

INTERNATIONAL Banker

AUTHORITATIVE ANALYSIS ON INTERNATIONAL BANKING

Palladium: the Year's Top Performer So Far

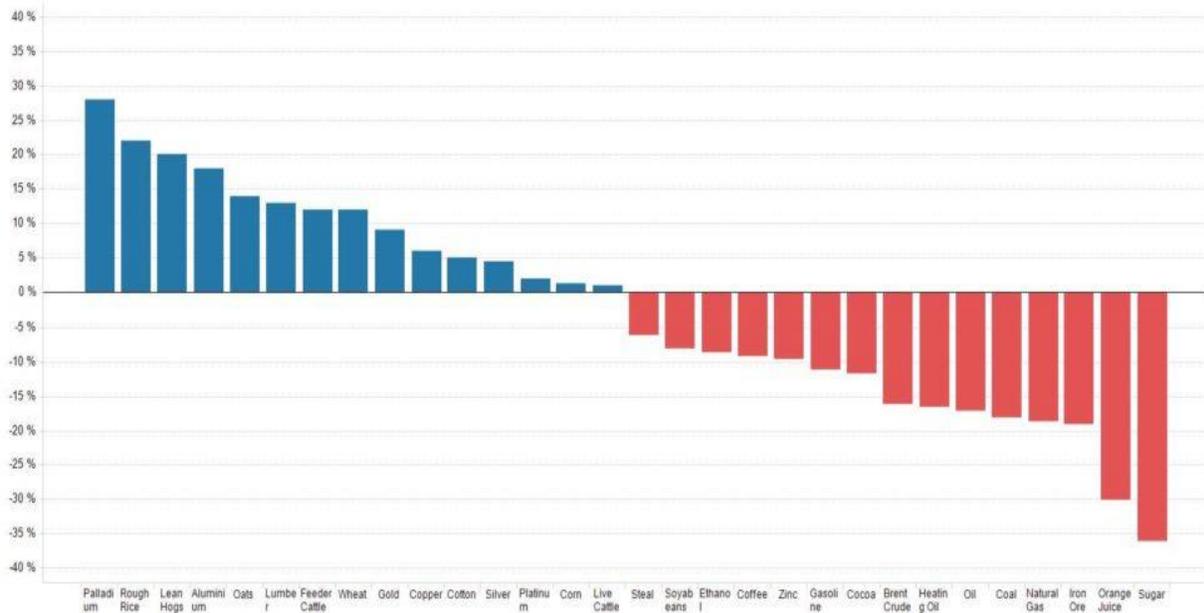
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By Elizabeth Frasier-Nelson, International Banker

The first half of the year saw a distinctly mixed performance being recorded within the commodities complex—a disappointing outcome when compared with the strong recoveries posted nearly across the board in 2016. This year, however, there was a roughly even split between winners and losers during the first six months. While sugar had a disastrous first half, to end up at the bottom of the table, the top was taken somewhat surprisingly by palladium:

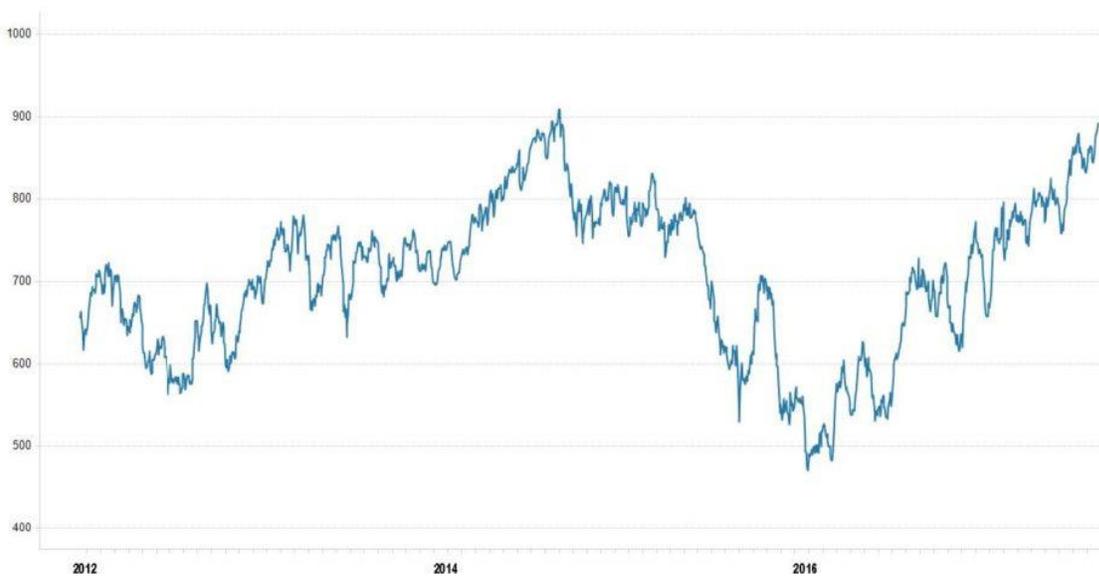
Performance of Major Commodity Front-Month Futures – YTD
(As of 6/28/2017)



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 Data provided from Optuma (www.Optuma.com)

Indeed, palladium has been rallying since 2016, with consistent price increases allowing the silvery-white metal to post 16-year highs in June:

Palladium



SOURCE: TRADINGECONOMICS.COM | OTC

Many analysts view palladium's strong showing as the result of a combination of factors, rather than any one single dominant issue. According to UBS analyst Joni Teves, "Perhaps there isn't one big explanation or a specific catalyst that has led to the recent market moves, but rather a confluence of factors that have actually been brewing (and market participants) have been discussing for a while."

