

New Gold Stock Environment

At Zeal we welcomed the new year by publishing the latest edition of our Favorite Gold-Producing Stocks Research Report. And looking back a lot has happened in the gold stock arena since the last installment. In fact in just over a year the environment in which we trade these stocks has radically changed. While some of the environmental forces have occurred from the inside out, the most impactful are external in nature and have really caught investors off guard.

Investors started their head scratching early on in 2008 when gold stocks performed quite sluggishly in response to a strong gold upleg. Gold soared 54% from its August 2007 low of \$651 to its March 2008 all-time nominal high of \$1005. Yet measured by the HUI, gold stocks were only able to eke out a gain of 69% over this same period of time.

Gold stocks leveraging gold's gains by only 1.3x was pathetic. This was well below [historical precedent](#) and did not provide investors with sufficient-enough positive leverage to reward them for the risks of owning gold mining companies.

Gold stocks were then dragged down in the typical [summer doldrums](#) that tend to hammer the PMs. And July and August were none too kind to the HUI, lopping off 33% at worst in these two months. But hope sprung eternal going into September, in what has historically been the beginning of a [seasonally strong](#) time for gold and gold stocks.

But what September brought to the entire global marketplace, including gold stocks, would be a force that would trump not only historical precedent, but logic and fundamentals. The [Great Stock Panic of 2008](#) that took shape in September grew into a storm of epic proportions. And in its destructive path that stretched into October and November, every asset class was devastated.

Gold stocks were struck particularly hard. In the first few weeks of October the HUI was crushed, down by a whopping 52%! And from its all-time high just 7 months prior, the October 27th bottom had the HUI down a breathtaking 71%. This anomalous panic selling brought gold stocks down to levels not seen since mid-2003.

But this end-of-the-gold-stock-world scenario was preposterous. The last time the HUI was this low gold was trading near \$350. Did gold get sold off to these same levels amidst this global stock panic? Not even close! At its worst gold didn't even break through \$700. Gold was one of the best-performing, or least-damaged, assets during these deep dark months in the second half of 2008.

Interestingly this stock panic has created a chain reaction of events that are likely to bolster gold's already-smashing fundamentals, thus giving it even more appreciation potential going forward. In an essay published just last week my

business partner Adam Hamilton expounded on how the economic stimuli put forth by the world's bureaucrats in response to this stock panic will only improve the [fundamentals](#) for this ongoing secular gold bull.

As Adam clearly conveys, there is no doubt that gold's fundamentals are extremely bullish. And this should allow the price of gold to reside at levels that would make mining it very profitable. But there is also no doubt that the credit crisis that spawned this stock panic will have an interim effect on how gold mining companies do business.

In very short order the morose condition of the financial markets has caused even profitable mining companies to drastically alter their business plans. And this rapid change is readily apparent in the language and actions coming from the world's gold producers.

Financials are of course a key segment to consider when analyzing a gold stock. And while the gold mining industry tends to be more dynamic than most, meaning a lot can change over the course of a year, the changes on the financial front of recent have been staggering.

And these changes are readily apparent from one quarter to the next. There has been a vast difference in gold stock commentary and outlook from financial reporting between Q2 and Q3 2008 (reporting typically lags a quarter by about 4 to 6 weeks). And the tone has been the same from nearly every company. The following excerpt from a Q3 release by one of the elite HUI components sums this up nicely:

"The global economy is currently experiencing one of the most unsettled times in recent history. With the severe correction in the capital markets, and illiquidity in the credit markets, a sociopolitical and economic shift of incredible proportions is taking place... In the context of this environment, successful companies will be the ones that are able to maintain flexibility, continue to generate cash flow, preserve capital and maximize cash balances."

The last part of this statement is what really caught my attention. And that's because preservation of capital and maximizing cash balances is totally uncharacteristic of gold mining companies. In fact throughout the course of this gold bull the opposite has been true.

