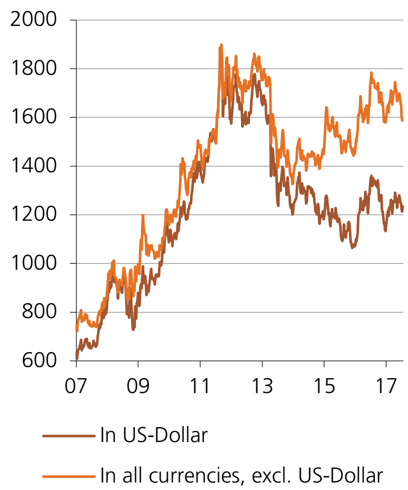
Degussa Market Report
21 July 2017
Economics · Finance · Precious Metals

"The American economy has suffered from chronic inflation, and from destructive booms and busts, because that inflation has been invariably generated by the Fed itself. That role, in fact, is the very purpose of its existence: to cartelize the private commercial banks, and to help them inflate money and credit together, pumping in reserves to the banks, and bailing them out if they get into trouble."

—Murray N. Rothbard (1926 – 1995)

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

OUR TOP ISSUE

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

The Fed Remains on Course – to Trouble

The Federal Reserve (Fed) is widely expected to continue to tighten its monetary policy this year. According to a latest Reuters Poll, the US central bank is likely to start shrinking its US$4 trillion balance sheet in September and, moreover, raise further its key interest rate, which is currently standing in a range of 1.0 to 1.25 percent, in the fourth quarter this year.

According to mainstream economic wisdom, the time has come for the US economy to return to a more normal level of interest rates. Industrial output is expanding at a decent clip, official unemployment has declined markedly, and prices in the stock and housing market show a sustained upward drift. Considering these circumstances, the US economy can now shoulder a tighter monetary policy, it is said.

It should be understood, however, that there will be side-effects, even unintended consequences, if and when the Fed hikes interest rates further. Most important, the Fed doesn't know where the "neutral interest rate" is. If it does too much, the economy might well collapse. If the Fed does not do enough, it will only prolong the artificial boom, causing ongoing malinvestment and, ultimately, another crisis.

Admittedly, this is nothing new: The Fed has always been a cause of boom and bust. It sets into motion an artificial upswing by issuing new fiat money through bank credit expansion. Such a boom, however, must sooner rather than later break down and turn into a bust. It is, therefore, strongly advised to expect nothing good coming out of Fed interventions.

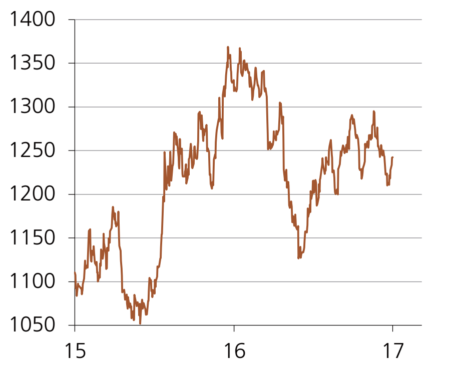
Going through the numbers

This holds also true for the Fed's plan to start selling securities it has bought during the financial and economic crisis to prop up the economic and financial system. Back in 2008 and 2009, the Fed provided the US banking system with an enormous cash infusion by granting loans to and purchasing securities from banks.

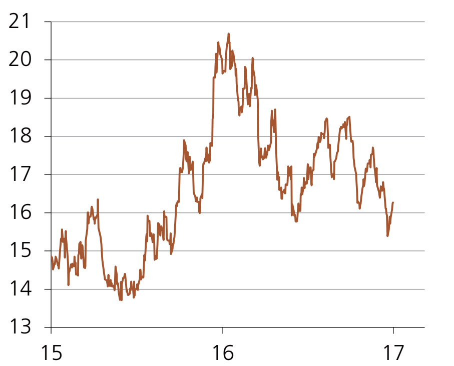
The Fed ramped up banks' cash holdings from US$ 24.9bn to US$ 2,398.1bn from September 2008 to July 2017. It did so by buying Treasuries and mortgage-backed securities (MBS) amounting to US$ 1,908.9bn and US$1,770.3bn, respectively. In the meantime, however, banks have repaid most of the loans provided by the Fed.

