

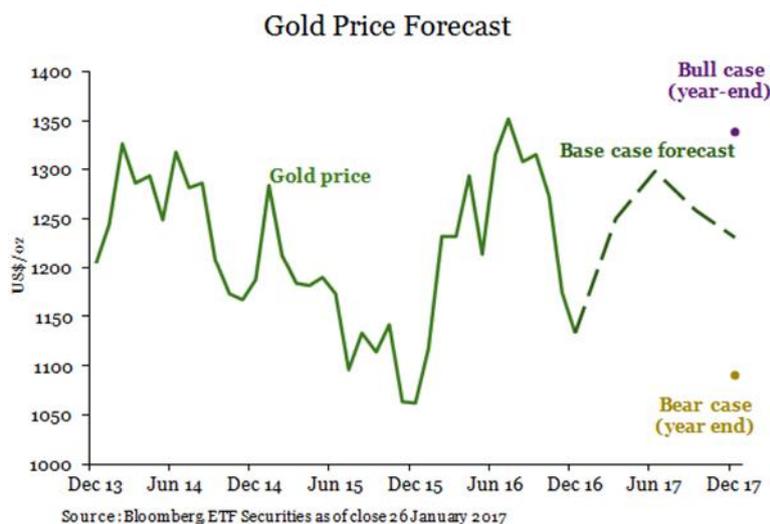
Gold Outlook 2017: Further upside likely

Summary

-) While the US Federal Reserve (Fed) is highly likely to increase rates this year, inflation will remain stubbornly high, maintaining a low real rate environment. Gold prices could rise 8% in the first half of the year, aided by a weaker US Dollar (USD). However, USD strengthening in the second half of the year and subdued enthusiasm for the metal in the futures market could drive a sell-off, with gold ending the year at US\$1230/oz, just 2.5% higher than today.
-) In a bullish scenario for gold, the Fed will be slow to act and inflation will be markedly above market expectations, while the USD weakens. Gold would end the year at US\$1380/oz (15%).
-) In a bearish scenario for gold, the Fed will move more aggressively, seeing the USD appreciate and burst the bond market bubble. Gold would end the year at US\$1095/oz (-9%).

2017 gold price

Gold has had a strong start to the year with the metal having risen 3.6% so far. We expect gold to end the year at US\$1230/oz, up from US\$1185/oz (2.5%). However, gold could peak at a higher level, at around US\$1300/oz mid-year (+8%).



