Degussa Market Report

16 February 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	1.350.0	0.0	5.9	8.1
Silver	16.8	-3.2	2.5	-8.1
Platinum	1.000.2	-0.9	6.3	-2.2
Palladium	1.016.3	-6.9	1.0	32.2
II. In euro				
Gold	1.082.1	-0.4	1.1	-8.3
Silver	13.5	-3.7	-2.1	-21.9
Platinum	801.7	-1.3	1.7	-16.9
Palladium	815.0	-7.3	-3.7	12.1
III. Gold price in other currencies				
JPY	144.075.0	-1.8	0.5	2.4
CNY	8.564.3	0.4	1.7	-0.1
GBP	959.8	0.8	1.9	-4.8
INR	86.280.4	1.9	5.0	3.7
RUB	76.731.0	1.1	3.0	5.5

Source: Thomson Financial; own calculations.

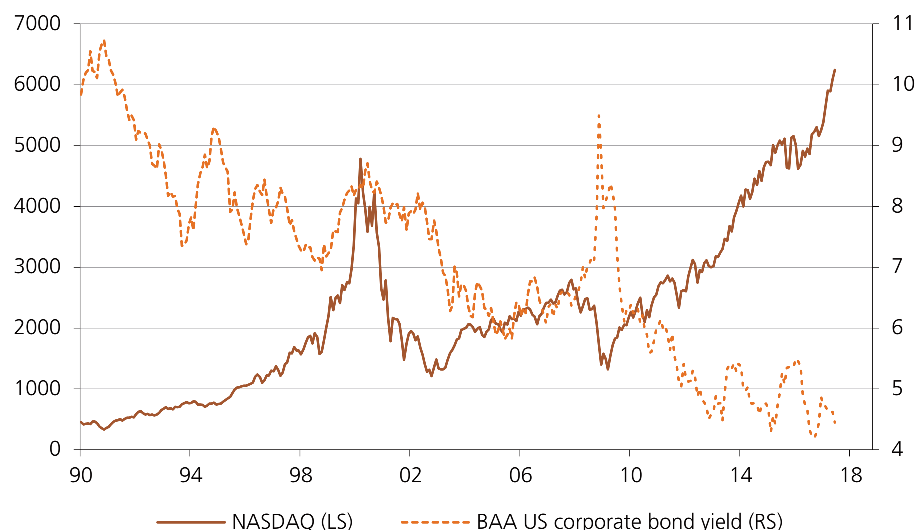
OUR TOP ISSUE

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

The Fed makes the stock market a risky place

Reading through *Security Analysis*, the roadmap for investing first published in 1934 by Benjamin Graham (1894 – 1976) and David L. Dodd (1895 – 1988), I learned something quite interesting: The basis of stock valuation had changed quite drastically in the period between 1927 and 1929. The stock buying public "departed more and more from the factual approach and technique of security analysis and concerned itself increasingly with the elements of potentiality and prophecy"[1], write Graham and Dodd.

1 Declining interest rates propel stock prices higher
NASDAQ and US corporate bond yield in percent



Source: Thomson Financial.

What they mean is that in the pre WWI world, stocks were typically valued on the basis of a three-part concept: (i) a decent track record of firms' dividend returns, (ii) a stable and satisfactory earnings record, and (iii) a strong balance sheet, with sufficient backing by tangible assets.[2] The "New-Era" theory of stock valuation reads, summarized in one sentence, as follows: "The value of a common stock depends entirely upon what it will earn in the future."[3]

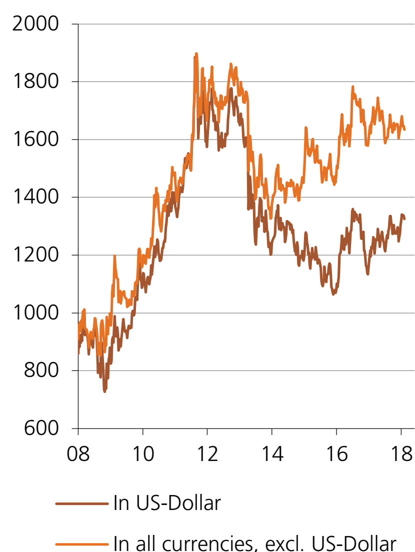
Current dividends should only have a slight impact upon a stock's valuation, and as firms' asset values did not have an apparent relationship with their earning power, asset values were said to be devoid of importance when it comes to cal-

[1] Graham, B., Dodd, D. L. (1940), Security Analysis, p. 349.
[2] *Ibid*, p. 356.
[3] *Ibid*, p. 356.

