Platinum – Identity Crisis

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- it has continued to trade at a discount to gold
- the metal’s premium to palladium has narrowed
- in USD the price has underperformed all of the other precious metals by a large margin, continuing the pattern of the past 3 years.

The metal appears to be suffering a crisis of identity:

- investors buy gold to preserve wealth;
- they buy silver as a leveraged, lower cost version of gold;
- they buy palladium as the Chinese auto industry continues to expand at close to double-digit rates.

Why should they buy platinum?

And if there are good reasons to invest, does $925/oz represent ‘value’ for buy and hold investors?
Platinum – Identity Crisis

identity crisis
noun
“a period of uncertainty and confusion in which a person’s sense of identity becomes insecure, typically due to a change in their expected aims or role in society”

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There are several uncertainties to grapple with:

- Substitution (by palladium), diesel’s image problem, and concerns about the pace at which battery (not fuel cell) drive-train technology is developing have all undermined platinum’s environmental/“green” credentials
- The metal’s key jewellery market has been contracting for three years in a row
- The rand’s inverse correlation to USD metal prices has muted the anticipated reduction in primary supply from South Africa, and lower-cost supply from Canada and Zimbabwe has increased.
- Potential investors have to try to reconcile a wide spread of guesses about the global level of refined inventories and what PGM refiners Johnson Matthey PLC describe as “significant stock fluctuations”.

A week to forget

Whether you are considering fundamentals or price, this has been a particularly poor week for platinum. The metal has fallen to a 6-month low as gold has dropped and the market has had to digest one of the least optimistic market reports from Johnson Matthey that we can remember (“PGM Market Report November 2016”, available at http://www.platinum.matthey.com/).

Since the US election, platinum has suffered alongside gold as real rates have gone up and the dollar has strengthened. As a result, Comex futures open interest has dropped, and speculative longs have cut Tocom positions – stale length is exiting.

Comex futures open interest has fallen by circa 7,600 lots (380k oz) since the election (of which we estimate perhaps 30% represents speculative length being cut), while Tocom open interest across general public and overseas CTAs has dropped by a combined 17,000 lots (around 100 k oz).
In contrast, the volume of platinum held by the ETF Securities platinum ETF increased by circa 125k oz during late October and early November. However, given the opposing moves in price and futures positions it seems likely that build was due to arbitrage activity rather than new investment inflows.

Palladium’s outperformance has been striking, the Pt: Pd ratio lurching from 1.6: 1 to within a whisker of 1.3: 1 and the spread collapsing by $100 to $225/oz.

Parity is not guaranteed but it is no longer improbable

![Graph](source: Bloomberg)

That may in part be due to shorts in the DEC Nymex palladium contract covering, though positions have been moderate. More notable has been a sharp move to the left in palladium forwards, which would tend to indicate that one or more entities with physical positions have been caught short. Either way, it is clear that palladium demand is stronger relative to the availability of near-term metal than platinum demand. There has been no such tightness at the front end of the platinum curve, and the contango has been widening throughout the year.

Platinum futures: 1st-2nd contract spread – no tightness here...

![Graph](source:)

On the plus side, the sponge discount for platinum has at least evaporated, though that is more to do with the supply side rather than demand: South African producers have worked to reduce both refined and in-process inventory and autocatalyst scrap flows have not been as strong as expected.

Platinum also continues to suffer in comparison to gold. The white metal has spent almost the entire year trading at a discount to gold of between -$200 and -$300/oz.
Is the market wrong?

With the market apparently in agreement that platinum will continue to underperform both gold and palladium, can we find anything that would justify a non-consensus position? Is there anything fundamental for longer-term investors to get excited about that the market is overlooking?

