Degussa Market Report

26 May 2017 — Economics · Finance · Precious Metals

OUR TOP ISSUES

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

No Escape From the Policy of Easy Money

The strong dependency of the world's largest economies on exceptionally low interest rates argues against a return to "normal" yield levels.

Gold and Bitcoin

Bitcoin seems to be increasingly challenging fiat money: In addition to gold (and silver), bitcoin is becoming a fairly attractive monetary alternative.

How to Cope with Uncertainty

In capital markets investors have to deal with uncertainty rather than risk. However, the "price versus value" principle helps to master it.

Real Estate Price Inflation in Germany

The inflation of real estate prices gains momentum in Germany. Such a development is, indubitably, highly problematic for the economy.

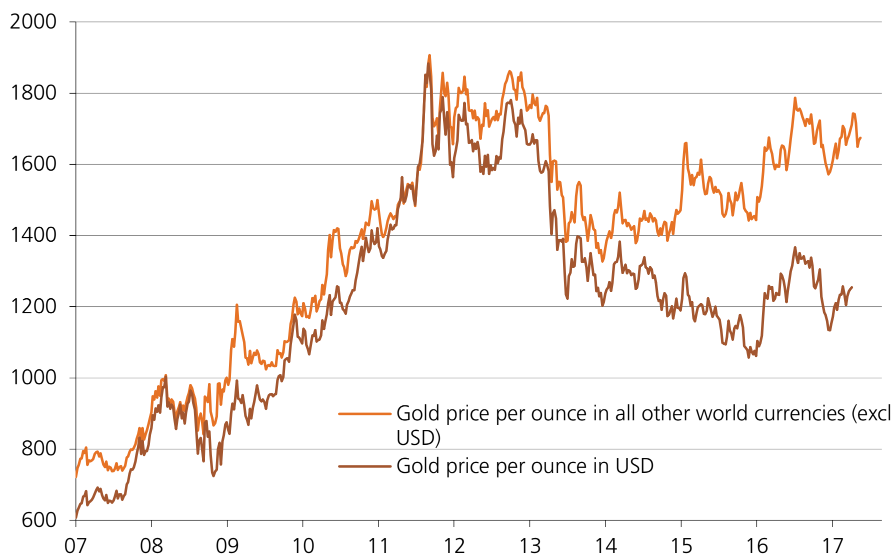
Precious Metal Market Report

A change in sentiment among investors puts the dollar under pressure, while precious metal prices benefit.

Gold price per ounce

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

January 2007 to May 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.

USD per ounce of gold

USD per ounce of silver

EURUSD

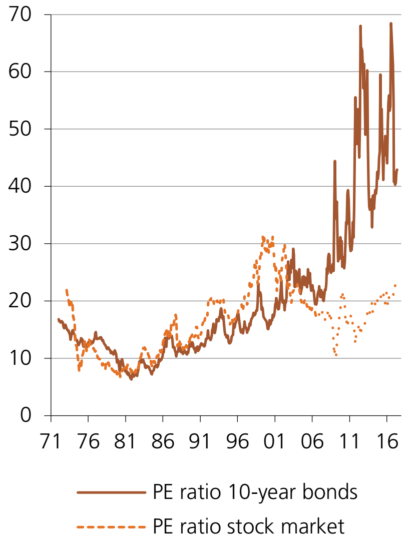
Source: Thomson Financial.

Precious metals prices

	Actual (spot)	Change against (in percent): 2 W	3 M	12 M
I. In US-dollar				
Gold	1,255.3	2.8	0.6	3.3
Silver	17.2	5.0	-6.8	7.1
Platinum	947.3	3.7	-8.0	-3.2
Palladium	765.3	-6.1	-0.7	40.0
II. In euro				
Gold	1,119.9	0.3	-5.5	2.7
Silver	15.3	3.1	-11.8	6.5
Platinum	845.0	2.1	-13.0	-3.9
Palladium	682.9	-7.9	-6.0	39.1
III. Gold price in other currencies				
JPY	140,231.4	1.3	-0.3	4.3
CNY	8,630.6	1.7	-0.1	8.0
GBP	969.0	2.4	-4.2	15.8
INR	81,187.4	1.9	-3.1	-0.4
RUB	70,796.1	-1.0	-3.6	-10.6

