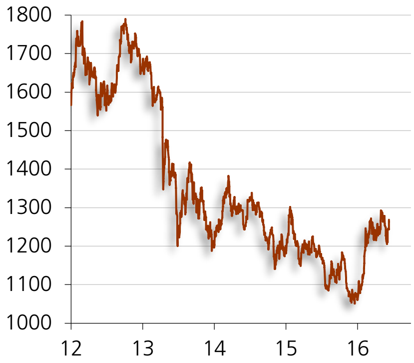
Degussa *Market Report*

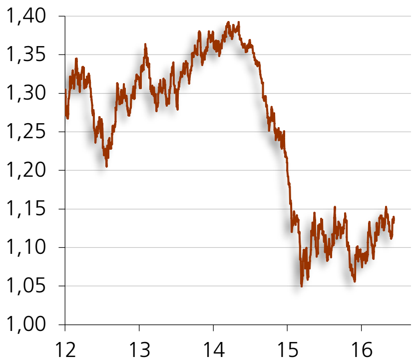
10 June 2016 Economics · Finance · Precious Metals

USD per ounce of gold



USD per ounce of silver

EUR USD



Source: Bloomberg. Daily data

Precious metals prices

	Actual (spot)	Change against (in percent): 2 W	3 M	12 M
I. In US-dollar				
Gold	1.268,8	1,3	2,9	8,2
Silver	17,3	4,7	12,6	10,2
Platinum	996,8	-2,5	2,2	-7,8
Palladium	554,3	-1,2	-1,6	-17,8
II. In euro				
Gold	1.120,9	0,5	3,5	6,5
Silver	15,3	4,0	13,2	8,6
Platinum	880,5	-3,4	2,7	-9,2
Palladium	489,5	-1,8	-1,0	-19,1
III. Gold price in other currencies				
JPY	135.481,6	-1,7	-2,3	-5,5
CNY	8.331,1	1,7	4,5	14,5
GBP	878,6	1,8	2,6	17,7
INR	84.826,6	1,9	4,1	13,6
RUB	82.039,1	-1,9	-1,0	26,5

Source: Bloomberg; own calculations.

OUR TOP ISSUES

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

Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike

Investors may be better off holding on to gold and stocks even if the Fed heaves and hoes to haul up rates.

Go for Stocks, Not Bonds

A word to the wise investor: Keep an eye on the stock market, but watch bond valuations like a wary cat.

The Target2 Crisis Returns

Deutsche Bundesbank's Target2 claims are edging up as the ECB bails out financially unsound states and banks.

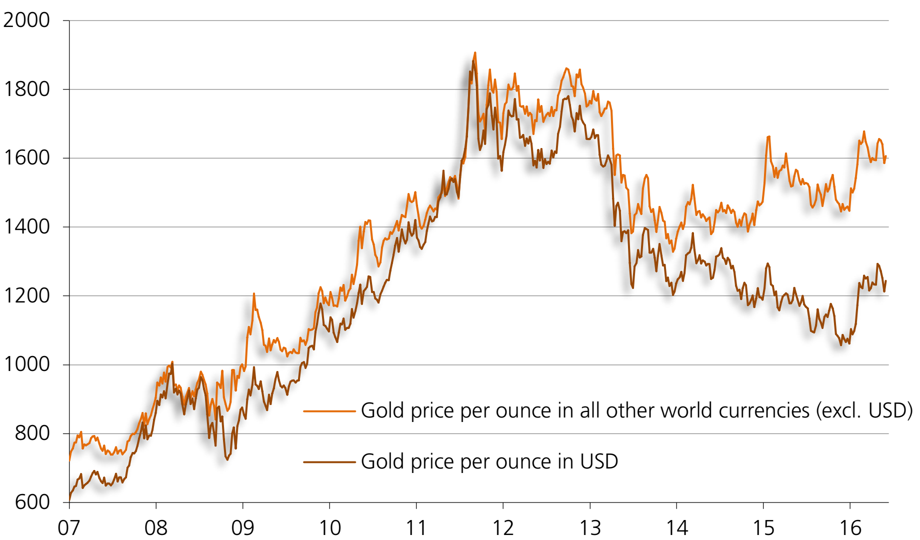
A Modern Twist on Socialism

Nationalizing the means of production is so yesterday; today's brand of socialism is all about controlling the power people have over their property.

Precious Metal Market

With a rate hike on the horizon in the USA, precious metals prices may be facing headwinds in the near term.

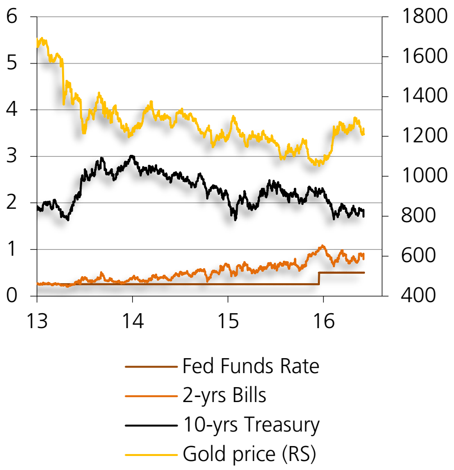
Gold price per ounce
*in US dollars and all world currencies (excl. the US dollar)**
January 2007 to June 2016



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

Rising short-term rates dampen gold price

Gold price (USD/oz) and select US interest rates in percent



Source: Thomson Financial

When short-term interest rates ascended in the USA around mid-2013, the gold price began to slide. Higher interest rates drive down the demand for gold as it becomes more expensive to hold on to that gilt metal. And dwindling demand causes its price to dip.

But if short-term interest rates increased, how is it that long-term US interest rates actually decreased?

Good question. Here's how the math works: Long-term interest rates are largely determined by the sum of expected future short-term interest rates. Rising short-term rates, accompanied by falling long-term interest rates, would suggest that financial market players expect the Fed to eventually reverse its policy on higher interest rates. However, financial markets certainly don't expect the Fed to bring interest rates back to 'normal' levels anytime soon.

Fed chairman Janet Yellen indicated in her latest address on 6 June that the central bank may well raise rates further at its forthcoming June meeting (despite disappointing news from the labor market of late), and if not in June, then at its 27 July meeting. This slow, careful approach shows what great difficulty the Fed faces in ending its ultra-low interest rate policy. Hammering down interest rates until they hit rock bottom is easy, but political constraints make it rather difficult to haul them back up again.

Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike

Investors may be better off holding on to gold and stocks even if the Fed heaves and hoes to haul up rates.

Is the Federal Reserve (Fed) about to raise the Federal Funds Rate at its next meeting on 15 June? The global economy in general and precious metals markets in particular have a lot riding on the answer to this question.

Analysts who make their living reading tea leaves such as the minutes of the latest Fed meeting published on 18 May believed that borrowing rates could go up as early as June. This expectation was tabled when disappointing US labor market data were published on 3 June.

