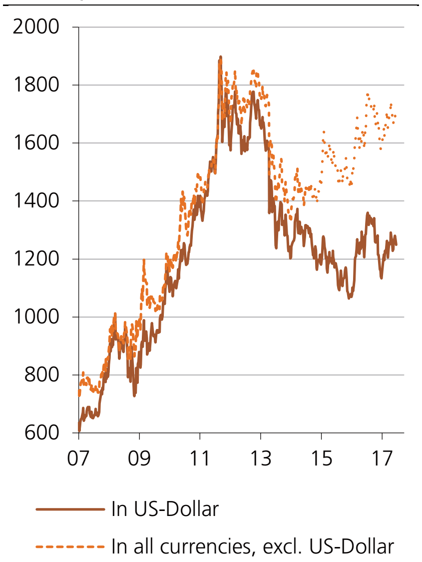
Degussa Market Report

23 June 2017 Economics · Finance · Precious Metals

"In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. … This is the shabby secret of the welfare statists' tirades against gold"

—Alan Greenspan, written in 1966.

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

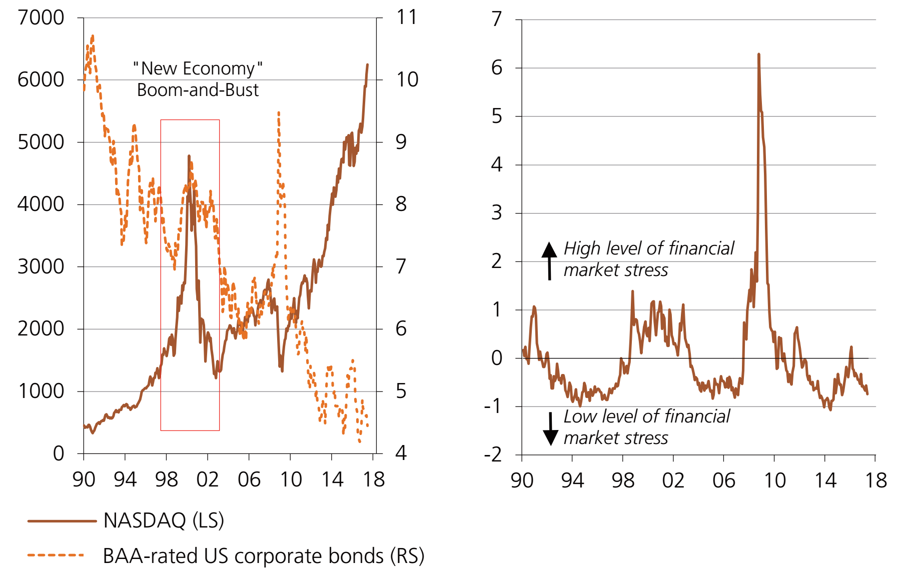
Super-Bubble in Danger

In our latest article (**Trapped in Boom-and-Bust**, 9 June 2017), we suggested that especially bond markets have reached bubble territory: bond prices have become artificially inflated by central banks' unprecedented monetary policies. Meanwhile, however, the US Federal Reserve (Fed) keeps bringing up its borrowing rate, and even the European Central Bank (ECB) is now toying with the idea of putting an end to its expansionary policy sooner or later.

Strong price gains, low interest rates, subdued risk aversion

(a) NASDAQ and yield on US BAA-rated corporate bonds in %[1]

(b) „Stress indicator" for US financial markets [2]



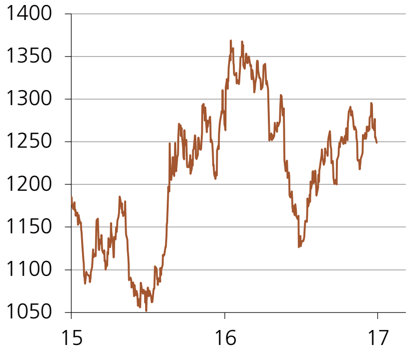
Source: Thomson Financial. [1] For BAA-rated US corporate bonds. [2] Financial market stress indicator provided by the Federal Reserve Bank of Kansas City. A rising (falling) line indicates rising (falling) tensions in financial markets.

