Degussa Market Report

28 September 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	1.198.4	0.3	-7.7	-5.7
Silver	14.4	2.4	-11.7	-12.7
Platinum	823.0	5.7	-8.7	-9.6
Palladium	1.058.4	7.9	7.4	16.4
II. In euro				
Gold	1.018.4	-1.6	-8.2	-6.0
Silver	12.3	0.6	-12.2	-13.0
Platinum	699.3	3.4	-9.8	-10.0
Palladium	899.0	6.1	6.4	15.9
III. Gold price in other currencies				
JPY	135.277.0	1.9	-4.2	-5.6
CNY	8.236.8	0.7	-1.0	-2.6
GBP	910.2	-1.6	-6.7	-4.9
INR	87.040.5	1.9	-0.5	4.9
RUB	78.891.3	-5.5	-2.5	7.3

Source: Thomson Financial; own calculations.

OUR TOP ISSUE

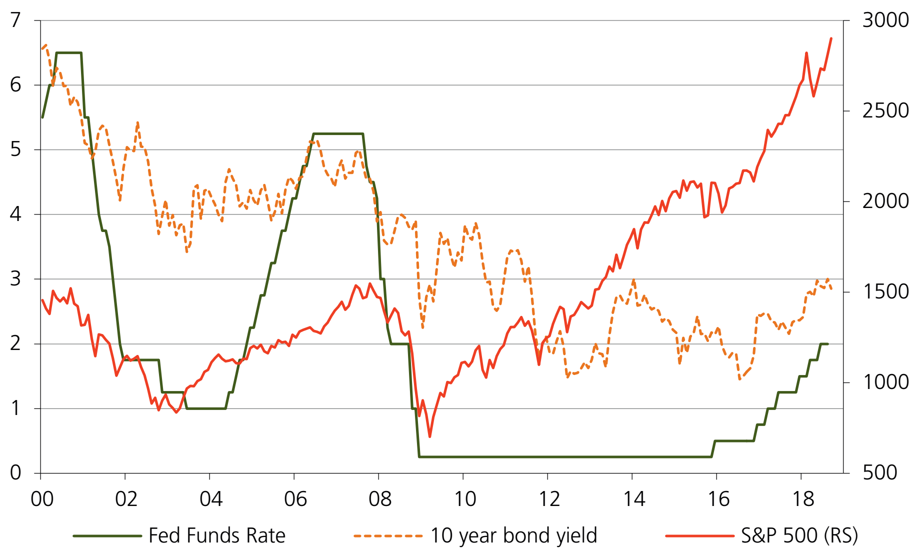
*This is a short summary of our fortnightly **Degussa Marktreport**.*

The Fed's Blind Flight

US interest rates keep creeping upwards, largely because the US Federal Reserve (Fed) is expected to ramp up borrowings costs further in the coming quarters. The Federal Funds Rate is now in a bandwidth of 1.75 to 2.0 per cent, and the yield on 10-year Treasuries has recently climbed slightly above the 3 per cent level. Higher, let alone further rising, borrowing costs can be expected to have far-reaching consequences for the economy and financial markets in particular.

This becomes clear if we reflect upon the Fed's interest rate policy by employing sound economic theory. Let us therefore begin with highlighting five effects that result from the Fed lowering market interest rates – by slashing its Federal Funds Rate and/or by bidding up bond prices and thus suppressing capital market yields across the board. For this should help us better understand what the Fed's current tightening of monetary policy might hold in store.

Low interest rates have been fueling stock prices
S&P 500 and US interest rates in per cent



Source: Thomson Financial.

Effects of interest rate manipulation

1.) The artificially suppressed interest rate induces an unsustainable boom: It discourages savings and encourages consumption and investment, thereby seducing the economy to live beyond its means. Firms hire new staff, increase their production facilities, pay higher wages – and the economy expands.

2.) The forced depression of the interest rate makes firm to engage long-term investments, which become more profitable as interest rate declines. The overall production and employment structure of the economy gets distorted: Scarce resources are increasingly lured into the capital goods industries, drawn away from the consumer goods industry.

