Degussa Market Report

18 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	1.286.3	1.4	2.6	-3.8
Silver	17.0	2.6	2.8	-14.0
Platinum	970.8	1.1	5.0	-7.4
Palladium	925.5	4.6	7.5	35.5
II. In euro				
Gold	1.095.4	2.5	-2.1	-8.3
Silver	14.5	3.7	-2.0	-18.0
Platinum	826.7	1.9	-0.4	-12.0
Palladium	788.0	5.9	1.9	29.0
III. Gold price in other currencies				
JPY	141.057.0	1.1	1.5	5.2
CNY	8.583.6	0.8	0.6	-3.7
GBP	998.7	3.5	1.8	-2.6
INR	82.536.1	2.2	2.2	-7.5
RUB	75.992.6	-0.7	5.0	-11.0

Source: Thomson Reuters; own calculations.

OUR TOP ISSUE

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

Gold In Times Of Boom And Bust

The major economies of the world keep expanding. According to official statistics, output is increasing, unemployment rates are declining, and stock prices are edging higher. Investor risk aversion, which rose to very high levels in the period of financial market turmoil, has come down considerably, lending a boost to credit transactions and pushing asset prices upwards. It seems that the economic and financial crisis of 2008/2009 has finally been overcome.

However, there is reason to keep interpreting these developments with a healthy dose of skepticism, not getting carried away by all the talk about a 'firming recovery', because the pick-up of economic activity has been brought about by an unprecedentedly loose monetary policy: Central banks have brought interest rates to extremely low levels and bailed out struggling borrowers by running the electronic printing presses.

Monetary policy has put to rest investor risk concerns

Federal Reserve Bank of St. Louis Financial Market Stress Indicator(1)

Source: Thomson Financial. (1) A rise (decline) in the series denotes a rise (decline) in market stress.

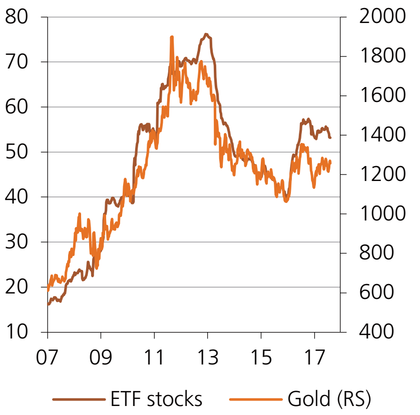
By no means less important, central banks have provided financial markets with a 'safety net': They have signalled financial market agents – implicitly or explicitly – that they would come to their rescue, fending off recession and financial market crashes. This has contributed to declining risk premia. For instance, lenders have become less concerned about potential borrower defaults and issue loans at very low interest rates.

What is more, in stock markets future cash flows are discounted at artificially low interest rates. This, in turn, increases firms' present values and thus their stock prices and valuation levels. As firms' cost of capital decline, new invest-

Higher US short-term yields have dampened ETF gold demand
ETF gold stock (million ounces) and 2-year US yield in percent

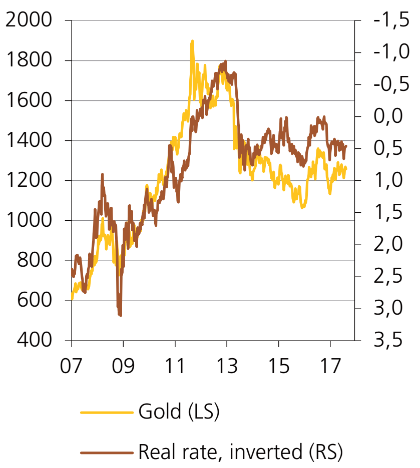
Source: Thomson Financial.

Higher US short-term yields have dampened ETF gold demand
ETF gold stock (million ounces) and price of gold (USD/oz)



Source: Thomson Financial.

Long-term real interest rates suggest higher gold price
Price of gold (USD/oz) and real interest rate in percent[1]



Source: Thomson Financial. [1] Calculated from 10-year US TIPS.

ments are brought on the way – investments that would not have been undertaken had there not been an artificial lowering of interest rates and risk premia caused by monetary policies.

