Degussa Market Report

24 November 2017 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	1.291.5	0.5	-0.4	13.1
Silver	17.1	0.8	1.1	7.0
Platinum	931.0	-0.6	0.1	3.8
Palladium	1.004.4	-0.6	9.6	51.0
II. In euro				
Gold	1.089.8	-1.2	0.4	-0.5
Silver	14.5	-0.7	1.9	-6.1
Platinum	785.6	-2.0	0.7	-9.0
Palladium	848.0	-2.3	10.1	32.5
III. Gold price in other currencies				
JPY	143.679.0	-1.4	-1.1	7.4
CNY	8.491.6	-0.4	-0.6	7.0
GBP	970.3	-0.7	1.0	4.0
INR	83.392.2	-0.1	-0.8	7.2
RUB	75.478.5	-0.8	1.2	9.4

Source: Thomson Reuters; own calculations.

OUR TOP ISSUE

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

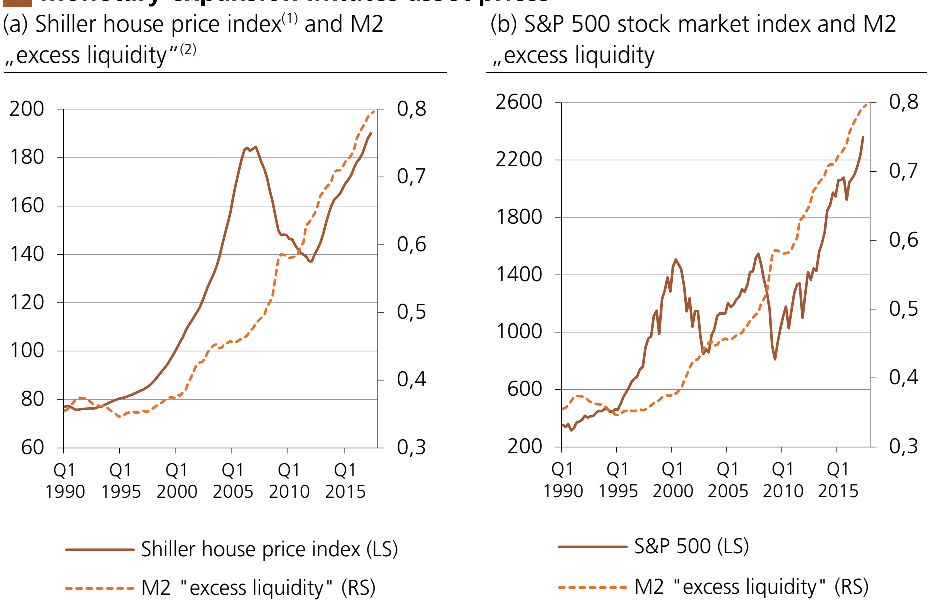
NEW: GOLD IN ART, SEE PAGE 4

There Is, And Will Be More, Inflation

We live in inflationary times. Some people might consider this statement controversial. This is because these days inflation is widely understood as a rise in the consumer price index (CPI) of more than 2 percent per year. However, there are strong reasons to question this viewpoint. On the one hand, the CPI does not include "assets" such as, for instance, stocks, housing, real estate, etc. As a result, the price developments of these goods are not accounted for by the changes in the CPI.

On the other hand, and even more essential, price changes of goods and services typically are associated with changes in the quantity of money. This is why economists used to understand a rise in the quantity of money as inflationary (and a decline in the quantity of money as deflationary). There is sound economic reason for this viewpoint: Without money sloshing around, there could not be a phenomenon like inflation – that is an ongoing upward trend in all prices of goods and services over time. Inflation is inextricably linked to money.

1 Monetary expansion inflates asset prices



Source: Thomson Financial; own calculation. Period: Q1 1990 to Q3 2017. (1) Nationwide index. (2) Stock of M2 divided by nominal GDP (which is simply the reciprocal of the income velocity of money).

