Degussa Market Report

12 May 2017 Economics · Finance · Precious Metals

OUR TOP ISSUE

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

The Fed Will Likely Chicken Out on Planned Rate Hikes

"The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion."

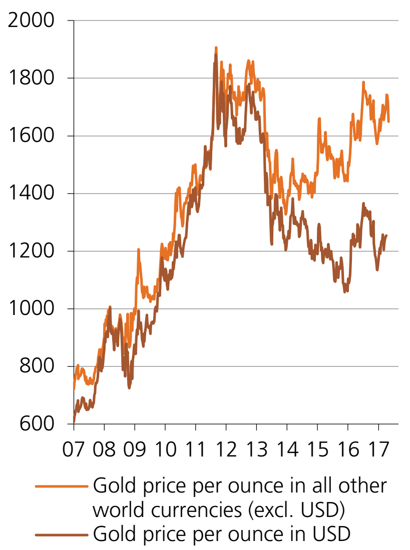
—Ludwig von Mises

The Austrian business cycle theory tells us that the injection of new money created through bank lending out of thin air causes an artificial boom; and that the slowdown of credit and money creation, let alone a decline in available loanable funds, turns the boom into bust. Recent bank lending data in the US show a noticeable slowdown in bank lending rates, setting in around autumn 2016. Does it signal trouble down the road?

There is no easy answer to this question. Various forces are at work. As far as the supply side is concerned, banks may have tightened their lending standards due to higher delinquency rates, restricting access to new loans. Banks may also sell off credit exposure to non-banks such as, for instance, mutual funds, insurance companies etc. Both developments would actually translate into a decline in the level of bank lending aggregates and thus their growth rates.

The same holds if and when banks revalue their security portfolio following higher market interest rates. Under a 'mark-to-market' accounting, an increase in interest rates reduces the present value of cash flows coming from, say, corporate and government bonds. If and when these securities are included in bank credit aggregates, their reduced market price would also show up in a decline in the growth rate of these lending aggregate.

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

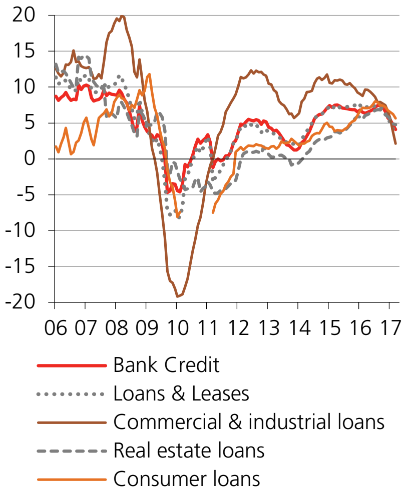
As far as the demand side is concerned, corporates may increasingly refrain from adding to their debt because they are, due to strong earnings, cash rich at the moment. It is also possible that corporates prefer issuing money and capital market instruments rather than obtaining new bank loans. Again, both developments would make themselves felt in the growth rates of bank lending coming down.

In any case, the analysis of bank credit developments reminds us that the US economy is addicted to the inflow of new money and credit created out of thin air. The latter is, so to speak, the lifeblood that keeps the boom going that has been set into motion by the Fed's easy monetary policy in the first place. This insight may be illustrated be the chart below, which shows US bank credit and the S&P 500 stock market index since the early 1990.

One the one hand, stock prices have been propelled upwards over time by increases in productivity and earnings growth. On the other hand, the injection of new money created through bank lending out of thin air has caused prices, including stock prices, to move up. And not only that. The Fed's downward manipulation of interest rates has also encouraged business models that can only survive if borrowing rates remain low, or go down further over time.

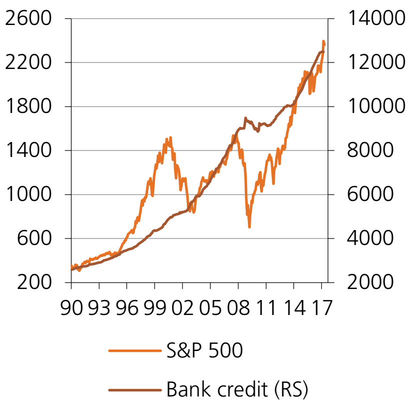
This is because the issuance of new money through credit creation pushes the market interest rate to below the level it would take if there wasn't an out of

Slowdown in US bank lending
US bank credit aggregates, y/y in percent



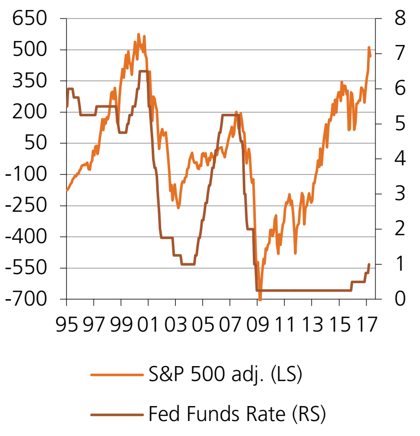
Source: Thomson Financial; own calculations.

