Gold: Returns Pinned on FX Volatility

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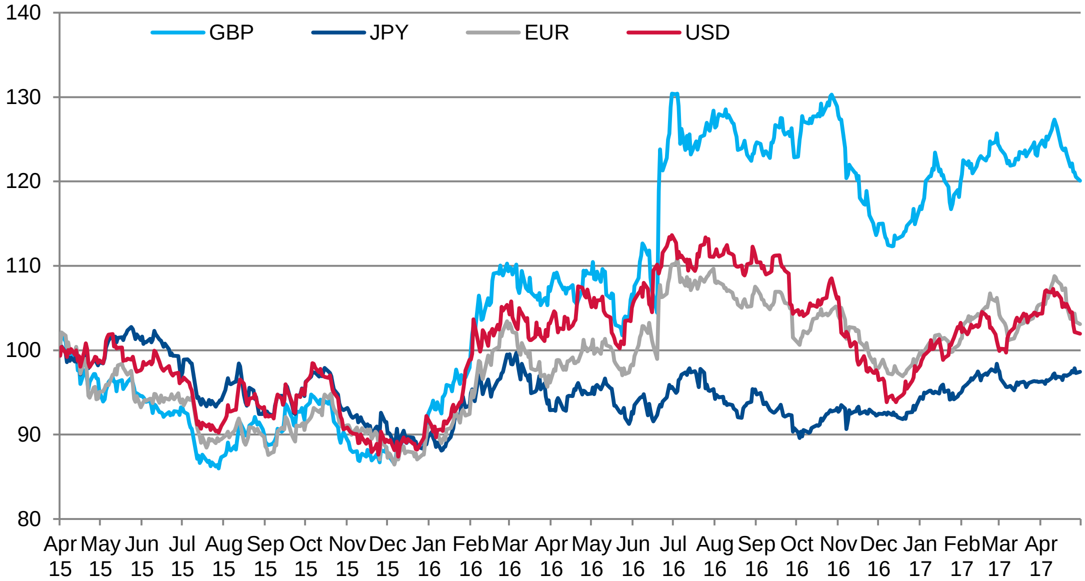
Gold denominated in Euro/Yen/GBP and Dollar: *GBP denominated gold posted strong gains since last year's referendum.*



Source: Bloomberg,Sucden Financial April 2015 = 100

Spot gold has appreciated 7.3% year-to-date (YTD) to $1,230/oz with demand for the yellow metal improving in ebbs and flows against a backdrop of geopolitical uncertainty in conjunction with rising inflationary pressure. Price volatility has become more pronounced in recent months as opposing forces are exerted on the precious metal long considered a safe haven as well as a hedge against inflation.

However, gains in gold denominated in other currencies have been less pronounced. Looking at the price movements for gold denominated in GBP, EUR, and JPY and comparing the macroeconomic outlook for each currency, we put forward a case for the most attractive currency for gold buyers over the coming months given the expectations for gold prices to trade broadly range bound albeit with increased volatility.

At the time of writing, gold prices in yen have gained 3.9% YTD, positioning it as the best performer out of the four main currencies we have analysed. Sterling was the next best, up 2.6% YTD as of the 12th of May close, however returns were a lot more pronounced through to mid-April ahead of PM Theresa May calling a general election. Year-to-date performance until 18th April was 11.3% from the January low to a high of £1,033/oz.

A similar story can be said for the euro as prices improved 11.14% to €1,221/oz up until the 18th of April. Since the week of the announcement, gold denominated in euro has fallen approximately 8% becoming the worst performer of the group, albeit only marginally, with YTD gains of 2.4%.

DOLLAR

After a blistering run in the immediate aftermath of the US Presidential election in November, which saw the trade weighted dollar index rally from 122.8 on 11th November to a fresh 15 year high of 129.07 at the end of December, the greenback has cooled somewhat as momentum slows and investor sentiment alone struggles to prop up dollar support.