This, in turn, has reduced banks' cash holdings to US$ 2,398.2bn. As a result, the US banking system does not have enough base money to pay for the Fed's crisis-related bond purchases of US$3.755.8bn. Simply put: *It has become impossible for the Fed to sell all the bonds it has purchased.*

Gold (USD per ounce)

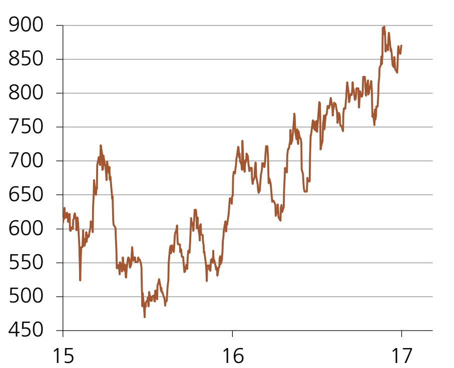


Silver (USD per ounce)



Platinum (USD per ounce)

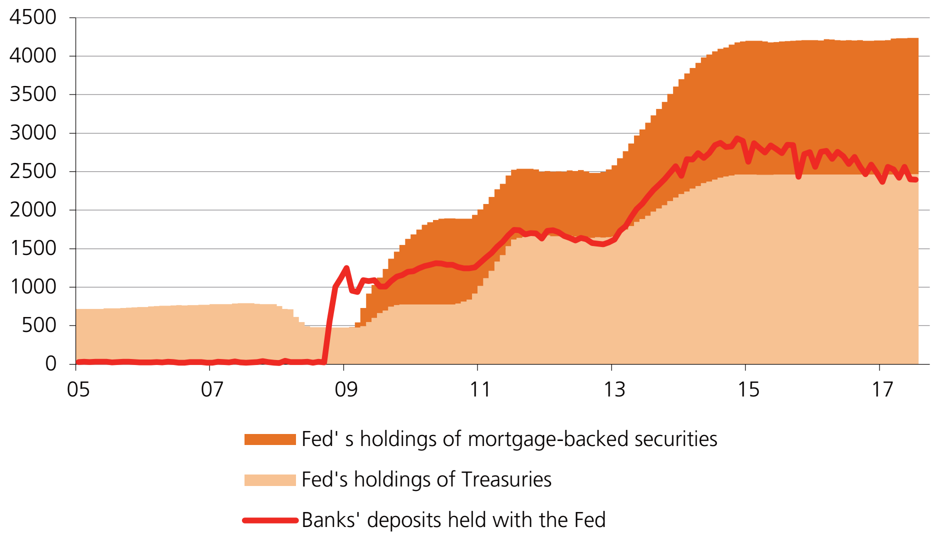
Palladium (USD per ounce)



Source: Thomson Financial.

Banks have too little cash to pay for all the Fed's bonds

Fed's securities holdings and banks' deposits held with the Fed, US$ bn)



Source: Thomson Financial.

If the Fed were to shed just 64 percent of its current bond holdings, the base money supply in the US banking system would be completely wiped out, making the banking sector effectively illiquid. In this process, US interbank interest rates would presumably spike, sending shock waves through the economic and financial system, not only in the US but worldwide.

Three options

It is safe to assume that the Fed and the banks would want to avoid such a scenario. This leaves the Fed with three options. Option 1: The Fed sells only a (small) part of its current Treasury and MBS to avoid a liquidity shortage in the interbank money market. In other words: The Fed would have to keep sitting on a significant part of its bond holdings and buy new bonds once they mature.

Option 2: The Fed sells off its bond holdings and, at the same time, runs liquidity providing operations to keep banks sufficiently equipped with cash. It purchases, for instance, consumer and/or corporate loans from banks and issues new base money. As a result, the Fed's assets in its balance sheet would see Treasuries and MBS go down, and consumer and corporate loans go up.

Option 3: The Fed swaps its Treasury and MBS holdings into short-term maturities and sells these papers over time, thereby reducing the base money supply in the banking system as far as possible. This way, the Fed would reduce its active involvement in the credit markets somewhat, confining it mainly to the short-term end of the market.

