The Effect of Lease Rates on Precious Metals Markets

By Merlin Marr-Johnson, Metals Analyst, HSBC Bank USA

In the precious metals markets, lease rates are frequently cited as root causes for metal price behaviour. However, the reason for the lease rate behaviour itself is rarely examined. This short article aims to discuss the main features of the leasing markets that lie behind gold, silver, platinum and palladium.

First, it is probably worth returning to the simplest fundamental of all. As changes in buying (demand) and selling (supply) affect prices, so changes in borrowing (demand) and lending (supply) affect lease rates.

A lease rate is simply the going market ‘price’ for borrowing or lending the market. If a market is oversupplied relative to demand, prices/lease rates are low, and if a market is undersupplied relative to demand, prices/lease rates are high.

It is interesting to note, however, that an oversupplied spot market does not necessarily mean that the lending market is oversupplied (nor vice versa). Remember that during the late 1990s, when gold prices were declining from $400/oz in early 1996 to $255/oz by mid-1999, the spot market was awash with gold – but lease rates were higher then than they are now. As the chart below shows, one-year lease rates are currently under 1%, but for the four years running from 1996 to the end of 1999, one-year lease rates averaged 2.12%.

Gold

Again, the key to lease rates is in the supply and demand of lending. Staying with gold, the supply side for gold lease rates rests firmly on the large lending reserves available to the market. Central banks currently hold approximately 29,000 tonnes of gold (multi-lateral institutions hold around another 4,200 tonnes). With the perceived economic stability of the 1990s, and strong returns being achieved by most asset classes, central bank reserve managers came under increasing pressure to make assets work for them. Accordingly, central banks entered the market as significant lenders of their strategic gold reserves.

It is ironic that the dollar strength and strong equity market performances drove some central banks to sell gold to avoid an opportunity cost, and that this very same negative sentiment towards gold as an asset led to producers hedging (borrowing gold). Hedging was encouraged by a negative view on gold, and strong interest rates on dollars that meant producers could sell gold forward and borrow it for the interim, taking advantage of the interest rate differential between dollar yields and lease rates. The producers therefore unwittingly reinforced the arguments for a declining spot market and a rising lease rate. The borrowing, of course, helped generate a strong demand environment for borrowed gold, which elevated lease rates to over 2%.

The reason for the shift lower in lease rates since 2000 stems from an almost total reversal of every factor cited in the previous paragraph, causing a marked reduction in borrowing demand, thereby leading to oversupply in the lending market. The vicious cycle of price depreciation, strong dollar yields and producer and fund short selling has been transformed into a positive spiral of price appreciation and producer and fund buying. Lease rates have dropped.

In March 2001 a brief surge in the shorter-dated lease rates occurred as lending was spread further along the curve – up to an unprecedented three years by central banks. The move was in direct response to a lack of return in the shorter-dated contracts,
but, as it happened, it unfortunately coincided with some short-term borrowing, and the change in lending patterns caused a short-lived spike in lease rates. Overall, central banks have been powerless to stimulate borrowing demand and, given the current fundamental weaknesses plaguing the major economies globally, we question whether there is likely to be committed short selling in gold in the years to come. Lease rates are likely to remain low.

**Platinum**

The platinum market is the polar opposite to gold, but the principles remain the same. The main problem facing both the spot and the futures markets is the depletion of above-ground stocks and the lack of a lender of last resort. Charts 3 and 4, at right, illustrate the point clearly. For gold, calculated cumulative above-ground stocks have barely changed over the past 30 years, staying around 32,000 tonnes, but the platinum inventory levels swing between zero and 30 tonnes. Although the quantity of inventory held prior to 1975 in platinum is unknown, we believe that current inventory levels are close to zero.

What is more alarming is that with current demand projection the market is forecast to enter uncharted territory with regard to supply and demand deficits. Price risks remain skewed to the upside and there does not appear to be much prospect of a net inventory accumulation at any stage in the next few years coming in to ease the borrowing market. One-month lease rates have averaged 9% over the past two years.

