Degussa Market Report

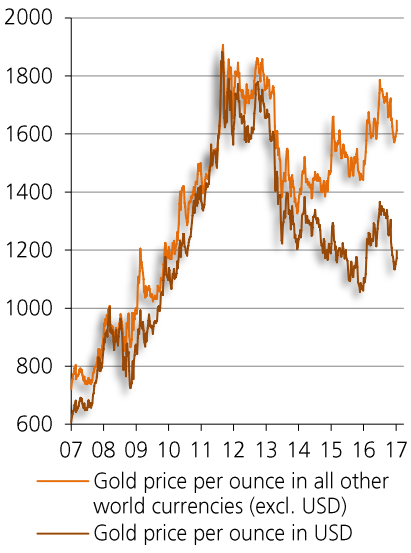
20 January 2017 Economics · Finance · Precious Metals

OUR TOP ISSUE

"The instinct for gold is found among all peoples, savage and civilized, throughout history. Gold is today, as it has been for centuries, the most widely treasured and the most highly marketable commodity in the world."

—Edwin W. Kemmerer (1875 - 1945)

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

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

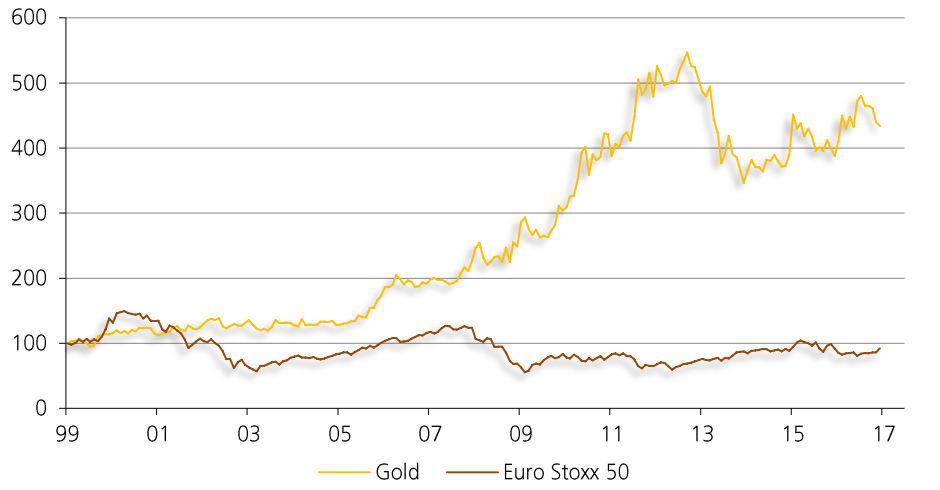
A Year of Change

Summary

- **The US presidency under Donald J. Trump can be expected to bring far-reaching changes to geopolitics and the world economic system.**
- **This comes with new risks, but also offers great chances in terms of higher economic growth.**
- **Interest rates are most likely to remain low - as major central banks won't really abandon their expansionary monetary policies.**
- **More than ever, the continuing existence of the euro area will depend on the ECB keeping monetizing debt.**
- **Inflation is likely to accelerate in the euro area going forward - and will, as interest rates stay low, reduce the value of peoples' life time savings.**
- **We recommend taking a long-term view, keep gold, invest in the stocks of good companies and refrain from holding euro denominated debt.**

Something big is going on: The presidency of Donald J. Trump will most likely bring far-reaching changes – not only for the US but for the entire world, with effects we are only just beginning to understand.

Gold has ‚outperformed' the euro area stock market
Gold price (EUR/oz) and Euro Stoxx 50 stock market index



Source: Bloomberg; own calculation. Series are indexed (January 1999 = 100).

The consequences will be economic and geopolitical. To begin on a rather positive note: President-elect Trump does not wish to crusade and does not seem to be willing to harness America's exceptionalism to bring about a new world order by political and military means. It is likely that that future US foreign policy under Mr Trump might be much less interventionist and militarily aggressive than it has

been in the past. Having said that, there is reason to hope this attitude pays off when it comes to, for instance, US-Russian relations.

One has to view current plans for US trade policy with quite some concern, however. If it really turns out to be protectionist (via, for instance, imposing import tariffs), it would certainly hurt the global economy. For protectionism disturbs the international division of labour and eventually lowers the productivity for all parties concerned. Undermining free trade could also develop political tensions among the parties concerned.

