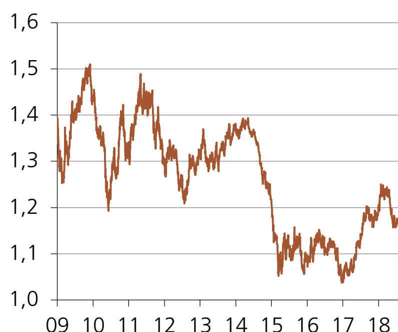
Degussa Market Report

20 July 2018 | 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	1.225.2	-2.5	-5.1	-4.6
Silver	15.5	-3.7	-5.8	-8.9
Platinum	807.0	-3.9	-8.6	-17.2
Palladium	910.2	-3.8	-5.5	-2.4
II. In euro				
Gold	1.053.5	-2.2	-3.9	-3.5
Silver	13.3	-3.3	-4.6	-7.8
Platinum	693.9	-3.3	-7.7	-16.1
Palladium	783.0	-3.5	-4.4	-0.9
III. Gold price in other currencies				
JPY	138.211.0	-0.4	-3.4	-1.8
CNY	8.230.2	-1.2	-0.1	-3.8
GBP	939.0	-1.1	-2.0	-6.2
INR	84.071.2	-2.6	-4.2	2.2
RUB	77.280.1	-2.8	-3.9	1.9

Source: Thomson Reuters; own calculations.

OUR TOP ISSUES

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

Not All Is Well In Financial Markets

It seems to be a hard time for those expressing concern about the build-up of risks in the economic and financial system: The major economies in the world are expanding at a decent clip, credit default concerns are very low, and stock and housing prices keep going up, driven by investor optimism and supported by an ongoing low interest rate environment.

Moreover, cyclical indicators do currently not suggest that something terrible is just around the corner. But of course, there is good reason not to get carried away by the "all is well" mentality that has gripped financial market action. For central banks have, by way of their monetary policies of exceptionally low interest rates, set into motion an artificial upswing ("boom").

While the boom leads to higher output and employment levels, it also causes – beneath the surface, so to speak – malinvestment on a grand scale: The development of the economies' production and employment structure is getting diverted from the path it would have taken had there not been a downward manipulation of interest rates on the part of central banks.

Some theory

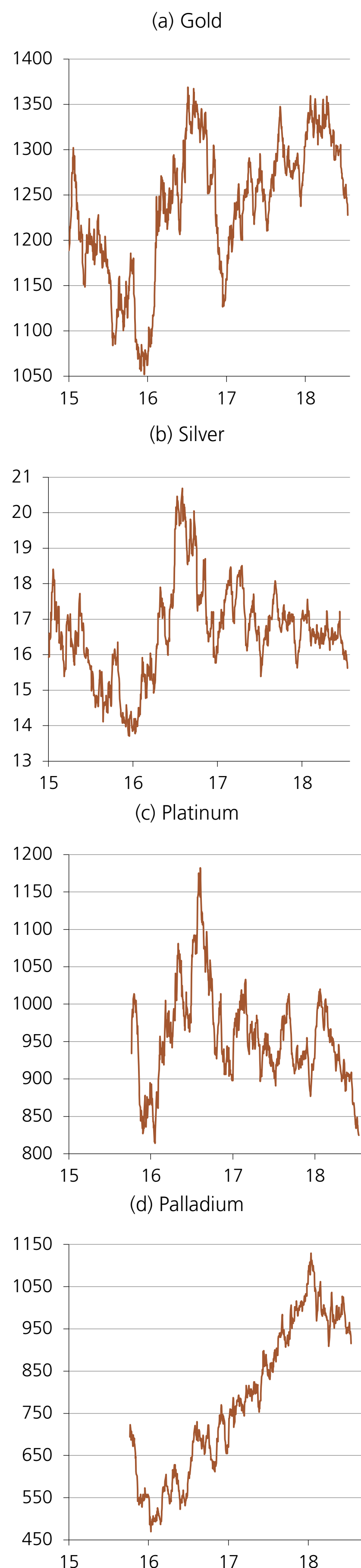
This becomes obvious once a sound theory of the interest rate is taken into account, as put forward by the Austrian School of Economics, in particular by Ludwig von Mises (1881 – 1973). To explain this in some detail, we have to make a distinction between the 'pure, or: originary, interest rate' and the 'nominal market interest rate'.

