Degussa Market Report

4 August 2017 Economics · Finance · Precious Metals

USD per ounce of gold

USD per ounce of silver

EURUSD

Source: Thomson Financial.

Precious metals prices	Actual (spot)	Change against (in percent): 2 W	3 M	12 M
I. In US-dollar				
Gold	1.268.4	1.9	-0.9	-5.7
Silver	16.6	2.1	-5.0	-15.9
Platinum	961.2	3.8	1.0	-11.4
Palladium	889.2	5.5	5.8	29.4
II. In euro				
Gold	1.067.6	-0.2	-5.9	-10.7
Silver	14.0	-0.1	-9.8	-20.4
Platinum	809.0	1.6	-4.3	-16.4
Palladium	748.0	3.0	0.4	22.0
III. Gold price in other currencies				
JPY	139.653.0	0.3	-1.1	2.1
CNY	8.517.4	1.3	-2.2	-4.9
GBP	964.9	0.6	-2.8	-4.3
INR	80.760.3	0.8	-2.0	-9.7
RUB	76.279.0	4.1	5.3	-11.6

Source: Thomson Reuters; own calculations.

OUR TOP ISSUE

This is a short summary of our fortnightly ***Degussa Marktreport****.*

The Underpriced Risk

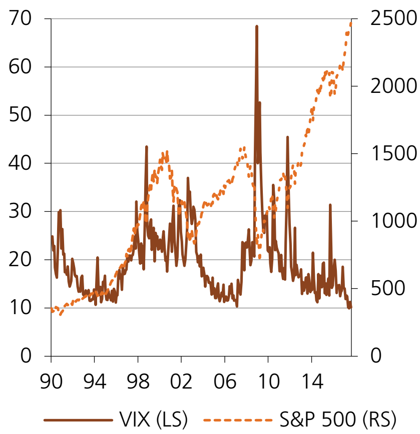
If you invest your money, you will have to deal with numerous risks. For instance, if you buy a bond, you run the risk of the borrower defaulting or being repaid with debased money. As a stock investor, you face the risk that the company's business model will not live up to expectations, or that it, at the extreme, will go bankrupt. In an unhampered financial market, prices are formed for these and other risk factors.

For instance, a bond with a high default risk will typically carry a high yield. The same goes for debt denominated in an unsound currency. Stocks of companies that are deemed risky tend to trade at a lower valuation level than those considered low risk. All these risk premiums, if determined in the unhampered market, constitute a portion of an asset's price, be it a bond or a share. They play a vital role in the way capital is allocated in an economy.

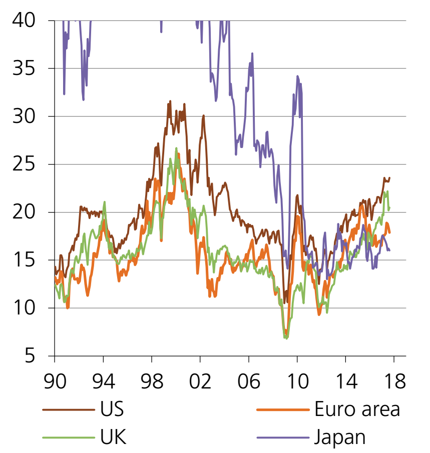
Risk premiums are meant to compensate investors for the risk of losses resulting from adverse developments. If you buy a stock at a depressed price relative to the firm's earnings power, it tends to reduce your downside (while offering the chance of great gains). At the same time, risk premiums increase investors' cost of capital. This, in turn, discourages them from engaging in overly risky investments.

