Why platinum is overtaking gold this year

04/27/16 11:53 AM EDT

By Michael Brush, MarketWatch

Historically, platinum has traded at a premium to gold, not a discount

If you missed the nice run in gold so far this year, here's a way to make up for lost ground.

Buy platinum.

Platinum has already crushed gold in 2016, advancing about 22% vs. 17% for gold.

This trend is likely to continue for a simple reason. Historically, platinum often sells for about 1.5 times the value of gold per ounce. Recently, though, it's sold for about 80% the price of gold.

This discount may well continue to close -- as it has so far this year -- and then revert to a premium. As this happens, platinum will keep outperforming gold.

This is likely to happen for the following reasons.

Mean reversion

First, history shows that the platinum-gold discount normally does revert to a premium. "Platinum has been at a sustained discount to gold only four times in the past 40 years," points out Tom Winmill of the Midas Fund. "In all cases it recovered in the subsequent year."

In short, this is a classic "reversion to the mean" story. "It's pretty rare for platinum to be below the price of gold," agrees Ryan McIntyre, an analyst with Tocqueville Asset Management, who is also bullish on platinum.

But what might make this reversion happen?

A market imbalance

For one, it looks like demand for platinum exceeds supply. Last year, mining and recycling produced 7.82 million ounces of platinum. But demand was 8.2 million ounces, points out Winmill, citing numbers from the World Platinum Investment Council.

The difference came from "inventory," or above-ground stocks. But this can't go on forever.

That's because relative to gold, the above-ground stock of platinum is pretty thin at 2.3 million ounces, or about 28% of demand.

"I think the deficit is here to stay and we could run through those above-ground stocks," says Winmill.

Platinum is tough to mine and smelt. And in South Africa, which much of the world's platinum resides, mining is often hindered by strikes and electricity outages. "Extra demand is not met by a flood of supply," says Winmill. "This is a recipe for a potential spike."

Global growth

Unlike gold, platinum is used pretty extensively in industry. This could help explain the unusual discount to gold. After all, many investors remain fearful that the global economy and manufacturing are going to sink into recession. Others worry that China's growth is not all it's cracked up to be.

But what if they're wrong and Chinese and global growth pick up? Then platinum demand will improve, driving prices higher. U.S. Global Investors CEO Frank Holmes expects improved growth in China. He thinks job growth in China will boost demand for cars, which will spark demand for platinum.

As for global growth, it may not go gangbusters. But even 1.5% annual GDP growth will be enough to create sufficient platinum demand to move the price up, says Winmill.

The Volkswagen effect

Another problem for platinum is Volkswagen AG. The Volkswagen emissions scandal has investors thinking that demand for its diesel-engine cars will be in trouble for a long time. Platinum is essential for catalytic converters used with diesel engines. (In contrast, in gasoline engine converters, palladium can substitute for platinum.) So if demand for diesel cars goes down, demand for platinum would, too.

This theory has a few holes in it, though. First, diesel-powered cars will likely remain popular in Europe, because diesel fuel costs so much less than gasoline. "At some point this whole debate about diesel gets put behind us," says Shree Kargutkar at Sprott Asset Management. "Diesel cars are not going away."

"From my research, the amount of platinum that will no longer be used because people don't want to buy Volkswagens is de minimis," agrees Winmill. "It is something, but it is not going to move the metal."

Even if diesel auto sales were in trouble, diesel-powered trucks are definitely not going away, says Winmill. And they're a much bigger source of demand for catalytic-converter platinum than cars.

Keep in mind that emission standards will continue to get tougher, says Tocqueville's McIntyre.

Emission controls are also spreading to off-road vehicles and power generators. Both trends will support demand for platinum.

A known unknown

Finally, a supply shock could happen at any point because of strikes, rolling brownouts or other problems in South Africa. "Labor contracts in South Africa expire in June. That needs to get resolved," notes Diana Racanelli, a natural resources analyst at Manulife Asset Management.

How to play platinum

The safer way to play platinum is to buy an exchange-traded fund, like ETFS Physical Platinum. Platinum stocks are a lot riskier because mining companies typically have operations in South Africa, where strikes and power outages can easily disrupt production.

If you do want to venture into stocks, though, here are two to consider, says Winmill. Platinum Group Metals Ltd.(PLG) operates mines in South Africa that are close to the surface, so they aren't as expensive as deep-shaft mines. It also has big, undeveloped deposits still to exploit. But because of the risks, this one is "not for the faint of heart," says Winmill.

Another to consider is Ivanhoe Mines Ltd. , listed on the Toronto stock exchange. Ivanhoe has South African deposits that may be relatively cheap to mine. But actual mining won't start any time soon, so this is a long-term hold, says Winmill.

What could go wrong?

Of course, markets being markets, not everyone agrees that the unusual platinum-gold price differential has to narrow more and eventually revert to a premium.

Mike Underhill, a portfolio manager at the RidgeWorth Capital Innovations Global Resources and Infrastructure Fund, says it's better to short platinum now, or at least keep it out of your portfolio. That's because weak global growth will put a lid on industrial demand. "As long as economic growth remains sluggish, the outlook for platinum is dim," says the portfolio manager.

He thinks platinum has gotten a free ride of late, tagging on gold's coattails. But this free ride is unjustified, he says, Gold is popular now in part as a form of portfolio insurance for uncertain times. But platinum will never serve this purpose, since a large part of demand comes from industry.

"You see so many people chasing platinum thinking it is analogous to gold. But there is only one kind of gold, and that's gold," says Underhill. "Gold is a great investment in times of volatility, uncertainty complexity and ambiguity."

Platinum? Not so much, he says.

Zhiwei Ren, managing director and portfolio manager with Penn Mutual Asset Management, which has $20 billion under management, thinks commodity prices are up in part because of government-induced credit expansion in China aimed at boosting growth. This has fueled speculation in commodities.

But this source of demand for metals like platinum may not last, he says.

And T. Rowe Price portfolio manager Rick de los Reyes says technology advances now allow catalytic converters to be made with much less platinum, a trend that will continue. Meanwhile, more of the metal can be harvested from recycling old converters, also because of better technology. "You have growing supply from recycling meeting lower demand." That's not a recipe for higher platinum prices.

Besides, he says, history doesn't necessarily have to repeat itself in the markets -- or even rhyme. "I don't think there is any rule that says platinum has to be higher than gold," he says. "Just because historically it's been that way doesn't mean anything."

At the time of publication, Michael Brush had no positions in any stocks mentioned in this column. Brush is a Manhattan-based financial writer who publishes the stock newsletter Brush Up on Stocks (http://www.uponstocks.com). Brush has covered business for the New York Times and The Economist group, and he attended Columbia Business School in the Knight-Bagehot program.

-Michael Brush; 415-439-6400; AskNewswires@dowjones.com

(END) Dow Jones Newswires

04-27-16 1153ET