GLOBAL BANKING AND MARKETS

ScotiaMocatta

Metal Matters August 2017

After correcting in June and early July, bullion prices rebounded, driven by the weaker dollar and the Fed turning less hawkish. Geopolitical concern in the market is surprisingly low.

- A surprise turnaround in the Fed stance from being hawkish to less hawkish, combined with political paralysis in Washington, has weakened the dollar and turned Gold prices higher.
- Despite continued North Korean missile tests, markets are not unsettled and as such, safe-haven demand for Gold seems low.
- We expect this to change as the longer North Korea has to develop its technology the more of a threat to the US it will become.
- Geopolitical tensions are likely to rise either as President Donald Trump tries to cajole China/Russia to sort out the North Korean problem, or as he takes unilateral action.
- Markets seem to be complacent about many of the world’s problems – we would not be surprised to see more investors diversify into Gold as a form of insurance.

The combination of increased volatility at low prices and a historically high gross short fund position may signal a change of trend for Silver.

- The consensus outlook for US monetary policy makes it difficult to be bullish for bullion prices, but despite this, we find ourselves being mildly bullish.

Palladium and Platinum prices and their fundamentals are poles apart - Platinum trades at just a $60/oz premium to Palladium.

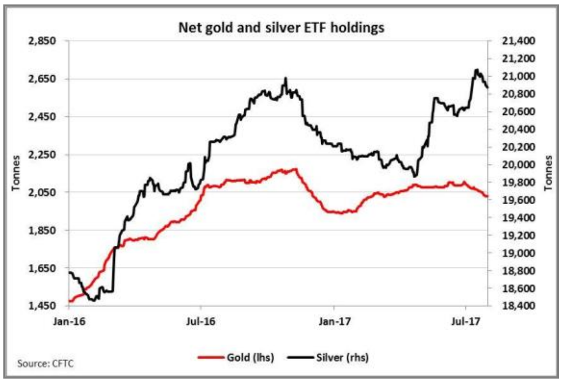
- We expect the premium to recover as disappointing auto sales hit Palladium demand harder than Platinum; further production cuts in South Africa would affect global Platinum supply more than Palladium supply.

Gold prices are underpinned by weak dollar and a less hawkish Fed

Gold prices sold off in June as geopolitical and political issues died down, but instability in President Donald Trump's administration, his lack of progress on key policy and a Fed that has become less hawkish have all since led to more dollar weakness. All these factors have helped underpin a stronger Gold price, which in turn, after some delay, has led to fund short covering and some fresh buying.

Numerous reasons to be bullish for Gold

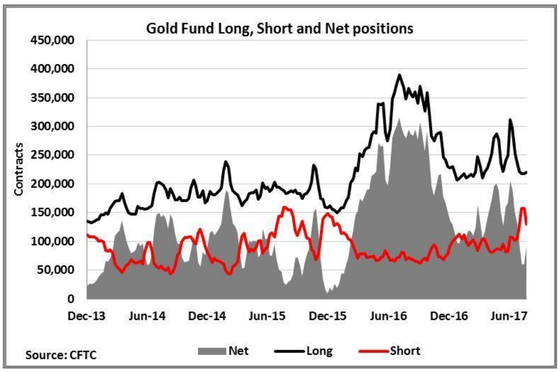
The Fed's less hawkish stance led to weaker US treasury yield, reducing the opportunity cost of holding Gold, and the weaker dollar has lowered Gold prices denominated in other currencies, which may have boosted demand. These are both bullish developments. Although the market does not seem to have many geopolitical concerns at present, we are not sure everybody thinks the same. Some investors may well be looking to top up their safe-haven investments given record high equity markets, a dysfunctional US administration and the ongoing aggressive action by North Korea, which continues unfettered.