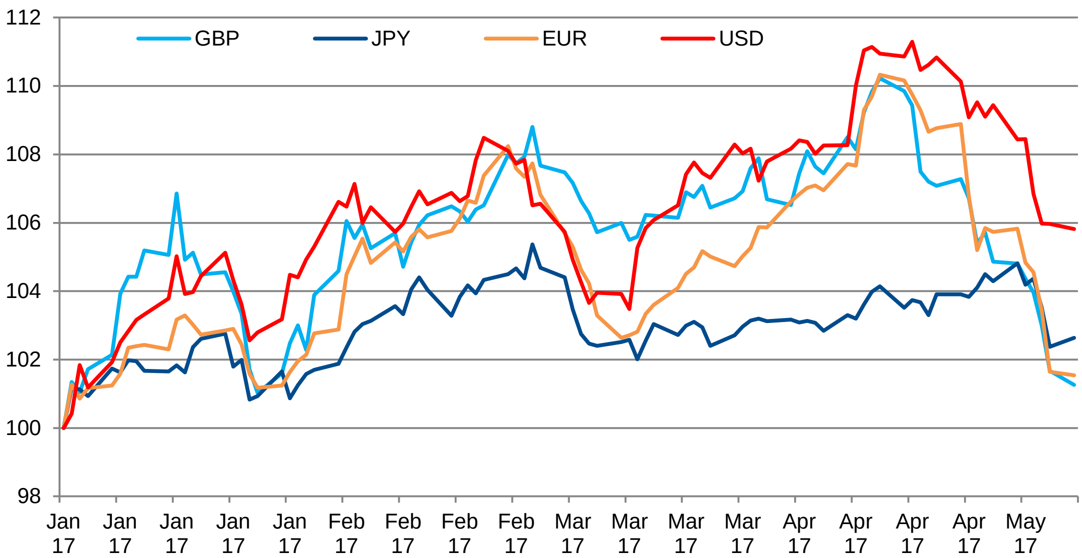
Since the start of the year the trade weighted dollar index has retraced 2.94% and with no new information surrounding the massive fiscal stimulus promised by President Trump the exuberant mood among investors has given way to cautious buying and at times panic selling. Macro data coming out of the US continues to signal towards strong performance. Recent data out this month indicate a labour market nearing full employment with unemployment in April declining by 0.1% from the previous month to 4.4%. Steady growth in durable goods orders and industrial production further bolster the US economic outlook and provide a foundation for the Fed's continued push towards tightening monetary policy.

While we view this gradual tightening of monetary policy as a plus point for the long term prospects of the US economy, on a broad trade weighted basis the dollar still looks markedly overvalued when compared with its long run average, which over the past ten years sits at just under 106.

Currently, market sentiment is dominated by the political storm unfolding in Washington as President Trump acclimatises to life in office. As such news headlines will carry more weight than macro data heading into the second half of the year. Accordingly we expect gold prices to trade for the most part within a $50 range between $1,225 and $1,285/oz for the coming months. Spikes either side will be short lived and driven by kneejerk investor reactions.

Given the sideways range projected for gold prices and against a back drop of geopolitical tension and de-syncing macro outlooks across key regions we present a case for gold denominated in EUR, GBP and JPY.

Gold denominated in Euro/Yen/GBP and Dollar: *Spot gold denominated in yen has been less volatile.*



Source::Bloomberg,Sucden Financial

Jan 2017 =100

EURO

The euro effective exchange rate puts the index at 89.5 as of the 9th of May; this is a high for 2017 as the index has oscillated between 87.60 and 89.50. Current levels are below the 5 year average of 90.75 which is fractionally below year's high of 90.80 in October. The recent swings are attributed to uncertainty within the area; however recent economic data suggests that the recovery is gathering pace. Recent GDP forecasts from the IMF project euro-area growth at 1.7% year-on-year for 2017 with economic sentiment at the highest point since September 2007.

Monetary policy remains accommodative, despite tapering bond purchases to €60bn a month the ECB remains committed in its support of financial markets even as inflation creeps higher. The Eurozone core CPI reading for April came in at 1.2% year-on-year; acceleration on March's reading of 0.7% y/y.The outlook ahead is by no means a foregone conclusion with political risk as well as looming credit issues in Greece and Italy. Despite these threats to euro-area stability, we believe the euro is somewhat undervalued and anticipate some strength in the currency in the coming quarters on the back of a cohesive macroeconomic outlook.