Gold price per ounce

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

January 2008 to February 2018



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.

culating a stock's "fair price". A firm's earnings record was only relevant to the extent that it might indicate what changes in a firm's future earnings were likely to be expected. In other words, the New-Era theory of stock valuation was quite a break compared to the valuation technique employed in the past.

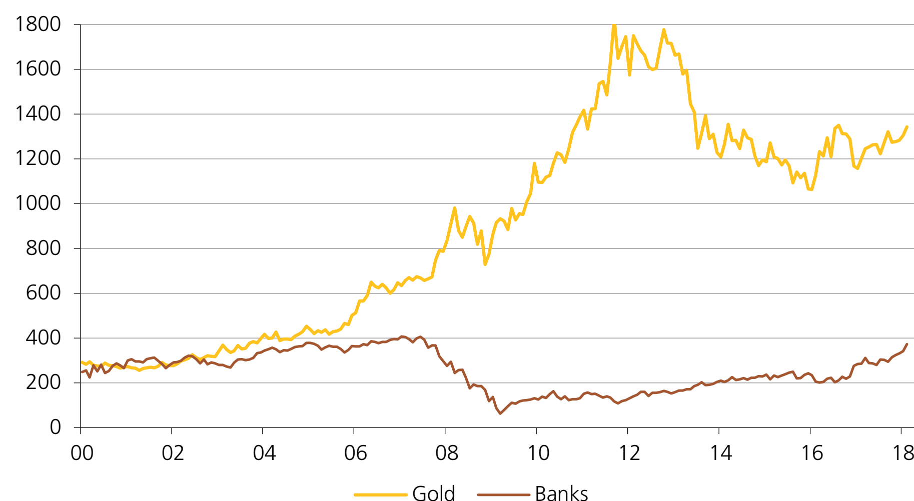
According to Graham and Dodd, there were two significant causes why such a change in the approach to stock valuation occurred. First, accounting data of a firm's past proved to be increasingly unreliable as a guide for making wise investment decisions. The reason for this was rapid changes in demand structures and product and process technologies. Second, the expectation of future rewards became increasingly attractive to many investors, in fact, "irresistibly alluring".

The New-Era theory of stock valuation, which people followed in the hot phase of the 1927-1929 stock market rally, turned out to suffer from two weaknesses, according to Graham and Dodd. First, it encouraged people to speculate heavily: Stock prices were driven by expected future profits, detached from "the facts of the established past". Second, established standards of valuation were thrown overboard. Any prevalent valuation level could easily be interpreted to be the new standard of valuation.

"Fantastic reasoning" fuelled the stock market bubble because people did not have to concern themselves with the question of the "fair price" of a stock any longer. With the New-Era theory of valuation, people would buy "good" stocks, regardless of their price, in the hope of having found a get-rich-scheme, given that there was the possibility of the new level of standard valuation in the future being higher than the level of standard valuation seen in the past. We all know how tragic this doctrine turned out to be.

2 Gold protects against financial system risks

Price of gold (USD/oz) and US bank share prices (S&P 500)



Source: Thomson Financial.

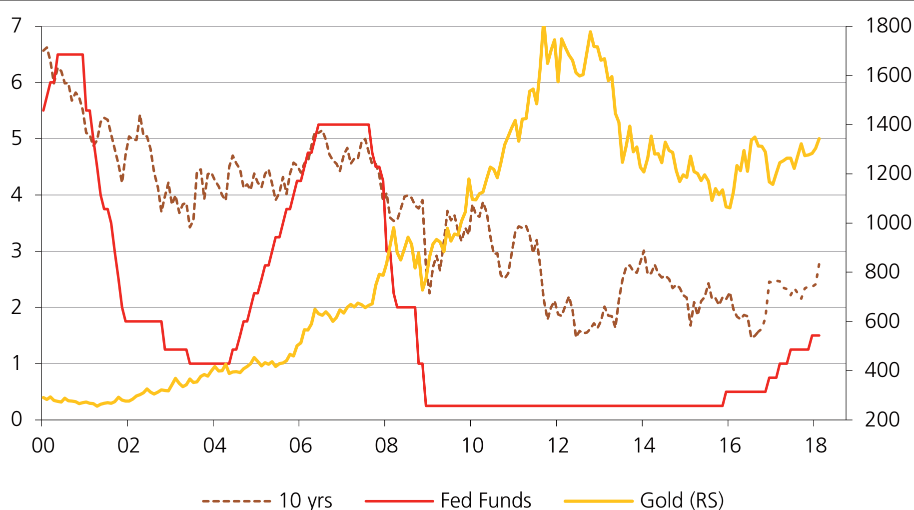
Then, the New-Era theory of valuation developed into a somewhat more elaborate doctrine. In his book "The Theory of Investment Value", published in 1937, John Burr Williams (1900 – 1989), presented the "dividend discount model". It says that the value of a firm's stock – and thus its "fair" price – is equal to the present value of all its future dividends. Williams' dividend discount model has become the standard valuation formula for stocks. However, it stands in the tradition of the New-Era theory of valuation doctrine.

