Freight Night

Quarterly Coffee Report – Q4 2018

Sucden Financial

Friday, 23 November 2018

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Executive Summary

- In our opinion global growth will moderate in 2019, despite the US economy showing persistent signs of strength
- European growth hampered by political uncertain, clarity regarding Brexit expected soon but fall out between Italy and the European Commission lingers
- G20 summit key for market direction but we remain doubtful US-Sino relations will improve significantly. Intellectual property at the core of the dispute
- Brazilian Real strength depends on the effectiveness of Jair Bolsonaro in his 1st year
- Origin currencies remain under pressure helping exports from these destinations
- M&A activity up 849% y/y after the $5.2bn merger between Whitbread and Coca-Cola for Costa
- Vietnam's shipments rising 21.7% y/y to 28.64m bags in 17/18 season. Brazilian green coffee shipments have totalled 11.55m bags so far in the 18/19 season
- We compare the 2018/19 season to the 2014/15 season when Brazil exported 4,564,257 bags and a further 2,328,215 bags around 413,548 tons in 2015/16 season
- We anticipate Robusta inventories to rise putting downward pressure on nearby spreads and the flat price
- For Arabica, we believe Colombia and Central America will lose market share to Brazil. We are seeing Peruvian and Honduran coffee shipped to Antwerp
- In our opinion currency whipsaws are likely to impact prices significantly in the coming months
- Rising inventories and plentiful supply to keep bias to the downside in coming months

Origin	2015/16	2016/17	2017/18	18/19
Brazil	51.3	56.0	52.0	62.0
Vietnam	26.8	24.5	28.0	29.0
Colombia	14.0	14.6	14.0	14.0
Indonesia	13.0	12.1	11.5	11.5
Honduras	5.5	7.4	7.5	7.1
India	6.1	6.3	6.3	6.0
Ethiopia	5.4	6.5	5.5	5.4
Uganda	3.4	4.7	4.8	4.6
Peru	3.4	4.0	4.1	4.0
Mexico	3.0	4.0	4.2	4.0
Guatemala	3.3	3.5	3.5	3.4
Nicaragua	2.2	2.6	2.5	2.2
Costa Rica	1.6	1.4	1.7	1.7
Ivory Coast	1.8	1.1	1.1	1.0
El Salvador	0.6	0.6	0.6	0.6
Papua New Guinea	0.7	1.2	0.7	0.7
Marginal Producers	5.0	5.0	5.0	5.0
Total Global Supply	151.30	159.60	158.00	167.2
Total Global Demand	152.10	154.38	158.00	159.6
Balance	-0.80	5.22	0.00	7.62

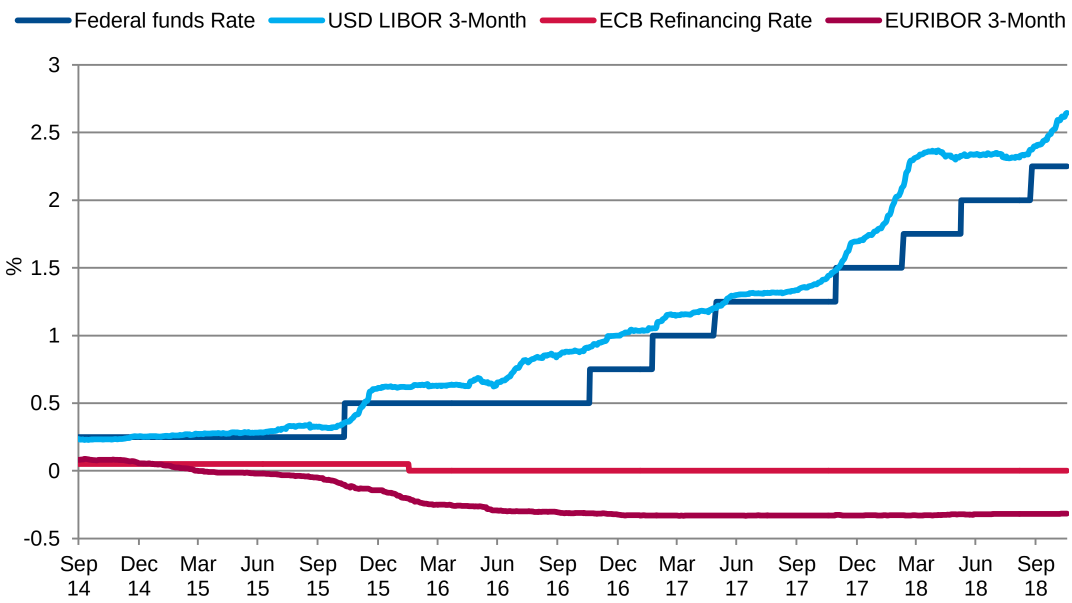
Source: Sucden Financial *million 60kg bags

Global economic growth has moderated as we have moved through 2018. PMI readings trend lower but remain expansionary, except for the US where Markit data was 55.7 for October, just off the April 2018 high of 56.5. The IMF has cut its global economic growth forecast to 3.7% y/y, a reduction of 0.2%. The IMF also downgraded their forecasts for global trade volume to 4% and 4.2% growth in 2018 and 2019 respectively. If true, we believe this will strengthen headwinds on economies reliant on trade, such as Europe and exporting emerging markets (EM).