One indicator of an overly generous monetary expansion is the link between the US money stock M2 and nominal GDP. This ratio can be referred to as a measure of "excess liquidity". Since the outbreak of the crisis 2008/2009, excess liquidity has been growing strongly – as GDP growth lagged behind the increase in the quantity of money. Presumably, a great deal of the monetary expansion has been driving asset prices upwards – most notably in the stock and housing market.

There is good reason to assume that overall the increase in prices has been exceeding CPI gains. In other words: The decline in the purchasing power of the US dollar is most likely much stronger than what the calculation based on official CPI would suggest. Well, you might be inclined to say "Let bygones be bygones". This, however, would undoubtedly understate the nature of the problem – and be unwise for the thoughtful investor. Because the inflationary development is here to stay, and - if anything - it will get worse.

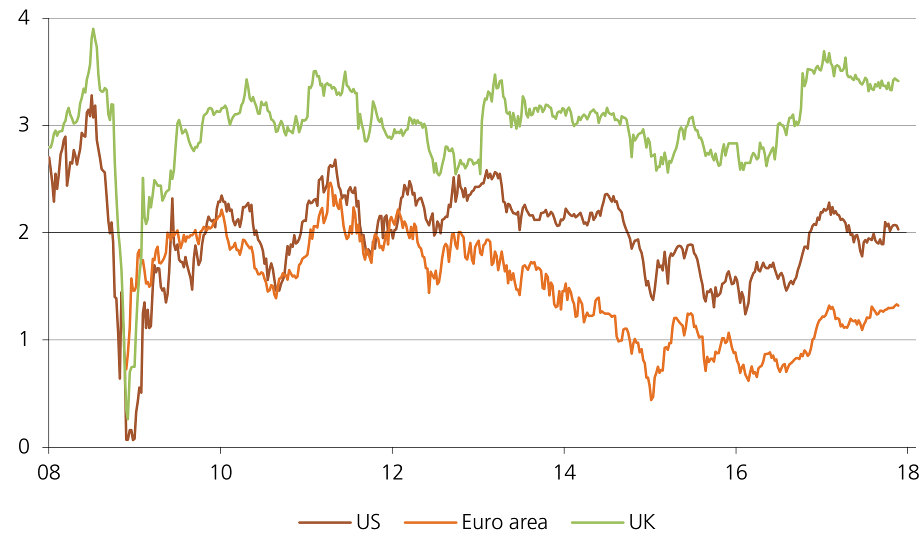
The Federal Reserve (Fed) has created just another monetary policy driven "boom": The US economy is fueled by extremely low interest rates, accompanied by credit and money growth (out of thin air). The monetary expansion leads to an artificial rise in consumption and investment spending, resulting in production and employment gains. Furthermore, the newly created liquidity finds its way into financial (asset) markets, driving up asset prices and valuation levels.

To keep the boom going – and prevent the "bust" –, the Fed has to make sure that credit and money supply keep increasing and that, by no means less important, borrowing and capital costs remain at fairly low levels. That said, the ongoing inflationary policy must – and for political reasons most likely will – go on. Higher interest rates and a slowdown of credit and money creation would, literally speaking, take away the punch bowl – and the party would come to a shrieking halt. The economic boom would turn into bust.

