GOLDMONTHLY

REDWARD ASSOCIATES

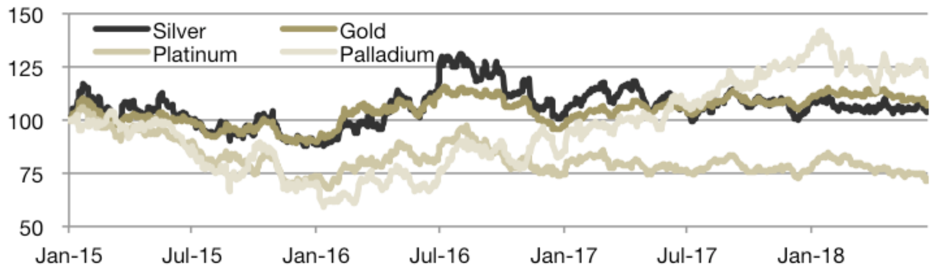
1 July 2018

HIGHLIGHTS

- Precious metals have weakened across-the-board, in line with our view that US monetary policy settings are a considerable headwind (page 1)
- Recent weakness in gold can be largely attributed to the USD, and our expectation for USD strength to extend suggests further downside risk in gold (page 2)
- The Federal Reserve upgraded their economic projections, in line with our estimates and IMF's forecasts (page 3)
- Geopolitical risks are escalating and media headlines have featured US President Trump heavily: the North Korean summit, a trade war with China, and tensions with traditional US allies (page 4)

Figure 1: Precious metals price indices (1 Jan 2015 = 100)

Headwinds faced by gold also weighed on other precious metals, particularly platinum



Source: Bloomberg

Gold's decline extends further

Consistent with our long-held expectation that tightening US monetary policy settings and persistent USD strength will be considerable headwinds for precious metal prices, we observed a notable downward correction across-the-board since the end of May — the price of gold weakened a further 2.9%, silver dipped 1.6%, palladium was down by 2.7%, while platinum was hardest hit with a decline of 5.2% over the same period.

While a rate hike at the June Federal Open Market Committee (FOMC) meeting was widely anticipated by financial market participants and fully priced in, the accompanying Statement's hawkish tilt in language and the Federal Reserve's explicit upward adjustment in their 'dot plot' skewing in favour of four 25bp rate hikes instead of three — in line with our view — appears to have taken the market by surprise. In our opinion, the US economy has been operating at fully capacity for some time and with the labour market set to tighten further, capacity pressures are emerging and this will continue to support a lift in prices towards the Federal Reserve's 2% inflation target.

Meanwhile, uncertainty relating to US trade relations particularly President Trump's policy of escalating trade disputes poses a considerable risk to global growth prospects, but while geopolitical risks have boosted demand for the USD, US Treasuries and the JPY, precious metals — particularly gold — have clearly fallen out of favour as a safe haven asset.

We continue to see downside risk in the price of gold, with scope for weakness to extend sub-USD1,200/oz over the coming year.

Figure 2: Price snapshot (21 Jun 18)

Price, USD/oz	Jun-18	%MoM	%YoY
Gold	1,265	-2.3%	1.5%
Silver	16.24	-2.0%	-0.9%
Platinum	863	-5.1%	-6.6%
Palladium	963	-3.1%	8.9%

Source: Bloomberg

Figure 3: Pricing and indicators (21 Jun 18)

Related indicators	Jun-18	%MoM	%YoY	Price in key currencies, /oz	Jun-18	%MoM	%YoY
S&P 500 Index	2,767	1.6%	13.6%	Gold / INR	86,236	-2.1%	7.3%
USD Index (5-country proxy)	123.95	2.5%	-1.0%	Gold / CNY	8,214	-0.3%	-3.4%
WTI Crude oil, USD/bbl	65	-9.2%	54.0%	Gold / AUD	1,720	0.7%	4.2%
Copper, USD/Mt	6764	-2.7%	18.3%	Gold / CAD	1,685	1.7%	1.4%
Bloomberg Comm. Index	86	-5.4%	8.6%	Gold / ZAR	17,334	6.6%	6.5%

Source: Bloomberg

Gold remains under pressure

- The current sell-off in gold remains quite orderly and while technical indicators suggest gold may be a little oversold, any rally is likely to be shallow

A rising US dollar is weighing on the price of gold

Between mid May and mid June, gold traded in a narrow 2% range between USD1,282-1,308/oz but has since breached key support and dipped to 3.6% within a one-week period to an intraday low of USD1261.07/oz on 21 June. The primary driver of gold's latest weakness is the resurgent USD with a year-to-date correlation of -0.916 on a daily basis. A simple bivariate regression of gold relative to the USD index suggests 'fair value' is currently USD1,277/oz but our expectation for further USD index strength suggests that 'fair value' is likely to fall to around USD1,190/oz in 12-months.

