distribution of vaccines, a premature withdrawal of fiscal/ monetary support or the Fed turning less dovish.

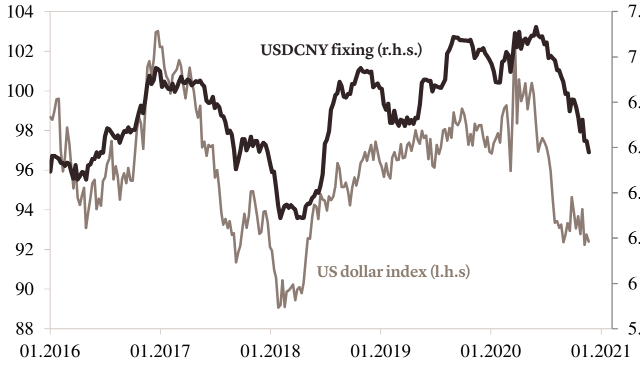
Vasileios Gkionakis, Global Head of FX Strategy
Kiran Kowshik, Global EMFX Strategist

28. Despite the 12% drop, the US dollar is still overvalued



Sources: Bloomberg, Lombard Odier calculations

29. USDCNY still in the process of re-alligning with the dollar



Sources: Bloomberg, Lombard Odier calculations

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SWITZERLAND

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

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

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

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

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

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

LONDON
Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID
Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).
Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
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Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st. 2, bld. 1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France. RCS PARIS B 803 905 157 · paris@lombardodier.com
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ABU-DHABI
Bank Lombard Odier & Co Ltd · Abu Dhabi Global Market Branch
Al Maryah Island · Abu Dhabi Global Market Square · Al Khatem Tower · 8th floor · P.O. Box 764646 · Abu Dhabi · UAE · abudhabi@lombardodier.com
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Lombard Odier Trust (Bermuda) Limited
3rd Floor, Victoria Place · 31 Victoria Street · Hamilton HM 10 · Bermuda · bermuda@lombardodier.com
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DUBAI
Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

ISRAEL
Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

MONTEVIDEO
Lombard Odier (Uruguay) SA
Luis Alberto de Herrera · Torre 2 · Oficina 2305 · 11300 Montevideo · Uruguay
montevideo@lombardodier.com
Supervised by Banco Central del Uruguay.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier (Panama) Inc.
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier (Hong Kong) Limited
3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
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SINGAPORE
Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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