Mr Trump's tax cut plans and his attempts to deregulate, however, look quite promising. According to the Tax Policy Center, Mr Trump will hand back 9.5 trillion US dollars (that is nearly half of the US GDP in 2016) to the people over the next decade, according to the Tax Policy Center. Two-thirds of the tax cuts would benefit individual income tax payers, and it would give people increased pecuniary resources for consuming, saving, and investing.

What does Mr. Trump's tax plan mean for the US budget deficit? The budget shortfall is estimated to add 2.8 percentage points to the US fiscal deficit in 2017, rising to around 4 percentage points per year in the years after that. These numbers, however, do not account for the impact the tax cuts might have on growth and possible spending cuts in the budget. The so-called "Laffer curve" effect may well come to the rescue.

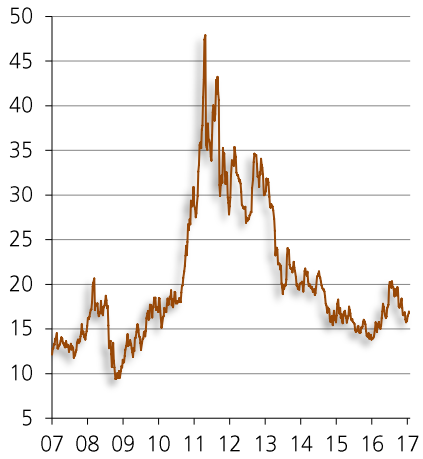
The Laffer curve says essentially that if taxation is too high, tax reduction increases (rather than decreases) tax revenues. Lowering taxes can, therefore, be regarded as more of a chance than a risk: money in the hands of firms and consumers can, and will almost certainly, be spent more wisely and productively than through the government. Also, Mr Trump has campaigned on the promise to roll back big government. Extensive budget cuts would also be a means for reining in the budget deficit. Concerns about a spinning-out-of-control US budget and, because of that, sharply rising inflation, seem to be overstated.

Finally, we should factor in that Mr Trump and his entire team are very much pro-business – as suggested, for instance, by their explicit endorsement of the work of Ayn Rand, the novelist and libertarian heroine who celebrated laissez-faire capitalism. Cutting taxes and doing away with red tape might not be popular with certain political pundits. However, there is quite some reason to think that Mr Trump's approach offers a real chance of promoting growth in the US, thus also benefitting other parts of the world.

Europe, and in particular the euro area, is most likely to come increasingly under pressure. The forces of disintegration are gaining ground. Great Britain's "Brexit" is making clear to all who can see that a withdrawal from the EU is actually possible and feasible - and this insight won't be lost on other countries. Important elections will be held this year in Germany, France and the Netherlands - the outcomes of which will most likely strengthen the political forces to roll back EU integration and restore national sovereignty. Such a development is, of course, a major challenge for the single currency. Abandoning the idea of an ever closer integration in Europe, basically calls into question its very existence.

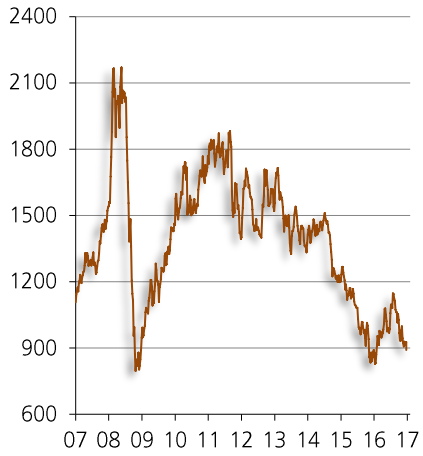
What about interest rates? They play a rather important role especially for precious metals markets. It seems likely that the Federal Reserve will hike further this year. However, any interest rate increase should be modest. For instance, financial markets expect the Federal Funds Rate to remain slightly below 1.5% and 10-year Treasury yields to stay at around 2.8%. We also think that this low interest environment is likely to stay for quite a while - especially so because of

Silver price (USD/oz)



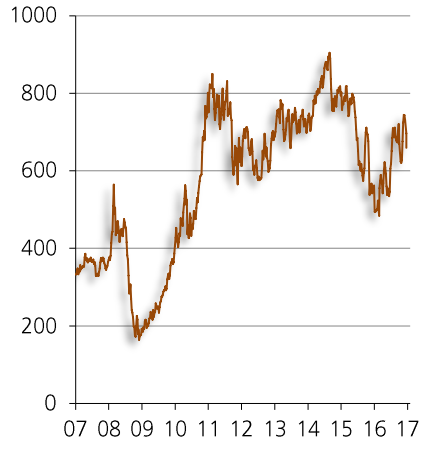
Source: Bloomberg.