Getting worse

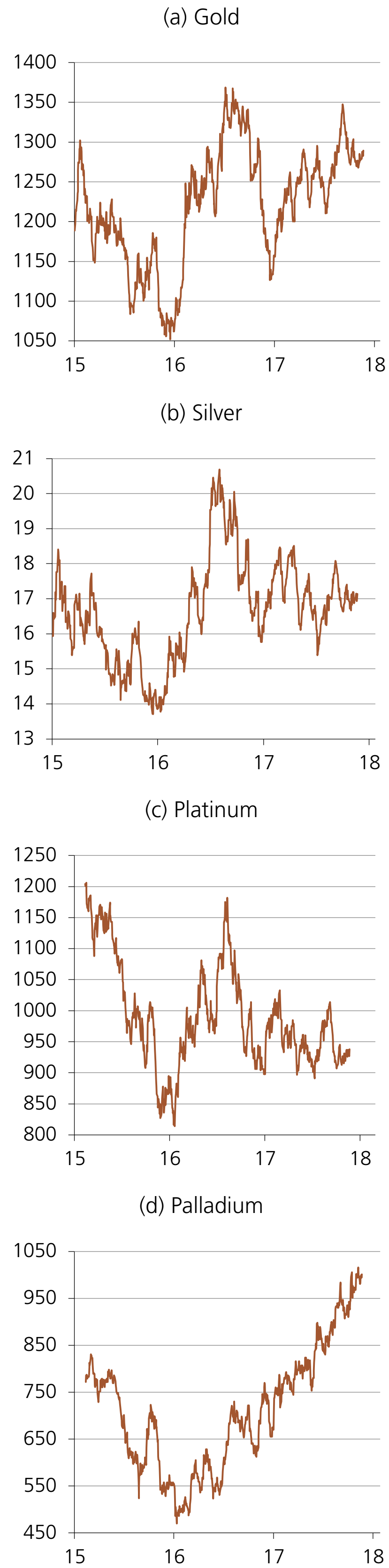
As you probably know, inflation only works if it is unnoticed – if there is "surprise inflation". However, as soon as people find out that the purchasing power of money goes down (more than they hitherto expected), they start adjusting: They factor a higher inflation rate into their contracts for wages, leases and credit. If this happens, there is no longer surprise inflation, and inflation loses its power to stimulate the economy (through false and misleading price signals, that is).

Inflation expectations are fairly subdued
Inflation expectations (in percent) derived from inflation swaps[1]



Source: Thomson Financial; own calculation. [1] Inflation expectations in five years for the coming five years.

Precious metal prices (USD/oz)

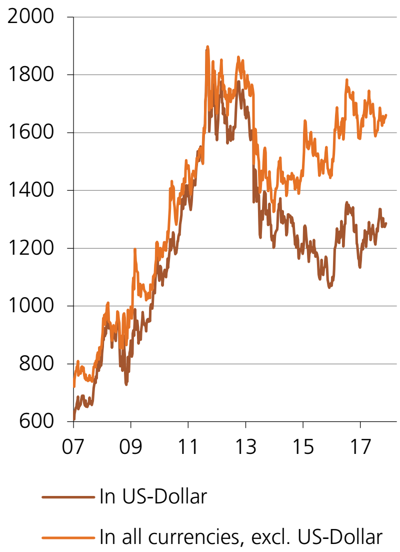


Source: Thomson Financial.

Gold price per ounce

in US dollars and all world currencies (excl. the US dollar)*

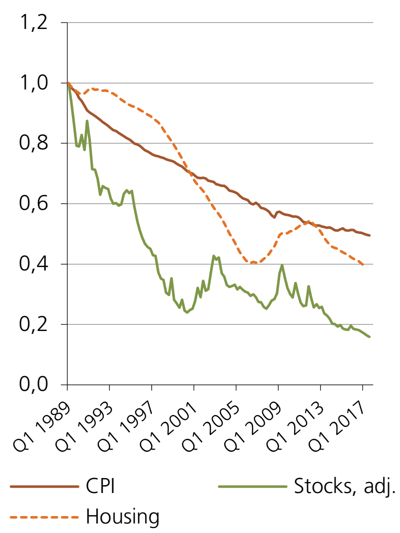
January 2007 to November 2017



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.

The declining purchasing power of the US dollar

Calculations based on CPI, stock prices[(1)] and housing prices[(2)]



Source: Thomson Financial; own calculation. Purchasing power: 1 divided by the respective price (index). Q1 '99 = 1. [(1)] Shiller house price index. [(2)] Stock prices adjusted for industrial production gains.

A central bank that wants to keep the boom going (and prevent the bust) is left with just one option: It has to create another dose, a higher dose, of surprise inflation. And as soon as people adjust to the higher level of inflation, even a higher level of surprise inflation loses its power. The reader may already know what such an "inflation game" is leading to: It puts the economy on a high-inflation road or, in the extreme case, a super-inflation road or even a hyper-inflation road that will ultimately destroy the purchasing power of the currency.

