Degussa Market Report

28 February 2019 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	1.327.0	1.0	9.3	0.7
Silver	15.9	0.3	11.6	-3.3
Platinum	859.2	7.7	2.8	-12.6
Palladium	1.552.0	10.7	43.9	48.9
II. In euro				
Gold	1.166.5	0.6	8.7	8.0
Silver	13.9	-0.1	11.0	3.9
Platinum	755.3	7.3	2.1	-6.3
Palladium	1.364.0	10.3	42.8	59.5
III. Gold price in other currencies				
JPY	146.577.0	1.7	6.9	4.3
CNY	8.875.2	0.2	4.8	6.4
GBP	1.001.2	-1.3	5.3	4.6
INR	94.652.8	1.9	5.4	10.2
RUB	87.264.2	1.5	9.1	17.5

Source: Thomson Financial; own calculations.

OUR TOP ISSUES

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

The Fed Takes Full Control of the Bond Market – And Raises The Value of Gold

The US Federal Reserve (Fed) has signalled to financial markets that it wants to pause further monetary policy tightening for some time. Investors, however, take a somewhat different view of what the Fed is going to do: They assume that the Fed's interest rates hiking cycle has come to an end. This is pretty bad news for holders of cash, savings deposits and bonds: It means that inflation-adjusted US interest rates will – if price inflation remains at current levels – remain zero or even in negative territory.

By no means less important is the Fed's new plan to put an end to its balance sheet shrinking in the coming months. In this context, we have to remind ourselves that the Fed started buying government and mortgage bonds in the course of the financial and economic crisis 2008/2009. As a result, the Fed's balance sheet expanded from 870.3 US$bn in September 2007 to a record 4.489,3 US$bn in November 2015. In October 2017, however, the Fed decided to throw its crises-era bond purchase program into reverse.

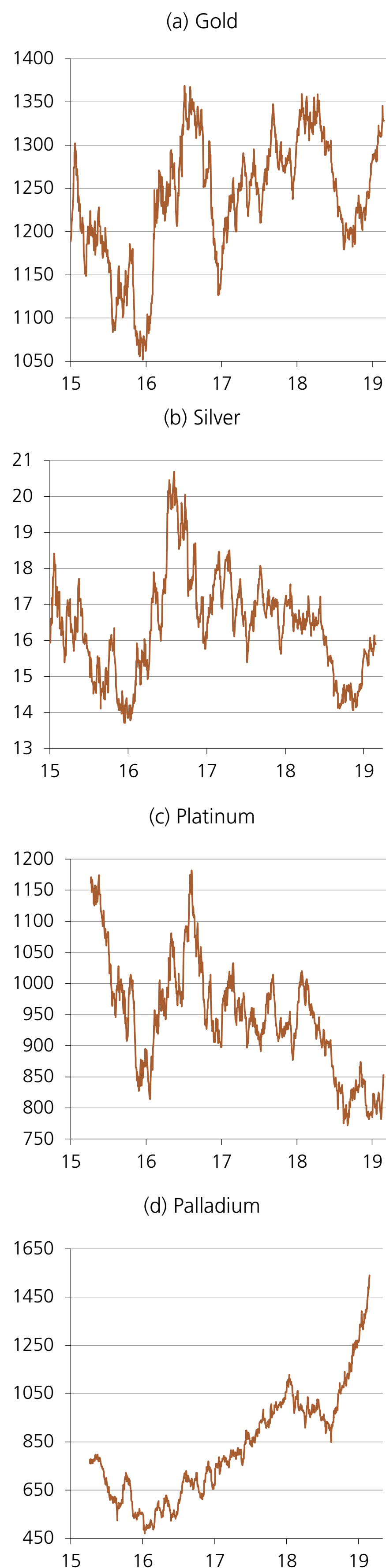
Since then, the Fed let its balance sheet shrink to 4.039.7 US$bn in February 2019 – mainly by allowing bonds to mature each month and not reinvesting the redemptions in the market place. Even if the balance sheet shrinking were to end soon, however, the Fed would remain in charge of a pretty sizable fixed income portfolio and would have to keep reinvesting significant amounts of money on a regular basis. In fact, it would remain a big buy-side player, exerting permanent downward pressure on market interest rates.

The Fed's overpowering impact on short-term as well as long-term market interest rates would be cemented. It may not even be an exaggeration to say that the Fed is about to become the "master of the yield curve". Looking ahead, it seems that credit market yields will be influenced predominantly by what investors expect the Fed to do in the future – and to a much lesser degree by peoples' expectations about future growth, fiscal deficits, inflation, and credit risk, to name a few.

