First Trust
Monday Morning OUTLOOK
December 15th, 2014
630-517-7756 • www.ftportfolios.com

Oil Price: Looks Reasonable

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

A former economic colleague, and mentor, used to say: "In the Bible, it says an ounce of gold will buy a fine suit of clothing." We have read the Bible, and we haven't found this, although there could be some high-powered math, using talents, cubits, frankincense and myrrh that make it true.

Nonetheless, the point stands – over long periods of time, relative value remains somewhat constant. Gold is trading at $1,210/oz. today and that's about the cost of a fine suit. There are suits that cost more, and less, but, well, you get the point.

The reason we bring this up, is that the same "relative price relationship" should hold true for other commodities over time. The gold-oil ratio (using West Texas Intermediate crude prices) has averaged 15.8 over the past 30 years – meaning one ounce of gold would buy 15.8 barrels of oil.

In 2005, the ratio reached a low of 6.7; in 1986, it hit a high of 30.1. From 1990-1999 oil prices averaged $19.70/bbl and gold prices averaged $351/oz – a ratio of 17.8. Today, oil is $57/bbl and gold is $1,210/oz., meaning an ounce of gold will buy 21.2 barrels of oil.

In other words, relative to history, either oil is cheap or gold is expensive. Looking at other commodity price relationships, like silver, shows the same thing. One interesting fact is that in the past 30 years, the CPI is up 126%, while oil is up 116%, showing that, right now, with oil prices down almost $50 from their recent peak, oil has risen about the same as a broad basket of consumer goods.

This doesn't mean that oil prices can't fall further. After all, markets do what markets do. What it does mean is that the recent collapse in oil prices is not a sign of broad deflation. It is result of a shift in the "oil supply curve" to the right, due to new technologies in energy – horizontal drilling and hydraulic fracturing. Remember, the supply curve slopes upward from the lower left to the upper right. When a new technology increases supply *at any price*, like the invention of the tractor did with crops, the entire supply curve shifts. When this happens, output rises and prices fall, unless there is a shift in demand.

These days, two things are happening to keep a lid on demand. First, developing economies, like China and Russia are experiencing slower growth. Second, new technologies – like LED lighting, more efficient computer chips and less waste in office buildings, homes and manufacturing – are reducing energy consumption. For example, an iPad uses $1.36 of electricity every year, while a desktop computer uses $30 of electricity per year.

So, a right-ward shift in the supply curve is occurring at the same time demand is falling short of what was previously expected. In other words, the decline in oil prices is due to macro-economic forces, and those forces are mostly good, not bad. As a result, the drop in oil prices is a good sign, not one that indicates economic problems. The drop in stock prices last week, if it was based on the idea that falling oil prices are a negative thing, is temporary.

More importantly, most relative price indicators suggest the oil price decline has gone too far. Using the current price of gold, a barrel of oil is fairly valued near $77. Alternatively, comparing oil to multiple different prices, including a fine suit of clothing, oil is fairly valued somewhere between $55 and $70/bbl.

Bottom line: stocks and oil have fallen too much. Stocks should rebound soon and, barring a collapse in gold, we look for stability and then rising prices for oil in the years ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-15 / 7:30 am	Empire State Mfg Index – Dec	12.4	**12.7**	-3.6	10.2
8:15 am	Industrial Production – Nov	+0.7%	**+0.6%**	+1.3%	-0.1%
8:15 am	Capacity Utilization – Nov	79.4%	**79.2%**	80.1%	78.9%
12-16 / 7:30 am	Housing Starts – Nov	1.040 Mil	**1.020 Mil**		1.009 Mil
12-17 / 7:30 am	CPI – Nov	-0.1%	**-0.1%**		0.0%
7:30 am	"Core" CPI – Nov	+0.1%	**+0.2%**		+0.2%
12-18 / 7:30 am	Initial Claims – Dec 13	295K	**299K**		294K
9:00 am	Leading Indicators – Nov	+0.5%	**+0.6%**		+0.9%
9:00 am	Philly Fed Survey – Dec	27.0	**32.4**		40.8

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.