



Heading Into The Last Quarter

Since at least late 2016 CPM Group has been forecasting that precious metals price increases would be modest through the first eight or nine months of 2017, but that the pace of such increases would accelerate during the fourth quarter of this year. CPM continues to anticipate this shift in the rate of price increases. CPM Group expects the typical seasonal strength during this period to be complemented by a whole host of events which could be positive for precious metals prices. While many of the factors listed below may not have negative consequences for the broader economy, there is always a possibility that they could. Furthermore, asset prices often move in anticipation of such risks, either individually or in some combination of them.

One of the factors, the outcome to which may not be known well beyond the fourth quarter of this year relates to heightened political risks globally. Tensions between the U.S. on one side and North Korea, Russia, Iran, and Syria, continue to simmer and likely to be around in the medium term. Relations between the U.S. and its traditional allies, including European governments and those of South Korea, Japan, and even China, also are tarnishing rapidly at this time. The possibility that these political risks turn into something bigger is expected to be positive for safe haven assets like precious metals. Even if they do

Gold Prices: 1 December 2010 to 5 October



not cause larger concerns in financial markets, they provide an undertone of nervousness and uncertainty that helps support investor interest in having some of their wealth and investment assets diversified into precious metals. The positive price impact of tensions between North Korea and The United States were seen on 25 September when gold prices shot up, albeit briefly, as rhetoric between the two countries' political leaders escalated. When senior members of the ruling party suggest that the president of the United States is precipitously ushering the country toward World War Three, astute citizens and investors seek some diversification and protection in gold and silver.

Five important factors that are closely related to the global economy and the outcome of which could be known over this quarter are:

- The selection of a new Fed chair,
- Possible reform of the U.S. tax code,
- A possible raising of the U.S. debt ceiling,
- An increase in U.S. interest rates in December, and
- An ECB announcement on scaling back of its massive bond portfolio.

Of the above events, the possible outcomes that might be negative for gold or precious metals prices seems already to be mostly factored into the market. For this reason, from the above factors those that are negative for gold (raising of U.S interest rates for example) are likely to have a limited downside impact on prices from present levels if they actually do materialize. If they do not materialize, however, or if what is finally delivered is less than expected, it could be positive for gold and precious metals. In other words, the impact of these factors on gold and precious metals prices is most likely to be neutral to positive going forward.

Contact Us: email: research@cpmgroup.com Telephone 212-785-8320 www.cpmgroup.com

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President Trump will be nominating a Fed chair over the course of the next several weeks. Janet Yellen’s term as chair is set to expire in February 2018. Among the top contenders at this time are Janet Yellen, Kevin Warsh, and Jerome Powell. The markets have some sense of what monetary policy is likely to look like if Trump re-nominates Yellen as chair. Jerome Powell also is considered dovish, similar to Yellen, which means a Fed under his leadership would not be expected to defer significantly from that under Janet Yellen. These two candidates would be less disruptive to markets and if anything gold may even get some bounce from the nomination of either of these candidates as chair to the Fed (because ahead of the nomination, markets will also factor in the possibility of a hawk being nominated as Fed chair). The third contender for the position, Kevin Warsh, can be considered more hawkish and his nomination, or any other hawk for that matter, could result in a decline in gold prices. A

hawkish Fed chair could however result in a stronger U.S. dollar, something Trump is not keen on. Furthermore, Trump’s stance toward Janet Yellen has changed since he was running for President, her re-nomination would be less bullish for the U.S. dollar and also the least disruptive potential nomination for financial markets, which are two factors that favor her.

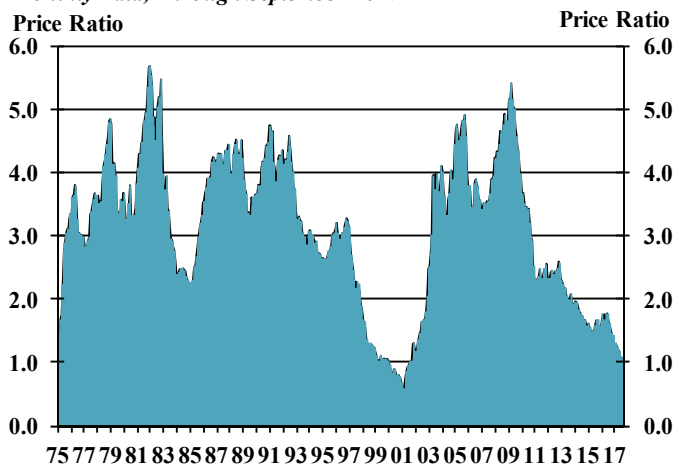
The markets also will be looking for an announcement on the reform of U.S. tax code before the end of this year. While this reform might be expected to be more likely to be passed compared to some of the other initiatives that have stalled this year, it is not guaranteed. Furthermore, what will be important to watch is whether the government is able to deliver reform as promised or if the final reform will be a reduced version of the initial plan. The latter is more likely, in which case there could be some softening in equity markets, which could be supportive of gold.