ETF redemptions on the rise

The lack of apparent geopolitical concern in the markets, combined with bullish equities, does seem to be prompting ETF investors to take profits. ETF holdings started July at 2,097 tonnes, but had fallen to 2,029 tonnes by month-end. The bulk of the reduction was seen in US ETFs, which is likely to have been influenced by continued rises in equity prices.

Since the start of the year, ETF holdings are up 79 tonnes; over the same period last year, holdings were up 611 tonnes. Given this subdued investor interest, prices do seem to have held up well – they are up $116 per oz, some 10 percent so far this year.



Funds turn bullish again

As the shaded area on the chart shows, the Net Long Fund Position (NLFP) had fallen to levels not seen since bear market turned into bull market back in early 2016. At 60,138 contracts, the NLFP has fallen at a fast pace from 204,465 contracts seen in mid-June. It is also massively down from the highs seen in July 2016, when it peaked at 315,963 contracts - which not surprisingly coincided with Gold prices peaking at around $1,375 per oz. As the generally rising red line on the chart above shows, the gross short position has been building in stages since last summer, but it grew more rapidly in June and July. Likewise, the gross long position peaked in early June. Longs turned buyers again in the second half of July, but most of the buying pressure in recent weeks has come from short covering. The gross long position looks well placed to grow further, while the short position looks quite elevated considering how well prices have held up.

All eyes on the dollar

There are numerous cross currents affecting Gold prices and these are unlikely to subside any time soon. The base view on US interest rates is that they are on the rise and that should underpin a stronger dollar. However, some surprisingly hawkish talk from the ECB and Bank of England caught the market off guard in July, so expectations for interest rate differentials had to be reworked. This, as well as some poor US data and disappointment over Trump's lack of progress on policy reforms, has led to a weaker dollar and correspondingly stronger currencies. In turn, that has supported Gold prices. The more hawkish tone from central banks on both sides of the Atlantic now sounds less hawkish, but the seed of thought has been placed in the market's mind and it does look as though they are now less bullish for the dollar. However, it seems likely that US interest rates will continue to rise and, as bond yields follow, the opportunity cost of holding Gold will rise too. If they do, the downward pressure is likely to build on Gold prices, but whether Gold prices fall will then depend on what else is happening at the time. It is not inconceivable that further rises in US interest rates could start to negatively impact the bond market and those emerging markets with high levels of dollar-denominated debt. In turn, that could become a concern for equity markets. In these scenarios, it would not be surprising to see investors' demand for safe-havens rise.

Awaiting developments over North Korea

Despite widespread condemnation, North Korea is pressing ahead with its nuclear and missile ambitions and with Russia and China bordering the country, neither seems to want to take a strong stance against it. And, neither Russia nor China would want a US-friendly United Korea as a neighbor. The US may feel time is not on its side – the longer North Korea is allowed to build up its capability, the more of a threat it will become to the US and as such it seems fairly likely that a geopolitical event will come about before too long. Given that three super-powers all have a stake in the issue, it is likely to become a major geopolitical issue that could have far-reaching implications. We were surprised that the latest series of missile tests by North Korea have not had a bigger impact on sentiment – there seems to be considerable complacency in the markets.

Physical demand seems robust

Judging by Swiss trade data, demand for Gold is strong. Switzerland exported 162.1 tonnes of Gold in June, while it imported only 124.9 tonnes, creating a deficit of 37.2 tonnes; this is after a 39 tonne deficit in May. In India, implantation of GST may see subdued demand for a while, but in time, it is expected to be beneficial for the market.

Technical & Summary– Gold prices have breached the long-term downtrend line that started from the 2011 high. The line has around seven points of contact, with the previous two in April and June this year beaching the line. This latest rally once again breached the line in July and, with spot Gold reaching $1,274/oz in early August, prices were $20/oz above the downtrend line, which suggests the line is broken. The stochastics are also rising, which bodes well for the uptrend to continue. Clearance of resistance at $1,295.55/oz would suggest at least a challenge of the July 2016 high of $1,375/oz. This would then put the focus on the August 2013 highs around $1,434/oz. Given the move towards tighter monetary policy, which should be negative for Gold overall, the developing bullish chart picture may be a warning that investors are buying more Gold as an insurance against heightened risk of trouble ahead – whether it be financial or geopolitical trouble.

