The Adjusted Gold/XAU Ratio as an Indicator of Forward Returns for Gold Stocks

The latest data have a clear message for investors: gold stocks are attractively priced.

That's the current finding of my model for evaluating stock prices of gold mining concerns, updating historic data to incorporate information as of April 30, 2012.

In an October 2011 an article explained how the ratio of gold prices to the price of XAU, a capitalization-weighted index consisting of 16 precious-metal mining companies, provides useful information that investors can use to anticipate the price of gold stocks.

The gold/XAU ratio has had an upward trend since 1968, which reduces the value of gold stocks relative to the price of gold bullion. Because of this trend, in order to make the current ratio directly comparable to the historic ratios, one has to increase the ratio's historic values to compensate. This adjustment enables us to predict the returns for XAU based on the historic returns that followed trend-adjusted gold/XAU ratios of equal magnitude.
My analysis shows that XAU is considerably undervalued, as the relationship between the price of gold and the shares of companies who mine it is now significantly above the long-term trend line.

Trend of the gold/XAU ratio and returns for XAU
Figure 1 shows data from 1977 to 2011, including the price of gold, XAU, the gold/XAU ratio, and the trendline of the ratio, all updated through April 30, 2012. The most recent gold/XAU ratio is approximately 10.5. For context, a ratio that high was seen only once before since 1977, in November 2008. The slope of the trend line indicates the rate at which gold stocks loose value relative to the price of gold bullion, which is now about 0.3% per month. Thus, if gold were to gain 4% over a year, $60 per ounce based on the current price, the value of gold stocks would not increase. The reason for this could be increasing mining costs, which are rising at about 8% year-over-year. With the average cash costs for gold miners at about $650 per ounce – a $60 increase would only compensate for the increased costs.