Decline in risk premiums (1)

(a) Stock market volatility and S&P 500



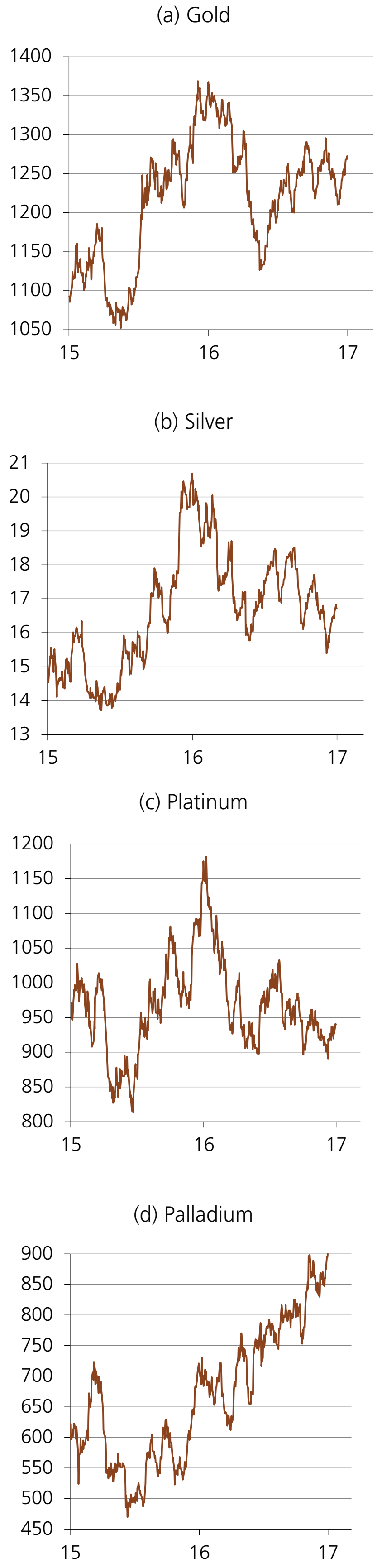
(b) Price-earnings ratios



Source: Thomson Financial.

In other words: Risk premiums determined in an unhampered market align the interests of savers and investors. Of course, one cannot be sure that ex ante risk premiums are always correct. Sometimes it turns out that risks were overestimated, sometimes they were underestimated. However, the unhampered market is still the best and most efficient means to determine the price of risk.

Precious metal prices in US dollar per ounce



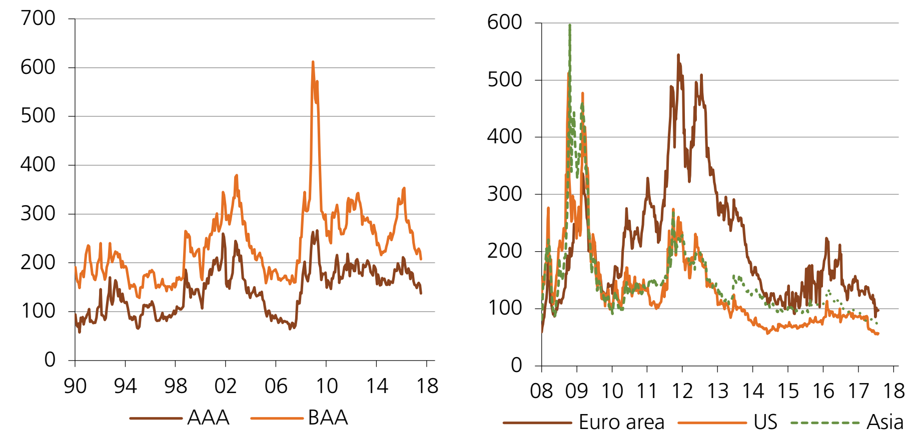
Source: Thomson Financial.

Central banks suppress risk premiums

Central banks, however, interfere and corrupt the best practice of the formation of the price of risk. In the last financial and economic crisis, central banks had lowered interest rates to unprecedented low levels and ramped up the quantity of (base) money to keep financially ailing governments and banks afloat and the economy going. In fact, they effectively put out a 'safety net', providing insurance to financial markets against potential systemic losses.