Inflationary impact of money creation through bank credit expansion
US bank credit, US$ bn, and S&P 500



Source: Thomson Financial.

The Fed is causing boom and bust
US Fed Funds Rate (%) and trend-adjusted S&P 500*



Source: Thomson Financial; own calculations. *De-trended with a linear trend.

thin air increase in money and credit. The downward interest rate distortion makes firms to embark upon investment projects that wouldn't have been undertaken under undistorted interest rates, and which can only survive economically if and when interest rates stay artificially low. Ludwig von Mises put succinctly the inescapable lesson to be drawn from the Austrian monetary business cycle theory: The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion.

It is Fed that is causing a recurrence of boom and bust. It initiates a boom through its easy money policy. In an attempt to reign in the excess it has created, the Fed at some point turns the boom into bust. To fight the bust it returns to an excessive monetary policy. The result is not only a volatile economy, but also an unsustainable build-up of ever greater amounts of debt on the part of government, consumers and corporates — making the final bust extremely costly.

As if there is joy in repetition, the Fed has again embarked upon a rate hiking cycle, suggesting indeed there is trouble down the road: Looking at the past, the Fed has a track record of having raised rates to the point where it made the credit-fueled boom-and-bubble economy come crashing down, causing great pain for the economy and the financial system. It is fair to say, however, that no one really knows how it will play out this time.

Even if the Fed succeeds in keeping the current boom going and pushing up stock and housing prices for now, however, the circumspect investor should remind himself that a boom will at some point be followed by bust; and that it would be quite short-sighted to, for instance, extrapolate the latest exuberant stock and housing market performance, especially when it has gone on for a while, into the future.

The takeaway from the Austrian monetary business cycle theory is this: Either the boom goes on, and interest rates continue to remain at very low levels. Or interest rates move back to normal, and the boom turns into bust. An ongoing boom, accompanied with a return to normal interest rates, however, is the least likely scenario. If the Fed has learned from its most recent past, it wouldn't be surprising if US interest rates will remain lower for longer.

