Degussa Market Report

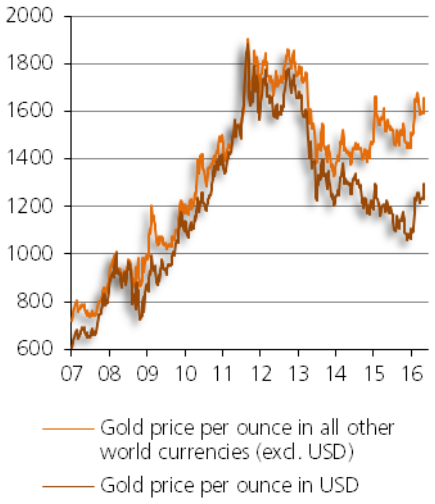
13 May 2016 Economics · Finance · Precious Metals

"...nobody is in a position to tell us how something more satisfactory could be put in place of the gold standard. ... The gold standard makes the determination of money's purchasing power independent of the changing ambitions and doctrines of political parties and pressure groups. This is not a defect of the gold standard; it is its main excellence."

— Ludwig von Mises, 1998, Human Action, pages 470 and 471

The gold price has been rising in practically all currencies expect US dollars since 2014

Gold price per ounce in US dollars and other currencies (excl. US dollars)*



Source: Bloomberg; own calculations. Series are indexed (2 September 2011 equals 1.900 - the latest record price of gold in US dollar).

TOP ISSUES

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

The Fight Against 'Secular Stagnation' and Its Consequences for Gold and Silver Prices

Summary:

- **As the concept of 'secular stagnation' gains purchase, it may well prod central banks…**
- **…to push interest rates into negative territory and pump out more and more money.**
- **If pursued with perseverance, this policy will compound rather than cure what's ailing economies:**
- **Rather than kick-start investments, it will trigger capital consumption and malinvestments on a grand scale…**
- **… and could undermine the purchasing power of money, thereby jeopardizing the lifetime savings of a great many people.**
- **Holding gold and silver rather than time and savings deposits looks to be a sound strategy in this situation.**
- **Although precious metal prices have bounced back with a remarkable first-quarter surge this year, we still see some upward potential for the remainder of 2016.**

Secular stagnation

Some influential economists contend that the 'natural' real interest rate is now negative. They argue that central banks need to plunge interest rates into subzero waters to keep economies afloat—now or at the latest when the next wave of recession hits an already foundering ship.

They also contend that governments must leap at the opportunity presented by low interest rates and ramp up credit-financed spending. In other words, they're calling for defict-spending programmes to boost production and employment by bolstering overall demand.

Take, for example, the European Central Bank (ECB) and the Bank of Japan: They're already steering short-term borrowing costs to south of the zero line, thereby nudging bond yields for medium-to-long-term maturities into negative territory.

The same economists are also haunted by the spectre of deflation. Their fear is that output will subside and unemployment will soar if prices fall across the board for a sustained period. To quell this threat, they say central banks ought to open up the floodgates and let the money gush.

On the Keynesian concept of secular stagnation:

US economist Alvin E. Hansen (1887 - 1975) used the term 'secular stagnation' in his 1938 presidential address to express his concern that economic growth would remain lacklustre and unemployment high so that the US economy may never truly recover from the Great Depression. In a nutshell, Hansen feared that declining population growth, waning expansionism into new territories, dwindling resources, and fewer innovations and investments could hamper economic progress.
Hansen's theory of secular stagnation is enjoying a revival led by US economist Lawrence H. Summers. He points to evidence that the US and other economies may be heading for or already mired in secular stagnation, and blames an oversupply of savings relative to investment demand for the new negative "equilibrium interest rate." This has led Summers to conclude that two basic policy measures are in order: For one, central banks have to push the interest rate into negative territory, with cash to be banned for this measure to be effective. For the other, governments should embark on credit-financed spending programmes to spur aggregate demand and encourage investments.
There is much to say about the misconceptions behind the idea of secular stagnation and the grave threat that this policy would pose for major economies. However, this is not the place to explore these failings at length, so it must suffice to note that the notion of a negative equilibrium interest rate is absurd. Logic dictates that the equilibrium rate could never be zero, let alone negative. On top of that, the problems of slow growth and high unemployment that plague many economies around the world can be pinned squarely on today's unbacked paper money system. It has given rise to a colossal debt pyramid and malinvestments on a similarly vast scale. This crippling burden is now encumbering productive forces. A policy rooted in Keynesian economics would exacerbate rather than allievate the problems of low growth and high unemployment. What is needed to spur economic growth and full employment is a free market economy, driven by profit-oriented incentives, with minimum government interventionism. Meddling governments cannot be expected to solve the very problems their interference has caused: lacklustre growth and high unemployment.

The good doctors see secular stagnation as an affliction caused by an oversupply of savings relative to investment and consumption demand. They insist that there is but one remedy for the symptoms of low growth, meagre if any wage increases, and downwardly mobile prices for goods and services: interventionist economic policy.

Upon closer inspection, though, secular stagnation looks suspiciously like yet another Keynesian misconception that its adherents seem eager enough to perpuate as a means to their end, which is to influence economic policies.

If the public buys into the idea of secular stagnation, they'll be waving the green flag for central banks and finance ministries to not only continue cruising along with their current policies, but also to put the pedal to the medal with even more aggressive approaches.

Possible consequences

So, what strategies would a 'war on secular stagnation' entail? In all likelihood:

- Interest rates will remain very low for the foreseeable future, and central banks may at times even push for subzero rates.
- Governments will seek to discourage and even ban cash, for it prevents savers from circumventing the effects of negative interest rates.
- Central banks will keep banks and governments liquid by upping the money supply.
- Opportunities to go on credit-financed spending sprees are just too irresistible for governments seeking to bolster aggregate demand, and they will pounce when presented with half a chance.
- Efforts to axe unsustainable debt will be stepped up by declaring debt repudiation, imposing negative interest rates, and/or reducing the purchasing power of money—that is, by ramping up inflation.