The originary interest rate is inseparably tied to human action: Each and one of us value an early satisfaction of a want more highly than a later satisfaction of the same want. In other words: We as human beings value a good that is presently available more highly than the same good available at a future point in time. This is the direct outcome of our time preference.

As a logical category of human action, time preference is always present, it is always and everywhere positive, and so is the originary interest rate. The latter manifests itself by the fact that a good available in the present is assigned a higher value than the same good at a later point in time. The value discount future goods suffer vis-à-vis present goods is indicative of the originary interest rate.

The originary interest rate is always positive; it cannot go down to zero, let alone fall into negative territory – because of positive time preference. At the same time, the originary interest rate is not a constant. One may well assume that it differs from one individual to the next, and even an individual's originary interest rate is not a constant over time.

Precious metal prices (USD/oz)



Source: Thomson Financial.

For instance, young people tend to have a higher originary interest rate when compared to, say, parents who tend to their children – so that for the former the value of future goods is much less compared to present goods than for the latter. Or: In times of a financial panic, peoples' originary interest rate typically goes up (sharply), as present needs become more important than future needs.

Unhampered versus hampered market

In an unhampered market, it is individuals' originary interest rate that determines how much they consume and save out of their income. The social originary interest rate emerges through the interplay between individuals' supply of and demand for savings. The nominal market interest rate is a composition of the social originary interest rate plus an inflation, credit and liquidity premium.

The interest rate as determined in an unhampered market brings investment and savings into line so that scarce resources are intertemporally coordinated: The interest rate as determined in an unhampered market ensures that available savings are sufficient to finalise all those investment projects deemed profitable at the prevailing market interest rate and satisfy consumption needs.

However, we do not live in unhampered capital markets. Central banks intervene massively in money and credit markets and tamper with the interest rate. They do not only determine short-term interest rates but also - through direct bond purchases - long-term interest rates. In fact, central banks, not free market forces, determine market interest rates more than ever.

Central bank monetary policy – the issuing of new money through credit expansion – diverts the nominal market interest rate from the level it would reach in an unhampered market. It thereby causes the real (that is inflation-adjusted) interest rate to fall below the social originary interest rate. This leads to a decline in savings, while consumption and investment go up.

What follows is an artificial economic upswing ("boom"), coaxing firms to engage in long-term investment projects in the capital goods industries at the expense of investment in consumer goods industries. Output and jobs gains thus created depend on the market interest rate to remain artificially suppressed.

The boom comes to an end and turns into a downswing ("bust"), if and when the interest rate goes up, i.e. the real market interest rate returns to the social originary interest rate. Because then many investment projects, which have hitherto seemed profitable, turn out to be 'flops'. Firms cut back on production, start liquidating unfinished investment projects and reduce their workforce.

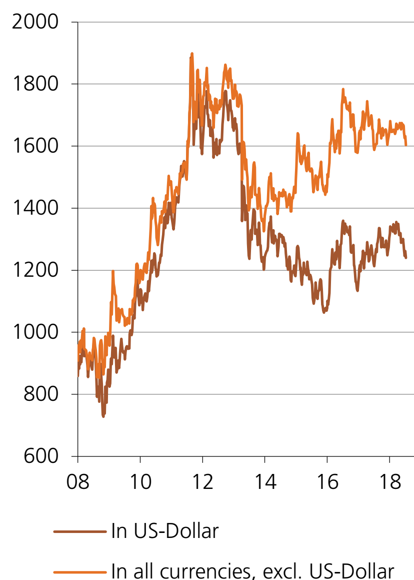
To avoid the bust, central banks keep pushing the market interest rate to a lower level once the economy starts weakening or financial markets are heading for trouble: Central banks try their very best to keep the artificial boom – which they have triggered by issuing new money and pushing market interest rates to artificially low levels – going.