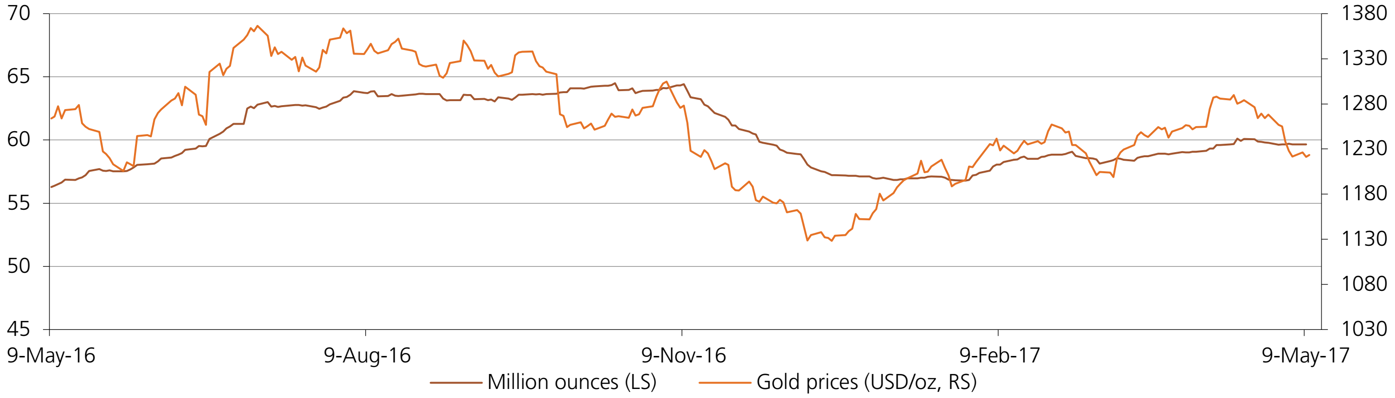
The Impact on Gold

The continuation of an expansionary monetary policy is positive for the price of gold in the long-term, we think. Gold is, and remains, attractive for at least two reasons. First, gold is the "hardest currency". Its purchasing power cannot be debased by political expediency. Secondly: Gold doesn't carry a default risk as e.g. bank deposits and bonds (denominated in unbacked paper money) do. On a final note, to us, the current gold price appears to be a decent bargain. In fact, buying gold at current prices offers a portfolio insurance which has upside price potential. In any case, the circumspect investor should remind himself that the “crisis” of the unbacked paper money system is far from being over.

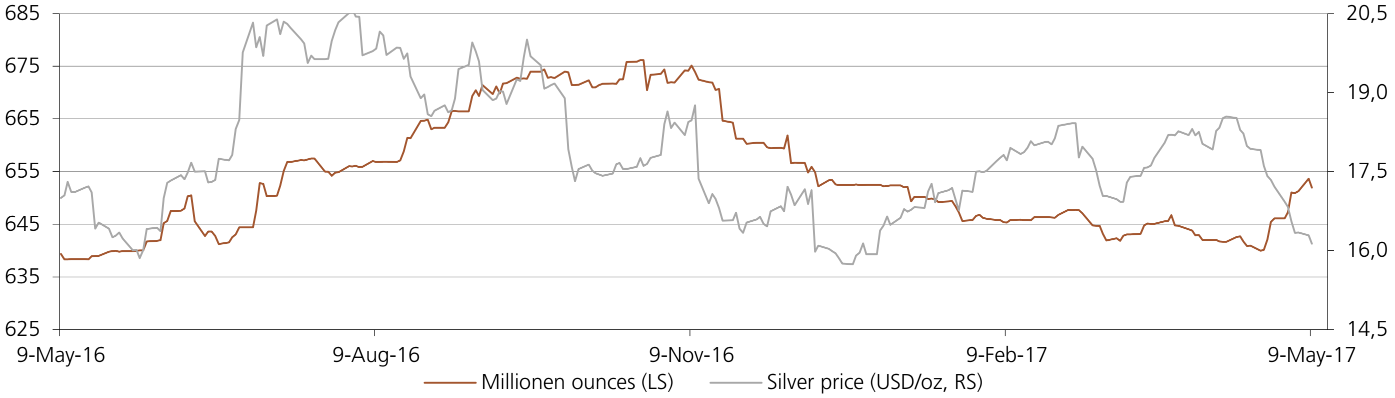
This article was published at the Ludwig von Mises Institute (www.mises.org) *on 2 May 2017.*

Precious metals prices and ETF holdings

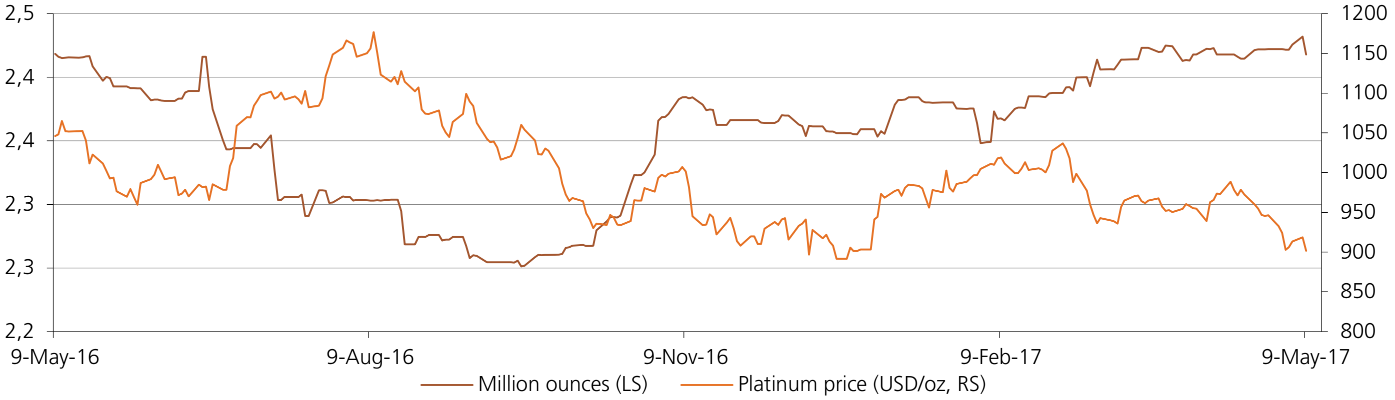
Gold ETFs (million ounces) und gold price (USD/oz)