The bond market would become chronically rigged. This spells trouble, for sure. For the market interest rate is of critical importance for bringing savings, investment and consumption into line. In a truly unhampered market, the market interest rate is determined freely by the supply of and demand for savings. This process makes sure that sufficient resources are at hand to realise all investment projects which are encouraged at the prevailing market interest rate – and the economy can prosper.

However, the Fed increasingly corrupts this process. It inadvertently suppresses short- and long-term interest rates to artificially low levels – levels that are low-

Precious metal prices (USD/oz) in the last 4 years



Source: Thomson Financial.

er than the interest rates determined in an unhampered market. As a consequence, savings decline, consumption rises, and investment expands. While this boosts economic activity in the short run, such a "boom" causes severe problems that will only surface later: a distortion of the economy's production and employment structure.

Artificially lowered interest rates encourage new investment and job creation in the 'higher stages' of production (that is the capital goods industry), which comes at the expense of economic activity in the 'lower stages' of production (the consumer goods industry). Overall production becomes more 'time consuming', and the boom – induced by artificially low interest rates – can only be upheld if borrowing rates remain at depressed levels or are reduced even further.

In a free market, an artificial boom would, at some point, turn into "bust" as, for instance, banks would rein in lending and investors would reduce their exposure to credit risk. In this process, market interest rates would be pushed back towards their natural levels. If that happens, the production and employment structure, which has been built up under the reign of artificially suppressed market interest rates, collapses. Such a "bust" represents the economically required correction of the aforegoing build-up of malinvestments.

However, this will no longer be possible once the Fed takes full control of market interest rates. For then any unwanted interest rate increase can be prevented. Should, say, a bond sell-off occur, the Fed could start buying debt paper until bond yields are brought down again to the levels deemed politically desirable. As money production monopolist, the Fed has great firepower, indeed: It can buy any amount of debt and pay with US dollar balances created out of thin air and thereby put the market interest rate where it wishes it to be.

Investors are well aware this. No portfolio manager will speculate against the Fed, because if the Fed wants interest rates at very low levels, investors have every reason to bet that market interest rates will eventually settle at levels targeted by the Fed. In fact, the Fed might not even have to buy bonds to enforce their market interest rate target. It could simply convey the message to banks' trading floors that it would like to see, for example, the 10-year government bond yield trading at 2.0 per cent – and the yield would move toward that level.

The Fed's latest announcement that it does not wish to withdraw from the bond market is by no means insignificant. It is an unmistakable indication that the Fed is prepared to squeeze out what little is left of the free market forces in the debt market space, as its purpose is to keep the fiat US dollar system going; and whatever is necessary to achieve this will be done. No doubt: One of the most critical issues in the 'fight against the bust' is gaining full control over the economy's market interest rate.

But where does this lead us? The Fed will keep the boom going for longer than it would without the Fed's intervention: The rise in the market interest rate that could potentially usher in the bust can, and will, most likely be prevented. A continuation of artificially low interest rates, however, means more malinvestment. And the more malinvestment there is, the higher the costs of a correcting bust in term of output and employment losses will be.

What can it go wrong? The trouble would start if private and institutional investors were to turn their back on the debt market. To prevent a rise in market interest rates due to, say, a broad-based bond market sell-off, the central bank has to step in and purchase debt against issuing newly created money balances. This is, of course, an inflationary policy that could unfold in either one of two

scenarios.

In the first scenario, price inflation goes up to, say, 4 or 6 per cent per annum – to a level at which people might reduce their money holdings somewhat, but do not flee out of the currency altogether. With market interest rates remaining fixed at levels between, say, zero and 2 percent, people suffer real losses on their deposits and bonds. They are getting poorer, while debtors become richer – as their liabilities are devalued in real monetary terms. In this way the central bank brings about a drawn-out redistribution of wealth on a grand scale.

In the second scenario, in the light of an actual or expected rise in inflation, people lose their confidence in the value of the currency. They try to rid themselves of their money balances, withdraw bank deposits and divest their bond holdings. To prevent this from raising market interest rates, the central bank has purchase more debt and issue more money. This causes confidence in the value of money to decline further. The debt market sell-off continues, and more money is issued, so that eventually price inflation accelerates.