So far, however, financial markets have remained fairly relaxed. In fact, inflation is not seen as a major problem as proven by, for instance, inflation expectations. How come? There might be two reasons for this. First, the majority of people derive their inflation expectations from experienced CPI inflation (we ca speak of "adaptive inflation expectations"). As the latter has been relatively low for many years, people do not expect inflation to edge up in the years to come.

Second, many people still do not seem to realize that "asset price inflation" ruins the purchasing power of money in the same way as CPI inflation does: If you want to buy stocks, houses or land with your money, you will get less for your money if prices for these goods go up. However, as long as asset price inflation is not understood as a form of "true inflation", inflation expectations will not grow, and central banks can continue their inflationary scheme.

Against this backdrop, the careful investor can draw two conclusions. First, inflation is alive and kicking, and it is currently clearly detectable in asset price increases. Second, an inflationary boom runs the risk of turning into a bust at some point – a scenario which would hit the economy, the financial system, and asset prices hard. When it comes to cash holdings and portfolio insurance, gold seems to be an attractive option, especially at current prices (which we would consider "relatively cheap").

At the same time, the careful investor should pay heed to the saying "Nothing ventured, nothing gained": If you do not take risks, you will never accomplish anything. For long-term investors, putting money into stocks is most likely to pay off if two conditions are met: (1) Invest in those great companies that can do business even in times of economic and financial turbulence; and (2) do not pay too high a price even for the stocks of great companies. That said, gold and stocks are two proper portfolio ingredients for the careful investor.

Gold In Art

Gustav Klimt, The Kiss, 1907/08, oil on canvas, 180 x 180 cm: Austrian Gallery Belvedere

The painting "The Kiss" is regarded as one of Klimt's main works from the "Golden Period" between 1903 and 1909. During this period, the artist used gold and gold leaf in his paintings. The "Golden Period" was triggered by two trips to Ravenna in 1903, during which the painter studied Byzantine mosaics with golden backgrounds.

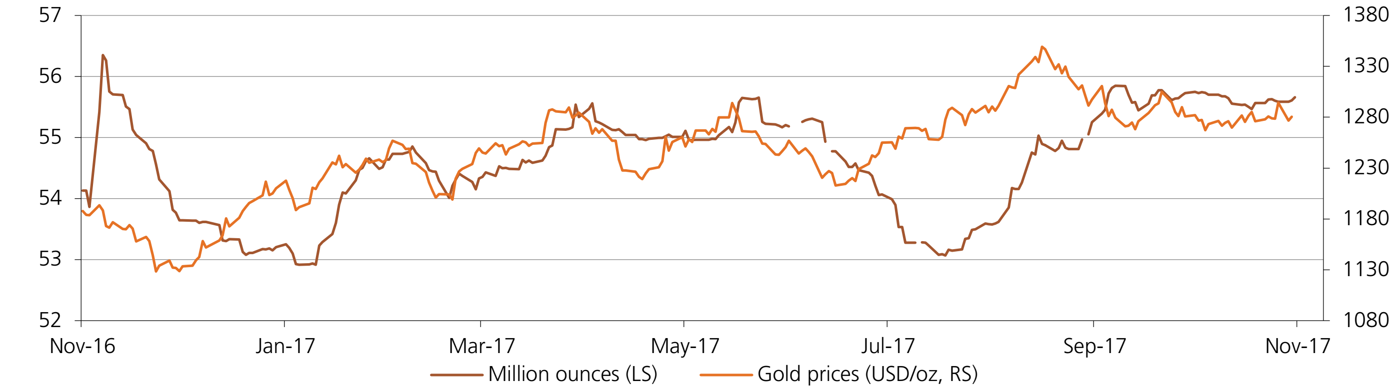
The use of the material gold in Klimt's pictures conveys religious and magical as well as high material values. Over the years, the artist used more and more gold paint for his works. Thus, the image surface of the painting "The Kiss" by Gustav Klimt is almost completely covered with gold paint and gold leaf.