3.) The artificial decline in interest rates inflates stock and housing prices: Future cash flows are discounted at a lower interest rate, thereby increasing their present value and, as a result, their market price. Exceptionally low interest rates also contribute to increasing valuation levels of asset markets – meaning that, for example, stocks and housing become more expensive relative to the incomes they generate.

4.) The fall in interest rates contributes to an increase in all prices of goods and services. This is because firms purchase factors of production at a price that reflects the value added (the "marginal value product") by employing these factors of production, discounted at the going market interest rate. In other words: Lower interest rates push up prices for intermediary goods such as, say, energy and labour.

5.) Investors' risk appetite tends to increase as interest rates go down. The low interest rate policy reduces credit costs, making borrowing more affordable – especially so as borrowers' collateral gains in market value. Credit-hungry consumers, firms and public sector entities can roll-over maturing debt at most favourable interest rates, and low credit costs encourage amassing even more debt.

The "natural rate of interest"

Against this backdrop, one might be inclined to think that a rise in interest rates must inevitably and immediately cause trouble: slowing down economic expansion; exploding the economy's production and employment structure; deflating asset prices; putting borrowers under funding pressure. However, things are not that simple, as much depends on the so-called "natural interest rate".

The (unobservable) natural interest rate is part of the market interest rate, and it is the interest rate at which savings are brought in line with investments so that the economy is doing just fine. If the central bank pushes the market interest rate below the natural interest rate, the economy is driven into a boom; and if the market interest rate is raised above the natural interest rate, the economy is thrown into bust.

So if we want to form a view about what the Fed's interest rate hiking means for the economy and financial markets, we have to develop an opinion about the level of the natural interest rate: In case the natural interest rate has gone up in recent years, higher Fed interest rates would cause less trouble for the economy and financial markets compared with the case in which the natural interest rate has remained at a very low level.

A trial and error process

The problem is, however, that we do not, and cannot, know the level of the natural interest rate. The capital market cannot provide us this information due to the Fed's permanent interventions: The central bank keeps issuing unbacked US dollar balances produced by bank credit out of thin air, diverting market interest rates systematically from the levels that would prevail had there been no money issued by the Fed.

What is more, there is no fixed, or immutable, relation between figures such as, for example, growth of gross domestic product and the interest rate. In fact, a given level of the natural interest rate can be, depending on the circumstances, compatible with a high or a low level of savings and investment. Having said that, it is only appropriate to consider the Fed’s monetary policy as a “blind flight” when it comes to setting market interest rates.

As the Fed does not and cannot know the correct level of interest rates, its policy is a “trial and error” process. Since the end of 2015, the Fed has embarked, albeit slowly and cautiously, on an interest hiking path. At least so far, the US economy has continued to expand, with production and employment increasing – and this suggests that the Fed has kept the market interest rate below the natural interest rate.

In other words: The current boom that has been going on for quite a while has not yet faced retribution. This, however, is no reason for complacency as it brings forth more malinvestment and more overconsumption, causes people to make more and more unwise decisions, and the Fed's interest rate hiking is increasing the probability that something will go wrong at some point, that the boom may eventually derail, giving way to a bust.

Mind the “cluster of errors”

Experience tells us that business activity may move along smoothly for quite a while, while malinvestment, which brings production out of sync with market demand, is piling up. Then, all of a sudden, the economy is thrown into disarray: In not just one business sector, but in virtually all of them "clusters of business errors" surface. This is one of the main characteristic features of the real-life boom and bust cycle.

The monetary theory of the trade cycle put forward by the Austrian School of Economic does not only explain the “cluster of errors” phenomenon. It has much more to offer: It makes us understand the economic and ethical problems that come with the structure of our monetary system, in which central banks hold the money production monopoly, creating money out of thin air through bank credit expansion air.

Central bank action causes, for instance, chronic inflation – which benefits a few at the expense of many –; sets into motion boom and bust cycles; and increases the economies' debt burden. The truth is that keeping the market interest rate artificially low – below the natural interest rate, that is – has become essential to keep the current boom going and prevent the debt pyramid from crashing down.

