2002: A Year of Mixed Fortunes for Precious Metals

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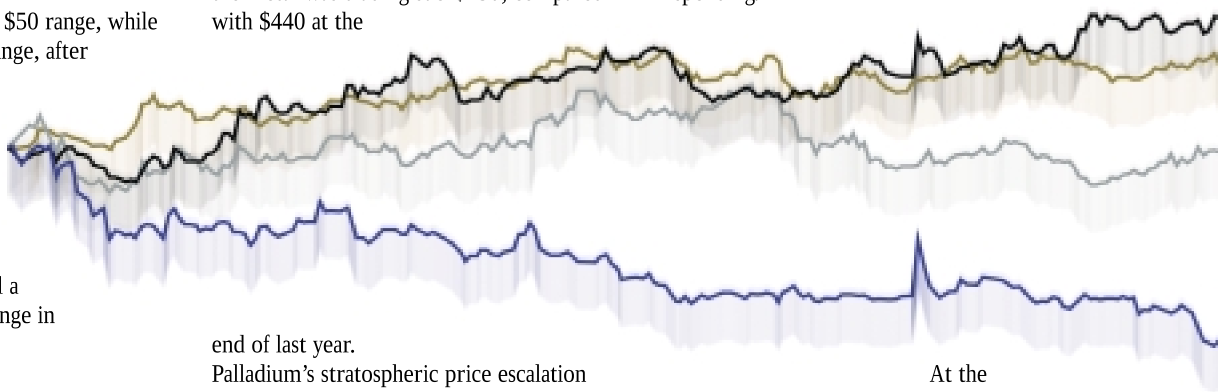
There should be no complaints about the opportunities presented to the astute trader by precious metals in 2002. There was something for everyone – although timing was still everything when it came to making money.

Gold prices traded across a $50 range, while silver managed a 90-cent range, after briefly breaking above $5 mid-year. Once again, though, pgms provided the real spectacle: platinum traded within a $150 range while palladium spanned almost $190 (large, but still a mere shadow of its $775 range in 2001).



It was a year of mixed fortunes, though there always appeared to be a story running in at least one metal at any given time. Measured on price performance alone, gold for once looked good, supported by a cocktail of producer 'de-hedging', dollar weakness and generally improved sentiment. After opening the year under $280, it reached a high for the year of $330 and was trading 17% higher by early December, just shy of its year high. It finishes the year with an annual average of $309: a 14% improvement over 2001 and the first +$300 average since 1997.

However, in other currencies, the weakness of the dollar contributed to a less impressive performance – with yen gold rising 10% over the year and euro gold by just 4%. The rand gold price actually registered a 15% decline, a reflection of that currency's recovery against the dollar.

In contrast, average dollar prices for silver and platinum rose a more modest 5% and 2% year-on-year to $4.60 and $536, respectively – although these still looked stellar against the 2002 performance of most equity markets. However, simple averages understate platinum's performance – the positive demand picture being painted by many for the metal in 2002 and upbeat market sentiment attracted investor interest, and by year-end platinum was trading back at $600, up 24% from the start of the year and 32% above its February low.

There was no doubt as to the loser of the year: the annual average $340 price for palladium was down 43% from 2001, and by year-end the metal was trading sub-$250, compared with $440 at the end of last year.

Palladium's stratospheric price escalation and the great damage done to the metal's industrial base market on the back of unpredictable Russian supplies became very apparent during the year – as did the financial damage administered by the whole affair to some of the metal's largest industrial consumers.

Taking a wider view of the market, there was plenty of seat shuffling among participants. The overall trend of further staff attrition was confirmed, with many major players re-orienting business to more profitable areas and cutting costs. The year also saw the exit of a number of well-respected analysts from both the commodity and equity side of the business – although some of this slack was taken up by increased activity on the part of several of the independent research houses. The ripple of change extended into the wider industry universe. There were changes in key senior personnel at the World Gold Council, while the Gold Institute, the Washington-based lobbying organisation, announced it was closing its doors.

Historic reviews are interesting - and unavoidable (it's that time of year) - but far more concerning is the outlook for 2003.

At the end of 2002 there is considerable uncertainty over what the coming year holds in store. Risks are high that economic performance will consistently fall short of expectations next year – while international tensions remain high and the threat of terrorist attacks persists. As economic growth remains weak, unemployment may rise, damaging consumer sentiment and dampening spending. At the same time, equity markets are expected to remain soft as the industrial-led worldwide economic slowdown intensifies over the winter and into the spring. Governments and their central banks are likely to keep interest rates low and perhaps, as in the case of the US Federal Reserve and the ECB, there may even be further rate cuts. For precious metals this is a scenario that presents many challenges – and perhaps even a few opportunities.

