Myrmikan Research

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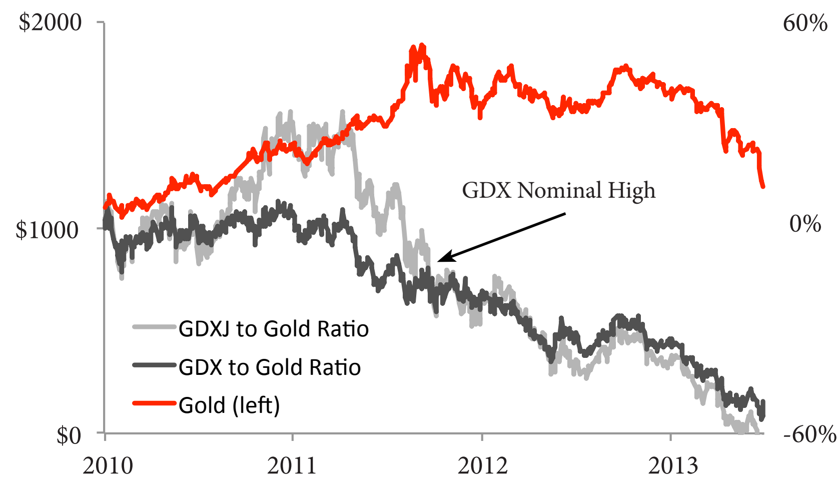
Discontent

There is great discontent in the gold sector due to the perception that gold stocks are not keeping up. On February 16, for example, gold settled at $1236 with the GDXJ Junior Gold Miners ETF trading at $42.11. Two months later, on April 25, gold settled at $1270, up $34, whereas the GDXJ was down 23%!

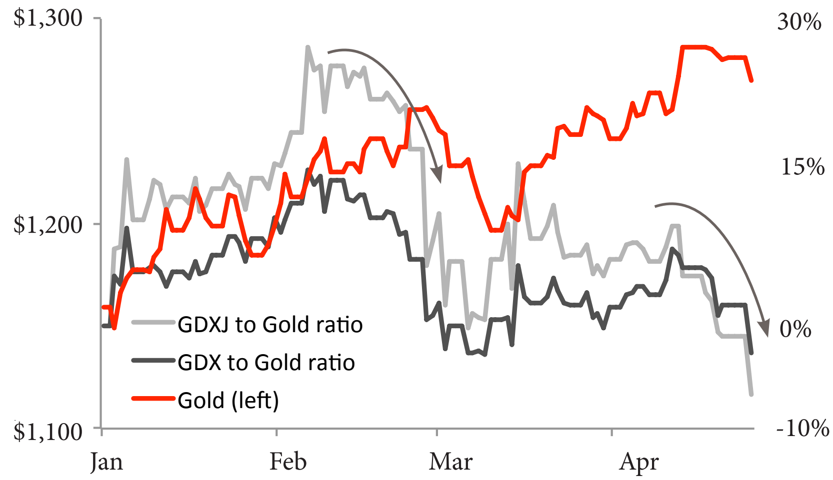
Gold investors are especially sensitive to divergences between gold stocks and the metal because it was such a divergence that signalled the top of the market in 2011 and presaged the 2013 collapse. Note that the chart below shows the performance of the GDX and GDXJ ETFs not in dollar terms but in terms of gold. The GDX made its nominal high at the same time as gold, in fact. But the ratios told a different story. Gold mining stocks do not "catch up" to gold. Rather, gold "catches down" to gold stocks.

Gold Stocks Falling in Terms of Gold Signals the Top



And it isn't just the major moves—gold stocks seem to be able to predict small moves as well. The chart below shows gold and the ETF ratios since the beginning of the year. The ratios started collapsing in February long before gold reached its interim peak. Note, however, that the underperformance was as short as the correction was mild and that gold stocks started bouncing before gold turned.

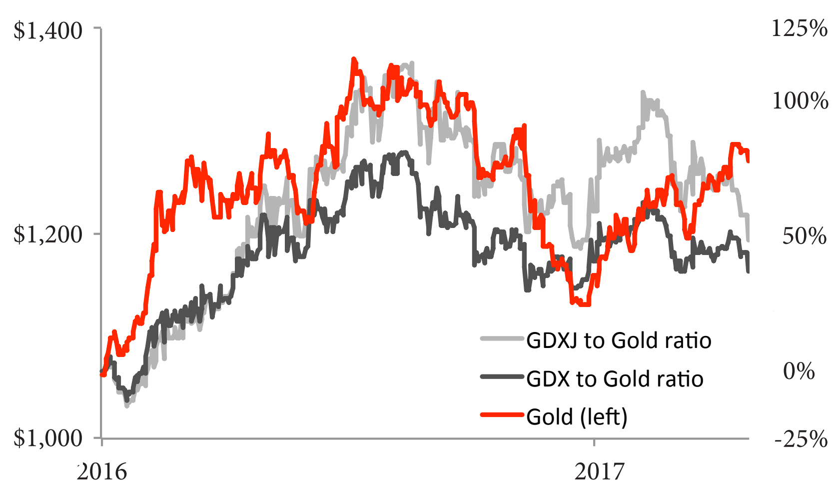
GOLD STOCKS FALLING IN TERMS OF GOLD SIGNALS THE TOP



