Precious Metals Monthly: Palladium still hogging the limelight

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Summary:

GOLD finished the first quarter up a measly 1%, and finished - what could have been a very bullish month for prices - down 1.4%. We continue to believe that it wont take just 1 attempt to break the cyclical range earmarked by $1350; either side of $1300 is the safe zone for now, as it awaits for a $-negative catalyst to evolve. Our original overarching 2019 investment theme - being long volatility, short politics and short the $ (which is best expressed by being long Gold) - is changing. One needs to search for relatively under owned late cycle inflation hedges that can piggy-back recovering stock markets. Gold should do well under that thinking, but there are other higher-beta real assets—such as platinum, copper and silver—that have better upside potential, given this ultra accommodative pivot by global Central Banks.

SILVER posted another monthly loss in March (of almost 3%), as it struggled to find the sustained buying given persistently saturated supplies solidifying a firm technical ceiling at $16.20. We continue to believe the Gold/Silver ratio will remain lofty at 82-86 especially in periods of $ strength, given the lack of new industrial uses/technologies and the lack of an convincing investment story. Tactical opportunities exist but breakouts are limited, when Gold is <$1350 and the investment case for Silver as a undervalued inflation hedge, fails to gain traction, for now.

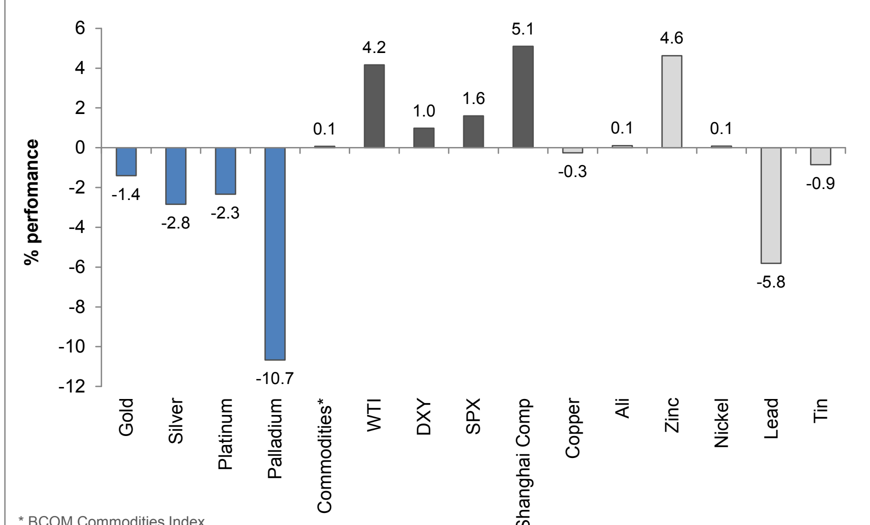
PLATINUMS raw S&Ds still remain out of favor—European manufacturing data has been soft, theres the overhang of Brexit, sluggish Chinese jewelry demand/SGE volumes, the threat of a US trade war on the auto sector, diesel demand share is falling, and South African producers are not voluntarily cutting supply given lofty by-byproduct prices. Tactically, however, the mere anticipation of auto switching and the risk of industrial action in SA, are potential triggers. The investor risk reward argument still favors platinum length, especially if the Gold view is favorable, given platinum's relative cheapness and its real asset characteristics in a stimulative macro environment in which investors are on the prowl for higher beta inflation hedges

PALLADIUMS fortunes reversed in jaw dropping fashion in March as it broke its 7 month winning streak to close the month down 11%. Structurally and fundamentally not much has changed, from a technology perspective for Palladium—its still on track to post growing deficits in 2019 as emission legislation in Europe and China brings demand forward (forecasted at double-digit growth in 2019). However, in the short-term, the market is simply not as tight as it was 3 months ago and flat prices will recalibrate lower to reflect this, which was a temporary and long overdue (albeit painful) repricing. If forward rates remain backwardated, but stabilized in a lower 0 to –10% range, as we believe, palladiums fair price range should be $1350-1450. However, theres likely to be increased volatility in flat prices for the remainder of 2019, as the rather contained uptrend channel was broken, participants scramble to test boundaries and liquidity (as has been the case) inexplicably comes and goes.

