STGFM Insight

Precious Metals

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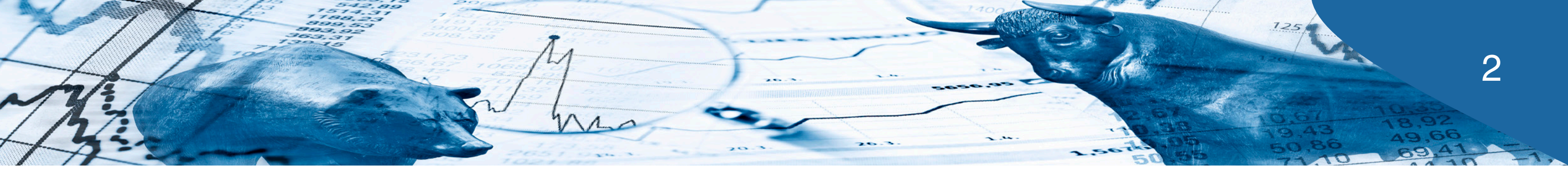


Precious metals had a weak start to the year

Financial markets quite often display strange sorts of movements that run counter to an observer's intuition. Some movements only in hindsight appear logical and consequential to the facts as they unravel, while others can be dismissed as counter-trend market moves, basically correcting the previous exuberance of some investors. We take the view that the latter is true for the precious metals market in the early months of 2021 – put differently, we may expect a significant price increase in many of the chemical elements treated in this STGFM insight.

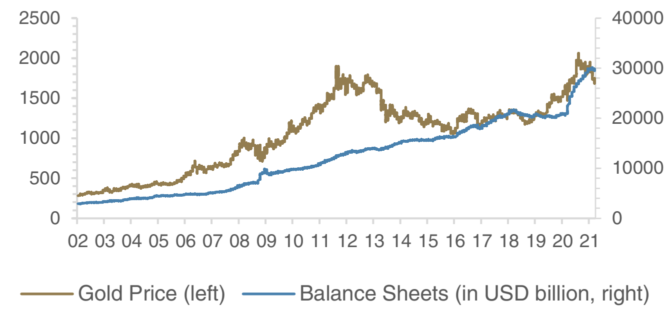
There are several different perspectives on an investment topic such as gold, silver, and the platinum-group metals (PGM). In the following, we aim to shed light on the supply/demand situation, but also other fundamental factors such as the outlook for real rates. Sentiment and positioning data, displaying the market segments' different views on the outlook for precious metals prices, are important factors to take into the analysis as well.

Very slow supply reaction

Starting with the fundamental outlook for gold, we first look at the general supply/demand situation. In 2020, global gold supply amounted to about 4'600 metric tons, of which roughly three quarters is primary production from mining activities, with the remaining quarter stemming from gold recycling. Although the gold price underwent significant price changes in the past 10 years, it is noteworthy that global supply has basically remained the same: total annual supply, that is production, recycling and producer net hedging (i.e. forward selling parts of the production to secure loans) stood between 4'300 and 4'900 tons between 2010 and 2020.

The mining industry is very capital intensive and slow in building up capacity. According to an industry insider, the permitting process of a new mine alone can take up to 5 years, that is, before any brick has been laid. Therefore, the mine supply reaction to any changes in price is very slow. The scrap supply, on the other hand rises quickly with significantly higher prices. The gold bull market from 2001 to 2011, during which the price of gold rose more than sevenfold to above 1900 USD per ounce, resulted in a rather meagre production increase: global gold production in 2000 was estimated to be about 2'500 tons, in 2010 it had risen to 2'800 tons. Only by 2017, the mark of 3'500 tons of annual gold production was exceeded, notably some 6 years after the all-time high of 1940 USD/oz. that had been recorded in September 2011.

