Martin Arnold
Global FX and Commodity Strategist
Research
research@etfsecurities.com

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Precious Metals Ratios:

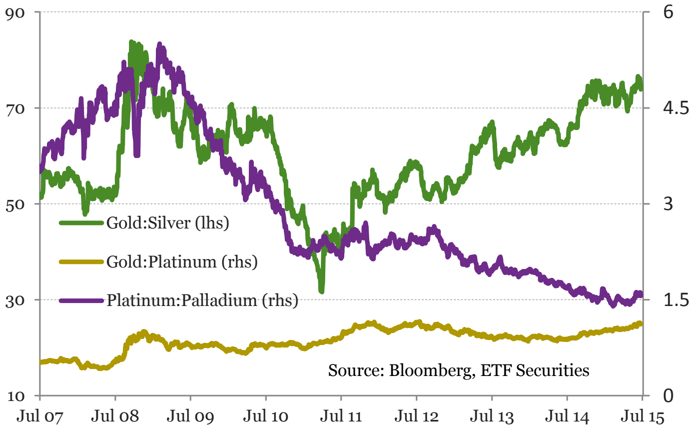
A good guide of relative value?

- Gold:silver ratio remains elevated as silver rides gold's coattails lower. However, with economic activity likely to favour silver, traditionally high correlations could break down in 2015/16.
- Gold:platinum ratio shows that sentiment has been the performance driver in the precious metals sector, overwhelming fundamental conditions.
- Platinum:palladium ratio shows platinum undervalued, although a move back toward more historical levels will be prolonged.
- A potential gold rebound? Seasonal demand for gold historically robust in Q3.

Correlations and ratios.

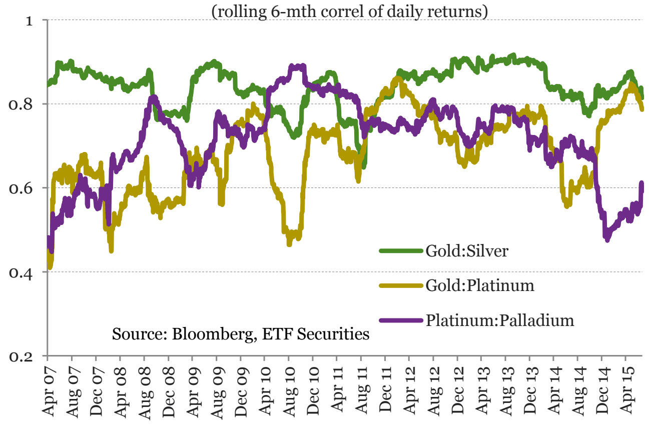
Ratios comparing the prices of various precious metals are often followed as key metrics highlighting the relative value of precious metals in relation to one another. Being widely followed, it is instructive to understand why ratio analysis can be a persuasive argument in the relative value comparison of precious metals. We believe that while some ratios can be useful in determining relative value, others can give misleading signals. Underlying fundamentals, investor sentiment and the prevailing stage of the economic cycle are key factors that also need to be taken into account.

Precious metals ratios



Correlations are one of the key metrics that can give a guide of whether or not a particular ratio is likely to be a good indicator of relative value. However, care must be taken as correlations themselves can also be meaningless on face value.

Precious metal correlations
(rolling 6-mth correl of daily returns)

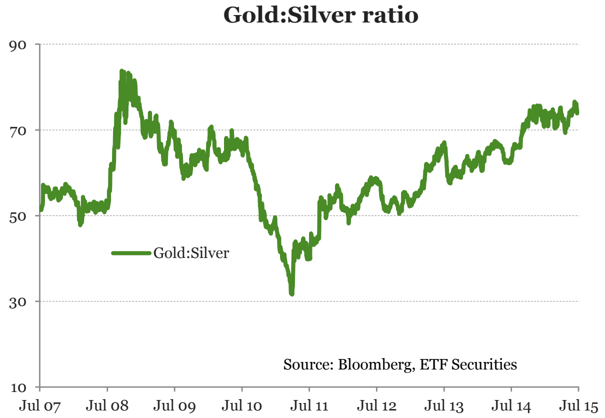


Recent months have shown that gold and silver correlations remain in line with historical averages, while platinum and palladium have been depressed compared to traditional ranges, although the relationship is gaining strength. Meanwhile gold and platinum have recently had elevated correlation, but that strength has been fading as we expect fundamentals to reassert over the negative sentiment that has pervaded the precious metals sector.