In the transition from secular bear to secular bull the gold miners have had to refocus their efforts on rebuilding and actually growing their once-downtrodden industry. With the price of gold on the rise the producers of this yellow metal have been scrambling to ramp up supply in order to meet fast-growing demand.

And since building infrastructure in the mining industry requires such massive amounts of capital, this process has proven to be quite expensive. Mineral

exploration, project development, and mine operation require huge capital outflows. So much so that operating cash flows are usually insufficient to cover all three.

In order to supplement cash-flow shortfalls, miners have had to tap funds via equity and debt financings. And even with these capital infusions, capital expenditures were still stretched to the maximum. The only time you saw material cash on the balance sheets of these gold miners, that in excess of mandated liquidity requirements, was when it was tagged for imminent capex.

On top of project capex there was also a massive consolidation occurring in the gold mining industry. Cash that wasn't being used to fund organic growth was being used in the M&A arena. With capex and M&A, the preservation of capital and growth of cash was a foreign concept to gold miners.

So with this recent radical shift in strategy as characterized by the excerpt above, what has changed with the gold stocks? Well before I address this question the first thing I'd like to do is determine what hasn't changed for gold stocks. And knowing what I know today is there any reason why I wouldn't want to own them?

There is no doubt that the fallout from this stock panic will have a material and even lasting effect on the global economy. Any company that provides a good or service is likely to suffer in some way, shape, or form. A sharp decrease in global consumption has had a snowball effect that has transpired into what will likely be one doozy of a recession.

But gold miners are in a unique situation relative to most other companies. They sell a product that has not seen demand destruction. In fact the product they sell will likely be more sought after in the coming years than ever before in history. Their product is also finite. This precious metal is so sparingly stored in nature's womb that its suppliers have had [little success](#) growing its production.

The success of gold stocks indeed rides on the success of their underlying product, gold. In fact the only environment to invest in a gold mining company, thus taking on the myriad of risks that come with it, is in a rising gold price environment. But in order to take on these risks there must be incentive. And the positive leverage mentioned earlier is the incentive gold stock investors long for.

Inherently gold mining profits should leverage gold's gains. And in a stable-cost environment margins should soar as the price of gold rises. It is the realization and anticipation of stellar profits that attracts investors to gold stocks. As a general rule of thumb I like to see at least 2x leverage, which is why the leverage seen in the last gold upleg was so disappointing.

But I believe strong positive leverage will return. And we are already seeing this in recent months. From their late October bottoms to their recent highs gold and the HUI were up 24% and 100% respectively. This 4.2-to-1 leverage is the type of leverage that got investors excited early on in this gold bull. And going forward this positive leverage will bring more investors back into the game.

So in a rising gold environment, with anticipated positive leverage, there is ample reason to own gold stocks. Gold stocks have been one of the best-performing stock sectors since the turn of the century, and they are likely to continue to be as the secular gold bull marches on.

Next comes the arduous task of picking the gold stocks that have the highest probabilities for success. Now I've detailed what to look for when [researching mining stocks](#) in past essays, and ultimately with some simple analysis investors should be able to narrow down the field. Knowing how a gold miner ranks in a handful of high-level fundamental categories can reveal its position when scrubbed up against its industry peers.

Does a miner produce its gold at a low cost from a long-life project(s)? Does it have good management? Are its financials under control? Does it have a growth strategy? Provocatively these simple questions bring unfavorable answers for a large number of gold miners. And like separating the wheat from the chaff, this winnowing exercise is an important step in separating the strong gold stocks from the weak ones.

Once filtered the resulting pool is the best-of-the-best. And in this pool there can be a wide spectrum of stocks that range from the world's biggest senior gold producers to micro-cap junior producers making their small but important impact on the gold mining industry.

In compiling the stocks that populate our latest report we followed this same line of research and then some. But the Great Stock Panic of 2008 has accentuated one specific category. As mentioned, in just a few short months this credit crisis has drastically altered even the gold stock landscape. And financials are now in the limelight more than ever before.