Sound economic theory conveys a sobering message: There is little reason to think that the Fed, in its “blind flight”, will succeed in upholding the boom indefinitely. Stock and housing markets may continue to go up in price for quite a while – who knows how long. But this does by no means refute the insight that the Fed creates, via its interest rate policy, booms which turn into busts at some point.

In view of the risks that come with an increasingly overstretched fiat money system, we consider gold as an effective insurance: The value of gold cannot be debased by central bank policies, and gold – in contrast to fiat money deposits and short-term debt – does not carry any default risk. Bought at current prices, gold is an insurance that has upward value potential.

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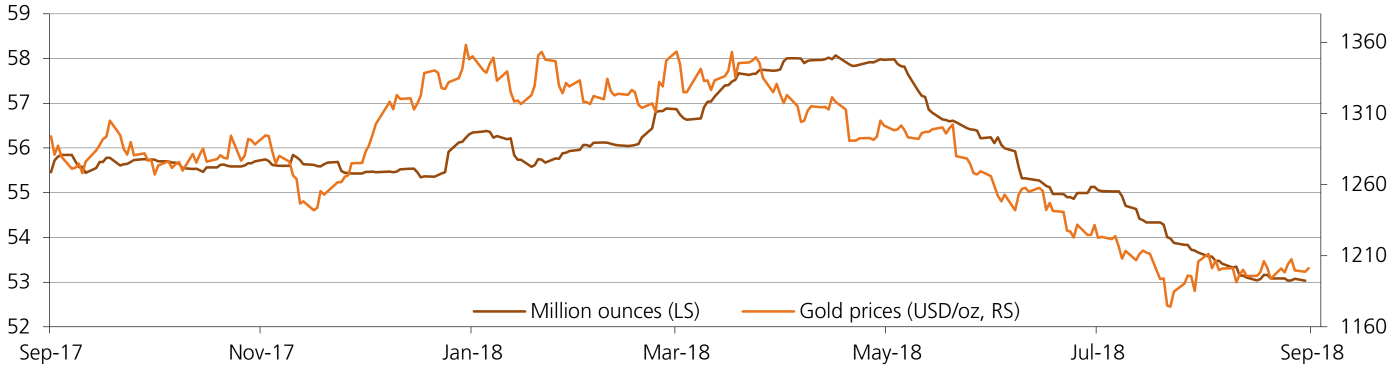
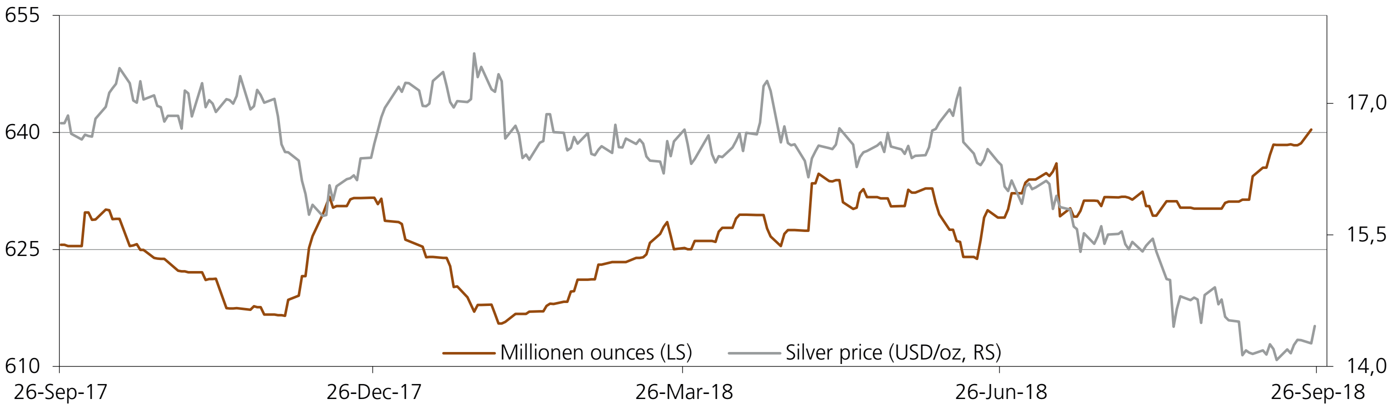
Precious metals prices and ETF holdings

