Forecasting Beyond the Credit Crisis – Part 1: The Dow/Gold Ratio

Using the Dow/Gold ratio as a forecasting tool, it can be seen that there is more trouble to come for investors in equities in the form of substandard real returns on investment.

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Recent months have seen enormous volatility and despair in the financial markets of the world. Huge losses have been incurred and investors of all varieties have felt the sting of the broad-based economic weakness that is permeating around the globe. Though central banks have attempted to lessen the blow by sharply cutting interest rates and injecting hundreds of billions of dollars into the global economy, there remains strong negative sentiment among the investing public and most are left wondering when the carnage will end. As difficult as it is to predict a true market bottom (since, by definition, the bottom can only be defined once it has been left well behind), history can often serve as a guide and past examples can serve as useful proxies. In this first installment of an ongoing series, we will examine the Dow/Gold ratio, a frequently cited but under-appreciated figure for forecasting long-term underlying trends. From this analysis, and the subsequent ones to follow, we will attempt to roughly gauge the current state of equity markets, how they fit along the historical spectrum, and their most likely direction heading into the future.

The Dow/Gold ratio has long been a favourite metric for good reason: it is a fantastic proxy for the relative value of the market. It is widely known that, in times of economic weakness or high inflation, there is an increased move towards holding gold as an investment. For centuries, gold has been the ultimate currency and continues to be just that for many market participants. Since paper money backed by governments can come and go, gold is often credited as the best store of wealth as it has been around and valued as a currency for thousands of years. As such, the ratio of the Dow Jones Industrial Average to the price of gold has frequently been cited as a relative value metric and can often point towards peaks and troughs in the economic cycle. An examination of the historical level of the Dow/Gold ratio can perhaps shed some light on the question which all investors are desperate to know in light of current market conditions: when will it all be over?

Dow/Gold Ratio from 1940-2008

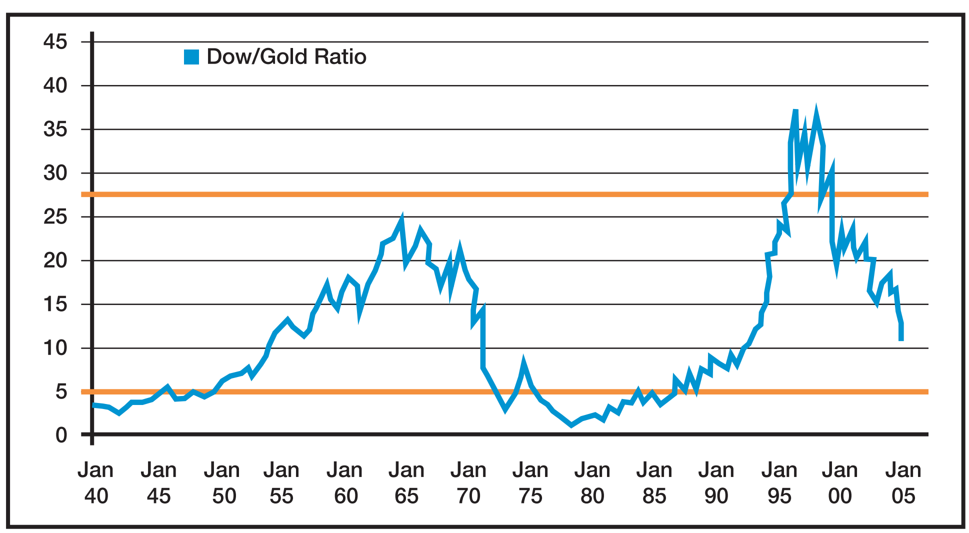

Chart: ***Dow/Gold ratio from 1940 through 2008***. Some interesting items can be instantly discerned as they relate to the current examination. Perhaps most importantly, it can be seen that the extreme values of the Dow/Gold ratio seem to coincide with the turning points of secular market trends. Secular market trends are prolonged periods of general upward or downward movements in equity markets, generally characterized by substantial positive real returns (that is, after accounting for inflation) on investment during secular bull markets and low, if not negative, real returns during secular bear markets.