Directly or indirectly, US interest rates have a great deal of sway over precious metal prices, in particular gold and silver: When interest rates are high, holding gold is a costly proposition.

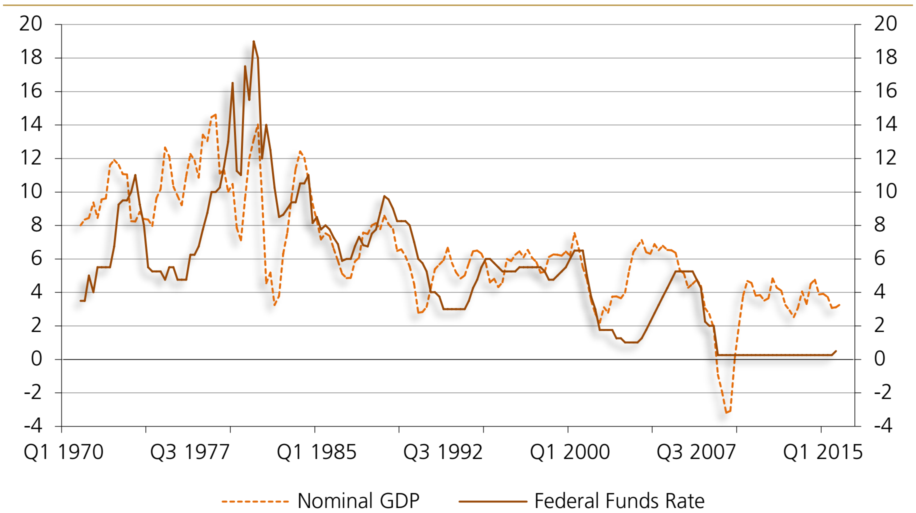
The gold's owner doesn't earn interest that could be earned with an interest-bearing security such as bonds. Vice versa, it's cheaper to hold gold when interest rates are low.

Although the situation now favors precious metals, the prospect of higher US interest rates would suggest that prices could be facing some headwind soon if the Fed actually follows through and ratchet up rates.

Few would contest the fact that the US Federal Funds Rate is too low by any measure, especially with borrowing costs well below the expansion rate of the US nominal GDP.

US Federal Funds Rate at an extraordinarily low level

US nominal GDP growth and Federal Funds Rate in percent

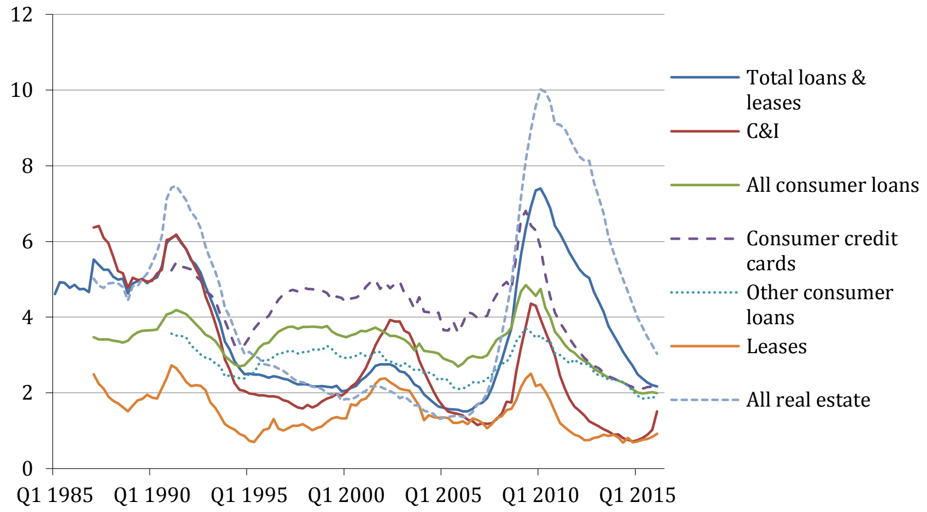


Source: Thomson Financial; own calculations

Effects of higher rates

However, the Fed may wish to postpone further rate hikes for any number of reasons, one being the fear that higher borrowing costs could put a damper on business activities.

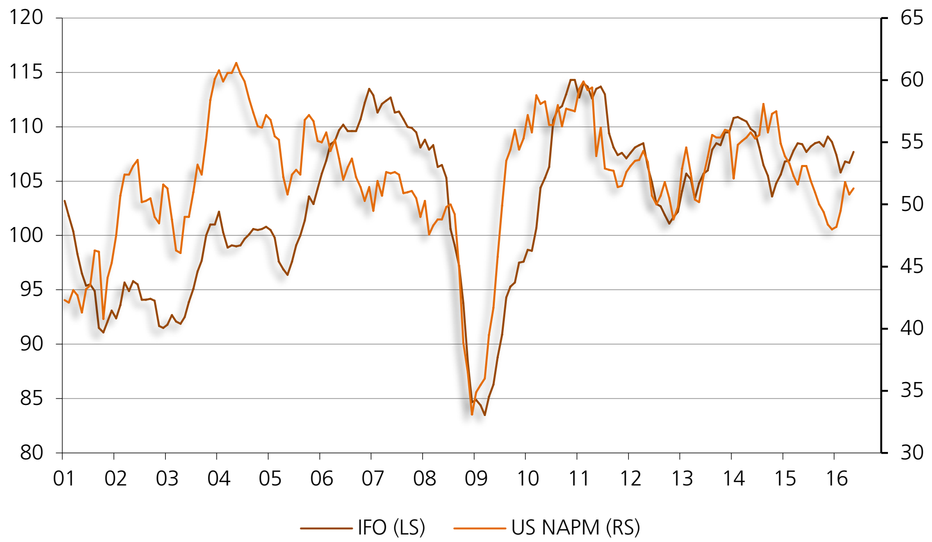
1 Delinquency rates of outstanding bank loans in the US in percent



► Delinquency rates have remained fairly subdued overall, with the sole exception of corporate loans, which have edged up slightly.

Source: Thomson Financial, Federal Reserve.