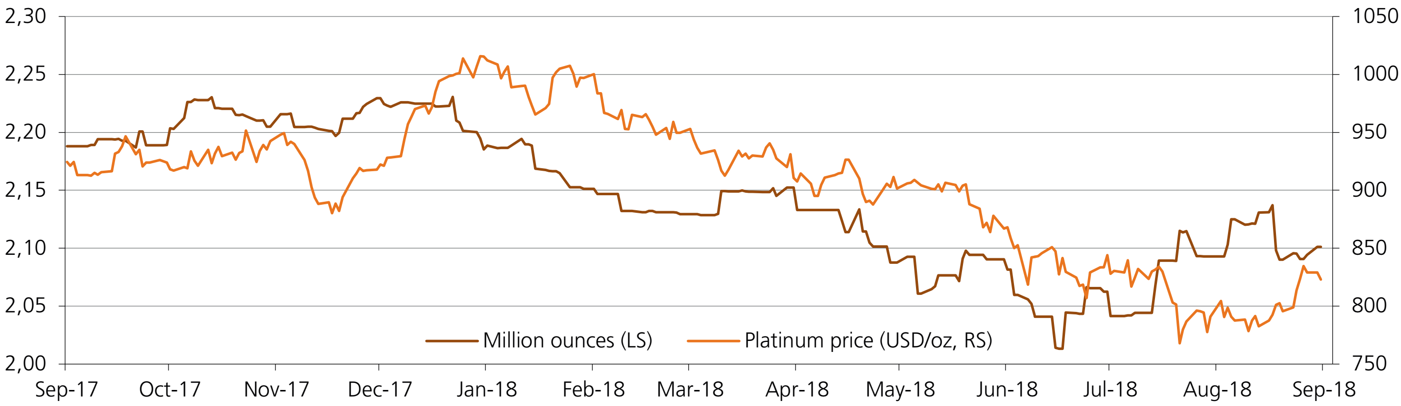
Gold ETFs (million ounces) und gold price (USD/oz)



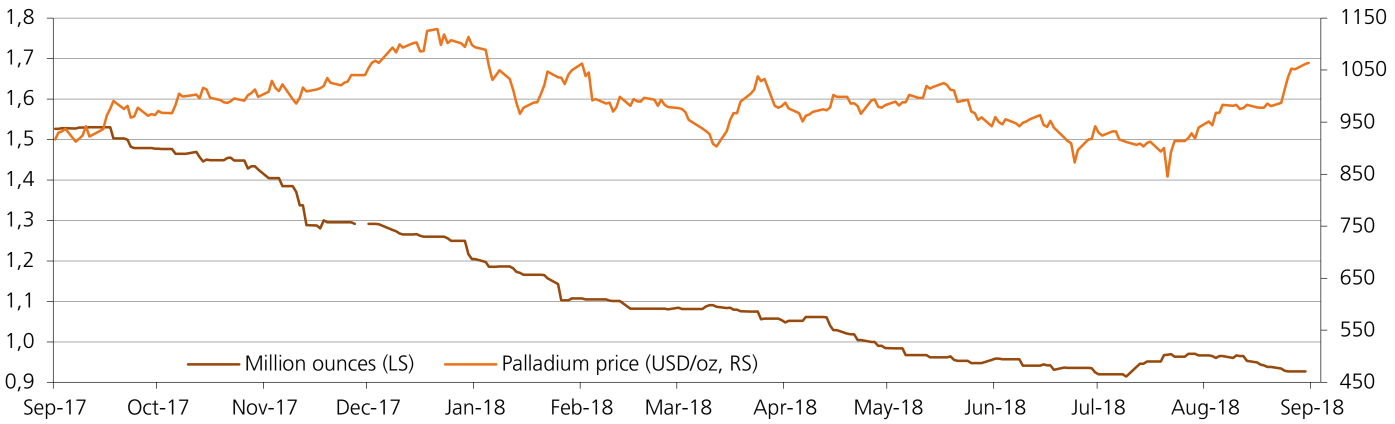
Silver ETFs (million ounces) and silver price (USD/oz)