GOLD PRICE AND MAJOR CENTRAL BANKS' COMBINED BALANCE SHEETS



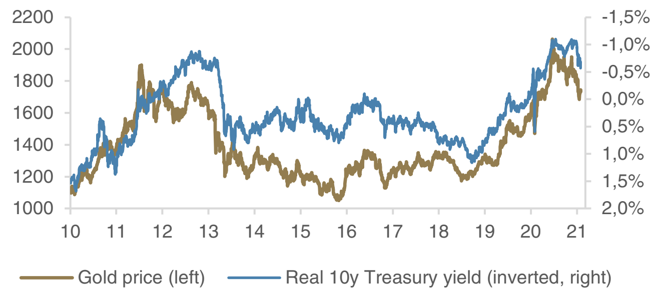
Source: Bloomberg

Four years after the top, in mid-2015, the gold price reached 1050 USD, some 45% below the previous all-time highs. This led to a significant cut in exploration budgets as well as maintenance capex being kept at a minimum, weighing on the medium-term outlook for gold production. However, thanks to productivity gains due to technological progress, the global gold mining industry is set to grow production volumes by up to 2.5% p.a. in this decade, according to some observers. The question remains whether this supply increase will meet demand.

Real interest rates as opportunity cost

Investment demand, be it via physical coins and bars, or via gold ETFs, will play a decisive role in the coming years. The current investment environment, driven by the financial repression on behalf of central banks which is signified by very low and even negative real interest rates (that is, adjusted for inflation), speaks in favor of gold. An important metric to assess the value of a chunk of metal that does not provide any cashflows are real interest rates, as they measure the (inflation-adjusted) opportunity cost of holding it. At negative real interest rates, positive nominal coupons (or dividends) are eaten up by inflation, leading to a loss in purchasing power for investors in interest-paying securities. Looking at the long-term negative relationship between gold and real interest rates, the connection is quite apparent:

GOLD PRICE AND REAL INTEREST RATES

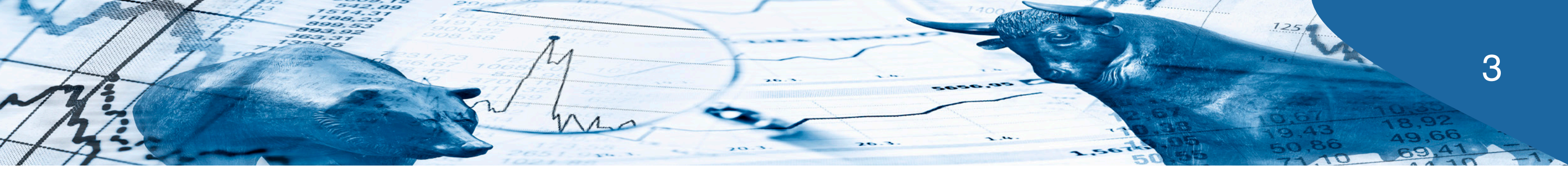


Source: Bloomberg

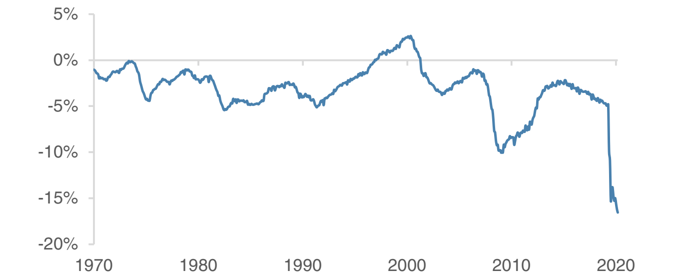
High real rates are negative for gold, whereas negative real rates tended to boost precious metals prices. During times of elevated inflation rates, such as in the 1970s, gold acted as a safe haven for investors trying to find a shelter from the erosion of purchasing power that affected nominal (paper) currencies.

