

January 16, 2019 – Lessons From Palladium

Taking a momentary break from JPMorgan and the Justice Department in regards to silver and gold, I'd like to look at the two metals in light of the recent price action in another precious metal, palladium. In fact, there have been a number of highly informative articles of late on palladium, including a two-part series from Sprott Asset Management. Here's part 2 (with the link to part 1 imbedded).

<http://www.sprott.com/insights/the-palladium-play-part-2/>

The current interest in palladium is as a result of a pronounced price rise over the past few years to record levels, exceeding \$1300 an ounce on a spot or cash basis. Such price levels put palladium prices slightly above gold prices, a rare but not unprecedented event. In fact, back in 2001, a surge in palladium prices to above \$1100 an ounce, put the metal at four times the then-current gold price. Palladium's premium over gold only lasted for a couple of years and since 2003 until very recently, the price of gold exceeded the price of palladium.

As recently as early 2016, gold was close to its current price (around \$1300), while palladium was close to \$525, or nearly \$800 below the price of gold. As recently as this past August, palladium wasn't much above \$800 as the precious metals hit the price lows for the year; so it's clear that palladium has been the star price performer in the overall precious metals rally to date. While there is some price influence from speculative futures contract positioning on the NYMEX, of all the precious metals, such positioning is less important in palladium than it is in silver, gold or platinum (as well as copper).

So if palladium's price is not driven by futures positioning, what accounts for the historic price surge? As recent articles have pointed out, the price surge is overwhelmingly the result of tight physical market conditions. In fact, it is no exaggeration to state that palladium has been in a state of physical shortage, where consumption demand has exceeded current mine and recycling production for years, necessitating the drawdown and depletion of existing world inventories to balance the supply/demand equation.

A true structural commodity deficit results in a depletion in world inventories as long as current consumption exceeds current production. In a very real sense, the world can't consume more of a commodity than exists, but it can consume more of a commodity than is being produced, as long as there are existing inventories to draw from. (You may recall that a structural deficit existed in silver for more than 65 years, from 1940 to early 2006, depleting nearly 10 billion oz of world silver inventories).

For a commodity in a structural deficit, the deficit can only last until consumable inventories run out somewhere above actual zero inventories. By that point, the price would have risen enough to stimulate extra production or restrict current demand. This is the essence of the law of supply and demand. In retrospect, for silver, the structural deficit came to an end in 2006, as prices began to rise above the near flat line of \$5 that prevailed for close to two decades until then. The price rationing process stimulating production and curtailing consumption is undoubtedly underway in palladium, but pinpointing the precise moment current supply and demand come into balance without the need to draw from inventories is most usually visible only after the fact.

What can be done in real time is to study inventory drawdown. For palladium, much inventory was held by Russia, the world's largest producer and traditionally not at all transparent about such matters. It is thought that most of Russia's palladium inventory is now largely depleted, given the persistent high price over the past several years, especially on a relative basis compared to other metals. That leaves us with known and visible world palladium inventories – mainly in the form of exchange and, more recently, ETF holdings.

With the introduction of precious metals ETFs in the mid-2000s, total visible palladium holdings rose sharply to nearly 3.4 million oz by late 2014. Prior to 2006, visible world palladium inventories were virtually non-existent; not because no inventories existed, but because the inventories weren't visible and recorded. The creation of various palladium ETFs and a sharp increase in NYMEX warehouse inventories caused the sharp jump to 3.4 million oz into 2014. But most visible of all was the sharp decline in known world palladium inventories thereafter, as the structural deficit took its toll.

From 2014, total visible world palladium inventories fell from 3.4 million oz to under 0.9 million oz today, a drop of 2.5 million oz or more than 73% (source sharelynx.com). Included in those figures was a drop in NYMEX palladium warehouse inventories from 500,000 oz to under 50,000 oz today. Most remarkable is that the shocking drop in visible palladium inventories occurred primarily in ETF holdings as palladium prices rose strongly over this period.