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	1198.2		14.5		825.8		1058.7	
II. Gliding averages								
5 days	1202.2		14.3		825.8		1048.6	
10 days	1201.4		14.3		814.7		1017.2	
20 days	1199.9		14.3		800.3		997.1	
50 days	1205.6		14.8		807.9		946.5	
100 days	1243.1		15.6		844.1		960.6	
200 days	1284.3		16.1		900.2		989.2	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1248	1472	16.0	21.0	936	1048	1033	1261
(1)	*4*	*23*	*11*	*45*	*13*	*27*	*-2*	*19*
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

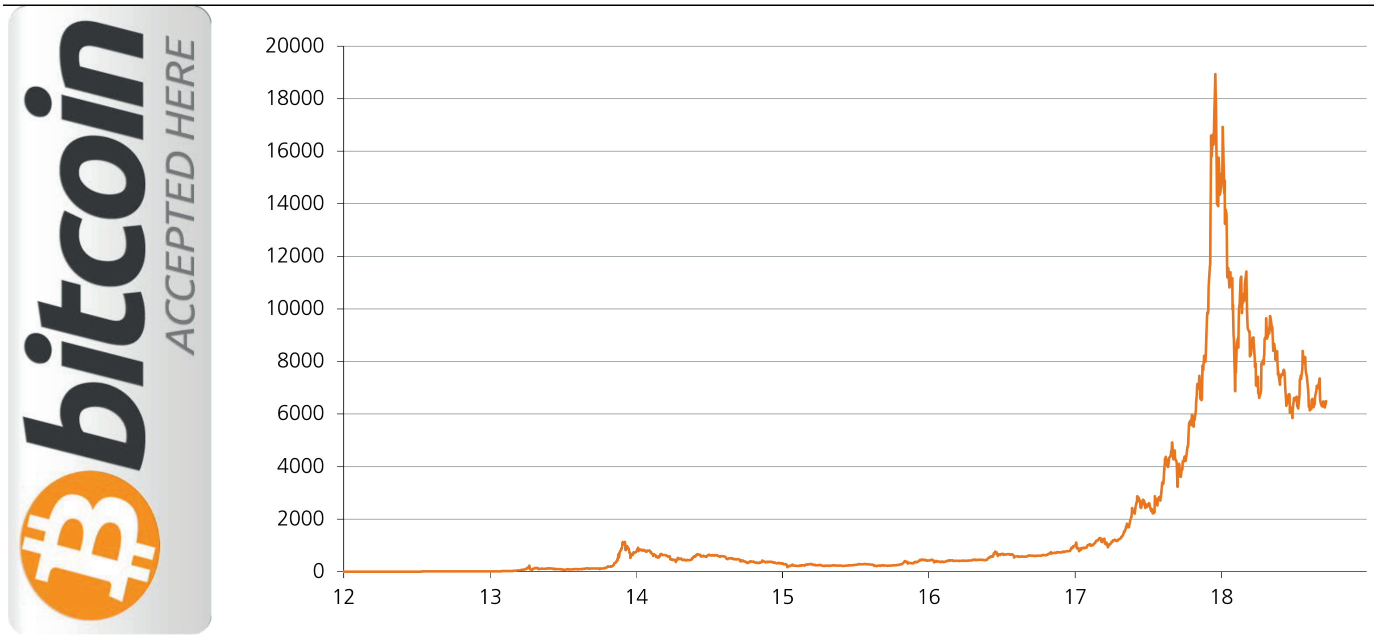
	Gold		Silver		Platinum		Palladium	
I. Actual	1018.4		12.3		701.9		899.8	
II. Gliding averages								
5 days	1023.1		12.2		702.7		892.3	
10 days	1025.8		12.2		695.6		868.5	
20 days	1028.6		12.3		686.0		854.7	
50 days	1038.0		12.8		695.6		814.7	
100 days	1065.8		13.4		723.7		823.6	
200 days	1074.8		13.5		752.7		828.0	
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)	*6*	*25*	*13*	*48*	*15*	*29*	*-1*	*21*
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