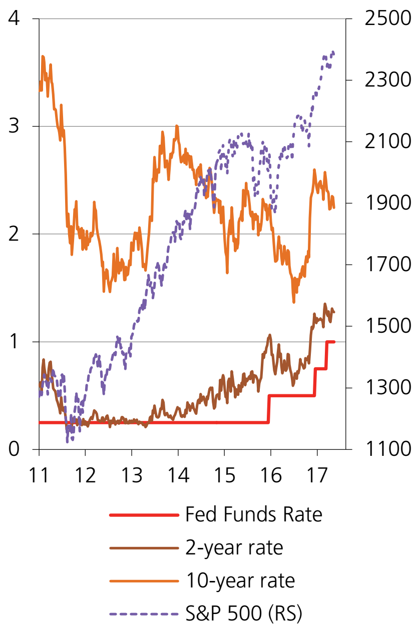
Source: Bloomberg; own calculations.

The US bond market keeps trading at a quite high valuation
The price earnings ratio of the US bond and stock market[1)]



Source: Thomson Financial; own calculations. [1)] 10-year US Treasury bonds and S&P 500.

Stock prices have gone up despite higher short-term rates
Selected US interest rates in percent and S&P 500 index



Source: Thomson Financial.

The Make-believe World of Fiat Money

The US bond market keeps trading at a quite high valuation. For instance, the 10-year US Treasury bond presents a price-earnings (PE) ratio of 43. In other words: It takes 43 years for the investor to recoup the bond's purchase price through coupon payments. The bond market's PE ratio even went up as high as 68 in June 2012 and July 2016, respectively.

In comparison, the PE ratio of the stock market is at 23, which is significantly higher than its long-term average of close to 17 for the period from 1973 to 2017. That said, the 10-year Treasury bond has become more hazardous compared to stocks. This is what the PE ratio tells us: The higher (lower) the PE ratio, the higher (lower) the investor's risk.

How come that US bond valuations are that high? Many economists would argue that the reason is a "savings glut": Relative to investments, savings balances are high, resulting in a substantially decreased market clearing interest rate. There is, however, another, much less sanguine explanation:

The Fed has pushed interest rates to artificially low levels. It has, in the wake of the financial and economic crisis 2008/2009, lowered banks' funding costs to basically zero, and furthermore purchased government and mortgage bonds on a grand scale. This has forced bond yields down and, in turn, inflated bond prices.

By now the Fed has changed its course. It has raised its interest rate three times since December 2015, bringing it to 1 percent. This, however, has not had any significant impact on long-term yields. 10-year US Treasury yields are still at a relatively low 2.4 percent. Is it possible that the Fed has lost its grip on long-term yields? Should the "savings glut theory" be proven right in the end?

Unlikely. Long-term interest rates are, simply put, nothing but the average of the expected development of short-term interest rates up to the maturity of the bond. That said, even if short-term rates go up, long-term bond yields can remain unchanged (or even decline) if market participants expect short-term rate increases to be short-lived (or to be reversed soon).

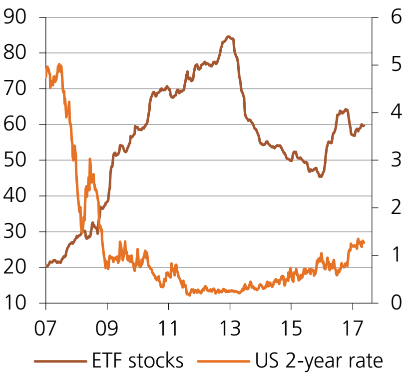
The still very low long-term interest rates in the US may, therefore, signal that despite rhetoric suggesting otherwise, market agents expect the Fed to keep interest rates low, to refrain from returning yields to levels formerly considered "normal". Against this backdrop, the Fed's latest series of short-term rates increases is merely seen as a cosmetic adjustment.

Such an explanation would concur with the Austrian Monetary Business Cycle Theory (ABCT). It implies that if and when unbacked paper, or fiat, money is issued through bank credit expansion, market interest rates are lowered below their natural levels – the levels that would prevail if without bank credit expansion out of thin air.