Gold:Silver ratio

Having their roots as monetary metals, gold and silver have historically tended to have a high correlation. Gold in particular, is seen as a store of value, for many reasons – a lack of faith in government policy, a country's banking system or the debasement of fiat currencies from inflation or central bank policy to name a few. Although a large proportion of silver demand comes from industry, in the current environment, industrial demand for silver has been lacklustre. As a result, it has ridden on the coattails of gold, reverting to its more traditional role as a safe haven investment and jewellery raw material.

The gold:silver ratio is currently trading at an elevated level, hitting the highest level of 76 times in July 2015 in 6 years. As the global economic recovery begins to gather pace, we expect the current undervaluation of silver to fade, as industrial demand begins to dominate demand growth. With correlations hovering within a normal range, as industrial activity picks up pace for silver, we expect the gold:silver ratio to decline more in line with longer term averages of 60, as correlations begin to decline. Silver will outperform gold to the upside in coming months.

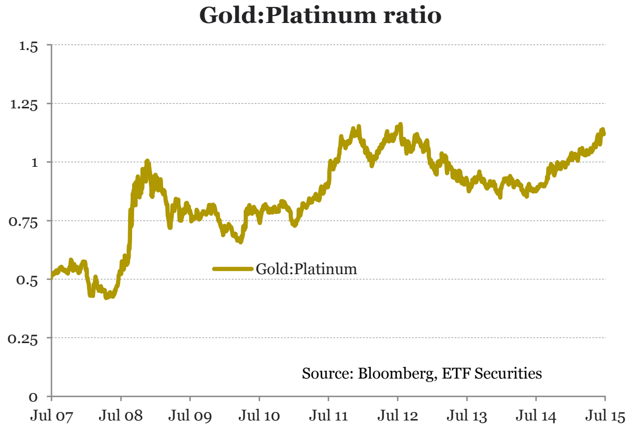


Gold:Platinum ratio

Although the logic behind the gold:platinum ratio lies largely with the role of both metals in jewellery applications, it is worth digging a little deeper to uncover the devil in the detail.

The correlation between gold and platinum has been volatile in recent years, suggesting that the value of the gold:platinum ratio as a relative value indicator could be transitive. Although the ratio is at the highest level since August 2012, the underlying fundamentals remain divergent.

We feel that the gold:platinum ratio offers a less compelling relative value indicator because of the underlying diverging uses of the two precious metals. However, it does indicate that sentiment is taking charge over fundamentals, as platinum market has been in a deficit market for several years and gold has been shunned widely as a risk hedge.



Breaking down the detail

The use of gold in jewellery, particularly in emerging markets, has a lot to do with it being seen as a store of wealth. EM countries where there is significant state intervention and a lack of confidence in banking infrastructure gold has historically served individuals as a hard asset in which to store wealth. Aside from silver, other precious metals have not historically been used as a store of value in this way.

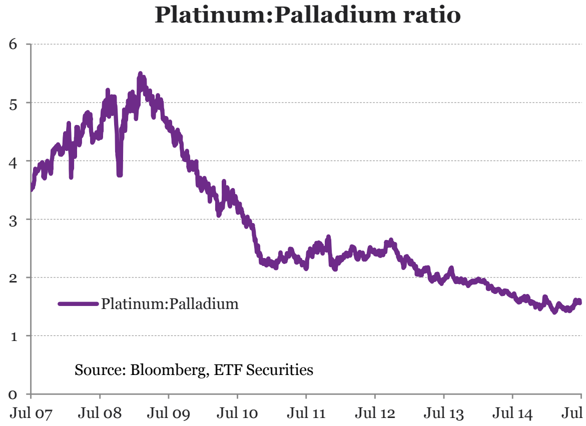
Although jewellery demand accounts for nearly 55% of demand for gold, for platinum it represents around 35%. The divergence becomes starker when viewing the underlying demand for jewellery on a regional basis. China is key for platinum, accounting for 65% of total jewellery demand (25% of overall platinum demand), whereas it represents only 38% of total gold jewellery demand (15% of total demand). Indeed, for gold, India is just as important, accounting for over 40% of total jewellery demand.