"The Kiss", originally "Die Liebespaar", was acquired in 1908 for the then high sum of 25,000 crowns for today's Österreichische Galerie Belvedere.

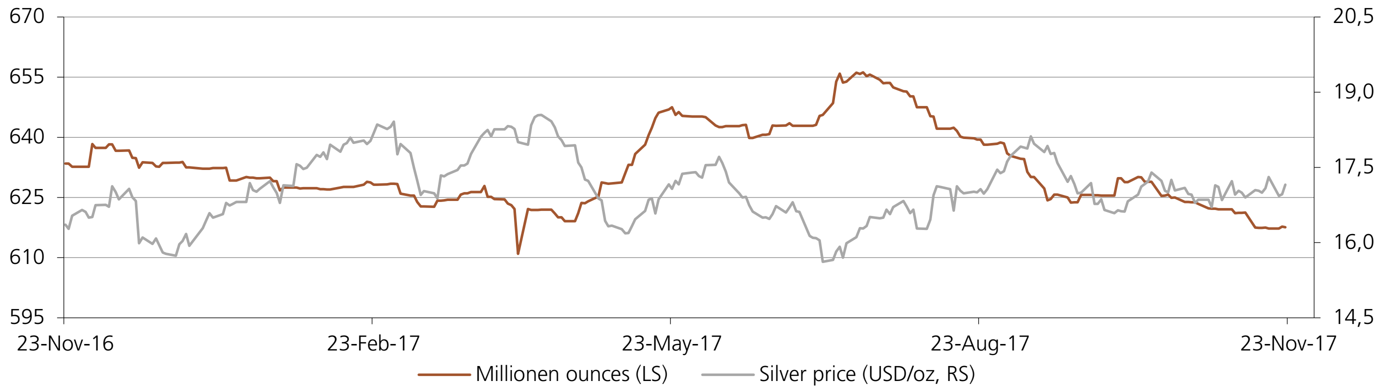
Author: Dr. Ruth E. Polleit Riechert, Art Historian.

Precious metals prices and ETF holdings

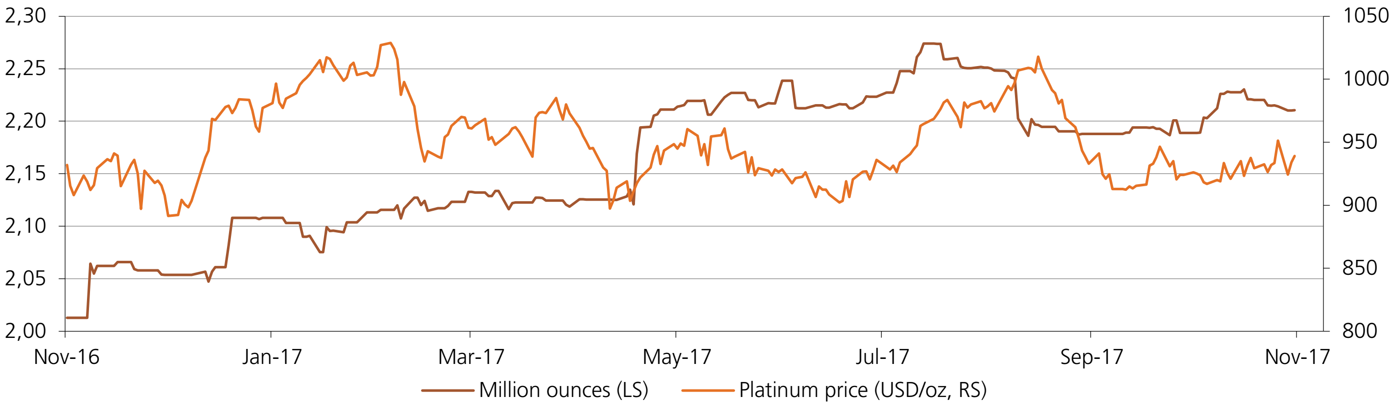
Gold ETFs (million ounces) und gold price (USD/oz)



