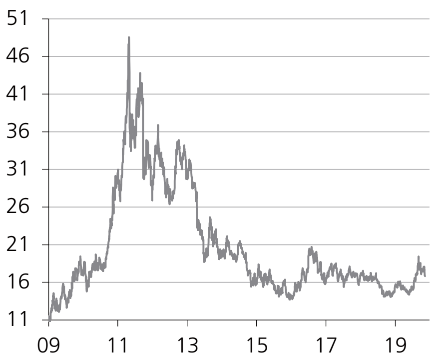
Degussa Market Report

5 December 2019 Economics · Finance · Precious Metals

USD per ounce of gold

USD per ounce of silver



EURUSD

Source: Thomson Financial; graphs by Degussa.

Precious metals prices				
	Actual	Change against (in percent):		
	(spot)	2 W	3 M	12 M
I. In US-dollar				
Gold	1.477.3	0.7	-3.5	15.2
Silver	17.2	1.3	-6.9	10.9
Platinum	909.9	2.3	-2.1	14.9
Palladium	1.854.9	8.8	21.2	47.1
II. In euro				
Gold	1.332.9	0.4	-4.5	19.3
Silver	15.5	1.0	-7.9	15.1
Platinum	821.0	2.0	-3.1	18.5
Palladium	1.674.0	8.6	19.9	51.6
III. Gold price in other currencies				
JPY	160.448.0	0.6	-1.3	14.2
CNY	10.431.0	1.5	-5.0	18.3
GBP	1.136.6	0.0	-10.4	13.1
INR	105.966.0	1.9	-3.8	18.8
RUB	94.754.9	1.3	-7.3	6.1

Source: Thomson Financial; calculations by Degussa.

OUR TOP ISSUES

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

WHY THE FEARED CRASH KEEPS US WAITING

The Austrian Business Cycle Theory offers a sound explanation of what happens with the economy if and when the central banks, in close cooperation with commercial banks, create new money balances through credit expansion. Said credit expansion causes the market interest rate to drop below its ‘natural level’, tempting people to save less, consume more, and drives firms to increase investment spending. The economy enters into a boom phase.

However, the boom is unstainable. After the effect of the injection of new money balances has worked itself through the economy, consumers and entrepreneurs realise that the economic expansion has been a one-off affair. They return to their previously preferred savings-consumption-investment affinity: Once again, they save more, consume, and invest less. This manifests itself in a rising market interest rate and the boom subsequently turns into bust.

CREDIT MARKET DISTORTION

The market interest rate plays a crucial role in the boom and bust cycle. As it is manipulated downwards by the central bank, a boom sets off, and as the market interest returns to its ‘natural level’, the boom turns into bust. This explains why central banks have been increasingly trying to gain full control over the market interest rate in recent years: For he who controls the market interest rate controls the boom and bust cycle.

The major central banks around the world have effectively taken over the credit markets in an attempt to prevent the current boom from turning into yet another bust. On the one hand, monetary authorities fix the short-term market interest rate in the interbank funding market. By doing so, they also exert a rather strong influence on credit rates across all maturities.

On the other hand, central banks influence long-term interest rates directly: They purchase long-term bonds, thereby determining their price and yield. The credit market ‘government securities’ can be expected to already be under full control of monetary policymakers; and it is just a technicality for any central bank to extend its purchases if needed to bank and corporate debentures and mortgage debt.

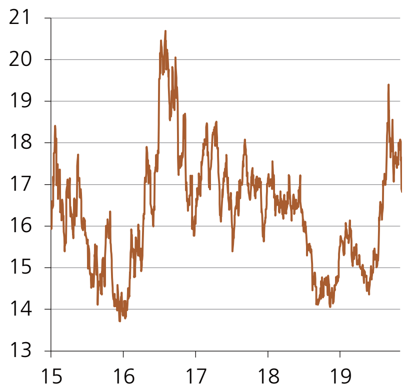
KEEPING THE BOOM GOING

If and when central banks succeed in keeping market interest rates at very low levels, the ‘correction mechanism’ – namely a rise in market interest rates – is

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

(a) Gold

(b) Silver



(c) Platinum

(d) Palladium

Source: Thomson Financial; graphs by Degussa.

put to rest, and the boom can be kept going, while the bust is postponed. Basically, all major central banks around the world have taken recourse to policies controlling market interest rates, and quite effectively so as the economic expansion – fuelled by overconsumption and malinvestment – in the last decade testifies.