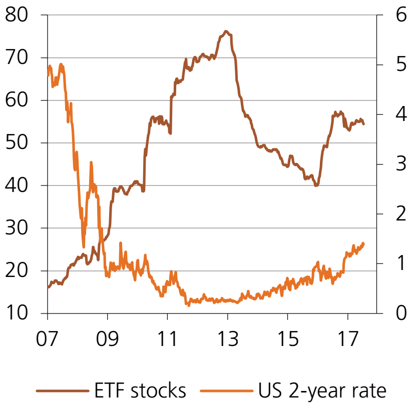
Interest rates will remain distorted

That said, it will be enlightening to see which option the Fed will ultimately choose. Option 1 and 2 would be indicative of the Fed wanting to retain its powerful grip on the price action and consequently the yields in fixed income markets. Option 3 would suggest that the Fed allows interest rates in the long-term end of the market to normalize at least to some extent.

Whatever option it chooses, however, the Fed will, one way or another, keep distorting interest rates. By issuing new quantities of fiat money through credit

Gold-ETF stocks went up despite higher short-term rates, …

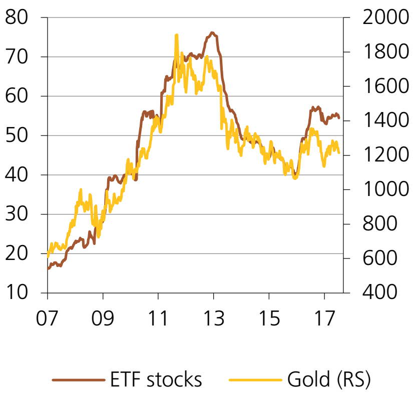
Gold price (USD per ounce) and US short-term interest rate in %



Source: Thomson Financial.

… and this has certainly supported the price of gold

Gold price (USD per ounce) and US short-term interest rate in %



Source: Thomson Financial.

Precious metals prices				
	Actual (spot)	Change against (in percent): 2 W	3 M	12 M
I. In US-dollar				
Gold	1.245.8	1.7	-0.7	-5.9
Silver	16.4	2.3	-2.7	-11.6
Platinum	925.7	1.7	-1.4	-13.6
Palladium	846.1	1.4	11.4	24.1
II. In euro				
Gold	1.070.7	-0.1	-4.4	-8.9
Silver	14.1	0.4	-6.4	-14.5
Platinum	795.5	-0.1	-4.7	-16.7
Palladium	727.0	-0.3	7.5	20.2
III. Gold price in other currencies				
JPY	139.232.0	0.4	-0.3	4.7
CNY	8.420.8	1.1	-2.5	-4.4
GBP	959.0	1.6	-0.4	-4.1
INR	80.192.8	1.2	-1.0	-9.7
RUB	73.385.7	-0.3	2.7	-15.0

Source: Thomson Reuters; own calculations.

expansion, the Fed inevitably wreaks havoc on the economy's price system and production structure. It manipulates the perception of risk and flatters the value of future cash flows.

This, in turn, causes many economic and social problems. Most importantly, the Fed's actions debase the purchasing power of the US dollar, thereby destroying much of peoples' life-time savings. What is more, the Fed's policy coercively redistributes income and wealth, thereby creating winners and losers, and it also brings about costly boom and busts.

Just to be on the safe side: The Fed is not the solution to all these problems. It is the actual cause. Whatever the US central bank will do: Be assured it will remain on course to trouble – whatever the Fed will be doing in terms of setting interest rates and dealing with the all bonds it has purchased against issuing new fiat dollars.

While this is certainly a gloomy message, it might help investors to make wiser decisions. Because if the Fed causes another round of trouble, it will most likely take resort to even lower interest rates and issuing even more fiat money. So whatever happens short-term, there is good reason to expect that the fiat dollar – and this holds true for all fiat currencies – will lose value.