The dividend discount model caters to speculative frenzies. For instance, it might justify a high price of a firm's stock even if the firm has not delivered any dividend so far – just by referring to a firm's earnings power that is hopefully going to unfold in the future. At the same time, however, the dividend discount model clearly rests on a sound economic idea. It epitomizes a *category of human action*, namely *time preference*: One US dollar today is –and logically so – valued more than a buck to be received in one year's time.

Assume an investor calculates that the "fair" stock price based on the dividend discount model to be 100 US$. He realizes that the stock trades in the market at 80 US$. In this case, the dividend discount model would recommend *buying* the stock. If, however, the "fair" stock price turns out to be, say, 60 US$, the investor is advised to refrain from buying the stock. Likewise, if the investor finds that the fair value of the stock he bought at 80 US$ has fallen to, say, 60 US$, the recommendation is selling the stock.

3 Gold price undeterred by higher interest rates

Price of gold (USD/oz) and selected US interest rates in percent



Source: Thomson Financial.

In addition to estimating a firm's future dividends, the investor must also come up with an estimate of the interest rate with which future dividends are discounted to the present. If using too high (low) a discount rate, the investor will underestimate (overestimate) a stock's "fair" price. As a result, the investor will miss attractive investment opportunities (or buy an overpriced stock, yielding an unsatisfactory return). As it turns out, the interest rate plays a particularly critical role in this context.

This is because in a world of unfettered paper – or *fiat* – money, the interest rate is controlled by the central bank. In the US, for instance, the Federal Reserve (Fed) controls short-term interest rates. In doing so, the Fed determines commercial banks' funding costs and governs more or less all other interest rates in the market as well. Against this backdrop, it becomes clear that the Fed exerts an enormous influence on stock prices and valuations if and when investors make use of the dividend discount model.

There are two important ways through which the central bank and its effectively *inflationary machinations* influence stock prices. *First*, a lowering of Fed interest rates reduces the discount rate with which investors discount expected future dividends, thereby increasing the "fair" values of stocks. *Second*, lowering the Fed

interest rates brings down firms' credit costs. This, in turn, lowers firms' interest expenditures, translating into higher profits, thereby also increasing a firm's present value and thus its stock price.

While the Fed can pump up stock prices by way of bringing its interest rate down, such a market intervention has, without doubt, *seriously negative side effects*. This is what the Austrian Business Cycle Theory (ABCT) unmistakably reveals. If the central bank facilitates the increase in the quantity of money through bank credit expansion, the market interest rate will inevitably and artificially be depressed below its "natural level" – the impact of which will not be lost upon consumers, entrepreneurs, banks, and states.

The economy will embark upon a debt-financed "boom". Artificially lowered interest rates cause consumption and investment to go up and savings to go down. The economy starts living beyond its means and is put on an unsustainable path. The credit-fuelled economic expansion can only be upheld if and when the central bank succeeds in pushing interest rate to ever lower levels. Pushing down the interest rate to an unnaturally low level is a policy of preventing the boom from turning into "bust".

