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Oil versus Gold: Economic Insights from Relative Value Dynamics

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Comparing the relative value of two high profile commodities can often reveal interesting insights. Our analysis of the oil-gold relative price suggests that worries of deflation may be overdone and confirms our view that the oil price collapse may be more reflective of the production boom than consumption trends.

In recent months, the exchange rate between gold and oil has experienced a very strong move, bringing the oil-gold ratio (the number of barrels of oil needed to purchase one ounce of gold) to near record highs (Figure 1). Since June, the number of barrels of WTI required to purchase one ounce of gold has more than doubled from 12.5 to 28 as oil prices plunged in dollar terms, while gold prices held relatively steady (Figure 2). During the past 30 years, the oil-gold ratio has averaged about 16 barrels of oil for one ounce of gold. That said, the oil-gold ratio is not yet at historical extremes: it achieved 28.25 in February 2009 and rose to over 30 during the 1985-86 slump in oil prices. While this recent run-up in the oil-gold ratio has been driven by the drop in the oil price, it is interesting to examine these two commodities together to appreciate what they may be telling us about the future of the global economy.

Historical Context

From 1986 to 1999, gold prices were less volatile than oil prices; neither displayed persistent trends; and the oil-gold ratio averaged close to 20 (barrels of oil per ounce of gold). Things changed in the 2000s, as China-led emerging market growth spurred demand for all kinds of commodities. Both oil and gold prices ascended to new heights, however, oil prices initially rose faster than gold, and oil continued to be the more volatile component of the relative value ratio. This emerging market super-growth period took the oil-gold ratio down to an average of close to 10 between January 2000 and September 2008, when Lehman Brothers collapsed.

The financial crisis of 2008, however, set in motion some very different patterns. Since October 2008, the oil-gold ratio has averaged around 16 but has been in an extremely wide range with high volatility. First, oil prices fell as the depth of the recession became apparent, while gold prices went to new record highs reflecting gold's flight-to-quality characteristic amid fears of financial instability. Then there was a role reversal. Oil prices recovered with rising global geo-political tensions, while gold prices fell as (a) central banks made clear they were going to backstop the financial system and (b) US dollar based inflation failed to materialize despite massive central bank asset purchases. The current leg in the second half of 2014 and early 2015 has seen a sharp collapse of the dollar price of oil with relative stability in the dollar price of gold, taking the oil-gold ratio to its recent highs.

Short-term Factor

Gold prices currently may be supported by a negative gold forward (GOFO) rate, indicative of tighter supplies or renewed buying from India. Also, political risks in Europe related to new worries over the possibility of a Greek exit from the Euro have probably helped support gold buying. Finally, we note that gold has fallen in recent years from a USD perspective, but has held steady or risen from the

perspective of investors in many developing economies of the world, maintaining its role as a store of value (Figure 3). Indeed, declines in many emerging market currencies versus the US dollar may have also led to demand for gold from this sector.

Oil prices have fallen faster and further than most industry analysts thought was likely or even possible. See our research report, "Visualizing Energy Market Dynamics" (4 December 2014), in which we argued that asset allocation dynamics had the potential to overpower physical supply-demand calculations and lead to the oil price spending considerable time below a hypothetical fundamental valuation. Moreover, the combination of oil politics and the cash flow needs of indebted private oil producing companies suggest that production will not be materially impacted immediately by the price drop, even though long-term capital investment projects may be delayed or indefinitely postponed.

Market Implications

To our minds, gold remaining stable while oil falls suggests oil is much more of a production story than a lack of demand one. Analysts that focus on the potential of deflation tend to make the heroic leap that a global recession will follow. That is not what the oil-gold ratio is telling, at least right now. If deflation is mostly due to production increases, including commodities, then a mild deflation should not be viewed as an indicator of a future global recession.

