The Investment Case For Junior Mining Companies

Part I: Technical View

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May 05, 2008

Already sold your junior mining shares lately? No? Well better hurry then since juniors have nowhere to go but down. Why trust your hard earned capital to a bunch of liars sitting on empty drill holes? Why trust your hard earned money to entities that won't be able to raise fresh capital needed for ongoing exploration efforts? Don't you recognize that most juniors don't own anything but a few empty drill holes indeed? Don't you recognize that most juniors won't find anything ever since only one out of 2000 projects will make it to a mine? Why fool yourself in order to try to guess which project will make it to a mine? Don't you know the market is always right? The market has spoken, juniors should be avoided like the plague, don't you get it? Why else would juniors be trading these days as if gold were $330? Don't you agree that if $1000 gold can't lift the juniors that $2000 gold won't do it either? So if you don't own juniors congratulations, if you do own juniors then sell them while they're still trading above 0. Then invest your remaining money into entities that are producing since those are the only ones being profitable in a rising precious metals environment.

Pretty encouraging statements right? Does it reflect my opinion about junior mining companies? Well sure enough the statements above are by no means a reflection of my opinion but unfortunately we're dealing with sentiment like this these days and many may wonder if this will ever come to an end. Even good drilling results can't lift a junior these days since sellers are all lined up to in order to cash in. We've seen plenty of examples lately whereby companies doubled over night upon stellar drilling results only to see them drifting back again to pre-discovery levels. So did we bet on the wrong sector after all? What should we do now? Sell, hold or add to our existing positions?

Let's first start off with the popular bear tunes when it comes to junior mining sector. Many advisors will tell you to avoid the juniors (or sell them if you own them) because of:

- Juniors are being shorted by Hedge-funds as part of a spread they play in the gold mining shares. They go long senior gold shares, short juniors thereby depressing the juniors to unimaginable lows
- Juniors are facing difficulties in order to finance their exploration programs due to the on-going credit crisis. A junior that can't finance itself will bleed to death.
- Juniors are facing sky-rocketing exploration costs which in turn accelerates the burn-rate of the remaining cash and therefore accelerates their way towards bankruptcy
- Most juniors won't find anything since only one out of 2000 projects will make it to a mine. Trying to guess which projects could evolve into a mine will most probably lead to tremendous disappointments..
- There are so many new companies and promoters that money from the usual small mining cap investors is diluted

- The uranium boom and the ETFs are diverting plenty of money away from the (gold) juniors.

Sentiment like this has pushed the junior sector towards incredible lows but it seems that there's light at the end of this long dark tunnel. I will deal with sentiment mentioned above in part II (Fundamental over view) but first I want to address the technical picture which is extremely encouraging. Undervaluation Juniors vs Gold reached its extreme in February this year. Since then the juniors didn't correct as much as gold (percentage wise) which has led to an increase of the CDNX/GOLD ratio (see also "**Juniors - Buy Of a Lifetime**". This is an encouraging sign since it means that the CDNX/GOLD ratio has bottomed out. All previous major BUY opportunities for juniors occurred at bottoms like we're witnessing now.

Current situation reminds to the one of late 2002 when sentiment was as bad as it could get and needless to say the juniors were extremely undervalued against gold those days.

It was back then when I wrote my first piece on junior mining companies (2003 – Year of the Junior Mining Companies) and stated:

> Profits of 100% to more than 1000% are in the pipeline next year (2003) if invested in high quality junior exploration companies! END.

Well, I had a lucky shot I guess since the entire junior sector exploded to the upside and appreciated by a multiple of 100% towards the end of the year. Sure enough it was hallelujah time for the gold shares back then and people bought hand over fist all the gold shares they could get their hands on. The year of 2003 turned out to be the best year for the junior sector in this gold bull market so far.

The reason for bringing this up is because (as mentioned above) current situation (from a technical perspective) is very similar as in late 2002. Investors who are feeling depressed about their junior investments should realize that we've been there before and extreme depressed levels never persist for a long period of time. It's just a law of nature, all items swing from under-valuation to over-valuation and back. The junior sector is extremely under-valuated these days (just like in late 2002) and it's only a matter of time before this sector will be moving towards an over-valuation again. Back in 2002 it took the junior sector about one year to morph from a severe under-valuation against gold towards a severe over-valuation against gold. Since we're dealing with a very similar setup as in 2002 it wouldn't surprise me to see another junior hype (over-valuation against gold) within 12+ months from now and yes, we definitely find ourselves in BUY territories right here right now. The only short-term uncertainty is how far gold could correct further from here on. Did we bottom out at $850? Or will gold correct further towards levels just below its 200 dma? Although I think that $850 has a fair chance to hold as major support we can't rule out a return to gold's 200 dma either which would translate itself into gold prices in the low 800's.

