Why Gold Stocks Suck

A Monday Morning Musing from Mickey the Mercenary Geologist

Contact@MercenaryGeologist.com

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"Gold stocks suck," said fellow newsletter writer Eric Coffin in a presentation at the recent Cambridge House Investment Conference in Calgary. I could not agree more.

Let's review the fundamentals to understand why his words ring true.

Most micro-cap resource stocks were immersed and have stayed underwater since a sector-wide high in early March 2011. The Toronto Venture Exchange Index, which serves as a good proxy, is down 43% from that period of time. Weakness in the resource sector has occurred despite record or near-record prices for most commodities in 2011 and continuing high prices into the second quarter of 2012.

Reasons for the decline in junior exploration and mining stocks are many:

- The Japan earthquake and tsunami in mid-March 2011 resulted in a significant downturn of the world's third largest economy and substantial damage not only to the uranium industry but to the entire resource sector. Some mining operations have been substantially affected by delays in delivery of heavy equipment from Japanese manufacturers.

- Private placements in Q4 2010 and Q1 2011 became free-trading and began hitting the market four months before the summer doldrums started. Professional investors and speculators essentially front-ran the old adage, "Sell in May and go away."

- The usual seasonal weakness in the summer of 2011 was followed by a 30% correction in commodities in the early fall that devastated resource equity markets.

- Many investors sitting on significant capital gains from early in 2011 balanced them with massive tax-loss selling near year's-end.

- Continuing economic worries in Europe related to the bad debts of Greece, Portugal, Spain, and now Italy have led to general risk aversion among investors and speculators.

- The continuing high price of oil has inflated exploration and development costs and resulted in less work being accomplished at higher expenditures than advertised.

- Environmental opposition and bureaucratic regulation have led to the delay of many projects with most juniors' timelines not being met at their budgeted cost.

- A slowdown of growth in China from higher interest rates and stricter bank leverage requirements in late 2010 and 2011 has reduced overall demand for industrial commodities.

- Reluctance of financial institutions to bankroll large mine projects because of sharply escalating capital expenditures and operating costs has trickled down to a tight market for equity funding of junior company projects.

- The US Federal Reserve's postponement of a third round of quantitative easing, at least until after the November elections, has resulted in range-bound and stagnant prices for precious metals.

The ten factors listed above have contributed to an on-going bear market for junior resource stocks.

However, in my opinion the main reason that speculators have lost interest in the high risk / high reward micro-cap sector is the overall poor performance of these equities since January of 2011. Simply put, a legion of juniors has consistently over-promised and under-delivered for several years now and investors finally have grown weary of the charade.

Daily trading volumes and the value of the Toronto Venture Exchange show the disinterest and resulting downturns:

Chart Courtesy of MSN Money

This chart shows that:

- More than 200 million shares were traded daily for most of the first quarter of 2011.

- There were only three days with trading volumes greater than 200 million shares in April 2011.

- There have been two days with trading volumes greater than 150 million shares since May 2011.

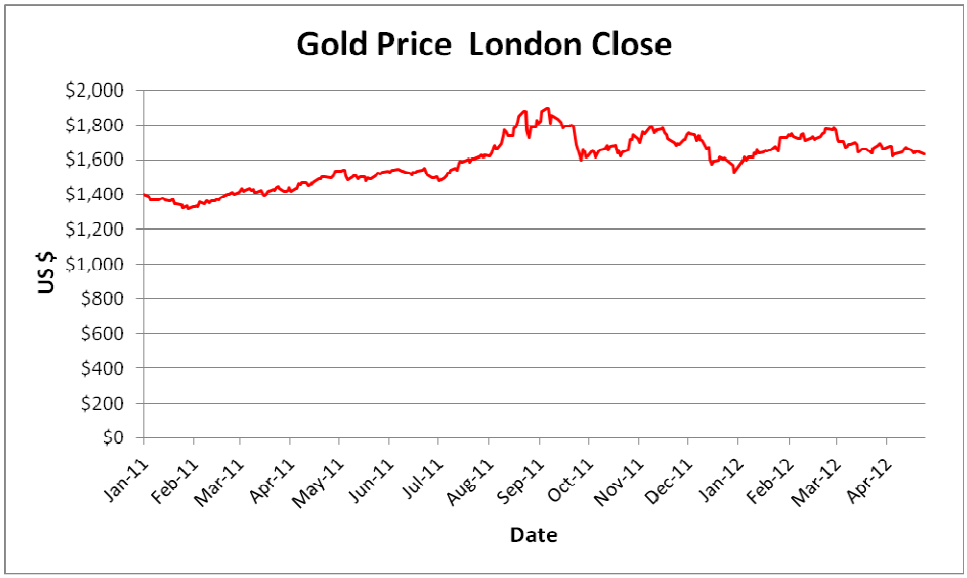
- Average daily volumes have been less than 100 million shares since July 2011.