Contents:

Base metals to be published later this week

Metals performances vs the rest, March 2019



* BCOM Commodities Index

Source: Scotiabank Commodities Strategy

Gold: Gold finished the first quarter up a measly 1%, and finished—what could have been a very bullish month for prices - down 1.4%. We continue to believe that it wont take just 1 attempt to break the cyclical range earmarked by $1350; either side of $1300 is the safe zone for now, as it awaits for a $-negative catalyst to evolve.

Gold was a let down for many given the events in March—there was a momentous shift in the Fed tone (their indifference about inflation and the thinking that they're likely to *cut* rates this year especially now that Stephen Moore is part of the conversation and the Mueller investigation is behind us). This Fed shift induced some seismic moves in US Treasuries, inverting the yield curve and bringing forward temporary "recession obsession" fears. The pool of negative yielding global securities surpassed $10tn again and TIPS broke out of a 3year trend reflecting the sea change in some thinking that the Fed wont be able to contain inflation given their easy money policy while the US economy grows, albeit less slowly. TIPS understood this inflation threat, Gold didn't. The disconnect between Gold and the large fall in both real and nominal US rates is due to a few spoilers:

1. the $ simply continues to internalize everyone else's domestic problems (eg: Brexit, China & European growth fears) instead of its own, remaining cyclically strong

2. A dovish Fed has less of a bearish impact on the $, than originally thought, as they are still *relatively hawkish* vs the ROW given the propensity for other CBs to fold dovish on weaker data, as well

3. There's a lack of sustained US equity volatility and macro fear, as risk appetite recovers well after a tumultuous Q4'18. This is driven by the Feds dovish pivot helping to ease recession fears, leading a collective vol suppressive regime to tame financial, macro & geopolitical uncertainty which was largely expected for 2019

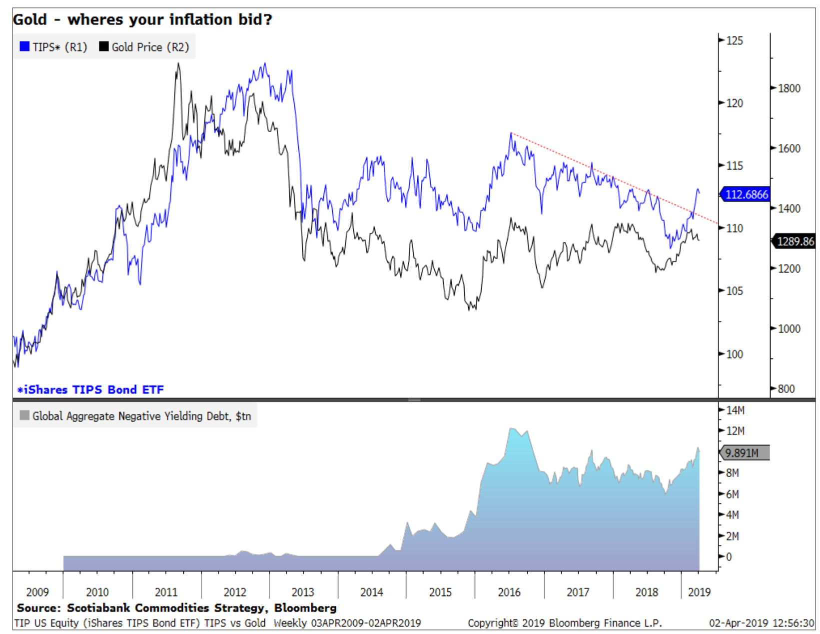
US equities (SPX) have returned back to October 2018 levels, when Gold was sub $1200, so this ~$100 premium reflects some structural inflows from both ETFs and Central Banks, which are capitalizing on a mix of positive simmering drivers (as highlighted in table 1):

- In the first 2 months of 2019, the largest most active 3 CBs (Kazakhstan, Russia & China) accumulated 27% (13 tonnes) more gold than they did during the same period in 2018. Global CBs currently hold <62% of their allocated reserves in the $, a 3rd quarterly decline and the lowest level since 2013 (according IMF data in March) highlighting the de-dollarization theme many (EM) CBs are accelerating toward; a constructive bullet point for Gold on dips below $1300

- Gold ETFs accumulated 800K oz in March 2019, bringing changes in total holdings for 2019 into positive territory. The resilience in ETF flows amidst rising global equity pricing is encouraging given the recent historical correlation between risk asset (outflows) and safe haven (inflows)

Our original overarching 2019 investment theme—being long volatility, short politics and short the $ (which is best expressed by being long Gold) - is changing. One needs to search for relatively under owned late cycle *inflation* hedges that can piggy-back recovering stock markets. Gold should do well under that thinking, but there are other higher-beta real assets—such as platinum, copper and silver—that have better upside potential, given this ultra accommodative pivot by global Central Banks.