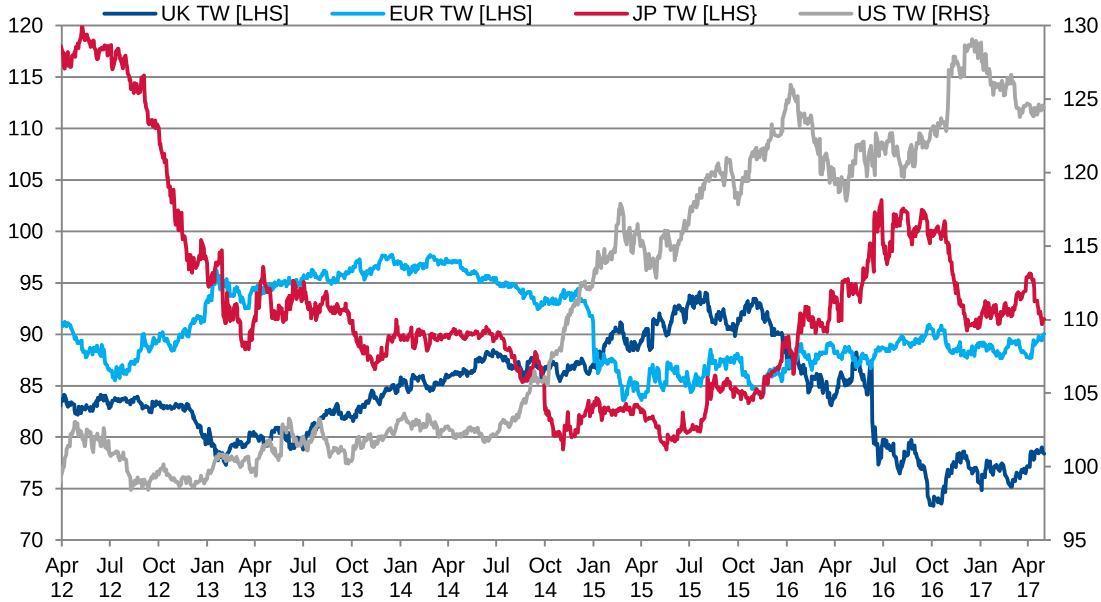
It is hoped that France's newly elected President, Emmanuel Macron can unite the country and help modernise the economy which coupled with a win for the SPD party in the German Federal Elections this September, will enhance the outlook for the Eurozone with higher growth prospects a boon for the euro.

Accordingly, given the volatile, range bound outlook for spot gold prices denominated in dollars, investors may be well positioned to purchase euro backed gold ETF's as one way of gaining exposure to currency moves while maintaining a hedge against inflation and geopolitical risk at the same time. The more obvious route of exchanging dollars for euros and purchasing bullion, bars and coins would provide the same exposure, however, comes with higher costs of transaction and storage.

Recent euro volatility is likely to continue as we move through the calendar year due to the start of Brexit negotiations and German Presidential elections. We anticipate a wide range of 1.06 to 1.12.

If spot gold reaches our upper bound range as does the euro $1,285 and 1.12 respectively, bullion denominated in euro could reach €1,147/oz. This currency play could yield a return of 2.1% using €1,122/oz the spot price as of17th of May; this translates to an appreciation of €25.

GBP, EUR, JPY and USD Trade Weighted Index: *The Dollar weighted index is heavily overvalued compared to recent years whilst the other indices look undervalued.*



Source::Bloomberg

GBP

With the UK general election fast approaching and the main parties hitting the campaign trail; the abysmal performance from Labour in the local elections has left Jeremy Corbyn with work to do. Since Theresa May called the election sterling has strengthened approximately 3% against the dollar, trading at an average of $1.286 to the pound the week after the French elections.