A different view

Mainstream economists would consider the current situation to be a 'natural recovery': Monetary policies, they say, have 'stimulated' the economies, having brought them back into growth territory. Most importantly, central banks have prevented recession-depression, which, so the narrative goes, would otherwise have fallen upon us. The visible improvement in economic activity and rising asset prices is referred to as evidence that the monetary policy has been successful.

Looking through the lens of the 'Austrian School of Economics', however, a rather different picture emerges. 'Austrians' would argue that it was central banks' monetary policy that has caused the latest crisis in the first place. Artificially suppressed interest rates and money creation out of thin air through bank credit expansion had created a credit 'boom' of massive proportions. However, this boom turned out to be unsustainable, and it inevitably had to turn into a 'bust'.

It was central banks' easy money policies that lured firms and consumers into false spending decisions. Firms embarked upon investment projects, which would not have been made had interest rates not been manipulated downwards. Consumers ran into debt, living beyond their means. The effects of bad investments ('malinvestment'), combined with those from overstretched financial positions, made for a perfect storm.

However, central banks did not allow the bust to do its work – namely cleaning the slate. In fact, they did more of the same. By pushing down interest rates even further, by issuing even more money created out of thin air, and by preventing unsound firms and banks from going out of business, the unfolding bust was turned back into yet another boom – which is now widely hailed as central banks having successfully defeated the forces of crisis.

Sowing the seeds of the next crisis

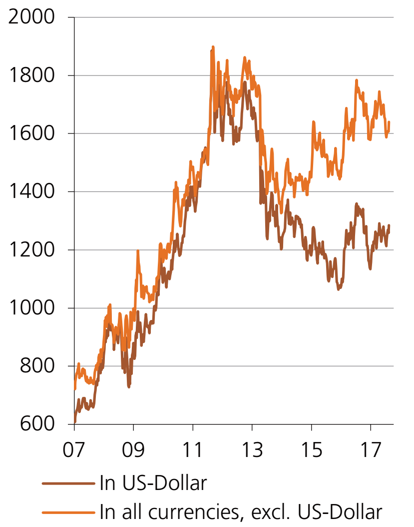
Unfortunately, the truth is that monetary policies keep sowing the seeds of the next crisis. The current period of economic expansion – with its output gains and job creation – brings forth another round of malinvestment, which sooner or later will become evident. This is, for sure, not a question of *if* but a question of *when*, according to the Austrian Business Cycle Theory.

But wait: Isn't the Federal Reserve (Fed) raising interest rates? Doesn't that signal that the Fed is on the way of returning interest rates and thus financial conditions back to 'normal'? Indeed, the Fed has raised its main interest rate in December 2015 from an all-time low of 0.0 – 0.25 percent to 1.0 – 1.25 in June 2017. This, however, does not mean that the Fed will put an end to the notorious boom-and-bust-cycle.

On the contrary. By raising interest rates further, the Fed will unmask many investments as 'flops', and it will push quite a few borrowers over the cliff. In fact, the policy of 'normalizing interest rates' would have to accept a (substantial) slowdown in economic activity, if not a full-blown recession and stock market crash with all its accompanying social and political consequences. Would the Fed have the guts to pursue this road? Would people accept it?

Presumably not: People enjoy and applaud the boom. They hate the bust and, naturally, they want to escape it. Against this backdrop, it seems to be practically

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.

impossible for the Fed to bring interest rates back to a level which prevents any further malinvestments, or false spending decisions in general. That said, as soon as the economic and financial structure – built up by heavily suppressed interest rates – starts to falter, the Fed is likely to turn back to monetary expansion.

Central banks will make it worse

An escape from boom and bust is not in the cards. The more quickly the Fed brings interest rates up, the more quickly the current 'recovery' can be expected to turn into bust; and the longer the Fed keeps interest rates at suppressed levels, the greater the malinvestments and the more severe the market's subsequent adjustment process will be – resulting in decreased output and job losses.

Central banks – the Fed as well as it peers in other countries – will most likely keep interest rates at a relatively low level. Any interest rate increases can be expected to remain limited and of a temporary nature. The disturbing truth is that *central bank policies have put the economies on the road to inflation*: Issuing ever greater amounts of unbacked money in an attempt to overcome the consequences of having issued unbacked money in the first place.