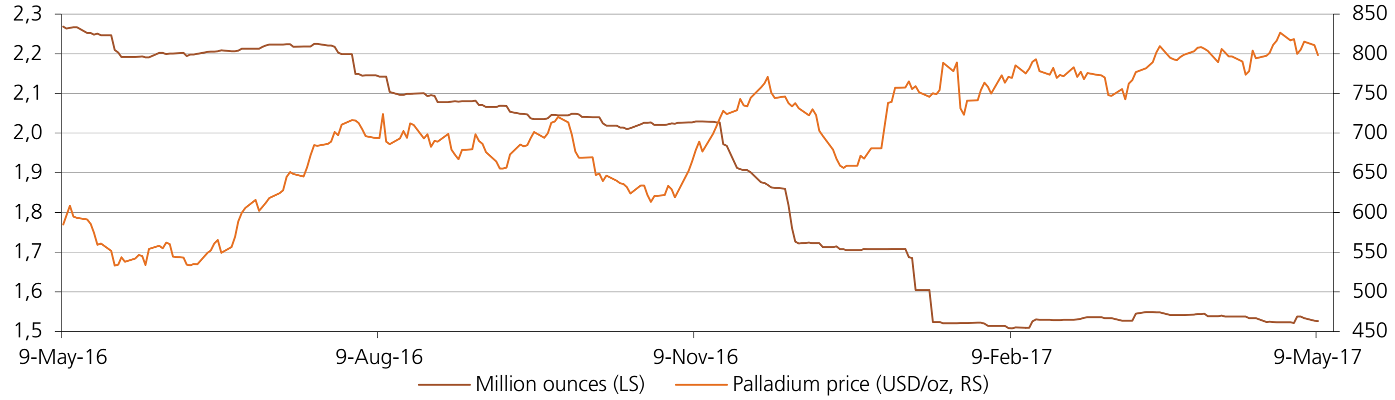
Silver ETFs (million ounces) and silver price (USD/oz)



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	1,221.1		16.2		911.5		803.3	
II. Gliding averages								
5 days	1,230.6		16.3		906.4		804.6	
10 days	1,246.8		16.7		924.1		809.9	
20 days	1,264.2		17.4		947.8		803.5	
50 days	1,248.1		17.6		955.2		790.7	
100 days	1,224.4		17.4		964.5		767.2	
200 days	1,248.6		17.8		985.0		727.5	
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	1,123.6		14.9		838.8		738.8	
II. Gliding averages								
5 days	1,125.6		14.9		829.1		735.9	
10 days	1,142.7		15.3		846.9		742.2	
20 days	1,169.2		16.1		876.7		742.9	
50 days	1,162.8		16.4		890.2		736.6	
100 days	1,147.2		16.3		903.8		718.7	
200 days	1,152.4		16.4		909.1		672.7	
III. Projections for 2017								
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1,118	1,353	15.5	22.40	882	1,071	682	876
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	