Seasoned investors know that trading volume and market capitalization are strongly correlated. The lack of liquidity in the junior resource sector is shown by the on-going downtick of the Venture index.

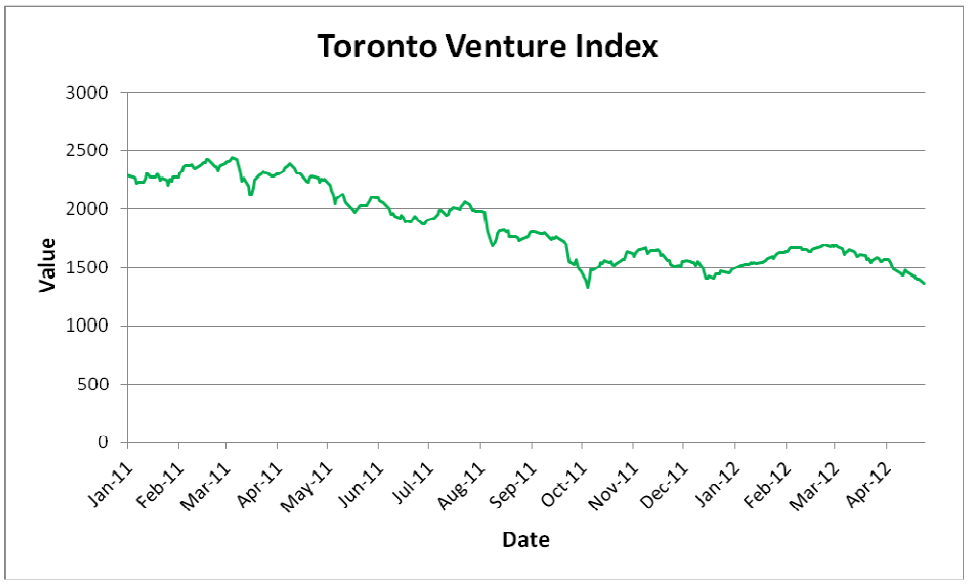
According to my friend Glen Jones at **Intierra Resource Intelligence**, nearly 80% of the1716 micro-cap (herein defined as <$500 million market value) exploration and/or mining companies listed on the Toronto Stock Exchange and Toronto Venture Exchange have a property with gold as a primary or secondary commodity. A little less than half of those reported news on the property in the past 12 months.

Since January 4, 2011, the performance of junior gold stocks has been dismal compared to the price of gold.

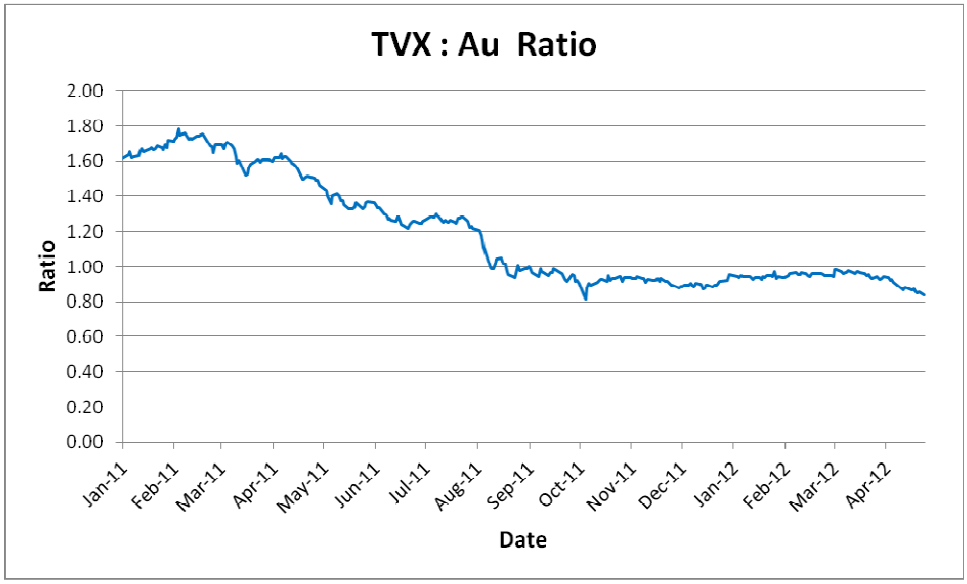
- Gold has risen from $1389/oz to $1642/oz for an 18% gain:



- The Toronto Venture index has a 39% decline from 2275 to 1398:



- The abyssmal performance of junior resource gold stocks is best illustrated by a ratio of the Toronto Venture Index to gold, which has dropped from 1.64 to 0.84 for a 49% loss:



The junior gold sector boomed post-global financial crisis from Q2 2009 thru Q1 2011 because commodity prices rebounded to new highs and venture capital was readily available for all comers. Many gold stocks lacking the necessary criteria of a tight share structure, an experienced and successful management, and a robust flagship project were financed with "itchy money" during this period.