Warning against inflation admittedly seems to be misplaced when consumer and producer price inflation are low by historical standards, and when the Fed is (and possibly, with a time lag, some other major central banks are as well) about to raising interest rates. However, it is advisable for the investor to consider any attempt on the part of the central banks to raise rates to be limited and temporary.

To be on the safe side: Monetary policies are already inflationary. Not only consumer prices keep rising over time. In recent years in particular asset prices – the prices of, say, stocks, bonds, housing, and art – have been going up substantially, thereby debasing the purchasing power of money. If anything, central banks will make matters worse, as their 'road to inflation' policies can be expected, if anything, to gain momentum in what lies ahead.

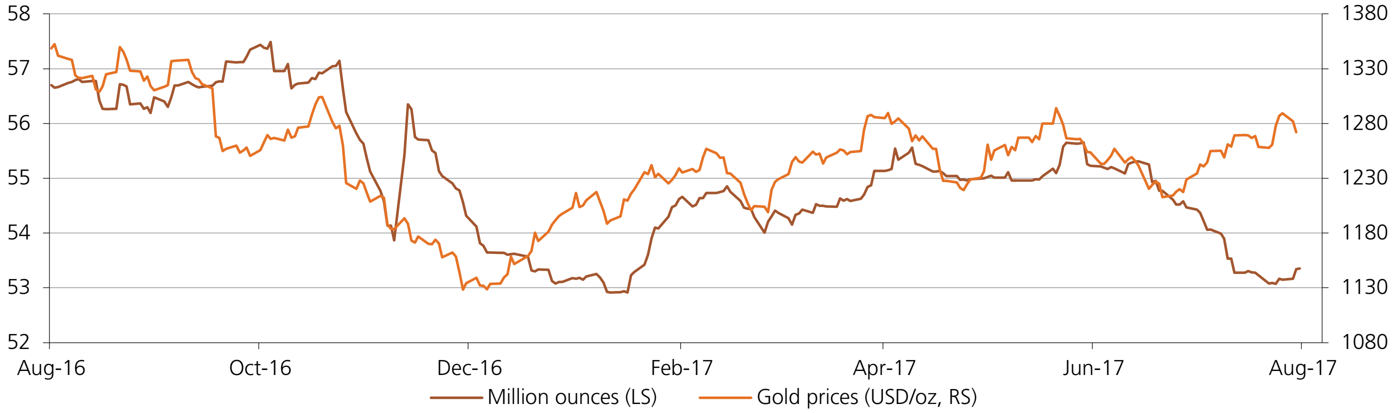
Building up downside protection

Against this backdrop it makes sense for long-term investors to protect their portfolio against inflation. One option is holding physical gold. Gold is the 'ultimate means of payment', it 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 and bonds.

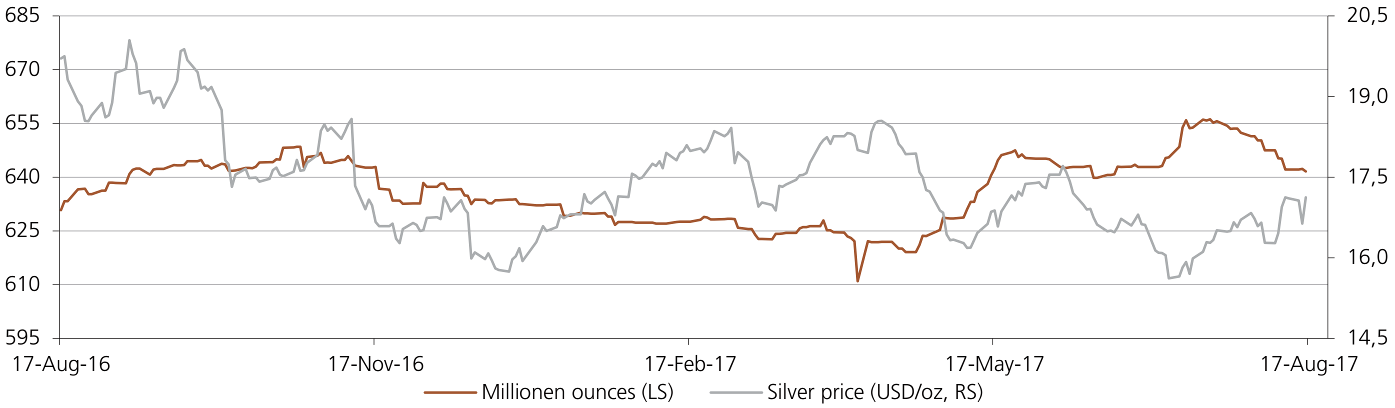
That said, gold can be viewed as an effective long-term hedge against the vagueness of central banks' monetary policies, which keep eroding the purchasing power of unbacked paper money. As its current price does not appear to be expensive (when measured against assets such as bonds and stocks), gold seems to be an insurance with upside price potential.