Decline in risk premiums (2)

(a) Credit spreads over US Treasuries in bp(1) | (b) Credit default swap rates for bank bonds, 5 years, bp



Source: Thomson Financial.

By doing so, central banks have put investor risk aversion to sleep: Under their guidance, financial markets are now betting on, and have high confidence in, monetary policy makers successfully fending off any new problems in the economic and financial system. This seems to be the message the price action in financial markets is conveying to us. For instance, stock price fluctuations have returned to very low levels, accompanied by strong stock market gains and high valuations.

The yield spread of risky corporate bonds over US Treasuries has returned to levels last seen in early 2008. Or look at the prices for credit default insurance for bank bonds: They also have returned to pre-crisis levels, suggesting investor credit concerns have markedly declined. In other words: Investors are back again, eagerly taking on additional credit risk and willingly financing corporates' investments at suppressed costs of capital.

Central banks have thus not only artificially reduced interest rates by lowering credit costs, they have also artificially reduced risk premiums by (explicitly or implicitly) signaling to the financial markets that they are prepared to basically 'do whatever it takes' to prevent another meltdown as witnessed in 2008/2009. The consequence is that financial markets and economies depend on central bank action more than ever before.

There is no easy way out of this situation. If interest rates go up – be it through rate hikes or the elimination of the 'safety net' – the current recovery will most likely come to a halt, if it does not turn into a bust straight away: With higher interest rates, the economic structure, built on artificially low interest rates, would run into serious trouble. The idea of central banks 'normalizing' interest rates without output losses or even a recession appears illusionary at best.

Against this backdrop, it is interesting to see that, for instance, the US Federal Reserve and the European Central Bank (ECB) may want to bring short-term interest

World Gold Council: Gold demand and supply data for Q2 2017

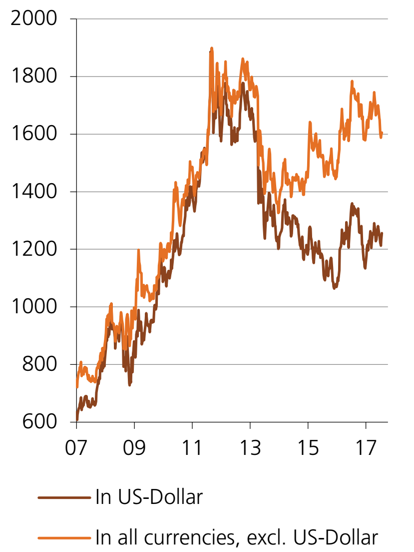
—Q2 2017 gold demand of 953.4 tons was 10% lower than Q2 2016, …
—… basically affected by record ETF inflows in 2016: demand from ETFs slowed strongly after last year's H1 surge.
—Jewellery demand rose 8% y/y (India: +41% y/y, China: –5% y/y).
—Investment demand fell 34% y/y due to a y/y decline in gold ETF demand (-76% y/y). Coin and bar demand was up 13% y/y.
— Central bank demand up 20% y/y.
— Gold used in technology rose 2% y/y.
—Total gold supply declined 8% y/y (recycled gold: -18% y/y).

Overall, Q2 2017 data actually point towards a strengthening of gold demand, accompanied by a decline in gold supply – which should be positive for the price of gold, we think, if and when this trend continues. The full report can be found ***here***.

Gold price per ounce

in US dollars and all world currencies (excl. the US dollar)*

January 2007 to August 2017



Source: Bloomberg; own calculations. *Calculated from the gold price (USD/oz) and the nominal trade weighted exchange rate of the US dollar. The timeline was indexed at 5 September 2011 with a value of 1.900.

rates back up (further). At the same time, however, there is no evidence that monetary policy makers have any plans to remove the 'safety net' that has so successfully brought down risk premiums in asset markets and thus the cost of capital.