Tailwinds	Headwinds
A late cycle Fed pause, rate cut increasingly likely soon, Inflationary fears	A stubbornly perky US$
Higher pace of Central Bank gold buying, diversifying against fiat currencies, the US$ & an imminent recession	Lack of macro fear; the inbred resilience of US equities and other higher yielding Gold 'detractors'
Expanding pool of negative yielding debt securities; overall structurally lower global bond yields	Lack of momentum, technical follow-through & severe failures leading to investor apprehension
Growing talk around MMT (Modern Monetary Theory), and other alternative Fed tools	Muted physical support from India & China as prices in local terms defer purchases
Unsustainable US debt/fiscal path	
A pickup in socialist rhetoric & polarizing politics	
Gold Producer consolidation / M&A	



Silver:

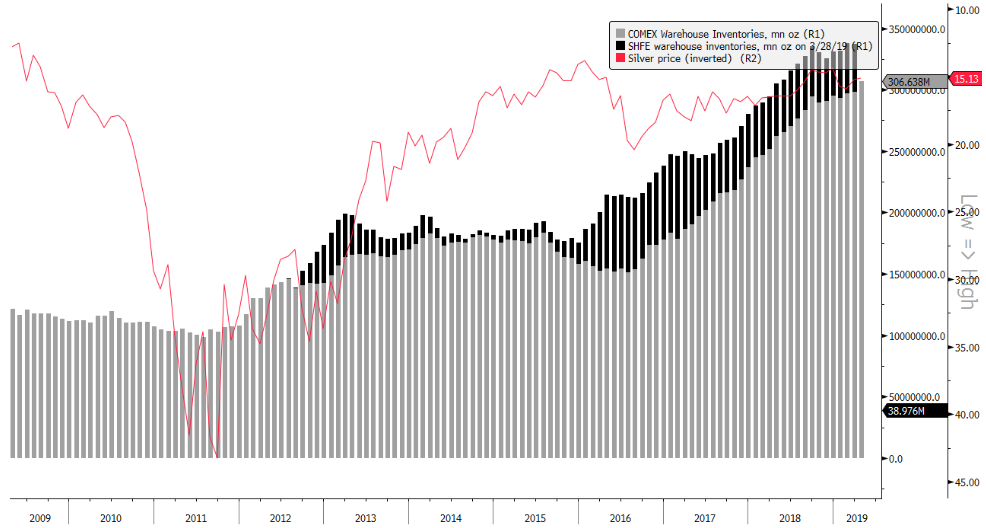
Silver posted another monthly loss in March (of almost 3%), as it struggled to find the typical momentum investor buying given persistently saturated supplies solidifying a firm technical ceiling at $16.20.

Visible exchange inventories (COMEX & SHFE) increased further in March highlighting the lack of new industrial uses/technologies and the lack of an convincing investment story or driver. ETF inflows remained largely muted and COT investors liquidated almost 200mn oz in the 1st half of March. Silver prices, being relatively subdued both on an historical basis and vs Gold, aren't at attractive hedging levels for producers to lock in forward sales. However, the large contango forward curve and Silvers by-product nature creates a structural headwind going forward as both producers capitalize on this curve for appropriate financing purposes and fundamental investors remain sidelined.

The Gold/Silver ratio remains very elevated near the top end at around 86, and Silver is unable to capitalize on other positive tailwinds such as the base (Copper) repricing in Q1'19. However, behind this lackluster price performance and outlook, there is a bright spot for Silver industrial demand stemming from the global photovoltaics markets*. The PV industry topped expectations in 2018 with newly installed capacity reaching a new high of ~100GW largely due to the fall in module prices. This strong growth in new PV capacity should continue the next few years as countries commit to renewable energy targets. However, part of this growth will be offset by the underlying commitment to thrift Silver out in order to cut costs. Overall, the longer Silver remains near its cyclical floor around $15, AND the longer price volatility is contained, the better chance it has of attracting and inducing new technologies and end-use demand.