Precious metals prices and ETF holdings

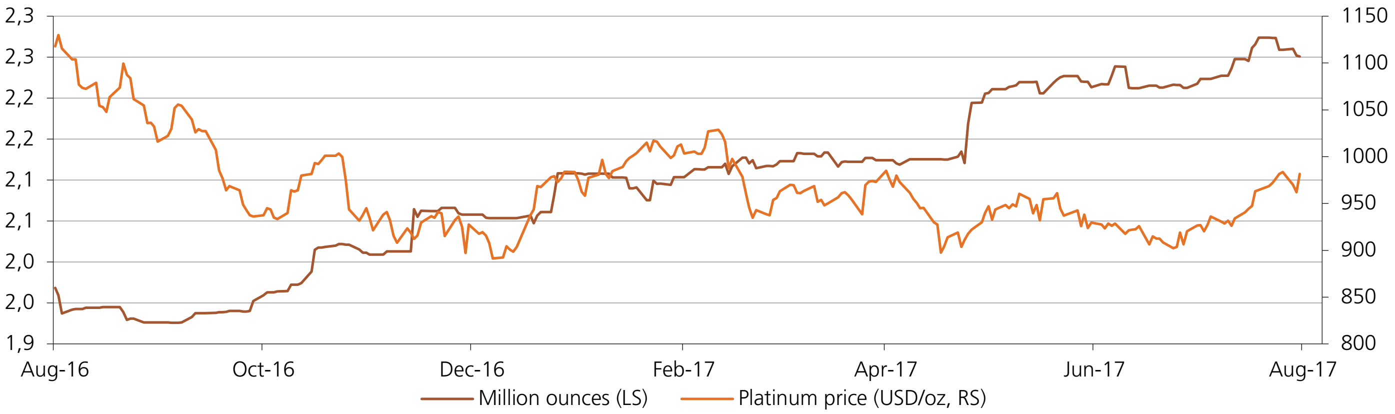
Gold ETFs (million ounces) und gold price (USD/oz)



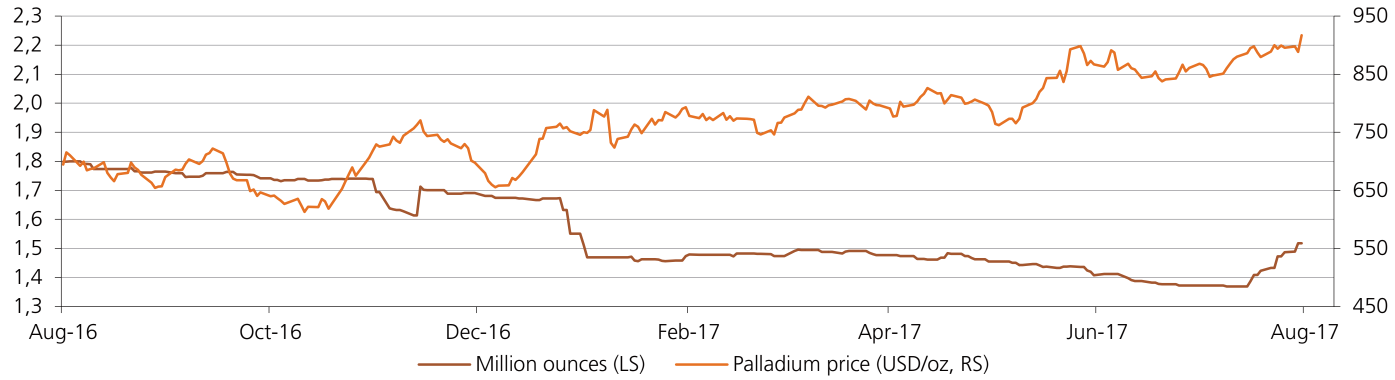
Silver ETFs (million ounces) and silver price (USD/oz)



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



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



Source: Thomson Financial.