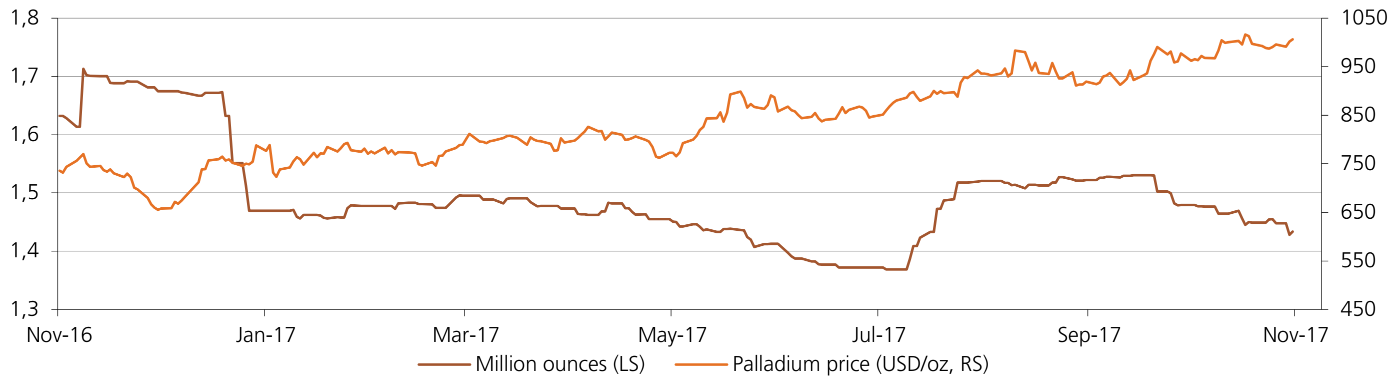
Silver ETFs (million ounces) and silver price (USD/oz)



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	1291.8		17.1		931.2		1004.1	
II. Gliding averages								
5 days	1285.1		17.1		933.6		995.0	
10 days	1282.3		17.0		933.5		995.2	
20 days	1278.3		17.0		928.5		991.9	
50 days	1285.6		17.0		928.8		962.2	
100 days	1281.2		16.9		943.8		931.3	
200 days	1265.8		17.1		947.4		869.2	
III. Projections for 2017								
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1148.0	1390.0	15.9	23.0	906.0	1100.0	700.0	900.0
IV. Annual averages								
2013	1429		24		1487		724	
2014	1260		19		1382		800	
2015	1163		16		1065		706	
2016	1242		17		985		617	