Unfortunately the answer appears to be no (or at least, not yet), judging by Johnson Matthey’s reading of supply and demand trends. Their latest assessment paints a gloomy near-term picture:

**Autocatalyst**

- This year is likely to have been the peak year for platinum loadings in the Euro 6 round of emissions legislation
- Lower average loadings of PGM and increased palladium content of heavy duty diesel catalyst systems in Europe
- Falling heavy duty truck production in North America
- A steep fall in diesel car sales in India (the largest and until this year, the fastest-growing, emerging market for diesels) thanks to increased regulatory pressure
- European scrap returns are forecast to increase by 5% this year, even though a build in scrap autocatalyst inventories and a rise in average end-of-life vehicle age has deferred some secondary supply

**Jewellery – not much love**

More concerning is that this year will be the third successive annual decline in jewellery demand in China, leading JM to suggest “demand in the Chinese jewellery sector seems set on a downward trend”.

The PGM producers collectively spent $10s of millions on creating the Chinese jewellery market in the late 1990s and early 2000s via the Platinum Guild. Demand grew from almost nothing to almost 2 million oz/year (net) over a decade, largely thanks to marketing. Of course, that marketing was greatly assisted by the fact that it began just as platinum entered an almost decade long bull market – it is much easier to sell something as a luxury item + store of value when its price is appreciating year on year. Platinum also traded at widening premium to gold throughout the 1998-2007 decade. That relationship, however, has reversed markedly and it is not entirely coincidental that SGE platinum volumes have fallen.

Source: Bloomberg
This year JM estimates that Chinese jewellery demand (net of recycling) will be around 1.5m. oz, that's 25% lower than the peak. The market has lost 0.5m. oz of what was supposed to be price responsive demand. Platinum’s carefully crafted image as a distinctive, premium product is under threat in its largest jewellery market and with sales heavily dependent on the bridal sector, a structural fall in the marriage rate is not good news.

On the plus side, a section of the Indian jewellery market is apparently continuing to embrace platinum: JM predict 20% yoy growth in demand this year, despite the prolonged strike that disrupted the jewellery manufacturing sector. However, growth in India is occurring off a base that is an order of magnitude smaller than China and so in terms of ounces is not expected to be sufficient to prevent a further decline in gross jewellery demand in 2017.

**Industrial highlights**

Demand from other industrial sectors – notably glass fabrication and petrochemical catalysts – has been robust this year. That may persist into 2017 but much of that demand growth is cyclical and related to capital investment – two or three good years are typically followed by several leaner ones.

**Sustaining Japanese investment will require even lower prices**

Japanese investors have been strong buyers of small platinum bars over the past 18 months but they have been the exception. And even with that accumulation of metal – forecast to total 500k oz this year – plus what JM obliquely refers to as “reports of stock building in China” the price has not responded as ETFs have released metal back to the market.

We do not think that the current pace of Japanese investment demand is sustainable. There was a strong upturn in buying when the platinum price in yen first fell below ¥3,500 per gram in H2 2015, reaching 7-year lows. This year the price has been even weaker in Yen terms, three times falling below ¥3,200/g. Yet JM’s forecast for this year is 200k oz less than for last year; in order for Japanese demand to be sustained at that rate prices will likely have to fall even further.

**Prices below ¥3,500/g are becoming the norm**

![铂金价格走势](source:Bloomberg)

**Mine supply of little help**

We can always find tail risks to primary supply of platinum – regime change in Zimbabwe, for example – but those are neither predictable nor tradeable.
More predictable is the inverse correlation between USD commodity prices and the South African rand, which has supported revenues and offset much (though not all) of the cost inflation experienced by producers. That, combined with the political impediments to suspending high-cost production and new output from projects that were approved several years back, has resulted in a muted supply response to the drop in USD metal prices.

### Rand depreciation offsetting USD commodity price falls

![Graph showing Rand depreciation offsetting USD commodity price falls](source: Bloomberg, ICBC Standard Bank)

**Is platinum a value play? Not yet...**

So does $925/oz platinum represent ‘value’ for buy and hold investors? If their investment horizon extends to 2020 and beyond then in our view the answer is yes. Further tightening of emissions regulations for heavy-duty diesel vehicles in both China and India should result in several years of very strong growth in the use of the metal in emissions systems, which is unlikely to be matched by growth in either primary or secondary supply.

However, $925/oz is clearly not as good value as $850, which is where the metal was trading nine months ago. From a chart perspective it appears that there is a reasonable prospect of it heading back there before year-end, particularly if EUR breaks the 1.05 level.
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