This, in turn, sets an artificial economic upswing (boom) into motion. Consumption and investment expansion goes up, greatly encouraged by artificially lowered borrowing costs. The boom, however, turns into a bust as soon as market interest rates go up and return to their natural levels. If and when this happens, the boom turns into a bust.

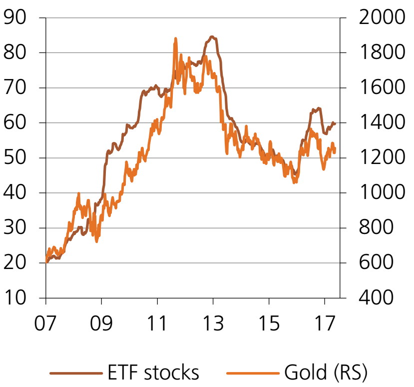
To keep the boom going, the Fed must keep interest rates below their natural levels; it cannot raise them back to "normal". First and foremost, higher interest rates would presumably burst the asset price bubble. The credit market in particular would collapse, stock and housing prices tumble, and it would send the financial system and the economy into a tailspin.

Gold ETF demand moved up further as US interest rates increased, …
Gold ETFs (million ounces) and US 2-year gov't bond yield in percent



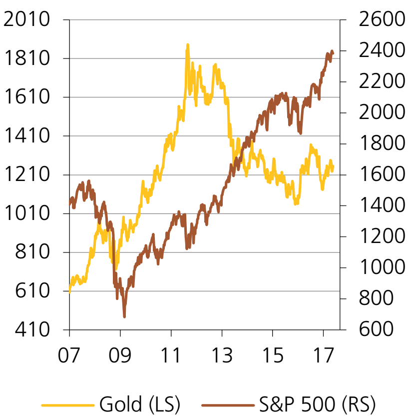
Source: Thomson Financial.

… and this should be supportive for the price of gold
Gold ETFs (million ounces) and price of gold (USD/oz)



Source: Thomson Financial.

Gold as a hedge against potential set-back in stock markets
Price earnings ratio of the S&P 500 and gold price (USD/oz)



Source: Thomson Financial.

One may ask: Why is the Fed raising rates then? Perhaps the Fed's decision-makers think that the US economy has overcome the crisis and needs higher interest rates. Others might want to tighten policy for getting the short-term inflation adjusted interest rate out of negative territory.

Be it as it may, the disconcerting truth is this: Fed rate hikes close the gap between the natural interest rate (wherever it may be) and the actual interest rate level. This, in turn, puts a break on the boom, bringing it closer to bust. It is impossible to know with certainty at what interest rate level the US economy would fall over the cliff.

One thing is fairly certain, though: Without artificially low interest rates, the US economy, and with it the world economy, is heading for tough times. Maybe the Fed's current rate hiking spree will end in tears, resulting in another collapse. Or the Fed refrains from raising rates and keeps the boom going a little bit longer. Ludwig von Mises (1881 – 1973) put it as follows:

"[T]he boom cannot continue indefinitely. There are two alternatives. Either the banks continue the credit expansion without restriction and thus cause constantly mounting price increases and an ever-growing orgy of speculation, which, as in all other cases of unlimited inflation, ends in a "crack-up boom" and in a collapse of the money and credit system. Or the banks stop before this point is reached, voluntarily renounce further credit expansion and thus bring about the crisis. The depression follows in both instances."[1]

Given current bond and stock market valuations, investors seem to be fairly confident that the Fed will succeed in keeping the boom going, that the central bank will not overdo it in terms of raising interest rates. And yes, perhaps central bankers may have learned in recent years, having become highly knowledgeable in keeping up the make-believe world of fiat money.

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.