Great distortion

From the viewpoint of 'pure theory' it is quite clear where all this is headed: The longer the boom has been going on, the more severe is malinvestment, and the bigger the ensuing bust – the loss in output and jobs and losses in capital values - will be. When it comes to making use of the insights of 'pure theory' for real-life purposes, however, we have to take account of the 'prevailing conditions'.

If, for instance, the economy has enjoyed productive gains during the boom, its expansion may continue for longer than what 'pure theory' would suggest. Like-

Gold price per ounce
in US dollars and all world currencies (excl. the US dollar)*
January 2008 to July 2018



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.

wise, peoples' originary interest rate may fall (for various reasons), and if this is the case, the distorting the effect originating from central banks' downward manipulation of market (and real) interest rates would be reduced.

Under such ‚prevailing conditions' the harmful effects of central banks' monetary policies would be kept in check so that the economies could even afford a higher debt load, and elevated valuations for, e.g. stocks would not necessarily reflect a bubble. While this would indeed be a quite positive scenario, the question is: Is it also a realistic scenario?

The key hurdle to meaningfully answering this question is that we do not know where the 'correct' level of the interest rate is. Central banks' chronic interventions in credit markets have been causing a 'truly great distortion', having us robbed of the very mechanism that could bring about the social originary interest rate: namely free market forces.

Reason for caution

In fact, the ongoing issuance of fiat money through credit expansion (money 'creation' out of thin air) is indicative that something sinister is at work: namely that the real market interest rate has been pushed below the social originary interest rate, influencing businessmen and consumers to make unwise decisions.

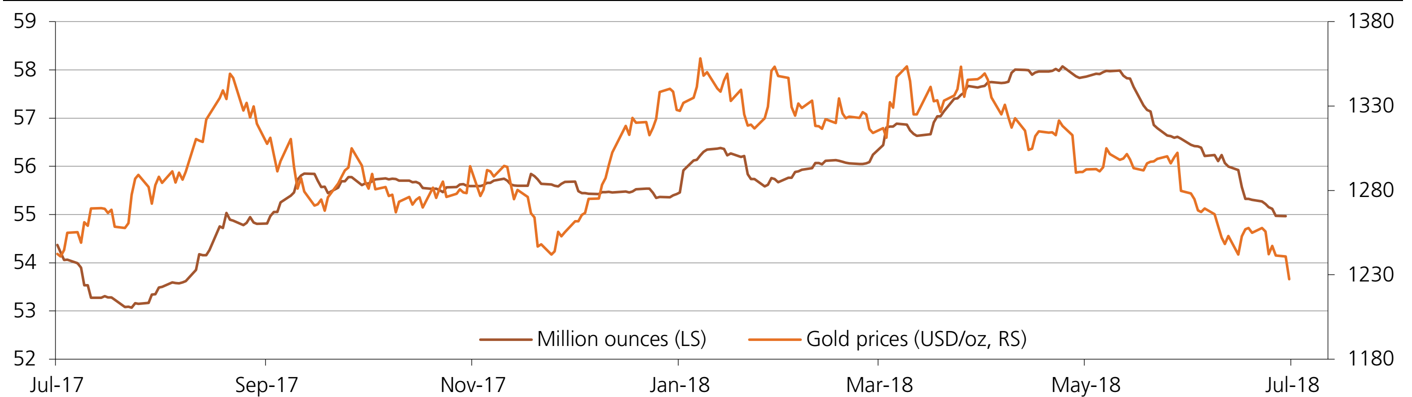
Dance until the music stops, is the motto on financial markets. Central banks can be expected to keep the music playing as long as possible – that is fuelling the boom going by a policy of whatever it takes – and this means suppressing the interest rate to an artificially low level and churning out ever more credit and money to prevent any crash from occurring.

The prime victim of such a monetary policy will be, of course, fiat money's purchasing power. It can be expected to continue to fall chronically, and with it, the real value of fixed claims denominated in fiat money goes down. All the more so, as an approaching bust will most likely make central banks opening up their monetary spigots.