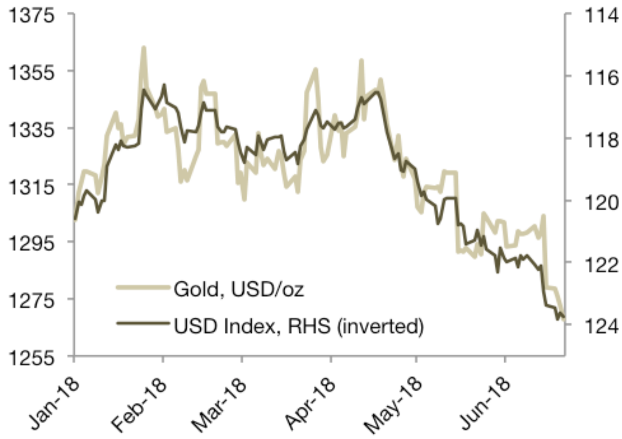
Our broader indicator model for gold, which incorporates base metals, the US 10-year bond yield and the S&P500 VIX index, suggests 'fair value' at USD1,246/oz at the time of writing. We believe that a stronger USD is likely to occur in tandem with a rise in the US 10-year bond yield, a fall in base metal prices and a lift in asset market volatility. Were the US 10-year bond yield to rise to 3.5%, base metals to fall in line with the rising USD index (-7.6%), and the S&P500 VIX index rise to 18%, our 'fair value' for gold falls to just USD1,146/oz bringing it to levels seen in December 2016.

Recall, even on a longer-term basis we have struggled to be optimistic about the prospects for gold over the coming year as gold valuations appear stretched with gold trading around 60% above its post-Bretton Woods average on a real basis and the Mint Ratio (Gold/Silver) currently 77.9, 23% above its post-Bretton Woods average.

Technical indicators continue to point to weakness although momentum indicators suggest that the current sell-off may be a little extended. That said, the gold options market remains sanguine with one-month at-the-money-forward (ATMF) implied volatility just 8.9% and risk reversals remain skewed (25-delta) to gold call options by around 0.5%, suggesting little selling pressure in the gold options market. Likewise, while we have observed selling, known exchange traded funds (ETF) holdings have fallen by only 29t since the end of May to 2,201t — this compares to the bout of accumulation of 62t in April. The latest Commodity Futures Trading Commission (CFTC) report also suggests subdued trading activity by speculators, with net long speculative holdings increasing by just 2,706 contracts (8t) in the first two weeks of June.

Figure 4: Gold price and USD index

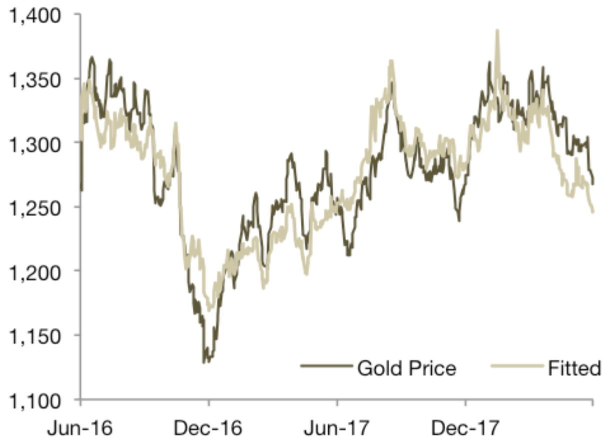
Gold has closely tracked movements in the USD index



Source: Bloomberg

Figure 5: Gold price, USD/oz

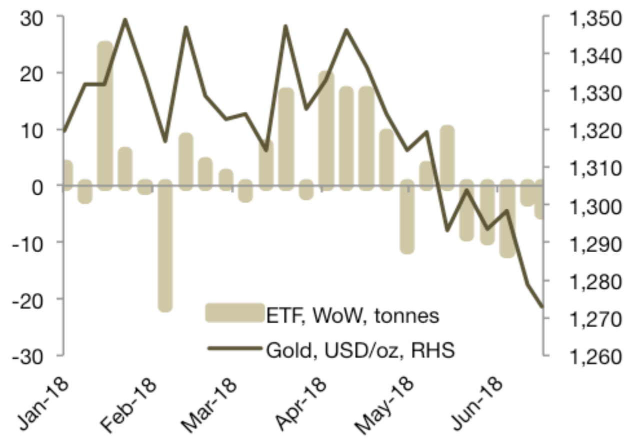
Gold's fundamental drivers suggest further downside risk



