Crude Oil – Gold Non-Relationship Breaking Down

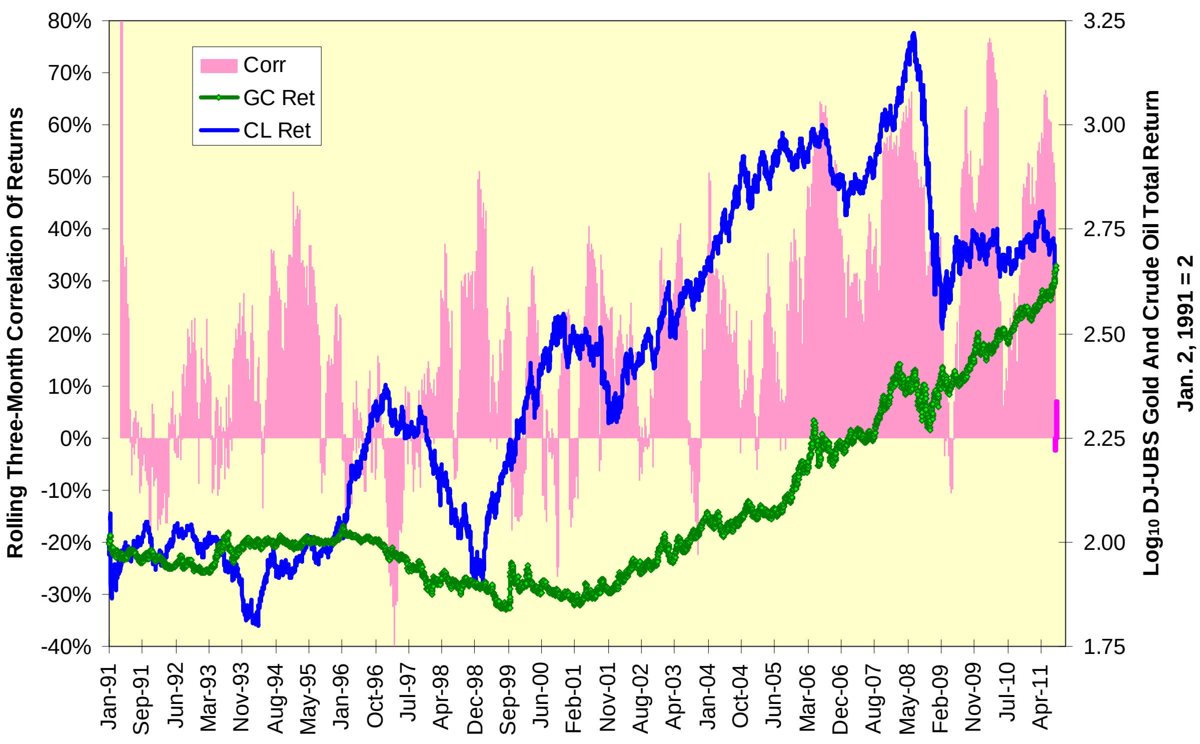
There is an old saying in the oil business, "Oil is found in men's minds." This is not related to Calouste Gulbenkian's famous, "Oil partnerships are greasy," but rather a tribute to the innovative thinking that goes on today and is giving us both crude oil and natural gas production out of previously uneconomic shale formations.

In a similar vein, and without the benefit of new energy sources, correlation is found in traders' minds. I addressed the non-relationship between crude oil and gold back in May 2010, but the earth stayed in its orbit after publication and traders persisted in linking the two markets.

The extreme market volatility of last week knocked crude oil down hard because, and traders know this to be a fact despite not a single scintilla of evidence supporting it, West Texas Intermediate crude oil for delivery in September fell for than 17% from the end of August by early last week. That is correct; stocks fall and the short-term supply/demand balance of next-month deliveries shifts 17%. Gold shot higher over the same period for the very solid fundamental reason no one could be sure whether paper money meant anything anymore given the proclivities of governments around the world to print first and ask questions later.

