Can gold help predict the direction of the stock market? One little-known ratio based on the price of the yellow metal has a good track record of doing just that—and investors should be cheered by what it’s showing now.

Gold, of course, is one of the best-performing asset classes this year, with a gain of 17.7%. Its strong performance has led to a renewed focus on any of number of market indicators that key off gold trends. But with a few notable exceptions, most of them do not stand up to statistical scrutiny.

Consider: The ratio of gold to silver prices has fallen 5% since late June, which means that, even though gold has risen by more than $100 over that period, silver has risen even faster. Some of the advisers I track say that a falling gold-silver price ratio is a reliable bullish indicator for the yellow metal. Dennis Gartman, the financial adviser and publisher of the Gartman Letter, recently wrote to clients: “historically all great bull markets in the precious metals are contiguous with a weak and inexorably falling gold-silver ratio.”

Not all the advisers I monitor interpret this ratio in this way, however. Tom McClellan, editor of the McClellan Market Report, wrote last year in a special
report to subscribers that, based on his analysis of past data, a gold-silver price ratio of 80 or above “usually...means a bottom for gold (and silver) prices.” The ratio currently stands around 88.

These different ways of interpreting the gold-silver ratio have prompted me to investigate its forecasting abilities. To do so, I fed into my PC daily gold and silver values back to 1976, which is soon after gold began to freely trade in the U.S. I then measured the success of the ratio’s trend over the recent past in predicting gold’s subsequent performance.

I came up with nothing that satisfied traditional standards of statistical significance.

Then I compared gold’s performance subsequent to gold-silver ratios above and below 80, the threshold identified by McClellan. Again, I came up empty.

How, then, did the idea arise in the first place that the gold-silver ratio had forecasting abilities? My hunch is that there were certain periods over the past four decades in which it exhibited what appeared to be an uncanny ability to forecast gold’s price. Unfortunately, that ability did not persist.

It’s worth remembering that, when testing the statistical validity of an indicator, the gold standard (so to speak) is to measure its performance over an entirely different period than the one used to “discover” its existence in the first place to see if the indicator continues to work. Preferably, that different period is in real time after its existence was first hypothesized.

The gold-silver ratio would not have survived this out-of-sample test.

To his credit, McClellan acknowledged the ratio’s shortcomings. “One curious point about this ratio is that it has not always worked,” he wrote in his 2018 special report. “There was a period in the late 1990s when it worked entirely backwards”—that is, the correlation between the ratio and gold during that period ran in the opposite direction.

To be sure, the precious-metals market is not the only investment arena in which investors claim to have found some otherwise uncannily accurate indicator that turns out to be no better than a coin flip. But the gold market in particular seems to be especially ripe for such claims, since there is no straightforward way to calculate bullion’s fair value.

Campbell Harvey, a Duke University finance professor, told Barron’s that gold is unique in this regard. “For a company, we can look at the fundamentals, the sales, the margins, new investments, debt and dividends, and build a bottom up valuation,” he said. “For a country, we can do a similar exercise looking at
GDP growth, indebtedness, and consumer behavior, and get a sense of the value of sovereign debt or stock markets. For gold, there is not much to work with.

The only gold-related ratio that I’m aware of whose forecasting power satisfies the rigorous standards of statistical significance is the ratio of gold’s price to platinum’s. But it doesn’t forecast the price of gold. Instead, this ratio forecasts the stock market, according to an academic study by Darien Huang, a former finance professor at Cornell University, and Mete Kilic, an assistant professor of finance and business economics at the University of Southern California.

The professors found that the stock market tends to perform better following higher ratios than lower.

Though no indicator is perfect, Kilic and Huang found that, since 1975, the gold-platinum ratio has had a significantly better record when predicting the stock market’s subsequent one-year return than nine other well-known indicators that researchers previously found to have predictive ability—including the cyclically adjusted price/earnings (CAPE) ratio made famous by Yale University professor and Nobel laureate Robert Shiller.

Fortunately, the gold/platinum ratio is currently telling a bullish story. As you can see from the accompanying chart, it is at its highest level of the past five years, with gold having appreciated at a faster pace than platinum.

**Bullish for Equities**

Gold’s relative strength compared with platinum over the past five years.

The reason this ratio works, the authors argue, is that gold responds to different factors than platinum does. The latter primarily reflects changes in
industrial demand, while gold responds both to that demand as well as investor demand for a hedge against geopolitical and economic uncertainty.

A high gold/platinum price ratio therefore means investors believe there is a higher-than-average level of uncertainty that could sabotage the stock market. To induce investors to incur that risk, equities must deliver a higher-than-average expected return. But to provide that higher expected return in the future, the stock market has to have been a subpar performer in the recent past.

You may find this explanation hard to square with the stock market’s strong year-to-date performance. But the S&P 500 is still only barely higher than where it stood one year ago.

In effect, the professors’ study is saying, the stock market over the past year would have performed better but for the above-average, and rising, level of geopolitical risk. If they’re right, that in turn means that the stock market over the coming year will perform better than it otherwise would have.

If correct, that prediction could be worth its weight in gold.

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