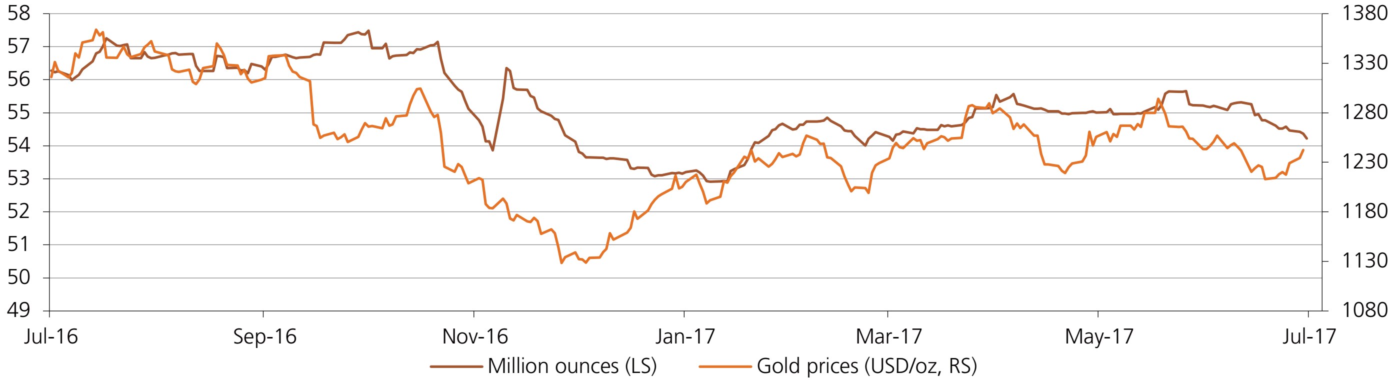
Case for gold

Investors are well advised to bear in mind the dangers that result from the fiat money system - such as, for instance, capital misallocation and debasement of money's purchasing power. At the same time, however, the careful investor should not jump ship prematurely because the fiat money system might be held up for longer than some may fear and others might hope.

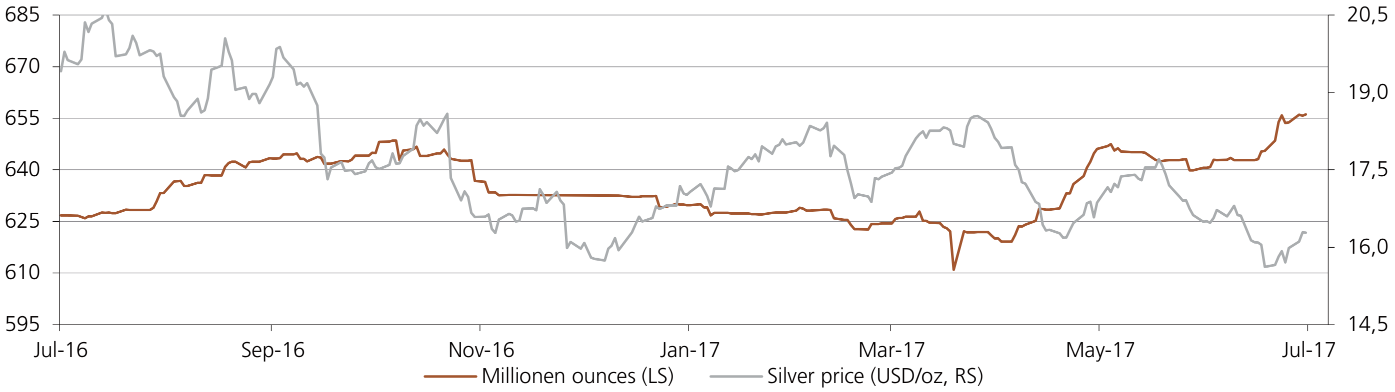
It is against this backdrop that we consider gold to be a valuable portfolio component. Gold is, by all means, a "sound currency". Its purchasing power cannot be debased by political expediency. Furthermore, gold serves as portfolio insurance: It protects its holder against potential payment defaults. At its current value, we would think gold offers protection that comes with an upside price potential.