The question is, however, whether the boom can last indefinitely, whether the economies can flourish with chronically artificially suppressed interest rates? This is a rather complicated question, deserving of an elaborate answer. To start with, the boom can be kept going as long as market interest rates remain suppressed below the economy's 'natural interest rate'.

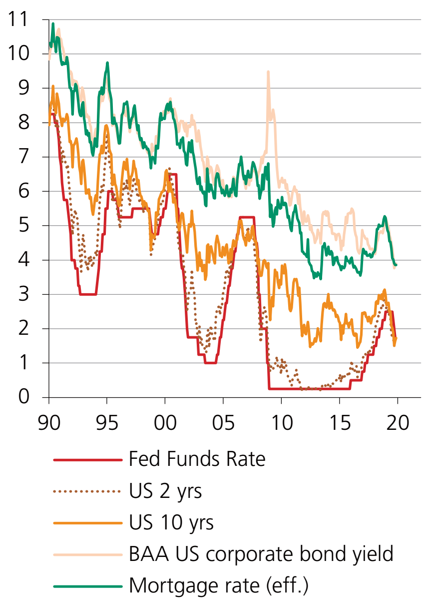
If however, the market interest rate hits zero, things take a nasty turn, as people would stop saving and investing. Why save and invest, why take any risks that do not yield a positive return? In fact, with the market interest rate hitting zero, capital consumption sets in and the division of labour collapses. A nightmare scenario: If the market interest rate disappears, we will fall back into a primitive hand-to-month economy.

CAUSING PRICE BUBBLES

Against this backdrop, we may say the following: As long as there is still room for pushing the market interest rate down further, the chances are reasonably good that the boom continues, and that the bust will be adjourned into the future. As per the charts below, current market interest rates in the US have not reached rock bottom yet. Corporate and mortgage credit costs in particular still have some way to go before hitting zero.

1 Declining interest rates, rising stock prices

(a) Selected US interest rates in per cent



(b) S&P 500 stock market index

Source: Thomson Financial; graph by Degussa

Meanwhile, the forced depression of market interest rates drives up asset prices such as, for instance, stocks for at least two reasons. First, expected future profits are discounted at a lower interest rate, thereby increasing their present value and thus market price. Second, lower interest rates reduce firms' cost of debt, translating into higher profits – which also contributes to higher stock prices in the market place.

It should therefore not come as a surprise that the decline in market interest rates in recent years has indeed been accompanied by buoyant stock prices – as illustrated in the chart above. Just to point out one thing again: The decline in market interest rates is only one factor among many others which explain why stock prices have gone up in recent years. But it is a significant factor, and it contributes to the build-up of a price bubble.

WIPING OUT INVESTMENT RETURNS

As long as the boom keeps going, people rejoice – especially so when asset returns remain buoyant –, they do not question the underlying forces driving the 'make-believe world of prosperity'. However, a monetary policy of ever-lower interest rates can only go so far. For if central banks push their key interest rate and government bond yields to zero, they basically drag down all other investment returns with them.

This is because investors, in a desperate search for yields, would bid up the prices for assets such as, say, stocks, land, and real estate. As the purchase price of these assets rises relative to their intrinsic value, future investment returns diminish and in the extreme case converge towards the central bank's zero interest rate. At least, in theory, a central bank nailing down its key interest rate at zero would also drive investment returns of existing assets towards zero.

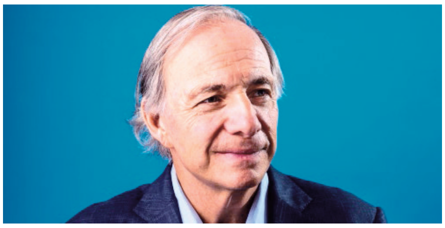
However, the division of labour would already start unravelling at a market interest rate of slightly higher than zero. The reason is that acting man – be it as a consumer or an entrepreneur – has a time preference that is always and everywhere positive, and so is its manifestation, the originary interest rate (or 'natural interest rate'). The originary interest rate is always and everywhere positive, it cannot fall to zero, let alone become negative.

A HELPING HAND FROM ABOVE?

