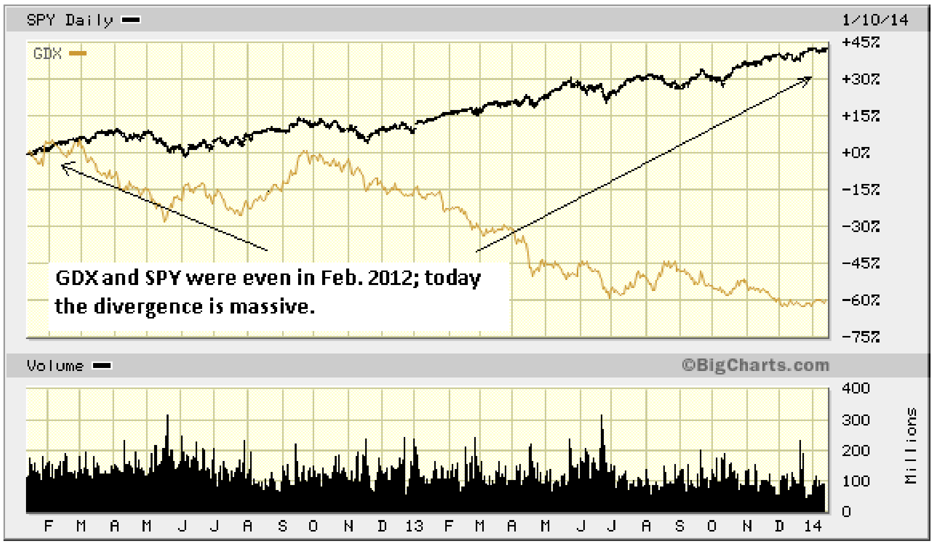
Long Miners/Short S&P ("LMSSP") for 2014

As a follow-up to the Barron's Investor Sentiment sent earlier, here is Goldman Sachs telling you that they are now "short" the U.S. stock market. **On Friday night, Goldman Sach's Chief Strategist, David Kostin issued a research note with one simple message:** "The S&P500 Is Now Overvalued By Almost Any Measure." **I suggest you read the Goldman note first and then move on to the "Long Miners/Short S&P" ("LMSSP") strategy and the link to the story is [here](#).**



Miners(GDX) Versus Blue-Chips (SPY)

Strategy

On a $100,000 investment, here is the transaction.

Sell $50,000 worth of the SPY-US (ETF for the S&P500 Index) at $184.00

Short 271 SPY @ $184.00 for $50,000 credit

Buy $50,000 worth of the GDX (Gold Miners ETF)

Buy 2,272 GDX-US @ $22 for $50,000 debit

This a "paired trade" that is a "market neutral" strategy. I don't care which direction the market moves as long as the GDX outperforms the S&P. Since 2012, the Gold Miners (GDX-US) have crashed while the blue-chips (SPY-US) have been on a central bank-induced rampage. I tried several times in 2013 to pick the top via the VIX only to watch in amazement as that "invisible hand" saved stocks every single time they looked ready to correct. With investor sentiment above 70% bulls for a nearly six-month stretch (first time ever since I began to subscribe to Barron's back in 1983), this strategy is not an attempt to "Fight the Fed" but rather one which neutralizes the impact of government intervention (Plunge Protection Team hijinks).

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Ratio of GDX to SPY

Two years ago almost to the day, GDX closed at $55.00 while the SPY closed at $125. If we assume a return to the levels of Jan/2012, the following actions would be taken:

Buy 271 SPY-US @ $125 for $38,775 debit (profit $11,775)
<u>Sell 2,272 GDX-US @ $55 for $124,960 credit (profit $74,960)</u>
Total profit: $86,375
Initial investment: $100,000

Total return (excluding interest charges on short position) 86.4%

This is the optimum outcome in a scenario where Goldman is correct and the S&P drops by 32% and which assumes that the miners actually recover to the Jan/2012 levels. Now let's see how it looks if the markets continue to climb another 20% in the S&P but where the ratio of the GDX:SPY recovers 50% from .12 to .26. The spread between the two ETF's which is at $166 ($184-$22) narrows by 50% to $83 as the S&P moves from $184 to $220.

Buy 271 SPY-US @ $220 for $59,620 debit ($9,620 loss)
<u>Sell 2,272 GDX-US @ $84.60 for $192,246 credit ($142,246 gain)</u>
Total profit: $82,626