Inflationary combination of fiscal and monetary stimulus

What is the outlook for real rates for the coming years? Put differently, as central banks globally have committed to "lower for longer", when it comes to yield levels, what is the medium-term outlook for inflation? We hold the distinct view that the chances of rising prices in the economy are higher than any time in the past 30 years, because so many different factors are all pointing in one direction. Often mentioned is the aggressive growth of central bank balance sheets, but the decisive point to us is the enormous stimulus on the fiscal side that is being distributed as well. The US government for instance sent out its stimulus payment checks in the past week amounting to up to 1400 USD per person – for an estimated total amount of about USD 400bn, forming part of the USD 1.9tn corona relief package that was just signed by US president Biden. The combination of unprecedented fiscal support with the already ultra-loose monetary policy will lead to a surge in demand that will have inflationary consequences.



US FEDERAL GOVERNMENT DEFICIT AS % OF GDP



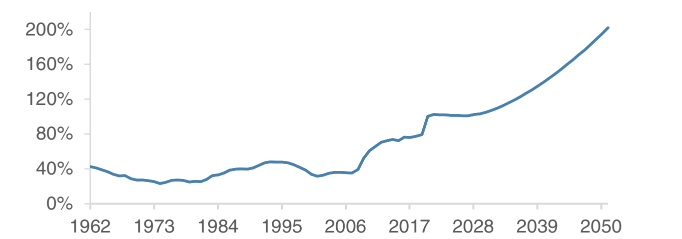
Source: Bloomberg

Another viewpoint supports our view that real interest rates will remain suppressed: the sheer amount of outstanding debt has risen by multiples, both in the private and public domain. In USD terms, US federal outstanding debt outstanding has risen about fivefold in the past 20 years, and this process is set to continue. According to the Congressional Budget Office, a bi-partisan group, the US fiscal deficit in 2021 will amount to more than 10% of gdp and will average 4.4% of gdp during this decade. In other words, outstanding government debt will continue to rise. Thanks to the low interest rates prevailing, the federal government spends only about 9% of its outlays on interest payments - with a weighted coupon of about 1.8%, that is. Should we see a return to historical averages in yields, the blow to government finances will be material. The CBO for instance estimates that by the year 2051, net interest payments by the government will make about 8% of gdp, eating up more than a quarter of all government expenditures.

Financial repression

Now, these are all nominal figures. The real figures are a function of future inflation rates, which we do not know at this point. Drawing parallels to the past, however, can offer perspectives: the US government's financial situation after World War II was similarly bleak as today. In effect, many economists view the latest global recession more similar to an exogeneous shock like a natural disaster or war, rather than a correction to previous excesses in boom times, as happens usually at the end of each business cycle. The timing of the recovery, for instance, is a good indicator, in that the economy is already snapping back from the precipitous fall in activity, due to the lockdowns in many countries. Back to the mid-1940s: confronted with heavy loads of indebtedness, governments chose to use a strategy called "financial repression": suppressing real rates of interest, that is keeping nominal interest rates very low while allowing inflation to be elevated (but not too high). In 1946, US federal debt stood at 118% of gdp, while 25 years later this figure had dropped to 34%. This not because of falling USD amounts (it only briefly fell from 1946 to 1951 by about 15% and reached the post-war 1946 level already in 1961), but the rise in nominal gdp, to which inflation contributed 3.2% p.a.

US FEDERAL DEBT RELATIVE TO GDP



Source: www.cbo.gov/publication756977#data

We are therefore convinced that the only avenue for governments is to repeat this approach of financial repression – cynical observers could add that they simply continue on what had started already after the Global Financial Crisis (2008/09). There are a number of signs that the trust in fiat currencies has started to erode. The rise in cryptocurrency market capitalization is among the most prominent today, as many digital assets offer strict supply volume limits, compared to ever growing fiat currency supply. Put bluntly: after 40 years of generally falling inflation, the stage is set for a secular turn.

Long-term structural developments such as inflation can easily be masked by short-term market volatility. The recent jump in real interest rates, from -1% to 0% within 10 weeks, has taken its toll on precious metals prices, dropping about 5% since year end, although with a high degree of dispersion (Platinum +12%, Gold -7%, Silver -25%).