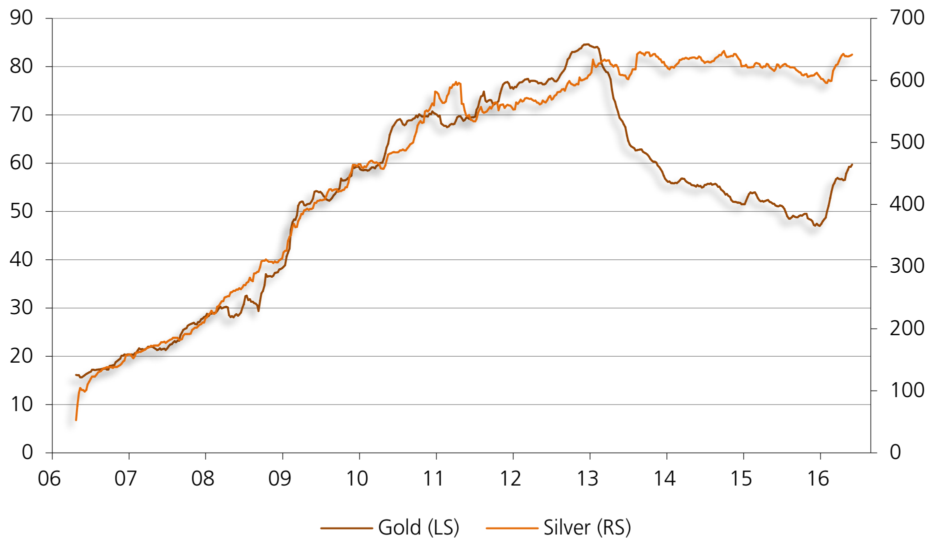
2 Business cycle indicators in the USA and Germany



► Business cycle indicators point to sustained growth.

Source: Thomson Financial

3 Gold and silver ETFs, in million ounces

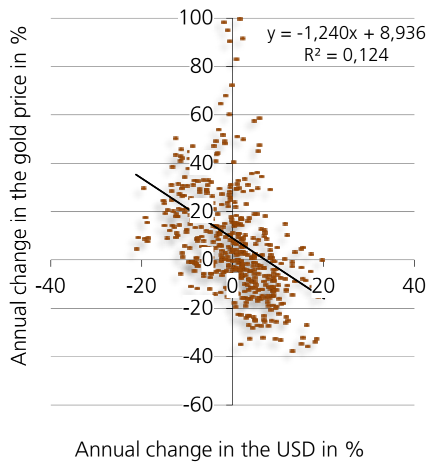


► Gold and silver ETFs have been enjoying substantial inflows of late, despite the possibility of the Fed upping rates soon.

Source: Bloomberg

Gold price rises over the long term, unaffected by US dollar's fluctuating value

Gold price (USD/oz) and external value of the US dollar* (y/y in %, respectively)

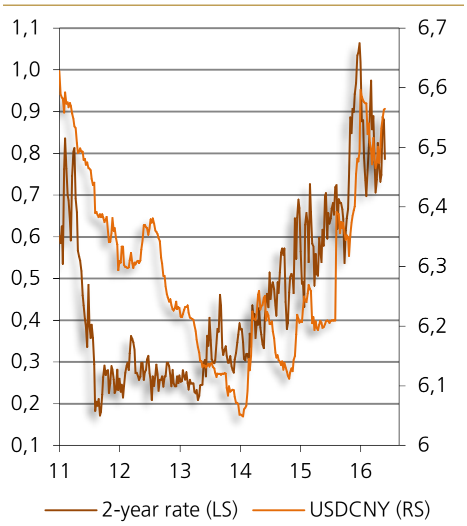


Source: Thomson Financial. Period: January 1973 to May 2016. *Trade weighted exchange rate

The graph above plots changes in the gold price against the US dollar's fluctuating value. Of course, the gold price reacts to swings in the US dollar exchange rate: When the US dollar appreciates or depreciates, the gold price falls and rises accordingly. However, the gold price went up by around nine percent per year on average in the period under review, irrespective of the US dollar's ups and downs. This tells us in no uncertain words that the price of gold isn't dictated by the US dollar. It has a life of its own!

Higher US short-term rates put pressure on the Chinese renminbi

Yield of two-year US bills in % and USDCNY exchange rate

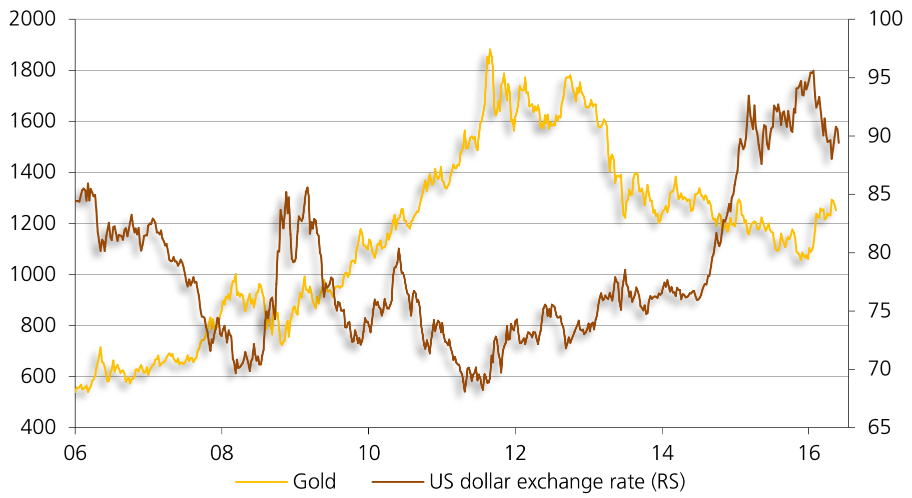


That would seem plausible enough given that the latest upswing in the US economic cycle has been fueled by ultra-low interest rates.

What's more, rising US rates would probably attract foreign capital to the USA, especially in view of the low interest rates in many other currency areas such as Europe and Japan. This would buoy the US dollar exchange rate. The stateside corporate scene would be somewhat less than ecstatic over this turn of events.

US dollar's appreciation accompanied by lower gold prices

Gold price (USD/oz) and the external value of the US dollar



Source: Thomson Financial

A stronger US dollar bolstered by higher US rates is likely to reduce liquidity in the global financial system. Capital would flow out of, say, emerging markets and into the US. This could hit these markets hard, and the fallout (such as defaults and recession) may eventually make its way to the USA.

Higher US rates would affect financial markets—that much is clear. The long reign of low rates contributed to the inflated prices of bonds, marketable credit structures and, of course, housing. Bloated prices have pumped up banks and financial firms' equity capital. Deflating asset prices would hit the financial sector where it hurts, in the P&L columns, with potentially negative effects on business activity in general.

There's another force at work that could give the Fed less room to maneuver: China. Rising US rates have put the external value of the renminbi under growing pressure vis-à-vis the US dollar. As capital departs China, the Peoples' Bank is bound to sell its greenback reserves to prevent the currency from depreciating further in FX markets. An even weaker renminbi exchange rate could have far-reaching repercussions for international trade.

For one, it would make Chinese products even more competitive. Manufacturers in the USA, Europe, Japan and elsewhere would have to cut costs or corners to remain in the running. If their margins for increasing productivity and slashing expenses are too narrow, they will have to downsize wages or the workforce. In other words, if a currency devaluation is forced upon China, prices would come under severe pressure, a prospect that instills fear in the hearts of many.