Precious metals prices

In US-dollar

	Gold		Silver		Platinum		Palladium	
I. Actual	1.287.3		17.1		975.7		923.0	
II. Gliding averages								
5 days	1.280.6		17.0		969.8		897.4	
10 days	1.271.5		16.7		968.8		893.1	
20 days	1.265.3		16.6		950.2		882.1	
50 days	1.251.0		16.5		932.2		870.5	
100 days	1.255.5		17.0		938.8		835.7	
200 days	1.228.7		17.0		948.7		790.2	
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	

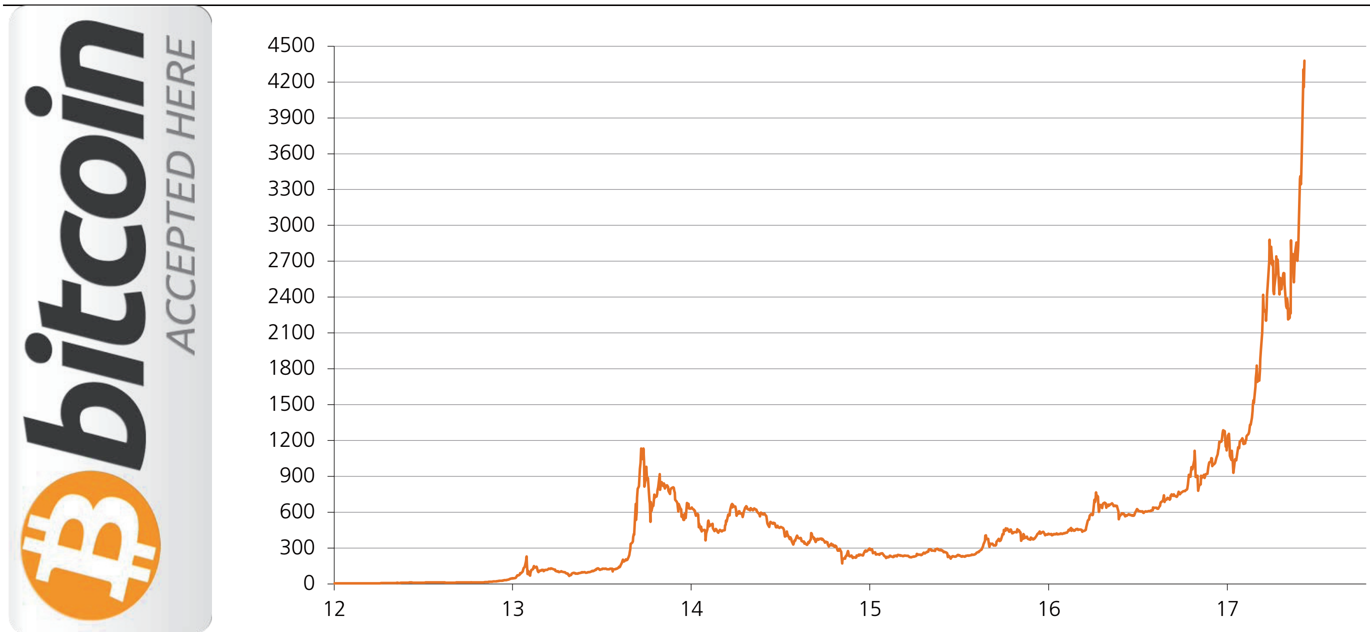
In euro

	Gold		Silver		Platinum		Palladium	
I. Actual	1.096.1		14.5		830.8		785.9	
II. Gliding averages								
5 days	1.089.9		14.4		825.4		763.8	
10 days	1.080.8		14.2		823.5		759.1	
20 days	1.078.0		14.2		809.5		751.4	
50 days	1.089.7		14.4		811.9		758.3	
100 days	1.121.7		15.2		838.8		745.8	
200 days	1.126.1		15.6		870.3		723.1	
III. Projections for 2017	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1.008	1.221	14.0	20.20	796	966	615	791
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