US economic growth moderated from 4.2% in Q2 to 3.5% in Q3 as consumer spending, which is 66% of the US economy, grew 4% q/q helping to offset a 7.9% decline in business spending. Growth in consumer spending is likely to support coffee demand in the US. The reduction in non-residential investment growth in Q3 is an indicator to watch going forward as it could cause the FOMC to downgrade their assessment of business investment growth going forward.

The labour market in the US remains strong, with NFPs at 250,000 for October as the unemployment rate remained at 3.7%. We anticipate the shortage of skilled talent to increase as the US approaches full employment, but the rise in average hourly earnings of 3.1% y/y is conducive to the economy as it is above inflation. We expect the Fed to continue their hawkish rate path but believe the final $267bn worth of tariffs would present a significant downside risk to the economy and is ultimately inflationary to US consumers. Following the mid-terms, Trump's original fiscal plans are less likely, but there are compromises to be had which may enable stimulus.

US Federal Funds Rate &USD Libor 3-month vs ECB Refinancing Rate &EUIBOR 3-Month: *Clear divergence in the cost of borrowing due to monetary policy differences.*



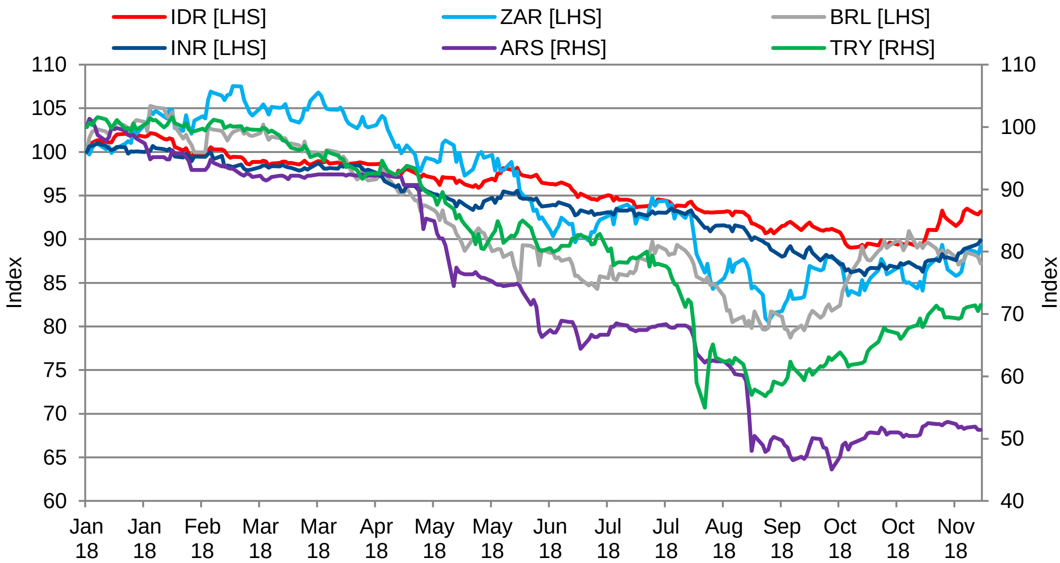
Source: Bloomberg

Despite the strength of the US economy in the immediate term, we expect growth to moderate in 2019, as inflationary tariffs damage consumer expenditure and the impact of the tax cuts disintegrate. The reaction of the S&P 500 to the suggestion of further tariffs implies US companies believe further tariffs would be detrimental to the health of the economy. We are not apprehensive about the US YTD deficit being wider 10.1% y/y due to where they are in the cycle. The G20 summit at the end of November is paramount to the global economy in 2019. We expect US-Sino relations to remain tense, but both sides seem optimistic that progress can be made. We believe the ideological difference surrounding technology is the focal point of the disagreement.

Comparatively, the European economy continues to feel the pressure of political risk with Q3 GDP at 1.7% y/y down from 2.2%y/y in Q2. Tensions between the European Commission and members are high. Brexit, as well as the dispute with Italy regarding their budget, are centre stage. Following the Commission's rejection of the budget, the Italian government rejected the European Commission's demands. The commission could issue an excessive debt procedure (EDP) against Italy. The spread between Italian and German 10 year yield was 3.14% as of 22/11/2018 after peaking at 3.26% on October 18th. The re-escalation of tensions is likely to keep the spread elevated.

Strong employment data continues to buoy the economy with unemployment at 8.1%. This, in conjunction rising inflation has caused the ECB to indicate an end to asset buying in December. Wage growth per employee climbed to 2.3% in Q2 up from 1.9% in Q1. Core inflation remains subdued at 1.1%, and we expect ECB monetary policy to remain accommodative in 2019. Minutes from the meeting indicate interest rates will remain at current levels at least through summer 2019. The council cited protectionism as a headwind to the European economy due to adverse effects on trade and investment denoted by declines in global and export orders in the manufacturing PMI, which declined to 52 in October from 60.6 in December 2017.

Emerging Market Currencies Index (01/01/ 2018 = 100): *EM currencies have come under significant pressure.*



Source:Bloomberg

Origin Focus

After months of tribulation, Jair Bolsonaro will take office on January 1st 2019. Since the first round of elections, the IBOVESPA has gained 6% as of November 22nd, the Real has initially gained 6.35% to R$3.5954 on 29th October since then USD has strengthened 5.62% and with the exchange rate now at R$3.7975 as of 22nd November. Since However, since the beginning of September, the Brazilian currency has strengthened 10.10%. Bolsonaro's pro-business and anti-crime campaign meant he was the clear favourite in the polls, the catalyst for the currency strengthening. Jair Bolsonaro's economic advisor, Paulo Guedes, a liberal economist, has suggested privatisation and public spending cuts and economic deregulation.