The problem with bringing rates back up

All this goes to exemplify that higher Fed rates could rock the global economy and financial system. And it also gives the reader an idea of how hard it would be for the Fed to execute an about-face and haul rates that have been so low for so long back up to reasonable levels. How this could be done without wreaking economic and financial havoc is anybody's guess.

What makes a policy reversal so difficult is that artificially low interest rates induced firms to seize investment opportunities that they would have ignored had not interest rates been suppressed. Flat-lining interest rates encourage consumers to live beyond their means. And they entice governments to ramp up their debt financing, with low interest rates providing more leeway in their budgets.

Any assessment of the Fed's prospective efforts to heave rates back up must consider that interest rates trend downwards over the long-term in an unbacked paper money system. The central bank is sure to keep pounding interest rates down to ever lower levels. And when interest rates hikes come, even more drastic cuts soon follow. This is the only way to prevent a boom—ignited by issuing mountains of unbacked paper—from busting. It's not just in the USA that this rule holds true; it applies in equal measure to other major unbacked paper currency areas around the world.

The pros of gold and stocks

Sooner or later interest rates will hit zero or even dip below that line. Credit market distortions like this create risks, for example, by causing malinvestments on a grand scale. They also devalue savings denominated in unbacked paper currencies such as bank deposits and debentures issued by banks and governments. That's a bane for the thrifty, but a boon for the currency that is gold.

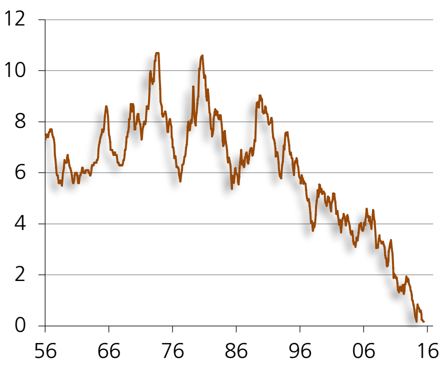
As we see it, gold is indeed a currency. As such, it competes with other currencies such as the US dollar, the euro and the Japanese yen, to name just a few. At current prices (1.250 US dollars or 1.100 euros per ounce), this gilt metal doesn't appear expensive at all to us, and it looks even more affordable in the wake of the monetary expansion that has swept the globe. The investor with an eye on the long-term prize could do worse than holding gold. It's an effective and time-proven vaccine against the ills of unbacked paper money, and its chances of appreciating further look good.

On top of that, the quantity of gold, unlike that of unbacked paper money, cannot be increased at will or the whims of political expediency. Ultimately, gold's buying power is beyond the reach of any political entity. This is another reason why gold can be rightfully called the "ultimate means of payment".

Even if the Fed succeeds in raising rates in the months ahead, it appears unlikely to us that the underlying trend towards ever lower interest rates will be abandoned anytime soon. In a world where central banks are determined to keep the wheels turning by printing money with wild abandon, gold should be a part of an investor's liquidity holdings. There is also good reason to keep investing in stocks. The following article explains why.

The interest rate's unprecedented downturn

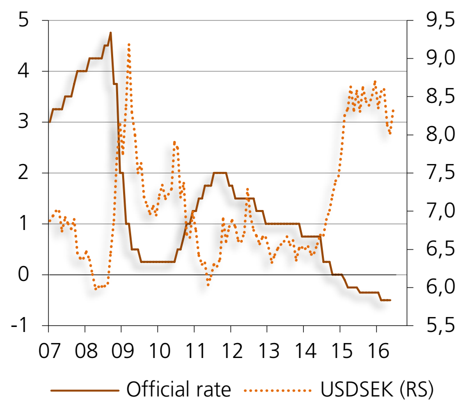
Yield on long-term German gov't bonds* in percent



Source: Thomson Financial; yield on 9- to 10 year German gov't bonds

Negative rates and currency depreciation—a Swedish case study

Riksbank rate in percent and external value of the krona vis-à-vis the US dollar



Source: Thomson Financial

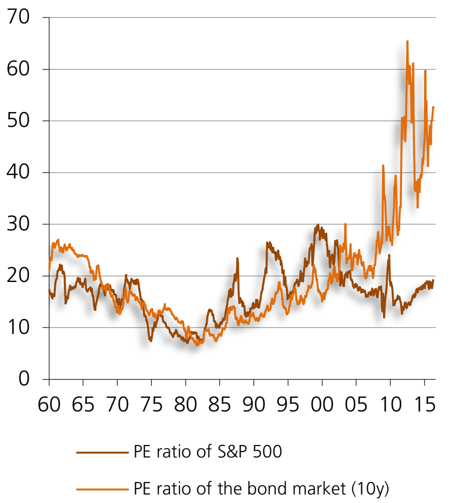
The European Central Bank, the Bank of Japan, the Swedish Riksbank, the Danish Nationalbank and the Swiss Nationalbank slashed their official rates to zero or below. As the Swedish case study graphically illustrates, negative interest rates exert a devaluing effect on the domestic currency. Capital is clearly moving out of the currency with negative yields and into currencies thought to be less 'lossy'. The obvious conclusion is that one country's negative rate policy puts pressure on other countries that do not want their currencies to appreciate as a result of increasing capital inflows.

A word on the price-earnings ratio: Are shares priced at fair value?

The price-earnings (*PE*) ratio typically serves as a rule-of-thumb measure for stock market valuation. The PE ratio is calculated by dividing the price of, say, the stock market capitalization (*P*) by firms' earnings (*E*):
(1) $PE = P / E$.
A PE ratio of 10 tells us that it takes 10 years for the money spent on the stock market to return (assuming annual earnings remain constant). The higher the PE ratio, the more risky the investment, and vice versa.
Equation (1) is the reciprocal of the earnings yield (r):
(2) $PE = 1 / r$.
The earnings yield consists of various elements, including the market interest rate and a risk premium. The central bank can control market interest rates by adjusting the short-term rate and/or the long-term rate. The risk premium, in contrast, is determined by the market; it is somewhat beyond the central bank's direct control.

That said, reducing the market interest rate may not necessarily lower the earrings yield, which would be the case if it were accompanied by a higher risk premium. For instance, investors may grow concerned that ultra-low interest rates give rise to bubbles and malinvestment, thereby increasing their risk premium for holding onto risky assets. This, in turn, would actually work against stock price inflation.

The bond market bubble
PE ratio of the US stock and bond market



Source: Thomson Financial, R. Shiller; own calculations

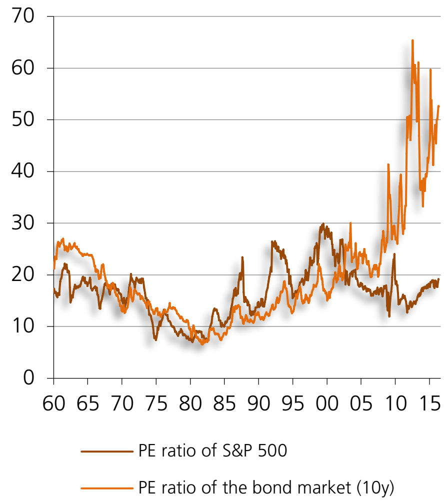
Go for Stocks, Not Bonds

A word to the wise investor: Keep an eye on the stock market, but watch bond valuations like a wary cat.