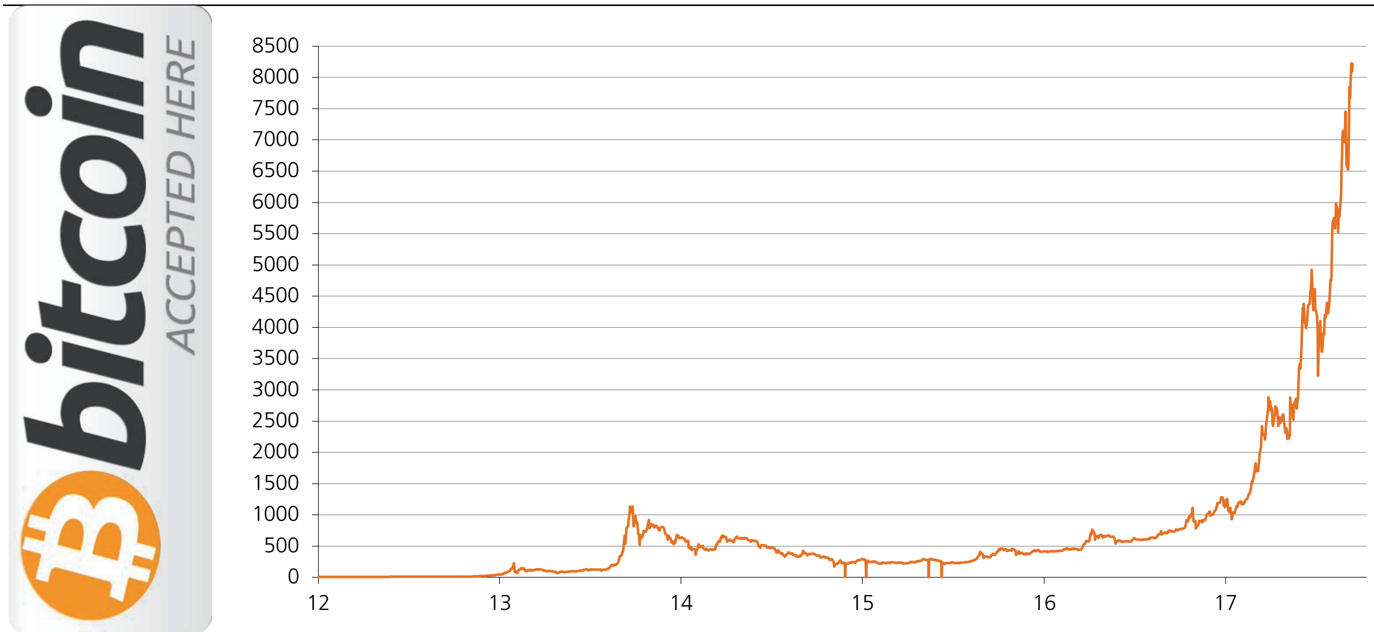
In euro

	Gold		Silver		Platinum		Palladium	
I. Actual	1090.3		14.4		786.0		847.4	
II. Gliding averages								
5 days	1092.5		14.5		793.7		845.9	
10 days	1093.0		14.5		795.7		848.3	
20 days	1094.7		14.5		795.1		849.5	
50 days	1092.8		14.5		789.5		818.1	
100 days	1090.0		14.4		802.9		792.4	
200 days	1118.2		15.2		837.7		765.9	
III. Projections for 2017								
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1000.4	1211.3	13.8	20.0	789.5	958.6	610.0	784.3
IV. Annual averages								
2013	1079		18		1123		547	
2014	945		14		1035		601	
2015	1044		14		955		633	
2016	1120		15		888		557	

Source: Thomson Financial; own calculations and estimates.