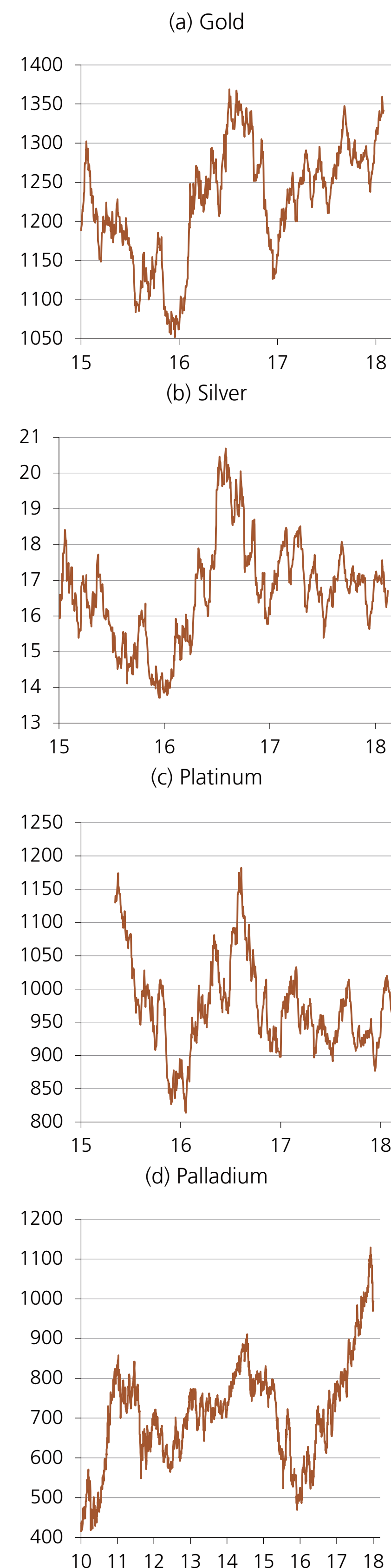
As long as investors remain confident that the central bank will succeed in keeping the economy going by bringing interest rates down over time, monetary policy itself will cause "fair" stock prices to go up. This is all the more a delicate insight because central banks' policies of artificially lowering the interest rate inevitably lead to malinvestment. Firms are tempted to embark upon investment projects many of which cannot be realized profitably – investments that in the end won't increase but decrease the value of many firms.

For central banks' inflationary machinations lead to a squandering of scarce resources and cause a great deal social and political problems. As Ludwig von Mises (1881 – 1973) was well aware of the consequences of the boom. He noted: "The boom produces impoverishment. But still more disastrous are its moral ravages. It makes people despondent and dispirited. … In the opinion of the public, more inflation and more credit expansion are the only remedy against the evils which inflation and credit expansion have brought about."[4]

As soon as firms realize that their profits fall short of expectations, they cut production. Jobs created in the boom will be lost. The artificial boom collapses. Businesspeople and investors find themselves misled by central banks' downward manipulation of interest rates. Stocks, hitherto traded at seemingly justified high valuation levels, crash. In an attempt to fend off the economic and financial crisis, the central bank brings interest rates to even lower levels, thereby postponing economic adjustment and causing even more malinvestment.

Fiat money and central banking are the reasons why the economies experience the rather unpleasant boom-bust-cycle phenomenon, most notoriously accompanied by wild swings in stock prices and stock valuation levels. It is by no means an exaggeration to say that it is the Fed that makes the stock market a risky place. This becomes pretty obvious when we combine the insights about the history of the doctrines of stock valuation and sound economics in the form of the ABCT.

Precious metal prices (USD/oz)



Source: Thomson Financial.

[4] Mises, L. v. (1998), Human Action, p. 574.