One of the factors that was driving gold prices higher in early September was the eventual outcome of the U.S. debt ceiling. This discussion has now been postponed until December. While there is a very low probability of the ceiling not being raised, the issue is expected to provide at least some drama, and thus support to gold prices ahead of the deadline.

The market also will be keeping an eye out for another interest rate increase. There is a fairly strong probability that the next interest rate increase occurs in December. That said, the price of gold is not likely to sink much fur-

Platinum - Palladium Price Ratio

Monthly Data, Through September 2017



Commodities Research and Consulting,
Asset Management, and Investment Banking

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email: research@cpmgroup.com
Telephone 212-785-8320



ther from present levels on the basis of another rate hike, because this expectation is already factored into the market. It will however rise in the event that the interest rate is not increased in December.

In addition to all of these factors, there could be some unsettling developments emerging from the Chinese party congress this quarter, although at present the likely outcomes are expected to be calming rather than alarming to world financial markets.

The further moves toward decentralizing political power in Europe, following the Catalonian vote this past weekend, also could lend some ‘quiet’ support to investor concerns, helping support demand for precious metals prices.

Platinum Group Metals

After nearly two decades the palladium price has moved to a premium to platinum. While palladium fundamentals are stronger than those of platinum it seems like palladium’s price has risen too far too fast, if the price moves were based solely on longer term market fundamentals. Slowing U.S. and Chinese passenger vehicle markets coupled with rising secondary supply and large investor inventory could cause prices to reverse. That said, markets typically build on an existing trend and given the strength and sustainability of the present rally in palladium prices, weakness in the near term could be treated as a buying opportunity. Thus, any major decline in palladium prices may be more likely in the medium term versus the short term.

Furthermore, an expectation of overall strength in the precious metals markets should help support palladium prices at elevated levels and prevent platinum prices from declining further. Platinum’s relatively weaker fundamentals seem to be factored in to the metal’s price, which should prevent any further decline as well.

Medium-Term Outlook

Gold

Gold prices are forecast to move between \$1,260 and \$1,350 over the next three months. Several factors will unfold over the next three months which should keep prices moving in a volatile fashion. Most of the negative news related to gold already seems to be factored into prices and barring any surprises gold prices should be expected to move sideways to higher over the remainder of the year.

Silver

Silver prices are expected to move sideways to higher for the remainder of the year. Prices are likely to face initial resistance at \$17.25. If prices are able to break above this

level they could test \$18. Seasonal strength in silver prices and overall strength in the precious metals complex is expected to lift prices higher during the fourth quarter of the year.

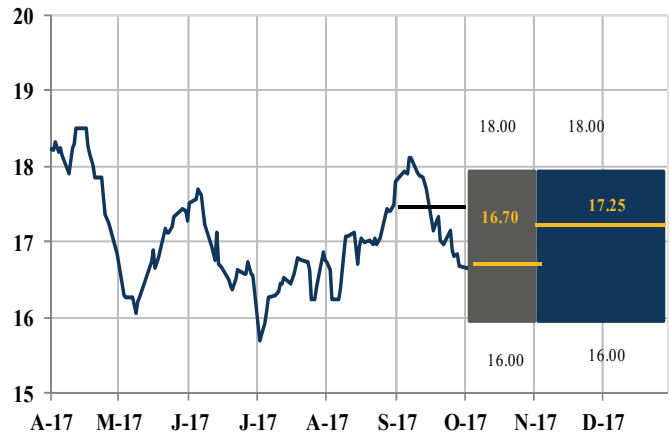
Platinum

Over the next couple of months currently low price levels, coupled with signs of tightening mine supply in South Africa as well as continued uncertainty over the country's new Mining Charter, could see investors liquidate their short positions and build fresh long positions in platinum. Prices may rise to \$1,030 in October. If this level is breached, a move higher toward \$1,075 is possible. If there is broad-based negative sentiment toward precious metals, possibly coming from a relatively stronger U.S. dollar, prices could see some investor sell-

