GOLD RESILIENT IN ADVERSITY

BY RHONA O'CONNELL, HEAD OF MARKET ANALYSIS EMEA AND ASIA, INTL FCSTONE

SUMMARY

Amid the febrile atmosphere that has surrounded the commodities markets in the unhappy fall-out from the spread of the COVID-19 virus, one element has been stoic (for the most part) and that has been gold. On a snapshot basis (Chart 1) from the start of the year to the time of writing in early May, gold has been the outperformer within the sector, reflecting its role as a mitigator of risk as investors have sought sanctuary from the vicissitudes of the economic environment.

And a good thing too, as far as the infrastructure of the gold market itself is concerned, with the jewellery sectors on their knees in Asia and with parts of East Asia selling metal back into the market, while India is still closed for business, although China is once again on the move. The slack has been taken up by bullion investors, as illustrated by the increase of 414t in ETF holdings in the year to date, effectively absorbing the equivalent of more than a third of world mine production.

It has not been plain sailing, as the logistics of moving metal has been hamstrung by the lack of flights, although this is now easing. Platinum and palladium have had similar experiences, exacerbated by the lockdown in the mining sector in South Arica and the fact that more than one large refinery has been concentrating on producing gold in order to help ease the position, and only now are the PGMs and silver flowing through again.

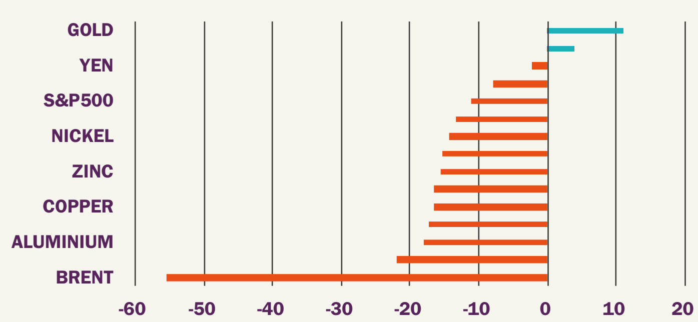
The supply chains in the commodities under consideration here have come under stress, and in the case of gold at one point and oil over a longer period of time, have broken down. At the other end of the chain, the reduction in industrial metals demand, which will be extended for many months, has easily outstripped any constraints on mine output.

Oil has been the major sufferer, and although prices are recovering from the cataclysmic falls in WTI in April, the demand profile remains patchy at best.

Equities have been on the defensive in response to economic uncertainty. There was some buoyancy in a few bourses in early May, reflecting China's rejuvenation and some optimism, well-founded or otherwise, over the easing of restrictions in developed nations. The slightly longer term, which will see the virus exerting an increased effect in developing nations, is a different issue – and is pertinent for coffee.

The increase of 414t in ETF holdings in the year to date effectively absorbing the equivalent of more than a third of world mine production

CHART 1
ALL ASSETS - RELATIVE PERFORMANCE SNAPSHOT JAN 2020 - 6 MAY 2020



MARKET DEVELOPMENTS

Gold was still in a reasonably bullish mood at the start of this year. The metal benefited from continued risk hedging over concerns about slowing economies, geopolitical tensions in the Middle East and uncertainty over the success or otherwise of Phase One of the trade agreement between the United States and China, but it was arguable that most of the likely tailwinds were priced into the market and that the upside was probably relatively limited.

Oil also entered 2020 in a relatively upbeat mood, with WTI trading near $61 and Brent at $66. Cracks were beginning to show, however, with market observers concerned about economic slowdown and the potential for surpluses to build if the producers did not act. Even then, though, the base case for the market was in the region of $60/bbl.

CHART 2
PRECIOUS METAL PRICES (INDEX=100)

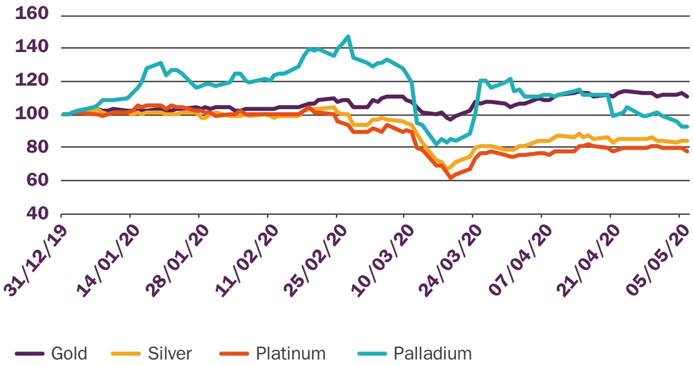


CHART 3
GOLD, ALUMINIUM, COPPER, BRENT AND COFFEE (INDEX=100)