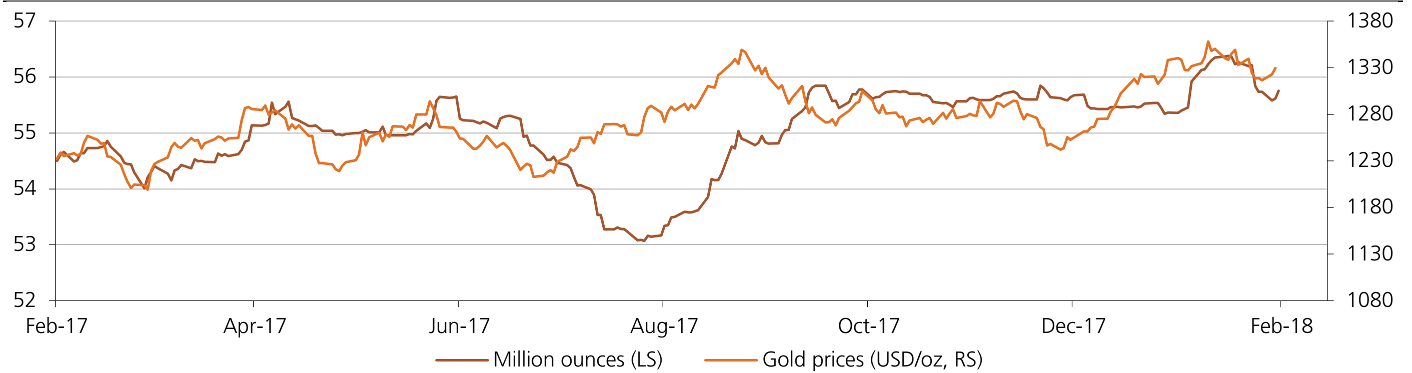
Gold In Art

Gold was extremely important in ancient Egypt. For the Egyptians, gold was the symbol of: the sun, divine enlightenment, wisdom and immortality; was the visible presence of the gods in matter. Golden grave goods date back to 4,000 BC and were meant to help to eternal existence. The photo above shows the death mask of Pharaoh Tutankhamun, who is said to have reigned between 1332 and 1323 BC. His magnificent golden death mask covers head, shoulders and chest, and it has a weight of more than 12 kilograms. It is now in the Egyptian Museum in Cairo.

With friendly support of Dr Ruth Polleit Riechert*, Art Historian.*

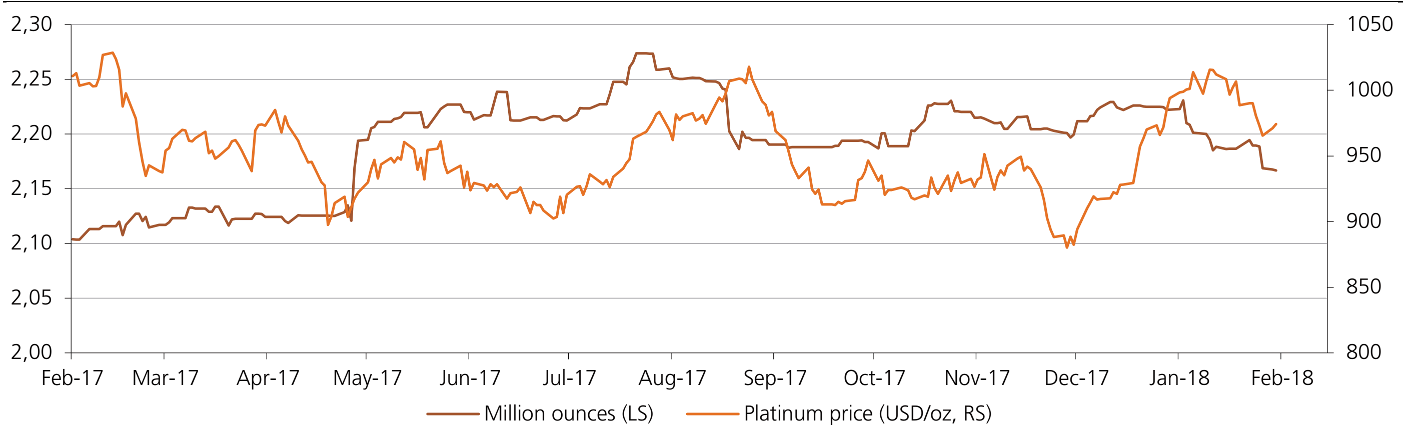
Precious metals prices and ETF holdings

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.

Looking ahead: precious metals prices

In US-dollar

	Gold		Silver		Platinum		Palladium	
I. Actual	1354.6		16.9		1004.2		1016.7	
II. Gliding averages								
5 days	1326.3		16.5		970.0		985.0	
10 days	1329.0		16.6		980.6		1006.0	
20 days	1335.5		16.9		995.3		1048.2	
50 days	1308.1		16.7		957.7		1052.6	
100 days	1294.4		16.8		942.2		1016.2	
200 days	1282.7		16.8		944.6		945.8	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1248	1472	16.0	21.0	936	1048	1033	1261
(1)	*-8*	*9*	*-6*	*24*	*-7*	*4*	*2*	*24*
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	1085.7		13.6		804.9		814.9	
II. Gliding averages								
5 days	1077.5		13.4		788.1		800.2	
10 days	1076.0		13.4		793.9		814.4	
20 days	1081.1		13.7		805.7		848.5	
50 days	1080.6		13.8		790.9		869.9	
100 days	1085.0		14.1		789.5		851.6	
200 days	1093.2		14.4		805.1		804.8	
III. Bandwidths for 2018	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*	*High*
	1069.2	1260.5	13.7	18.0	801.7	897.9	884.5	1080.0
(1)	*-2*	*16*	*1*	*32*	*0*	*12*	*9*	*33*
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.