Sentiment and positioning

Adding another perspective on the investment topic, the sentiment regarding precious metals investments (mainly gold & silver) has turned distinctly negative as a result of the recent price correction. While this excessive pessimism may extend for some more weeks, the chances are rising markedly that an intermediate bottom is being put in, opening the way towards new all-time highs. Presented in a different manner: if the negative view on the topic is prevailing, the conclusion is near that many market participants have positioned accordingly and hence no further selling, but rather a closing of short positions will happen next, leading prices to rise.

Another interesting angle on the investment topic of precious metals is the futures positioning data. There are two major groups active in the futures market, the commercials and the speculators or non-commercials. The latter players are the hedge funds, while the former consist of the miners which use the futures markets to sell forward parts of their production. As one may expect, the track record of the commercials is much better than that of the speculators, especially around extreme positioning readings. Also, quick positioning changes can hint at major market turns to take place soon. The past weeks' reduction in commercials' net (short) futures positioning by a third, for instance, to us is another strong argument that the time has come to add precious metals.

Silver and Platinum favored as well

So what about the other precious metals, like silver, platinum, and palladium, to name the most important ones? We like them for several reasons. Silver for instance, the "poor man's gold", in the past 20 years on average moved 40% more than gold, based on monthly data. What is more, silver has more industrial uses than its yellow sister, with about 50% of demand coming from the industrial sector plus 10% from the photovoltaic industry, with the remaining 40% falling into jewelry and investment demand. Silver's outstanding electric conductivity means that its use in the energy transition away from fossil fuels will continue to grow very healthily.

Another interesting fundamental situation can be spotted in platinum, of which about 80% are mined in South Africa. In terms of volumes, the global platinum production amounts to about 5% of global gold production. Therefore, any increase in attention from global investors could lead to a strong price surge. Also, when viewed against palladium, another PGM metal, the outlook for platinum remains favorable. In relative terms, platinum used to display significantly higher prices compared to palladium but is now trading at a discount of more than 50%.

We consider the discount to disappear in the years ahead, as the use of platinum e.g. in hydrogen-based fuel cells could well outstrip supply. One important price factor is the external value of the South African rand, as its rise would increase production costs measured in USD and hence lead to further price rises, according to the marginal cost of production argument.

PRICE OF PLATINUM VS PALLADIUM

Source: Bloomberg

Is the bottom in?

Short-term risks to the call exist. First and foremost, markets could continue to push central banks to offer even more monetary support. By continuously driving up real interest rates, they tighten financial conditions which at one point could spell trouble for the real economy. In the coming months, central banks will have to walk a tight rope, as any market disruption resulting from a stark increase in yields would put into danger the whole recovery. The growing divergence between forward market rates and Fed guidance will coerce the central bank to act, most likely in a first step via another "operation twist", and potentially by exerting "yield-curve control" (YCC) which means that yields will be capped at a certain level.

There are some voices calling for a significant equity market correction and corresponding bout in volatility, before the Fed takes the next step in unorthodox monetary policy, and hence suggest to wait with adding to precious metals positions until new central bank measures are announced. We take the view that the best approach to be taken is starting to buy already at today's levels, with the possibility to add if, in the short term, further weakness ensues. On a 12- to 18-month basis, we see significantly higher prices and, rather likely, again some extreme measures of optimism among investors, as opposed to today's pessimistic sentiment.

CONCLUSION

- The current pandemic environment has set the stage for unprecedented government stimulus on a fiscal level, while the monetary support on behalf of central banks continues to be with us for a long time – we fear that an inflationary period is upon us.
- While the purchasing power of fiat (paper) currencies dwindles, real assets such as commodities usually fared very well during times of elevated rates of inflation.
- We are bullish precious metals! Supply is constrained and the growth reaction tends to take several years. With investment demand set to grow in the face of rising inflation rates, this bodes well for significant price increases.
- Investor sentiment as well as futures positioning data hint at some form of capitulation by speculators and retail investors – the timing is right to add to positions!
- Both silver and platinum which both are used in electronics and electric systems offer a promising outlook, as the energy transformation will lead to a more intensive use and hence rising demand, further supporting prices.

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