Wait a minute – haven't I always maintained that investors collectively buy markets that rise strongly in price? Yes, I have, as that's the experience of markets through the ages. Then why have investors failed to buy palladium ETFs on a price rise that exceeded the price rise of other precious metals? I see two basic reasons. One, palladium ETF investors were outbid by industrial users and two, palladium isn't a truly popular investment asset. Please allow me to expand on this.

Palladium prices were in the \$200 range when various ETFs began to be offered in 2006 and that investment demand did drive prices to \$600 by mid-2007. But palladium prices then crashed back below \$200 by yearend 2007. From there, prices then climbed to over \$800 by early 2011, as total visible physical holdings hit 3 million oz for the first time. Early ETF investors began to cash out and were replaced by industrial users who bought shares of palladium ETFs in order to secure metal. This is the most plausible explanation for the shocking drop in physical palladium holdings in world palladium ETFs.

I believe the reason early investors cashed out of palladium ETFs, to be replaced by industrial users is that palladium didn't have the long investment history of gold or silver. First discovered in the early 1800s, palladium's roots only went back 200 years, whereas gold's and silver's roots went back thousands of years. Let's face it – Jesus Christ was betrayed for 30 pieces of silver

2000 years ago, although I suppose it was possible that Judas Iscariot would have settled for two pieces of gold instead. It was not possible that he would accept palladium. My point is that when it comes to worldwide acceptance as primary investment assets, there is no comparing gold and silver with palladium. Perhaps some great collective investment demand might yet develop for palladium, but that hasn't been the case to date.

Therefore, the first lesson to be learned from the dramatic price rise in palladium is that it was driven by industrial demand, not investment demand. This is a point I have made for many years, usually referring to silver, certainly prior to 2006. In fact, I have always maintained that any commodity that was consumed was capable of going into a shortage when consumption demand exceeded production. Since every world commodity, except one, is primarily produced in order to be consumed, that means every commodity is capable of going into a deficit consumption pattern and shortage.

The one exception, of course, is gold, where instead of being consumed, production is intended on being saved and held as a store of value, including as jewelry. That's not to say that gold can't increase in value because it has and will — only not because its inventories are being depleted, as can occur in all other commodities. Gold is capable of climbing as high as there are numbers (in the words of my former desk mate at Merrill Lynch) as anything, just not due to an industrial consumption-induced shortage. In fact, there has never been a year in world history where there was less in gold inventories than in the prior year (possibly excepting a treasure ship sinking or two).

The second lesson to be learned from the great rise in palladium is to wonder what the heck the price rise would have looked like had there been collective investment demand to go along with the obvious industrial demand that drove the rally. As far as I know, there is only one commodity capable of experiencing the dual force of industrial and investment demand — silver. To be sure, there is no deficit consumption pattern currently in force in silver, as there is a bit more silver having been added to world inventories annually for the past ten years or so. But the amounts are not large — no more than 5% to 10% of total world production annually. Please keep in mind that the deficit in palladium runs about the same percentages.

The kicker in silver is that investment demand can literally set in on a moment's notice. In fact, all it would likely take is a decisive initial upward move in price. Preventing that upward move, of course, has been the prime motive of JPMorgan in squashing every budding price rally in silver for the past 8 years; for the dual purpose of collecting ill-gotten trading profits in COMEX futures trading and in amassing more than 800 million oz of physical silver on the down low. I also believe it is important to recognize that the reason JPMorgan accumulated physical silver (and gold) and not palladium is because there wasn't enough palladium available to buy.

Returning to the JPMorgan/silver theme, I received an excellent question from a subscriber this week. Stephen asked if I wasn't being a bit myopic (not his words) in focusing strictly on JPMorgan and not on any other banks, such as Citibank, who may be complicit in the ongoing manipulation. It's a fair point that requires an explanation.