Even though gold has proven to be the strongest commodity in this time of across-the-board selling of every asset, even the gold miners are adversely affected. Not only are their stocks indiscriminately, and unjustifiably, sold off with everything else, these wild credit markets are accentuating the need for strong financials.

Up until recently gold miners had no problem procuring the capital to maintain strong financials. The sharp appreciation of their stock prices allowed robust equity financings with minimal dilutive impact. And credit was readily available as it was easy to find buyers of corporate debt, many miners had large untapped

lines of credit, and banks were happy to initiate project loans on future mining operations.

But things sure have taken an about face in recent months. Equity financings are now much more difficult. Not only is it harder to find investors who haven't been burned and are willing to subscribe to shares, the depressed stock prices translate to more shares sold in order to fund a capex that hasn't changed. This has a much more dilutive effect.

And as you well know the credit markets are now all but frozen with banks unwilling to lend new money or approve new lines of credit. Another issue along these same lines is banks are now much less willing to refinance debt in the fashion in which they had in the past. Many gold miners may get into trouble in this area.

Ultimately when capital was uninhibitedly coming and going it wasn't a big deal to pay off or refinance debt with near-term maturities. But with cash from financings slowing to a halt, some mining companies may be pinched to meet their impending obligations with banks that are much less flexible. This may come in the form of inability to meet debt payments and/or halting capex for project development.

This tightened credit environment will affect individual companies in different ways. And for most companies it is likely that their business plans will need to materially change. This is why financials must now be scrutinized at a higher level when analyzing gold stocks. Eventually the credit markets will loosen up, but until they do even the gold miners will need to be prudent in managing their balance sheets and future capex.

Those miners that stand above the rest right now are not over-extended and are flexible on their capital commitments, are selling low-cost gold production for healthy margins, have operating cash flows and existing lines of credit that can build cash and meet current and near-term debt obligations, and have long-term debt that matures comfortably into the future.

Interestingly this credit crisis can actually create some incredible opportunities for those elite gold miners that have their financials under control. Most gold stocks, especially the juniors, have seen their market capitalizations plummet amidst this stock panic. And at \$800+ gold some of the projects these companies control are vastly undervalued.

Those well-to-do gold miners that actually have cash and available credit are in position to gobble up cheap assets that would greatly bolster their portfolios. I wouldn't be surprised to see an increase in M&A activity over the next year or so. The financially strong gold companies should be able to take advantage of those that are now cash-strapped.

At Zeal we've performed extensive research and have identified our favorite gold-producing stocks that are in position to thrive in today's environment. After screening the initial pool of the world's primary gold producers we isolated our top 12 and performed a detailed analysis of operation and project fundamentals for each company while also considering such factors as company history, management, geopolitics, and of course financials.

If you don't have the hundreds of hours of bandwidth or the experience necessary to perform gold stock research on your own, we can take care of that for you. We strive to identify the highest-potential stocks in a given sector so we know which ones to trade personally and in our [acclaimed newsletters](#). If you wish to have this comprehensive research at your fingertips, [please purchase](#) our brand new Favorite 12 Gold-Producing Stocks Research Report today.

The bottom line is considering gold's smashing fundamentals now and in the future, gold stocks have been unfairly beaten up in this recent stock panic. Even though the HUI has recovered somewhat from its ridiculous October lows, gold stocks are still cheap relative to gold. They are trading as though gold is still at \$600.

After the 2008 carnage I expect gold stocks to be among the best-performing stock sectors of 2009. But investors must be prudent in their stock picking. Gold stocks are still likely to be volatile and an ongoing tight credit market will wreak havoc on those companies that are ill-equipped to successfully manage their financials.

Scott Wright

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So how can you profit from this information? We publish an acclaimed monthly newsletter, [Zeal Intelligence](#), that details exactly what we are doing in terms of actual stock and options trading based on all the lessons we have learned in our market research as well as provides in-depth market analysis and commentary. Please consider joining us each month at ... www.zeallc.com/subscribe.htm

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