Platinum price (USD/oz)



Source: Bloomberg.

Palladium price (USD/oz)



Source: Bloomberg.

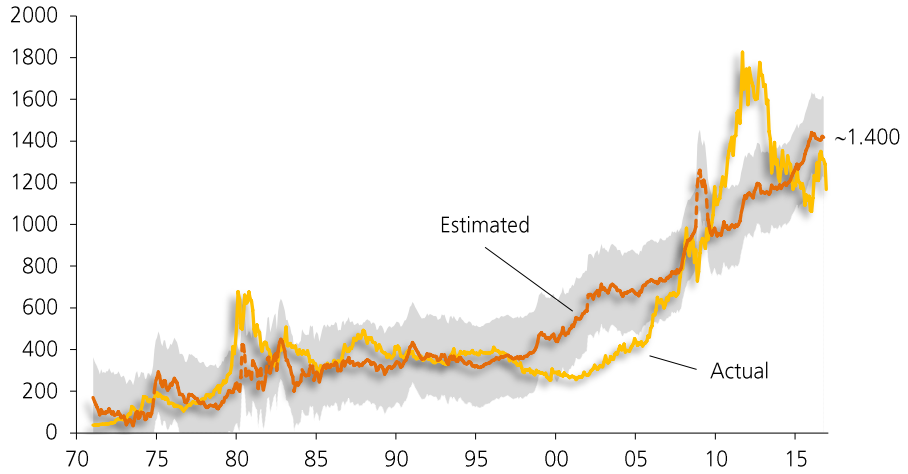
the still very high level of debt, not only in the US, but worldwide. In the euro area and Japan, short- and long-term rates should remain at their extreme lows.

A question of price

Against the backdrop of a number of uncertainties - and we would see the developments in the euro area as a big risk factor - holding gold as part of the liquid portfolio is a sensible strategy. A key question is, however, where the gold price might be heading in 2017. Rather than coming up with a forecast in this article, we want to roll out something different: We have developed a long-term equation for explaining the gold price by taking recourse to the quantity of money, short-term interest rates (adjusted for consumer price inflation) and a credit spread. By doing so, we actually came up with a kind of "equilibrium" price of gold: It says that the actual price of gold should be in line with the long-term equation if and when the latter holds up. If the actual price of gold is lower (higher) than its equilibrium price, gold is undervalued (overvalued).

Actual gold price "too low"

Gold price (USD/oz), actual and estimated



Source: Thomson Financial; own calculation.

Estimated range of precious metal prices (USD/oz) in 2017

	Actual[1)]	High	Low
Gold	1.204	1.390	1.148
Silber	17	23	15,95
Platin	956	1.100	906
Palladium	751	900	700

Own estimates. [1)] As of 19 January 2017.

Of course, a number of criticisms can be levelled against this approach. No doubt about that. But it gives at least some additional information that may help to form a view about the future course of the price of gold. Our estimation says that the equilibrium price for gold is currently around 1,400 USD/oz, so the current price of gold of around 1,200 USD/oz is "too low", that is it has upside potential. To be sure: It does not mean that the gold price would immediately rush to that higher level. It just says that such a rise would likely come sooner or later. The impact of additional risks that might emerge is not included but would increase the upside for the equilibrium price of gold further.