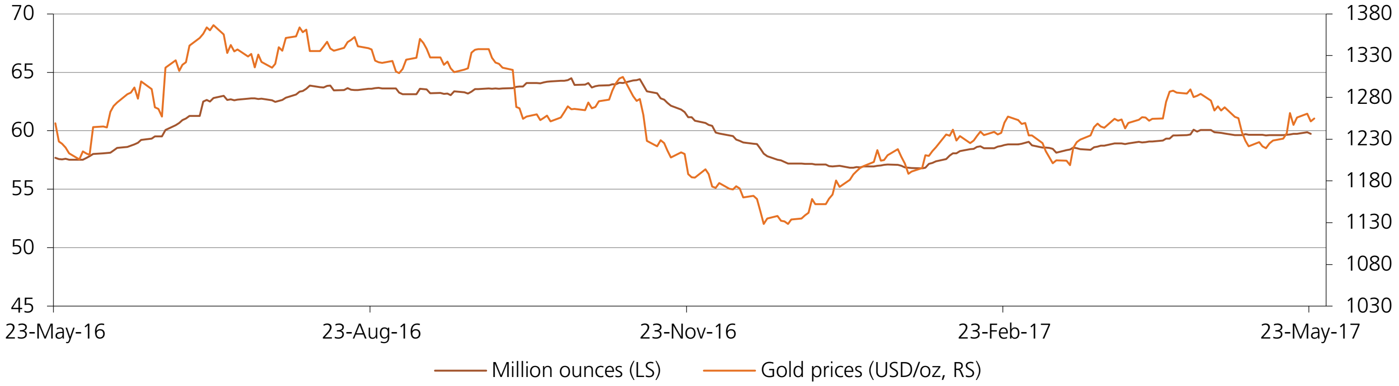
"The purpose of the issue of paper money is generally to relieve the financial necessities of the government. It is a costly expedient, resorted to only in desperate extremities. … It is peculiarly liable to be the subject of political intrigue and of popular misunderstanding."

—Frank A. Fetter
(1863 - 1949)

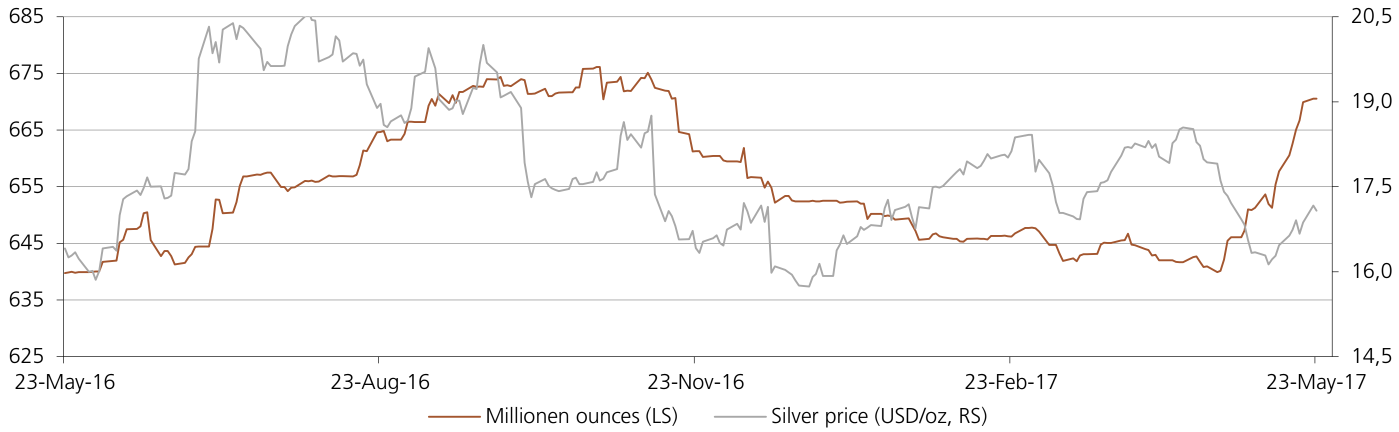
[1] Mises (1940), Interventionism: An Economic Analysis, The Foundation for Economic Education, Inc., Irvington-on-Hudson, New York, p. 40.

