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Steve Palmer: Juniors Staged to Climb from New Ground Floor?

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Whether irrational exuberance or the faltering dot-com industry triggered it, the economic downturn of 2001 hit junior resource companies hard. They bounced back in a big way. "Downturn" understates the current scenario, but AlphaNorth Asset Management President and CEO Steve Palmer sees similarities. He looks forward to taking advantage of opportunities "to get in on some of what has now become the new ground floor" and make some "tremendous gains." While he anticipates more bad news on the employment front, he also tells The Gold Report followers that he believes "we've avoided the abyss" and confidence is returning.

The Gold Report: Tell us about your outlook for the natural resource sector for 2009 and your thinking about the primary market of commodities—precious metals, base metals and so forth. Also, are these markets separate or all tied together?

Steve Palmer: 2008 was clearly a disaster for almost everybody. I manage a generalist fund, so it's not focused only on resources. At the beginning of 2008, I was fairly cautious on resources. I thought the easy money had been made and the risk-reward wasn't that good compared to some other sectors. However, with the pullback in many of the commodities, many of the resource companies are back to marginal cost of production and the share prices have been pounded so much—in many cases, below their cash value—that those resource opportunities are much more interesting at this stage.

The index I track for the small-cap focused fund I manage is the TSX Venture Index, which is the most comparable benchmark. This index has declined about 80% peak-to-trough. I think it peaked in the spring of ’07 and last year was down over 70%. That’s probably one of the worst-performing indices in the world as it’s heavily weighted toward resources. A lot of the junior companies in Canada are resource companies, probably a little more than 50%. So I think it’s a great opportunity to get in on some of what has now become the new ground floor.

The last time this occurred, back in ’01, I was managing a small-cap fund at a major financial institution that was invested heavily in the junior technology and biotech stocks. There was a significant correction; the NASDAQ declined by 80% over a two-year period and dragged the small caps down with it. The small cap fund I was managing at the time went through a rough patch and bottomed in April 2003, but was up more than 900% over the next four years. So when I look forward from where we are today, I see a similar opportunity for a period of tremendous gains, significantly above what you’d normally expect on a long-term basis.

TGR: But it’s such a different market now. Part of what drove the commodities move earlier in this decade was global growth. What’s the driver going to be in ’09?

SP: I think stabilization. The areas of big scares in the fourth quarter—the financial system and credit markets—needed to stabilize and that seems to have occurred. Credit spreads have come down and indicators of panic (such as T-bills with a negative yield) have subsided. People aren’t panicking like that anymore; it seems we’ve avoided the abyss and we have moved on to addressing the economic downturn.

TGR: Are you looking for a rebound?

SP: Not that we’re out of the woods yet, but there could be a big bounce. Governments are being very aggressive in trying to get things moving again. The stock market hits bottoms before you see the worst of the job numbers, though, many months before. That’s occurred almost every time in the past. This time, too, we can expect to see unemployment keep getting worse after the market has long since bottomed.

TGR: Do you think we saw a bottom in November and December, particularly in the junior resource sector?

SP: I definitely think it was a bottom, at least a short-term bottom. The level of panic was unprecedented. Compounding that was the timing of tax-loss selling that had to be done before year-end, so some stocks plunged to insanely low levels. This wasn't due to fundamentals—it was all liquidity-driven, tax-loss selling driven and forced selling by various funds.

But as I said, I think most of that's behind us. We're in a more normal market and people are starting to look at fundamentals again. From the bottom that the TSX Venture hit, we've already had a nice little bounce, more than 25%, in just a few weeks. The larger-cap stocks bounced, too, but only half as much.

TGR: What about the broader markets, the S&P and Dow? Have they bottomed, too?

SP: I focus more on the Canadian markets. With the narrow number of stocks and the way the index is calculated, I think the Dow is an irrelevant benchmark. I don't even look at that index. The S&P is a broader measure of U.S. large caps. I don't expect it to go rocketing back up, but the bottom from November has held. I do a lot of technical analysis work and the charts are indicating to me now that, after the initial January bounce, we've pulled back fairly significantly. A lot of people are calling it a re-test of the low. It looks as if the S&P has bounced off 800 and it wouldn't surprise me if it traded up to 1,000 before heading back down again in the spring. It will probably trade in a channel this year.

TGR: Harking back to your stability theme.

SP: Yes. And once we have some stability, people will regain confidence. There's going to be a lot of money made in some areas of the market. Recently the golds have done really well, and takeouts will occur, especially when we have the very depressed juniors.