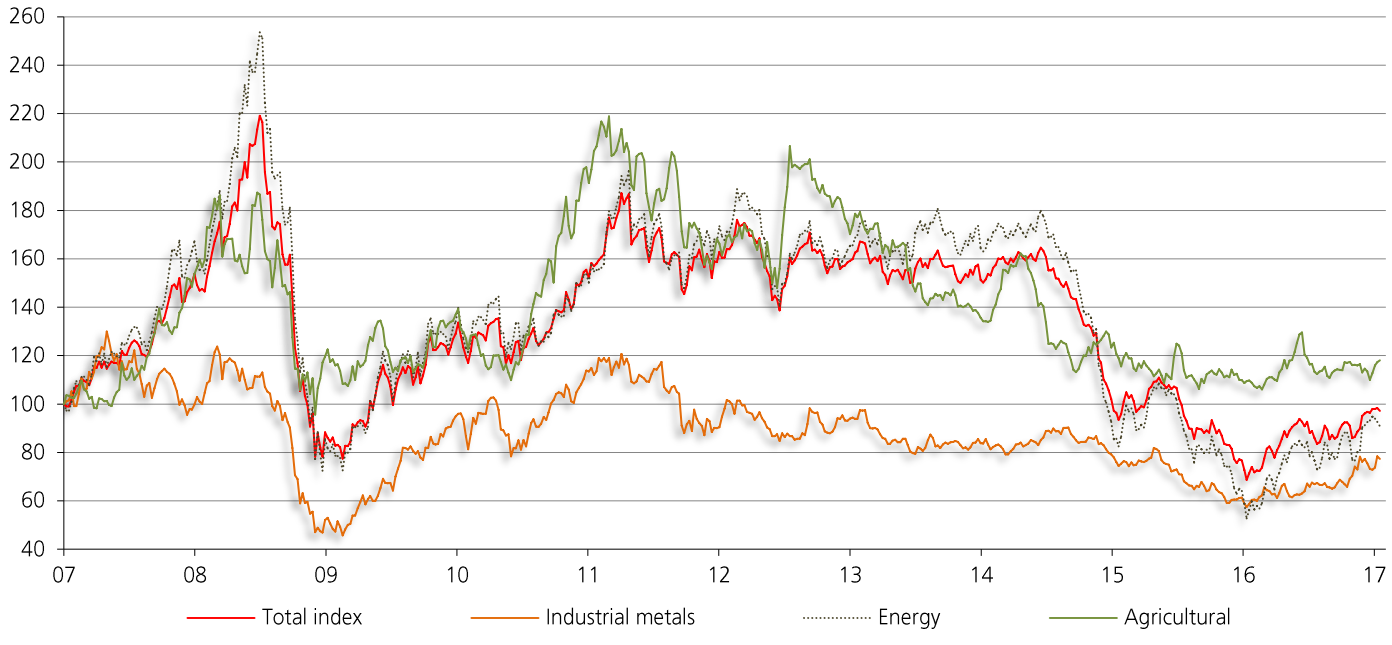
Commodity prices

Selected commodity prices

	Actual price	Change against (in percent):					Volatility (in percent):	
	in US-dollar	1 week	1 mth	3 mths	6 mths	12 mths	30 days	90 days
I. Energy								
WTI crude oil	51.59	-4.4	7.4	3.3	14.5	5.1	27.7	34.9
Brent crude oil	54.49	-4.6	9.2	5.4	18.5	3.5	26.8	33.6
Gasoline	154.58	-5.4	8.0	7.2	24.0	14.0	25.2	30.6
Heating oil	162.35	-4.7	5.6	3.3	15.5	3.2	24.7	30.9
Gas oil	481.00	-3.6	7.2	5.9	19.1	...	23.6	30.0
Natural gas	3.32	1.0	2.9	1.3	-2.9	15.8	62.0	44.8
II. Agriculture								
Corn	366.00	2.2	0.9	5.6	4.1	-9.4	16.2	20.3
Wheat	423.25	0.0	-2.4	-0.4	-8.0	-20.1	23.9	21.9
Soy beans	1062.75	6.8	4.3	10.1	7.1	17.0	20.6	17.6
Coffee	150.75	5.5	-10.0	-2.7	-1.1	14.7	22.8	26.6
Sugar	20.18	-2.7	-6.4	-12.3	3.8	39.0	31.1	29.1
Cotton	72.99	-1.4	5.2	6.5	-1.2	13.6	16.1	17.5
III. Industrial metals								
Aluminum	1826.00	6.6	5.3	9.1	11.1	26.3	14.6	15.6
Copper	5739.50	2.7	18.3	18.0	16.5	25.2	21.3	21.8
Zinc	2769.00	5.7	12.5	16.5	23.5	77.2	32.6	31.7
Lead	2285.00	11.1	10.7	7.6	25.3	38.7	36.8	33.9
Iron ore	82.60	0.2	32.4	43.0	41.7	90.8	...	...
IV. Precious metals								
Gold	1204.80	2.7	-5.4	-8.4	-10.8	13.2	14.4	13.8
Silver	16.96	2.8	-4.8	-11.6	-16.6	20.2	27.9	27.7
Platinum	958.83	-1.0	-1.8	-6.7	-16.5	15.3	28.5	22.9
Palladium	751.97	-0.7	22.1	4.3	5.9	38.5	28.4	27.5
V. Ratios								
Gold-silver	71.04	-0.2	-0.6	3.5	6.7	-5.8	17.8	17.9
Gold-platinum	1.26	3.5	-3.7	-2.0	6.8	-1.8	21.1	17.1
Gold-palladium	1.60	3.4	-22.5	-12.3	-15.8	-18.2	26.5	26.6
Palladium-platinum	0.78	0.0	24.2	11.7	26.8	20.0	28.5	27.6