Most notably, the latest rise in US short-term yields has been accompanied by a decline in long-term bond yields. Presumably, investors expect that the Fed will not hike interest rates much further, and/or that higher short-term interest rates will prove to be short-lived, and are going to be reversed quickly. In any case, bond markets do not seem to expect interest rates to go back to normal anytime soon. Several reasons could be responsible for such an expectation.

First and foremost, the US economy appears to be addicted to cheap money. The latest economic recovery has been orchestrated, in particular, through a hefty dose of easy monetary policy. It is therefore fair to assume that businesses will have a hard time coping with higher interest rates. For instance, corporations, consumers, and mortgage borrowers, in general, will face higher credit costs and a less favourable access to funding if and when interest rates edge higher.

Precious metal prices in US dollar per ounce

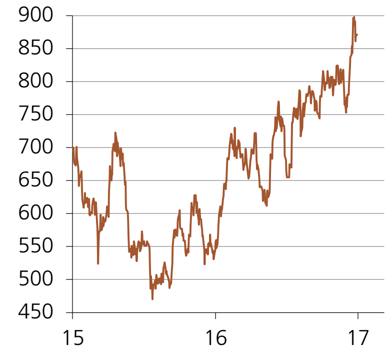
(a) Gold



(b) Silver

(c) Platinum

(d) Palladium

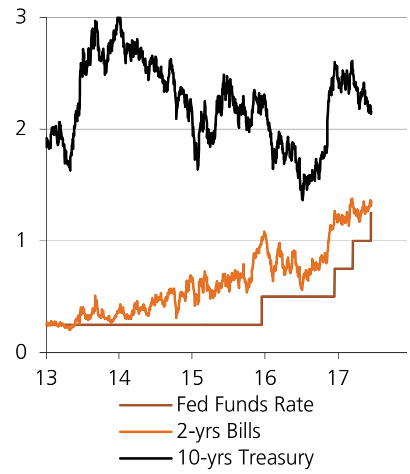


Source: Thomson Financial.

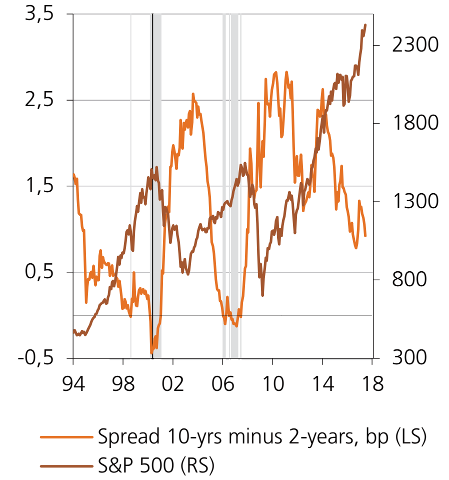
Furthermore, inflated asset markets could easily implode. Higher interest rates would send the prices of stocks, bonds, and housing southward: Expected future cash flows would be discounted at a higher interest rate, therefore deflating their present values and thus market prices. The deflation of asset markets would hit borrowers particularly hard: In their balance sheet, asset value would nosedive, while nominal debt would remain unchanged so that equity capital is wiped out.

Subdued rate hike expectations, flattening yield curve

(a) Federal Funds Rate and 2- and 10-year bond yields in %



(b) S&P 500 and the shape of the yield curve in basis points[(1)]



Source: Thomson Financial; own calculation. [(1)] Grey area: Periods in which the yield curve was inverted.

Moreover, the yield curve has become flatter and flatter in recent years. This, in turn, suggests that banks' profit opportunities from lending have been shrinking, potentially dampening the inflow of new credit into the economic system. A further decline of the yield spread could bring real trouble: In the past, a flat or even inverted yield curve has been accompanied by a significant economic downturn or even a stock market crash.