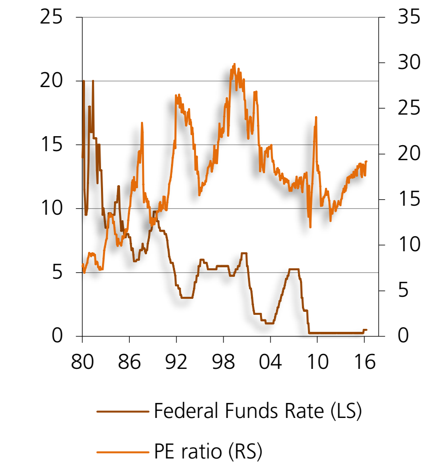
The soaring share prices of recent decades can be pinned on a number of developments. One is surely the trend towards ever lower interest rates. Central banks have done their worst to suppress rates to an all-time low. For every action there is a reaction, and this policy was the rocket fuel that propelled stock prices. Let us count the reasons why:

The interest rate and the stock market valuation

(a) S&P 500 and US Federal Fund Rate in percent



(b) PE ratio of the S&P 500 KGV and Federal Funds Rate in percent



Source: Thomson Financial; own calculations

One reason is the low interest, low cost rule: the less interest a company has to pay, the less it will cost to service its debt. This boosts profits, especially those of highly leveraged companies. The other reason is another rule: The lower the interest rate, the lower the discount factor for discounting firms' expected future cash flows, and the higher their current value and thus the higher the share price.

In the wake of the Fed's zero interest rate policy, which effectively started in 2009, the PE ratios of US firms have not gone up as markedly as one might have expected given the extremely low interest rates. See the column left on the left for more on this. The drop in market interest rates may well have been accompanied by a rise in the equity premium. Accordingly, the earnings yield demanded by investors has remained largely unchanged or went up marginally.

Nonetheless, it would appear that stock market investors have been rather circumspect. Mindful of the economic and financial risks attached to any policy favoring extraordinarily low interest rates, they refrained from pushing valuation levels much higher. Furthermore, it's not carved in stone that higher Fed interest rates—if they do indeed come to pass—will drive down stock valuations: They may actually weigh down the risk premium, thereby compensating for the effect of a higher market interest rate. From this perspective, bonds rather than stocks would appear to be overvalued. In addition, long-term stock holdings offer an opportunity to earn a positive real yield on capital invested. This is a benefit that a buy-and-hold bond strategy is most unlikely to deliver, especially in a regime where central banks keep pushing rates down and printing money.

Precious metals prices, actual and projections (per ounce)

In US-dollar

	Gold		Silver		Platinum		Palladium	
I. Actual	1.268,8		17,3		996,8		554,3	
II. Gliding averages								
5 days	1.257,3		16,9		999,4		556,6	
10 days	1.237,0		16,5		986,2		550,7	
20 days	1.241,7		16,5		1.000,9		554,2	
50 days	1.249,5		16,6		1.011,4		571,9	
100 days	1.230,9		15,9		975,2		553,6	
200 days	1.168,2		15,3		941,8		572,2	
III. Projections								
	Rante		*Range*		*Range*		*Range*	
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
Q2 2016	1.139	1.280	16,1	17,3	790	1.050	560	610
Q3 2016	1.175	1.320	16,1	17,9	820	1.090	580	630
Q4 2016	1.251	1.360	15,6	18,4	770	1.130	590	650
Q1 2017	1.279	1.390	16,3	19,1	1.010	1.180	620	670
IV. Annual averages								
2013	1.398		23,4		1.473		725	
2014	1.252		18,6		1.370		805	
2015	1.154		15,5		1.043		684	
2016 (projected)	1.209		16,2		905		570	

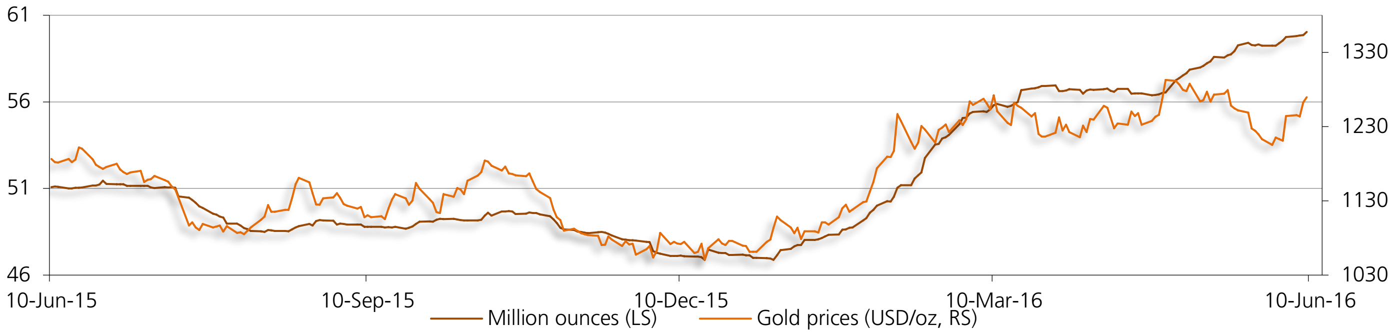
In Euro

	Gold		Silver		Platinum		Palladium	
I. Actual	1.120,9		15,3		880,6		489,7	
II. Gliding averages								
5 days	1.106,6		14,9		879,6		489,9	
10 days	1.099,2		14,6		876,3		489,4	
20 days	1.104,1		14,7		890,0		492,8	
50 days	1.103,6		14,7		893,3		505,1	
100 days	1.098,5		14,2		870,1		493,9	
200 days	1.052,1		13,8		848,0		515,3	
III. Projections								
	Range		*Range*		*Range*		*Range*	
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
Q2 2016	1.008	1.133	14,3	15,4	699	929	496	540
Q3 2016	1.119	1.257	15,3	17,0	781	1.038	552	600
Q4 2016	1.227	1.333	15,3	18,0	755	1.108	578	637
Q1 2017	1.279	1.390	16,3	19,1	1.010	1.180	620	670
IV. Annual averages								
2013	1.052		18		1.108		545	
2014	949		14		1.036		611	
2015	1.045		14		945		619	
2016 (projected)	1.116		15		835		526	