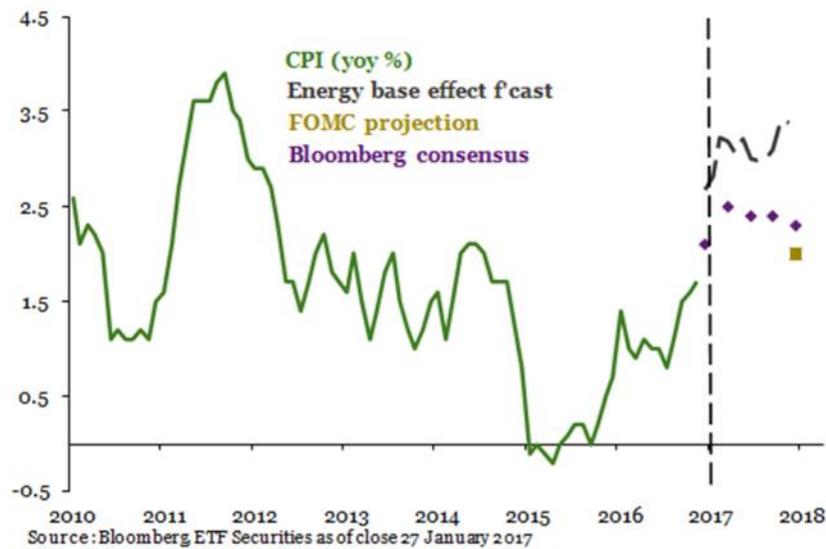
Inflation to surprise on the upside

US inflation is rising rapidly. Higher energy prices today compared with a year ago will likely see inflation rise substantially above the Federal Reserve's target of 2%. Aside from the volatile energy component, core prices are likely to rise as the US labour market shows signs of tightness. The unemployment rate at 4.7% is close to the 'natural rate', indicating that any further improvement is likely to be highly inflationary. We believe that headline inflation will reach 2.9% in the first half of the year as a result of higher energy prices compared to a year ago, but even as the base effect fades, inflation will remain elevated at 2.7% in the second half of the year. Inflation will rise despite the Fed delivering on all three rate hikes implied in its 'dot plots'. We believe inflation will be substantially higher than the Fed's projection of 1.9% and the consensus view of 2.5%.

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CPI to rebound in 2017



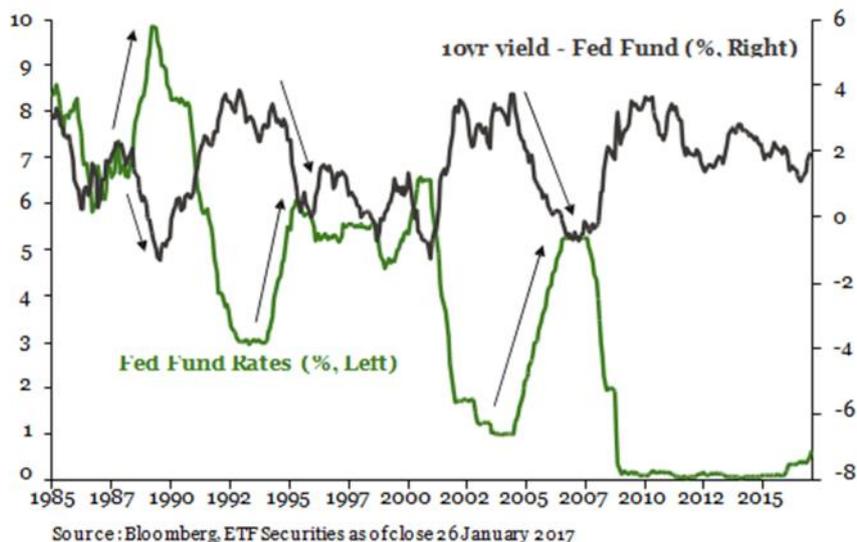
Dollar appreciation to follow depreciation

We expect the USD to depreciate in the near-term after the currency has risen too far, too fast. The risk of the Fed's actions not living up to its rhetoric is likely to place downward pressure on the currency. USD could fall as much as 2% from today's levels in the first half of the year. As the Fed comes to terms with having to be more active with monetary policy in mid-2017, we feel that the USD could stage a rebound. The USD is likely to end the year 3% higher than today.

Nominal bond yields rise

Nominal bond yields are expected to rise as the Fed raises policy interest rates. We expect the Fed to deliver all three of the rate hikes indicated in its 'dot plot'. Although policy rates will increase by 0.75%, we believe that nominal US 10-year bond yields will increase by 0.5% by year-end (from 2.5% to 3.0%) as we typically see the yield curve flatten in rate rising environments.