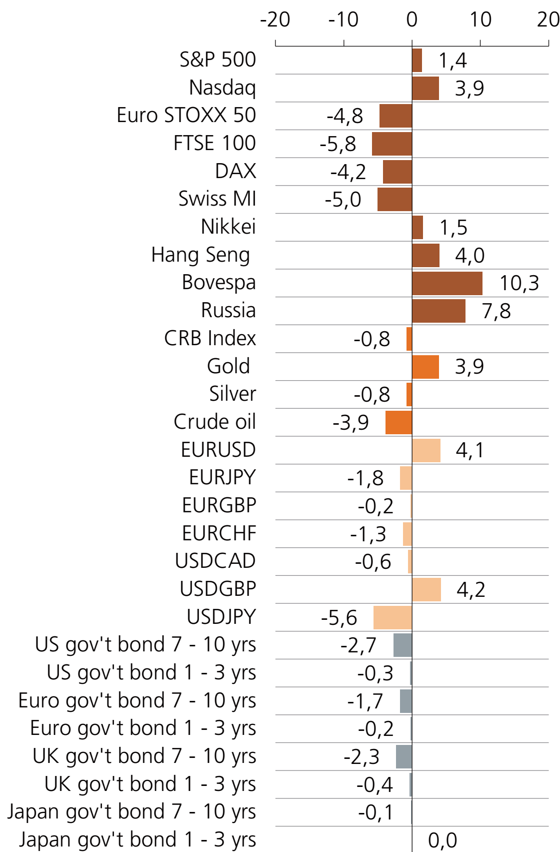
Bitcoin, performance of various asset classes

Bitcoin in US dollars

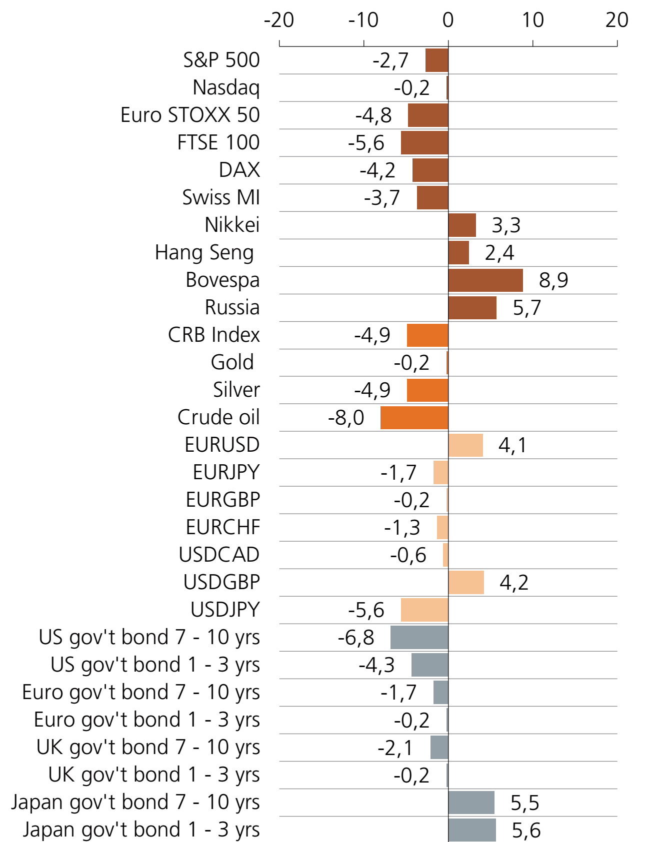
Source: Thomson Financial.

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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16 September 2016	Central Banks May Choose Helicopter Money Over Negative Rates
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19 August 2016	Debt Monetized En Masse to Fend Off the Euro Crash?
5 August 2016	*No English issue due to summer break*

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