The Keynesian standpoint is that such measures will help restore growth, but the Austrian School of Economics teaches that they are counterproductive and jeopardize prosperity.

Take, for instance, the negative interest rate policy. Keynesians would argue that it goes to restore economies' equilibrium. Austrians, in sharp contrast, would contend that it encourages capital consumption and malinvestment on a grand scale.

The notion that the purchasing power of money could be at peril seems prepostrous now, but if a campaign against secular stagnation gains sufficient momentum, peoples' lifetime savings—much of which is invested in bank deposits and bonds—could be in real danger.

Influencing the gold price

Such policy measures are sure to affect precious metals prices, and gold and silver prices especially. Determinants that have a systematic impact on the price of gold typically include:

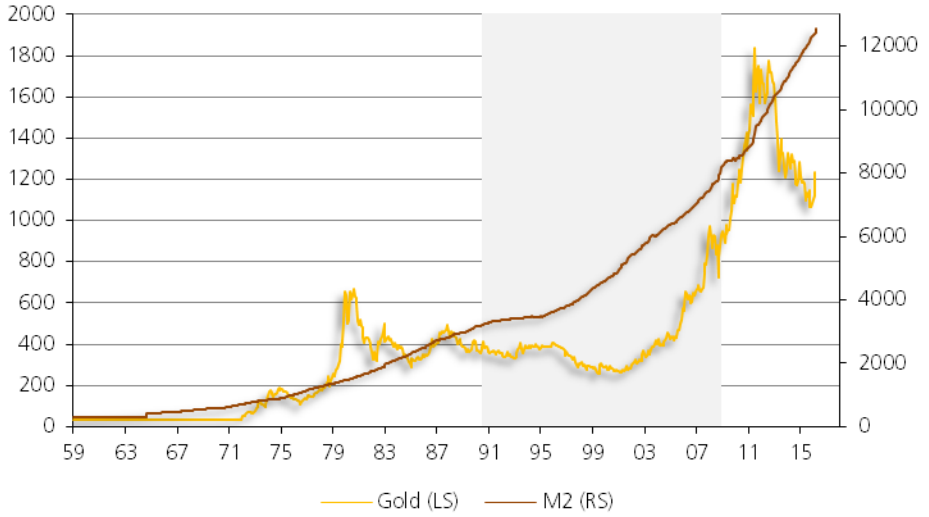
- *The money supply*: A rise (fall) in the quantity of available money can be expected to raise (lower) the prices for goods and services, including the price of gold, and vice versa.
- *Interest rates*: Rising (falling) interest rates make gold a less (more) attractive proposition. Declining (rising) demand for gold leads to lower (higher) prices (other things being equal).
- *Inflation*: The higher (lower) the inflation rate, the more (less) attractive it is to hold gold; the higher (lower) the demand for gold, the higher (lower) the price of gold will be.
- *Credit risk*: Rising credit risk makes gold more attractive; falling credit risk less so. Gold not only hedges against inflation, it also immunizes against payment defaults.

These determinants would figure prominently in any economic policy aimed to fight secular stagnation, and would surely drive up the gold price—and silver's as well, as the reader shall soon discover.

Let us zoom in for a closer look at perhaps the single most powerful determinant for the price of gold, the quantity of money. The graph below indicates that in the last decades, the growing money supply was accompanied by a higher gold price.

Monetary expansion, higher gold price

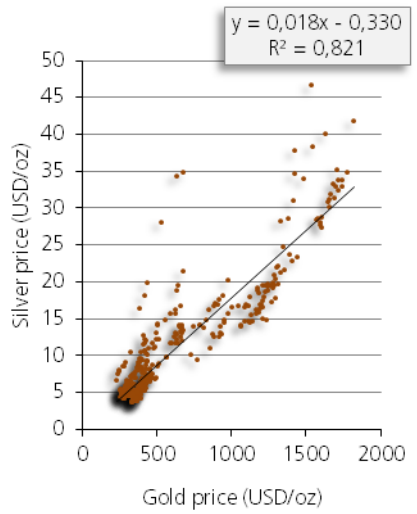
Gold price (USD/oz) and the M2 US money supply in billion $*



Source: Bloomberg. *Grey area:
Periods in which central banks were net sellers of gold

It also indicates that more recently, gold prices have been a lot lower than expected in view of the long-term relationship between the price of gold and the money supply. This suggests that gold is relatively inexpensive now, and that there is room at the top for the price to climb.

On the ratio between the prices of gold and silver
The price of silver in relation to the price of gold (in USD/oz, respectively)

