DJIA/Gold Ratio

***e*Research Corporation** is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan reviews the ratio of the Dow Jones Industrial Average to the price of Gold. At some point, the DJIA will turn down and Gold will out-perform. Question is: When?

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Bob Weir, CFA
Director of Research

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The McClellan Chart-In-Focus

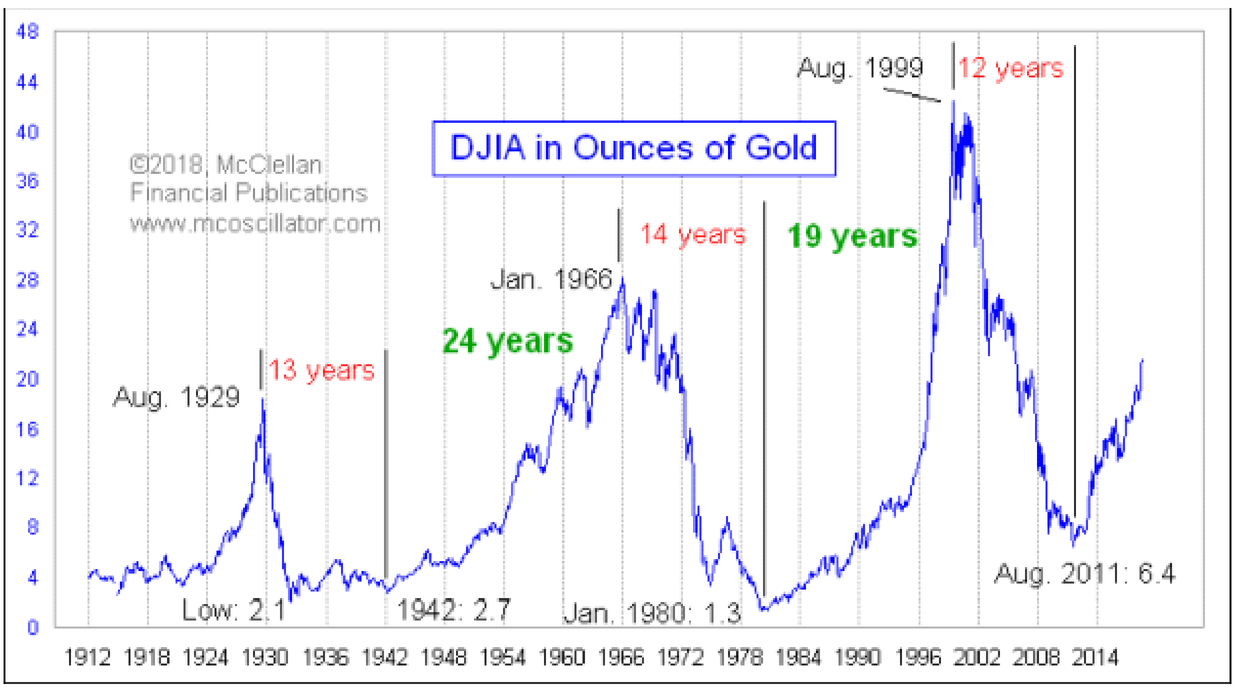
by Tom McClellan (bio at end)

DJIA/Gold Ratio

Every chart of price data is a depiction of a ratio. If you look at a chart of your favorite stock, what you are really looking at is the ratio of the value of your stock to the value of the dollar, since stock prices are quoted in dollars. AAPL recently was at 226 dollars per share. Gold recently is at 1200 dollars per ounce. Every price is a ratio.

But you don't have to have currency in a ratio. The value of the DJIA is an approximation of dollars per something; I will not discuss the merits of that index's construction here. However, if you take the DJIA's "dollars per something" and compare it to gold's "dollars per ounce", you can factor out the currency and get a ratio of "something per ounce". Again, don't get me started on what the DJIA's value means.

This week's chart looks at the DJIA to gold ratio. Restating the units, what it shows is the value of the DJIA, measured in ounces of gold. What is interesting is that over a really long period of time, the boundaries of how far this ratio can go up or down tends to stay in a pretty consistent range. It is a hugely wide range, but it is consistent.



It is important to remember that for the first half of the chart, the price of gold was fixed by the U.S. government, first at $20.67/oz, and then it rose starting in 1933 to its eventual fix of $35/oz in 1935. Gold was only allowed to float freely beginning in 1969. And the public was not allowed to trade it until January 1975.

Another interesting point about this ratio is that it shows a pretty consistent periodicity. From peak to trough is 12-14 years, and then from trough to the next peak is somewhere around 20+ years. One big problem with this observation is that the sample size is pretty small. The DJIA has only existed since 1896, so if we are going to count long-cycle behaviors, it is going to take a few more generations to have enough data to make for a reasonable sample size. In the meantime, we have to do what we can with the data we have available.

