

EUR/USD, Oil and Inflation - Gold at \$1000/oz Again?

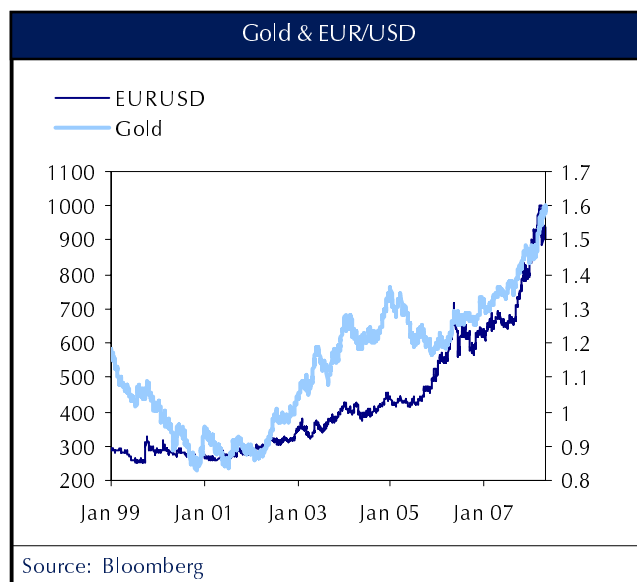
This week, currency markets saw significant volatility with the EUR/USD reaching a new high of 1.6018 on 22 Apr. While we see the strength in the EUR against the USD as being attributable to the dichotomy between the monetary policy trajectories of the US and the Eurozone central banks, we think some part of EUR strength is a result of higher crude oil prices which in turn have driven the concomitant rise in gold prices.

The rise in crude oil prices to a high of \$118/bbl has been a factor pushing the EUR/USD higher. The increase in the nominal price of oil as oil producers try to maintain their export balances, has been one of the main drivers behind higher Eurozone inflation figures (besides food prices) which has thus far stayed the ECB's hand from cutting rates despite increasing signs of a weakening Eurozone economy. This continuous cycle has supported the EUR/USD higher.

The link between gold and EUR/USD is less direct. Gold, unlike other commodities, trades more like a financial asset. Besides demand for its use as a metal and portfolio diversification; gold acts as both an inflation hedge and a safe haven asset in recessions. These other factors have been largely gold positive since 2003. Increasing signs of a weak US economy continues to drive US interest rate expectations and the USD lower, contributing to the demand for gold as a safe haven. The specter of inflation driven by the rise in crude oil and food prices in turn has supported the demand for gold as a hedge against inflation. In turn, gold prices have risen in nominal terms as the USD has declined in value, rising some 270% over the past 7yrs from its low of just 225.50.

Overnight, the EUR/USD fell to a low of 1.5638 before the pair settled at 1.5683, down from the record high of 1.6018 on 22 Apr, on worries about contagion from the US led-slowdown to the Eurozone. Correspondingly, gold slipped 2% overnight to end at a 3wk low below the support level of \$900/oz on the back of a broadly stronger USD and better than expected US economic reports. Comex June gold traded between \$885.3-907.5/oz and settled \$19.60 lower at \$889.40/oz. Failure of the EUR/USD to sustain highs above the 1.60 levels suggest that in the near term further upside to the pair is likely to be limited. However, we think it is too early to suggest a conclusive end to USD weakness given that the US housing market weakness has yet to see a bottom.

We continue to see US interest rate and exchange rate trends as still supportive in the medium term and see gold price as likely to benefit from real interest rates moving lower. We see gold as taking its cue from USD movements in the short term and see the metal as fundamentally well supported by external drivers including inflationary pressures, concerns about a broader economic slowdown, geopolitical tensions and continued USD weakness on Fed rate cuts.



In light of heightened inflationary pressures which show no sign of abating in the short term and increasing signs of weakening in the Eurozone economy, we see the ECB as still likely to stay a steady hand and keep rates unchanged. As such we see risks of the EUR/USD testing the 1.60 levels again before pulling back later in the year. Given the recent correlation between gold and the currency pair, we see gold prices as likely to test the \$950/oz level before breaking through and potentially testing the \$1000/oz level in the medium term, just below its record high of \$1030/oz reached on 17 Mar should the EUR move decisively above the 1.60 levels.

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