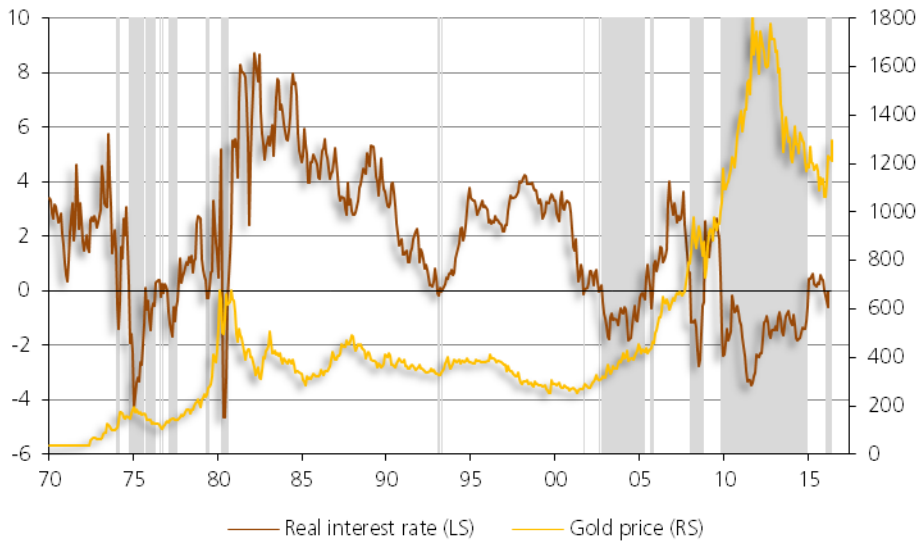


Source: Bloomberg; own calculations Period: February 1979 to May 2016

This graph shows the price of silver in relation to the price of gold (in US dollars per ounce, respectively) from February 1979 to May 2016. Two things stand out here: For one, there was a fairly close, positive relationship between silver and gold prices. A rise (fall) in the price of gold was accompanied by a rise (fall) in the price of silver. For the other, the change in the price of silver was disproportionate to the change in gold price: In the period under review, a 10 percent rise in the gold price was accompanied by an 18 percent rise in the silver price, on average (and vice versa).
What's more, statistical evidence indicates that *directional movements* of the silver price were by and large caused by changes in the gold price. The silver price had no life of its own, so to speak. That said, betting money on silver tended to be a strategy for investors to *leverage* their price expectations as far as gold was concerned.
All this suggests that silver could be looking like an increasingly attractive proposition for savers and investors in this era of mounting 'financial repression.' A natural diversification of precious metals portfolios could well follow. Perhaps most importantly, silver could be a less enticing target for governments than gold, which is still the world's ultimate means of payment. As such, it is the unerring and incorruptible barometer of peoples' confidence in unbacked paper money.

The real (inflation-adjusted) interest rate is another important determinant for the gold price. In the past, the gold price climbed during periods of negative real market interest rates, most notably at the start of the 21st century.

Negative real rates, higher gold price
Gold price (USD/oz) and US real interest rate*



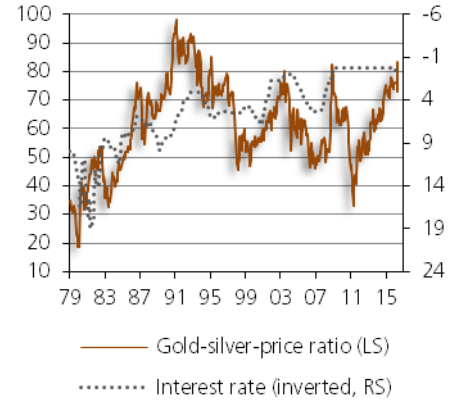
Source: Bloomberg; own calculations
*Three-month US interest rates minus consumer price inflation
Grey areas: Periods of a negative real interest rate

The gold-to-silver price ratio

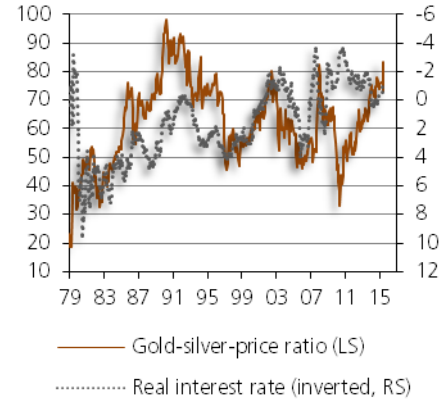
If economic policy is deployed as the main weapon against secular stagnation, negative interest rates and a vastly greater money supply will be the new normal. And that will have consequences for precious metals prices.

Ratio between the gold and silver price (USD/oz) and US interest rate*

(a) Gold-to-silver price ratio and nominal interest rate



(b) Gold-to-silver price ratio and real interest rate**



Source: Thomson Financial; own calcuations. *Federal Funds Rate. **Deflated with US consumer price inflation

If the outlook calls for the gold price to rise, then what is in store for the silver price? The gold-to-silver price ratio is now around 74, which is historically a fairly high level. However, caution is in order when interpreting the gold-to-silver price ratio.

Generally speaking, the gold-to-silver price ratio does not provide any clear-cut clues that would compel an investor to buy or sell, at least not over the short-to-medium term. However, if we look at its long-term trajectory, a very interesting picture emerges: The gold-to-silver price ratio is *negatively correlated with the interest rate*.

In the past and on average, silver outperformed gold when interest rates climbed, while gold outperformed silver when interest rates dropped. The negative interest rate policy advocated by those who wish to wage war against secular stagnation would therefore favor gold over silver.

However, there is a strong argument why silver may become somewhat more attractive going forward than the prospects of negative interest rates would lead us to expect: Silver has a monetary function, which has been increasingly phased out in recent years.

Under a policy regime aimed to combat secular stagnation, many savers and investors may want to diversify their precious metals holdings, mainly for two reasons: Silver has been underperforming in recent years and therefore (still) has the potential to outperform gold. And silver is less likely than gold to fall prey to governments' 'financially repressive' actions. In other words: If push comes to shove, holding silver is much less likely to collide with government interests than holding gold.

Gold, silver and stocks

When interest rates dwindle towards or dip below zero, bank time and savings deposits forfeit their competitive advantage over gold and silver. It is fair to say that the latter becomes a serious rival for the former.

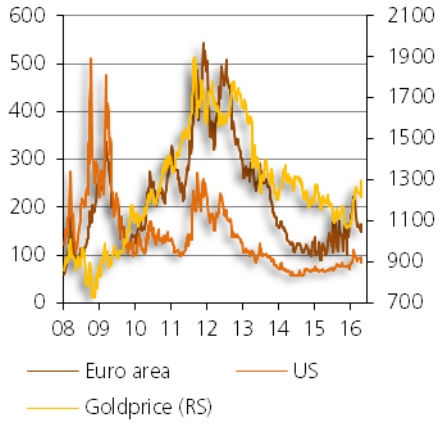
The purchasing power of gold and silver cannot be reduced as political expediency dictates; say, by pursuing a negative interest rate policy and turning the spigot to flood the money pool. This is why gold and silver can be considered substitutes for relatively liquid bank deposits held for the medium to long term.