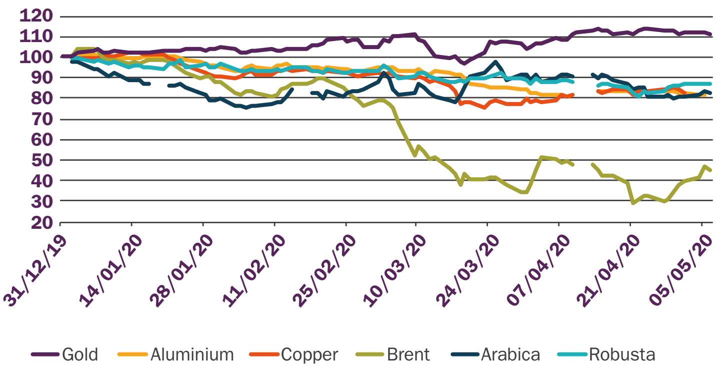
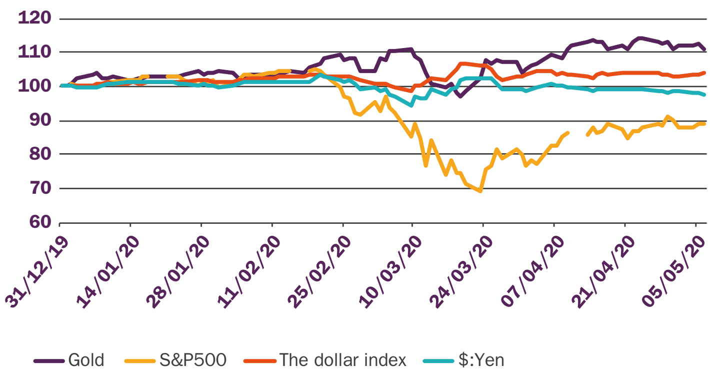


CHART 4
GOLD, S&P500, $ INDEX AND $:Y (INDEX=100)



TRANSPORT – HITTING PGMS AND ALUMINIUM AS WELL AS OIL

The paralysis in the transport sector is the key to much of the woes of the bottom three performers in this selection – oil, platinum and aluminium – as well as palladium and zinc, although in all three former cases, the markets also have their own problems. Oil was heading into oversupply, which became exacerbated by a price war between Saudi and Russia, even before the virus took hold. As we write, Brent has more or less unwound the spike downwards in late April that was triggered by WTI's problems, and sentiment has started to change as it is increasingly clear that US producers are cutting back and gasoline inventories are dropping, suggesting that the United States may be past the worst. The market still needs to tread with caution though, as the Cushing hub storage is more or less completely leased out, and while Brent has more storage flexibility as much more of that is seaborne, VLCC (Very Large Crude Carrier) rates have been soaring due to high demand for large-scale tanker storage capacity. It sounds as if India's storage is full, and pressure is building on the Gulf and the Far East. The fact that Cushing was close to brimming over meant that a number of longs in the May NYMEX contract were desperate to get out of their positions, because they would have had nowhere to store the material if they had had to take delivery and this triggered the massive spike downwards in April.

THE STATE OF THE AUTO SECTOR IS NOW STARTING TO BITE – PALLADIUM IS UNDER PRESSURE AND MAY WELL STRUGGLE FOR MUCH OF THE REST OF THIS YEAR

A key market fundamental here is that some 7.5% to 8.0% of crude output is destined for jet fuel, with a hefty 42% going into road transport. Transportation is key also to both aluminium and platinum, accounting for 40% and 37% of world demand respectively, and the sector is posting some mind-numbing numbers for April. Further, some 80% of palladium demand is transport dependent, but its snapshot performance is better than that of platinum as a result of a strong prior bull market in 2019 and extending into early 2020 as a result of industrial stockpiling. The state of the auto sector is now starting to bite – palladium is under pressure and may well struggle for much of the rest of this year.

Forecasting vehicle sales for this year is fraught with pitfalls, but we can make a rough estimate based on the individual nations' results that we have to hand. Best case is a gradual revival in the second half of the year across the board. This suggests that platinum will post a surplus of approximately seven weeks' global industrial demand this year and next, while palladium will move into a surplus this year (with a probable reversion to deficit next year).