From a political point of view, central banks might find it hard to bring interest rates back up, especially back to a level where real interest rates are positive. This holds true for the Fed as well as for the ECB. In fact, the monetary policy of increasing borrowing rates by a significant margin could indeed prick the "Super-Bubble" which has been deliberately inflated and nurtured by central banks over the last decades.

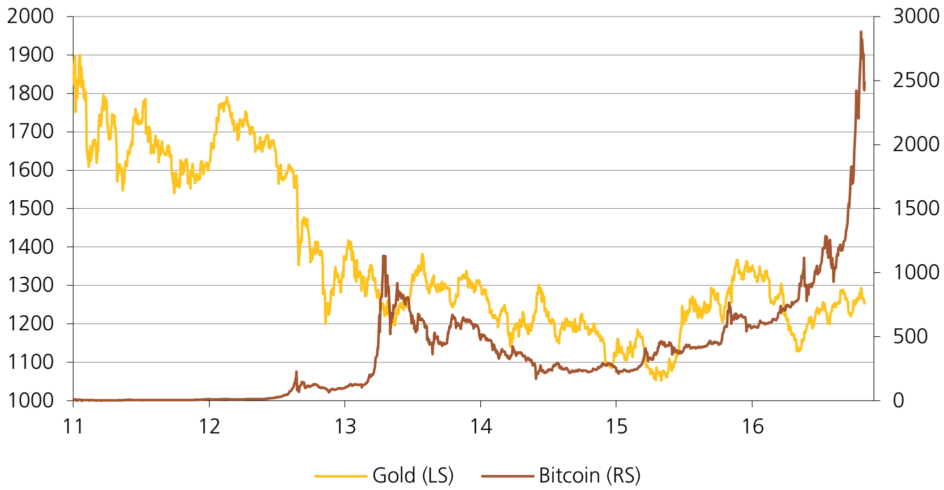
Given the far-reaching consequences, the bursting of the Super-Bubble would put central banks – which are political entities, catering to the needs of governments and the banking apparatus, in a position in which they will be expected to do whatever it takes to keep the economy and financial markets from going over the cliff. This would also mean that they could abandon their current hike attempts and go back to loosening the purse strings if deemed politically desirable.

Trouble down the road

Sound economic theory suggests that today's fiat money systems are subject to recurrent waves of boom and bust. Sooner or later the artificial economic upswing (boom), set into motion by central banks' expansionary policies, will turn into an economic downswing (bust). In fact, a bust is the economically inevitable consequence of a boom. However, there are no rules that would allow us to predict the timing and duration of the various stages of the boom-and-bust cycle.

The prudent investor has various ways of dealing with the uncertainty that comes with boom-and-bust cycles. One of which is to keep liquidity in the form of "gold currency". Gold is, by all means, sound money. Its purchasing power, in contrast to fiat money, cannot be debased according to political expediency. What is more, gold does not carry a default risk. In that sense, gold is portfolio insurance par excellence (provided, or course, that it has been bought at a reasonable price).

Gold and bitcoin – protection against trouble in the fiat money system
Price of gold (USD/oz) and price of bitcoin (USD per unit)