Yield curve flattens as rates increase

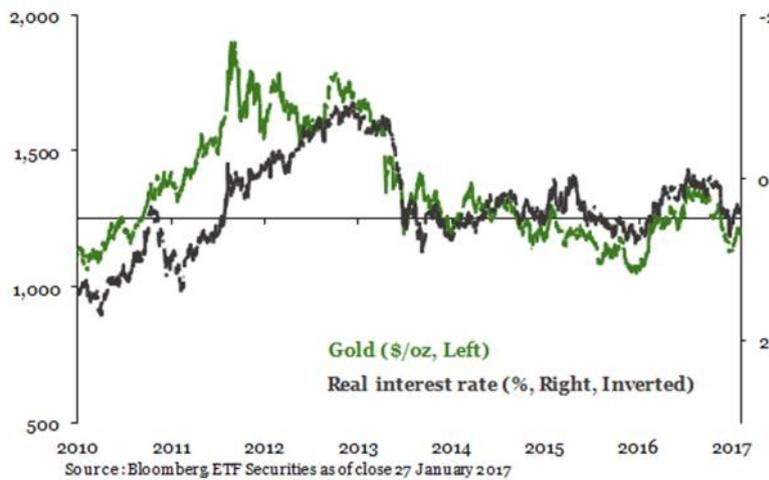


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With inflation remaining elevated, despite the increase in nominal yields, real yields will be low and could even decline from just under 0.5% currently. Given gold's historic negative relationship with real rates, a rising nominal rate environment is still consistent with rising gold prices.

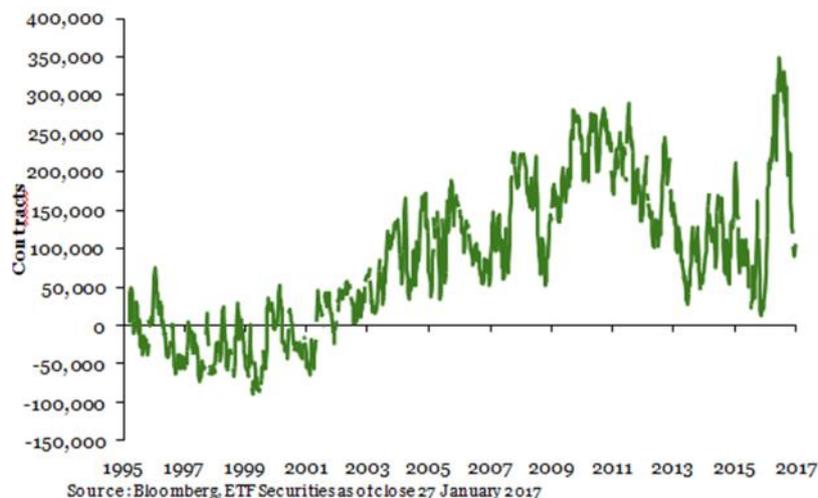
Gold vs. US Real Interest Rate



Positioning less sensitive to shocks

Market sentiment toward gold has become subdued. Speculative positioning in gold futures has fallen drastically from last year. In July 2016 speculative positioning in gold futures reached an all-time high of 347,445 net long contracts as the shock result of Brexit led market participants toward the safe haven asset. But other shocks failed to muster as much enthusiasm for the metal. The surprise win for President Trump or the rejection of constitutional reform in Italy for example had little lasting support for the metal in terms of price or positioning. Speculative positioning fell below 100,000 contracts by the end of the year. It appears that the market has become desensitised by shock events. We think there could be a small uptick in positioning due to the French, Dutch and German elections this year, but not to the levels we saw last year. There is also the risk that market uncertainty around Trump's policies drives more investment in gold futures. We expect positioning to rise to 120,000 (which is markedly lower than the average of 220,000 last year).

Gold Futures Speculative Positioning



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Bull case

In a scenario where the Fed only increases rates twice this year while inflation rises to 3.2%, the USD could lose further ground, depreciating by 1%. More marked curve flattening could see nominal rates only rise to 2.7%. If markets become more responsive to shocks, speculative positions could move higher to 200,000 (close to the average positioning for last year). Under this scenario gold could rise to US\$1380/oz by year end.

Bear case

In a scenario where the Fed tries to get ahead of the curve and reduce the risk of higher inflation becoming entrenched into expectations, the central bank could raise rates four times this year. Most of the impact on inflation will only be felt in 2018, with inflation at the end of 2017 still around 2.4%. However, the USD may appreciate 5% while bond yields rise to 3.3%, a scenario consistent with the end of the bond market bubble. With markets more focused on a tightening monetary environment rather than political stress points, speculative positioning in gold could fall to 40,000 (significantly below the long term average of 88,000 net long contracts). Our model indicates that gold would fall to US\$1095/oz in such a scenario by year end.

Source Document prepared by ETF Securities Limited

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