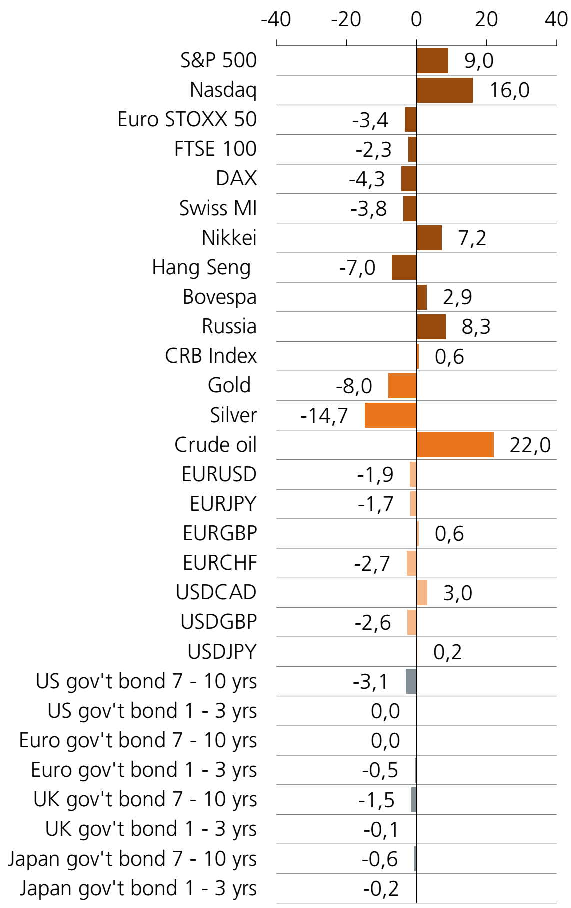
Bitcoin in US dollars



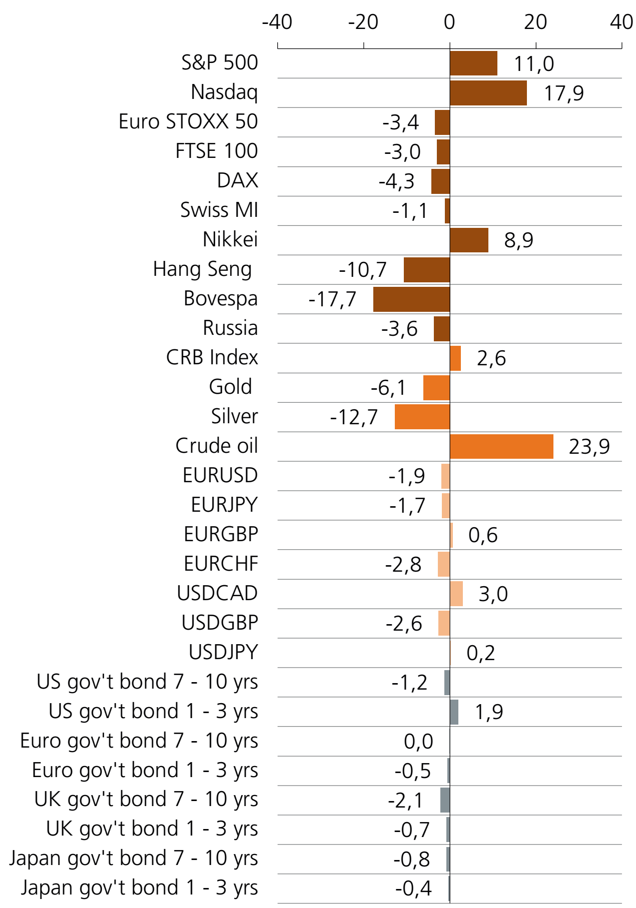
Source: Thomson Financial.

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*

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