Source: Bloomberg, Redward Associates

Figure 6: ETF holdings, WoW tonnes

Net selling in ETF holdings have been steady but modest



Source: World Gold Council, Metals Focus

Federal Reserve delivers an upbeat outlook

- The Federal Reserve has upgraded their economic projections, consistent with our estimates and the IMF's latest forecasts
- We maintain our call for further rate hikes in both September and December this year plus three hikes in 2019

Solid economic outlook supports further rate hikes

Consistent with market expectations, the Federal Reserve raised the Federal funds rate by 25bp to 1.75-2.00% at their latest Federal Open Market Committee meeting (12-13 June). More importantly, the accompanying Statement revealed an upbeat tilt in language relative to the May FOMC, notably that *"economic activity has been rising at a solid rate"* (from *"moderate"*) while household spending has *"picked up"* (from *"moderated"*) and further gradual increases in the funds rate is consistent with *"sustained expansion of economic activity"* (from *"a moderate pace in the medium term"*).

The upgrade in outlook is also reflected in the Federal Reserve's economic projections for 2018 with real Gross Domestic Product (GDP) revised slightly higher, unemployment lower, and their expectation for Personal Consumption Expenditure (PCE) inflation to reach their policy target brought forward, forecasting a rise to 2.1% this year (+0.2pp) with core PCE inflation rising to 2.0% (+0.1pp). We note that the Federal Reserve omitted the following comment in the latest Statement — *"the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data"* — which may serve as a signal that market participants should look beyond noise and temporary distortions in high frequency data.

These forecast revisions are consistent with our long-held view that economic momentum in the US is building, driving a gradual pick up in capacity pressures and upward support for underlying inflationary pressures. We maintain our baseline expectation for the Federal Reserve to deliver four 25bp rate hikes in 2018 and three in 2019 — market pricing for a fourth hike this year has risen to about 50% at the time of writing according to CME FedWatch. We maintain our view that US long-term bond yields are set to rise further, supporting USD strength and remaining a headwind for gold.

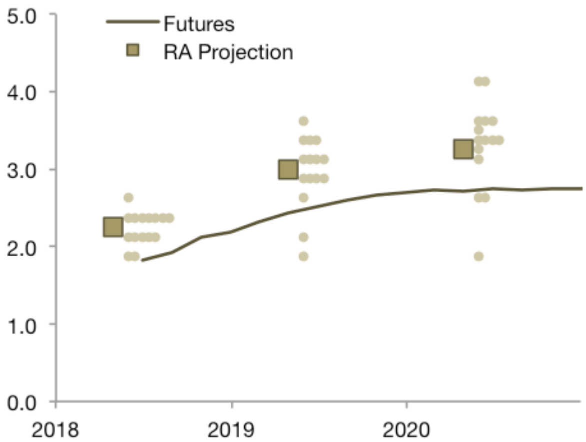
Our view is broadly shared by the IMF's latest Article IV

On 14 June, the International Monetary Fund (IMF) released its Staff Concluding Statement of the *2018 Article IV Mission for the United States*. The IMF estimates that real GDP will expand 2.9% this year and 2.7% next, well above their estimate of potential GDP growth of 1.75%, which is in line with our estimates. The IMF project that the labour market *"is beyond full employment"* but labour market conditions are likely to tighten further consistent with unemployment falling to 3.5% this year and 3.4% next, also consistent with our own view. With the economy operating above full employment and the output gap set to rise to positive 1.2pp this year and 1.9pp by 2019, *"wages and unit labour costs are anticipated to increase at a modest pace"* consistent with a rise in core PCE inflation to 2.0% this year and 2.3% in 2019.

We agree with the IMF that the near-term outlook for the USD remains skewed towards strength although the IMF considers it *"moderately overvalued"* with the US's external position worsening. It is apparent that the IMF is also concerned about medium-term fiscal sustainability and US trade policy which both represent a significant risks on the horizon.