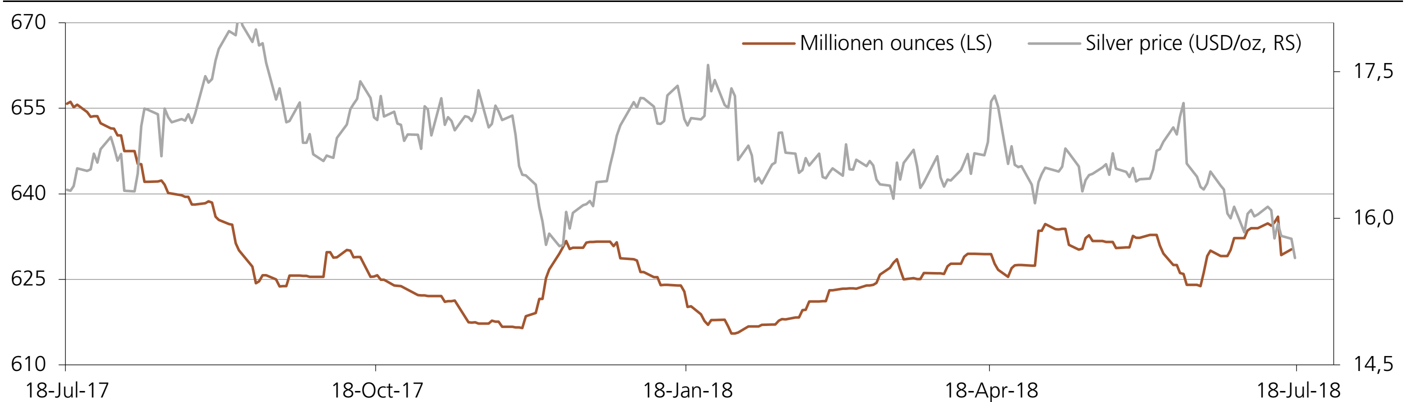
This, in turn, suggests a scenario outlined by Murray N. Rothard (1926 – 1995), who wrote: "We can look forward, therefore, not precisely to a 1929-type depression, but to an inflationary depression of massive proportions." In other words: Investors are well advised to expect a pretty challenging market environment once the next crisis hits – which is not a question of if but of when.

Precious metals prices and ETF holdings

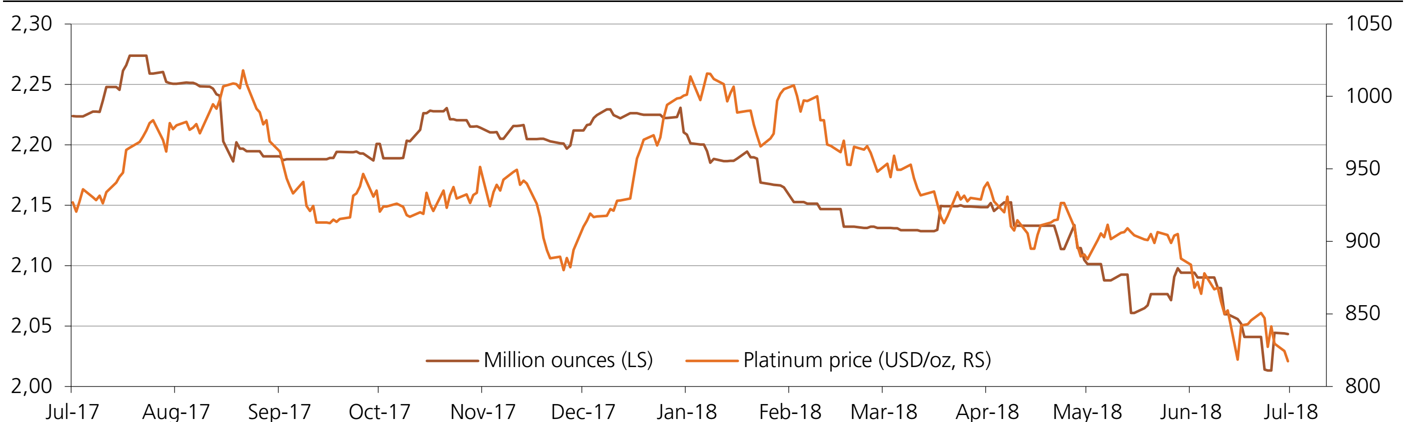
Gold ETFs (million ounces) und gold price (USD/oz)