Precious metals prices and ETF holdings

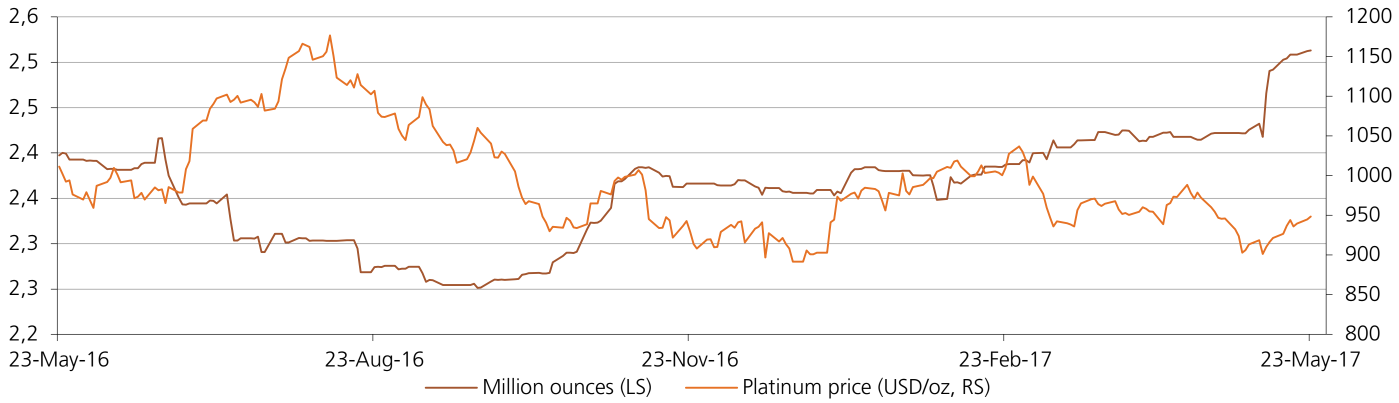
Gold ETFs (million ounces) und gold price (USD/oz)



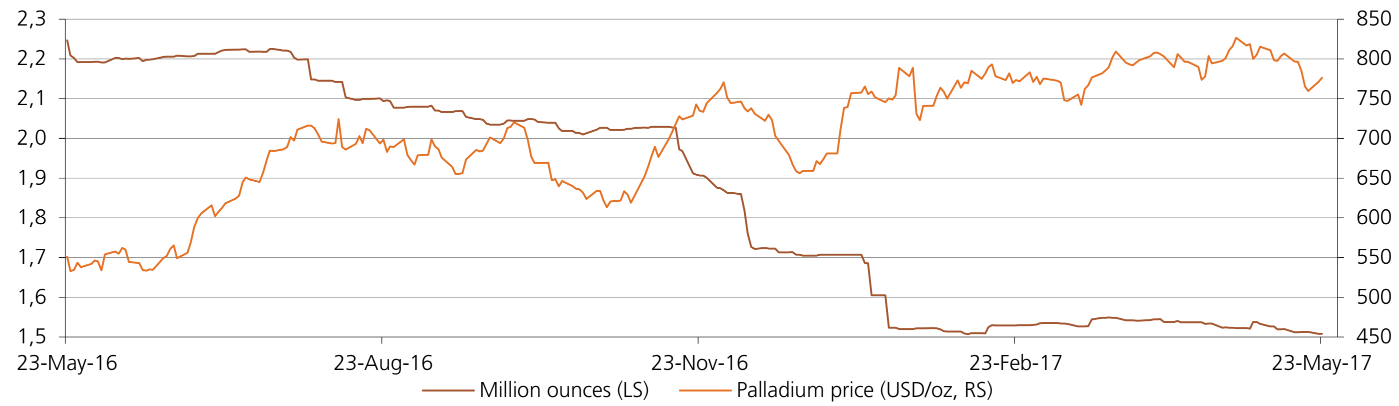
Silver ETFs (million ounces) and silver price (USD/oz)



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	1,258.1		17.2		949.5		767.5	
II. Gliding averages								
5 days	1,256.2		17.0		942.0		765.0	
10 days	1,246.5		16.8		936.3		784.0	
20 days	1,244.5		16.7		928.1		797.1	
50 days	1,254.2		17.5		948.6		796.3	
100 days	1,235.3		17.5		967.1		779.6	
200 days	1,242.9		17.6		973.4		732.2	
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	1,119.3		15.3		844.8		682.8	
II. Gliding averages								
5 days	1,122.0		15.1		841.3		683.3	
10 days	1,123.1		15.1		843.7		706.7	
20 days	1,131.0		15.2		843.3		724.6	
50 days	1,157.3		16.1		875.5		734.8	
100 days	1,150.4		16.3		900.9		726.0	
200 days	1,147.8		16.3		899.0		677.1	
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.