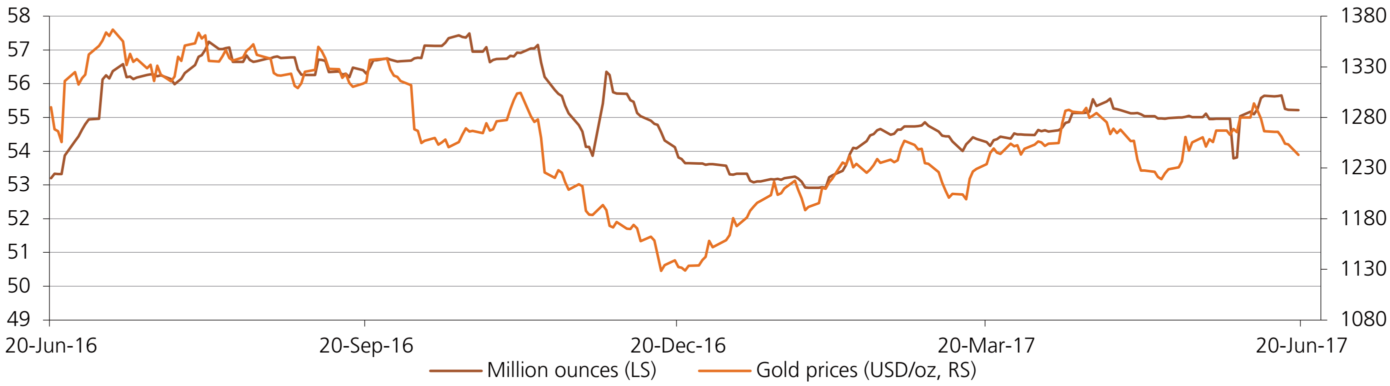
Source: Thomson Financial.

In this context, it is interesting to see that the price of bitcoin skyrocketed in recently. There are certainly several reasons for this. One reason is undoubtedly the fact that the cyber unit offers a potential "escape route" from fiat money. That said, bitcoin (and other cyber units as well) might, increasingly so, serve as a "safe haven" in future times of trouble. And there will be for sure new waves of trouble going forward – especially if and when central banks keep hiking rates.

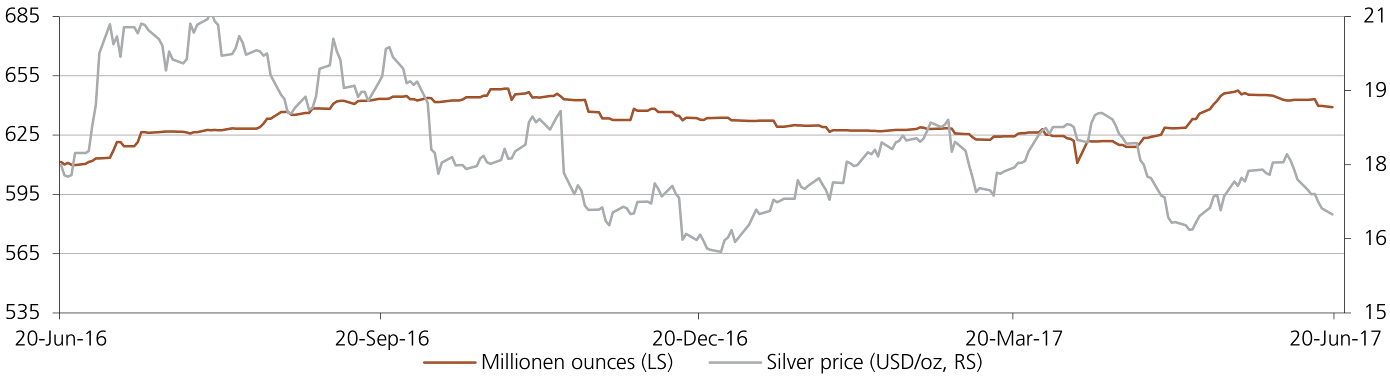
As alternatives to fiat money become increasingly accepted, positive spill-over effects can be expected for gold. Gold has always been the monetary prototype of a "safe haven". Going forward, gold may be increasingly in demand for its store of value function and, by making use of the Blockchain, as a digitalized means of payment. We think that at its current price gold offers an upside potential as far as its future purchasing power and portfolio insurance function are concerned.