Figure 7: Federal funds rate, %

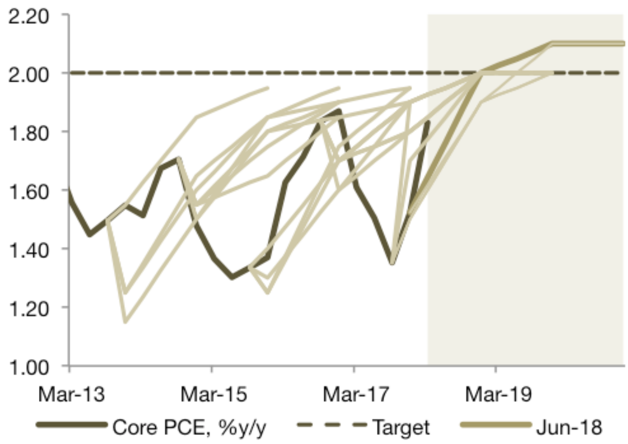
The 'dot plot' is now broadly consistent with our own expectation



Source: Federal Reserve, Bloomberg, Redward Associates

Figure 8: Fed forecasts of PCE inflation, %

The 2% inflation target is expected to be achieved by year end



Source: Federal Reserve, Redward Associates

Geopolitics are escalating… but gold is not

- Unsurprisingly, the North Korean summit made little actual progress
- A Sino-US trade war is likely to disrupt regional supply chains, driving market volatility across Asia-Pacific
- Tensions in US trade relations with other major trading partners also raise concerns about global growth prospects

Beyond political developments relating to North Korea, tensions in US trade negotiations and retaliation measures have escalated over the past month, weighing on market sentiment with financial market participants increasingly concerned about its impact on global growth prospects. Although geopolitical risks are once again driving demand for safe haven assets, the latest bout appears to have been concentrated in the USD, US Treasuries and the JPY, while gold prices slumped in comparison. In our opinion, this may relate to unpredictability in market trends (notably President Trump's policies) and higher transaction costs for gold, and given the likely dynamics of the USD and US bond yields over the coming year we continue to see downside risk.

No breakthroughs achieved at the North Korean summit

The 2018 North Korea-US summit held in Singapore on 12 June featured heavily in the headlines of major media outlets over much of the past month. Following the meeting with North Korean leader Kim Jong Un, US President Donald Tump highlighted in his press conference that the two countries promise to work toward *"denuclearisation of the Korean Peninsula"* and that *"we will be stopping the war games"* suggesting that the US may halt joint military exercises with its key allies, South Korea, as the drills are *"provocative"*. The joint statement contained few specifics on the denuclearisation process and made no mention of the trade sanctions on North Korea, although China's Foreign Ministry suggested post-summit that sanctions relief could be considered if North Korea abides by United Nations resolutions. While it appears that the US made substantial concessions in these negotiations, we are wary that President Trump has walked back on various announcements during his term — financial market participants appear to share this view and remain cautious given the lack of clarity.

China declares a "Trade War"

President Trump announced on 15 June the imposition of 25% tariffs on USD 50bn worth of Chinese imports with USD 34bn of those tariffs to take effect on 6 July and the balance to come at a later date. US tariffs target China's *Made in China 2025* initiative and cover a range of goods including aerospace, automobiles, communications technology, new materials and robotics. China responded almost straight away, announcing 25% tariffs on USD 50bn worth of US imports to take effect on 6 July. China's tariffs are initially focussed on a range of agricultural goods — notably vegetables — with tariffs likely to be enforced on energy and medical supplies at a later date.

As President Trump then looked to extend its tariffs to USD200bn with of Chinese products, China's Commerce Ministry declared, *"the US has initiated a trade war"* and China will respond with *"comprehensive quantitative and qualitative measures and retaliate forcefully"*.

A tit-for-tat Sino-US trade war is likely to prove negative for the investment and growth outlook across Emerging Asia and Australasia owing to China's increasingly central position in intra-regional supply chains. Downward pressure on Asian bourses would likely be associated with foreign liquidation of equity holdings and drive a pick up in volatility across a range of asset markets.

President Trump does not spare its traditional allies

Just ahead of the summit with Kim, US tensions with traditional allies also spiked as President Trump left the G7 summit early, retracted his endorsement of the joint communique, and then described Canadian Prime Minister Trudeau as *"very dishonest and weak".*

In response to the US tariffs on aluminium and steel imports effective 1 June, Canada is set to impose retaliatory action on USD16.6bn worth of US products from 1 July; Mexico announced tariffs on USD3bn worth of goods such as pork, cheese and bourbon; while the European Union will impose tariffs on USD3.2bn worth of goods including a *"rebalancing"* tariff on US steel along with tariffs on motorbikes and jeans.

Recovery in the euro zone could be derailed…

Recent developments in Italy owing to the new populist government's imprudent fiscal spending plans, which indicate that a new Eurozone debt crisis may be emerging, also raise concerns about economic momentum in Europe particularly given the European Central Bank (ECB)'s pivotal discussion on 14 June that monetary accomodation may soon be curtailed — the Bank anticipates conditions to be appropriate by September 2018 for winding down its extensive quantitative easing program and then ending net asset purchases by year end, with the key ECB interest rates likely to remain on hold at least through mid 2019.

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