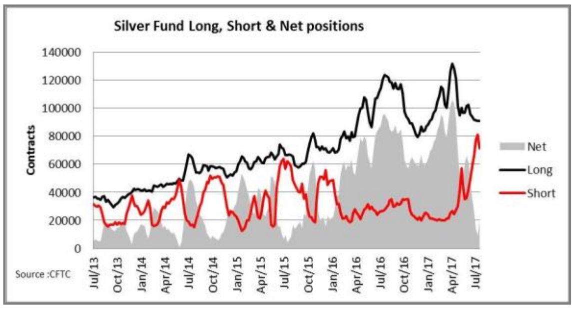
Gold Statistics	2013	2014	2015	2016	Q1 2017	Q2 2017	Jun-17	Jul-17
London Prices (US$/oz)								
AM fix	1410.80	1266.34	1162.49	1248.16	1219.03	1257.89	1261.28	1235.10
Pm fix	1411.03	1266.20	1161.3	1248.34	1219.36	1256.96	1260.26	1236.22
Average	1410.92	1266.27	1161.89	1248.25	1219.20	1257.43	1260.77	1235.66
Parity prices								
Australian - A$/oz	1,454	1,403	1543.9	1,679	1,609	1,675	1,670	1,585
South Africa Rand/kg	433,964	440,562	474,410	589,051	517,663	532,959	521,977	520,925
Japan Y/g	4,252	4,146	4,355	4,203	4,296	4,329	4,332	4,302
India Rupee/oz	81,973	77,077	74,310	83,721	81,540	80,959	81,135	79,519
COMEX - futures contracts								
Stocks ('000oz)	8,103	8,203	7,422	8,962	8,963	8,801	8,617	8,661
Vol (million contracts)	46.27	40.52	41.76	51.84	16.49	15.89	4.91	5.96
OI ('000 contracts)	398	380	418	551	429	467	457	449
CFTC (futures only data)								
Net Spec position Long (Short)	68,381	98,265	88,022	201,250	146,130	162,799	131,672	90,831
TOCOM								
Stocks ('000oz)	120	146	127	120	83	76	75	71
Volume ('000 contracts)	12,223	8,744	7,928	8,540	1,538	1,456	575	~
OI ('000 contracts)	111	88	94	88	80	79	83	79
Other Indicators								
FT Au Mines Index	1,789	1,409	1,061	1,579	1,568	1,481	1,420	1,515
Dow Jones Index	15,090	16,837	17,524	18,062	20,571	21,180	21,460	21,914
US$ Index	81.3	83.0	96.7	97.1	100.6	97.3	96.4	92.9
Gold Bullion Imports, tonnes (exports)								
Dubai	350	136	118	~				
China	2192	1297	1,610	1,281				
India	824	776	949	582				
Italy	107	103	~	~				
Japan	28	-80	-107	~				
Singapore	225	284	~	~				
South Korea	24	24	~	~				
Taiwan	20	22	30	27.5				
Turkey	266	102	49	106				

Data: Financial Times; Bombay Bullion Association; LBMA; TOCOM; COMEX; CFTC, REUTERS
Figures are period averages unless marked by *, indicating the period end. OI= Open Interest on the exchange

~ = data not available yet, *italics* = estimates

Silver's sell-off runs into buying, key now will be whether shorts start to cover

Silver prices were extremely volatile in July; prices were under pressure at the start of the month following the release of strong US data that gave the US dollar a boost. Weakness then continued with prices suffering a flash crash in the early hours of 7th July, which momentarily took prices down below $15/oz before closing the day at $15.60/oz. The spike low was followed by a rebound that continued through to the end of the month, with prices finishing July at $16.82/oz. Silver prices have therefore been more volatile than Gold prices, which is often the case, but like Gold, the Silver chart picture going into August is looking quite bullish with prices breaching the down trend line off the April high. Silver prices are also recouping some relative strength compared with Gold with the Gold/Silver ratio falling to 75.75, having been above 79 on the day after the downward spike in Silver prices. That said, the ratio has been oscillating higher since July 2016, when it was around 65.50, so on that count Silver prices are still weak relative to Gold.