In that sense, gold and silver immunize the portfolio against the evils of the unbacked paper money system, which can be expected to be used for outright inflationary purposes once governments whole-heartedly embrace a policy targeting secular stagnation.

Of course, gold and silver serve monetary purposes, for example, to store wealth. They are no substitutes for productive capital such as investments in companies, which yield a positive return on capital invested for as long as economic growth persists.

At a time when governments and their central banks are poised to go all-out in their efforts to fight secular stagnation, investors should seriously consider replacing some longer-term bank deposits with gold and silver, and investing in stocks rather than bonds.

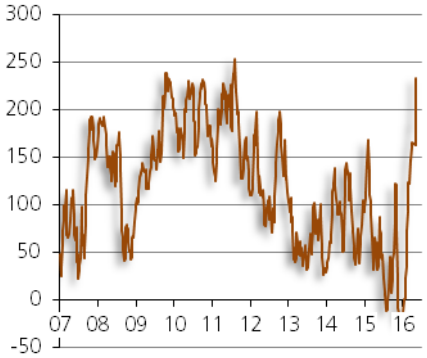
Credit default concerns remain relatively subdued
CDS* on banks (in basis points) and the gold price (USD/oz)



Source: Bloomberg. *"Credit Default Swap" (CDS) spreads for 5-year bank bonds. Put simply, CDS spreads denote the price for insuring against payment defaults

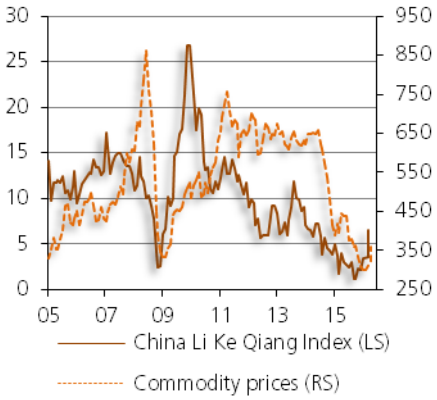
Central banks are keen to dispel any concerns that governments and banks could default on their payment obligations. This is why they have cut interest rates to exceedingly low levels and are bailing out financially ailing borrowers by issuing any amount of credit and money required. This policy has mitigated credit default concerns since late 2012 in the USA and since mid-2013 in the euro zone.
The gold price dropped as investors' credit default concerns dwindled. Why did this happen? Holding gold is not only a hedge against inflation. It is also an insurance against credit defaults: In contrast to bank deposits and bonds issued by governments, corporates and banks, gold does not carry any credit (or payment) risk. When financial markets realized that central banks would keep the system on life support for political reasons, credit default concerns eased considerably, and demand for insurance against payment defaults waned. That is why the gold price came down.
However, it takes more than just a leap of faith to believe that central banks can keep churning out ever more credit and money to fend off credit default concerns without at some point sparking inflation concerns. And surging expectations of inflation will benefit the price of precious metals, gold and silver in particular, and especially so if and when central banks hold interest rates down at artificially low levels.

Institutional investors bullish on gold again
Net long positions in gold of managed money, contracts in k



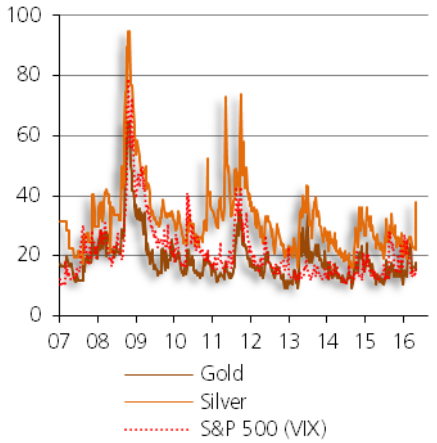
Source: Bloomberg.

China's economy over the hump—for now
China's business cycle indicator and commodity prices (in US dollar)



Source: Bloomberg.

Precious metals price volatility still at a relatively low level
Volatility in percent*



Source: Bloomberg; calculated from 1 mths at the money options.

Precious Metals Market

Precious metal prices have the potential to climb further; price volatility, however, is likely to increase.

Precious metals prices in the last two weeks

	Gold	Silber	Platin	Palladium
In USD (per ounce)				
Actual	1265.7	17.0	1048.5	587.5
Change in the last two weeks				
in USD	26.0	0.0	35.1	-17.1
in %	2.1	-0.1	3.5	-2.8
Highest price	1293.0	17.8	1080.5	623.1
Lowest price	1237.9	17.0	1013.4	584.8
In Euro (per ounce)				
Actual	1109.6	14.9	920.4	515.7
Change in the last two weeks				
in USD	13.6	-0.1	23.2	-19.5
in %	1.2	-1.0	2.6	-3.6
Highest price	1130.6	15.5	947.5	549.6
Lowest price	1096.0	14.9	897.2	513.4

Source: Bloomberg; own calculations.

Seeing as how precious metals prices have spiked since the start of this year, investors may be asking themselves if these price gains are here to stay. And if so, is there room for more growth in the course of the year?

The recent hikes in gold, silver, platinum and palladium prices came in a bearish market where the outlook for the global economy was rather less than rosy. Meanwhile, though, the data suggest that cyclical improvements are underway in many parts of the world. At the very least, economic activity is far more brisk than the majority of market observers had expected. Perhaps most significantly, it would appear that the prevailing regime of rock-bottom interest rates has provided a shot in the arm to global business, even if there will be a tall toll to pay for all the malinvestment that is likely to follow. Commodity prices in general are rebounding, a development which bodes well for precious metals prices. Recent increases in precious metals certainly seem to be driven by fundamentals rather than speculation.