As mentioned in our June report, Brazil was caught in the EM contagion crossfire as the perfect storm of Fed tightening, and stronger dollar battered EM currencies. Even though Brazil's short-term external debt is considerably lower than other emerging economies at 7.2% of GDP. Net debt as a percentage of GDP is 52.2% as of September; however, we highlight Brazil's exporting status in the world economy with 2018's current account projected to be less than -2% of GDP. Brazil's reserve coverage is 155.2% of adequacy considerably higher than Turkey, Argentina and South Africa at 74.1%, 101.2% and 64.2% respectively. In their latest meeting, the central bank maintained the interest rate and this may be the rhetoric until mid-2019.

The new Brazilian regime will no doubt enjoy a honeymoon period which could strengthen the Real into R$3.55; giving rise to the KC contract in this instance we favour the arbitrage trade. Brazil's congress is notoriously chaotic, and the premise that this will be left behind is bold. Bolsonaro's appointment of Sergio Moro is a step in the right direction in tackling corruption, but there's a long way to go.

Another key factor for Real strength is the pension scheme; the market needs to see clear progress on this issue in the first year. In addition, Bolsonaro needs to improve competitiveness & productivity. We remain optimistic for Brazil but questions over the long-term benefits of a candidate who has flirted with the idea of a military dictatorship remain. We expect a honeymoon period but will it be more of a dead cat bounce?

The Indonesian rupiah appreciated 4.2% in November to 14,580 to the $. The country's hawkish monetary and economic policy could generate foreign inflows. The elimination of the election risk following the mid-terms has benefited some emerging currencies but none as much the rupiah. Global market hopes of a trade deal seem naive at this time. We expect negotiations to buoy market sentiment, but the ideological difference surrounding intellectual property remains paramount to a deal. Risk appetite remains subdued, and this is likely to cap rupiah gains in the near term, but the Indonesian economy shows a fundamental promise which may attract flows as appetite returns.

The JP Morgan EM spot FX index has fallen 12.66% to 62.80 from its February high of 71.90 and 8.36% on a YTD basis as of 22nd November. The strength of the US economy and rising interest rates have caused flows into the dollar, providing severe headwinds to EM economies and increasing the cost of their foreign debt. Furthermore, the JP Morgan EM volatility index has retreated from the September high of 13 to 10.17 as of November 22nd.

We maintain our house view that as the Fed comes to the end of their monetary cycle and US growth slows, dollar strength will wane. However, in the immediate term we expect the dollar to firm and suggest that EM currencies with a current account deficit are not in the clear and we expect persistent volatility during tightening conditions for fragile EM economies.

Corporate Activity

The significant amount of M&A activity is a dominant theme as the industry consolidates. Lavazza acquired Mars Drinks, including Flavia and Klix vending systems, for $650m. Another high profile deal was between Whitbread and Coca-Cola. The deal worth $5.2bn is for Costa coffee which has 4,000 stores in 32 countries and brings year-on-year M&A growth to 849% in the coffee sector alone. Similar to previous high profile acquisitions, Costa's strategy will focus on China as they aim to triple their number of stores to 1,200 stores by 2022. Costa is employing innovative marketing campaigns to promote the consumption of coffee. In a JV with Aliyun, Alibaba's cloud division, Costa has opened two themed stores in Hangzhou.

Mintel estimates that China's coffee shop market will grow at a CAGR of 5.7% in the next 5 years, taking the market size to 79.4bn yuan vs 60.2bn yuan last year. Starbucks reported that same store sales in mainland China fell 2% in Q2, down from 4% growth and 6% growth in the previous 2 quarters. Accordingly, Starbucks highlighted a governmental crackdown on delivery drivers who broke traffic laws or were involved in accidents.

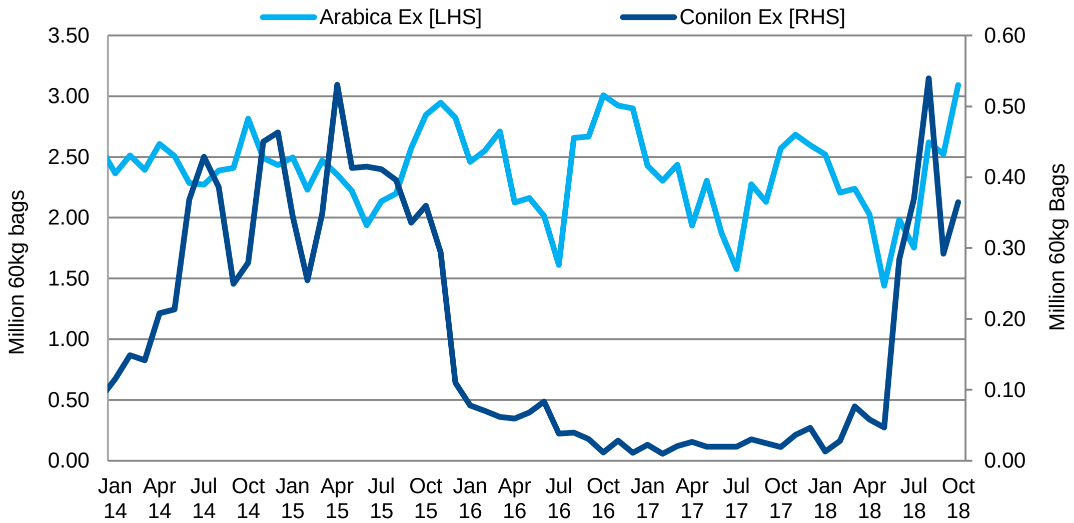
Staying in China, Luckin Coffee seeks to double its valuation after closing a funding round of $200m in July. The organisation has set its sights on a valuation of $1.5-2bn and is exploring the possibility of an IPO. Luckin Coffee embarked on a fresh $200-300m round at the beginning of November. Indeed, the company's growth has been exponential and now has 660 sites in 13 Chinese cities since being founded in October 2017.

