AquilaFlash

Record-low interest rates, expansionary monetary policies plus the general wish for "competitive" currencies will push gold higher

Business cycle indicators don't show any improvement in the world economy. And current trade hostilities could spill over into currency wars. Germany wants to boost government spending in order to support its economy. Gold should do well in this environment.

Business cycle indicators continue to disappoint
The German economy contracted slightly (by 0.1%) in the second quarter and recent Chinese industrial production data have also disappointed. In the US there is now less optimism, with the August figure for consumer confidence hitting a seven-month low.

Trade wars could degenerate into currency wars
Currency is an important weapon in the trade war arsenal. Irresponsibly stimulative monetary policies are employed in order to weaken the currency, and thereby raise international competitiveness, boosting the economy. The problem is that this strategy only works provided others don't copy it. If every country aims at currency devaluation, a competition ensues to be "the most expansionary central bank in the world". (This development is one reason why bond yields are moving ever deeper into negative territory even though global indebtedness continues to increase in relation to the size of the global economy.) Currency warfare could well be the next escalation of current trade hostilities. Thus, President Trump has stated that the US will no longer tolerate the supposed currency manipulation of China, or of Germany under the umbrella of the Eurozone. He is now putting enormous pressure on the Fed to cut interest rates sharply and soon with the aim of devaluing the US dollar. After Mr. Trump announced on August 1 a 10% tariff on an additional $300bn worth of US imports from China, the yuan promptly lost value, trading above 7 to the US dollar for the first time since 2008. President Trump then responded with allegations of manipulation and ratcheted up the pressure on Fed Chairman Powell to cut interest rates further. Thus, the opening salvos in a yuan-dollar currency war have already been fired. Even though around half of the recently announced tariffs will not be implemented for the time being, real de-escalation of the US-China trade conflict is a long way off. For that, we will probably have to wait for the US economy to suffer a severe downturn and the peak campaigning period in the forthcoming (2020) US Presidential election.

For investors, the problems posed by negative interest rates have intensified
The aggregate value of bonds posting negative yields has now risen to $16 trillion, with the yield on 10-year German Federal government bonds now minus 0.65%.

Abolishing physical cash and strongly negative interest rates are no longer unthinkable….
It disturbs us that the IMF and its chief, Mme. Lagarde view negative interest rate policies as an appropriate mechanism for boosting the economy. Here is a quote from the IMF Working Paper, *Enabling Deep Negative Rates to Fight Recessions: A Guide*: «*The experience of the Great Recession and its aftermath revealed that a lower bound on interest rates can be a serious obstacle for fighting recessions. However, the zero lower bound is not a law of nature; it is a policy choice. The central message of this paper is that with readily available tools a central bank can enable deep negative rates whenever needed – thus maintaining the power of monetary policy in the future to end recessions within a short time*».

….nor are negative mortgage interest rates
In Denmark, Jyske Bank will pay borrowers 0.5% a year on their 10-year mortgages. No cash will be paid but the interest will be credited on a monthly basis by way of a reduction in the capital sum borrowed.

Berlin is contemplating a shift towards Keynesian economic policies

The German economy contracted slightly in the second quarter. In response, Germany's Federal government is discussing a Euro 50bn increase in public spending should the economy show substantial weakness. More important than the mooted size of the stimulus is the message that Germany is prepared to subordinate the goal of fiscal consolidation to the need to support economic growth. This development is probably the main reason why we now have a (temporary in our view) end to recent stock market weakness and, indeed, decent gains on European bourses in recent days. The more fiscal policy can replace monetary policy as the mechanism for economic stimulus, the more we should expect higher or less-negative interest rates. The German policy shift has supported the euro, and thus removed some pressure from the SNB while also going some way to lessen tensions with the US. With the suggestion of a shift in the direction of a positive European yield curve, it is also a plus for Europe's stricken banking system.

The inverted yield curve suggests that the world economy is in a bad way

The inversion of the US yield curve is not a good sign. If expectations of further interest rate cuts are not fulfilled, markets could come under heavy selling pressure. The risks of a recession in the US have increased.

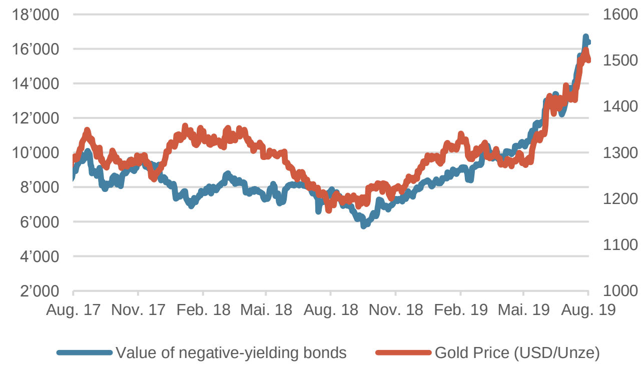
China has reacted to weak economic data with additional stimuli

China hopes that by reducing business financing costs it can stimulate the economy. But Peking may well not stop there. A second step would be to prepare for a further depreciation of the yuan. Such a politically determined move could well have significant international consequences.

US-Chinese rivalry will extend over coming decades

The US is engaged on several fronts in a long-term, hitherto not military, struggle with China for the status of "World Number 1 Power". No trade deal that might be agreed between the two rivals will change this. In China's view it is time not only to move on from a "century of humiliation" but also to compensate for it. China wants to be the world's Number 1 power by 2049. This goal encompasses military, economic, financial, technological and ideological influence. Put differently, China wants a new world order with herself at the center. While the outcome of the forthcoming struggle is uncertain, it is likely to be associated with heightened geo-political risks, including those posed by proxy wars involving secondary, allied powers.

Global market value of negative yielding bonds (US $bn) and the gold price (US $ per ounce)



Source: Bloomberg Finance L.P.

Gold price likely to rise over the medium-term

Precious metals, and especially gold, ought to be among the main beneficiaries of recent developments. Indeed, gold has produced a strong return since its technical "outbreak" to the upside in July. Further, any decision to do away with physical cash, or merely more discussion about such a move, should be very positive for gold. Bonds posting negative yields now account for around 30% of the total market capitalization of investment grade bonds. The higher this percentage and the higher the absolute value of negative-yielding bonds, the more positive for gold (see chart). Fundamentally, gold does not pay interest but, on the other hand, investors in it are not required to pay interest as they now are on their quality bond investments. Moreover, gold provides protection against inflation and promotes portfolio diversification. Central banks seem to share this opinion. They purchased a record $15.7bn worth of gold (or 374 tonnes) in the first six months of the year according to the World Gold Council. More thoughts on Gold:
https://www.aquila.ch/blog/goldpreis-und-anlagestrategie-teil-1/

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