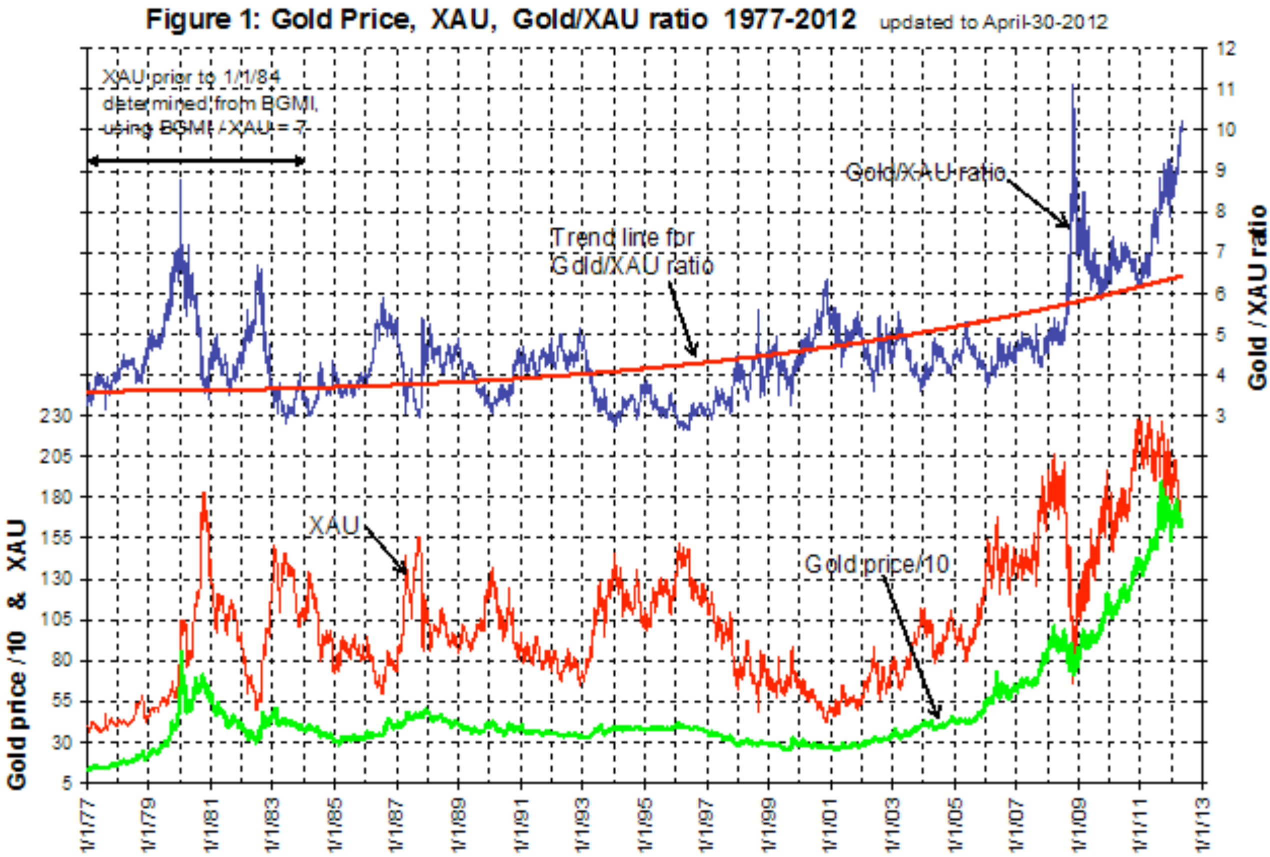

Figure 2 shows the price of gold, XAU, the trend-adjusted gold/XAU ratio, and the linear regression line of that adjusted ratio. The linear regression line is horizontal, indicating that the adjusted ratio is not trending in any direction, which confirms that one can compare the adjusted ratios directly with each other over time. It also shows that past adjusted ratios were higher than the current level early in 1980, which was not the case for the un-adjusted ratio depicted in Figure 1.

Also shown is a blue trend line that connects the five peaks of the trend-adjusted ratio between 1980 and 2001, as well as the trend line's extension from 2001 to the end of 2012. One can see that the 2008 peak of the trend-adjusted ratio fits the extended trend line reasonably well. Also, after each of the identified peaks of the ratio, there has been a significant gain in the level of XAU that occurred jointly with an increase of the price of gold.

Currently the gold/XAU ratio is below the extension of the trend line. If the blue trend line is indeed an indicator for peaks in the ratio, then we can expect such a peak to occur soon. Extending the current trend of the adjusted ratio, as represented by the short green line, we can anticipate intersection with the blue line at a level of about 11.4, which would indicate the expected peak level of the gold/XAU ratio. An increase in the price of gold with XAU gaining relatively less – or, alternatively, a further decline of XAU with gold remaining at the current price – could lead to the anticipated peak level. Once the trend-adjusted ratio has formed a peak and starts to decline, one can reasonably expect good gains for gold stocks afterwards, as has always been the case in the past. Those prior examples are listed in Table 1.