The situation in the second scenario would presumably become messy if price inflation were to rise to too high a level, causing people extreme economic and social pain, which typically hits low- and middle-income earners particularly hard. The public at large would likely start protesting against the inflationary expropriation at one point. Indeed, monetary history is full of examples in which unacceptably high inflation ended in political upheaval and even revolution.

Against this backdrop it is a rather uncomfortable development that the Fed – especially so as it effectively leads central bank action around the world – does not only keep interfering with market interest rates but is also about to make permanent its dominant influence on bond and thus overall credit market conditions. All this does by no means solve the economic and monetary problems the Fed has caused in the first place but will make them even worse.

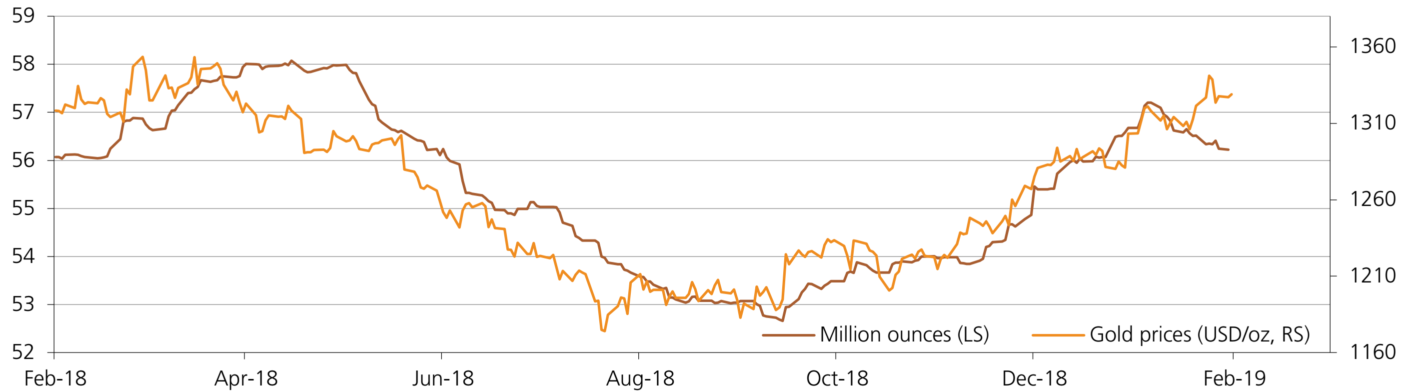
Fortunately, the Austrian economic Ludwig von Mises pointed out, on the basis of sound economic reasoning, how to abandon the road to ruin followed by the Fed and basically all major central banks around the world. With economic and political acumen he wrote: "*There is only one way out of the crisis: Forgo every attempt to prevent the impact of market prices on production. Give up the pursuit of policies which seek to establish interest rates, wage rates and commodity prices different from those the market indicates. This may contradict the prevailing view. It certainly is not popular. Today all governments and political parties have full confidence in interventionism and it is not likely that they will abandon their program. However, it is perhaps not too optimistic to assume that those governments and parties whose policies have led to this crisis will some day disappear from the stage and make way for men whose economic program leads, not to destruction and chaos, but to economic development and progress.*" [1]

The outlook of low interest rates can be expected to result in a *structural* appreciation of the value of gold from the viewpoint of savers and investors – and this should push the price of gold higher going forward.

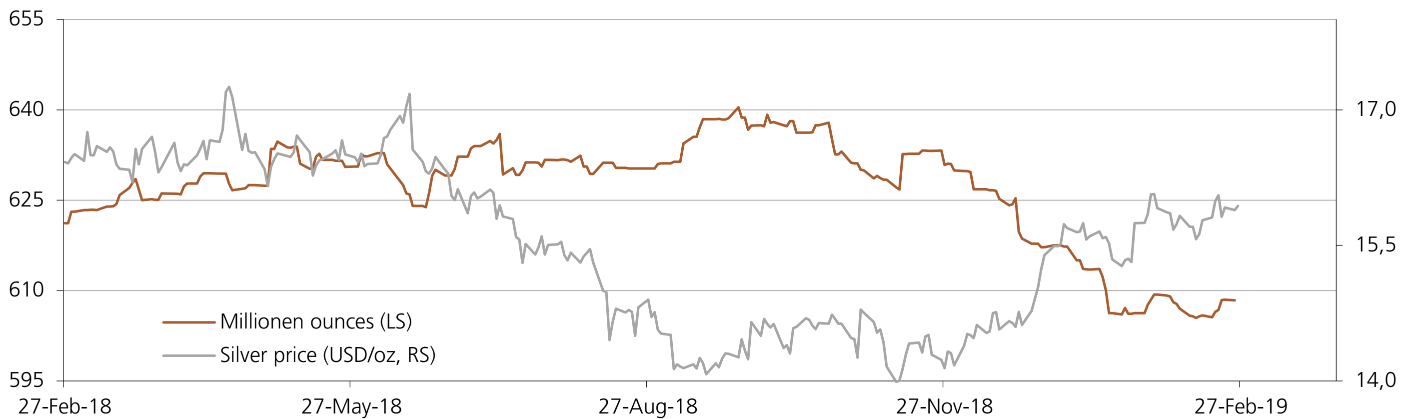
[1] Mises, L. v. (2006), The Causes of the Economic Crisis, Ludwig von Mises Institute, Auburn, US Alabama, p. 181 – 182.