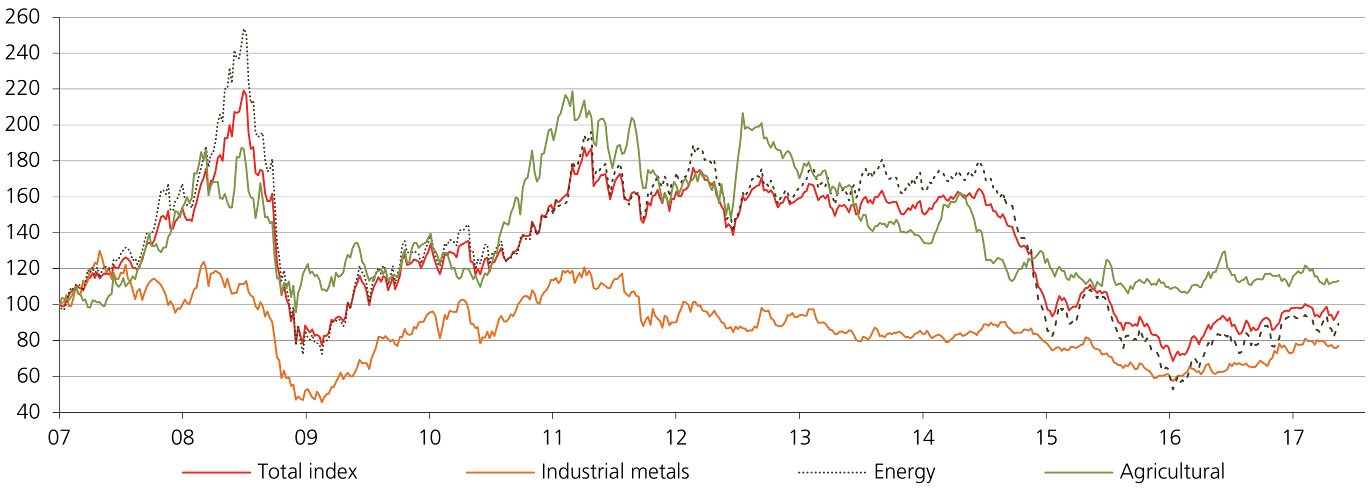
Commodity prices

Selected commodity prices

	Actual price in US-dollar	Change against (in percent): 1 week	1 mth	3 mths	6 mths	12 mths	Volatility (in percent): 30 days	90 days
I. Energy								
WTI crude oil	51.32	4.7	-6.7	-6.2	-3.1	14.6	26.9	22.9
Brent crude oil	53.94	4.4	-5.4	-4.4	-0.4	17.9	26.3	22.3
Gasoline	164.90	2.8	-6.6	-7.6	-4.2	10.2	25.9	20.7
Heating oil	160.40	5.8	-3.3	-3.1	-0.4	17.2	23.5	20.6
Gas oil	478.50	4.3	-3.8	-5.4	1.8	...	22.7	21.1
Natural gas	3.21	-0.5	8.8	-1.4	-0.9	19.7	30.8	33.4
II. Agriculture								
Corn	371.00	0.9	-2.6	-0.7	2.1	-4.4	20.5	16.8
Wheat	432.25	1.9	-5.7	-3.4	0.2	-18.6	26.8	21.5
Soy beans	947.75	-2.9	-9.3	-9.0	-10.1	1.6	14.4	13.3
Coffee	128.55	-2.2	-11.3	-16.7	-17.1	-6.2	29.1	22.4
Sugar	15.67	-1.3	-17.8	-22.4	-16.0	0.9	31.2	24.4
Cotton	72.97	-1.8	-1.9	1.6	4.4	21.2	12.3	10.0
III. Industrial metals								
Aluminum	1943.00	1.0	1.0	6.8	12.2	27.8	14.9	14.0
Copper	5714.00	1.8	-4.3	-4.6	-1.9	17.9	19.7	21.0
Zinc	2658.00	4.4	-5.9	-7.1	-1.6	46.3	26.4	25.0
Lead	2096.00	0.6	-7.1	-11.6	-11.4	22.9	26.8	25.3
Iron ore	59.80	0.2	-35.3	...	-24.4	12.4	51.3	37.6
IV. Precious metals								
Gold	1255.25	1.5	-0.1	3.7	6.8	1.9	9.3	10.2
Silver	17.16	2.5	-6.8	-1.9	4.0	11.6	15.5	16.2
Platinum	947.28	1.1	-8.0	-4.5	4.1	-2.9	15.4	17.0
Palladium	765.32	-3.5	-0.7	1.5	-1.0	35.9	20.6	26.0
V. Ratios								
Gold-silver	73.16	-0.9	7.3	5.7	2.8	-8.7	12.4	11.1
Gold-platinum	1.33	0.4	8.7	8.6	2.7	4.9	13.5	13.1
Gold-palladium	1.64	5.2	0.5	2.2	7.6	-25.1	24.1	25.1
Palladium-platinu	0.81	-4.6	8.1	6.3	-4.6	40.1	22.2	22.7