What bothers investors is that even as gold surpassed its February peak, the gold stock ETF ratios barely recovered and have lurched lower in recent days. On cue, the day after the French election, the results of which will allow the European Union to survive a bit longer, gold took a nosedive and bubble stocks are soaring. Deutsche Bank, for example, jumped 10% on the news.

Investor concerns are likely overblown for three reasons. First, scaling the above chart back to 2016 provides a very different perspective. On this larger scale, below, the recent decay in the ETF ratios appears to be mostly a correction of over-exuberance in February rather than a secular trend. The ratios are, in fact, behaving more or less how they should, rising during gold bull phases and falling during bear phases.

GOLD STOCKS BEHAVING DECENTLY



Second, adjusting for the exuberance in February, the current underperformance of the ratios visible at the tail end of the chart has lasted a few days, not the three years which led to the 2013 collapse.

Third, there is an explanation for the particular weakness in the GDXJ that is completely independent of prospective gold prices. Most indices are market-capitalization-weighted, meaning that the larger the company, the more weighting it has in the index. As discussed in Myrmikan's April letter, indices have the best strategy because our asset-based banking system strongly favors large companies over small ones, which is why ever more capital flows to the largest companies through passive-ETF investing.

The one exception to this dynamic is the gold mining sector for reasons discussed in the letter. In gold mining, scale is the enemy, as holders of the GDXJ are now discovering. This ETF alone holds \$5.4 billion of its \$30 billion universe. It has grown so large that it is bumping up against the regulatory prohibition against owning more than 20% stakes in its component stocks (surpassing that level in Canada would require the ETF to tender for the entire company). The ETF cannot add smaller companies because the illiquidity of the micro-cap universe prevents the frequent buying and selling that is required to balance capital flows. So, the only thing to do is add larger companies.

Van Eck, the sponsor of the GDXJ, has announced that it is changing the design of the ETF as of June 17 such that, if the rules had been in effect at the end of March, the largest company would have had a market capitalization of around \$2.9 billion, up from \$1.8 billion, and the weighted average market capitalization would have been around \$1.7 billion, up from \$967 million.

There are second and third order effects of GDXJ's announcement. First, the new composition rules have allowed bank analysts to figure out which companies are going to be added to the ETF and which ones are going to be reduced. The GDXJ will need to sell between 2.5% and 8% of the market capitalizations of the holdings it is reducing, enormously large trades. Zerohedge has helpfully posted the lists of gainers and losers, enabling traders to front-run the changes:

http://www.zerohedge.com/news/2017-04-19/real-message-gdxj-mess

In other words, the GDXJ will be selling into weakness and buying into strength. Needless to say, some of the smaller companies on the "loser" list have been slaughtered in the past few days, names that are still part of the ETF. It is a wonder the GDXJ has not dropped more, but then it's only April and the changes are scheduled to occur in June.

Things could get even worse for the ETF. The GDXJ is billed as the more volatile cousin of the GDX, but the real fun is in JNUG, a Direxion ETF that is designed to provide *triple* the daily volatility of the GDXJ: if the GDXJ is up 5% in a day, the JNUG should return 15%. It decays rather rapidly, given the nature of the options that underlie it, but it did managed to soar from \$2 in January of 2016 to \$32 by June, sixteen times in six months. As GDXJ becomes more mature, JNUG will lose a lot of its juice and thus its attraction to millennial day traders. This is a problem because Scotiabank estimates that up to *half* of GDXJ shares may be held by Direxion as hedges against the swaps it uses to create the JNUG. If traders lose interest in gambling on JNUG, it will force additional large liquidations by the GDXJ.

In 2011, gold stocks seemed to sense in advance that valuations were improper given approaching macro-conditions. The current underperformance of junior gold stocks appears to be a short-term, liquidity-driven phenomenon as the market rediscovers that scale is the enemy of performance (investors in the broader markets will at some point learn this same lesson in much more dramatic fashion).

Usually it is folly to expect gold stocks to "catch up" to gold. Underperformance normally heralds corrections. In the immediate case, however, given the known dislocation of an enormous amount of capital in a tiny sector, and the improving macro-environment for gold, underperformance appears to be a rare opportunity to deploy capital at very advantageous terms.

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