Greed will come back quickly, as well. We've had several greed cycles just in the last decade. We had the whole junior bull market around Bre-X in 1987. That whole thing imploded. The benchmark at the time was the Vancouver Stock Exchange Index, which was the measure in Canada of all these resource plays. It declined 75% after the Bre-X blew up. It wasn't long after that when everybody scrambled to buy technology stocks in '99, and then they imploded. Then in 2002, we started the latest bull run in commodities. So we've had three major up-and-down cycles in the last 10-12 years. It will occur again.

TGR: Does your technical analysis give you an idea where the various commodities will be in 2009?

SP: Yes. I use the charts a lot because commodity prices are so hard to predict; so many factors are involved. Those who set commodity price targets are wrong 80% of the time. If you're contrarian, too, it usually works. For example, during a broker-sponsored dinner with 30-plus portfolio managers at the Prospectors & Developers Association of Canada (PDAC) convention in early March last year, they went around the table and asked everyone what they thought gold would be at the next PDAC. Gold was around $960 at the time and everybody was forecasting prices of $1,500 to $2,000. It's almost a year later now and the 2009 PDAC convention is coming up. So we're almost there right now and there were only two people at that dinner—I was one—who predicted a lower gold price. I picked $885. Where it makes sense, I like to go against the crowd. It looks to me like many of the commodities are going to lift in the short term. I wouldn't be short.

TGR: So where do you see gold going in '09?

SP: I trade gold almost exclusively—on technicals. It's very much correlated inversely with the U.S. dollar. One gold analyst plotted the correlation since January '06 and it was minus 0.926, almost perfectly inversely correlated since January '06. All you need to do is put up two charts side by side—gold and the U.S. dollar—and you can see it clearly. You don't need to calculate any fancy correlation numbers.

TGR: So you expect gold to be good going forward, considering all the troubles the U.S. dollar has?

SP: I have been quite negative on the U.S. dollar and thus quite bullish for most of the past few years on gold. I picked a lower gold price a year ago for two reasons: 1) the USdollar had made a significant move lower and was due for a rebound (technicals), and 2) it was a contrarian call as everyone was bullish. However, the direction of the U.S. dollar seems harder to predict now; it could be in for a period of strength. If the U.S. economy leads the way out of this global mess, the U.S. dollar will be strong and that's not good for gold.

TGR: So if the U.S. leads us out of this global problem, you're saying the U.S. dollar will be strong and that would put negative pressure on gold?

SP: Yes. That may be offset somewhat by inflation concerns or the "fear" trade persisting for a period of time. I'm not predicting that gold's going to collapse or anything, but I'm not a super bull like a lot of people. We see a fair number of gold bugs around.

TGR: What about some specific stocks that you'd have *The Gold Report* readers take a look at?

SP: Colossus Minerals Inc. (TSX:CSI) is one I really like. They've been getting some phenomenal grades drilling on their property in Brazil. Garimperos had been hauling gold out of a big pit created there; it's thought that they took 2 million ounces of gold out of the pit; very high-grade zones of several thousand grams per ton in some cases. After the pit got flooded, it was in limbo with the locals for many decades. Colossus got their hands on it a couple of years ago and went back and started doing re-assays of some of the historical drilling results and re-drilling, as well. The grades they're getting are quite good. It's not just gold; they have very high platinum and palladium grades, as well.

TGR: So Colossus came in, acquired the property, got rid of the water and—

SP: No, the water's still there. It's like a little lake, actually, in the pit. I think they're drilling southwest of the pit, and the gold zone continues there. They're currently considering drilling from a barge, too, to see if they can intersect some of the zones that were being mined before.

TGR: How deep is the lake?

SP: It's probably about 100 meters deep. That's another thing. The gold zones are very near surface, which lowers the mining costs significantly, as well. So it would be a very profitable operation because it's so shallow and very high grade.

TGR: Do they have a 43-101 on this?

SP: No, they're working on that. They just started Phase II drilling and will be doing a 43-101 report this year. The company has enough money to carry out their Phase II over the balance of this year. The market cap is about $70 million. They could have several million ounces of gold equivalent there. I would consider a takeout highly likely once they get a little more advanced.

TGR: By one of the majors?

SP: Yes, I think several of them have been on the property already.

TGR: Interesting. Another company to look at?