Many low-grade projects with marginal to bad economics were promoted, company managers consistently over-promised and under-delivered, and repeated equity financings, often at lower and lower prices, led to massive dilution and obliterated the gains of longer-term committed shareholders.

In classic bull markets, greed rules and investors become speculators. Fearful of missing the next big thing, they indiscriminately throw money at each and every opportunity.

It's especially important at these times to try and separate the few contenders from the many pretenders, find a few good companies that have a chance to become miners, and disregard the majority who exist solely to "mine the stock market" (**Mercenary Musing, October 20, 2008**).

In late January 2011 I sensed that gold stocks had became overbought and, made a conscious decision to lighten my exposure. At that time I ceased coverage on two advanced explorers from which we had taken our doubles in less than 12 months. Four months later I exited a typically underachieving gold explorer and subsequently took a tax-loss on it at year's end (**Mercenary Musing, September 12, 2011**).

As market valuations have dwindled over the past 14 months, it has become increasingly apparent to me that the Toronto Venture Exchange is overloaded with and burdened by a plethora of junior gold explorers that will never be successful and reward shareholders.

Little wonder the investing public has become disillusioned, disinterested, and disgusted.

Now that we are in a bear market for juniors, most stocks, whether good or bad or ugly, will suffer in a like manner. Some writers, mavens, gurus, and pundits have recently called the bottom or surmised that the bottom is near and now is the time to buy.

I disagree.

We are coming into May when selling is normally expected to pickup, and that will be followed by the dog-day doldrums of July and August. The economic outlook in Europe is no better, China continues to slow its economy, the US Fed, partisan policymakers, and *politicos* will do nothing of import before the November elections, the price of oil remains high, and metals prices are stagnant. Markets are skittish and subject to a whim within an undercurrent of trepidation. None of the above factors will inspire the confidence of risk capital in the short term.

Although I am a contrarian by nature, I do not foresee a catalyst for improvement before Labor Day at the very earliest, and I do not intend to participate as a wholesale buyer at this juncture.

The real question in front of us cannot be answered at this time: Could this game be over or is it just in an extended rain-delay?

That said, at some point valuations for the small minority of fundamentally strong gold companies will make for some no-brainer buys. Until then, I prefer to sit on the sidelines and simply watch the carnage continue.

Despite my bearish bent, I remain a committed shareholder of two gold companies currently covered via **Mercenary Alerts for free email subscribers only**. These two issuers have the requisite three key criteria listed above and have maintained strong share prices even in this down market.

In addition, those who follow me know that all is never lost and I can always find something to go long on. Currently my cash is looking for graphite explorers and developers and oil companies with upside production stories and low debt. As always, I continue to search for compelling copper oxide and uranium plays.

Anybody out there got a hot tip? You know how to reach me.

Ciao for now,

Mickey Fulp
Mercenary Geologist

Acknowledgement: Erin Ostrom is the editor of **MercenaryGeologist.com**.

The **Mercenary Geologist Michael S. "Mickey" Fulp** is a Certified Professional Geologist with a B.Sc. Earth Sciences with honor from the University of Tulsa, and M.Sc. Geology from the University of New Mexico. Mickey has over 30 years experience as an exploration geologist searching for economic

deposits of base and precious metals, industrial minerals, uranium, coal, oil and gas, and water in North and South America, Europe, and Asia.

Mickey has worked for junior explorers, major mining companies, private companies, and investors as a consulting economic geologist for the past 24 years, specializing in geological mapping, property evaluation, and business development. In addition to Mickey's professional credentials and experience, he is high-altitude proficient, and is bilingual in English and Spanish. From 2003 to 2006, he made four outcrop ore discoveries in Peru, Nevada, Chile, and British Columbia.

Mickey is well-known and highly respected throughout the mining and exploration community due to his ongoing work as an analyst, writer, and speaker.

Contact: **Contact@MercenaryGeologist.com**

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