Bill Ackman's $900m stake in Starbucks outlines bullish sentiment for the Chinese coffee industry. Pershing Square believes Starbucks share price can double if their strategy for penetration into the Chinese market is successful. 34% of Chinese consumers purchased hot coffee in the past year, versus 70% in the UK. Chinese consumers spent more ($4.5) on each purchase than consumers in the UK at $2.9. The potential of China's coffee industry is blatant, and while Starbucks, Nestle and Costa target increased market share in China we anticipate Chinese consumer psychology will favour home grown companies such as Luckin.

S&D Update

According to ICO data, global shipments improved 2%y/y to 121,879,000 bags in the 17/18 coffee season. Major producers saw an increase in exports, with Vietnam's shipments rising 21.7% y/y to 28.64m bags. Indeed, customs data January to October 2018 indicates Vietnam exports totalled 26.062m bags, up 21.3% on the same period last year. We see this year's coffee crop at 29m bags for Vietnam including 1m Arabica, with good quality. The issue for the Vietnamese is the plentiful Conilon crop this year and next. However, Indonesian demand remains a bright spot, and we expect another 1m bags to ship from Vietnam to Indonesia next year.

Brazil Arabica Exports vs Conilon Exports: *Brazilian coffee shipments reached a record in October at 3.7m bags.*



Source: Bloomberg, Cecafe

Brazilian exports reached a record last month at 3.7m bags, 364,715 bags of Conilon. In the 18/19 season, Conilon exports have totalled 1.56m bags through October. We believe next year's Conilon crop will be equally strong. October exports reached 3.76m bags which is a record. The favourable FX rate led to a high of R$4.8/lb in October for the March 2019. The YTD high was in June when exchange prices in local currency reached R$5/lb.2018/19. Shipments for green coffee have totalled 11.55m bags since July, according to CeCafe, and a total of 30.45m bags for the 17/18 season a fall of 2.638m bags from the 16/17 season.

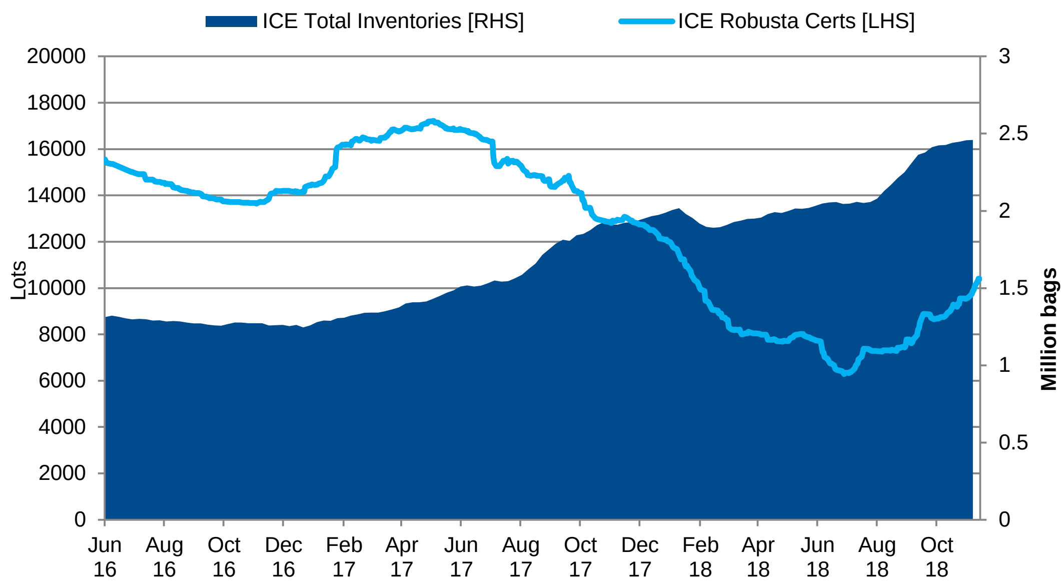
With our macro comment in mind, our house view is for EM currencies to benefit from global monetary policy convergence in H2 2019. In conjunction with this, if Jair Bolsonaro shows progress on key issues highlighted we expect the Real to strengthen into R$3.55. Current sentiment for EM assets is poor anticipate them to rally as growth improves and the Fed comes to the end of its cycle.

Inventories

Inventory data over the last 18 months provide an interesting dynamic to the market. Indeed, certified Robusta stocks drew down from 14,441 lots on September 29th 2017 which equates to 144,410 tons and 2.406m bags to 6,289 lots on July 5th 2018 which is 1.048m bags. We attribute this decline in stocks to the 16/17 Vietnam crop which was 24.5m bags, 2.575m bags below our 4 year average of 27.075m bags and the lower 16/17 Conillon crop.