Since central banks have established a rather firm grip on market interest rates, the chances are that the ongoing boom will continue – and it may well continue for much longer than most market observers expect at the current juncture. However, there should be little doubt that the longer the boom keeps going, the bigger the distortions in the economic and financial market system will become.

This, in turn, suggests that the severity of the crisis that must be expected to unfold at some point in the future – at the latest when all market interest rates have been pushed onto the zero line and investment returns have become negligible – is driven to ever-higher levels. This is something we do know from the Austrian Business Cycle Theory. But it is certainly not enough to come up with a reliable forecast.

It goes beyond the science of economics to come up with quantitative forecasts. What economics can do, however, is pointing out and making intelligible the conditions under which today's economic and financial systems work; in particular that market interest rate manipulation through central banks causes damages on a grand scale and will end badly – something that may only be prevented by a helping hand from above.



"I believe that it would be both risk-reducing and return-enhancing to consider adding gold to one's portfolio."

Bloomberg, 17 July 2019.

Precious metals prices

In US-dollar per ounce

	Gold		Silver		Platinum		Palladium	
I. Actual	1477.3		17.2		910.1		1855.2	
II. Gliding averages								
5 days	1472.6		17.2		910.6		1770.0	
10 days	1487.7		17.6		920.6		1781.0	
20 days	1489.6		17.6		910.7		1772.5	
50 days	1499.4		17.8		919.3		1686.0	
100 days	1477.4		17.1		884.4		1594.6	
200 days	1391.0		16.1		862.1		1508.5	
III. Estimate for end 2020	1690		22.9		930		1570	
Bandwidths	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1440	1840	16	26	780	990	1380	1650
(1)	*-3*	*25*	*-5*	*53*	*-14*	*9*	*-26*	*-11*
IV. Annual averages								
2016	1242		17.0		985		617	
2017	1253		17.1		947		857	
2018	1268		15.8		880		1019	

In euro per ounce

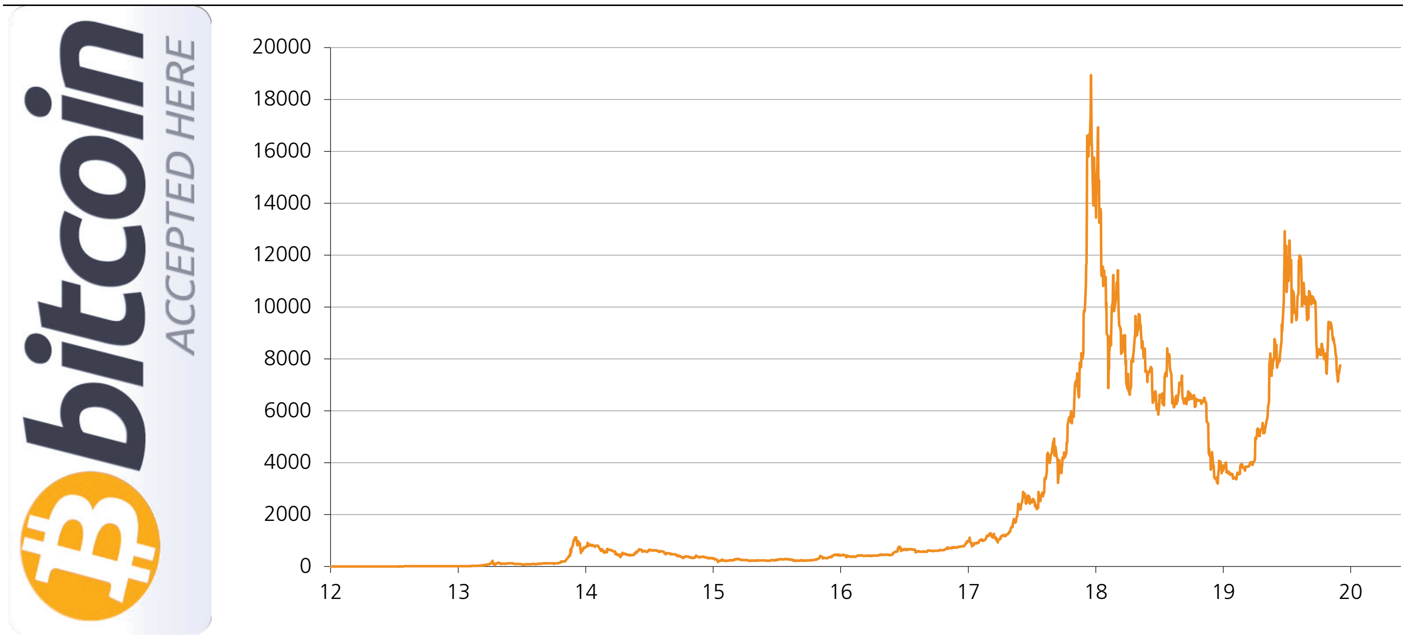
	Gold		Silver		Platinum		Palladium	
I. Actual	1333.2		15.5		821.4		1674.2	
II. Gliding averages								
5 days	1332.7		15.6		824.1		1601.8	
10 days	1340.6		15.8		829.6		1604.9	
20 days	1342.0		15.9		820.5		1596.8	
50 days	1358.1		16.1		832.7		1526.9	
100 days	1330.0		15.4		796.2		1435.5	
200 days	1244.2		14.4		771.0		1349.2	
III. Estimate for end 2020	1580		22		870		1470	
Bandwidths	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1350.0	1730.0	15.3	24.8	730.0	930.0	1290.0	1550.0
(1)	*1*	*30*	*-1*	*60*	*-11*	*13*	*-23*	*-7*
IV. Annual averages								
2016	1120		15		888		557	
2017	1116		15		844		760	
2018	1072		13		743		863	