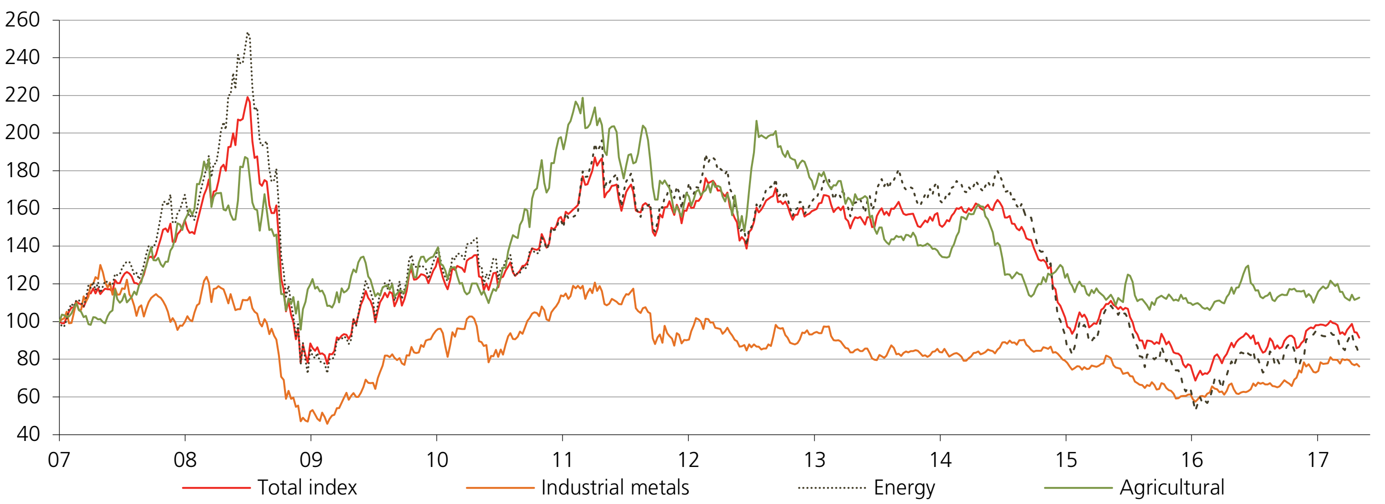
Source: Thomson Financial; own calculations and estimates.

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	47.17	-1.0	-13.8	-13.3	-10.5	5.8	26.7	24.4
Brent crude oil	49.97	-1.0	-12.3	-11.4	-7.7	9.2	25.5	23.3
Gasoline	152.62	0.8	-13.5	-14.5	-11.3	2.0	23.4	20.7
Heating oil	147.34	0.4	-11.1	-10.9	-8.5	7.7	22.6	21.6
Gas oil	443.75	-1.1	-10.4	-11.9	-4.9	...	22.3	21.7
Natural gas	3.33	4.1	12.6	2.1	2.6	23.9	30.8	36.6
II. Agriculture								
Corn	367.00	-1.4	-3.7	-1.8	1.0	-5.5	19.6	16.2
Wheat	427.00	-5.9	-6.9	-4.5	-1.0	-19.6	26.2	21.9
Soy beans	977.25	0.9	-6.4	-6.2	-7.3	4.7	11.4	14.2
Coffee	136.30	0.0	-5.9	-11.7	-12.1	-0.5	24.9	21.7
Sugar	15.65	-1.4	-17.9	-22.5	-16.1	0.8	26.5	23.1
Cotton	77.00	-3.0	-0.6	1.1	7.0	29.2	15.5	14.6
III. Industrial metals								
Aluminum	1870.00	-3.1	-2.8	2.8	8.0	23.0	15.0	14.5
Copper	5512.00	-5.0	-7.7	-8.0	-5.4	13.7	21.9	22.3
Zinc	2612.00	-1.6	-7.5	-8.7	-3.3	43.8	29.8	26.3
Lead	2173.00	-3.3	-3.7	-8.4	-8.1	27.4	26.9	28.4
Iron ore	58.73	0.2	-36.5	...	-25.8	10.4	...	...
IV. Precious metals								
Gold	1221.70	-2.7	-2.8	0.9	4.0	-0.9	9.7	10.4
Silver	16.20	-3.7	-12.0	-7.4	-1.9	5.4	13.9	16.2
Platinum	912.48	-1.3	-11.4	-8.0	0.3	-6.5	17.2	17.2
Palladium	805.40	-1.2	4.5	6.8	4.1	43.0	19.5	26.3
V. Ratios								
Gold-silver	75.40	1.0	10.5	8.9	5.9	-5.9	9.7	10.7
Gold-platinum	1.34	-1.4	9.8	9.7	3.7	6.0	14.5	13.2
Gold-palladium	1.52	-1.5	-7.0	-5.4	-0.5	-30.7	20.3	25.1
Palladium-platinu	0.88	0.1	18.0	16.1	4.2	53.0	18.5	22.9

Source: Bloomberg; own calculations.