That said, even an increase of central banks' short-term funding will not bring about a normalization of the cost of capital – as risk premiums will most likely remain artificially suppressed. Capital misallocation will continue and the artificial boom is kept alive and well. Investors, therefore, face quite a challenge: Malinvestments continue, and downside risks increase, while it might be too early to jump ship.

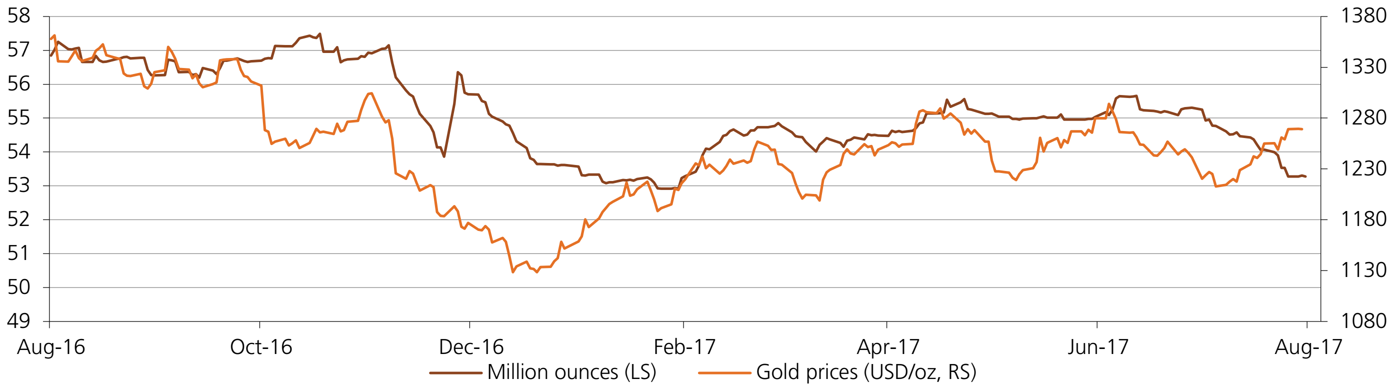
Building up downside protection

A reasonable reaction would be building up a downside protection for the investment portfolio. One option is holding physical gold. The yellow metal is the 'ultimate means of payment', one that cannot be debased by central banks' monetary policies – which most likely results in the printing of ever greater quantities of new money if things turn sour. Furthermore, gold does not carry any default risk as for instance bank deposits or short-term bonds.

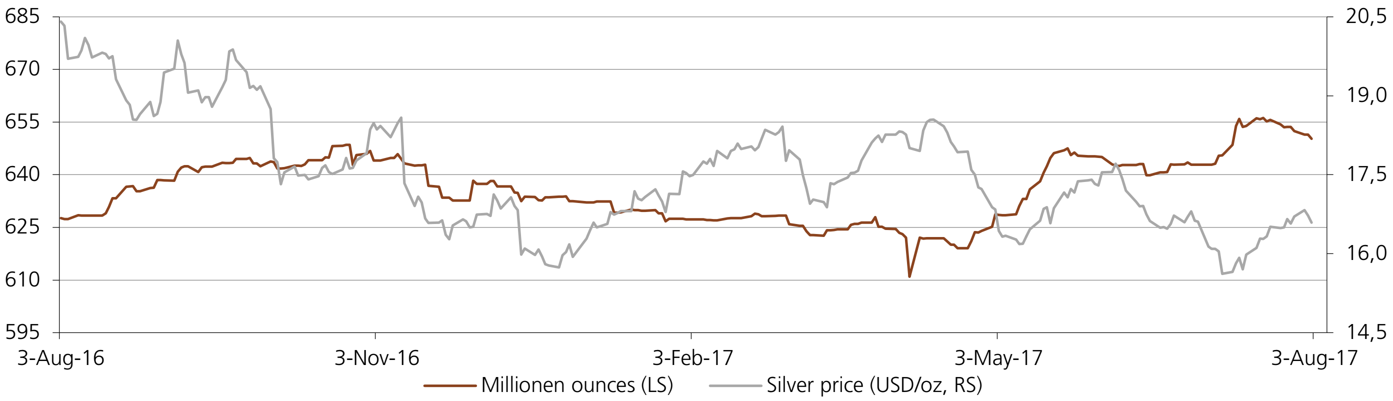
By no means less important: The current gold price does not appear to be expensive. It seems to be rather cheap when measured against assets such as bonds and stocks. That said, the current gold price seems to grant an effective hedge against the vagueness of unbacked paper money (the latter can actually become worthless while gold cannot), and at the current valuation, gold appears to be an insurance with upside potential in terms of price.