Source: Bloomberg; own calculations.

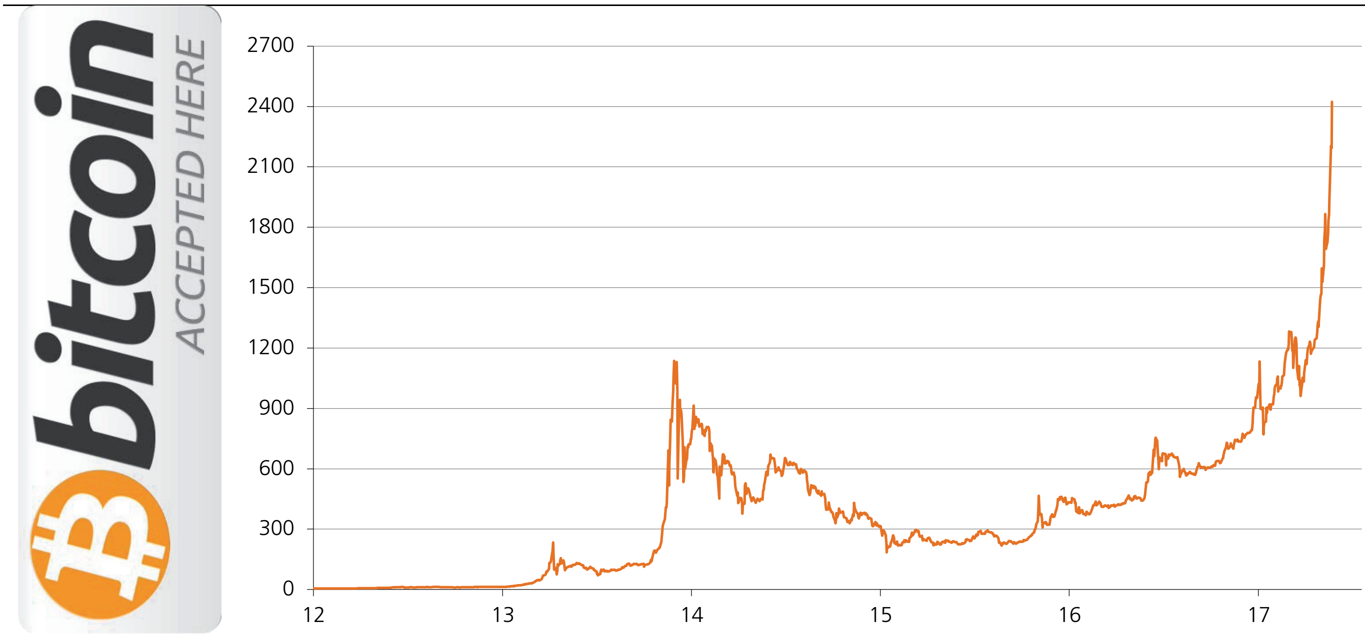
S&P commodity prices (in US dollar terms)