Source: Thomson Financial; own calculations and estimates. Numbers are rounded.

(1) Estimated return against actual price in percent.

Bitcoin, performance of various asset classes

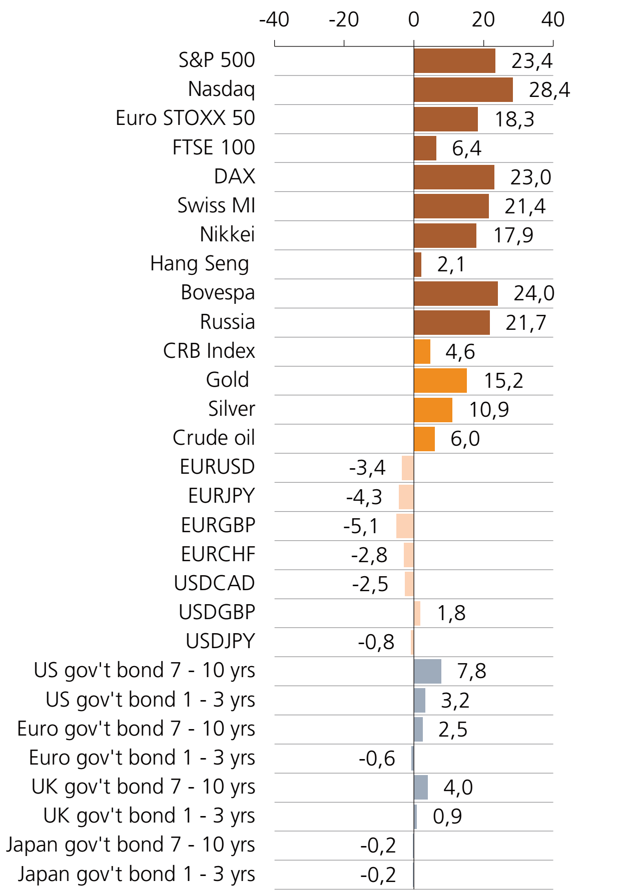
Bitcoin in US dollars



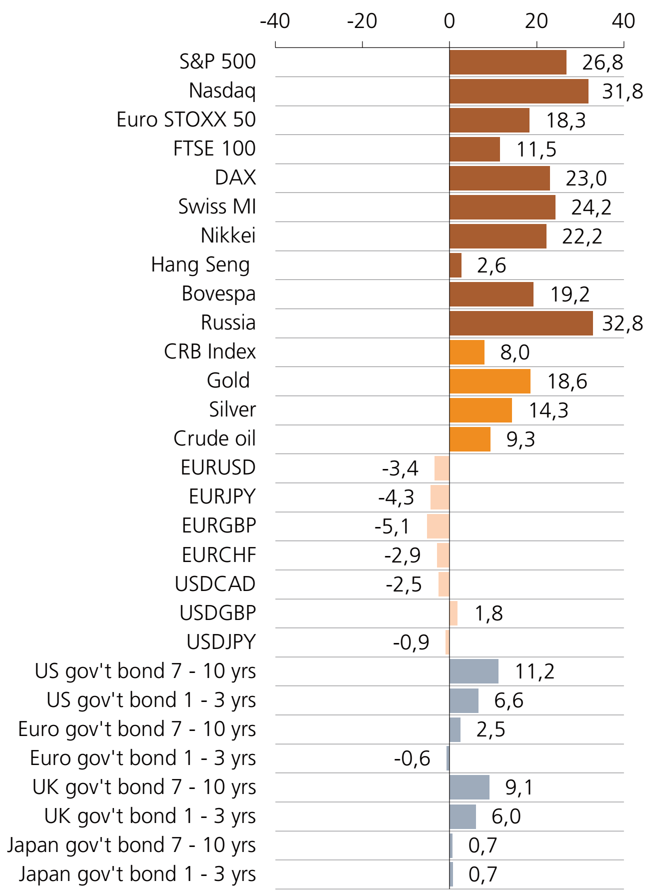
Source: Thomson Financial; graph by Degussa.

Performance of stocks, commodities, FX and bonds

(a) In national currencies



(b) In euro



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Articles in earlier issues of the *Degussa Market Report*

Issue	Content
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7 November 2019	ETFs Drive Gold Demand
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Editor in chief: Dr. Thorsten Polleit
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Degussa
GOLD UND SILBER.

Frankfurt Headquarters
Kettenhofweg 29 · 60325 Frankfurt
Phone: 069-860 068 – 0 · info@degussa-goldhandel.de

Retail buying and selling outlets in Germany:

Augsburg (shop & showroom): Maximiliansstraße 53 · 86150 Augsburg
Phone: 0821-508667 – 0 · augsburg@degussa-goldhandel.de

Berlin (shop & showroom): Fasanenstraße 70 · 10719 Berlin
Phone: 030-8872838 – 0 · berlin@degussa-goldhandel.de

Frankfurt (shop & showroom): Kettenhofweg 25 · 60325 Frankfurt
Phone: 069-860 068 – 100 · frankfurt@degussa-goldhandel.de

Hamburg (shop & showroom): Ballindamm 5 · 20095 Hamburg
