CHANCES AND RISKS FOR INVESTORS IN 2018

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SUMMARY

- The world economy can be expected to continue to expand at a fairly rapid clip in 2018.

- However, the current “boom” has been fueled by central banks’ ultra-loose monetary policy, which will cause trouble further down the road.

- For instance, exceptionally low interest rates will increase the level of overall indebtedness, …

- … and this will make it increasingly difficult to “normalize” interest rates anytime soon.

- As monetary policies remain expansionary, asset prices such as, say, stock and real estate prices, are likely to go up further …,

- … to be followed by higher consumer price inflation – both developments resulting in the erosion of the purchasing power of money.

- However, the current boom is particularly delicate as central banks have effectively put a “safety net” under financial markets, …

- … which encourages investors to undertake questionable trades and engage in risky investments.

- We consider holding gold as insurance against the vagaries of the unbacked paper money fueled boom, …

- … especially so as the current price of gold seems to be relatively cheap; that said, gold equates to portfolio insurance with upside value potential.

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“When you combine ignorance and leverage, you get some pretty interesting results.”

—Warren E. Buffett
1 Real GDP of selected economies

The major economies of the Western world are on an expansionary course, ...

Source: Thomson Financial; own calculation. (1) Q4 2007 = 100.

2 China’s business cycle and commodity prices (in US-Dollar)

... and the Chinese business cycle seems to be improving further, dragging commodity prices upwards.

Source: Thomson Financial; own calculations.

3 World Trade

World trade (export and import) keeps expanding at a healthy clip.

Source: CPB; own calculations. (2) In real terms, excl. construction, indexed (Jan. ’07 = 100).
4 Short-term interest rates in percent, in real terms(1)

Central banks have pushed (short-term) interest rates into negative territory.

Source: Thomson Financial.
(1) 2-year gov’t bond yields, deflated by consumer goods price inflation.

5 ECB balance sheet (€bn)(2) and long-term interest rates (%)

ECB’s bond purchases have pushed yields to extremely low levels.

Source: Thomson Financial.
(2) ECB plus euro area national central banks.

6 The “safety net”

Central banks have spread a safety net under financial markets – causing a great deal of „moral hazard”
7 **Financial market stress indicator**(1)

![Graph showing financial market stress indicator]

- Central banks' safety net has largely wiped out investor risk concerns.

Source Thomson Financial.

8 **Stock market volatility and S&500**

![Graph showing stock market volatility and S&500]

- This may also explain why stock market volatility has dropped to record lows, while prices have reached record highs.

Source Thomson Financial.

9 **NASDAQ and corporate bond yield in percent**

![Graph showing NASDAQ and corporate bond yield]

- Expansionary monetary policies, coupled with a retreat of investor risk concern, lowers cost of credit, and pushes up asset prices.

Source Thomson Financial.
10. Housing prices in selected currency areas

In many currency areas, housing prices inflate – in great part due to the expansionary monetary policies.

Source: Thomson Financial. (1) Indexed (Q2 2017 = 100).

11. Inflation expectations in financial markets in %

Inflation has remained fairly subdued, despite exceptionally low interest rates and increases in the quantity of money.

Source: Thomson Financial. (2) Inflation swaps: 5yrs in 5yrs.

12. Global debt (in % of GDP) and central banks’ policy rate (%)

Central banks push interest rates down, and debt levels go up and up ...

Source: BIS.
13 US banks and mutual fund industry (US dollar bn)

- Risk #1: Credit risk outside the banking system, where there is little equity capital, is increasingly bloated.

Source: Thomson Financial; own calculations.

14 China: GDP growth y/y in % and debt in % of GDP

- Risk #2: China’s economy has slowed down since 2008/2009, but the rate of debt increase has not ...

Source: Thomson Financial; own calculations.

15 Euro area banking sector (€bn)

- Risk #3: The Euro area suffers from an oversized banking system, and the ECB prevents it from shrinking.

Source: Thomson Financial; own calculations.
Selected “Target-2” balances, €bn

- Risk #4: Stress in the euro area continues. Germany’s “Target-2” balance reached 906.9 € bn in Dec. ’17 ...

Source: Deutsche Bundesbank, Universität Osnabrück.

US bank credit default rates in %

- US bank credit default rates have remained fairly subdued so far ...

Source: Thomson Financial. (1) Creditors to write off installment loans after 120 days of delinquency, while revolving credit accounts must be written off after 180 days.

US interest rates in percent

- Long-term interest rates have been on the decline – as the Fed keeps easing its monetary policy over time. An end to this policy is unlikely.

19 Price-earnings ratio of selected stock markets

With interest rates remaining low, equity valuation could well go up further.

Source: Thomson Financial.

20 EUR-USD und USD-EUR interest rate differential (bp)

Interest rate differential argues for a much lower EUR-USD.

Source: Thomson Financial; own calculations.

21 Stock markets performance and EUR-USD(1)

An outperforming US stock market should put the euro under pressure against the US dollar.

Source: Thomson Financial; own calculation. (1) US stock market index divided by euro area stock market index.
22 How we think about gold

What is Gold?

Asset
- Stocks
- Bonds
- Real estate
- ...
- Gold

Commodity
- Oil
- Industrial metals
- Agriculture
- ...
- Gold

Currency
- US dollar
- Euro
- Swiss Franc
- ...
- Gold

► We consider gold a currency — competing with unbacked paper currencies.

Source: Degussa.

23 What makes gold special?

Gold is a sound currency

Protects you against a loss in purchasing power

Protects you against payment defaults

► Gold has two major advantages over unbacked paper money ...

Source: Degussa.

“Gold is a currency. It is still, by all evidence, a premier currency. No fiat currency, including the dollar, can match it.”

Alan Greenspan,
Council of Foreign Affairs, 29 October 2014.
24 Attempt to estimate an ‘equilibrium’ price of gold

(a) Gold price (USD/oz), actual and estimated\(^1\)

(b) Deviation of the actual price from estimated price\(^2\)

Source: Thomson Financial; own calculations. \(^1\)Shaded area: Standard error. \(^2\)Shaded area: actual price below estimated price (undervaluation).

25 ETF gold demand (mm ounces) and US short-term rate in %

ETF gold demand has held up, despite short-term rates edging upwards.

Source: Thomson Financial.

26 ETF gold demand and gold price (USD/oz.)

ETF gold stocks and the price of gold tend to trade on the same bandwidth.

Source: Thomson Financial.
### In US-dollar

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<th>Silver</th>
<th>Platinum</th>
<th>Palladium</th>
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### In Euro

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Source: Thomson Financial; own calculations and estimates.

(1) Estimated return against actual price in percent.
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