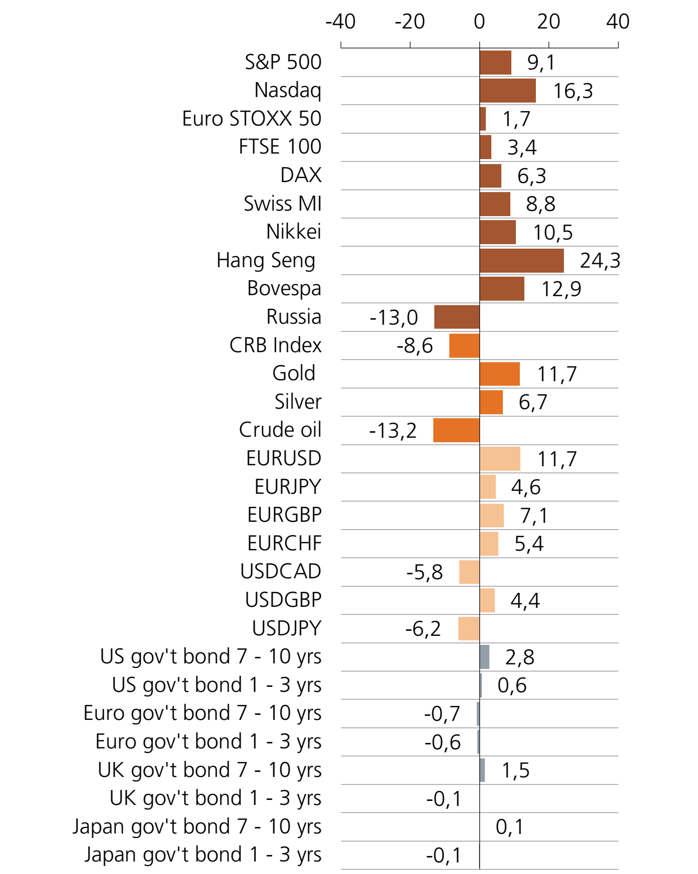
Bitcoin in US dollars



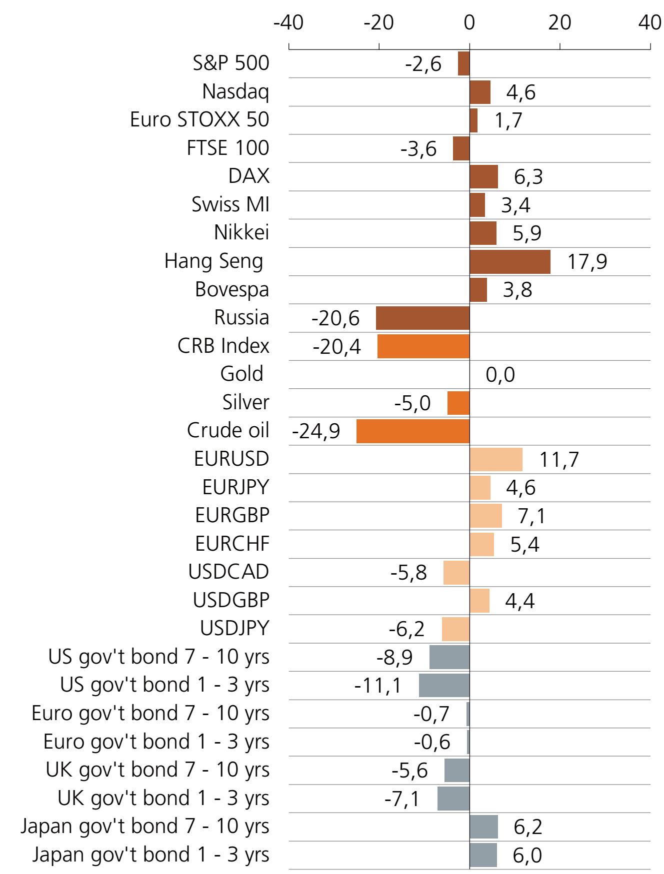
Source: Bloomberg.

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
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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
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