Precious metals prices and ETF holdings

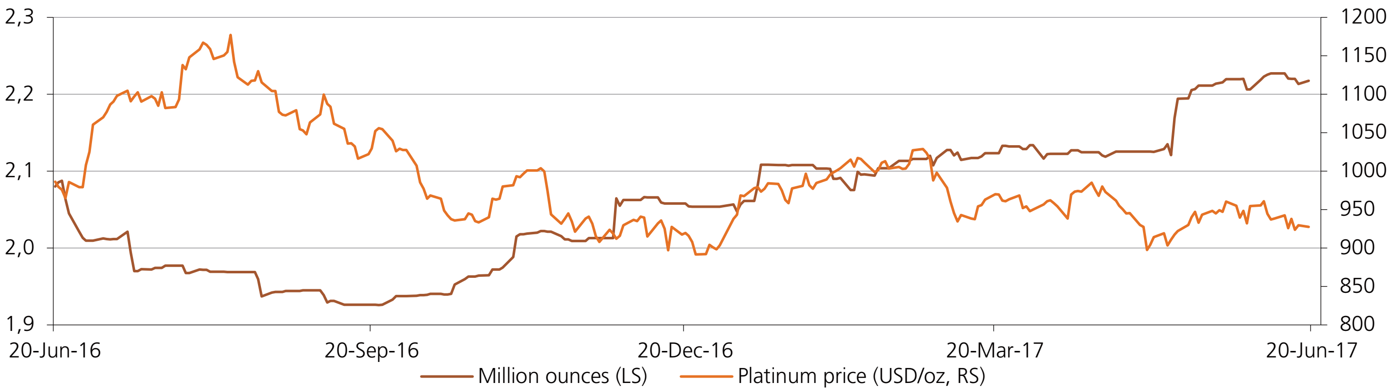
Gold ETFs (million ounces) und gold price (USD/oz)



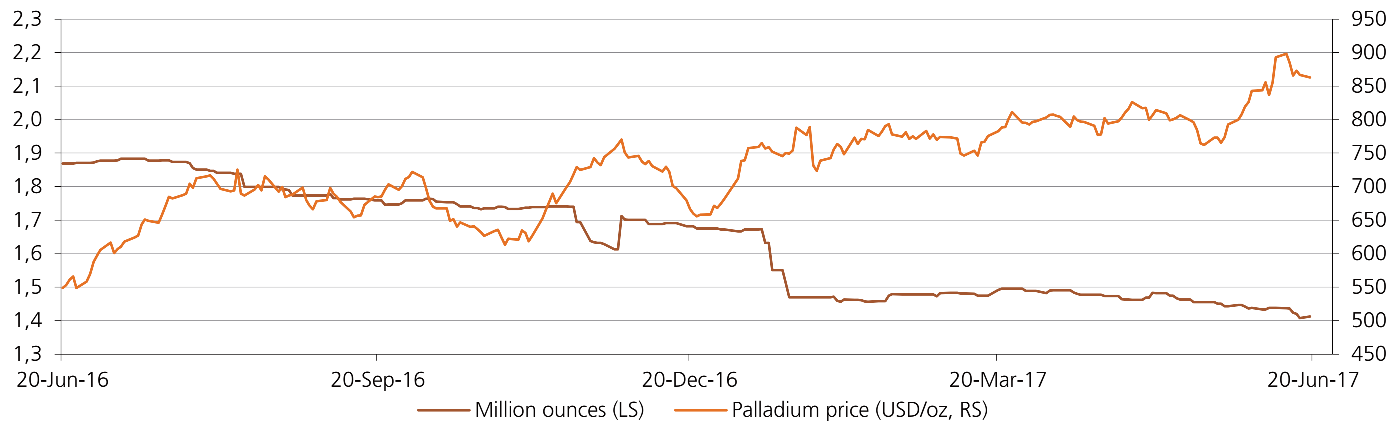
Silver ETFs (million ounces) and silver price (USD/oz)



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



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



Source: Bloomberg.