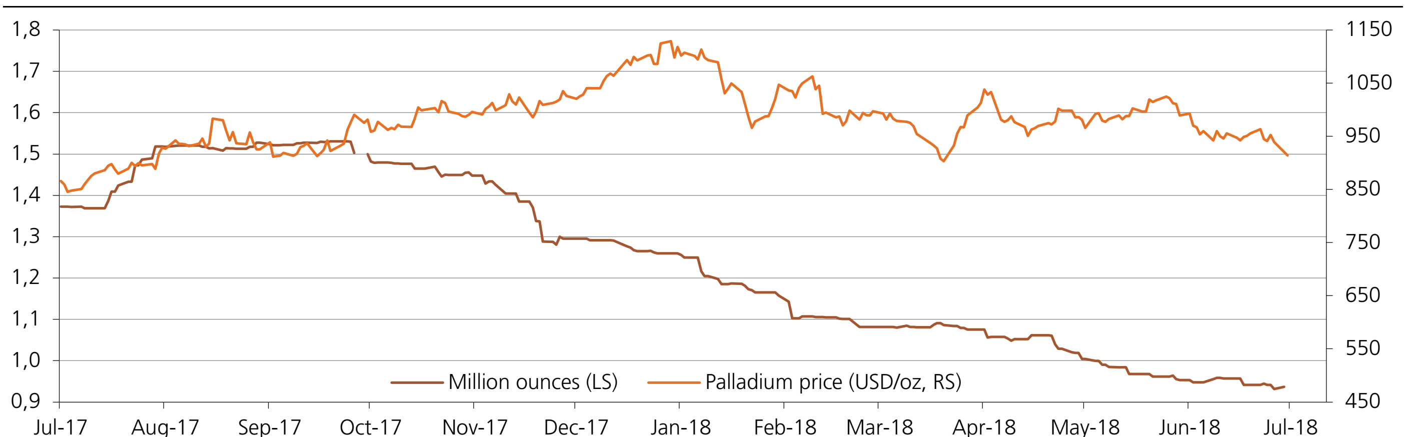
Silver ETFs (million ounces) and silver price (USD/oz)



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	1227.3		15.6		818.3		907.7	
II. Gliding averages								
5 days	1240.6		15.8		831.6		934.0	
10 days	1248.8		15.9		836.8		942.7	
20 days	1254.2		16.1		847.0		947.2	
50 days	1280.6		16.4		880.3		974.8	
100 days	1304.1		16.5		907.9		976.5	
200 days	1301.8		16.6		928.8		1001.2	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1248	1472	16.0	21.0	936	1048	1033	1261
(1)	*2*	*20*	*3*	*35*	*14*	*28*	*14*	*39*
IV. Annual averages								
2014	1260		19.1		1382		800	
2015	1163		15.7		1065		706	
2016	1242		17.0		985		617	
2017	1253		17.1		947		857	

