CPM Group

Market Commentary

No. 2 20 June 2016

Brexit and Gold

The gold market has been heavily influenced over the past several weeks by broader financial market uncertainty and concerns over the British referendum this Thursday, 23 June, as to whether the United Kingdom should remain in the European Union or leave.

On the surface the choice initially seemed obvious, with the potential economic damage of a British decision to exit the EU (Brexit) to the United Kingdom and many of its citizens so great that it seemed highly unlikely U.K. voters would vote to risk such financial losses. As time progressed, however, the prospects of a "Leave" vote rose above the "Remain" votes in polls since the beginning of June. That said, the most recent polls show a decline in the vote to Leave, with momentum growing for the "Remain" camp.

It is the ongoing uncertainty in the market that is beneficial to the price of gold. This uncertainty has helped propel gold from $1,205 on 1 June to $1,311 on 16 June. On Monday, as this is being released, gold had traded down to $1,277 in European trading and was then holding initially above $1,280 in New York. Prices may trade down to $1,260 and back up toward or above $1,300 in advance of Thursday's vote. After that prices are expected to drop back toward $1,200, and possibly lower, during the rest of June, July, and August.

Before focusing on gold, CPM will say that a decision to leave the EU would be bad for the British economy and people, but largely a wash for the global economy. The effects would be slow to emerge, for one thing. Any move to leave based on such a vote would take a minimum of two years, during which time the EU aristocracy might well wake up to the modern political trend toward devolution of power, so clear since over the past quarter century around the world.

On a global basis the real consequences primarily would reflect a shift of economic, financial, and political power away from the United Kingdom, with continental Europe and the United States being the primary benefactors, but other countries including China set to gain at England's expense. The bigger risk, to which EU members have only seemed to awaken in the past two or three weeks, is that a British move to leave the moribund and bureaucratically unworkable EU would be the trigger for a broader move for other member states to exit.

Turning to the important stuff, gold: CPM Group's view has been and continues to be that gold has risen back up from its early June low on Brexit uncertainty. The FOMC admission last Wednesday, 15 June, of the ill-advised nature of any interest rate hike in June or probably also July certainly helped push gold higher, but the key factor over the past three weeks seems to have been Brexit uncertainty.

CPM expects gold prices to come off after the British referendum Thursday, regardless of the outcome. It might come off more on a Remain vote and less on an Exit vote, but we expect it will come off sharply. There are numerous reasons to expect gold prices to fall back after this week. One of the first triggers could be a robust U.S. employment report for June and a possible upward revision to the dismal May employment figures. A stronger June employment report or revisions to the May numbers is not likely to prompt a rate hike by the Fed in July, but the market's obsession with the U.S. employment figure as the key indicator of Fed action is likely to negatively affect the gold price. Additionally, the summer months are a seasonally weak period of demand from both fabricators as well as investors. Demand from India is expected to continue to be particularly soft, with the rupee weakening, gold price rising, scrap supply increasing, and an almost complete absence of wedding days until November.

CPM's view remains that after a period of weaker prices from late June into August or September gold investment demand and prices will revive. The U.S. political process

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almost assures that. Financial markets continue to be overly concerned about prospects of a recession in the United States and other regions, which also should be reflected in continued demand for gold coins and investment products. While monetary policies are not particularly harrowing at this time, there are enormous structural imbalances that are yet to be addressed in an informed fashion, and, as alluded to above, the degree to which the monetary authorities in the United States appear determined to ignore the obvious policy requirements should indeed strike dread into the hearts of all observers. The scope for monetary policy errors seems greater today than it has been since the 1970s, while fiscal policies in the United States and Europe remain hopelessly unfocused on reality.

All of this suggests higher gold prices beyond the summer. **CPM's view is lower prices after Brexit, followed by higher prices after August or September.**

With this in mind CPM structured a couple of short term hedge and investment strategies designed to take advantage of the very great likelihood that prices could fall between Thursday and September. The investment positions and hedges were put in place with the expectation that they would be unwound at a profit within the next three months. While these are hedges for some companies, there is a bit of speculation or market timing involved.

One of the hedges we structured last Thursday ostensibly cost 10 cents an ounce to put in place but if prices dropped to $1,220 after Thursday the theoretical value would be $75.60 per ounce, all other things being equal. In reality, volatility would likely rise in a sell off, and the puts embedded in the trade might become even more valuable.

Given the nature of the trade, CPM's view is that such positions might be partially or completely unwound in a price sell off.

A couple of points need to be emphasized about these trades.

First, these are short-term trades. CPM expects prices to come off after the referendum for a variety of reasons. We expect prices to be weak from then into August or September. This is a trade designed to take advantage of a drop back to $1,220, $1,200, or even $1,180 or lower. Let us be clear here: Gold traded at $1,240 on 7 June, $1,220 on 3 June, and $1,205 on 1 June. The idea of prices falling that low is not an outrageous call for an out-sized move to levels not seen all within the current month.

On the other side, with the exception of last Thursday gold has not traded above $1,310 since August 2014, and it has not traded above that price for any significant amount of time since September 2013. **The probability tables are with this trade.**

Second, CPM expects prices will recover and rise later in the year – back to around $1,300 - $1,320 by the end of the year.

CPM does not know of any mainstream gold market participant looking for sharply higher prices over the next three months. There are, of course, the perma-bulls who always are expecting higher prices. For entertainment value, go back and see what they were predicting for gold when gold prices rose to $1,306 in early May. One of the more prominent of them posted an article calling the move above $1,300 the beginning of a run to $10,000 on 2 May.