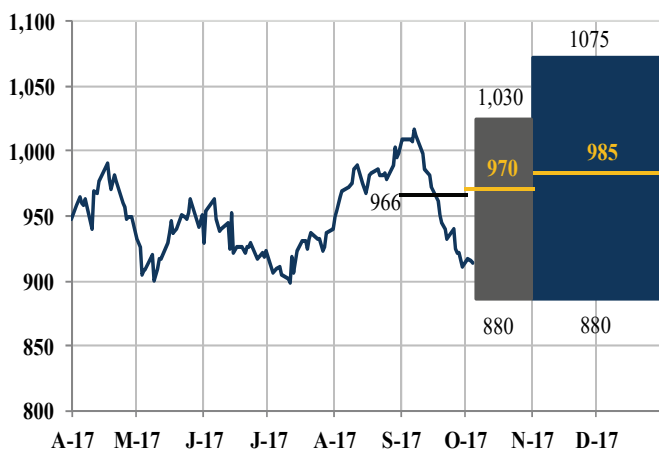
GOLD



SILVER



PLATINUM



PALLADIUM





ing and slip to \$895. Prices should be well supported at \$880, however.

Palladium

Currently high price levels in Nymex palladium could trigger profit-taking by investors in the near term, although investors are unlikely to massively liquidate their long positions given the imbalance in the December contract open interest. Prices may soften to \$895 in October or early November. If this level is breached, a move lower to \$865 is possible, although prices should be well supported at this level. A sharp spike down to \$835 cannot be ruled out if there is a broad-based shift in investor sentiment away from precious metals. Those new investors that have entered the palladium market could get out as quickly as they got into the market. Still palladium prices are likely to see a spike up again as the metal approaches the December Nymex futures delivery period. Prices could rise up to the early September peak of \$997.50; if this level is breached, a further increase toward \$1,080 could not be ruled out.

The Myth Of The Petro-Yuan

There is a network of commentary, on the internet and elsewhere, that traffics in what the current president of the United States calls fake news about gold and other financial assets and markets. George W. Bush called them the ‘bad internets’ in his day. Sometimes the theories and inaccurate stories in this corner of the world spills over into the broader gold market.

A story making the rounds of the bad internets at present has it that the Chinese government has issued a policy statement that it will pay for its petroleum imports in yuan that the oil sellers can then convert to gold in the international market. Importantly, the story points out that this purported Chinese government policy states that no Chinese gold will be used: Neither will the Chinese government use its gold to pay for oil, nor will it allow privately held gold in China to be sold for these yuan. The conclusion that the purveyors of this story want gold investors to believe is that the Chinese government in doing this is moving toward a gold-backed yuan and is working in cooperation with the Russian government in moving toward a gold-linked international currency system.

On the surface this story can be seen immediately to be nonsense. The most obvious aspect that tells you to ignore this is the point that the Chinese government has no say in how people who sell it oil or anything else use the currencies they receive in payment for that oil, goods, or services, once the currency is outside of China. Anyone with money, whether its yuan, dollars, yen, or pesos, may buy gold anytime they want in the international market. They do not need Chinese government permission, guidance, or direction to do so. And, sometimes oil exporters due ‘sterilize’ their dollar and other oil income by purchasing gold. At this point people should stop thinking about this concept, as it clearly is fabricated. Beyond that, there are other aspects of the story that pop up as warnings to not believe this. First, the fact that the story says the Chinese government will not use any of its gold or allow privately held Chinese gold to be used weakens the idea of any link between the yuan and gold.

Interestingly, Russia Today, the Russian pro-government television station that has been linked to the fake news and websites run by the Russian government to try to in-

fluence the U.S. presidential election last year has been a heavy reporter of this story.

The story also ties in with a failed effort to promote illogical thinking a couple of years ago. In 2014 the governments of Russia and China concluded a 30-year agreement under which Russia would sell \$400 billion of oil and gas to China. The deal would supply up to a fifth of China’s natural gas supplies. For Russia the deal would lessen Russia’s dependence on western European markets where it has had difficulties in recent years and where it was facing sanctions. The deal said the oil and gas could be paid for in yuan or rubles in addition to dollars or other currencies. The bad internets made a big deal of this, saying it was a move to lessen the dollar’s hegemony in international currency markets. It was. The stories in the bad internets failed to mention one thing, however: The sales would be denominated in U.S. dollars, but could be settled in other currencies.

CPM only mentioned the ‘petro-yuan’ story because clients and others who populate the real gold market are being distracted by it.

Precious Metals In A Portfolio

Adding precious metals to a portfolio of equity and debt instruments improves the return to risk profile of the portfolio. At least, they have done so in the long run, from 1968 through last year. This conclusion was made based on a study conducted by CPM Group of 450 separate portfolios, which contained equity, debt, and various combinations and weightings of the four exchange traded precious metals – gold, silver, platinum, and palladium.