BASE METALS – NOW A DEMAND STORY

Meanwhile, aluminium posted a record quarterly surplus in the first quarter of this year, as did zinc, which is also heavily exposed to the automotive sector as well as construction as a whole. The whole base metals suite is suffering massive demand destruction and, after price falls of 15% to 20% this year, it is hard to see any base metal posting a strong recovery in the next few months. Falls have been partially unwound in late April and early May, aided by improved sentiment in the United States and the acknowledgement of the rapid resumption of industrial activity in China, in particular, evidenced by the fact that the pollution count in China in early May was back up to 95% of the 2019 norm.

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That said, the road to recovery globally will be a long and bumpy one. Disruption to mine and refined supply as a result of lockdowns has been relatively limited in the base metals sector and the effect on industrial demand is the key focus for the next months. Note that silver has, in terms of price action, been more in the base metals' camp than in gold's, falling by over 16% in price through to early May. There has been some disruption to mine output in Latin America and silver's supply chain was hit by the closure of precious metal refineries and the fact that when they came back on stream, they were initially concentrating on gold, but that, even along with incredibly strong demand for silver coins among private investors in the West, has not been enough to shake off negative sentiment.

COFFEE – SUPPLY TENSIONS MOUNTING

The soft commodities are a completely different matter. A mine can go on care and maintenance, but you can't stop a crop growing without killing it completely!

So far, the key impact on the coffee market has been in consumer patterns, as the lockdowns have meant that less coffee is being drunk – typically, consumers imbibe more coffee when they're out, either at restaurants or 'taking away' from coffee houses, than they do at home (the same goes for food consumption overall – we generally eat more in one meal at a restaurant then we do indoors). So, as coffee shops around the world began to close in March, the price of Arabica (the bean favoured by barista-style brewing) came down and, by early May, had fallen 17%, with the fall exacerbated by the weakness in the Brazilian real. Thus far, there has been no problem with shipping coffee out of Brazil, but supplies will come under test in coming weeks as the spread of the virus in Brazil will hamper harvesting due to constraints on travel and the associated reduction in the size of the workforce available for harvesting. We have already seen this in Colombia, the world's third-largest coffee producer behind Brazil and Vietnam.

GOLD'S ROLE AS A RISK HEDGE

ITS ROBUST PERFORMANCE BY COMPARISON WITH ITS COMMODITY PEERS UNDERLINES THE SAFE-HAVEN STATUS THAT HAS BEEN EVIDENT SO FAR THIS YEAR

Robusta, for which Vietnam is a major producer, is favoured for domestic use (especially instant coffee), but here too, despite favourable relative fundamentals as a result of an increase in domestic usage, the price has dropped by 13% so far this year, partly due to weak commodity sentiment all round.

So far, there has been no discernible interruption to supplies, although a 15-day social distancing programme reportedly halted coffee trading in April. Inventories are ample and, while the markets remain more or less in risk-off mode, this sector too will remain under a cloud. Robusta has outperformed Arabica, reflecting concerns over lockdown and "social distancing". Time will tell as to their relative recoveries.

GOLD MAY UNDERPERFORM WHEN THE OTHER SECTORS RECOVER, BUT IS LIKELY TO REMAIN LESS VOLATILE IN PRICE

Gold's role as a risk hedge, and associated investment activity in the West, has cushioned it from the cataclysmic fall in physical demand in the price-responsive nations in the Middle East and across Asia (which was already underway last year). Its robust performance by comparison with its commodity peers underlines the safe-haven status that has been evident so far this year. There is little reason to expect that element to change in the foreseeable future.

This article was written by Rhona with support from Natalie Scott-Gray, Kevin Solomon and Will Rutherford-Roberts on the London Analysis team at INTL FCStone.

Rhona O'Connell has over 30 years' experience as a commodities analyst, and is a recognised authority in the precious metals sector. She has worked as a metals market analyst in many aspects of the industry, including the mining sector, commodities broking at Rudolf Wolff where she was a major contributor to Wolff's Guide to the LME, and in the equity markets and investment banking, where at Shearson Lehman she was the Group Precious Metals analyst responsible for advising a wide range of market participants from trading through equities to corporate finance.

She has held Extel ranking (2nd place) in the gold sector and has been the Association of Mining Analysts Commodities Analyst of the year, is a regular contributor to the media, and has a large number of speaking engagements to her name.

After a number of years running the GFMS team at Thomson Reuters she is now the Head of Market Analysis at INTL FCStone, where she is developing a team of analysts to support the EMEA and Asia sectors in particular.

She holds an honours degree in Law from the University of Cambridge.