Source: Bloomberg; own calculations.

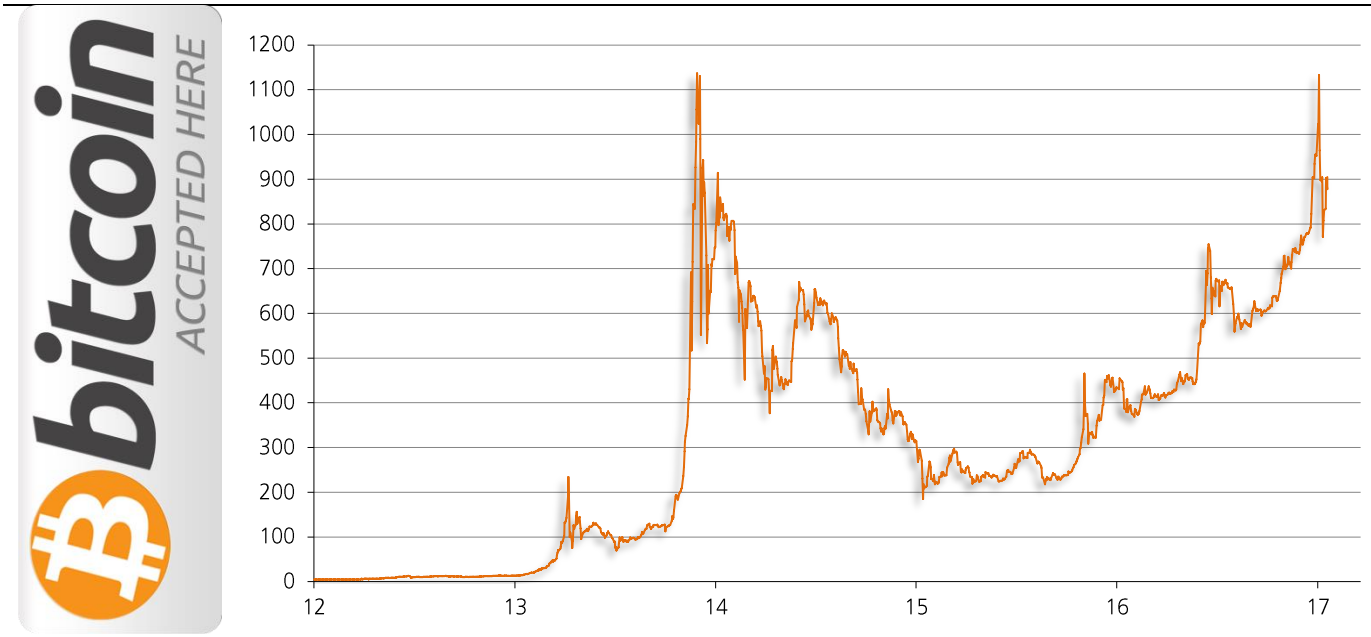
S&P commodity prices (in US dollar terms)