Precious metals prices

In US-dollar

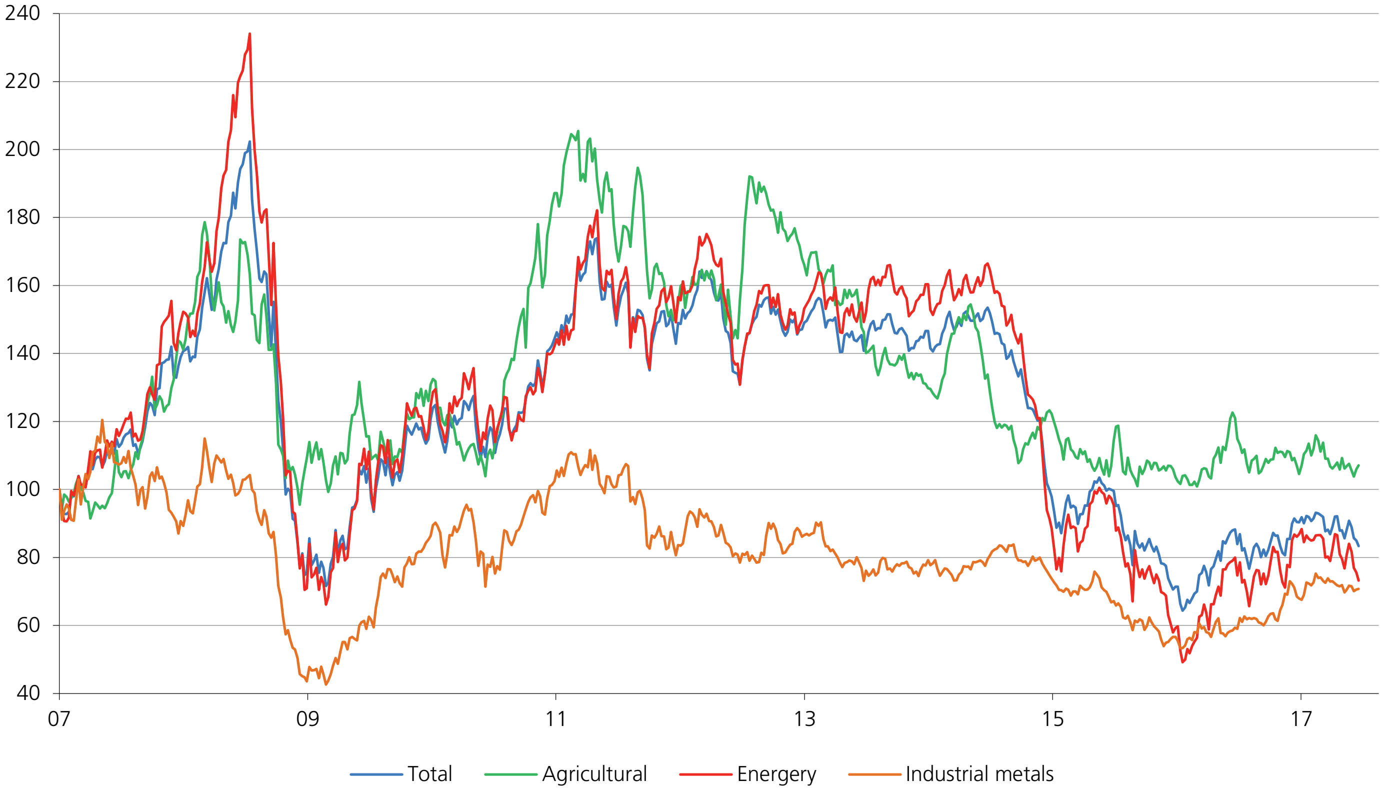
	Gold		Silver		Platinum		Palladium	
I. Actual	1,246.4		16.5		922.6		882.8	
II. Gliding averages								
5 days	1,255.7		16.7		925.0		871.0	
10 days	1,264.4		17.0		933.1		873.3	
20 days	1,266.9		17.2		940.2		839.4	
50 days	1,261.1		17.2		941.8		814.7	
100 days	1,248.7		17.5		960.4		797.1	
200 days	1,236.9		17.4		960.3		747.2	
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	1,118.7		14.8		828.0		792.3	
II. Gliding averages								
5 days	1,122.7		14.9		827.0		778.7	
10 days	1,128.9		15.1		833.1		779.8	
20 days	1,130.1		15.3		838.7		748.8	
50 days	1,144.4		15.6		854.8		739.1	
100 days	1,151.7		16.2		886.4		735.0	
200 days	1,142.7		16.1		887.6		690.6	
III. Projections for 2017	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1,118	1,353	15.5	22.40	882	1,071	682	876
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	