Precious metals prices and ETF holdings

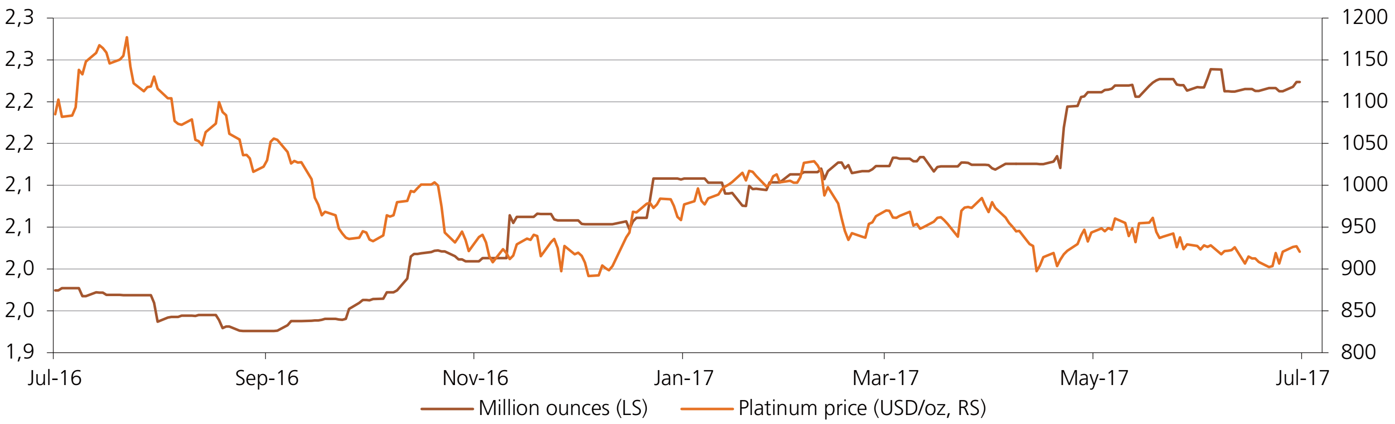
Gold ETFs (million ounces) und gold price (USD/oz)



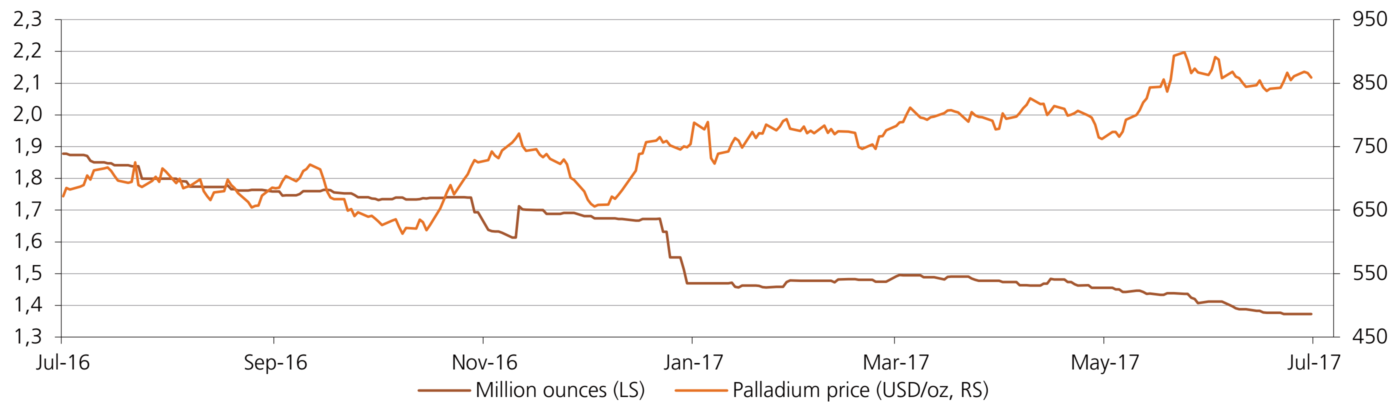
Silver ETFs (million ounces) and silver price (USD/oz)



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



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



Source: Bloom berg.