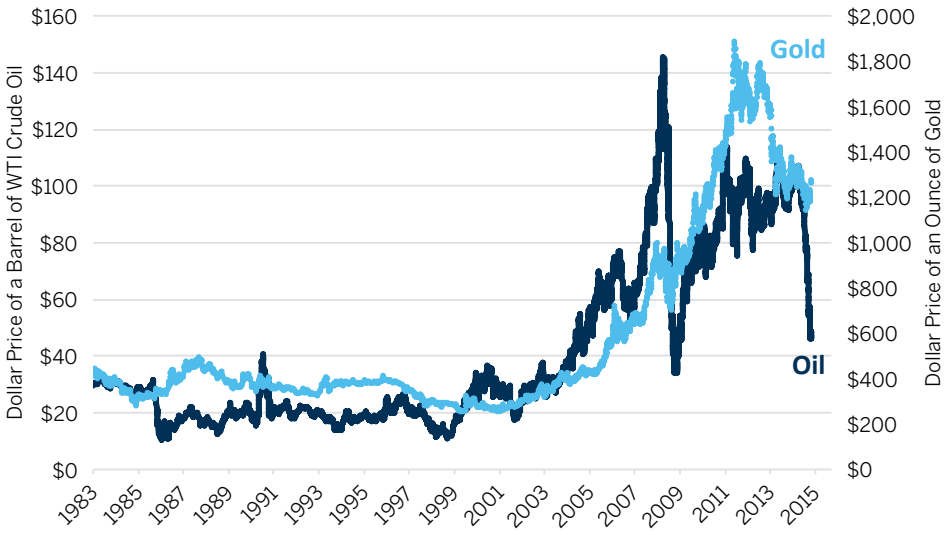
On the growth side, much is made of China's economic deceleration; China only grew 7.4% in real GDP terms in 2014, just below the government's target rate. And, by our forecasts (research report forthcoming in February 2015), China may only grow 6.5% or a little more in 2015. But let's be clear. China's real GDP growth rate still exceeds virtually all other major mature industrial countries. And, the world is not in a global recession, despite the impression one might get from some pundits. With the exception of the oil-producing emerging market countries, there are signs of incremental increases in real GDP growth for 2015 – not back to the go-go years of 2002-2007, but a little more growth nonetheless.

Moreover, if long-term deflation and a global recession were consensus market expectations, it is hard to believe the gold price would not have already collapsed. Deflation fears cut two ways for gold – no inflation is bad for gold, while deflation worries can increase fears of financial disasters, which can be good for gold.

Consider several scenarios. Currently, the crude oil and gold forward price curves show that the oil-gold ratio will decline from its current level of nearly 28 to around 24 by the end of 2015, and then towards 22.5 by the end of 2016. This market expectation should probably be given a very low probability, as it is really an average of two very different possible outcomes. That is, risks abound on both sides of the oil-gold trade. On the one hand oil prices could remain low versus gold for an extended period of time, as was the case in the 1986-88 period when the ratio ranged from 20-32.5. On the other hand the ratio could snap back more quickly, as was the case in 2009.