Precious metals prices and ETF holdings

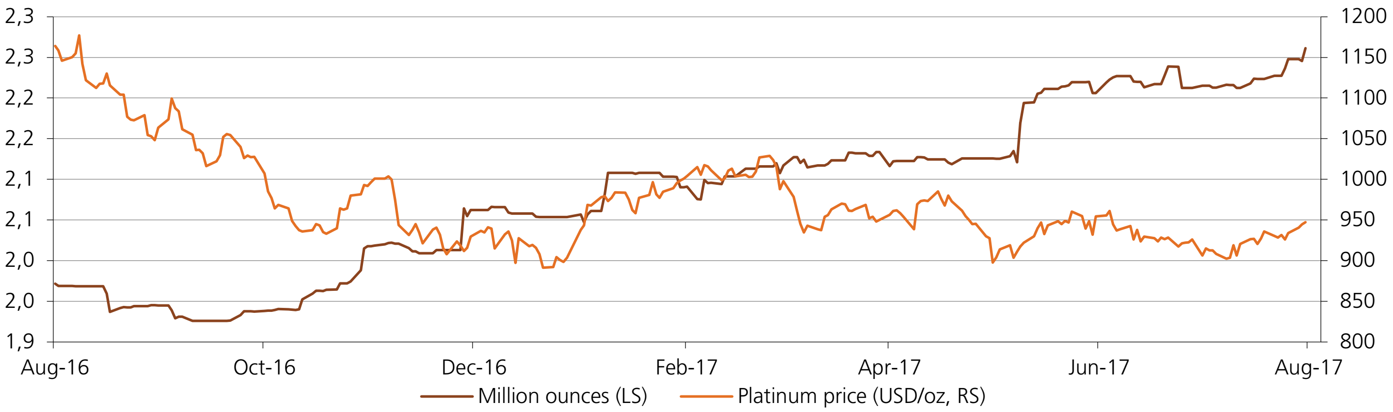
Gold ETFs (million ounces) und gold price (USD/oz)



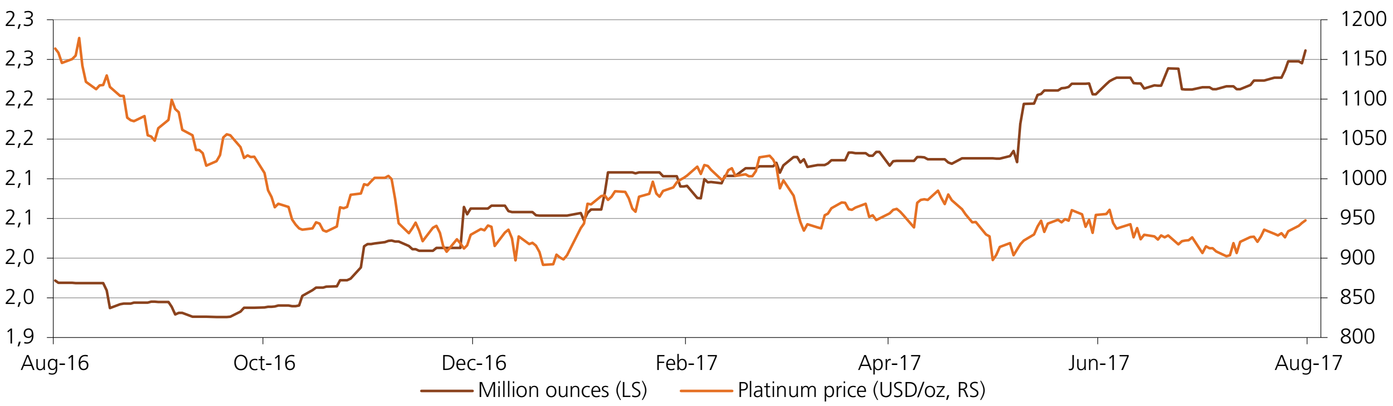
Silver ETFs (million ounces) and silver price (USD/oz)