Funds hold a large short position

The Net Long Fund Position (NLFP) on Comex Silver dropped to 9,376 contracts on 18th July, down from a high of 105,515 contracts on 11th April. The rapid drop has been driven by both long liquidation and short selling. The gross long position has dropped to 90,865 from a peak of 131,969, while the gross short position shot up to 81,400 (the highest we have on record going back to 2005) from a low this year of 19,797. The NLFP rebounded to 19,417 contracts on 25th July, driven by short covering. As the chart shows, there seems plenty of scope for short covering, even if the longs do not re-engage.

ETF investors remain supportive

Silver ETF investors have started to take some profits into the price rally. At 20,873 tonnes at the end of July, holdings are down from a mid-July peak of 21,072 tonnes, but they are up 228 tonnes from the start of the month and up 663 tonnes since the start of the year.

Technical

Down trends dominate Silver prices but the recent price rebound has breached the April-July down trend line. The stochastics on this weekly chart are also working higher and there seems to have been good buying following the early July spike lower. Silver prices have a wall of worry to climb, with resistance at $16.90/oz, $17.75/oz and $18.65/oz, so any rebound is likely to have to absorb considerable supply.

Summary – We are not overly bullish for Gold prices (and therefore by default Silver prices) based on likely monetary policy, but we are based on the market's complacency towards a host of issues including record high equities, the scale of global debt given the likely shift in monetary policy and with regards to North Korea. Given the large gross short fund position, we do think there is risk of aggressive short covering if a bullish catalyst emerges.

Silver Statistics	2013	2014	2015	2016	Q1 2017	Q2 2017	Jun-17	Jul-17
London Prices (US$/oz)								
Daily Fix	23.83	19.08	15.71	17.10	17.42	17.26	16.95	16.14
Parity (London) prices								
Japan (Y/g)	71.66	70.31	58.92	57.46	61.39	59.40	58.23	56.21
India (Rupee/oz)	1,380.7	1,312.5	1,004.7	1147.5	1,165.2	1,111.1	1,090.5	1,039.3
COMEX – futures contracts								
Stocks (Moz)*	165.9	178.9	171.6	162.1	185.7	203.5	208.9	215.4
Vol (million contracts)	14.5	13.7	13.5	17.0	4.7	6.39	2.4	1.8
OI (‘000 contracts)*	136.0	155.8	169.6	188.8	203.0	201.4	203.5	207.3
CFTC (Futures Only Data) non-commercial								
Net Positions *	11,929	19,307	31,269	69365.6	90,926	56,104	35,532	19,417
TOCOM								
Stocks (Moz)*	0.1	0.20	0.16	0.16	0.24	0.20	0.18	0.15
Futures Vol (‘000 contracts)	96.4	86.1	62.6	61.1	7.3	5.1	1.6	~
Futures OI (‘000 contracts)*	4.1	4.5	3.1	3.28	2.2	1.6	1.7	1.9
Other Indicators								
Gold/Silver ratio*	60.0	67.6	74.4	73.0	69.5	75.0	76.5	76.2
Silver Bullion Imports (tonnes)								
USA	3835	3835	5464	5956				
Japan	1688	1688	1560	1833				
India	5819	5819	7954	2793				
Italy	679	796	843	675				
Hong Kong	948	948	839	659				
China (exports)	1329	1369	2054	-137				