As long as governments keep the low interest rate policy going and the money supply growing, there is little to suggest that the upward drift of precious metals prices will stall. Most notably, the demise of the interest rate can be expected to lead to a *structural rise in the demand for gold and silver*. Institutional investors that tend to seek exposure to the precious metals market via exchange trade funds (ETFs) are likely to take a keen interest in gold, silver, platinum and palladium. Other investors may well follow. This is why we remain quite confident that precious metals' latest price gains are here to stay. There is reason to believe that prices may rise even further in 2016.

As can be seen in the table on the next page, we have revised our price estimates for gold, silver, platinum and palladium slightly upwards from the latest update of January this year. Note, though, that price volatility is most likely to increase from here on out if governments and their central banks meddle even more in the marketplace. This will create additional uncertainty, which will most likely spill over into precious metals markets.

Precious metals prices, actual and projections (per ounce)

In US-dollar

	Gold		Silver		Platinum		Palladium	
I. Actual	1,265.7		17.0		1,045.9		584.2	
II. Gliding averages								
5 days	1,279.2		17.3		1,061.9		599.6	
10 days	1,273.8		17.4		1,055.4		608.3	
20 days	1,258.0		17.0		1,029.5		593.1	
50 days	1,247.2		16.0		990.3		575.7	
100 days	1,191.8		15.3		939.4		543.6	
200 days	1,153.4		15.1		939.9		576.1	
III. Projections								
	Rante		*Range*		*Range*		*Range*	
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
Q1 2016	1,020	1,127	13.1	14.7	720	870	400	538
Q2 2016	1,139	1,280	16.1	17.3	790	1,050	560	610
Q3 2016	1,175	1,320	16.1	17.9	820	1,090	580	630
Q4 2016	1,251	1,360	15.6	18.4	770	1,130	590	650
Q1 2017	1,279	1,390	16.3	19.1	1,010	1,180	620	670
IV. Annual averages								
2013	1,398		23.4		1,473		725	
2014	1,252		18.6		1,370		805	
2015	1,227		16.8		1,190		775	
2016 (projected)	1,209		16.2		905		570	

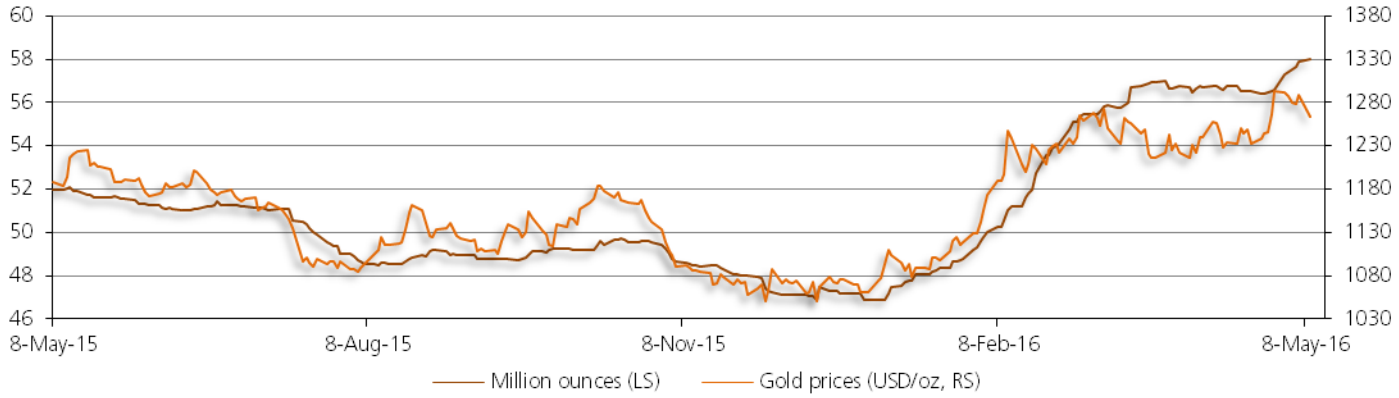
In Euro

	Gold		Silver		Platinum		Palladium	
I. Actual	1,111.1		14.9		918.2		512.9	
II. Gliding averages								
5 days	1,117.6		15.1		927.8		523.8	
10 days	1,115.7		15.2		924.4		532.9	
20 days	1,107.4		15.0		906.2		522.1	
50 days	1,107.6		14.2		879.2		511.2	
100 days	1,071.5		13.7		844.5		488.7	
200 days	1,040.1		13.6		847.4		519.5	
III. Projections								
	Range		*Range*		*Range*		*Range*	
	Low	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
Q1 2016	898	993	11.5	13.0	634	767	352	474
Q2 2016	1,065	1,196	15.1	16.2	738	981	523	570
Q3 2016	1,119	1,257	15.3	17.0	781	1,038	552	600
Q4 2016	1,227	1,333	15.3	18.0	755	1,108	578	637
Q1 2017	1,279	1,390	16.3	19.1	1,010	1,180	620	670
IV. Annual averages								
2013	1,052		18		1,108		545	
2014	949		14		1,036		611	
2015	1,045		14		945		619	
2016 (projected)	1,131		15		847		533	