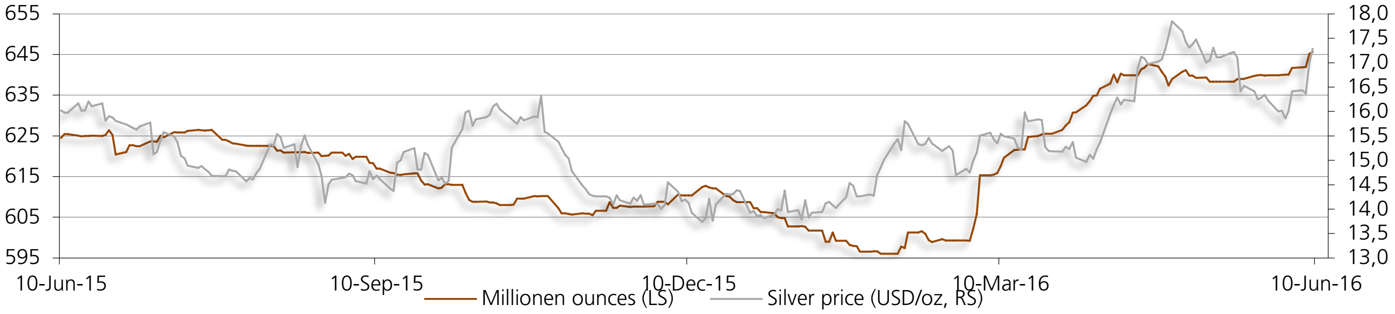
Source: Bloomberg; own calculations. Projections of Degussa Goldhandel GmbH (end of quarter); numbers are rounded.

Precious metals prices and ETF holdings

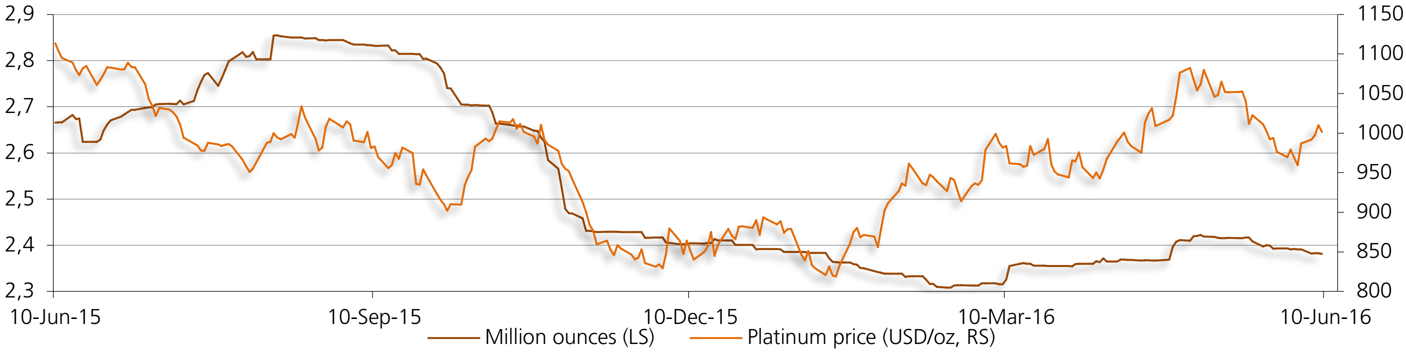
Gold ETFs (million ounces) and gold price (USD/oz)



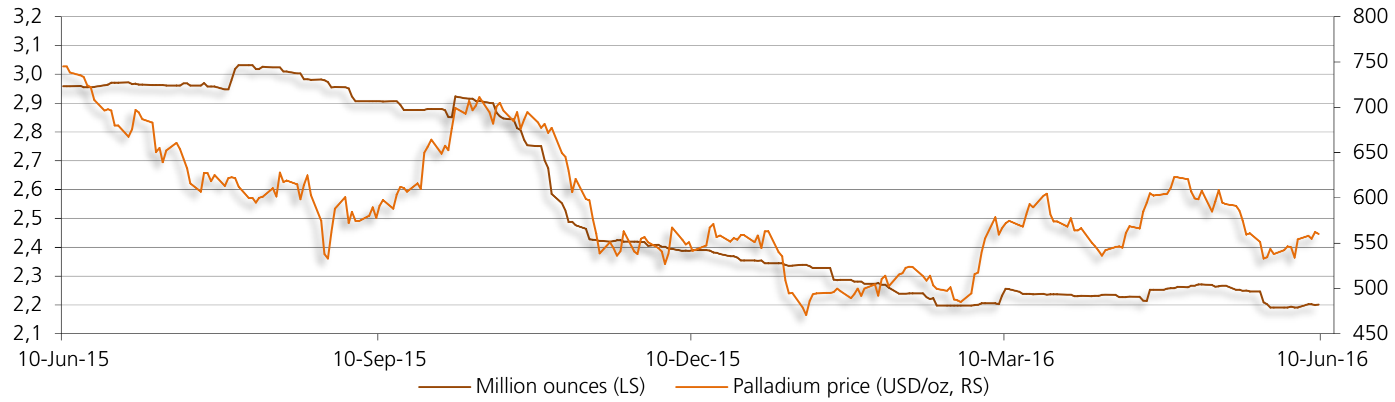
Silver ETFs (million ounces) and silver price (USD/oz)