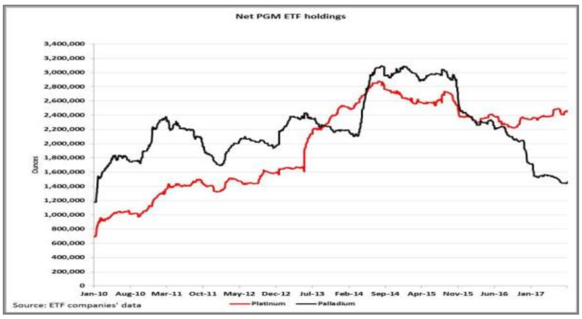
* Figures are period averages unless marked; ~ not available yet, *italics* = estimate.

Palladium and Platinum remain poles apart with a price differential of $60/oz

After spot Palladium prices rallied to $917/oz in early June (the highest since February 2001), prices corrected during the rest of June and into early July, falling to $829/oz, but since late July prices have been climbing again. Supply deficits have created a bullish market, but we remain wary that demand from the auto industry may disappoint the market, which could lead to a correction. While Palladium prices remain buoyant, Platinum prices have been weak; they breached the May low in July, but just avoided breaking the December 2016 low at $889/oz. In recent weeks, they have worked higher but Platinum prices are still only $60/oz above those of Palladium, when Platinum's average premium over Palladium in the ten years to the end of 2016 has been around $820/oz – as such the Platinum and Palladium markets have diverged massively. Platinum is not only relatively weak when compared with Palladium, it is also weak compared with Gold. Gold prices are at a $320/oz premium to Platinum prices, while over the ten years to 2016, Gold prices have been at a discount averaging $190/oz to Platinum prices.

Platinum's different demand structure

Platinum demand can be split three ways; basis 2015, jewellery accounted for 36%, autocatalysts 35% and other industrial uses 29%. Last year demand from the jewellery industry dropped 24%. Palladium has one dominant user with autocatalysts accounting for 75% of demand. Palladium demand has not therefore suffered to the same extent as Platinum and is one of the main reasons for Platinum's relative weakness. With auto demand expected to suffer this year and with South African mining under severe pressure – the country accounted for 79% of Platinum mine supply in 2016, while only 42% of Palladium mine supply – there may be a case for expecting price trends to reverse before too long. As recently as July 31, another Platinum mine shaft was closed in South Africa – either more cuts will follow, or the lower capital expenditure in recent years will lead to a decline in output going forward.



Investors and funds at odds

ETF investors are buying Platinum, while redeeming their holdings in Palladium – this suggests they too expect a change in the current price trends. Conversely, the funds trading Nymex have increased exposure to Palladium this year, while cutting Platinum holdings, although short-covering has started to be seen in Platinum in recent weeks and some profit-taking has started to be seen in Palladium.

Technical & Summary - Platinum prices have broken higher and look well placed to extend gains, while Palladium prices are on course to challenge the June highs. Given our views on demand growth in the auto industry and the stresses in South African mining, where any further production cuts would hit a greater percentage of Platinum's global mine output than Palladium's, we expect the squeezed Platinum price premium over Palladium to recover.

