Favourable fundamentals point to further upside for the palladium price

With the palladium price surpassing $1,900, and our 5-year PGM Forecast report due out next week, we take the opportunity to review our short-to-medium term projections for palladium. Overall, it is important to stress that palladium’s relentless price gains this year owe much to an increasingly tight physical market. Going forward, we expect this dynamic to remain in place for some time to come, which should justify further gains for the palladium price.

By contrast, fresh inflows from professional investors have if anything remained limited during 2019-to-date. On Nymex, for instance, palladium is the only precious metal that has seen a double-digit decline in futures trading volumes through to end-November. Over this period, net managed money longs held within the 1.0-1.4Moz range, far below their January 2018 all-time high (of 2.7Moz). As for ETPs, heavy outflows left holdings by August 80% at below their 2014 peak. Despite small inflows thereafter, the global total has remained near decade-lows.

This bias towards the physical market also helps to explain why palladium has decoupled from US equities in recent months (which historically has been positively correlated with the white metal). More important, as physical supplies have remained relatively tight, the scale of any price correction has become increasingly limited in recent months, while the duration of such price weakness has also proved to be shorter.
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Looking at palladium’s fundamentals in a little more detail, the tightness has been almost exclusively driven by autocatalyst demand, which accounts for over 80% of total palladium demand in 2019. There are several factors worth highlighting here. First, despite the widening price differential between platinum and palladium prices, we retain the view that technical constraints, limited budgets and uncertain cost benefits will all limit the extent of a meaningful shift from palladium to platinum in gasoline cars any time soon.

Second, despite a major fall in Chinese car sales this year, its potential negative impact on palladium autocatalyst demand has been more than offset by higher PGM loadings. In particular, palladium offtake was given a fresh boost following the decision by several provincial-level regions to adopt new emission standard from July 2019 onwards, ahead of the original July 2020 deadline. This buoyant demand is also evident in a pick-up in Hong Kong palladium imports from May onwards. Over January-October, total Hong Kong palladium imports grew by 24% y/y, with the annual total likely to hit a fresh all-time high. Looking ahead, as that emission standard is applied nationwide next year, this will continue to favour palladium demand. Outside China, a softer economic outlook has weighed on the automotive industry. Nevertheless, similar to China, tightening emission standards in several countries have also assisted palladium demand. In Europe, the metal has also benefited from gasoline’s rising market share in light duty vehicles.

Turning to palladium’s use in non-automotive applications, there are some areas that have already suffered thrifting and substitution losses, such as the electronics and dental sectors. Overall though, the impact on palladium’s supply/demand balance should be limited, given their relatively low share of total palladium demand. Meanwhile, technical constraints and requirements for high quality performance will also limit the extent to which substitution away from palladium can occur.

On the supply side, while growth is also expected, mainly due to higher recycling volumes, for the foreseeable future at least this will not keep pace of the gains on the demand side. Against this backdrop, a physical deficit is projected to persist in 2020, which will translate into a further drop in above-ground stocks over the next 12 months.

At first sight, with above-ground inventories estimated at just below 13Moz by end-2019 (equivalent to roughly 14 months of fabrication demand), physical supplies appear to be ample. However, we would caution that a good portion of this metal may not be readily available, as this includes palladium located in China or work-in-progress material held by end-users. As such, the palladium price may need to rise further in order to encourage liquidations from existing holders.
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Swiss gold watch sector remains healthy

The latest Swiss data shows that hallmarking of gold watches dropped by 11% y/y in November. For the first 11 months, total gold watches hallmarked were still up by 5% over 2018. As modest as this may appear, the ytd growth came from an elevated base, as the 2018 annual total jumped by 57% to its highest this decade. In fact, it is arguable that the luxury watch sector has managed to hold up well so far this year. (This also echoes the analysis from the last Weekly, in which we highlighted that the high-end jewellery sector seems to be unaffected by the global economic downturn.)

As illustrated below, the ytd growth in gold watches was largely down to a strong H1. That said, despite a major slowdown thereafter, the total has remained high by historical standards. More importantly, the weakness in H2.19 was to some extent also affected by a hefty fall in demand from Hong Kong (for a long period, the largest destination for Swiss watches) amid rising unrest there. Part of these losses, however, have been offset by a jump in direct exports to mainland China. In October, Swiss watch exports to the mainland surpassed Hong Kong for the first time since the Federation of the Swiss Watch Industry began keeping monthly records 30 years ago. Leaving aside gains from Hong Kong, watch sales in the mainland have also benefited from lower import duties as well as retail price cuts implemented by luxury brands as part of a global price harmonisation strategy which dates from 2018.

Excluding Greater China, the US recorded healthy growth, overtaking Hong Kong in recent months to become the top spot for Swiss watch exports (although it is still the second highest on a ytd basis). Elsewhere, shipments to East Asia also maintained modest gains. By contrast, demand in the EU has remained broadly steady, while shipments to the Middle East suffered a sizeable drop on the back of weak economic conditions and heightened geopolitical tensions.

Cumulative Swiss Gold Watch Hallmarking
PROUD MANUFACTURER OF THE LEXUS MELBOURNE CUP

GOLD, IT’S YOUR STANDARD.
Charts - Precious Metal Prices, US$/oz

Gold

Source: Bloomberg

Silver

Source: Bloomberg

Platinum

Source: Bloomberg

Palladium

Source: Bloomberg
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Charts - Ratios & Spreads

Gold:Silver Ratio

Gold:Oil (Brent) Ratio

Platinum-Gold Discount, US$/oz

Platinum-Palladium Discount, US$/oz

Source: Bloomberg

Source: Bloomberg
Charts - CME Futures Net Positions*

Gold

- Managed money positions; Source: Bloomberg

Silver

- Managed money positions; Source: Bloomberg

Platinum

- Managed money positions; Source: Bloomberg

Palladium

- Managed money positions; Source: Bloomberg
Charts - ETP Holdings

**Gold**
- Moz
- US$/oz
- Source: Bloomberg

**Silver**
- Moz
- US$/oz
- Source: Bloomberg

**Platinum**
- Moz
- US$/oz
- Source: Bloomberg

**Palladium**
- Moz
- US$/oz
- Source: Bloomberg
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