In Euro

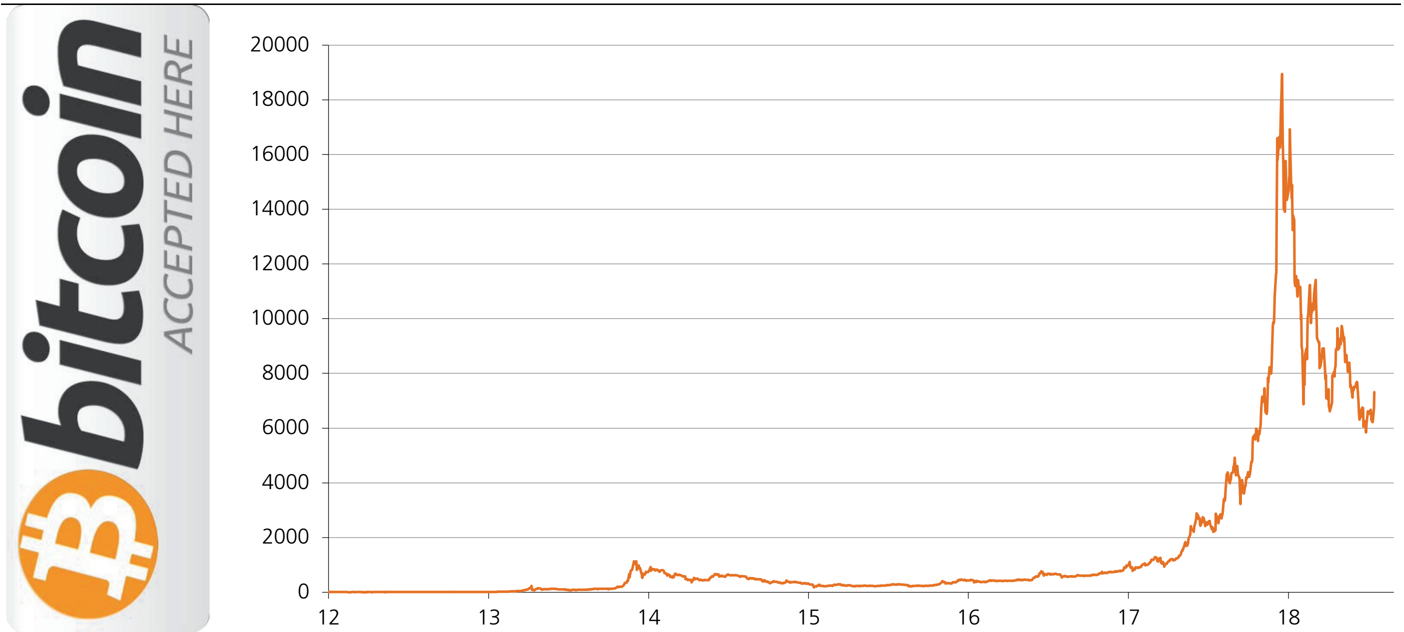
	Gold		Silver		Platinum		Palladium	
I. Actual	1053.5		13.3		702.5		779.2	
II. Gliding averages								
5 days	1061.0		13.5		711.2		798.8	
10 days	1066.9		13.6		714.9		805.4	
20 days	1075.1		13.8		726.0		811.9	
50 days	1093.7		14.0		751.8		832.4	
100 days	1088.5		13.7		757.6		815.4	
200 days	1086.5		13.9		774.9		835.8	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1080.8	1274.2	13.8	18.2	810.4	907.6	894.1	1091.7
(1)	*3*	*21*	*4*	*36*	*15*	*29*	*15*	*40*
IV. Annual averages								
2014	945		14		1035		601	
2015	1044		14		955		633	
2016	1120		15		888		557	
2017	1116		15		844		760	

Source: Thomson Financial; own calculations and estiamtes.

(1) Estimated return against actual price in percent.