Phone: 040-329 0872 – 0 · hamburg@degussa-goldhandel.de

Hanover (shop & showroom): Theaterstraße 7 · 30159 Hanover
Phone: 0511-897338 – 0 · hannover@degussa-goldhandel.de

Cologne (shop & showroom): Gereonstraße 18-32 · 50670 Cologne
Phone: 0221-120 620 – 0 · koeln@degussa-goldhandel.de

Munich (shop & showroom): Promenadeplatz 12 · 80333 Munich
Phone: 089-13 92613 – 18 · muenchen@degussa-goldhandel.de

Munich (Old Gold Centre): Promenadeplatz 10 · 80333 Munich
Phone: 089-1392613 – 10 · muenchen-altgold@degussa-goldhandel.de

Nuremberg (shop & showroom): Prinzregentenufer 7 · 90489 Nuremberg
Phone: 0911-669 488 – 0 · nuernberg@degussa-goldhandel.de

Pforzheim (refinery): Freiburger Straße 12 · 75179 Pforzheim
Phone: 07231-58795 – 0 · pforzheim@degussa-goldhandel.de

Stuttgart (shop & showroom): Kronprinzstraße 6 · 70173 Stuttgart
Phone: 0711-305893 – 6 · stuttgart@degussa-goldhandel.de

Retail buying and selling outlets around the world:

Zurich (shop & showroom): Bleicherweg 41 · 8002 Zurich
Phone: 0041-44-40341 10 · zuerich@degussa-goldhandel.ch

Geneva (shop & showroom): Quai du Mont-Blanc 5 · 1201 Genève
Phone: 0041-22 908 14 00 · geneve@degussa-goldhandel.ch

Madrid (shop & showroom): Calle de Velázquez 2 · 28001 Madrid
Phone: 0034-911 982 900 · info@degussa-mp.es

London Sharps Pixley Ltd. (member of the Degussa Group)
Phone: 0044-207 871 0532 · info@sharpspixley.com