Before heading deeper into the findings of the study, a little on the way the portfolios were set up. There were 15 different combinations in which the four precious metals were added to a portfolio containing equity and debt investments. The S&P 500 was used as a proxy for the equity markets and U.S. T-Bills or U.S. T-Bonds were used as a proxy for the debt component of the portfolio. For each combination of equity, debt, and precious metals there were 30 portfolios, with one half of these containing T-Bills and the other half T-Bonds. The precious metals weightings ranged from 0% to 70% of the portfolios. When more than one precious metal was included in a portfolio they were equally weighted and never exceeded 70% of the portfolio. Total precious metals weightings were raised in increments of 5%, with the first portfolio in the combination of equity, debt, and precious metals containing no precious metals. Monthly data from January 1968 to December 2016 were used in the study.

Precious Metal Impact on Return To Risk Ratio

The addition of precious metals to an equity and debt portfolio *invariably* improved the return to risk profile of the portfolio. In about a third of the cases the benefit of adding precious metals to the portfolio, to improve the return to risk ratio, peaked at 5% precious metals content. In about a fifth of the cases, the return to risk ratio improved with an addition of up to 10% of precious metals to a portfolio. In some cases however, the return to risk ratio continued to rise until 55% of the portfolio was made up of precious metals. The proportion of precious metals that resulted in the peak return to risk ratio was to a great degree influenced by the combination of precious metals in the portfolio.

Addition of Individual Precious Metals

When adding only individual metals to a debt and equity portfolio gold was the best choice for improving the return to risk ratio. Not only did gold raise this ratio the most from the return:risk ratio of a portfolio that contained only debt and equity, which stood at 1.31, but also continued to improve the return to risk ratio as more and more gold was being added to the portfolio. The benefit of adding gold to the portfolio peaked a 25%, beyond which the addition of gold weighed on the return to risk ratio. Above 25% metals content, the risks or portfolio volatility rose faster than the returns from having more gold in the portfolio. The benefit of adding each of the other precious metals individually to the portfolio peaked at 5% and the improvement in the return to risk ratio was relatively smaller compared with a portfolio that added only gold.

Addition of A Combination Of Precious Metals

When looking at combinations of various precious metals it was observed that those portfolios that contained gold generally performed better in raising returns for every unit of risk and those that contained silver provided lower return to risk ratios. This no doubt reflected the greater price volatility of silver compared to gold. While the PGMs (platinum and palladium) were better than silver at increasing returns for every unit of risk, they were not as good as gold.

The highest return to risk ratio for all portfolios under consideration was 1.54 and was observed in a portfolio that contained only debt, equity, and gold. Adding 25% of gold to a portfolio containing stocks and bonds resulted in this optimal portfolio with a return to risk ratio of 1.54. Other portfolios in which the return to risk ratio came close to 1.54 were the portfolios made up of gold-platinum, gold-palladium, gold-silver-platinum, gold-silver-palladium, gold-platinum-palladium, and one that contained all the precious metals. It should be noted that each of these portfolios contained gold. It should also be noted that to reach the optimal return to risk portfolio within these combination required upward of 40% of the portfolio being allocated to precious metals. This suggests that adding gold to a portfolio of debt and equity

instruments provides an optimal portfolio more efficiently than other combinations of precious metals.

Precious Metal Impact on Risk To Return Ratio

When looking at these portfolios from the perspective of risk per unit of return the portfolio that contained 25% gold scored the lowest risk relative to its historical return, making it most desirable from this perspective too. Other portfolios that had similar risk to return ratios were the gold-platinum and gold-palladium portfolios. From the portfolios that came close on a return to risk ratio to the 25% gold portfolio, all that contained silver were dropped as was the portfolio that contained gold-platinum-palladium. The relatively higher volatility of silver, platinum, and palladium compared to gold may explain this to some extent.

Precious Metal Impact on Sharpe Ratio

The Sharpe ratio measures the excess returns in a portfolio. The highest Sharpe ratio of 63.41% was observed in a portfolio that contained 35% gold. The portfolio which had the highest return to risk and risk to return ratio (composed of 25% gold) had a Sharpe ratio of 61.6%. There was no other portfolio among the other combinations that had a Sharpe ratio that was close to this.

Conclusion: Gold Does The Job Best

In conclusion, it can be said that adding gold to a portfolio of stocks and bonds has the greatest benefit to the risk return profile of a portfolio. While the addition of any precious metal or combination of precious metals improve the return to risk ratio of a portfolio, the addition of only gold to a portfolio pushed up the return to risk ratio the highest. While some combinations of precious metals are able to raise the return to risk ratio very close to the gold only portfolio, they require a significantly higher proportion of precious metals to do so.

Gold’s relatively low volatility compared to its peers makes it the best addition to a portfolio. The long-term median volatility of gold prices stood at 15.3% compared with 25%, 20%, and 27% for silver, platinum, and palladium, respectively.

A portfolio with 25% of its assets in Gold had the best risk:reward ratio