Precious metals prices and ETF holdings

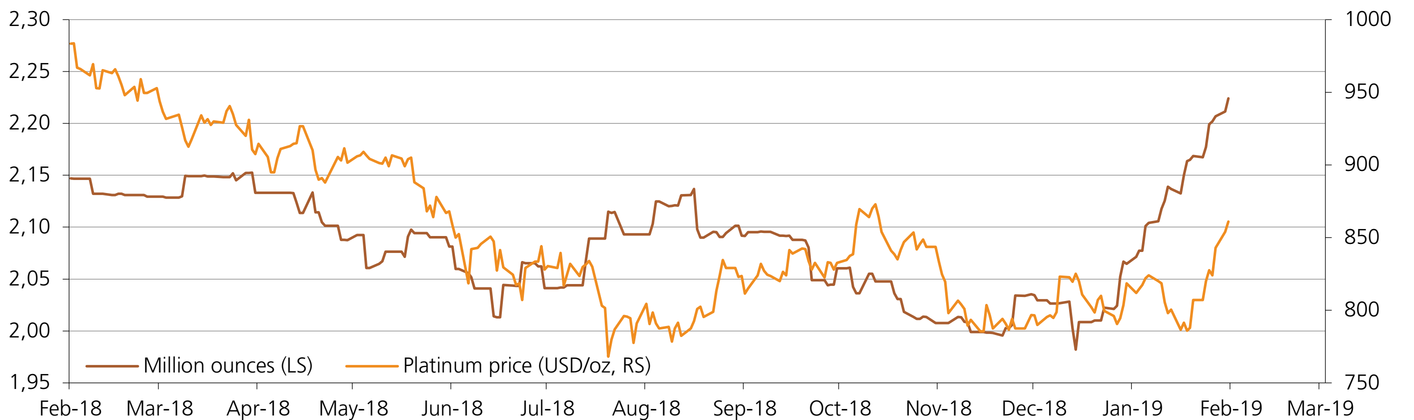
Gold ETFs (million ounces) und gold price (USD/oz)



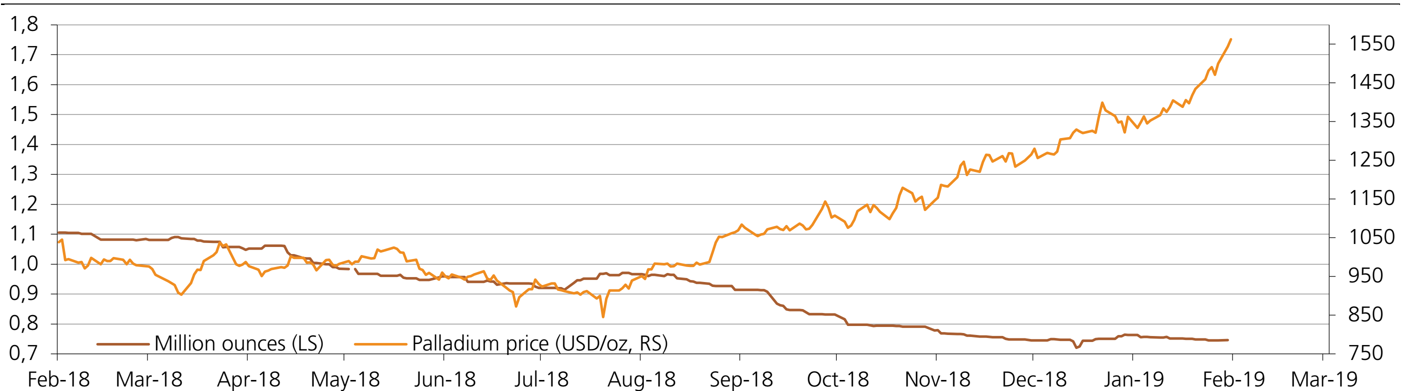
Silver ETFs (million ounces) and silver price (USD/oz)