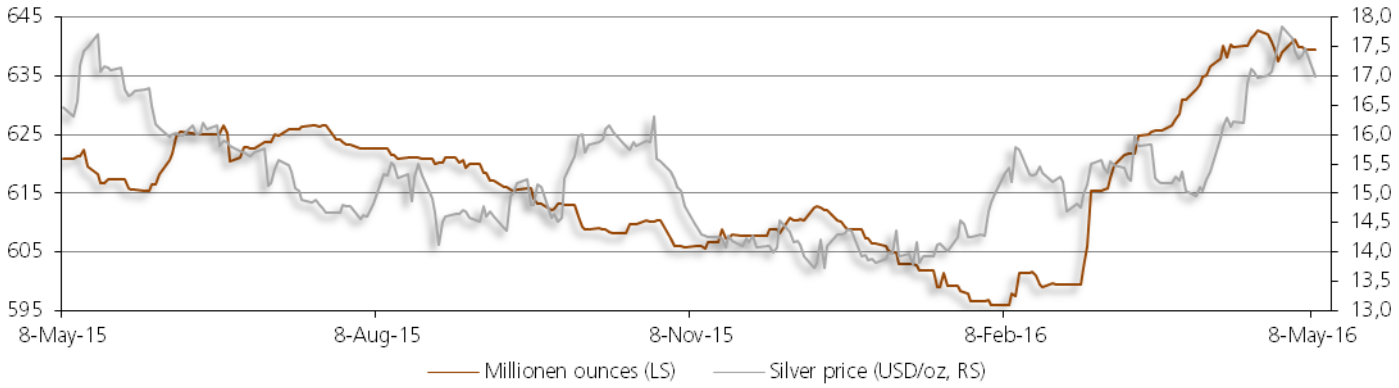
Source: Bloomberg; own calculations. Projections of Degussa Goldhandel GmbH (end of quarter); numbers are rounded.

Precious metals prices and ETF holdings

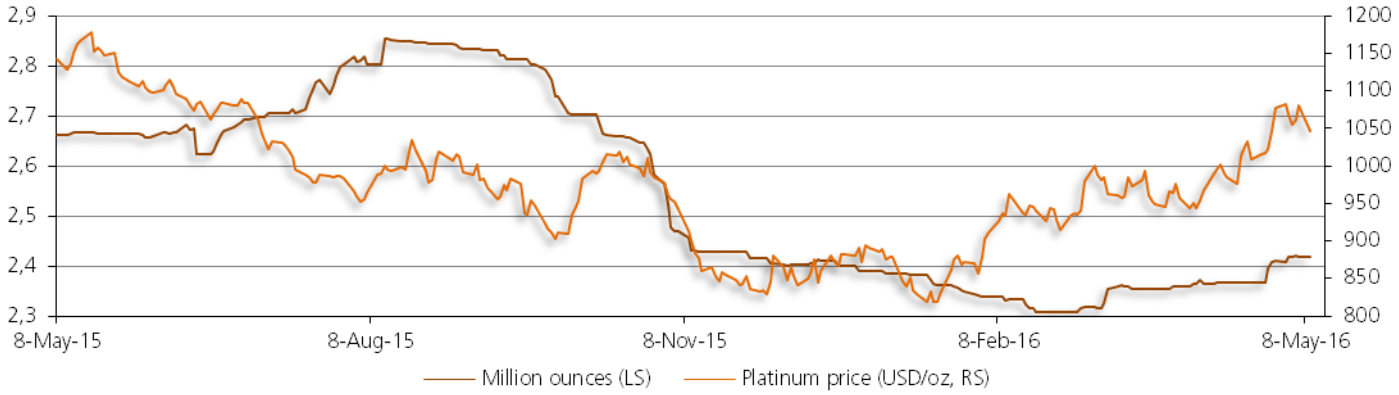
Gold ETFs (million ounces) and gold price (USD/oz)



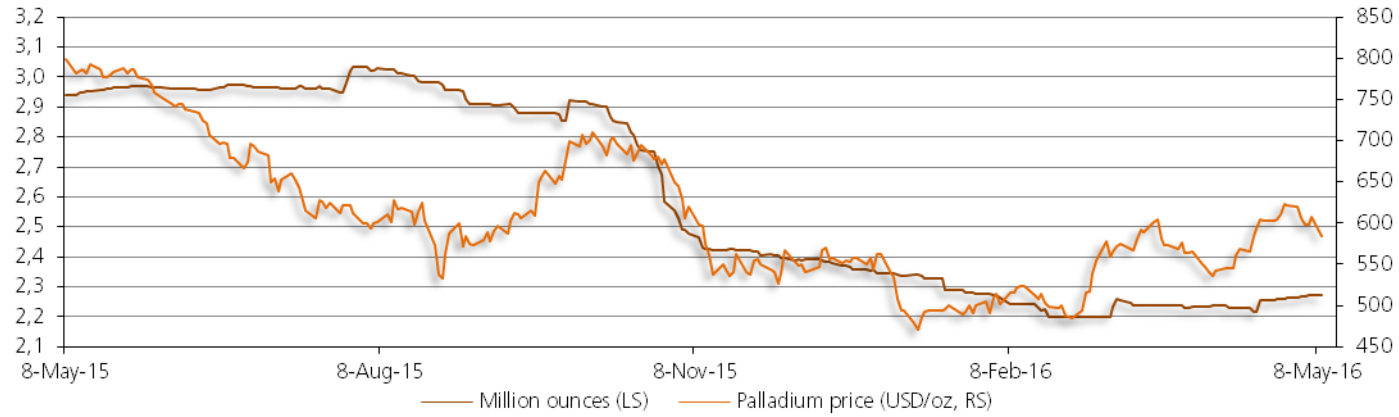
Silver ETFs (million ounces) and silver price (USD/oz)



Platinum ETFs (million ounces) and platinum price (USD/oz)



Palladium ETFs (million ounces) and palladium price (USD/oz)