As I tried to explain to Stephen, I was just following the hard facts. Citibank does show up as a big holder of precious metals in OTC derivatives in the Treasury Department's quarterly OCC report, but that report, unfortunately, doesn't breakdown net positions. Citibank is undoubtedly included in the CFTC's Commitments of Traders and Bank Participation reports but not with enough specificity to form firm conclusions. Additionally, Citibank rarely turns up in COMEX silver and gold delivery

statistics, suggesting it is strictly a paper trader.

On the other hand, the Department of Justice's Nov 6 announcement of the criminal guilty plea by the former trader from JPMorgan (and attached downloads) is as specific as could be hoped for. Included in the accompanying documents are clear statements that the trader who pleaded guilty and other traders working for the bank, engaged in illegal activities for their own benefit and for the benefit of the bank itself. No other banks were indicated to be involved, just the bank that employed the named trader and the other unnamed traders. Therefore, it would be a stretch for me to suggest that the Justice Department was looking at banks other than JPMorgan in its ongoing investigation.

That's not to say that other banks may not be drawn into the investigation, just that I see no evidence of that at this time. One of the things most peculiar about the DOJ's Nov 6 announcement was that it focused on JPMorgan exclusively; very much different than the other precious metals allegations of manipulation to that point brought by the CFTC or other market regulators. In fact, until the DOJ's announcement, JPMorgan was virtually the only bank not to have been alleged to have manipulated precious metals prices.

The truth is that in the past when allegations of precious metals manipulation were raised from time to time, the first thing I would look for is whether JPMorgan was included in the allegations. Invariably, JPMorgan's name was nowhere to be found and that was enough for me to conclude that whatever the merits of the cases may be, by not including JPM, the allegations were wide of the mark. I suppose it's possible that a case for precious metals manipulation could be made to stick that didn't involve JPMorgan, but count me as highly skeptical of any such occurrence.

It is now nearly a month since the US Government has been partially shut down and Friday will mark the fourth week running for no COT report, something unprecedented in the modern era (post 2000). Although gold and silver prices have been relatively flat over the past two reporting weeks thru yesterday, over the past four reporting weeks prices are higher and total open interest is higher, particularly in gold. Therefore, we know that there have been significant positioning changes, even though the verifying data are unavailable.

Over the past two days, total gold open interest has jumped by nearly 22,000 contracts, on somewhat tepid price action (no new highs or lows recorded) and regular trading volume. I suppose it could represent spread trading, but the actual changes in open interest by individual months is not highly indicative of that. Therefore, I'm somewhat scratching my head at the big changes in gold total open interest, now close to 90,000 contracts higher than the last official COT data on Dec 18. Total open interest in silver is still about 19,000 contracts higher than it was on Dec 18, so the big increase over the past two days is confined to gold.

There's no question that there have been big positioning changes over the past month in gold and silver, featuring big managed money buying and commercial selling. As such, sharp price moves in either direction, up or down, wouldn't be particularly surprising. In fact, it's somewhat surprising such moves haven't yet occurred. Also notable, if not completely surprising, is that the infuriatingly manipulative price gyrations attributed to spoofing have been held at bay. Then again, what nitwit would engage in spoofing after the announcement of a criminal guilty plea for same on Nov 6?

The key question in the significant positioning changes that have occurred since Dec 18 is the role of JPMorgan in that positioning. Has it or has it not added significantly to short positions in gold and silver

and if it has added, does it intend to rig prices lower to ring the cash register machine it created over the past 11 years? I wish I knew. In this particular regard we are all in the dark, thanks to the suspension of COT data. However, that doesn't change the fact that what JPMorgan does or doesn't do, under the influence of the Justice Department, is the critical element for future silver and gold prices. But it is precisely the involvement of the Justice Department that makes silver more bullish than it has ever been, regardless of what may transpire in the short term.

Ted Butler

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Silver – \$15.62 (200 day ma – \$15.40, 50 day ma – \$14.80)

Gold – \$1293 (200 day ma – \$1254, 50 day ma – \$1249)

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