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	1327.2		15.9		859.5		1554.6	
II. Gliding averages								
5 days	1332.7		16.0		836.8		1504.4	
10 days	1326.7		15.9		816.1		1469.6	
20 days	1320.1		15.8		812.9		1424.3	
50 days	1297.8		15.6		805.8		1351.8	
100 days	1262.3		15.0		817.1		1251.0	
200 days	1247.4		15.2		826.5		1109.7	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1223	1480	14.4	19.1	785	903	1204	1368
(1)	*-8*	*12*	*-9*	*20*	*-9*	*5*	*-23*	*-12*
IV. Annual averages								
2015	1163		15.7		1065		706	
2016	1242		17.0		985		617	
2017	1253		17.1		947		857	
2018	1268		15.8		880		1019	

In Euro

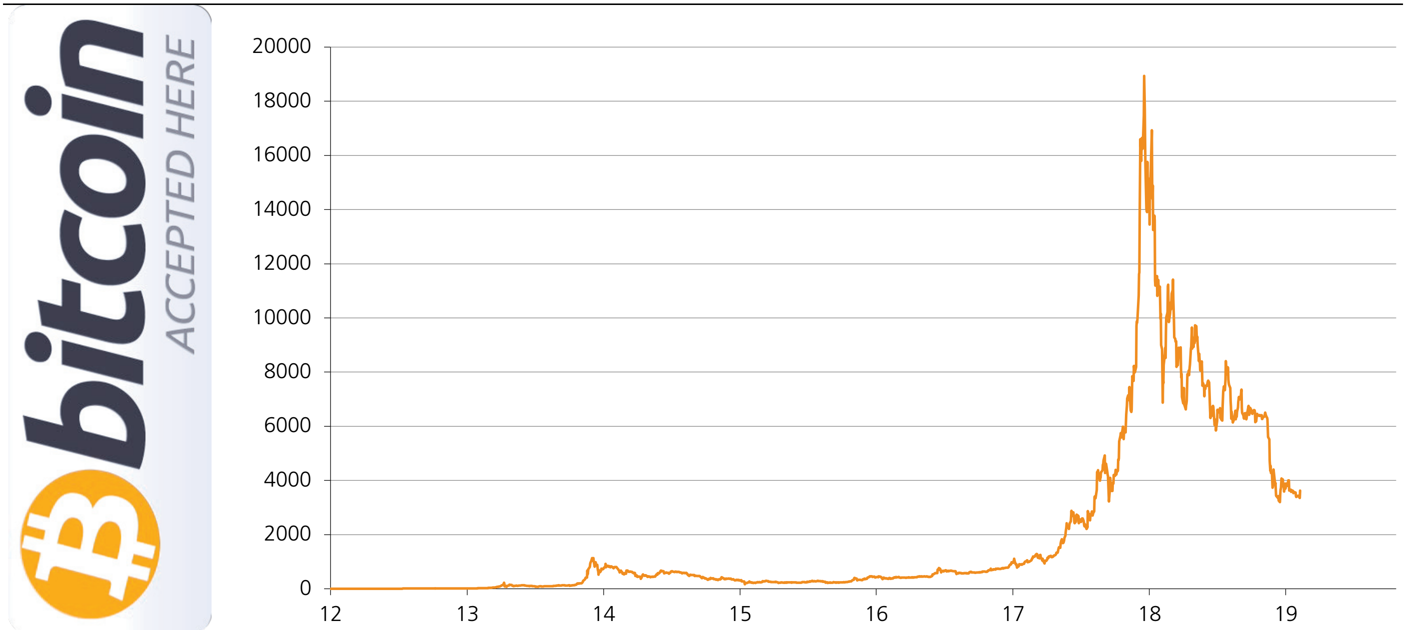
	Gold		Silver		Platinum		Palladium	
I. Actual	1166.9		14.0		755.7		1366.9	
II. Gliding averages								
5 days	1174.4		14.1		737.4		1325.6	
10 days	1171.9		14.0		720.8		1298.0	
20 days	1162.9		14.0		716.0		1254.7	
50 days	1139.4		13.7		707.4		1186.9	
100 days	1108.1		13.2		717.2		1098.3	
200 days	1083.6		13.2		717.8		965.2	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1098.8	1330.2	13.0	17.2	705.5	811.3	1081.7	1229.7
(1)	*-6*	*14*	*-7*	*23*	*-7*	*7*	*-21*	*-10*
IV. Annual averages								
2015	1044		14		955		633	
2016	1120		15		888		557	
2017	1116		15		844		760	
2018	1072		13		743		863	

Source: Thomson Financial; own calculations and estiamtes.