Source:Bloomberg

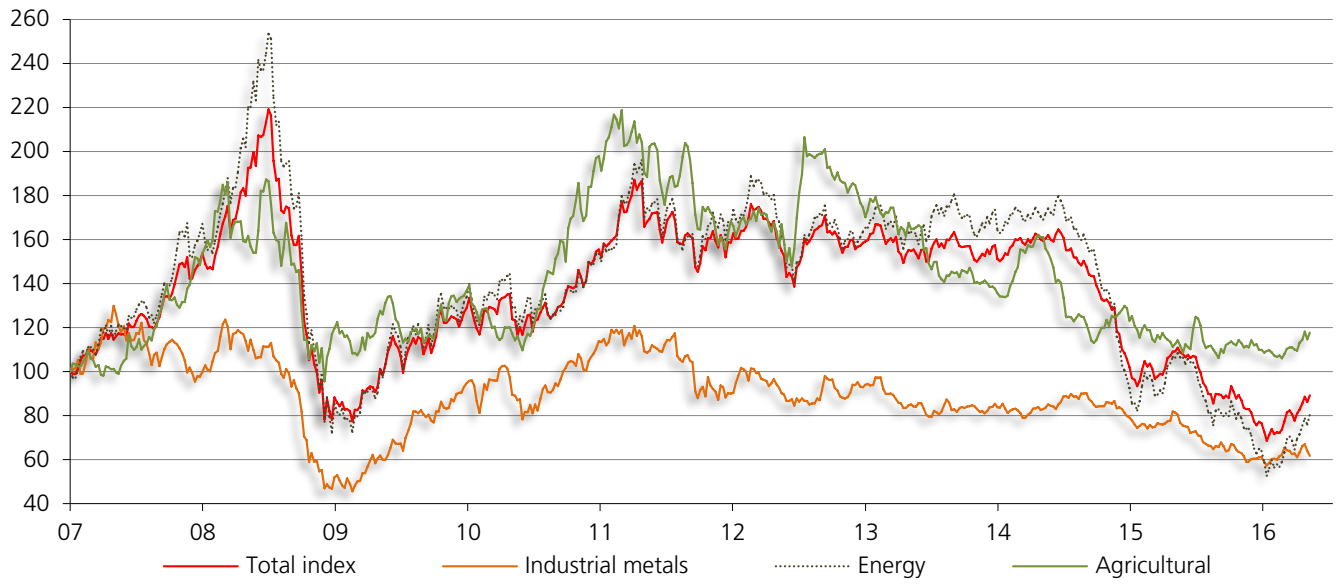
Commodity prices

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	.	-5.5	17.7	14.2	-5.8	-32.4	43.0	51.5
Brent crude oil	44.05	-7.0	16.4	14.7	-9.5	-38.1	43.6	53.8
Gasoline	145.33	-9.4	7.1	6.6	-7.4	-27.1	35.4	40.8
Heating oil	129.85	-6.3	14.5	14.5	-9.7	-36.7	45.1	49.5
Gas oil	386.50	-6.6	13.2	16.5	-14.5	…	46.1	48.0
Natural gas	2.14	-1.9	12.7	-11.1	-12.3	-30.0	50.1	38.8
II. Agriculture								
Corn	368.50	-5.9	1.9	-3.4	-4.0	-10.0	28.9	19.1
Wheat	456.25	-6.6	-0.9	-7.0	-7.4	-14.6	32.6	23.9
Soy beans	1030.25	0.0	18.8	15.8	15.1	6.3	22.1	15.4
Coffee	127.10	4.6	8.6	5.7	2.6	-16.1	26.3	26.5
Sugar	16.02	-1.8	12.8	22.8	13.1	9.0	36.4	31.7
Cotton	61.71	-3.2	9.7	-0.4	-3.5	-6.6	18.4	16.1
III. Industrial metals								
Aluminum	1561.00	-7.0	-0.8	2.8	8.0	-18.9	19.3	18.3
Copper	4686.00	-7.2	-0.2	2.7	2.2	-26.0	21.7	21.8
Zinc	1835.00	-5.3	4.0	13.1	17.4	-21.7	28.1	30.0
Lead	1730.50	-4.1	-1.3	0.7	5.1	-18.0	24.2	25.2
Iron ore	60.50	0.2	30.4	46.1	39.7	4.5	…	…
IV. Precious metals								
Gold	1265.44	-2.2	2.7	13.2	18.9	7.1	16.0	17.8
Silver	17.07	-4.4	15.1	19.7	21.0	6.3	23.5	25.0
Platinum	1045.90	-2.8	12.1	20.0	25.8	-7.8	25.5	25.4
Palladium	585.75	-5.9	18.5	17.3	7.9	-24.6	27.0	30.3
V. Ratios								
Gold-silver	74.14	2.3	-10.8	-5.2	-1.7	0.7	15.0	15.1
Gold-platinum	1.21	0.7	-8.5	-5.3	-5.5	16.2	13.9	18.9
Gold-palladium	2.16	4.8	-13.3	-3.8	10.2	42.1	25.4	31.5
Palladium-platinum	0.56	-3.8	5.7	-1.7	-14.2	-18.3	23.5	26.8

Source: Bloomberg; own calculations.

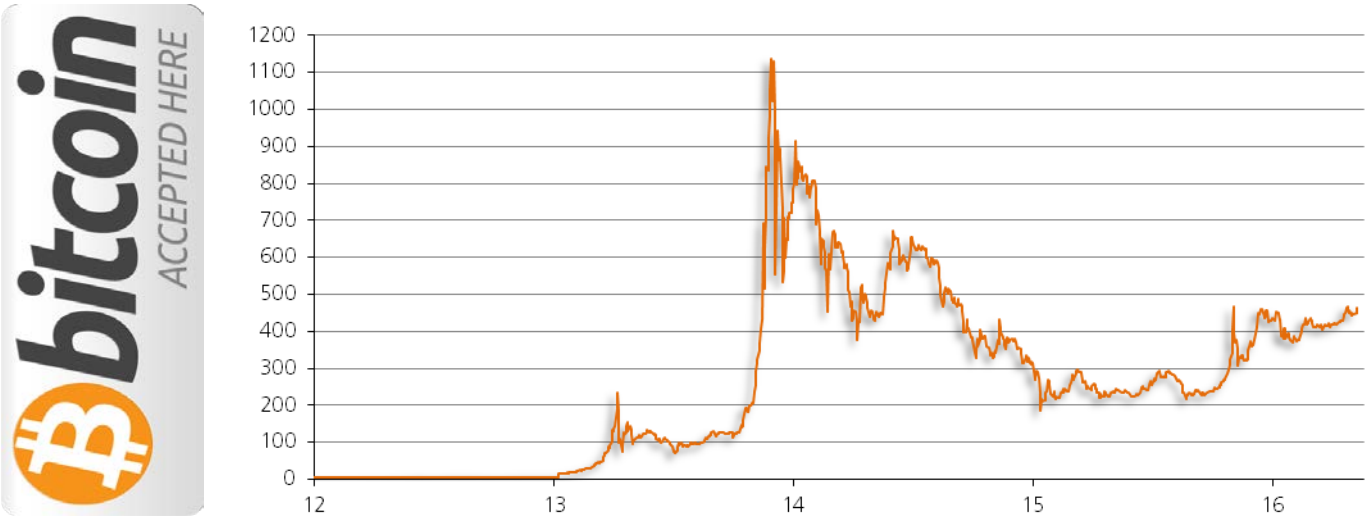
S&P commodity prices (in US dollar terms)