PGM Statistics	2013	2014	2015	2016	Q1 2017	Q2 2017	Jun-17	Jul-17
London Prices (US$/oz)								
Platinum	1,491	1,390	1,060	976	981	941	933	917
Palladium	727	809	692	611	765	818	863	856
Rhodium	1,061	1,180	953	694	891	960	982	1,025
Japanese Parity Prices (Y/g)								
Platinum	4,501	4,519	3,965	3,278	3,454	3,240	3,206	3,193
Palladium	2,198	2,636	2,587	2,050	2,693	2,817	2,965	2,979
South African Parity Prices (Rand/kg)								
Platinum	443,938	466,074	417,839	444,891	404,263	384,753	372,515	372,758
NYMEX Stocks ('000oz)								
Platinum	276.3	195.8	138.8	205.1	228.5	222.7	225.0	217.1
Palladium	656.9	347.4	134.0	71.1	58.8	45.6	41.7	40.6
CFTC Futures Only Data Long / (short) non-commercial								
Platinum	30,680	35,840	24,585	31,817	36,765	15,040	10,533	10,183
Palladium	22,369	22,276	12,080	8,765	17,794	20,149	21,039	19,289
Tocom - Platinum								
Stocks ('000oz)	38.1	46.6	53.8	57.1	42.1	48.4	52.0	44.9
Vol (Million contracts)	4.3	4.6	3.9	2.9	0.9	0.6	0.2	~
OI ('000 contracts)	55.7	72.6	69.7	52.7	48.5	63.6	69.3	67.4
Tocom - Palladium								
Stocks ('000oz)	4.4	3.2	5.4	11.1	5.7	3.6	3.9	3.9
Vol ('000 contracts)	79	77	63	29.6	9.1	8.1	3.7	~
OI ('000 contracts)	2.0	2.0	1.8	1.1	1.2	1.3	1.5	1.7
Other Indicators (US$/oz)								
Pt-Au spread	97	115	-100	-253	-261	-324	-317	-321
Pt-Pd spread	754	568	245	369	240	94	69	54
Platinum Bullion imports (kg)	2013	2014	2015	2016		2017		
USA	115,765	141,413	238,740	201,412		187,661	(Jan-Apr)	
Japan	48,336	32,684	47,283	44,786		21,807	(Jan-June)	
PalladiumBullion imports (kg)	2013	2014	2015					
USA	83,200	92,400	82,500	88,800		19,440	(Jan-Apr)	
Japan	58,571	58,429	57,223	58,860		31,305	(Jan-June)	

~ = data not available yet, *italics* = estimates

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CANADA
Toronto
Scotia Plaza
40 King Street West
Box 4085, Station 'A'
Scotia Plaza
Toronto, Ontario
M5W 2X6

Russell Browne
Russell.Browne@scotiabank.com
Tel: 1-212-225-6200
Fax: 1-212-225-6248

UNITED KINGDOM
London
201 Bishopsgate
6th Floor
London
EC2M 3NS

Anton Down
Anton.Down@scotiabank.com
Tel: 44-20-7826-5955
Fax: 44-20-7826-5948

Will Thomas
Will.Thomas@scotiabank.com
Tel: 44-20-7826-5928
Fax: 44-20-7826-5948

UNITED STATES
New York
250 Vesey Street
New York, N.Y. 10281

Bimal Das
Bimaldas@scotiabank.com
Tel: 1-212-225-6200
Fax: 1-212-225-6248

INDIA
Mumbai
91, 3rd North Avenue
Maker Maxity
Bandra Kurla Complex
Mumbai 400 051

Johnson Lewis
Johnson.Lewis@scotiabank.com
Tel: 91-22-6658-6901 (Direct)
Fax: 91-22-6658-6911

New Delhi
Upper Ground Floor
Dr. Gopal Das Bhavan
28 Barakhamba Road
New Delhi 110001

Prem Nath
Prem.Nath@scotiabank.com
Tel: 91-11-2335-8789
Fax: 91-11-2335-9342

Bangalore
#1110, 11th Floor, East Wing
26-27, Raheja Towers,
M.G. Road
Bangalore 560001

Mahendran Krishnamurthy
Mahendran.Krishnamurthy@scotiabank.com
Tel: 91-80-2532-5325
Fax: 91-80-2558-1435

HONG KONG SAR
21st Floor, Central Tower
28 Queen's Road Central
Central
Hong Kong

Alice Lam
Alice.Lam@scotiabank.com
Tel: 852-2861-4778
Fax: 852-2573-7869

SINGAPORE
1 Raffles Quay
#20-01, North Tower
One Raffles Quay
Singapore, 048583

Pramod Mohan
Pramod.mohan@scotiabank.com
Tel: 65-6305-8381
Fax: 65-6534-7825

Scotiabank