In a similar way to silver, industrial demand contributes over 60% of total platinum demand, a far cry from the 10% for its golden counterpart. In an environment of a global economic growth recovery, metals with industrial uses are much more likely to benefit. In turn, we expect that when sentiment turns and markets begin to price the underlying tight fundamental conditions, the upside for platinum appears more favourable than gold.

While jewellery has been a rising component of demand in recent years and will remain a significant feature of the platinum market, we expect that platinum's cyclical attributes will come to the fore in coming years. New European emission regulations (to be introduced in September 2015) will increase the weighting of platinum group metals in emission reduction systems. We expect that growing auto (and in turn autocatalyst) demand, which currently accounts for 41% of platinum demand, will account for a rising share of future growth, and increasingly bring greater weight to bear on price performance.

Platinum:Palladium ratio

We feel that the platinum:palladium ratio is a better way to look at platinum group metal (PGM) relative value, due to their demand and supply similarities.



Both PGMs are mined in similar geographic locales (South Africa and Russia account for the vast majority of platinum and palladium mining) and are subject to the same potential disruptions on the supply side.

Similarities exist on the demand side also. The major demand source for both derives from the autocatalyst market, although palladium's share is larger, at nearly 70% of total demand. The difference is also reflected in the jewellery sector, where palladium is used sparingly compared to platinum.

Early in 2015, the correlation between platinum and palladium broke down from longer term average levels, reflecting the resilience of platinum. At the same time, palladium prices lost ground as a result of its higher exposure to the Chinese auto market, which posted disappointing sales results.

We expect as Chinese demand for both platinum and palladium (both from jewellery and auto sales) normalises and global auto demand growth becomes more even, the platinum:palladium ratio will revert to more average levels seen in recent years. In any case, the platinum: palladium ratio in our view shows that platinum is relatively undervalued and we expect the ratio to stabilise before grinding higher toward the 2:1 level in the medium term.

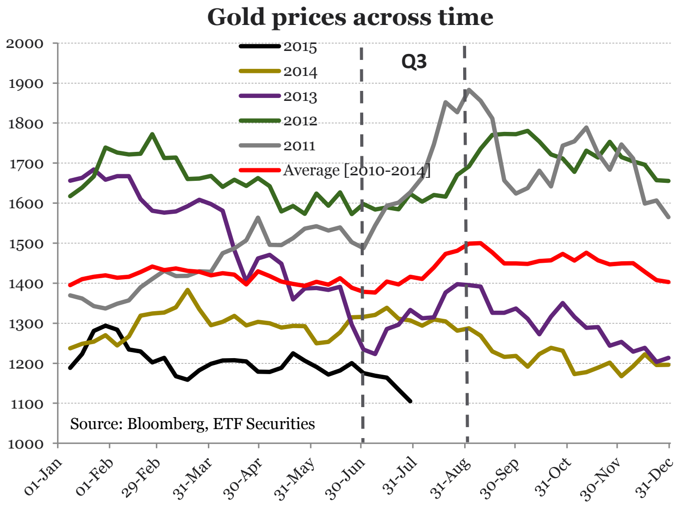
Potential rebound for gold?

While we expect rising economic activity to be broadly beneficial for 'industrially linked' precious metals, gold has its place in a balanced portfolio. While economic risks linger, investors could also benefit from a seasonal opportunity that is presenting itself.

Gold has seasonal patterns. Gold in the third quarter has tended, in recent years, to exhibit stronger performance as a result of lead-up buying for the Indian festival season.

Q3 is a seasonally strong period for gold historically. On average over the past four years, gold has rallied 6% in Q3, buoyed by strengthening physical demand on the back of festival buying in India.

If physical gold demand again is strong in Q3, it could provide some near-term respite from the gold price weakness seen thus far in 2015.



Upside for gold is likely to drag silver prices higher in the near-term, because of the currently elevated correlation between the two precious metals.

Important Information

The intelligent alternative

ETF Securities (UK) Limited
3 Lombard Street
London
EC3V 9AA
United Kingdom

t +44 (0)207 448 4330
f +44 (0)207 448 4366
e info@etfsecurities.com
w etfsecurities.com