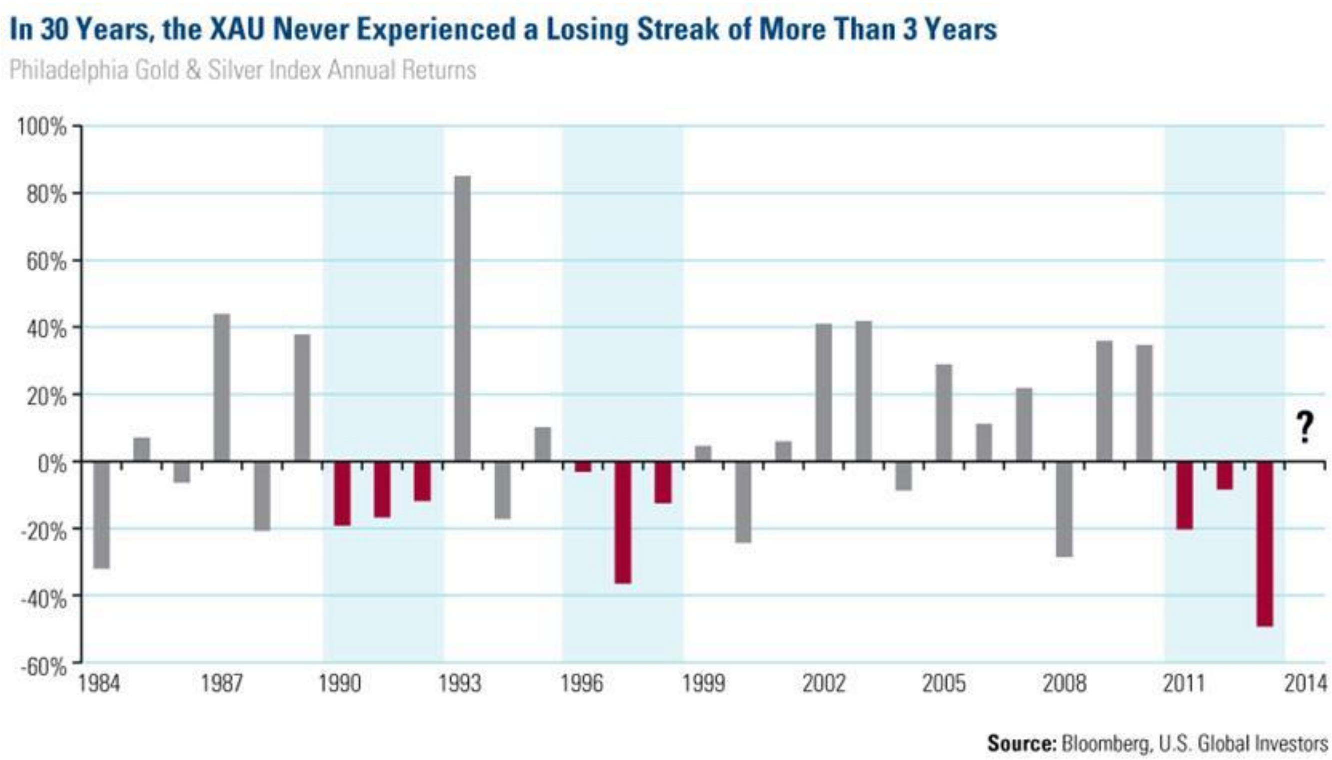
Total return: %82.6

Finally, let's assume a 20% correction in the S&P and and no movement in the miners.

Buy 271 SPY-US $147.20 for $39891 debit ($10,108 gain)
Sell 2272 GDX-US for $22 for $50,000 credit ($-0- gain)
Total profit: $10,108
Total return: %10.08

Worst-case scenario: **More of the same**

Obviously, this scenario assumes that we continue to see weakness in the gold mining shares and a continued positive divergence in the S&P. I think the probability of this event very unlikely. I hold out a recent article by Frank Holmes, CEO of U.S. Global Advisors in which he makes the following case "*Take a look at the Philadelphia Gold & Silver Index (XAU) during prior periods of stress. While gold stocks have a history of higher volatility compared to the overall U.S. market, consecutive periods of declines are rare. In 30 years, the XAU never had a losing streak of more than three years.*" Link is found here.



So, in the past thirty years, the gold miners have never had more than three years of decline and since it was early 2011, three years ago, that the miners began to crash, statistically, there is a high probability that 2014 is going to be an "up" year.

Risk Control:

There are two means of controlling risk in this trade:

1. On a two-day close under $1,180 (double bottom support) for the gold price, I would liquidate the miners (GDX-US) and place a buy-stop above the blue-chips (SPY-US).
2. We place a 15% risk horizon on the trade - $100,000 drops to $85,000 and we EXIT.

After a five-year ramp-up in blue-chip stocks orchestrated mainly by government intervention, there is a tendency to repeat behavior based upon that which worked in the past but as we all too painfully know, the 12-year bull in gold prices came to an agonizing end for many in 2012, with last year's decline coming despite massive money-printing and global currency debasement, both of which could not have been more bullish for the miners. As we move forward into 2014, there are no headlines that are suggesting "anything different" (like gold in 2011) as seen by the Investor Sentiment numbers (75% bulls) and yet the market is down the first five days of January. "Bear markets come like a thief in the night.." – just ask anyone who owned gold in 2013 – and I think that in six months, we will look back at January 2014 as the moment where the Bear quietly slipped in through the screen door and established his base camp. However, you can never underestimate the replacement power of equities in a reflationary environment because all you have to do is look at the Zimbabwe, Tokyo, and Caracas Stock Exchanges to see what inflationary policies have done to domestic stock prices there (zero correlation to those economies). The U.S. has been doing the exact same since the financial crisis in 2008 but they have done a masterful job in marketing "low inflation" and "recovery" as a reason to avoid gold, own U.S. dollars and stocks, and remain optimistic. It is on this last point that the "paired trade" makes so much sense. If we get a dollar crisis and inflation takes off in the U.S., there is no reason to think stocks will crash (other than a reduction in P/E multiples) because it will take many more depreciated dollars to buy one share of the SPY-US. Being short in U.S. dollars would be an extremely high-risk endeavor (just ask the Japanese, Zimbabweans, or the Venezuelans) so we offset that inflation risk by matching it with the most depressed sector in forty years – the Gold Miners (GDX-US).

The "Long Miners/Short S&P" is a sound trading strategy for the current environment and I urge everyone to consider it carefully as a compliment to the "balanced portfolio" approach.

MJB

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