Precious metals prices

In US-dollar

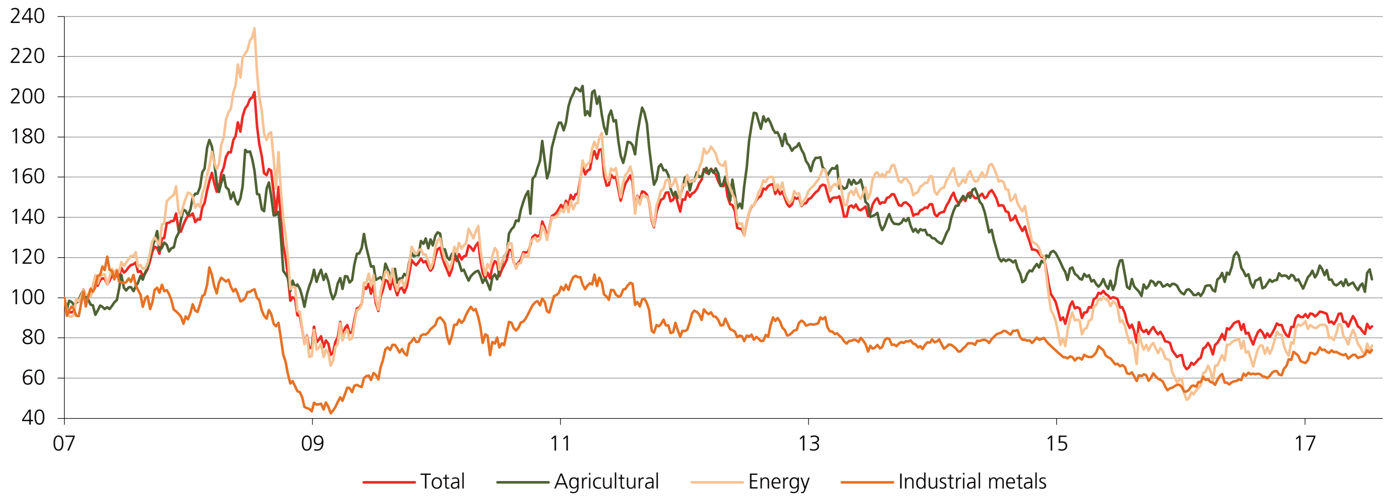
	Gold		Silver		Platinum		Palladium	
I. Actual	1.246.7		16.4		927.1		845.7	
II. Gliding averages								
5 days	1.232.7		16.0		922.2		864.8	
10 days	1.224.3		15.9		913.2		852.8	
20 days	1.232.4		16.2		915.4		855.6	
50 days	1.248.9		16.7		929.0		837.2	
100 days	1.248.2		17.1		941.0		814.2	
200 days	1.229.6		17.2		950.3		765.4	
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	1.071.8		14.1		797.0		727.1	
II. Gliding averages								
5 days	1.073.4		14.0		803.0		753.0	
10 days	1.069.7		13.9		797.9		745.1	
20 days	1.083.4		14.2		804.7		752.2	
50 days	1.110.0		14.8		825.7		743.9	
100 days	1.135.8		15.6		856.7		740.3	
200 days	1.134.4		15.8		877.3		705.7	
III. Projections for 2017								
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1.025	1.241	14.2	20.54	809	982	625	804
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	

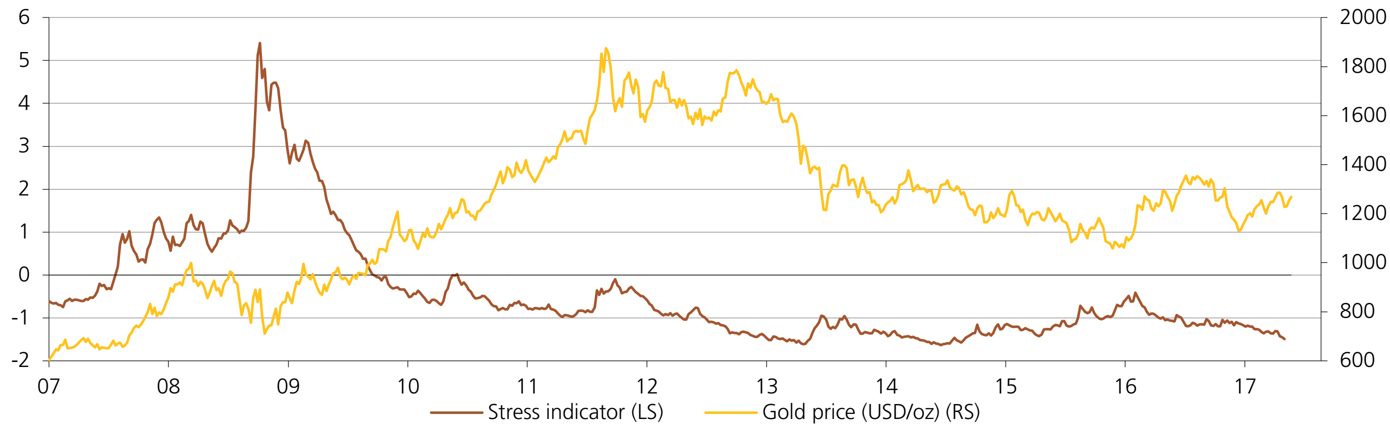
Source: Thomson Financial; own calculations and estimates.