Since July 5th when Robusta certified stocks were 6,289 lots, inventories have increased by 63.65% to 10,392 lots (1.732m bags) as of 22nd November. We attribute this rise to the considerable amount of Conilon shipments, 1.85m bags from July to October 2018. We expect Conilon shipments to remain elevated due to the 17m bag 17/18 Conilon crop and estimates for a similar 18/19 crop. We draw a comparison from the 2014/15 season when Brazil exported 4,564,257 bags and a further 2,328,215 bags around 413,548 tons of Conilons in 2015/16 season. ICE Robusta certified stocks stood at 2,777 lots in early 2014 and peaked at 20,595 lots in 2015 as Conillon was graded for ICE. Few industry participants will use Conilon in their blends but, the vast majority prefer Vietnam, and we cannot see that trend changing at present. In our opinion, over the coming months, ICE Robusta certs will continue to rise as Conilons arrive.

Total ICE inventories vs ICE Robusta Certified Stocks: *Persistent rise in ICE total stocks aided by the inflow of Conilon to Robusta certified stocks*.



Source:Bloomberg

Similarly, certified Arabica stocks have risen since the start of the 2017 coffee year. ICE exchange inventories have increased from 1.809m bags on October 2nd 2017 to 2.378m bags as of September 28th 2018, a rise of 0.569m bags. Accordingly, since January 2017 exchange inventories have increased 96.95% from 1.250m bags on January 3rd 2017 to 2.457m bags as of November 14th. We attribute this to strong Honduras and Peru production.

European Coffee Federation (ECF) stocks have climbed from 681,458 tons 11.35m bags in October 2017 to 703,368 tons which equates to 11.72m bags in September 2018, a change of 370,000 bags y/y. Similarly to ICE exchange inventories, we attribute the rise ECF stocks to the larger Honduras and Peru crops. Indeed, the breakdown of the certified stock data indicates a build in Honduras and Peruvian coffee with 1.145m bags Honduran coffee in Antwerp alone.

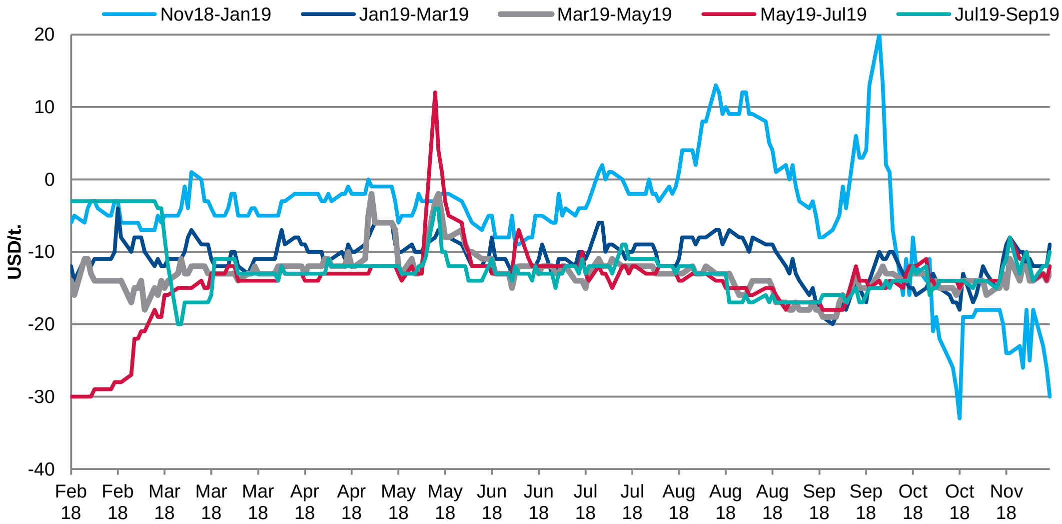
Critics of our conservative demand number may point to the 752,000 bag drawdown in Green Coffee Association (GCA) stocks and the 2018 YTD drawdown in Japanese Coffee Association stocks of 235,000 bags to suggest higher consumption. We believe the fall in GCA inventories is linked to the reduction in Brazilian shipments for the 17/18 season. Accordingly, spot Brazilian coffee in Europe was cheaper than origin resulting in withdrawals from GCA warehouses. What's more, there was a growing dynamic of Central American coffee being shipped straight to European warehouses, most notably Antwerp.

The combined total of ECF and GCA stocks in October 2017 18.54m bags in October this year; this figure was 18.1608m bags, including JCA this figure is 20.93m bags. As such, we maintain our global demand estimate for 159.6m bags and a global surplus of 7.62m bags in 18/19.

Price Activity

In our opinion, there is a downside bias for Robusta. Pending the incoming storm, which at the time of writing should not damage the crop, the new crop should start to flow in the next 3 weeks. The local price in Dak Lak is 35,300 VND/kg as of November 22nd which is significantly lower than sellers 40,000 VND/kg target. This in conjunction with the backlog of Conilon shipments is likely to put downward pressure on the flat price and nearby spreads. We believe the board will continue to trade the recent range of $1,450 to $1,800 in the coming months, with industry buying towards $1,500.