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



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



Source: Bloomberg

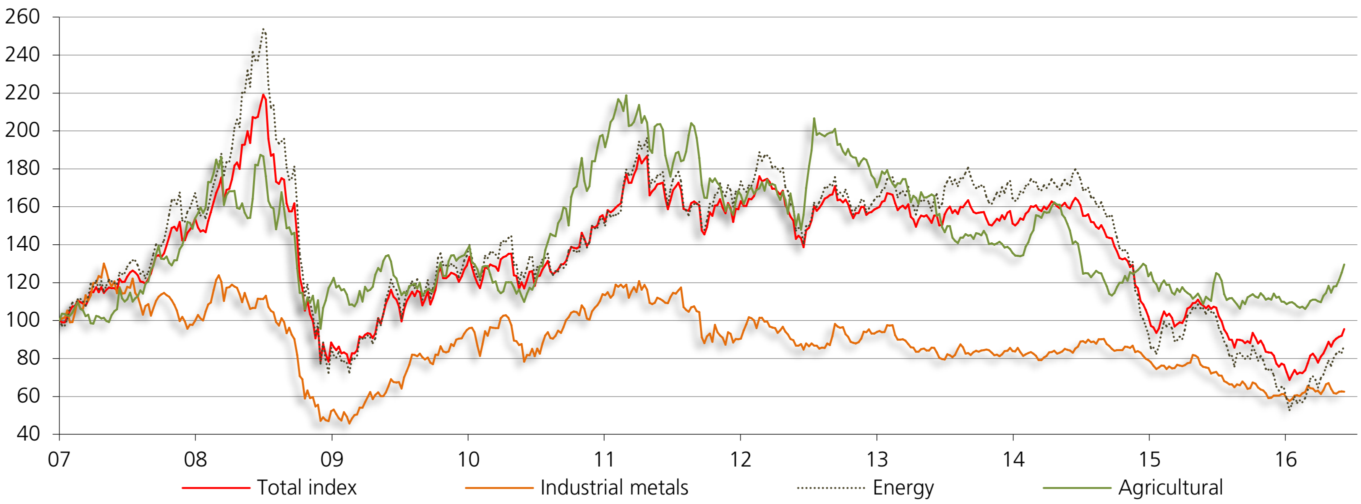
Commodity prices

Selected commodity prices

	Actual price in US-dollar	Change against (in percent): 1 week	1 mth	3 mths	6 mths	12 mths	Volatility (in percent): 30 days	90 days
I. Energy								
WTI crude oil	50,07	1,5	23,1	32,5	21,1	-20,1	26,6	42,3
Brent crude oil	51,52	3,1	25,0	34,0	23,2	-26,1	27,2	43,4
Gasoline	160,97	-1,7	10,3	19,1	7,0	-17,5	30,1	36,5
Heating oil	154,35	2,8	26,4	33,4	24,3	-23,6	27,6	39,8
Gas oil	458,25	2,1	24,3	31,8	23,9	…	32,8	40,6
Natural gas	2,58	19,0	19,9	30,0	2,9	-14,8	39,5	36,3
II. Agriculture								
Corn	425,25	3,0	19,5	17,6	14,8	8,8	24,7	21,5
Wheat	509,25	5,8	5,9	10,6	5,4	-3,0	28,1	25,9
Soy beans	1151,75	9,0	24,5	31,9	30,5	25,6	22,5	16,2
Coffee	135,85	10,2	3,5	14,4	2,5	-3,9	33,6	28,7
Sugar	19,80	12,0	26,8	38,4	34,9	42,2	28,9	29,0
Cotton	64,92	1,7	12,4	15,5	0,3	3,0	18,0	16,3
III. Industrial metals								
Aluminum	1577,00	1,3	3,8	0,3	4,6	-9,4	18,6	17,7
Copper	4515,00	-3,8	-6,8	-3,8	-4,0	-24,9	20,3	20,8
Zinc	2069,50	9,0	13,9	17,3	28,6	-5,4	24,6	28,0
Lead	1702,00	0,2	-0,2	-2,9	-5,1	-12,7	24,0	24,7
Iron ore	49,30	0.2	-7,3	6,3	13,6	-19,3	…	…
IV. Precious metals								
Gold	1268,76	4,7	2,9	3,0	19,4	6,6	14,7	17,7
Silver	17,31	6,7	12,6	16,7	24,7	3,3	23,7	24,6
Platinum	996,75	2,1	2,2	6,9	11,5	-10,4	21,6	23,8
Palladium	554,25	2,9	-1,6	12,1	-1,3	-28,7	29,4	28,9
V. Ratios								
Gold-silver	73,31	-1,9	-8,5	-11,8	-4,2	3,1	13,8	14,6
Gold-platinum	1,27	2,8	0,8	-3,7	7,1	19,0	12,2	15,6
Gold-palladium	2,29	1,6	4,6	-8,1	21,0	49,5	19,7	27,6
Palladium-platinum	0,56	1,2	-3,6	5,0	-11,5	-20,5	15,3	22,8

Source: Bloomberg; own calculations.

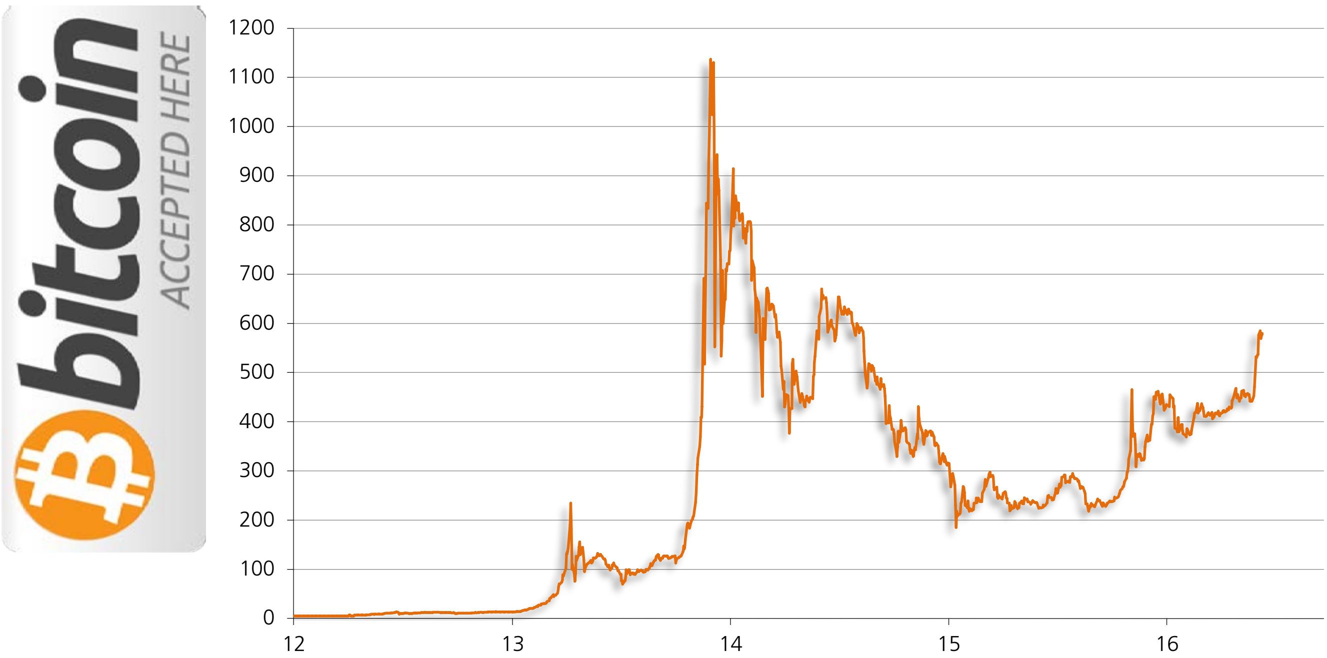
S&P commodity prices (in US dollar terms)



Source: Bloomberg. Series are indexed (January 2007 = 100)

