

Junior Resource Prospects

Just a few years ago, the junior resource stocks were hotter than the sun. The fact that the accelerating commodities bull was secular in nature was finally starting to sink in for mainstream traders. With a growing world in desperate need of endless new supplies of natural resources, capital flooded into junior resource stocks driving some truly epic gains.

Today that junior golden age feels like a distant memory from a lifetime ago. The unmitigated fury of the stock panic ravaged the junior resource stocks. Its monumental carnage created a canyon-sized discontinuity in sentiment that's been nearly impossible for traders to bridge and see beyond. Thus commodities juniors have been largely forgotten, collateral damage left for dead in a war they didn't start.

But with the stock markets now gradually recovering from the worst of the panic, dim memories of these tiny high-potential stocks are being rekindled. A small yet growing fraction of traders has started wondering how the prospects for the junior resource stocks look today. But in order to game their future, we first have to understand where they have been.

Measuring this unique sub-sector is certainly not easy. The ranks of commodities juniors are highly fluid and very amorphous. The junior churn is relentless, with old companies fading away into oblivion while new companies constantly form. This makes it very difficult to follow junior resource stocks as an aggregate group. How do you index them, pick key stocks to track, when their ranks are in constant flux?

The Canadians have made the best attempt yet at indexing this challenging sector. With Canada's vast and incredibly natural-resource-rich geography, commodities production is a major part of its economy. Mining is a very important sector up north, with 57% of the *world's* publicly-traded mining companies listing on Toronto's stock exchanges. At the end of 2008, 1427 mining companies listed in Toronto. This dwarfs the NYSE group's 116, the 216 listed in London, and even the 684 in Australia *combined!*

All the larger resource stocks list on the primary Toronto Stock Exchange. But the great majority (75%) do not meet the listing requirements of the TSX. They trade on the TSX Venture Exchange (CDNX), which is the busiest and most dynamic junior-resource-stock exchange on the planet. Once known as the Vancouver Stock Exchange, the CDNX has long been the Wild West of the commodities-stock world.

An index now known by the unwieldy name of S&P/TSX Venture Composite Index tracks the CDNX. But most traders just call it the CDNX, as I do. From now on "CDNX" refers to this index and not the broader exchange. This index's

construction is really ingenious, as it deftly captures the important junior resource stocks while keeping its component list relevant in the face of this sector's endless fluidity.

In order to be included in the CDNX index, two key requirements must be met. First, a stock has to have been listed for a minimum of 12 months. This keeps out the shakiest new issues that soon fail. Second, a stock has to account for at least 0.05% of the total market capitalization of all the stocks contained in the CDNX index. This requirement is *brilliant*, it ensures only the bigger and stronger juniors of this exchange will be indexed. Each calendar quarter the CDNX component list is adjusted to reflect these bigger juniors.

Out of around 2000 stocks listing on the CDNX, today 475 meet these requirements. Only they are included in the CDNX index. Of this elite group of juniors, 23% have the word "Resource" in their name, 22% "Resources", 10% "Energy", 8% "Gold", and 6% "Minerals". All together just over 70% of these 475 juniors are involved in the natural-resources sector! They also dominate by market cap, and this index is market-cap weighted. The other 30% are involved in technology, bio-tech, and other non-resource realms.

So while the CDNX is not exclusively junior resource stocks, it is close enough. And there is certainly no other index in the world that comes as close as the CDNX for accurately tracking this amorphous sector anyway. If you want to understand the fortunes of junior resource stocks as a whole, you have to follow the CDNX.

And at first glance, the CDNX has been doing quite well since the stock panic ended ([VXO](#) fell under 50 again) in mid-December. It is charted in blue below, with the CCI underneath it in red. The [Continuous Commodity Index](#), of course, is the premier measure of commodities prices. And since small resource stocks produce or explore for commodities, their ultimate success is governed by commodities prices.



As I'll discuss further later, the CDNX fell to apocalyptic lows in the stock panic. Between the plummeting general stock markets and plunging commodities prices, not many traders had the courage to hold commodities juniors. But once the CCI started to recover in late December, the CDNX shot up in a sharp initial recovery. Since then it has been trending higher in a tight uptrend, amplifying the CCI's gains.

The only time the CDNX fell under this uptrend's support was in late February and early March when economic despair set in. Despite all the [data to the contrary](#), traders started again fearing a new depression as stock prices plunged to fresh lows. Commodities were sold off too, which makes sense in the framework of the then-popular neo-depression worldview. A depression would definitely erode global commodities demand!

But we certainly weren't facing a true economic depression, merely depressed sentiment driven by depressed stock-market levels. And as soon as the stock markets started recovering in March, so did sentiment. Traders started bidding up both commodities and junior resource stocks, and the CDNX surged back up into its previous uptrend. Just this month, the CCI surged to new post-panic highs which the CDNX mirrored in a nice breakout surge of its own.

Since the CDNX bottomed on December 8th, it has rallied 57.6% at best as of May 12th. Buying interest in these junior resource stocks was naturally heavily dependent on the CCI's fortunes. In this recovery, the CDNX index has had a correlation r-square of 65% with the CCI. This means 2/3rds of the CDNX price

action can be statistically explained by the underlying activity in commodities prices.