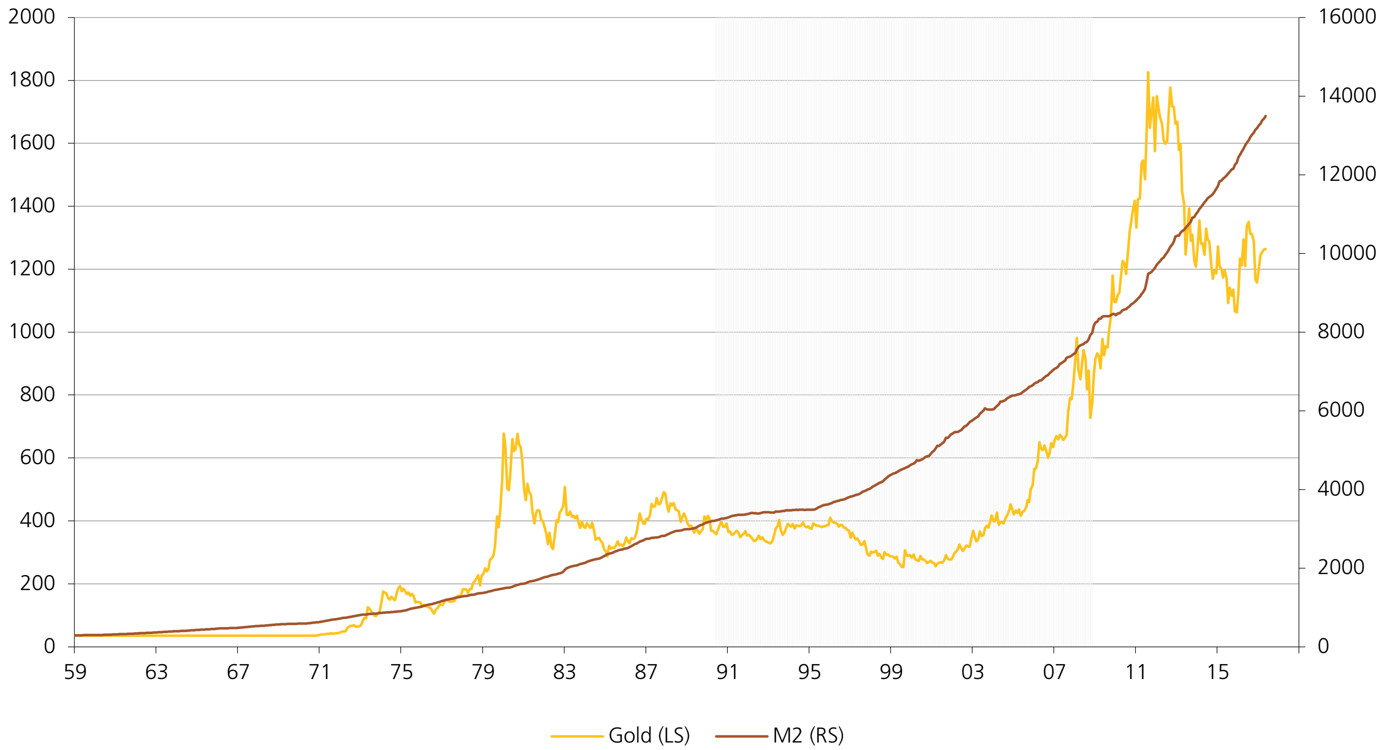
Source: Thomson Financial; own calculations and estimates.