Bitcoin, performance of various asset classes

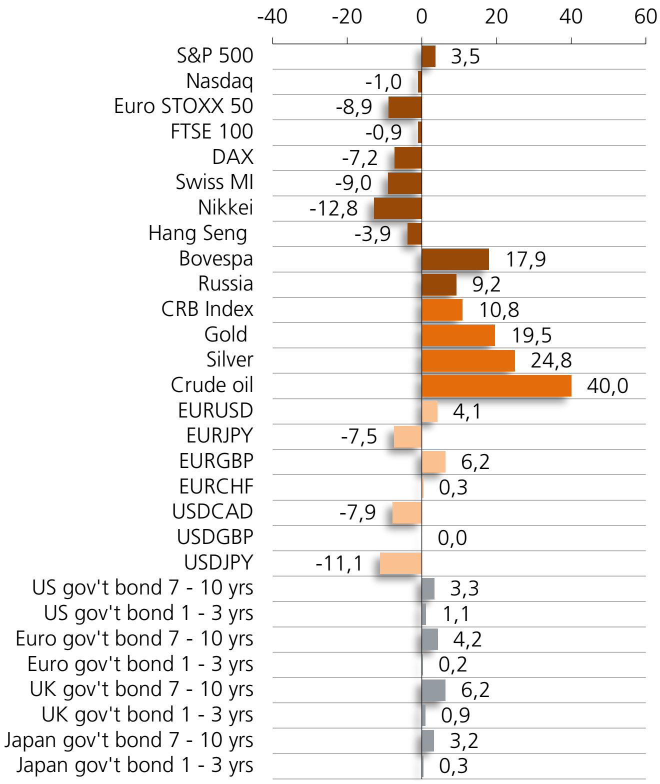
Bitcoin in US dollars



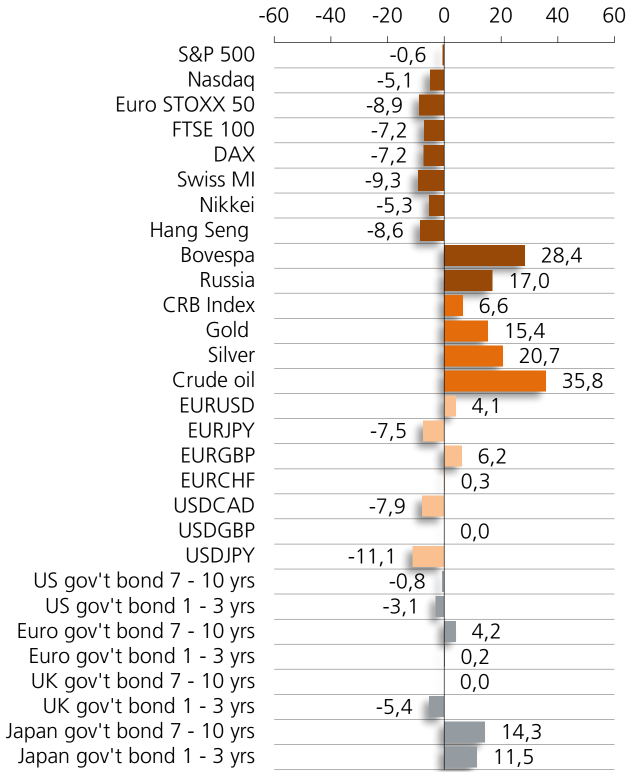
Source: Bloomberg

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euros



Soure: Bloomberg; own calculations

Articles in earlier issues of the *Degussa Market Report*

Issue	Content
10 June 2016	Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike
27 May 2016	The Illusion of Central Bank Independence and the Consequence for the Gold Price
13 May 2016	The Fight Against "Secular Stagnation" and What It Means 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/de/marktreport.aspx.

Disclaimer

Imprint
Market Report is published every 14 days on Fridays and is a free service provided by Degussa Goldhandel GmbH.
Deadline for this edition: 10 June 2016
Publisher: Degussa Goldhandel GmbH, Kettenhofweg 29, 60325 Frankfurt, Tel.: (069) 860068-0, Fax: (069) 860068-222
E-Mail: info@degussa-goldhandel.de, Internet: www.degussa-goldhandel.de
Editor in chief: Dr. Thorsten Polleit
Degussa Market Report is available on the Internet at: http://www.degussa-goldhandel.de/de/marktreport.aspx

Degussa
GOLD UND SILBER.

Frankfurt Headquarters
Kettenhofweg 29 · 60325 Frankfurt
Phone: 069-860 068 – 0 · info@degussa-goldhandel.de

Munich (shop & showroom)**:** Promenadeplatz 12 · 80333 Munich
Phone: 089-13 92613 – 18 · muenchen@degussa - goldhandel.de

Munich (Old Gold Centre): Promenadeplatz 10 · 80333 Munich
Phone 089-1392613 – 10 · muenchen-altgold@degussa-goldhandel.de

Nuremberg (shop & showroom)**:** Prinzregentenufer 7 · 90489 Nuremberg
Phone: 0911-669 488 – 0 · nuernberg@degussa-goldhandel.de

Pforzheim (refinery)**:** Freiburger Straße 12 · 75179 Pforzheim
Phone: 07231-58795 – 0 · pforzheim@degussa-goldhandel.de

Stuttgart (shop & showroom)**:** Kronprinzstraße 6 · 70173 Stuttgart
Phone:: 0711-305893 – 6 · stuttgart@degussa-goldhandel.de

Retail buying and selling outlets in Germany:

Frankfurt (shop & showroom)**:** Kettenhofweg 29 · 60325 Frankfurt
Phone: 069-860 068 – 100 · frankfurt@degussa-goldhandel.de

Berlin (shop & showroom)**:** Fasanenstraße 70 · 10719 Berlin
Phone: 030-8872838 – 0 · berlin@degussa-goldhandel.de

Hamburg (shop & showroom)**:** Ballindamm 5 · 20095 Hamburg
Phone: 040-329 0872 – 0 · hamburg@degussa-goldhandel.de

Hanover (shop & showroom)**:** Theaterstraße 7 · 30159 Hanover
Phone: 0511-897338 – 0 · hannover@degussa-goldhandel.de

Cologne (shop & showroom)**:** Gereonstraße 18-32 · 50670 Cologne
Phone: 0221-120 620 – 0 · koeln@degussa-goldhandel.de

Retail buying and selling outlets around the world:

Zurich (shop & showroom)**:** Bleicherweg 41 · 8002 Zurich
Phone: 0041-44-40341 10 · zuerich@degussa-goldhandel.ch

Geneva (shop & showroom): Quai du Mont-Blanc 5 · 1201 Genève
Phone: 0041-22 908 14 00 · geneve@degussa-goldhandel.ch

Madrid (shop & showroom)**:** Calle de Velázquez 2 · 28001 Madrid
Phone: 0034-911 982 900 · info@degussa-mp.es

Singapur (shop & showroom)**:** Degussa Precious Metals Asia Pte. Ltd.
22 Orchard Road, 01-01 · Singapur 238885 info@degussa-pm.sg

London Sharps Pixley Ltd (member of the Degussa Group)
Phone 0044-207 871 0532 · info@sharpspixley.com