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

Bitcoin, performance of various asset classes

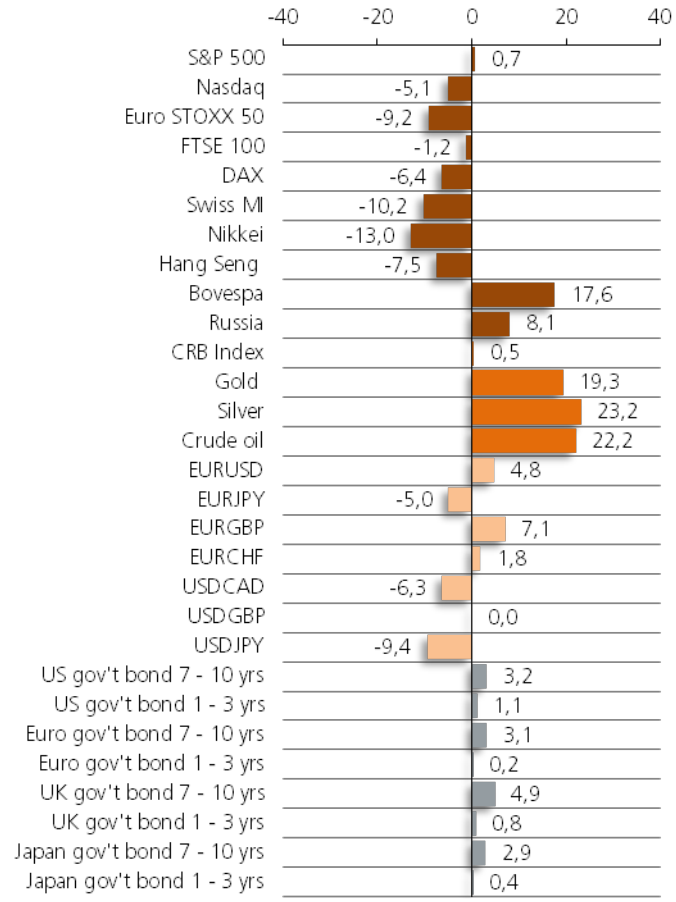
Bitcoin per US dollar



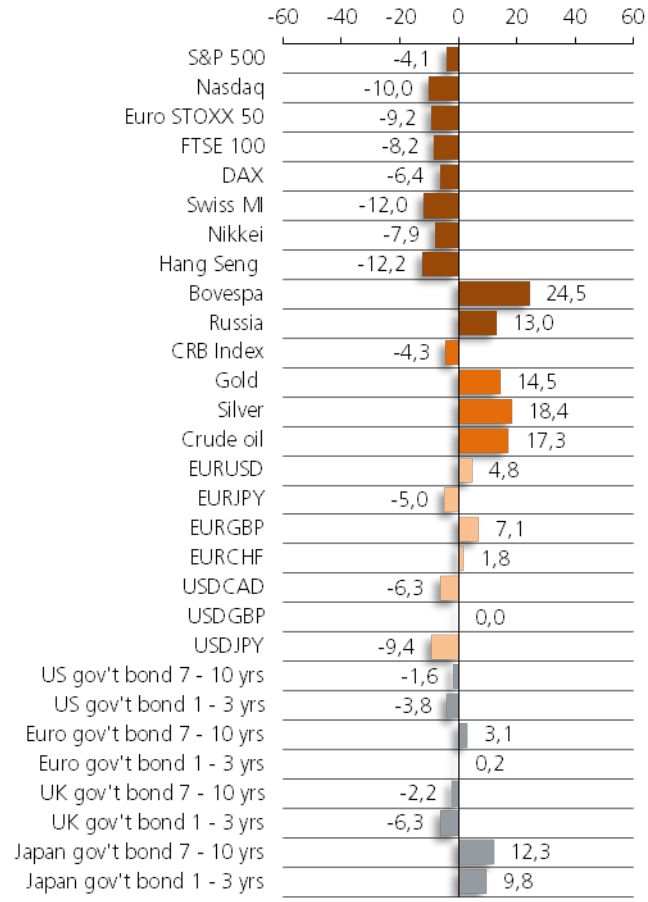
Source: Bloomberg

Performance of various asset classes since the start of the year in percent

(a) In national currencies



(b) In euros



Source: Bloomberg, own calculations

Articles in earlier issues of the *Degussa Market Report*

Issue	Content
13 May 2016	The Fight Against 'Secular Stagnation' and Its Consequences for Gold and Silver Prices
29 April 2016	US Dollar's Dominance Challenged By Gold
15 April 2016	A World without Returns
1 April 2016	Helicopter Euros Hovering on the Horizon
18 March 2016	Gold and Stocks Protect Against Helicopter Euros

The Degussa Marktreport (German) and the Degussa Market Report (English) are available at:
www.degussa-goldhandel.de/de/marktreport.aspx.

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