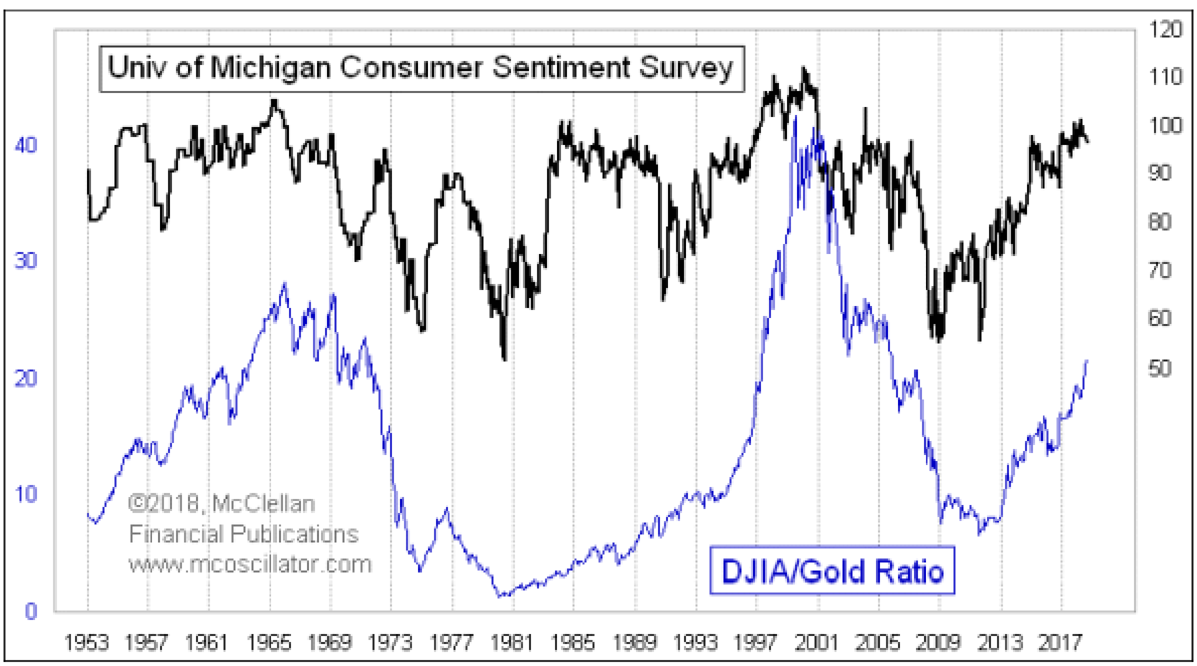
If we were to count from the 1907 crash low of the DJIA (not shown in this chart) to the 1929 high, that would be 22 years, which fits pretty well with the 24 years from 1942 to 1966, and the 19 years from 1980 to 1999. It is really hard to go back farther into the 1800s to get more iterations for this examination, because the meaning of "stocks" was not even the same back then. Again, we do the best we can with the data we have.

The recent rise in the DJIA has been coupled with the decline in gold prices from the 2011 gold price top, bringing a pretty high DJIA/gold ratio. It is far from the extreme high that we saw in 1999, but it is already up above the 1929 high, so on that basis it is "officially high". And this is early for the ~20 year period of a rising ratio that we have seen for the last 2-3 iterations.

So does that mean the ratio cannot keep rising? That is not a question which history gives us enough data to answer yet.

So what drives this ratio? The short answer is "confidence". When investors are feeling confident about the economy and the future, they bid up the prices of fake assets like stocks. When confidence is waning, they gravitate toward real assets like gold and land. So the movements of the DJIA/gold ratio are really a representation of long-term public sentiment.

We can see that relationship when we compare this ratio to the University of Michigan's Consumer Sentiment Survey:



Right now that ratio is up near the upper limits of its range, which implies that it is going to be harder for the DJIA/Gold Ratio to continue higher. For that to happen, consumer sentiment would have to continue to improve, and that is going to be hard to do as there is not much room left for improvement. If the consumer starts to lose confidence in the economy, that is going to show up in the University of Michigan data, and presumably also in the preference for stocks versus gold.

A drop in confidence will lead people to favor "real" assets over hypothetically-valued ones like stocks, and so if one is expecting such a change in confidence then gold would be a preferred asset. But just because confidence is high does not mean that it has to drop right away. Confidence remained high throughout the mid- to late-1980s, and the DJIA/Gold Ratio kept on rising.

Someday gold will out-perform stocks again. The higher that the DJIA/Gold Ratio goes, the more severe that such a prospective gold out-performance will be once this ratio turns down. But the shift does not have to appear right now, just because we are talking about it.

Tom McClellan, Editor,

The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* is provided on the following page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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