Platinum ETFs (million ounces) and platinum price (USD/oz)



Palladium ETFs (million ounces) and palladium price (USD/oz)



Source: Bloomberg.

Precious metals prices

In US-dollar

	Gold		Silver		Platinum		Palladium	
I. Actual	1.268.4		16.6		959.0		886.3	
II. Gliding averages								
5 days	1.267.7		16.7		935.4		888.4	
10 days	1.259.1		16.6		931.5		871.0	
20 days	1.241.7		16.2		922.4		861.9	
50 days	1.251.4		16.6		928.1		854.6	
100 days	1.252.8		17.1		938.4		825.5	
200 days	1.229.4		17.1		949.8		777.2	
III. Projections for 2017								
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1.148	1.390	15.9	23.00	906	1.100	700	900
IV. Annual averages								
2013	1.429		24.1		1.487		724	
2014	1.260		19.1		1.382		800	
2015	1.163		15.7		1.065		706	
2016	1.242		17.0		985		617	

In euro

	Gold		Silver		Platinum		Palladium	
I. Actual	1.068.3		14.0		807.7		746.5	
II. Gliding averages								
5 days	1.076.7		14.2		794.5		754.5	
10 days	1.075.3		14.1		795.5		743.8	
20 days	1.072.5		14.0		796.7		744.4	
50 days	1.100.4		14.6		816.1		751.3	
100 days	1.128.9		15.4		845.8		743.1	
200 days	1.130.4		15.7		874.0		713.9	
III. Projections for 2017								
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1.005	1.217	13.9	20.13	793	963	613	788
IV. Annual averages								
2013	1.079		18.2		1.123		547	
2014	945		14.3		1.035		601	
2015	1.044		14.1		955		633	
2016	1.120		15.4		888		557	

Source: Thomson Financial; own calculations and estimates.

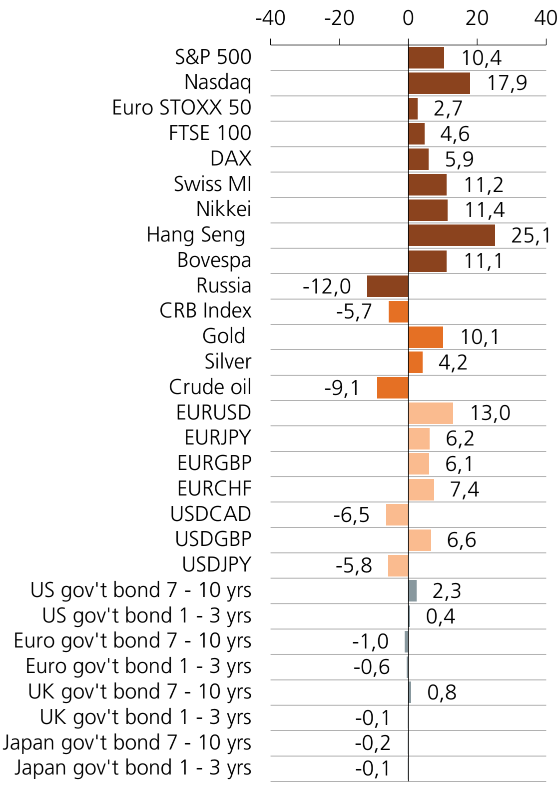
Bitcoin, performance of various asset classes