Robusta Calendar Spread: *November 18/January 19 spread has weakened towards cash and carry.*



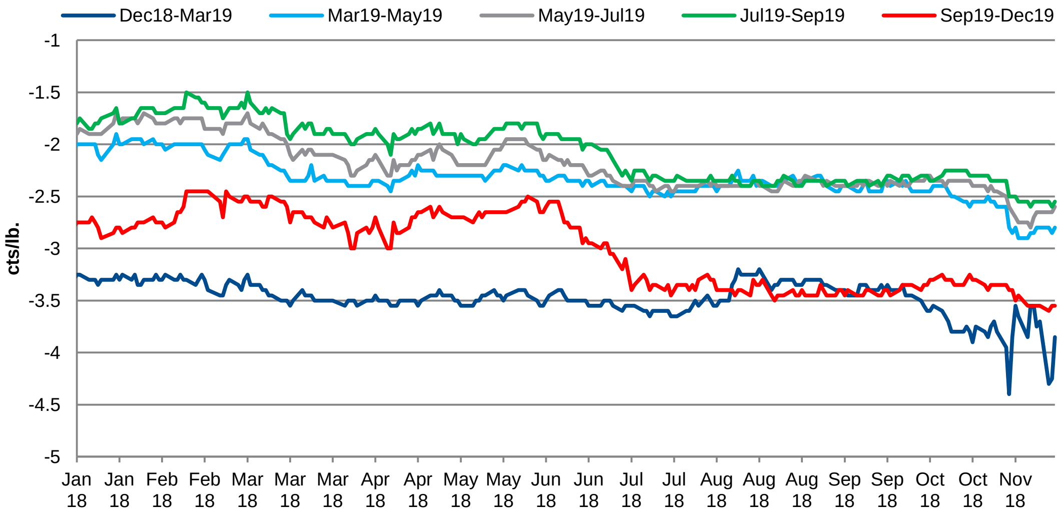
Source: Bloomberg

Focusing on the Robusta January/ March, we believe at -$12 (21/11/2018) the spread could come under pressure. Assuming a financing cost of $9.50 per month (7%) + rent + insurance, in our opinion the spread would need to widen to -$30 or wider for the cash and carry trade. For those holding certified stocks and wanting to hedge this exposure we favour selling a March $1,700 call and $1,550 put would generate $48/tonne of premium this was $56/tonne last week but the underlying has retreated, and there was some decay on the option.

For Arabica, according to CeCafe Brazilian sales totalled 12.868m bags between July and October. This may prompt Central America to lose market share as Brazilian quality, and bean size is very good. We see KC trading a 100-125cts/lb range with Colombia and Central America limiting the upside; once again we anticipate industry buying around 100cts/lb. Prices below 100cts/lb would incentivise the cash and carry trade.

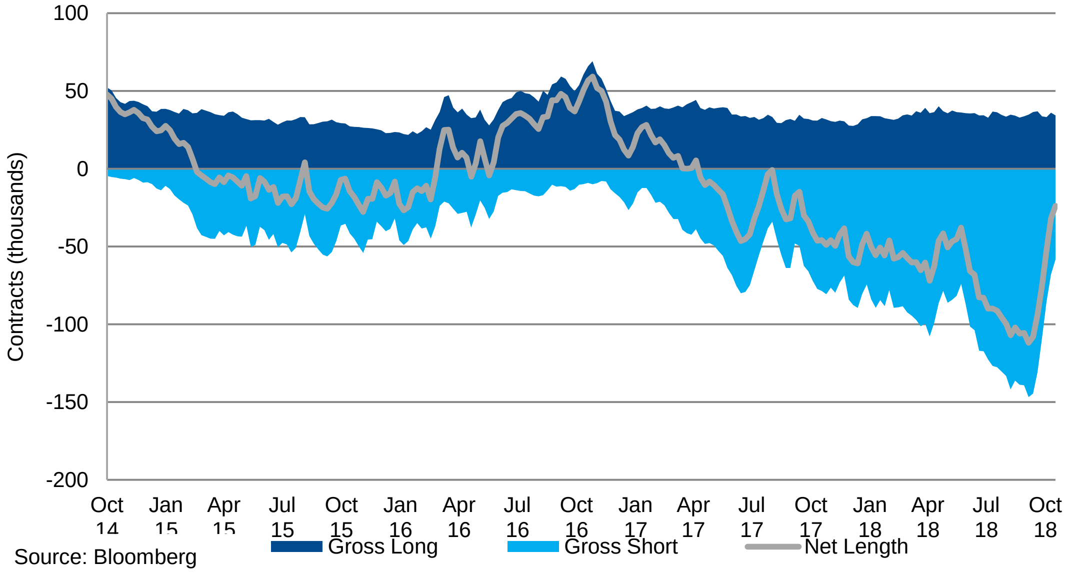
We favour the arbitrage if we continue to see short covering and the COT net short dissipates as a result of Real strength. We believe this would give rise to the NY contract and push the arbitrage to 45-50cts/lb. Conversely, rising inventories, weak Real and an increase in the net short position may prompt the arbitrage towards 30cts/lb. We favour the arbitrage it this level, but the million-dollar question is will we see another gross short of 120-140k contracts.

