

Junior Recovery?

Every so often I'm asked to describe the role of juniors in the commodities industry. And I simply reply, "They're like rabbits". Rabbits are seemingly insignificant and useless animals. But in actuality they serve a critical role in the food chain as a valuable source of nourishment for larger animals.

Like rabbits, juniors are seemingly insignificant. But their function in commodities lifecycles is indispensable. And also like rabbits, juniors are a valuable source of nourishment to their predators. One of their major roles is to feed the larger resource companies, ultimately serving to provide sustenance and longevity.

The primary purpose of junior resource companies is to explore, discover, and develop natural resources that are economically extractable and can feed the supply chain. They are in a sense responsible for finding the next generation of mines and oilfields. Without juniors, the balance of most commodities markets would be way off-kilter.

But in order for juniors to function they need their own food source, capital. The lifeblood of all junior resource companies is the almighty dollar. And since mineral and energy exploration is so capital-intensive, juniors require sizeable bankrolls to do what they do.

By definition juniors are non-producing explorationists. And since they aren't producing a product there are no sources of revenue. So with no cash flows, juniors must rely on investors to procure the necessary capital to survive. And in order to tap investor capital most juniors must list their companies on public stock exchanges, thus offering investors ownership stakes.

With non-stringent listing requirements at many of the exchanges that provide a market for smaller-capitalized companies, the junior population is quite robust. Any savvy entrepreneur can stake a plot of land, come up with a catchy name for his company, and advertise it as a high-potential resource play.

Because of this junior resource companies are a dime a dozen and the competition for investor capital is fierce. There are thousands of stocks to choose from that are hungry for your dollars. And these juniors will do whatever they can to attract investors to their ventures. But because of their small size and in some cases the exchanges in which they list, the sources of capital are limited.

Institutional capital from such sources as mutual, pension, and hedge funds typically has strict investment guidelines. Most of these funds cannot invest in small-cap stocks. And in most cases they can't even trade on junior level exchanges, regardless of company size. Because of this juniors are heavily reliant on investment capital from the retail, or individual, investor. Investors like

you and me are typically the primary source of funds for junior resource companies.

On the promotion side of things juniors can only do so much to market their projects. In reality this sector is heavily dependent on external market forces to drive interest in the fortunes of their proposed products. And the foundation of this interest is a bull market in whatever resource a junior is after. Investors aren't going to "go for the gold" unless fundamentals call for a prolonged period of rising prices.

And it is indeed the secular commodities bull that we are in the midst of that has brought interest to the junior markets. After years of underinvestment in commodities infrastructure and pipelines, prices are finally moving high enough to entice in exploration and development. And investors want a piece of the action.

Since this commodities bull market began, shortly after the turn of the century, investor capital has indeed found its way into the junior resource sector. But as quick as capital found its way in, it has been quicker finding its way out. And any investor in the junior realm the last couple years has felt the pain. Junior stocks have been sold off with reckless abandon since the second half of 2007. The risk side of the classic risk/reward tradeoff has been highly accentuated.

This carnage is best illustrated by looking at the performance of the S&P/TSX Venture Composite Index (symbol is CDNX based on the original Canadian Venture Exchange). The CDNX is comprised of nearly 500 stocks that represent the upper crust of the TSX Venture Exchange (TSX-V).

The TSX-V is home to a large contingent of the world's junior resource stocks. Most of the companies that populate this exchange are wannabe miners and drillers that don't have the liquidity and capital requirements to qualify for big-board listings. The TSX-V is in essence a portal for venture capital to fund start-ups via public equity. And since over 75% of the companies that list on this Canadian exchange are resource stocks, the TSX-V is as good of place as any to measure the health of the juniors.



This first chart displays a picture of the junior sector since the beginning of 2007. And it is this segment of time that really captures what has turned out to be a collapse in the junior equity markets. You'll notice that weakness crept in well before the [stock panic of 2008](#) took hold.

After an all-time high was achieved in the first half of 2007, the CDNX entered into a period of what was perceived to be a healthy consolidation. But as most commodities and commodities stocks began to rise again in the second half of the year and into the beginning of 2008, the CDNX took a different path and trended down. You can see that a period of lower highs carved a textbook descending triangle.

Technicians consider this chart pattern very bearish, and around the middle of 2008 the CDNX proved this tendency correct. It knifed through support and went into a virtual free-fall. By the midway point of 2008 the rest of the commodities complex had turned downward after a strong rally during the first half of the year, and this gave junior stock investors even more reason to sell.

Now even though the commodities complex was in correction mode, it needed to be. Commodities and commodities stocks were overbought in mid-2008 and needed a rebalancing on the sentiment front. But right where a correction might have ended or turned into a consolidation, in September 2008 the global stock panic took over. And the precipitous selling of virtually all assets took its toll on the juniors.

The CDNX correction accelerated into a rapid plunge in the second half of 2008. And when the CDNX hit its all-time low of 684 in early December it was down a staggering 76% on the year! Provocatively most of these losses happened in less than 6 months. From July 2, 2008 the CDNX would plummet 74% by the time it found its bottom, an *average loss of 0.68% per trading day* over this span.

With the selling finally exhausted toward the end of 2008, the CDNX entered into recovery mode. And since its bottom it has carved a nice uptrend that has seen it gain 75%. But even though this uptrend is encouraging, the junior markets are still in a state of disarray. This next chart pans out, capturing the history of the CDNX on a zeroed-axis long-term chart, and shows a still-ugly picture.