Correction Coming to An End? S&P Commodity Prices (in US dollar terms)



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

Underestimaing Risk? Gold price (USD/oz) and Financial Market Stress



Source: Thomson Financial, Kansas City Reserve Bank.

Will Stocks Keep Rising? S&P 500 and US banks' reserves with the Fed (US$ bn)

Source: Thomson Financial.

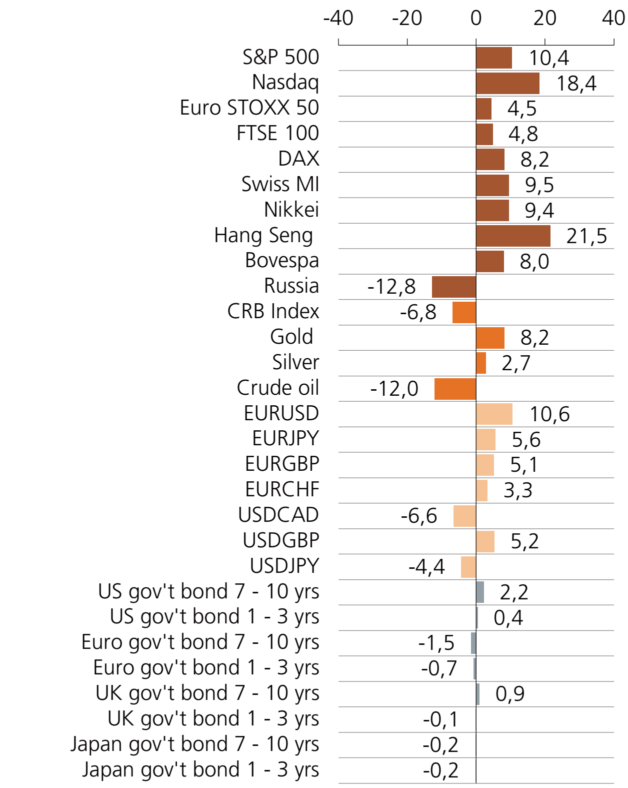
Bitcoin, performance of various asset classes

Bitcoin in US dollars

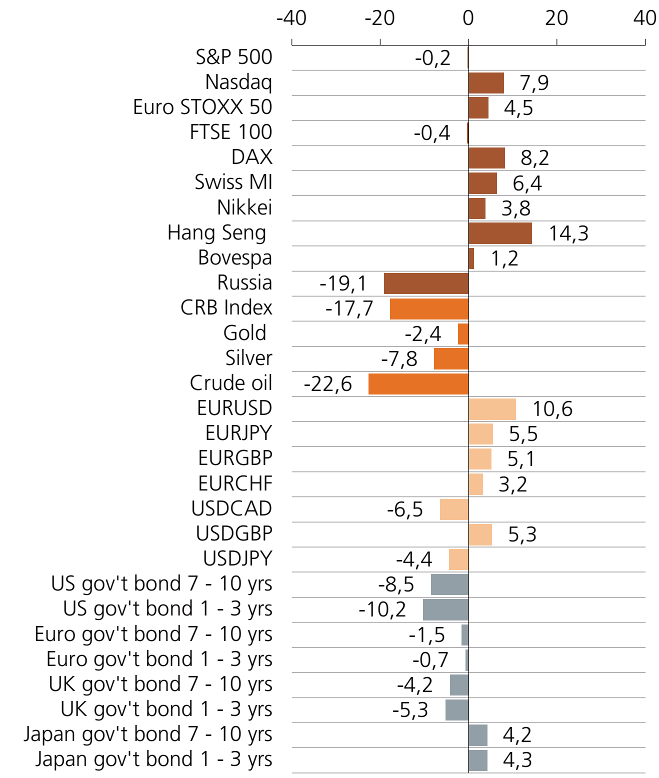
Source: Thomson Financial.

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euro



Source: Thomson Financial; own calculations

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GOLD UND SILBER.

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