Now a 58% run since early December, straddling a considerably lower low in the general stock markets, sounds pretty good at first glance. But it's really not. Compared to the major resource stocks, this performance is pathetic. At best since the panic, the HUI gold-stock index is up 134%! The major gold stocks' post-panic performance has run circles around the junior gold stocks' performance so far.

And as I look at the stellar post-panic performance of the long-term investments in our [Zeal Intelligence](#) investment portfolio, the outperformance of the large stocks is universal. There are not really any great large-cap commodities-stock indexes either, but considering a few performances from leaders within their respective sectors drives home the kinds of gains these major resource stocks have seen.

BHP Billiton, the world's largest diversified miner, has rallied 121% at best since the panic. Petrobras, the elite Brazilian oil major, is up 168% at best. Chesapeake Energy, the giant US natural-gas producer, is up 111% at best despite *much* weaker natural-gas prices after the stock panic. Freeport-McMoRan Copper, the elite giant copper miner, is up 209% at best. Market-darling gold major Goldcorp has rallied 132%, while the market-darling silver giant Silver Wheaton is up a whopping 263% at best since the panic!

And these massive gains are pretty representative of their respective sectors. Averaging 100%+ gains since the depths of the stock panic, the large-cap resource stocks have trounced the CDNX's measly 58% post-panic run. There is no doubt that investors and speculators have been better served by sticking with the big boys rather than betting on the small juniors.

This massive junior-resource underperformance is concerning many traders. As they perceive this phenomenon, they grow even more reluctant to risk their scarce and valuable capital in junior resource stocks. What is wrong with this once-hot sector? Are the juniors doomed to never regain their former glory? In order to address these questions, some critical perspective is necessary.

Junior resource stocks are *tiny* in market-cap terms. As an example, my business partner Scott Wright has done a vast amount of world-class research [on gold juniors](#). He recently crunched the numbers and found that 82% of the entire universe of junior golds had market caps under \$50m. Fully 50% had market caps under \$10m! And since there are many more junior gold companies than other commodities categories, these trivial market-cap levels are representative of junior resource stocks in general.

At the end of 2008, the 1071 mining stocks listed on the TSX Venture Exchange had a combined market cap of just C\$8.7b! A simple average yields a mean market cap for these companies of just C\$8m! This is so tiny it defies belief. And of course there are a handful of larger juniors that really skew this average. The great majority of CDNX companies probably have market caps under C\$5m. This has big implications.

These junior resource stocks are so small that institutional investors like mutual funds and hedge funds rarely bother with them. The reasons are many. If you run a fund and your minimum allocation to any one stock is \$10m, and juniors are trading at \$5m, then you simply can't buy them. Your buying alone would drive the price stratospheric and prevent you from getting deployed near market. And even if you could, you'd own so much of the company that it would be impossible for you to exit later without killing the price.

But it is not just juniors' tiny absolute sizes and meager trading volumes that are institutional deterrents. In the US, most of these juniors trade on the OTC Bulletin Board or Pink Sheets. Usually institutions will *not* buy stocks not listed on the major exchanges. OTC-listed stocks do report to the SEC quarterly, but stocks on the Pinks do not have to report to the SEC at all! Thus you never know what is really going on with them. And most US funds only trade stocks in the US, they are not willing to trade Canadian issues.

Thus institutions are almost never major investors in junior resource stocks. The only group of investors willing to overlook all these limitations is *individual retail investors*. Retail traders are perpetually enamored with very cheap stocks (they can own more shares) and they like the vast potential the successful juniors have to soar. They are not swinging big-enough lines as individuals to impact tiny-stock prices and they don't mind trading in Canada or on the US Pink Sheets. So retail traders *dominate* the junior scene!

Since the stock panic, nearly all of the recent stock buying has emerged from institutions. Professionals run these funds, they study the markets and understand psychology. They realize that fear was way overdone in the stock panic and resource-stock prices fell far too low to reflect any reasonable economic future. So they've been buying aggressively. But since the institutions only play in the major-exchange-listed larger resource stocks, this post-panic professional buying has not found its way into the juniors.

Meanwhile, as a thundering herd individuals are *highly* emotional. Since the panic they are generally sitting in cash, terrified at what the future might bring. Instead of being contrarians who want to buy when everyone else is scared, they take comfort in groupthink. Stocks will have to rally a long way, driven by institutional players, before most retail investors muster the courage to buy back in. And until retail commodities-stock traders return en masse, the junior resource stocks they dominate will continue to lag the majors.

This sounds discouraging, but it's really not. Retail investors are manic-depressive. They always return to stocks, but not until the markets convince them it is safe again (by rallying far off the lows). So once big commodities stocks, and commodities prices, travel high enough to eliminate the residual post-panic fear, retail traders are going to flood in *aggressively*. Their buying will spark huge surges in the tiny juniors and eventually lead to rampant greed as usual. Of course the gains and greed will feed on itself driving even more buying.