The other key difference between platinum and gold is the role that the Tokyo Commodities Exchange (TOCOM) plays in the market. The volume of material traded in Japan means that the platinum lease rate takes a leading role in driving spot prices.

Platinum on TOCOM is based on a futures contract – the active trading month is 12 months ahead. This gives the public a chance to trade out of the position profitably at some stage in the ensuing 11 months. If the Japanese general public (JGP) sell futures, this position will be offset against trade house long positions, and these trade houses will sell spot loco Zurich to mitigate the 12-month risk. In other words, JGP take an outright position in the market (short in this case) and the trade houses are therefore long futures and short spot, and they have to finance the 11-month gap. Trade houses borrow material on a rolling basis to meet the short obligations, until the contract expires and the trade houses receive platinum from the public. All very simple, but the net outcome is heavy borrowing of platinum when the JGP are short, and conversely lending when the JGP are long. Platinum lease rates are, unsurprisingly, volatile. The three clearly visible lease rate spikes over the past two years are associated with:
1) the palladium price high in early 2002
2) short-covering in post 9/11
3) JGP TOCOM short-selling coincident with loco Zurich tightness (in chronological order).

Not only can TOCOM positions change very rapidly, the volumes are large relative to other natural borrowers of platinum. Platinum has long been a mainstream financial instrument in Japan, and the JGP have been known to run with aggregate positions of up to 500,000oz long or short.

To put the TOCOM volumes in perspective, Johnson Matthey forecast combined total consumption of platinum in the glass and chemical sectors to be around 555,000oz. Glass and chemical borrowing for platinum in industrial processes is the main non-speculative source of borrowing, but sector requirements for platinum are met by both borrowing and purchases.

On top of this, NYMEX data show funds are currently holding some 229,000oz net long positions but, again, this varies on an intra-year basis. Remember that this entire process takes place in an illiquid market, with no obvious lenders of material beyond unmatched platinum held by commercial banks and some refiners. Even when the JGP are not running with net short positions, the platinum lease rate continues to stay at levels well above gold lease rates.

Palladium
Moving to palladium, we believe that one can now safely classify palladium as a by-product metal. Barring the Stillwater mine (which is, incidentally committed to expansion), palladium supplies are dictated by nickel/copper production rates in Russia and platinum production rates in South Africa, both of which are forecast to increase. A lack of supply constraints and weak demand indicate that for palladium there is a growing prospect of above ground stockpiles increasing in size.

A year ago Ford announced a writedown of USD1bn of what is believed to be a largely palladium stockpile – although the valuation price remains unknown. Only last month Norilsk declared that it had at least 876,000oz of palladium inventory at its disposal. HSBC sees the palladium market in structural oversupply in the coming years, which has grave implications for the lending market. Firstly industrial borrowing is likely to diminish as purchasing managers see opportunities for outright buying at lower and lower prices ahead. Secondly, a market in oversupply (and with existing aboveground stockpiles) is likely to see rising inventories and increasingly competitive lending – keeping rates low. Small wonder that one-month palladium lease rates have averaged 1.45% over the past year.

Silver
Finally, a few words on silver. Silver lease rates are low (one month 0.35%, one year 0.7%) reflecting low borrowing demand and sufficient lending supply. As at the end of 2001 GFMS had identified 18,440 tonnes of above ground silver stocks, with 9,200 tonnes held by European dealers (mostly loco London) and 5,300 tonnes held by central banks.

On the other side of this large lending potential, borrowing demand is scant. The most actively traded silver contract is the COMEX futures contract, with funds generally holding net long positions. Following the same principles as we worked through JGP activity on TOCOM earlier, funds take outright net long positions on COMEX, which are offset by trade house net short positions on COMEX. The trade houses therefore hold net long positions (locally London) to mitigate the contract risk (usually 2- to 3-month contracts) on COMEX. High levels of lending potential, low levels of borrowing? Result: low lease rates.

The only time lease rates do rally is from sudden allocations of material that shift the lending potential profile within a short space of time. An inventory reallocation last year caused a short-lived lease rate hike, but ultimately the price high of the year was generated by fund long position building, not short-covering, as shown in Charts 7 and 8 above.