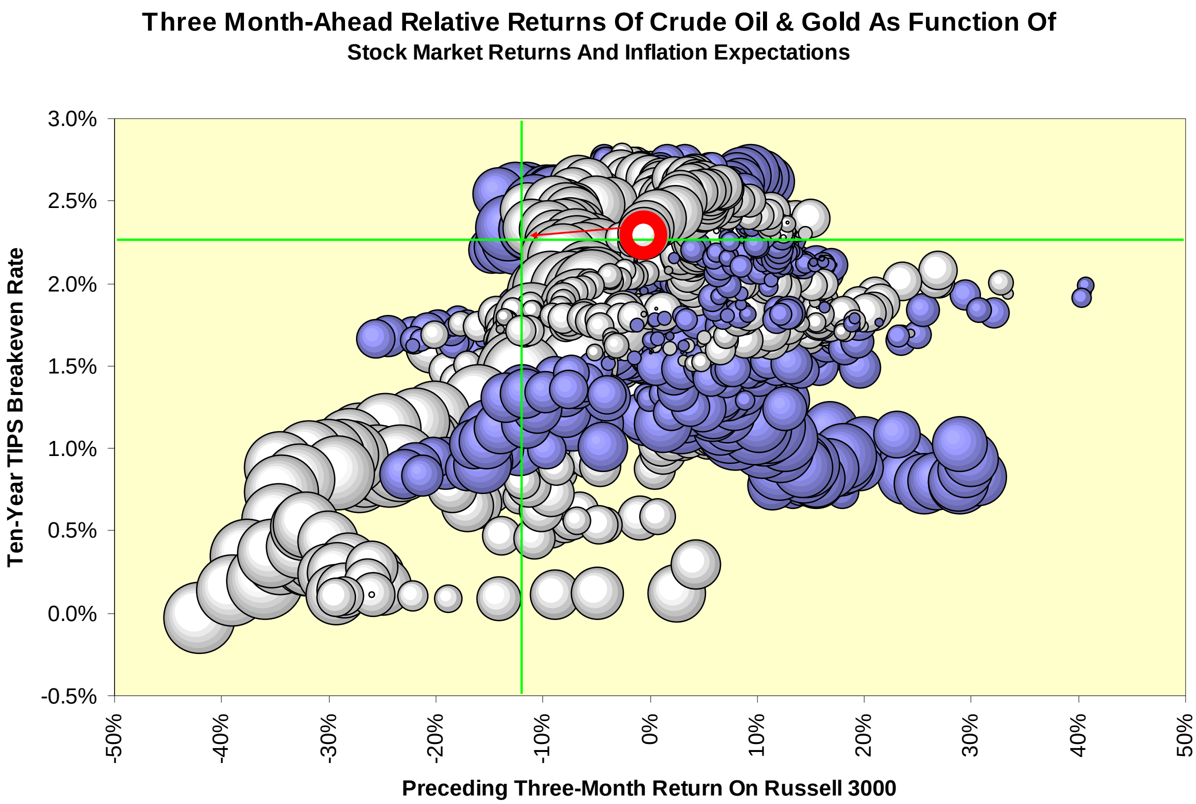
The net result is the correlation of returns between the Dow Jones-UBS crude oil and gold total return indices entered negative territory last week. This is not as unusual as some might think; it had been negative back in May 2009 and it was negative for long stretches during the late 1990s.

Gold And Crude Oil Correlation Of Returns Collapsing



Given gold's status as a superior good and its high income elasticity of demand in parts of the world and crude oil's negative price elasticity of demand, we have every reason to expect the relative returns of gold to exceed those of crude oil if global economic growth remains tepid and the propensity to keep the printing presses rolling remains.

This can be illustrated by mapping the relative returns for the crude oil and gold indices as a function of the preceding three months' returns on the Russell 3000 index and the current level of TIPS breakevens. Crude oil outperformance is depicted in blue; gold outperformance in white. The last datum used in highlighted in red, with an arrow drawn to the current value.



We are in a zone of prospective gold outperformance now. It would take a decline in TIPS breakevens or a move higher in the stock market to start pushing us back to crude oil outperformance. Of course, after the volatility seen last week, all predictions have to be taken with a very large grain of salt.