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

Bitcoin, performance of various asset classes

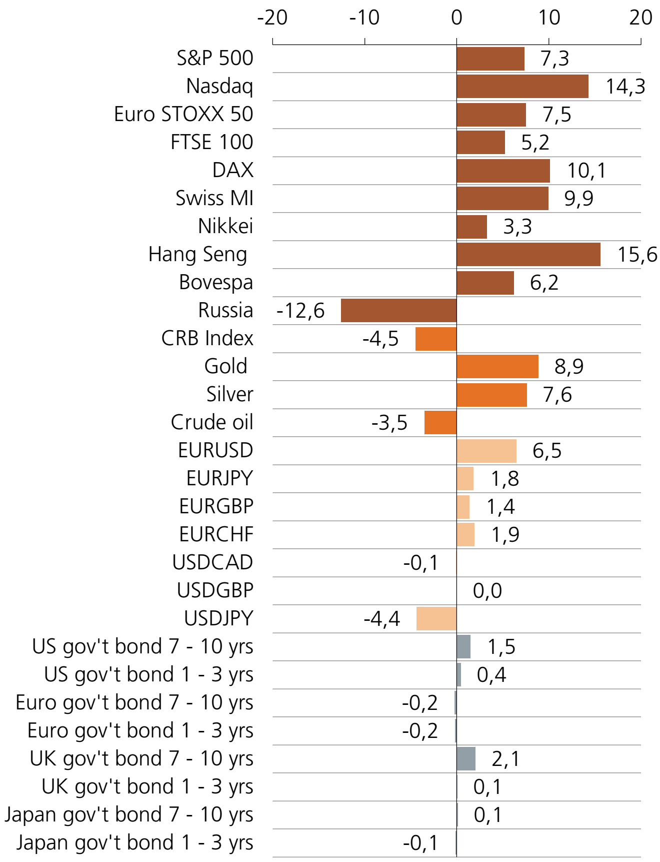
Bitcoin in US dollars



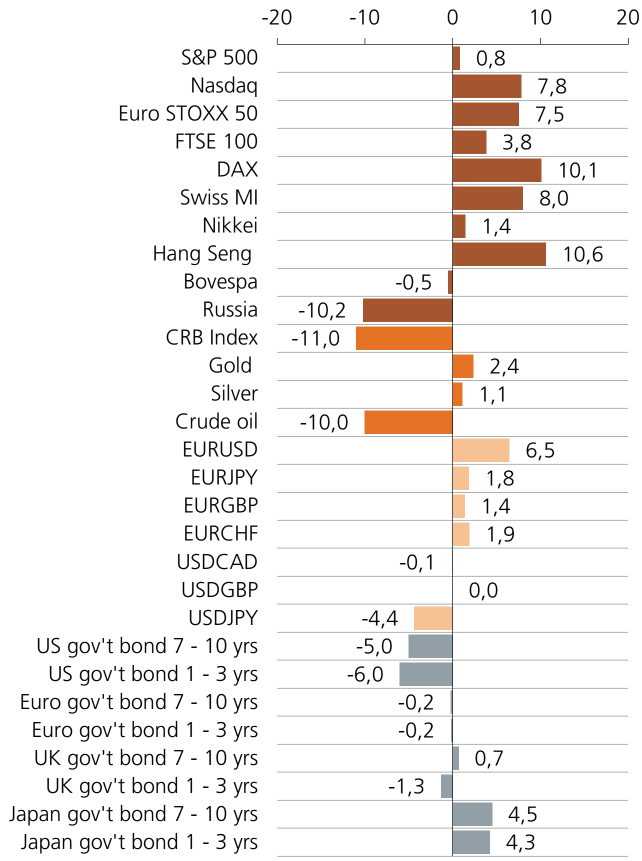
Source: Bloomberg

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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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
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16 September 2016	Central Banks May Choose Helicopter Money Over Negative Rates
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27 May 2016	Central Banks' Illusory Independence and the Price of Gold
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29 April 2016	US Dollar's Dominance Challenged By Gold
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1 April 2016	Helicopter Euros Hovering on the Horizon
18 March 2016	Gold and Stocks Protect Against 'Helicopter-Euros'

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