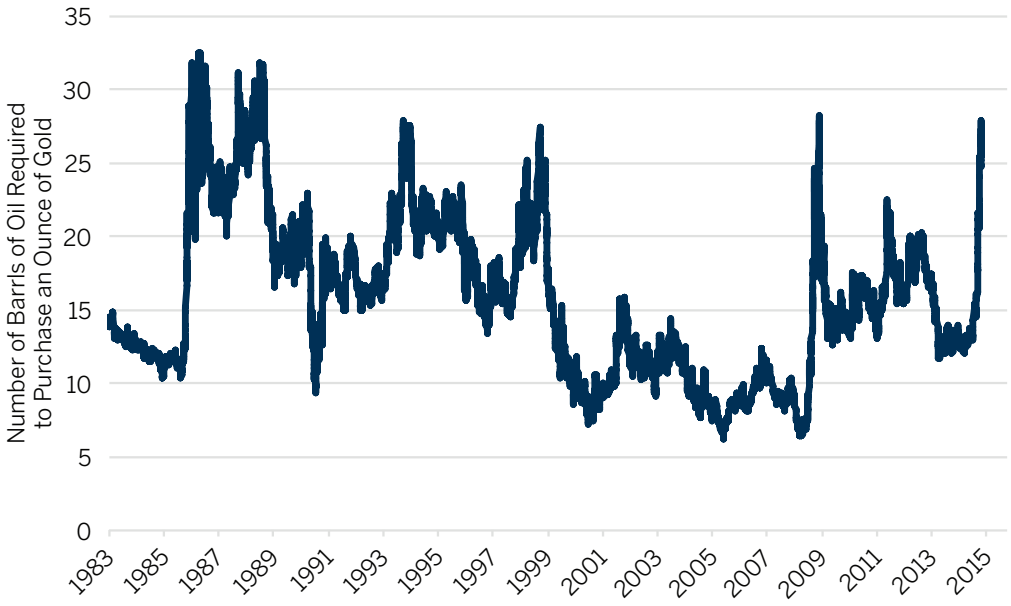
Please take careful note. We are not arguing the gold price will not fall at some time in the future. Our perspective is that the current rise in the oil-gold ratio is merely indicative that the energy production boom is much more responsible for oil's price collapse than fears of global deflation, lack of demand, and recession, which would have sent the gold price into decline as well. In our base case scenario for 2015, the dollar price of gold still looks vulnerable to substantial downside pressure due to healthy US economic growth, the intensifying debate of the possibility of a Fed rate rise in 2015, and the highly accommodative monetary policies of Europe and Japan. For gold to rally strongly, we think we would need strong evidence of inflation or another financial disaster, and both of these are given low probabilities.

Figure 1: Gold and Oil: A Tale of Two Commodities



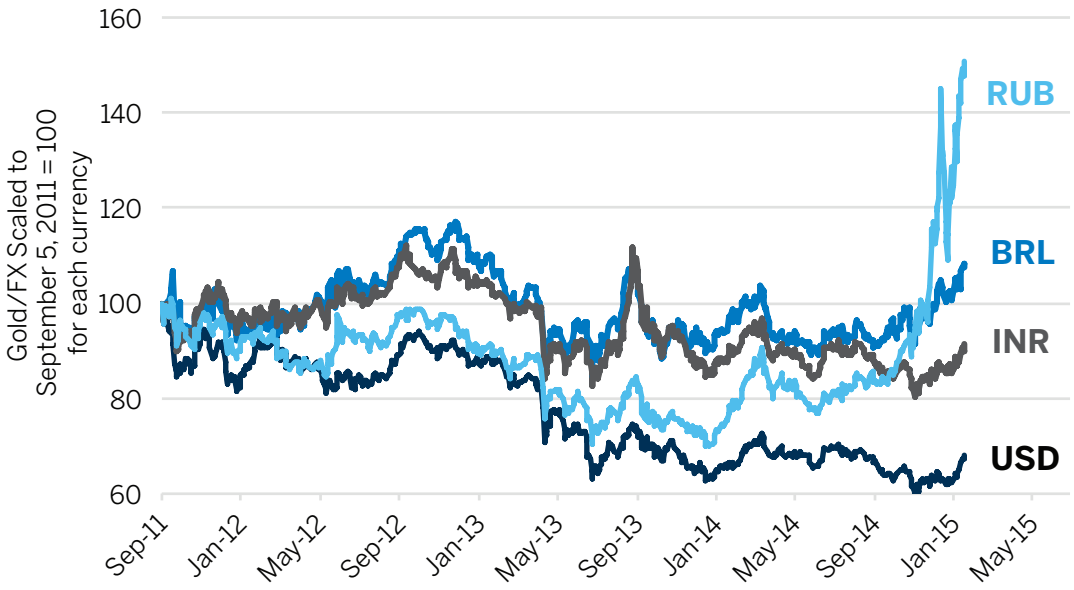
Source: Bloomberg Professional, GOLDS and USCRWTIC

Figure 2: Oil/Gold Ratio



Source: Bloomberg Professional, GCA and CLA, with CME Group Transformations.

Figure 3: Gold: USD, Brazilian real (BRL), Indian rupee (INR) & Russian ruble (RUB) perspectives



Source: Bloomberg Professional, GOLDS, BRL, INR and RUB