Figure 2: XAU & adjusted Gold/XAU ratio 1977-2012 updated to April-30-2012

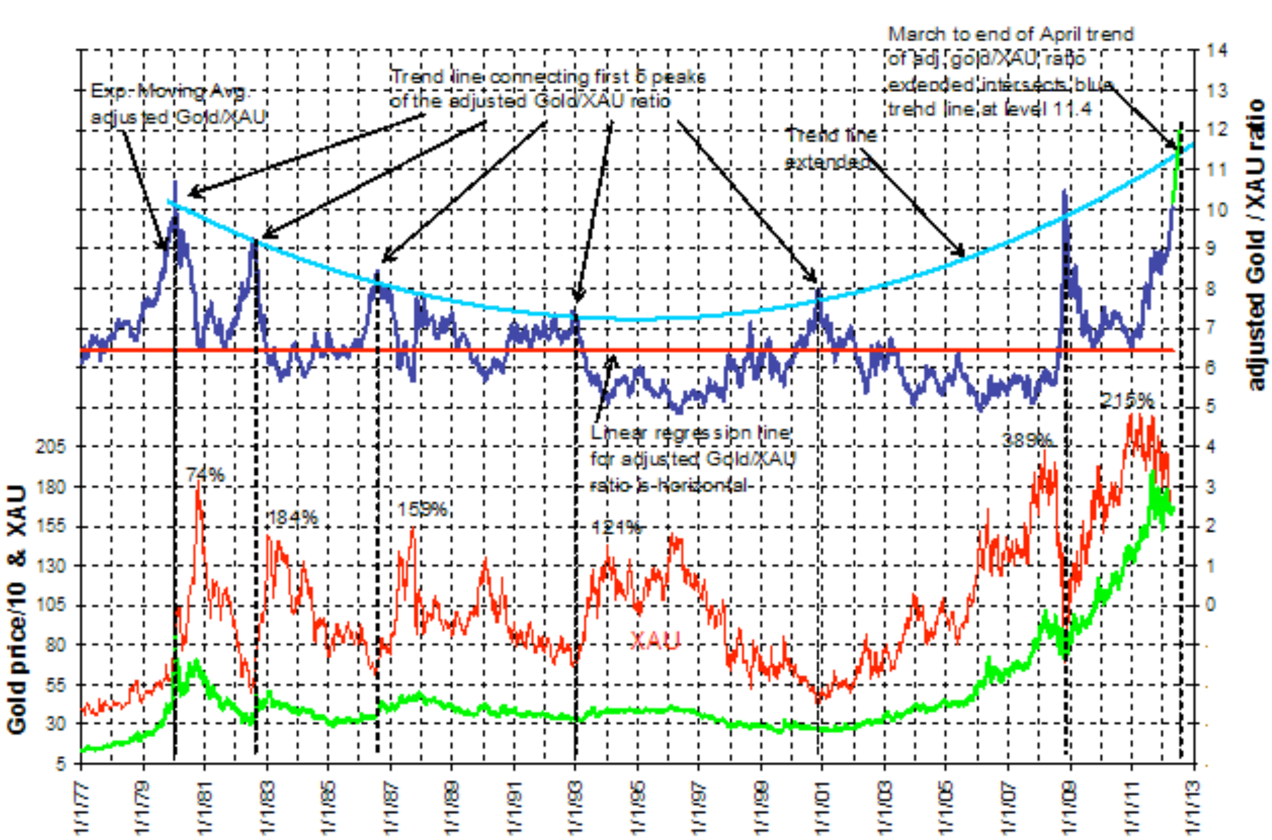

Table 1

date when peak of adjusted gold/XAU occurred	level of XAU at peak of adjusted gold/XAU	date when XAU gained most after peak of adjusted gold/XAU	max XAU after peak of adjusted gold/XAU	%-gain	annualized rate of return
1/21/1980	105.24	10/1/1980	183.59	74 %	122 %
7/15/1982	52.8	1/5/1983	150.11	184 %	795 %
7/30/1986	60.04	9/9/1987	155.74	159 %	136 %
11/30/1992	65.81	1/6/1994	145.57	121 %	106 %
11/20/2000	42.17	3/5/2008	206.37	389 %	24 %
10/28/2008	72.72	3/30/2011	228.95	215 %	61 %

The recent gold/XAU ratio and historic returns for XAU

As mentioned in my October 2011 article, one could have, based on the then-prevailing gold/XAU ratio of about 8.30, expected significant gains for XAU over the subsequent eight months. That time has almost passed, and XAU has instead lost value since then.

In order for XAU to gain, the gold/XAU ratio would have had to get lower and stay below the criterion value of 8.30 during the remainder of the stipulated investment period, or the extended investment period, as explained in the original article. Since the ratio never fell below 8.30 and is now about 10.5, the investment period is not complete, and thus a final determination cannot be made on whether the investment strategy was successful or not.

But what performance can we expect from gold stocks in the near future? Looking back we see that there were only two other occasions when the adjusted ratio was as high as the current level, namely in 1980 and 2008. The returns that followed on those occasions when the adjusted ratio was 10.0 are shown in the table below.

Table 2

Historic XAU Returns for Criteria Value of Adjusted Gold/XAU = 10.0 and minimum investment period of 180 days						
Investment Period from -	to	XAU value at start $	XAU value at end $	no. of months in each period	absolute return for each period	gain (loss) over period $
1/3/80	10/6/80	79.5	178.0	9.1	123.8 %	98.5
10/22/08	5/16/09	71.7	136.7	6.8	90.7 %	65.0
4/11/12	-	164.3	-	-	-	-

If history repeats itself, then substantial returns await investors in gold equities – and they may be realized fairly soon.