Bitcoin in US dollars

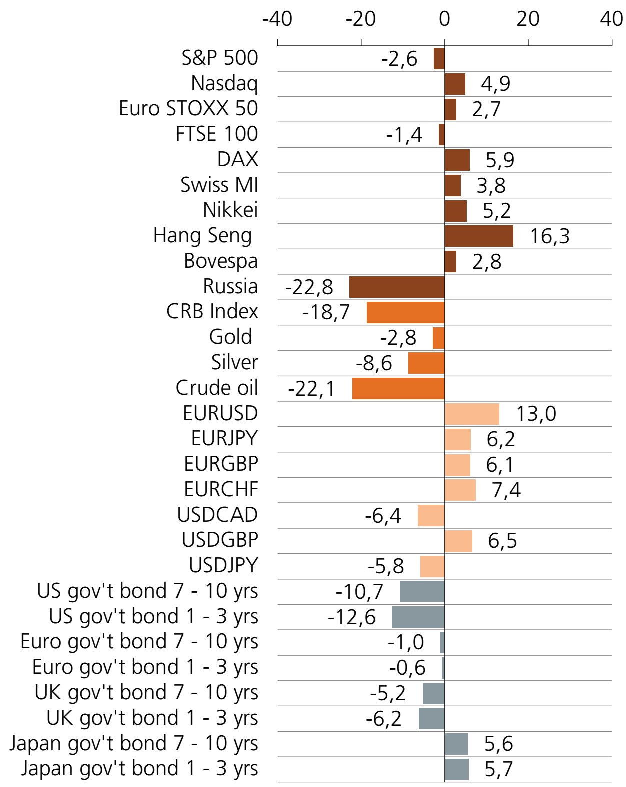
Source: Bloomberg

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euro



Source: Bloomberg; own calculations

Articles in earlier issues of the *Degussa Market Report*

Issue	Content
4 August 2017	The Underpriced Risk
21 July 2017	The Fed Remains on Course – to Trouble
7 July 2017	Gold And The Blockchain
23 June 2017	The Super-Bubble in Danger
9 June 2017	Trapped in Boom-and-Bust
26 May 2017	The Make-Believe World of Fiat Money
12 May 2017	The Fed Will Likely Chicken Out on Planned Rate Hikes
28 April 2017	Central Banks Will not Dare to Take Away the Punch Bowl
13 April 2017	The Gold Price Rise Tells Us: The Crisis Isn't Over Yet
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3 February 2017	Gold Insures Against Risks Lurking in the Financial System
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20 December 2016	Gold Rather Than Euro
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11 November 2016	Trump Election Puts Euro Under Pressure
28. October 2016	US Presidential Elections and the Price of Gold
14 October 2016	Amid Uncertainty, Opportunity Knocks
30 September 2016	On the Debt Ratio and the Price of Gold
16 September 2016	Central Banks May Choose Helicopter Money Over Negative Rates
2 September 2016	No return to "normal" interest rates
19 August 2016	Debt Monetized En Masse to Fend Off the Euro Crash?
5 August 2016	*No English issue due to summer break*
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8 July 2016	Escaping the Euro Trap
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10 June 2016	Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike
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13 May 2016	The Fight Against "Secular Stagnation" and Its Consequences for Gold and Silver Prices
29 April 2016	US Dollar's Dominance Challenged By Gold
15 April 2016	A World without Returns
1 April 2016	Helicopter Euros Hovering on the Horizon
18 March 2016	Gold and Stocks Protect Against 'Helicopter-Euros'

The Degussa Marktreport (German) and the Degussa Market Report (English) are available at:
www.degussa-goldhandel.de/infothek/marktreport/

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