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

Bitcoin, performance of various asset classes

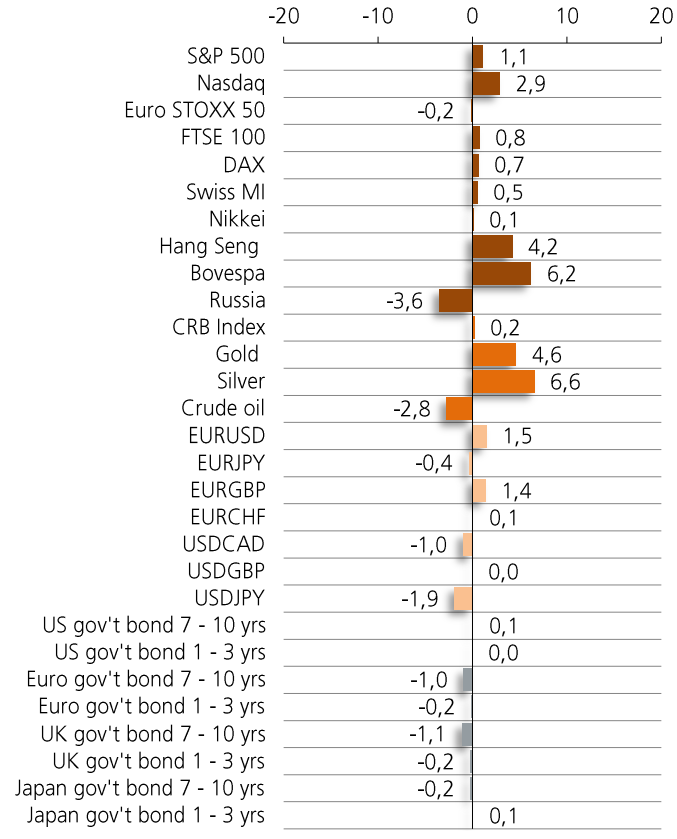
Bitcoin in US dollars



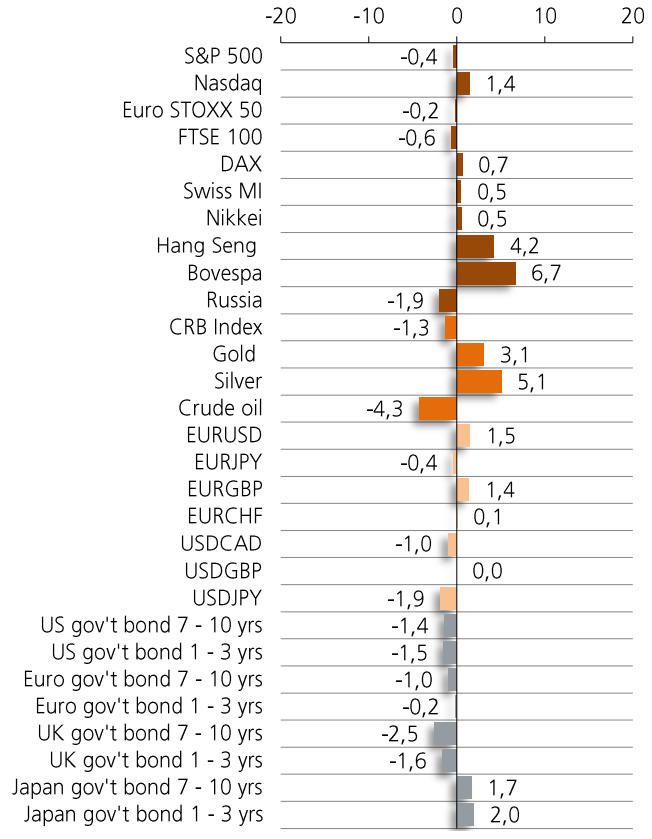
Source: Bloomberg

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euros



Source: Bloomberg; own calculations

Articles in earlier issues of the *Degussa Market Report*

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30 September 2016	On the Debt Ratio and the Price of Gold
16 September 2016	Central Banks May Choose Helicopter Money Over Negative Rates
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19 August 2016	Debt Monetized En Masse to Fend Off the Euro Crash?
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10 June 2016	Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike
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18 March 2016	Gold and Stocks Protect Against 'Helicopter-Euros'

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