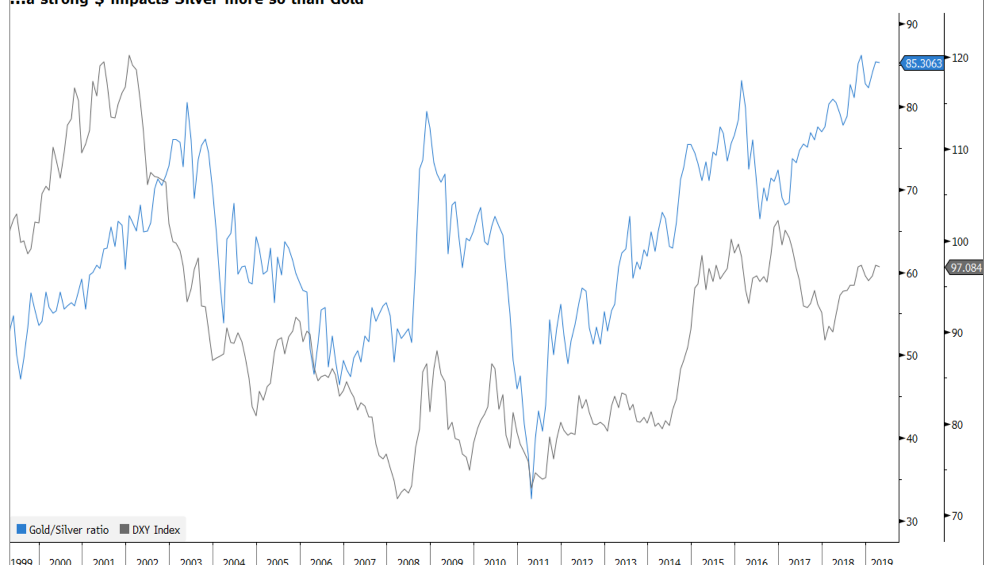
We continue to believe the Gold/Silver ratio will remain lofty at 82-86 especially in periods of $ strength. Tactical opportunities exist but breakouts are limited, when Gold is <$1350 and the investment case for Silver as a undervalued inflation hedge, fails to gain traction, for now.

Exchange Silver inventories
..at record highs



Source: Scotiabank Commodities Strategy, Bloomberg
COMXSILV Index (Comex Silver Inventory Data) comex shfe stilv stocks Monthly 31 Copyright© 2019 Bloomberg Finance L.P. 03-Apr-2019 14:30:16

DXY vs Gold/Silver ratio
...a strong $ impacts Silver more so than Gold



Source: Source:Bloomberg, Scotiabank Commodities Strategy
.GCSI U Index (gold silver ratio) DXY gc/SI & Fed stim Monthly 03APR1999-03APR2 Copyright© 2019 Bloomberg Finance L.P. 03-Apr-2019 14:26:27

*Please see Metals Focus Issue 297 weekly report that provides
A comprehensive analysis of this topic in depth.

Platinum:

Platinum's 2nd attempt to break $880 was short-lived as its supply-side risk premium was unwound in mid March (AMCus attempt to broaden its strike to Platinum producers was thwarted by the Labour Court in), and the month-end slaughter in palladium prices provided no window for Platinum (or any PGM) to outperform. However, its monthly losses of 2.3% were mild in comparison to Palladiums (-11%) and prices have steadied within the $830 (50DMA) and $880 range, averaging around a $450 discount to Gold prices, a decent improvement from its steep discount seen in February.