SP: Orko Silver Corp. (TSX.V:OK) is another, a $50 million market cap company. They have a property in Mexico they've been drilling, and should have an updated 43-101 report out any day now. It should add to the current inferred resource of 103 million ounces. A lot of the more senior names have done quite well recently. Some of them have doubled in the last couple of months. People are starting to look lower down on the market cap scale at some of the ones that haven't moved as much. So I think companies in the range of $50 million (where Orko is) and $70 million (where Colossus is) will be on people's radar screen, as well.

TGR: How far advanced is Orko? Is it close to other mines?

SP: Of course, Mexico is noted for its silver, and it has many, many silver mines. Orko is in an area with many mines around. They're at the stage now where they're proving up a resource and then they'll do a scoping study.

TGR: Do they have sufficient cash in the bank?

SP: They have $3 million in cash right now. They raised money last summer at $1.65 and the stock is 55 cents now.

TGR: Looking at the technical chart, they seem to have been building a base since October. It hasn't had the move that a lot of other juniors have.

SP: Exactly. That's why I like it. We've been picking away at it recently because I think it's good for a move. It could double quite easily in the next couple of months. Most of the precious metal names, like this one, I typically don't hold for many years unless it's a story like Colossus where I have a lot of conviction that they're building something that's going to be big and maybe taken over one day. Some of my positions, as with Orko, are initiated on technical analysis work but are also supported by fundamentals. Combining the commodity and the stock, this one looks like a good opportunity to get in on a timely basis and possibly double your money and move on.

TGR: Any others?

SP: Another one that has a similar chart is Silverstone Resources Corp. (TSX.V:SST). It's a royalty company, similar to Silver Wheaton, where they take the silver and gold from companies that have producing base metal mines with silver and gold as byproducts. So they typically buy the silver at $4 and the gold at $300 and then they can sell it into the market. There's little overhead required and you get your exposure to the commodity. In this case, with only $100 million market cap, Silverstone Resources is less liquid and trades at a much lower multiple than Silver Wheaton. I think Silver Wheaton's trades around 15 times cash flow and this one is close to three times 2009 cash flow.

TGR: And like Silver Wheaton, Silverstone Resources either has capital or access to capital?

SP: It's small working capital, but they have agreements to buy from these three mines and then they resell. It's just the timing of when they get paid, really. There's not much capital required. It's a royalty play at the moment. It's a very low cash flow multiple, lower risk. They probably would need to raise a little more capital on the back of a new off-take arrangement, which would be another avenue or catalyst to move the stock higher in the future.

TGR: What about any energy plays?

SP: One of my favorite energy names would be Sea Dragon Energy Inc. (TSX.V:SDX). They're currently drilling a well in the Gulf of Suez that we should have results on in a matter of weeks. It has a one-in-three shot at success. It IPO'd at 60 cents. It's currently trading at 14 cents. After they spend the money on the well, the cash per share will be 17 cents, so it's trading below cash, assuming a failure. So there could be some significant gains if they hit on this well.

The management team has done it before: The same guy (Said Arrata, Sea Dragon Chairman and Director) was behind Centurion Energy, which was a huge success and taken out for over a billion dollars a year or two ago. He's very well connected in Egypt. Sea Dragon is looking at other opportunities to get in on where junior companies are starved for cash, given that they have a significant amount that they raised on their IPO, $35 million I think. Even after drilling this well, they'll still have a lot of cash left and could get in very cheaply on other opportunities in the area.

Steve Palmer and Joey Javier, an investment team since 1998, took three key assets—their excellent track record, their experience and their belief that exploiting inefficiencies in the Canadian small-cap universe would produce superior long-term equity returns—to AlphaNorth Asset Management, launching the Toronto-based investment management firm in August 2007. By year-end 2007, the long biased small-cap hedge fund they built made its debut. Until Lehman Brothers' liquidated, credit markets froze, massive investor requests for redemptions forced hedge funds to sell out of their positions and "volatility" no longer came close to describing the frenzy in financial centers, the fund was flush and its investors were as happy as clams. Its first seven months netted a return of 35.6%, significantly outperforming the major Canadian indices. During that period, the TSX Venture Index declined by 3.7% and the TSX Composite Index rose by 7.4%.

Steve, who is a Chartered Financial Analyst, earned his BA in Economics at the University of Western Ontario. After starting in the investment community as a research associate, he moved to a major financial institution in mid-1998, where he met Joey and built his career. As Vice President of Canadian Equities, he managed assets of approximately $350 million, including a pooled fund that focused on small-cap companies.