

# GULF NEWS



## **Making a case for oil to head to \$70 by year end**

*Using a model that links oil price movements to gold, a spike is possible*

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Since its high of almost \$108 barrel in June 2014, we have witnessed a stunning collapse, and a subsequent bounce back, in the price of oil. In February 2016, West Texas Intermediate (WTI) was trading at \$26, a 76 per cent plunge from its June 2014 high.

It has since clawed its way back to \$53.70 (February 20, 2017). Thanks to the “golden constant”, I was able to anticipate the course of crude’s bounce back. Indeed, the price of crude has doubled since its cyclical nadir. Just as I predicted.

How did I nail the course of crude’s price, and where is the price of oil going from here? To answer these questions, we must have a model — a way of thinking about the problem. In this case, a starting point is Roy W. Jastram’s classic study, “The Golden Constant: The English and American Experience 1560-2007”.

In that work, Jastram finds that gold maintains its purchasing power over long periods of time, with the prices of other commodities adapting to the price of gold.

Taking the broad lead from Jastram, I developed a model. It employs the price of gold as a long-term benchmark for the price of oil. The idea being that, if the price of oil changes dramatically, the oil-gold price ratio will change and move away from its long-term value.

Forces will then be set in motion to move supply and demand so that the price of oil changes and the long-term oil-gold price ratio is reestablished. This represents nothing more than a reversion to the mean.

It explains why spot prices of gold and crude are parallel to each other and why the oil-gold price ratio hovers around 0.0721.

Sure enough, following crude’s price plunge, the world’s largest oil companies slashed capital expenditures for drilling and exploration by 40 per cent in the 2015-16 period alone. The major companies have reined in their appetites for mega projects, preferring smaller ones with much shorter time horizons.

As night follows day, oil and gasfield discoveries have hit a 60-year low.

Just how long will it take for the oil-gold price ratio to mean revert? My calculations (based on post-1973 data) are that a 50 per cent reversion of the ratio will occur every 13.7 months. Based on this observation, I expected a WTI spot price of \$57 a barrel by February 2017.

It is worth noting that, like Jastram, I find that oil prices have reverted to the long-run price of gold, rather than the price of gold reverting to that of oil. In short, the oil-gold price ratio reverts to its mean via changes in the price of oil.

The chart shows the price projection based on the oil-gold price ratio model. It also shows the historical course of prices. They are doing just what the golden constant predicts: oil prices are driving the price ratio back to its mean.

The model foretells a WTI spot price of \$70 a barrel by the end of the year, which is considerably higher than the current price of \$55.10 for the futures contract settling at that time.

A forecast price for year end that is so much higher than the futures contract for that date makes some question my oil-gold model. But, one who is not raising questions is the oil guru Gary Ross. He, too, is forecasting \$70 a barrel.

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