With the return of the juniors' core investing constituency inevitable, the last question is whether they have room to run higher technically and fundamentally. Do junior resource stocks deserve to be trading where they are today for commodities-price reasons? As this long-term CDNX and CCI chart reveals, juniors remain dirt cheap today relative to every conceivable measuring stick. Their prospects are very bright!



While the commodities correction started before the stock panic, the CCI's terminal plunge driven by it resulted in a massive 46.7% loss between early July and early December. Such a wild swing is unprecedented, as the CCI usually moves gradually due to its geometrically-averaged index construction. Meanwhile, from late May to early December, the CDNX plummeted a mind-blowing 74.8%! Ouch! Like the CCI, its terminal plunge was driven by the general-stock panic.

At worst at its panic lows, the CCI itself briefly fell back to November 2005 levels. But the plummet in the CDNX was so unbelievably precipitous that its *entire bull market* was more than erased! Despite commodities prices remaining much higher, at worst the CDNX was trading well below where it did all the way back in 2002! The devastating impact of the stock panic on junior-resource-stock prices could not have been more radical.

But fundamentally this made no sense at all. Scared retail traders panicked and totally abandoned the juniors. There was little buying to offset their relentless selling so junior stock prices fell to levels that didn't make any sense unless the world was truly ending. But the Apocalypse was not drawing nigh. There are several different ways this truth can be illustrated technically using the CDNX and CCI chart above.

Even at its panic low, the CCI merely descended to 327. This was a similar level to Q4 2005, where the CCI averaged 335 on close. Yet in that very quarter, the CDNX averaged 2075. This was literally 3x its panic low of December 2008! So using the CCI as a measure, *even in the very darkest days* the junior resource stocks were only trading at *a third* of where commodities-price fundamentals demanded.

Since the stock panic, the CCI has traded between 327 and 404. As you can see in this chart, these were the same levels this index traded at for the 19 months between November 2005 and May 2007. Yet over this very span, the CDNX averaged 2725! But since the panic it has only averaged 890, once again about a third of where commodities prices suggest it should be. Clearly these junior stocks remain an epic bargain fundamentally.

Of course in 2006 and early 2007 retail investors were getting greedy, driving the surge in the CDNX evident in this chart. So if you want to be really conservative, consider extending the CDNX's *pre-surge* uptrend rendered above. During the last long period of time where the CCI traded in the same range it has been in since the stock panic, the midpoint in the CDNX's secular uptrend ascended from 2000 to 2250 or so. So even by this conservative measure, today's CDNX near 1050 still looks ridiculously oversold.

Junior resource stocks, because they were driven so extremely low in the panic, have awesomely bullish prospects today. Even if commodities prices flatline going forward, juniors should *at least* double from here. And with commodities prices highly likely to [rise in the coming years](#), the embattled juniors should do far better. Retail investors' return is inevitable, and when they come back they will bid these stocks back up to more reasonable prices based on their underlying commodities' fundamentals.

At Zeal, we've been buying elite junior resource stocks to game this unsustainable anomaly. In our [Zeal Intelligence](#) newsletter trading portfolio,

we've bought and recommended elite gold, oil, and copper juniors. While they've done quite well already, the best gains are yet to come. As retail-investor confidence returns, the oversold junior sector is going to soar. [Subscribe today](#) to our acclaimed monthly newsletter and ride this coming junior surge higher with us!

With so many juniors yet so few truly great junior stocks, it takes an incredible amount of research to uncover the gems. So periodically we research the entire universe of juniors in a particular sector to find our favorites to trade going forward. Our latest [detailed fundamental report](#), on junior golds, has been very popular. While these elite stocks are gradually rising, their best gains by far are yet to come when retail investors get excited about gold stocks again. [Buy our report today](#) and get deployed for this coming rally!

The bottom line is junior resource stocks' prospects are extraordinarily bullish today! Panicking retail investors drove their prices far too low relative to commodities fundamentals during the recent fear bubble. Because of this anomaly, today you can buy many elite juniors for bargain prices not seen since the early days of this secular commodities bull. Yet today's prevailing commodities prices are over twice as high.

Our big world still consumes vast amounts of raw materials, even in these troubled times. And juniors remain critically important in the global commodities-supply pipeline since they take the big risks to explore for new deposits. Just as in the past, the juniors successful in this realm will yield legendary returns for their owners. At such crazy low prices today, if you ever wanted junior exposure now is the time to add it.

Adam Hamilton, CPA

May 15, 2009

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. Please consider joining us each month for tactical trading details and more in our premium Zeal Intelligence service at ... www.zeallc.com/subscribe.htm

Questions for Adam? I would be more than happy to address them through my private consulting business. Please visit www.zeallc.com/adam.htm for more information.

Thoughts, comments, or flames? Fire away at zelotes@zeallc.com. Due to my staggering and perpetually increasing e-mail load, I regret that I am not able to

respond to comments personally. I will read all messages though and really appreciate your feedback!

Copyright 2000 - 2009 Zeal Research (www.ZealLLC.com)