Bitcoin, performance of various asset classes

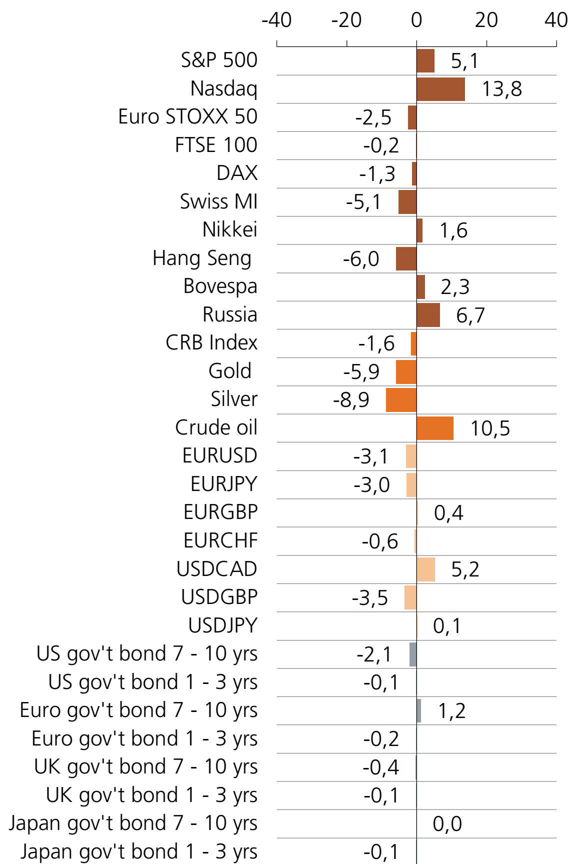
Bitcoin in US dollars



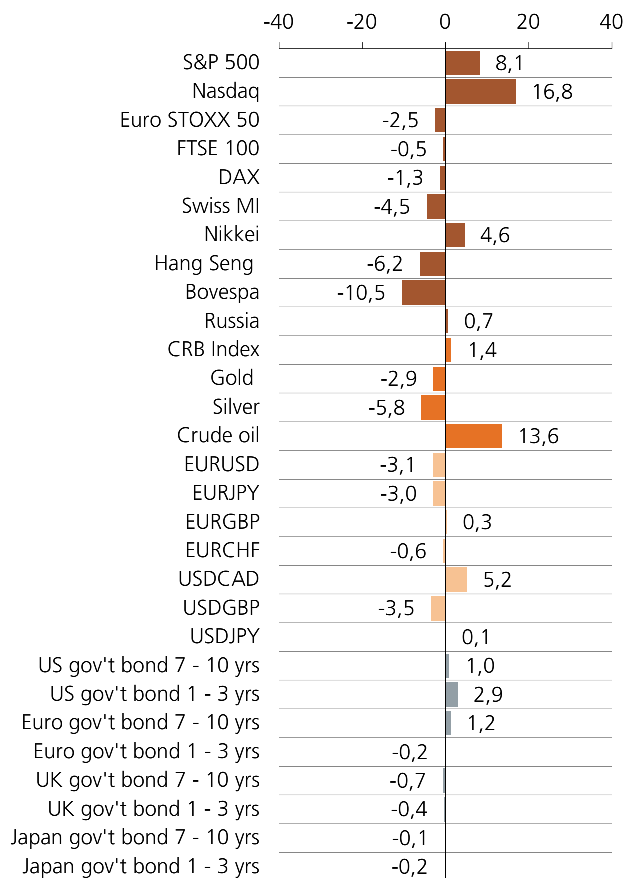
Source: Thomson Financial.

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euro



Source: Thomson Financial; own calculations

Articles in earlier issues of the *Degussa Market Report*

Issue	Content
20 July 2018	Not All Is Well In Financial Markets
22 June 2018	Euro-Banks In Trouble. A Case for Gold
8 June 2018	Demand for Gold ETFs up Despite Higher Interest Rates
25 May 2018	Mind The Interest Rate
11 May 2018	Mr Buffett on Gold – Viewed Differently
27 April 2018	Moving Towards Higher Gold Prices
13 April 2018	The Risk of a Currency Crisis
29 March 2018	Walking the Tightrope
16 March 2018	Gold, Interest Rates, And Money
2 March 2018	Gold in Times of Boom and Bust
16 February 2018	The Fed Makes The Stock Market A Risky Place
2 February 2018	Central Banks Put a Safety Net Under Financial Markets
19 January 2018	Chances And Risks For Investors in 2018
21 December 2017	New Competition: Gold and Crypto Currencies Against Fiat-Monies
8 December 2017	It Is Just Another Inflationary Boom
24 November 2017	There Is, And Will Be More, Inflation
10 November 2017	Calm Markets: The Great Mystery
27 October 2017	The Interest Rate Becomes A "Crash Factor"
13 October 2017	The Great Complacency
29 September 2017	The German Election Outcome Might Turn Up The Heat On The Euro
15 September 2017	A Case for Gold in the Investment Portfolio
1 September 2017	On the Intrinsic Price of Gold
18 August 2017	Gold in Times of Boom and Bust
4 August 2017	The Underpriced Risk
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
26 May 2017	The Make-Believe World of Fiat Money
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?

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