When it comes to meeting these challenges, the precious metals markets have already been adapting to an environment in which, despite some interesting price action, trading volumes have not expanded. The declining monthly clearing volumes published by the LBMA for both gold and silver in 2002 bear testimony to this. Many market participants are re-assessing or have already re-assessed their approach to these markets, the types of products sold and the trading platforms used.

The rapid consolidation by the gold mining industry into just a handful of major producers and the general swing away from the practice of hedging – while positive for price – has been a critical factor in this change of approach. The decline in producer hedging has had a knock-on effect on the gold liquidity market, and 2002 saw gold lease rates fall to extremely low historic levels.

Falling demand for borrowed gold and near-zero interest in turn contributed to the decision over the course of the year for a number of central banks to reduce their gold lending activities, in certain cases quite significantly. While lending may have been cut, there was no let up in central bank sales – although the pressure might have been off, given that media attention to this issue subsided once the last of the Bank of England's gold auction was out of the way.

If volumes were less last year, then there was also evidence of a further shift towards electronic trading at the expense of more traditional systems. Fragmentation of the market among different trading systems was further compounded by the opening of smaller local metals exchanges. Indeed, market liberalisation is now seemingly synonymous with the proliferation of local precious metals exchanges (with China the major new entrant this year) and the construction of local refining capacity (further exacerbating the over-capacity in international precious metals refining capacity).

Where there are challenges, there are opportunities, and palladium's challenge was evidently platinum's opportunity as the metals' fortunes suffered a key reversal over the year. Although the demand picture for industrial metals may look weak – especially in the case of silver – platinum looks set to be a major beneficiary of the tighter emissions controls now coming into force and the continued switch to diesel-based autos. After years of anticipation, platinum is also set to benefit as fuel cell technology moves closer to entering the mass market. Demand-side drivers have thus continued to swing further in favour of platinum even as producers embarked on a period of major supply-side expansion.

The prospects for gold remain more contentious. While its performance in 2002 was the best in years, it failed to meet the expectations of many. So in traditional fashion, what the gold market may have lacked in price action it made up for in words. Open season seemed to be declared on just about every market statistic in 2002 and there was no shortage of willing conference speakers stepping onto the podium to give their interpretation of the story. If there was bonanza for anyone in 2002 it was must have been conference organisers. The editors of precious metals websites were also beneficiaries, with substantial increases in their traffic – a sign (hopefully) of broadening interest in these markets.

Interestingly for gold, while the traditional jewellery demand base took a beating in 2002 this was largely overlooked as attention was drawn to the increasingly vocal debate on 'gold as an investment'. Whether 2003 turns out to be the renaissance year for gold investment is, by definition, not yet clear. What was evident though over the course of 2002 was an increased receptiveness by investors to include gold in wider discussions on asset allocation and portfolio diversification into alternative assets classes.

As the largest and most liquid market, gold presented a rather ambiguous picture for much of the year. This may seem a strange comment to make given the positive performance by gold prices and gold equities in 2002. Nevertheless, given the proliferation of column inches (nay miles) devoted to gold in both specialist and more mainstream press over the past year, and with the entry of ever-more eminent gurus into the fray, the principal result seemed to be an ever-widening polarisation of opinions on the metal.

Opinions on gold are fiercely held at the best of times, but this ferocity reached new heights in 2002. As the best performing market sector for much of the year, gold's investment credentials were necessarily dissected from every angle. Pro-gold arguments focussed on a market believed to be structurally short and set to benefit from deflationary pressures, leading ultimately to rising inflation. Gold's counter-cyclical attributes were also seen as supporting the metal's inclusion in more defensive portfolios. Against this, other research suggested that, since 1980 at least, there has been no common denominator to spikes in the US dollar price of gold. In short, 2002 witnessed a great deal of talk about gold's investment attributes (including the possible introduction of a gold dinar, suggested by the prime minister of Malaysia), but not a great deal of action.

That position could well change in 2003, but for 2002, gold investment remained principally the domain of southeast Asian and Japanese investors, with only limited involvement in the US and Europe. Indeed, the 'new and improved' data on gold demand introduced by the World Gold Council highlighted the continual disinvestment of gold from Europe for much of the year. Hence, potential new investors in gold were often barraged by diametrically opposing views on gold from the same podium – contributing perhaps to the still rather faltering nature of actual investor activity in the market. ■

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A graduate of the Royal School of Mines and a former LBMA vice chairman, Kevin's early career includes work in the South African gold mining industry, on mining operations in Western Australia and post-graduate research for the Japanese government studying that country's mining industry.

Precious metals prices in 2002 (All in USD and indexed to 2 Jan 2002 = 100)