S&P commodity prices (in US dollar terms)



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

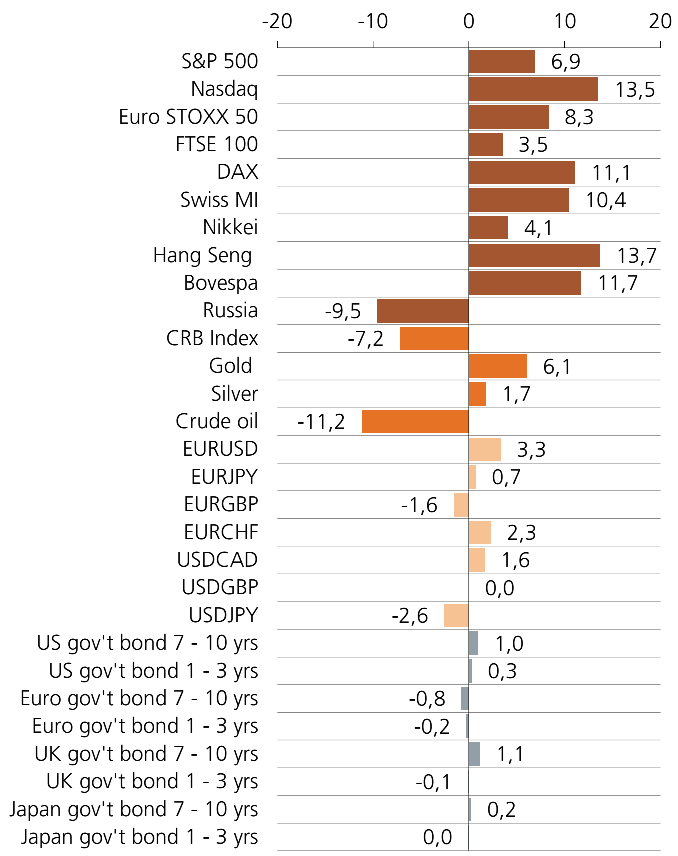
Bitcoin, performance of various asset classes

Bitcoin in US dollars

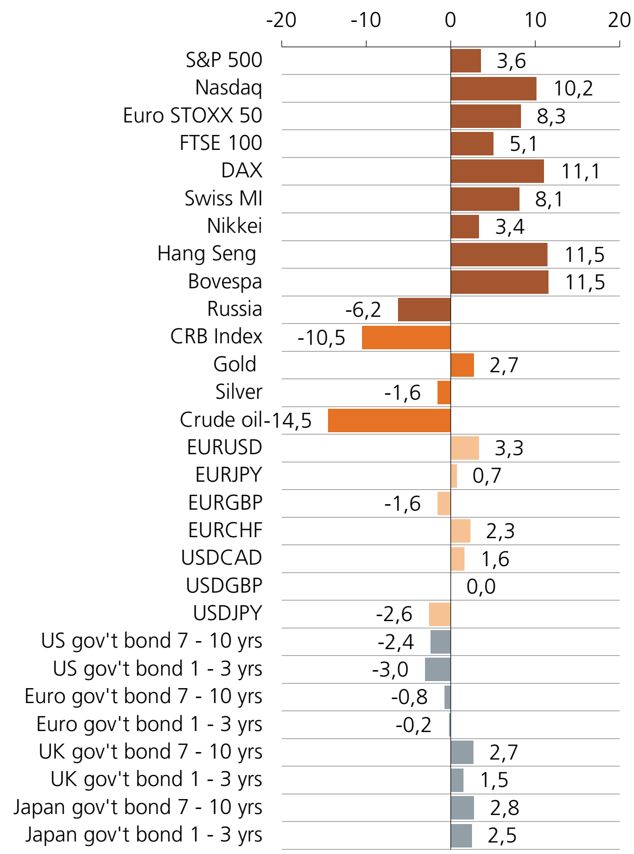
Source: Bloomberg

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euro



Source: Bloomberg; own calculations

Articles in earlier issues of the *Degussa Market Report*

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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
31 March 2017	ECB Negative Interest Rate Policy Will Come to an End
17 March 2017	The Fed's Half-Hearted Attempt of Monetary Tightening
3 March 2017	ECB Flirts With Higher Inflation. The Case For Gold
17 February 2017	Gold Gains Ground vis-a-vis the US-Dollar
3 February 2017	Gold Insures Against Risks Lurking in the Financial System
20 January 2017	The Year of Change
20 December 2016	Gold Rather Than Euro
25 November 2016	Mr Trump Loves Gold. Does Gold Love Him Back?
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*
22 July 2016	The Demise of the Interest Rate – the Comeback of Gold Money
8 July 2016	Escaping the Euro Trap
24 June 2014	The Credit Cycle and the Price of Gold
10 June 2016	Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike
27 May 2016	Central Banks' Illusory Independence and the Price of Gold
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'

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