Arabica Calendar Spreads: *The contango remains intact with nearby spreads under pressure although we highlight.*



Source: Bloomberg

ICE Arabica Non-Commercial Commitment of Traders: *A bout of short covering has seen the net short dissipate to 29,615 contracts.*

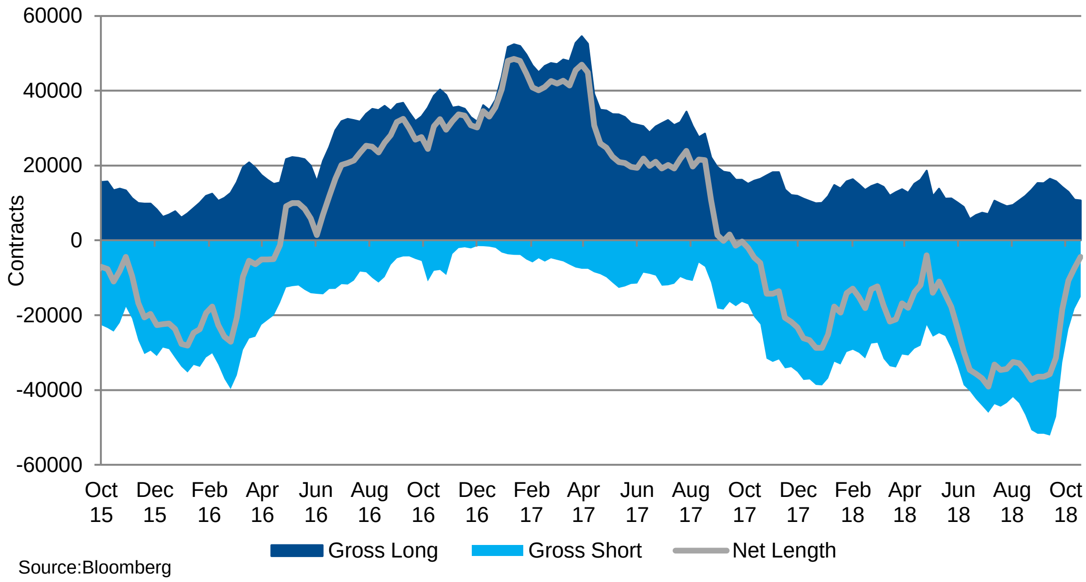


Source: Bloomberg

Commitment of Traders

The commitment of traders' reports affirms the considerable amount of short covering seen in October. Managed money for the KC contract reduced their net short by 74.60% (75,911 contracts) through to November 6th, to -25,823 contracts for futures and options. Money managers increased their short positions slightly the following week to -29,615 contracts. Consistent with this, commercial holdings reduced their net long by 74.78% to 20,472 contracts as of 13th of November. Index funds hold a net length of 43,738 contracts. Consistent with Arabica, the Robusta money managers have reduced their net length to -3,580 contracts a reduction of 31,437 contracts since the start of October. As of November 13th managed money held a net long of 276 contracts. The strength of the Real gave rise to the NY contract, prompting short covering within the market. The Real has stalled, and the market has sold off suggesting we may see investors start to increase their net short into 2019.

ICE Robusta Non-Commercial Commitment of Traders: *A bout of short covering has seen the net short dissipate to 29,615 contracts.*



Source:Bloomberg

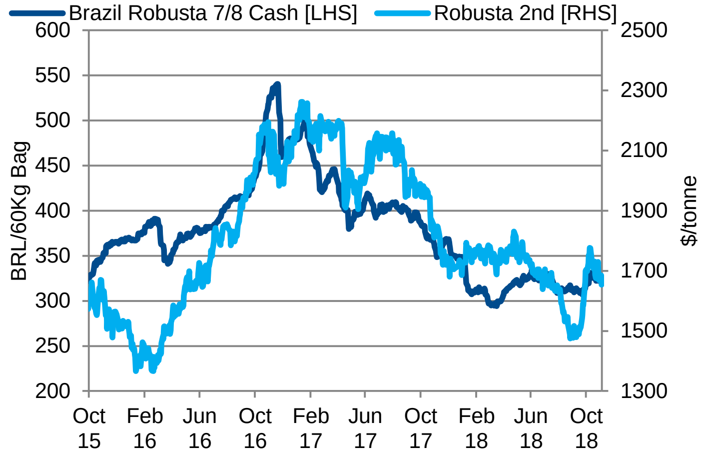
APPENDIX

Brazil

Crop Year	Production (M bags)	Exports (M bags)
11/12	49.725	29.855
12/13	56.5	30.909
13/14	56	31.018
14/15	50.50	36.573
15/16	51.3	35.484
16/17	56	33.082
17/18	52	30.808 (E)
18/19	60/62	

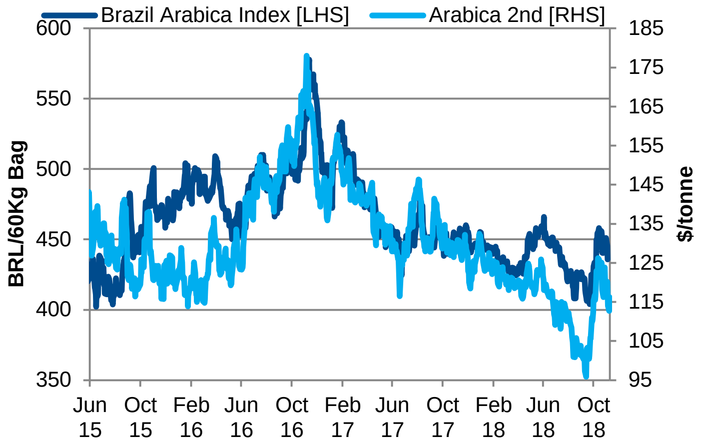
Source: Bloomberg, Sucden Financial, Cecafe