The bottom line however is:

Downside risk for gold has dropped below 10%! Downside risk dropping below 10% is good enough for me to start adding to my gold positions again. Remember, we already saw that GOLD/CDNX ratio bottomed out which means that if gold drops eg 10% the juniors (average, CDNX index) will be dropping less than 10%. So it's fair to say that downside risk for the average junior here is less than 10% as well.

On January 25 I wrote my piece '**Juniors - Buy of a Lifetime**' which suggested a major bottom must have been near for the junior sector based on the CDNX/GOLD ratio which had hit a 6 year low. Now after three months people are asking me when my prediction will come true since the juniors are still a bunch of lousy performers.

Believe it or not but I'm encouraged of what I see since February this year. Let's first take a peek at the CDNX/GOLD ratio chart of January 25. The CDNX/GOLD ratio chart reflects the valuation of juniors against gold. A low CDNX/GOLD ratio translates itself into an undervaluation of the juniors against gold and a high CDNX/GOLD ratio translates itself into an over-valuation of the junior shares against gold. The chart below clearly demonstrated the deepest undervaluation of the junior shares since late 2002 which suggested a major bottom must have been near.

NOTE: Since there isn't really a junior index I used the CDNX index which isn't really a perfect match but nevertheless good enough to draw our conclusions

Now three months later the juniors are still not performing well but they had to fight a severe drop in gold. The good news however is that the junior sector didn't correct as much (percentage wise, CDNX index) as the yellow metal itself. This of course translates itself into a rising CDNX/GOLD ratio. In other words, it seems that the CDNX/GOLD ratio has bottomed out! The current CDNX/GOLD ratio chart tells it all:

So it seems that after 4 months the bottom process has ended. This is very encouraging since all previous bottoms marked excellent entry points. Please note that during this bull market in gold the junior sector has found itself only once before in such deeply over-sold territories which was in late 2002. It took then about a year to move towards an over-valuation against gold which resulted in a banner year for the juniors in 2003! The beauty of this monthly chart is that it leaves plenty of room for a giant up-move for the junior sector that could last for more than a year.

In case you still doubt the CDNX/GOLD ratio might have bottomed please take a peek at the CDNX/GOLD weekly chart, this chart leaves no doubt:

This chart clearly demonstrates that the CDNX/GOLD ratio has bottomed out! This simply means that the junior sector has out performed the yellow metal itself over the last few weeks. Sure enough this hasn't translated into higher share prices for the juniors yet since they had to fight a $200 drop in gold.

So when can we expect the junior sector to be catching up?

Well, the answer is in gold itself. We have to be patient for gold to bottom out first and on its next up-leg we could expect the junior sector to be catching up. The good news is that gold most probably will bottom out soon since it's heavily over-sold and is likely to find strong support at the $850 mark:

The chart below shows the similarity of the gold correction in June 2006 and current one:

Although I do think gold has bottomed out at $850 you always have to prepare yourself mentally for a worst case scenario, a scenario in which gold's $850 support level doesn't hold. Then what? Well, in that case we will see gold ending up in the low 800's at or just below its own 200 dma. The thing is it doesn't really matter, the thing that matters is that the downside risk here has dropped below 10%!

These are the times to buy into the juniors (from a technical perspective), bottom is most likely in!

Highlights:

- Gold correction most probably over (bottomed out at $850)
- Junior sector just recovering from deepest over-sold condition since late 2002
- CDNX has started outperforming gold over the last few weeks
- Previous bottoms in CDNX/GOLD ratio were being characterized by sharp up-moves that lasted for many months
- CDNX/GOLD ratio charts leave plenty of room for a giant up-move that could last for more than a year
- Sentiment in junior sector has hit an all time low. This is a dream scenario from a contrarian perspective.

Next week we will discuss the fundamentals supporting the juniors, no matter how you slice it, they are the owners of future gold supply. The senior producers are hungry for new resources. Since they can't get it (not enough) by means of exploration they simply have to open up their check-books and buy the ounces...

So if you are a believer in gold's future then these are the times to increase your gold share positions since the gold shares are still selling at fire sale prices. In other words, downside risk is low. Higher gold prices the years ahead will lift the entire gold share sector but the most exciting rewards will come from junior mining companies making new discoveries.

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