Perhaps most decisive of all for palladium, however, has been the observable shift in consumer preferences within the automobile market. The metal's most common usage is in catalytic converters, which prevent the release of harmful emissions—about 80 percent of the metal's overall production is used by the automotive industry for this purpose. The increasing popularity of gasoline and hybrid vehicles—both of which use palladium-rich catalytic converters—and the marked decline in diesel vehicles, which tend to prefer *platinum* converters, go a long way towards explaining the greater interest in palladium at present, as well as perhaps why platinum has seen only modest gains so far this year.

Indeed, the first five months of the year saw diesel cars experience a decline in market share in Western Europe, falling from 50 to 46 percent, according to data from LMC Automotive. This shift has almost certainly been expedited by the "Dieselgate" scandal, in which German car company Volkswagen (VW) was found to be cheating in its emission tests by making its cars appear far less polluting than was truly the case. A total of 482,000 VW diesel cars on American roads were discovered by the US Environmental Protection Agency to have emitted up to 40 times more toxic fumes than was allowed, which resulted in the company having to admit that its cheating impacted 11 million cars globally. As such, car buyers who are now concerned about further legislation changes as a result of Dieselgate are increasingly rejecting platinum-rich diesel-powered vehicles in favour of palladium-rich gasoline ones.

As a group, precious metals are also considered to be "safe haven" investments—that is, during times of market uncertainty and/or turmoil, investors shift their holdings away from traditional asset classes, such as stocks and bonds, and into gold, silver and, to a lesser extent, platinum and palladium. Although the global economy continues to grow in 2017, markets particularly in the West continue to experience uncertainty, which may additionally explain some of the heightened demand boost for palladium this year. Geopolitical issues including Brexit, European elections and the Trump presidency have all contributed towards creating a climate of uncertainty in many financial markets, and, as such, palladium is likely to be perceived with greater interest from global investors when compared with previous years.

Supply-side factors are further helping to boost palladium prices at the moment. On the NYMEX (New York Mercantile Exchange) palladium stocks have fallen by more than 40 percent this year to their lowest level in about 14 years, while the selling of physically backed palladium exchange-traded funds has also slowed to a crawl. Indeed, there may be additional longer-term factors underpinning palladium's bullish performance. Since 2011, demand has been outpacing mining, with last year seeing a global production deficit of the metal for the fifth consecutive year. Catalyst manufacturer Johnson Matthey recently reported that the palladium-market deficit is expected to widen to 792,000 ounces in 2017 from 163,000 ounces in 2016. If so, then one might expect palladium prices to be well supported for quite some time yet.

Whether palladium can continue its upward march for the rest of the year is far from guaranteed, however. While Europe is seeing healthy car-sales growth, as well as a shift towards the palladium-rich catalytic converters of gasoline vehicles, two of the world's biggest markets are seeing declines in car sales. According to the China Association of Automobile Manufacturers, car sales fell by 0.1 percent in May from the previous year, while the US saw a 3-percent reduction during the same month.

Other than catalytic converters, moreover, palladium has very few industrial uses. Demand for palladium in jewellery has effectively vanished in recent years, while palladium investments remain at inconsequential levels. As such, demand for the product remains fragile; should electric vehicles begin to surge in popularity, for instance, the damage that might conceivably be done to the conventional car market and, in turn, to palladium demand could be substantial. Moreover, of the four tradeable precious metals (gold, silver, platinum and palladium), the palladium market is the smallest and least liquid, which means that any sudden injections or withdrawals of speculative funds are more likely to induce sharp price swings.

To compound matters further is the fact that the palladium futures curve has remained in backwardation for quite some time, which means that near-term futures contracts are being priced higher than longer-term ones. This illustrates that most of the demand for palladium is current, and that investors perhaps don't have as much bullish sentiment for the metal going forward.

Nevertheless, many see palladium's strong price surge continuing for some time, given the negligible change in supply and solid rise in demand being predicted for this year. According to a Reuters poll of 26 analysts and traders conducted in July, the average palladium price for 2017 is being predicted at \$811 per ounce for this year, which is 5 percent above the previous poll conducted in April. If such a price materialises, it would be the highest annual average price on record, going back three decades. Standard Chartered seems to share that sentiment. "We remain constructive on palladium's outlook," according to the bank's analyst, Suki Cooper. "Not only is the market set to deliver a deficit this year, but it looks set to be undersupplied over the coming years."