CEPEA Brazil ESALQ Robusta 7/8 Cash Price vs 2nd Month Robusta



Source:Bloomberg

CEPEA Brazil ESALQ Arabica Index vs 2nd Month Arabica



Source:Bloomberg

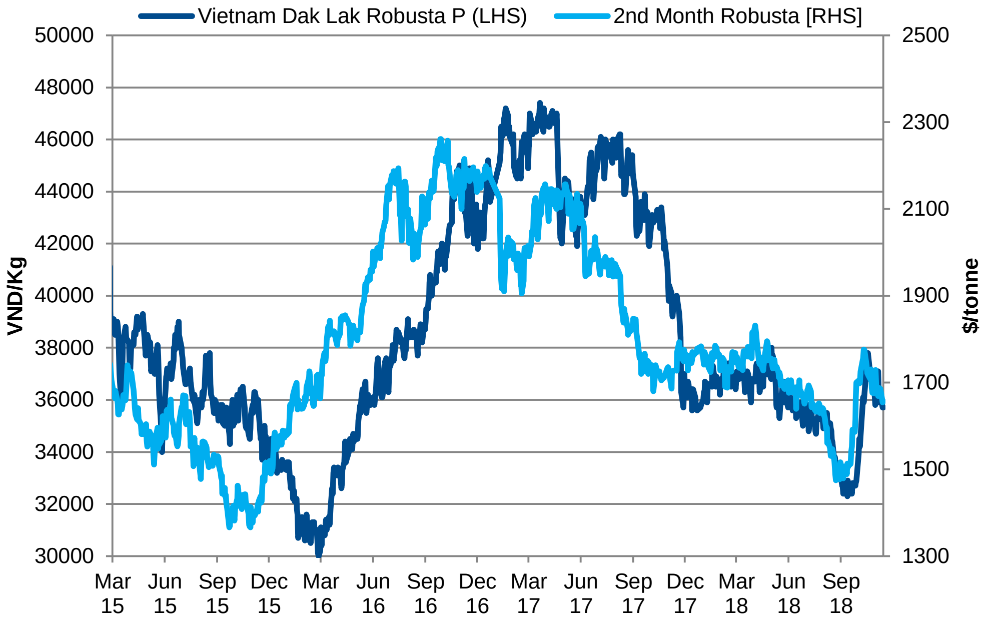
Brazil Exports Calendar Year

2013		2014		2015		2016		2017		2018	
January	2,567,872	January	2,780,355	January	3,058,483	January	2,809,026	January	2,646,584	January	2,720,043
February	2,232,519	February	2,930,002	February	2,747,025	February	2,938,361	February	2,590,952	February	2,511,693
March	2,591,392	March	2,782,556	March	3,134,534	March	3,102,523	March	2,833,454	March	2,697,583
April	2,775,451	April	3,117,426	April	3,209,230	April	2,458,225	April	2,240,212	April	2,388,842
May	2,580,846	May	3,015,673	May	2,930,329	May	2,529,042	May	2,602,588	May	1,729,332
June	2,363,496	June	2,960,845	June	2,683,792	June	2,450,947	June	2,191,622	June	2,583,347
July	2,232,764	July	3,037,055	July	2,879,707	July	1,967,328	July	1,873,431	July	2,463,850
August	2,660,238	August	3,095,886	August	2,906,060	August	3,044,488	August	2,610,209	August	3,539,794
September	2,726,534	September	2,989,593	September	3,190,760	September	3,068,374	September	2,441,736	September	3,120,389
October	3,234,855	October	3,346,513	October	3,531,666	October	3,363,064	October	2,902,113	October	3,746,739
November	2,699,059	November	3,153,172	November	3,497,405	November	3,277,106	November	2,963,138	November	
December	2,996,072	December	3,217,758	December	3,249,992	December	3,262,022	December	3,023,032	December	
	31,661,098		**36,426,834**		**37,018,983**		**34,270,506**		**30,919,071**		**27,501,612**

Source: Bloomberg, Cecafe

Vietnam

Vietnam Dak Lack Robusta Price vs 2nd Month Robusta



Source:Bloomberg

Vietnam Exports Coffee Volumes (Tonnes)

2013		2014		2015		2016		2017		2018	
January	219	January	143	January	132	January	170	January	140.3	January	201
February	100.4	February	184.1	February	92	February	119	February	146.4	February	129.9
March	157.9	March	278.3	March	130	March	181	March	168	March	200.2
April	110.8	April	210.8	April	104	April	186	April	134.8	April	156
May	110	May	137	May	106	May	162	May	122.2	May	149.8
June	88.4	June	108.1	June	104	June	158.5	June	122.2	June	156.3
July	90.7	July	89	July	107	July	139.8	July	101	July	132.8
August	83.7	August	98	August	92.59	August	152.7	August	95	August	135
September	63.6	September	97	September	87	September	129	September	79.5	September	130
October	61.2	October	96	October	89	October	117.3	October	79.1	October	130
November	80.4	November	84	November	96.2	November	114.7	November	100.5	November	
December	125.6	December	115	December	152	December	148.1	December	158	December	
	21,528,333		**27,338,333**		**21,529,833**		**29,635,000**		**24,116,667**		**25,350,000**

Source: General Statistics Office Vietnam, Vietnam Agri-Ministry

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Quarterly Coffee Report

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