For example, from 1950 to 1965, the ratio moved up steadily from approximately five to almost thirty; correspondingly, this time period represented a strong, fifteen-year secular bull market. From 1965 through until the early 1980's, a period seen as a profound secular bear market, the ratio dropped dramatically to approximately one. From there, the ratio rallied from this historic low to hit an all-time high of more than 40, peaking in the late 1990's; not surprisingly, this is approximately the same time the most recent secular bull market ended and when this author considers the current secular bear market to have begun. In essence, the ratio makes a high point at approximately the same time the market begins a prolonged correction, and makes a low point at about the same time an extended market rally begins, at least from a secular perspective.

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To further illustrate the point, two channel lines have been included in the chart, reflected as the upper and lower bands in orange. These two lines illustrate the approximate range in which the ratio has fluctuated over the duration of the observation period. The Dow/Gold ratio has spent the majority of the observation period within the channel fluctuating up and down, with three notable exceptions: the early 1940's, the early 1980's and the late 1990's. As alluded to previously, these time periods represent transition points between secular bull and bear markets. Moreover, not only were these periods transition points, but they also reflected moments when the stock market reached, with the benefit of hindsight, irrational and extreme levels on the high and low ends.

The relative consistency of the ratio within the channel allows for some confidence in terms of the predictive ability of the Dow/Gold ratio, as it has historically proved quite accurate regarding the onset of secular market trends and their duration. As such, given the above representation, it can be seen that current American equity markets are quite obviously in a secular bear market phase and, unfortunately, it should continue for some time to come. With history as a guide, it should be expected that the ratio between the level of the Dow Jones Industrial Average and the price of gold will fall further, perhaps to around five as a low point, though lower ratios have been observed in the past. While current market trends may stabilize or even reverse in the short-term, there appears to still be some difficulties to come over a longer investment horizon.

This is certainly illustrative for investors in either the index or the commodity, as it states a great deal about the future direction of these two markets. For example, as of early January 2009, the levels of each of these two assets were as follows:

- The closing level of the Dow Jones Industrial Average 9,015.10
- The price of gold (US $/oz) $843.15

This means that the ratio at the beginning of 2009 was still in excess of ten, well above the bottom predicted from historical observations of around five or perhaps even less. Assuming the Dow Jones Industrial Average held its current level, the price of gold would have to rise to around $1,800 per ounce to generate a Dow/Gold ratio of five and roughly signal a secular market bottom; for this to occur, gold will have to more than double in value. Conversely, the Dow Jones Industrial Average, in order to reach the historical low ratio of around five and assuming gold holds its current price level, will have to drop to around 4,215, representing another 53% drop from an already depressed level. While the end result will likely be a combination of a rise in the price of gold and further drop in the level of the Dow Jones Industrial Average, rather than the movement of a single input, it is nonetheless illustrative to see the degree to which the stock market remains relatively overvalued and/or gold remains relatively undervalued from a historical perspective.

Sadly, it would appear as though there is more pain yet to come in American equity markets, though in the short-term the market may allow participants to come up for air. As mentioned previously, it is highly probable that markets will reverse their current course over the near term. Though equities may currently be embroiled in a secular bear market, there are many examples of contrary movements during such times. A perfect example came during the most recent secular bull market, spanning 1982-2000. October 1987 saw one of the most severe corrections in history, and though this was a difficult time, the secular trend continued upwards and the sell-off was temporary. An additional example comes from the current secular bear market. At the beginning of 2002, the Dow Jones Industrial Average stood below 8000, but by October 2003 the index had risen to over 10,400, a rise of 30% in less than two years. The latter scenario is more than likely going to repeat itself in the very near future: stock markets will reverse themselves, even rally, over the coming months and perhaps years, but the underlying trend will remain the same over the course of the secular bear market.

Recent economic woes in the United States and around the world have led to significant losses in equity markets, the tightening of available credit to business and individuals, and monumental government intervention. While investors may seek and be granted short-term relief to the problems which the economy currently faces, the underlying secular market trend casts a dark shadow across the future of stock markets. Using the Dow/Gold ratio as a forecasting tool, it can be seen that there is more trouble to come for investors in equities in the form of substandard real returns on investment. In next month's discussion, we will examine another key metric in identifying underlying secular trends, and perhaps one of the most famous ratios in all of finance: the Price/Earnings ratio. As simple as this figure may be, it presents some interesting and profound results in the current context. *

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