The CDNX has a history that dates back to December 2001, which was when the Canadian Venture Exchange was acquired by the Toronto Stock Exchange. And this history goes far enough back to nearly capture the entirety of the commodities bull. While individual commodities began their bulls at different times, measured by the [CRB](#) the greater bull kicked off in late 2001.

Since juniors tend to be laggards (investors want confirmation of a strategic trend before they deploy risk capital) the CDNX's launching point about a year after the CRB's makes sense. And from its low in late 2002 the CDNX mounted a spectacular run, posting a 278% gain upon reaching its apex of 3370 in Q2 2007.

But from this high the consolidation, turned correction, turned panic-induced crash didn't let up until it had shed 80%. In very short order this staggering

descent wiped the gains of the CDNX's *entire* bull market! In October this index hit an *all-time low* before shedding an additional 23% by the time it was finished.

Junior resource stock investors that didn't pull out amidst this free-fall saw their capital simply obliterated. And though there has been a respectable rally off the bottom, the CDNX is still in dire straits. This chart's long-term view shows just how bad things really are. At 1185 the CDNX is still at 2003 levels!

Junior resource stocks are currently experiencing a serious crisis of confidence. Investors in this segment of the markets are trading these stocks as though the commodities bull is over. [But it is not](#). And for a little perspective, just compare commodities prices today to what they were the last time the CDNX was trading at these levels.

The average prices of gold, silver, oil, copper, uranium, and corn are 153%, 174%, 81%, 152%, 304%, and 58% higher respectively in 2009 versus 2003! With commodities prices so much higher today, even after the sharp corrections of 2008, how is it possible that the juniors can be so depressed?

There is no better way to explain this disconnect than inactivity on the part of retail investment. The CDNX's devastating selloff sent nearly all junior resource stock investors running for the hills. And they've been real slow to return. But it is hard to blame them with \$4 out of every \$5 gone. In fact because of this, it is likely that most junior investors that got burned in this crash are gone for good.

But with commodities and most of the larger commodities stocks finding their footing and leading the markets higher in this post-panic recovery period, the juniors will eventually follow. And it will likely take a whole new class of investors to drive the CDNX materially higher.

The face of this sector will be radically different than it was a couple years ago. This junior malaise is not only shaking out the investors, but it will also shake out many of the juniors. With stock prices for many of these companies so low, most juniors have been unable to raise sufficient-enough capital to advance and market their projects.

This creates a huge structural problem! A faltering junior market will have lasting effects that will permeate throughout the entire commodities markets. As mentioned earlier junior E&D activity is a critical component in growing the supply chains of *secular* commodities bulls. Many of the incoming mines and oilfields were discovered and developed by juniors before they were bought by the seniors, or these projects grew the juniors into larger companies themselves.

Without junior contributions future supplies will be tighter, thus causing prices to be even higher. Ultimately this is bullish for the future of commodities and the longevity of the greater bull, but it has exposed a big interim problem. The entire

junior industry is on life support and is in desperate need of a monetary transfusion.

Now eventually capital will flood back into the junior markets, but how far back will these little companies lag before the [leverage](#) investors command finally takes hold? There is no denying the fact that juniors are risky, which is why investors need to be rewarded for taking the risks inherent in junior speculation. But until confidence returns to the junior realm, this positive leverage will not materialize.

What kind of catalyst will there need to be to bring back junior excitement? Will it be another prolonged run-up in commodities prices, some larger investors pouring capital into this sector, or more mainstream exposure? It will likely be a combination of these factors among many, and only time will tell exactly when this will happen. But when the juniors do catch a bid, their gains will be fast and furious.

With an 80% decline from the top and only a slight recovery so far from the bottom, the CDNX has a long way to go before it returns to pre-panic levels. And the new generation of junior investors should see legendary gains in the coming years. Just to get back to 2000, about where the stock panic took hold of the CDNX, this index would need to rise another 69% from today's levels (a 192% gain from the bottom). And to return to its high the CDNX would need a 184% run from today's levels (a 392% rally from the bottom).

Ultimately we are still mired in the junior doldrums and these companies are facing a capital crisis. But there is a benefit to this dreary environment in that it will weed out many of the junk stocks. The juniors trying to advance projects that are not economic at lower commodities prices and/or have incompetent management/technical teams will be exposed and are not likely to see much investment capital for some time to come.

Going forward investors are likely to be a lot more discerning when choosing which junior stocks to speculate in. And at Zeal we want to be informed and ready to deploy capital when the junior revival occurs. Our last two [research reports](#) contain in-depth profiles on our favorite gold and silver juniors, and we have already taken several positions in our [newsletters](#). To purchase a report [click here](#). And to purchase our monthly newsletter [click here](#).

The bottom line is juniors serve an important role in the commodities markets. Without the entrepreneurial spirit and innovative nature of these wealth seekers, supply chains will be greatly constrained. The junior market has really struggled to survive lately as the after effects of the commodities correction and stock panic have greatly cut their inflows of capital. Junior stock investors are seemingly nowhere to be found.

A prolonged state of junior malaise will have lasting effects on commodities infrastructure, pipelines, and ultimately prices. And the commodities supply simply cannot be replenished without these juniors. Eventually there will be a marked recovery on the junior front. And when capital inevitably finds its way back into this sector of the markets, the survivors will soar to new heights.

Scott Wright

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