The market continues to deliberate whether substitution is occurring especially given the outsized moves in Palladium and Rhodium. Palladium has already clawed back a 1/3rd of the original high-low fall seen during week of March 25-29th, while Platinum fails to remain in the upper $800s. In addition, theres been (some unexplained) monstrous Platinum ETF inflows of +660K oz YTD, which hasn't coincided with sustained and substantial price appreciation (as one would expect) hinting that perhaps 'unwanted' above ground stocks (recall, platinum has recorded 8 surplus years the past 10years) is being warehoused in ETFs. These are some clear price and market signals highlighting that substitution was not the core driver behind palladiums large repricing; substitution is probably occurring incrementally (arguably platinum would be sub $800 if it wasn't) which was well emphasized by Anglo Americas recent comments "as new models get developed in the auto industry, adjustments will take place and maybe there will be some substitution there… the cost of changing is probably not worth the change. But over time it will change and platinum will come roaring back." There is incremental substitution occurring perhaps in the US auto market, but substitution is less likely in the Platinum-intensive European market (as they contend with RDE testing and meeting tighter emission standards), nor so in China (as they prepare for the rollout of China 6a/b regulations).

Platinums raw S&Ds still remain out of favor—European manufacturing data has been soft, theres the overhang of Brexit, sluggish Chinese jewelry demand/SGE volumes, the threat of a US trade war on the auto sector, diesel demand share is falling, and South African producers are not voluntarily cutting supply given lofty by-byproduct prices. Tactically, however the mere anticipation of auto switching and the risk of industrial action in SA (as wage talks get under way which could be complicated by either general elections and the takeover of Lonmin by Sibanye), are potential triggers. The investor risk reward argument still favors platinum length, especially if the Gold view is favorable, given platinum's relative cheapness and its real asset characteristics in a stimulative macro environment in which investors are on the prowl for higher beta inflation hedges; its only a matter of time before $880 becomes the new floor.

Platinum vs Palladium

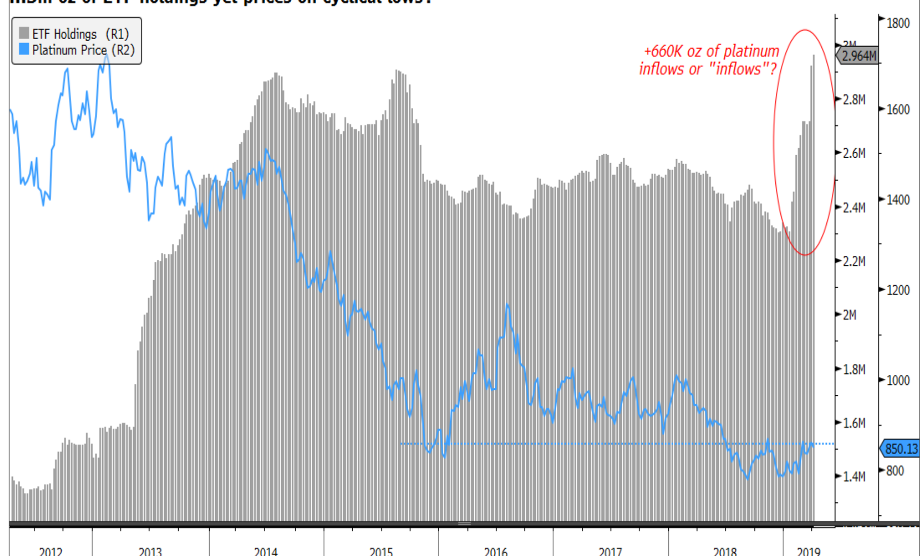
...peak disconnects

Source: Bloomberg, Scotiabank Commodities Strategy

PLAT Comdty (PLATINUM SPOT $/OZ) plpa spread Weekly 06OCT1999-02APR2019 Copyright© 2019 Bloomberg Finance L.P. 02-Apr-2019 14:40:34

Platinum ETF flows

...3m oz of ETF holdings yet prices on cyclical lows?



Source: Bloomberg, Scotiabank Commodities Strategy

ETFPPLTO Index (Platinum Holdings All Known ETFs) PL ETF COTR + Total2 Weekly 1 Copyright© 2019 Bloomberg Finance L.P. 02-Apr-2019 14:38:20

Palladium:

Palladiums fortunes reversed in jaw dropping fashion in March as it broke its 7 month winning streak to close the month down 11%. The sheer pace of the collapse—down $240 in 3 days, taking cash prices to $1350 was spectacular but not surprising; given the parabolic surge the past few months, the market never doubted that prices could just as easily reprice in dramatic fashion in a day on little news or updates.