With the new French President only in office for a matter of days, it is tough to denote much about President Macron's stance on Brexit. Intuitively, his election is not conducive to negotiations for the UK due to his pro-Europe stance. In his short time in office Macron has aligned with Angela Merkel, regarding his belief that Britain should not have access to the single market without accepting free-movement principles. However, the business minded President endeavours to get the French economy back on the front foot through boosting investment and building walls between key trade partners will add significant headwinds to his cause.

Key macro indicators signal a tentatively positive outlook for the UK economy with, unemployment has gradually declined over the past twelve months, hitting 4.7% in February whilst inflation which has picked up pace in recent months is expected to stay at 2.3% y/y in May. Additional upward pressure on prices is expected throughout the remainder of the year, which could prompt the ECB to adopt a more hawkish stance.

Hard economic data suggests that the post-Brexit bounce, driven largely by better than expected industrial and manufacturing output owing to a steep sterling discount is starting to lose momentum. However, May's manufacturing PMI surprised to the upside rising to 57.3 with the export market in particular benefiting from currency effects. GDP growth remains robust and while Brexit headwinds will likely prompt significant swings in risk assets, not only in the run up to the UK election but also after it.

As a result, we believe that the current pessimistic view of the pound has pushed it significantly below what the fundamentals would suggest. The trade weighted sterling index currently stands at 79 having coming from the 5 year high in 2015 of 93.79. The index has been on decline since and the current level is still below the 5-year average of 84. Attempts by the trade weighted broad index to surpass the 80 have been futile throughout the last year however anticipated strength in sterling could see this level broken.

Rightly or wrongly, a convincing mandate given to the Conservatives could give market participants some much-needed clarity, which we believe would bolster support for the pound. Similar to the Euro it is our opinion that buying gold denominated in sterling is set to yield stable returns when compared to the expectations for dollar base gold moves.

Applying the same calculation, assuming that gold reaches $1285/oz and the pound strengthens to1.35, using the price of as 17/05/2017 13:06 £962, this would actually result in a slight loss of 1.14% due to relative strength of sterling against the dollar.

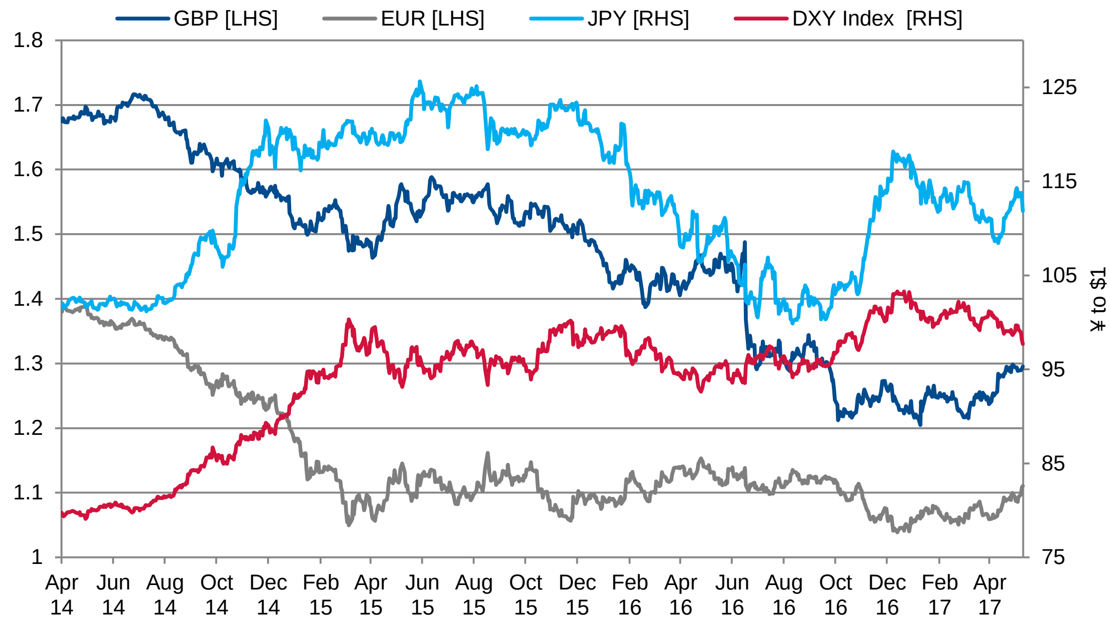
JPY

The safe haven aspect of the Japanese economy is no secret, with investors fleeing for the yen as apprehension in the global economy increases. The CBOE VIX reached a multi-year low last week at 9.56 nearly a year after the index reached 25.76 immediately after the Brexit vote. The lack of volatility in the markets coupled with the already high valuations may prompt investors to leverage up as they seek higher returns, which in the long may be damaging, with frustration in the market running high we believe the longer this run goes on, the larger the fall may be.