(1) Estimated return against actual price in percent.

Bitcoin, performance of various asset classes

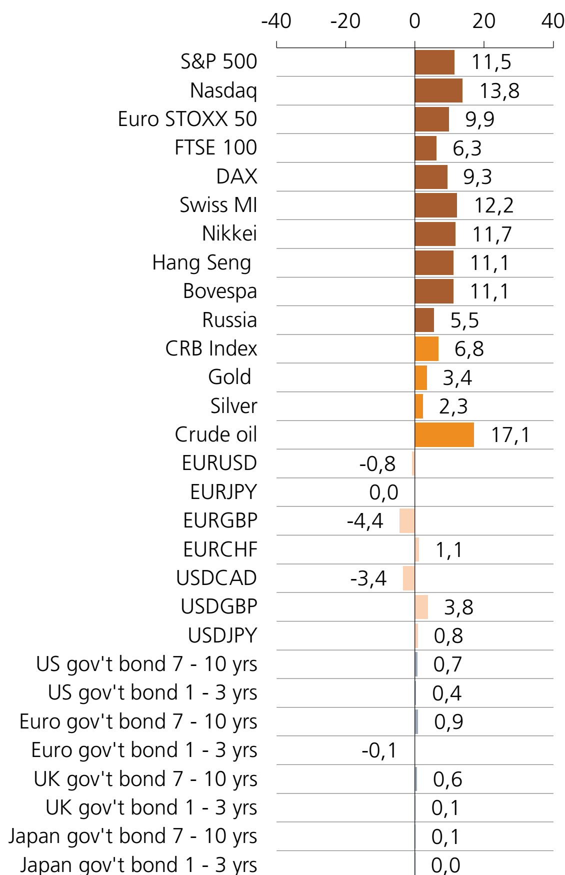
Bitcoin in US dollars



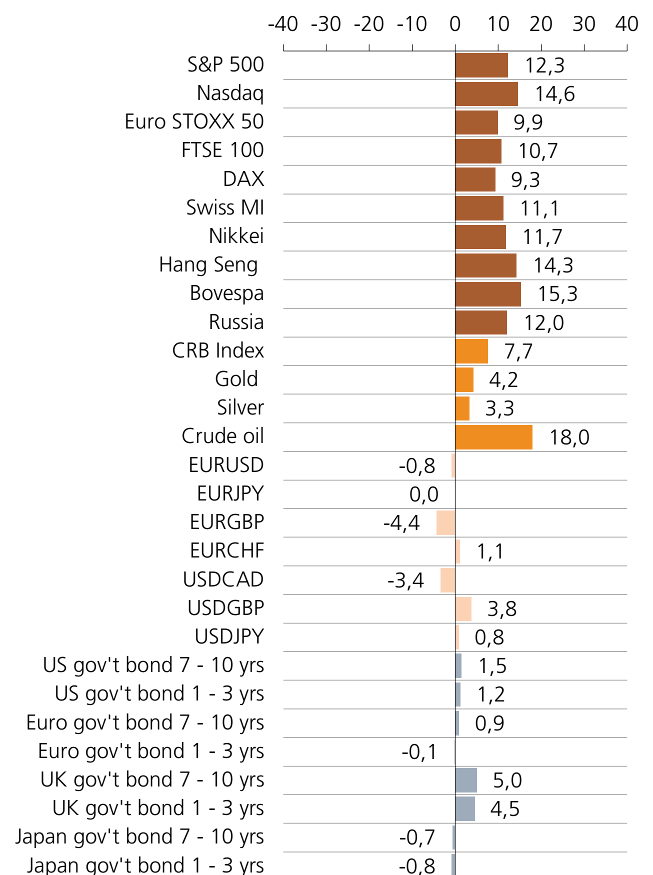
Source: Thomson Financial.

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*

Issue	Content
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17 January 2019	US Interest Rate Down, Price of Gold up
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10 December 2018	The Fed Supports Gold
23 November 2018	The Fed Is Not Our Saviour
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