S&P commodity prices (in US dollar terms)



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

Gold price (USD/oz) and US money stock M3 (USD billion)



Source: Thomson Financial. Grey area: Periods in which central banks were net-sellers of gold.

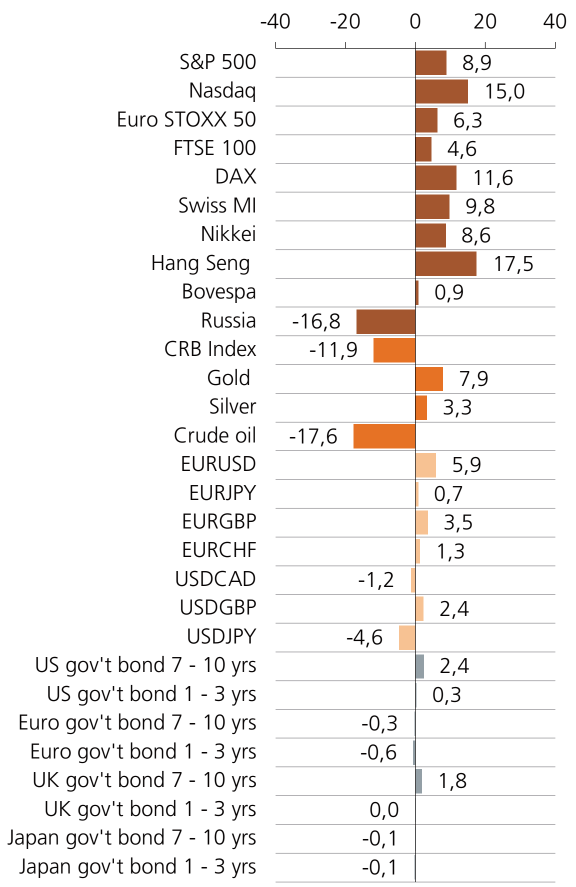
Bitcoin, performance of various asset classes

Bitcoin in US dollars

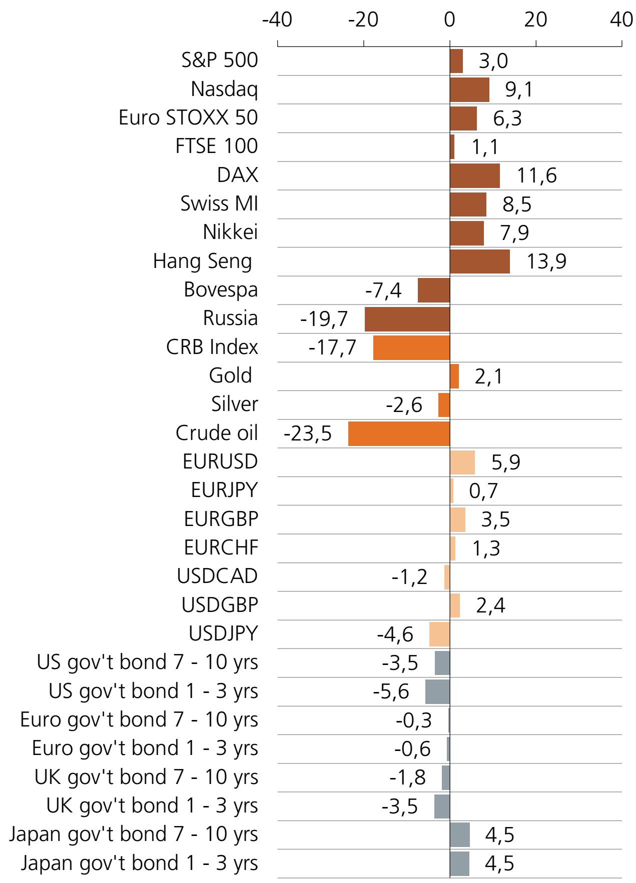
Source: Bloomberg

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*

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GOLD UND SILBER.

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