The inverse relationship between the world economy and the safe haven currency yen, suggests we may see further weakness to the Japanese currency as the global recovery picks up pace. However there may be arguments in favour of yen strength against the dollar.

Pressure in some major economies for central banks to raise interest rates may see the re-emergence of the carry trade. Japans notoriously low interest rates provide an opportunity for investors. Cheap credit in Japan allows traders to invest funds in a higher interest environment. Uncertainty in the market can cause investors to unwind positions, creating demand for yen. Admittedly, the global interest rate environment in major economies is low; limiting the upside and therefore legitimacy of such a trade but as inflation pressures increase, convincing central banks to hike rates, we could see the popularity of this trade rise in tandem. The EM interest rates may provide opportunity.

Japanese Yen vs Euro vs British Pound: *The dollar has strengthened considerably against major currencies but could this be starting to unravel?*



Source:Bloomberg

Demand for Japanese exports were bolstered by the weakness of the yen against the dollar in mid-December, the exchange rate reached ¥117.93. The current account hit its highest level since 2007 with a surplus of ¥20.2tn ($177bn) which translates to 3.8% of GDP for the financial year to March 2017. Encouragingly, the economy is not solely reliant on exports but has a significant exposure that will impact currency moves nonetheless. Japan’s model now benefits from its huge international creditor position. Direct investment in overseas assets, stocks and bonds reached ¥18tn (3.3% of GDP). At a time where the threat of protectionist policies is very real, the transition away from an export-based model is likely to benefit the economy in the long run.

The jobless rate in Japan is at the lowest rate since 1994 at 2.8%, below the 3.5% rate perceived to be the equivalent of full employment. The expectation would be for real wage growth to push higher. However, contrary to this real wage growth after offsetting the inflation in consumer prices fell by 0.8% y/y in March.

The Morgan Stanley yen trade weighted index shows that there is upside potential. The index came from a 2016 high of 102 but as the safe haven currency has weakened against the greenback the index retreated back to 90. The trade weighted index attempts to gain a foothold above 95 have struggled to gain traction. The 5-year average stands at 93.61 and we believe modest strength in the yen towards ¥109 could see the index hold above 95.

It is our view that the yen will gain some modest strength towards ¥109, against the dollar, which is weaker than the 5-year average exchange rate at of ¥105.15. Off the back of the credit threats in China coupled with frustration amongst investors with the lack of volatility.

Geopolitical risks to the world economy could see the safe haven currency strengthen further towards the 5-year average however the uptick in global sentiment we believe is likely to cap yen strengthening further.

As a currency play we believe that some modest strength in the yen to ¥109 whilst using the same upside target for spot gold of $1285/oz would yield a potential loss of 0.05% once accounting for the price difference between the current spot price of ¥140,147/oz. This figure does not account for transactional fees either, the implications of which would increase the costs of the trade.

The macro-agenda has packed a busy schedule in the Europe however recent developments in the US have also caused apprehension in the market. President Trump's political woes continue, causing investors to demand safe haven assets with bullion up 2.6% so far this week, starting 15th of May. The S&P 500 has pulled back from its recent high after the recent controversy regarding former FBI head James Comey and reportedly leaking confidential information to Russia.

To conclude, the recent spike may be short lived however amidst such unclear economically and politically times, demand for gold may increase. Even though the greenback has weakened it remains considerably above the 10 year average of the dollar index at 84.04. Accordingly we anticipate further weakness in the dollar but using the above methodology it is our view that holding euro denominated gold may prove the best trade with a return of 2.5% amidst a murky outlook.

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