Many have pinned the Palladium move on the exodus of investors or paper speculators, which could've contributed but were not a major driver (see box 1). The end of March selling, oddly, did not coincide with an unwind in general financial risk (ShComp & SPX remain buoyed) or substantial ZAR weakness, implying that macro dynamics (and subsequent generalist flows) were not the root cause. Instead, the loosening up in forwards the past 2 months (as buying and leasing behaviors changed) seemed to finally be taking a bite out of lofty flat prices (graph 1). That indicates that the general supply chain is finally responding to the backwardation with more output from primary and secondary producers; Q4'18 WIP at producers perhaps returned to market just as US scrap/refineries ramped up to cope and capitalize on backwardation and prices. In addition to this un-bottling in structural tightness, some short-term bearish tailwinds stemmed from quarter-end/yearend lack of liquidity, some bad technical breaks, the reversal of Rhodium pricing (the real auto demand proxy), the potential threat (or fear) of unknown stock-piles being released into the market and "bubble" labeling (arguably taken out of context) from the CEO of the largest PGM producer.

Structurally and fundamentally not much has changed, from a technology perspective (that we are aware of), for Palladium—its still on track to post growing deficits in 2019 as emission legislation in Europe and China brings demand forward (forecasted at double-digit growth in 2019). However, in the short-term, the market is simply not as tight as it was 3months ago and flat prices will recalibrate lower to reflect this, which was a temporary and long overdue (albeit painful) repricing. If forward rates remain backwardated, but stabilized in a lower 0 to –10% range, as we believe, palladiums fair price range should be $1350-1450. However, theres likely to be increased volatility in flat prices for the remainder of 2019, as the rather contained uptrend channel was broken, participants scramble to test boundaries and liquidity (as has been the case) inexplicably comes and goes.

Box 1: Paper investors own 1.3m oz, a decent amount but only half of what they owned at the peak (2.6m oz in 2017 and 2013-2015 era). The below quickly analyzes the positioning changes (aggregate Open Interest) vs historically large 5day moves to inform just how much of a role paper investors played…

This recent $200+ 5-day move saw ~390K oz of positioning (OI) outflows. Other large 5-day repricing:

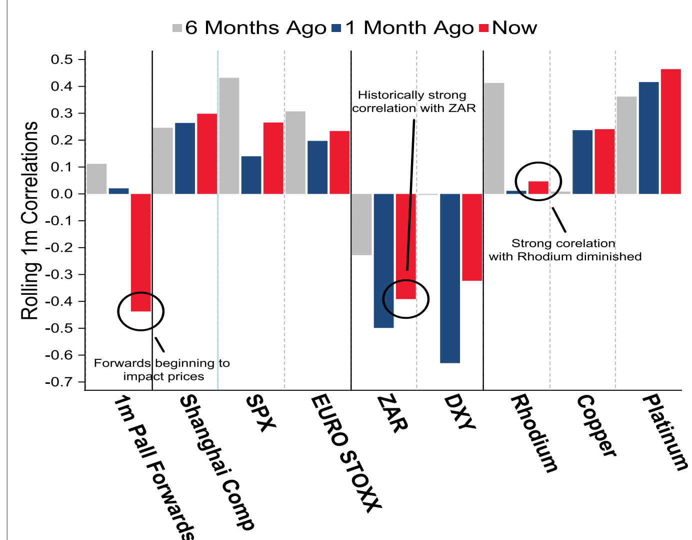
1. May 2010 ~$150 5-day fall with 390K oz of OI outflows
2. Nov 2010 ~$100 fall with 330K oz of outflows
3. June 2011 ~$100 fall with >400K oz of outflows

This $ repricing was around *double* the historically large moves, but the size of the similar positioning exit was similar.. IE: **IF there was *major* liquidation, positioning outflows should've and would've been much larger.**

Palladium
Drawdowns in known (ETF) inventories & backwardation, alleviates in 2019

Source: Bloomberg, Engelhard Corporation, Scotiabank Commodities Strategy
ETFPPDTO Index (Palladium Holdings All Known ETFs) Pall lease ETF vs Px Weekly   Copyright© 2019 Bloomberg Finance L.P.   03-Apr-2019 14:40:16

What's driving Palladium?
Correlation changes



Source: Macrobond, Scotiabank Commodities Strategy

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