Bitcoin, performance of various asset classes

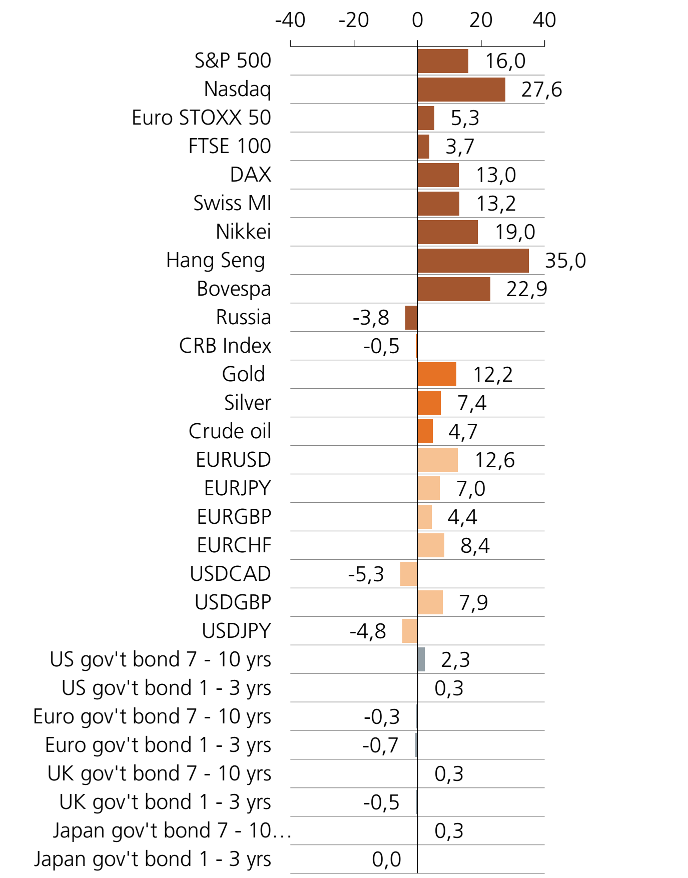
Bitcoin in US dollars



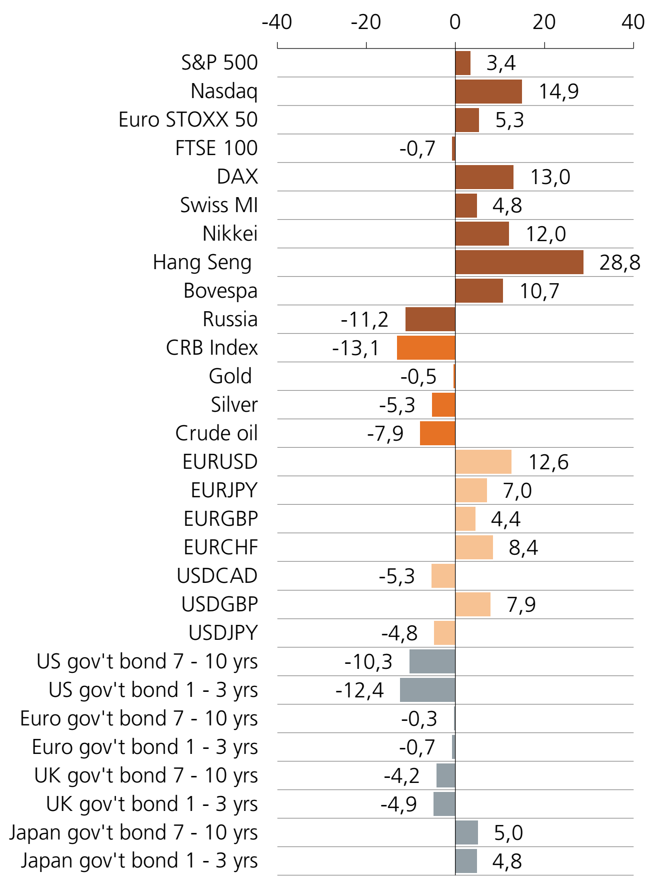
Source: Thomson Financial.

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
24 November 2017	There Is, And Will Be Bore, 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?
11 November 2016	Trump Election Puts Euro Under Pressure
28. October 2016	US Presidential Elections and the Price of Gold
14 October 2016	Amid Uncertainty, Opportunity Knocks
30 September 2016	On the Debt Ratio and the Price of Gold
16 September 2016	Central Banks May Choose Helicopter Money Over Negative Rates
2 September 2016	No return to "normal" interest rates
19 August 2016	Debt Monetized En Masse to Fend Off the Euro Crash?
5 August 2016	*No English issue due to summer break*
22 July 2016	The Demise of the Interest Rate – the Comeback of Gold Money
8 July 2016	Escaping the Euro Trap
24 June 2014	The Credit Cycle and the Price of Gold
10 June 2016	Savvy Investors Say Yes to Gold and Stocks Despite Prospective Fed Rate Hike
27 May 2016	Central Banks' Illusory Independence and the Price of Gold

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Imprint
Marktreport is published every 14 days on Fridays and is a free service provided by Degussa Goldhandel GmbH.
Deadline for this edition: 24 November 2017
Publisher: Degussa Goldhandel GmbH, Kettenhofweg 29, 60325 Frankfurt, Tel.: (069) 860068-0, Fax: (069) 860068-222
E-Mail: info@degussa-goldhandel.de, Internet: www.degussa-goldhandel.de
Editor in chief: Dr. Thorsten Polleit
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