

Growth Stocks Weekly

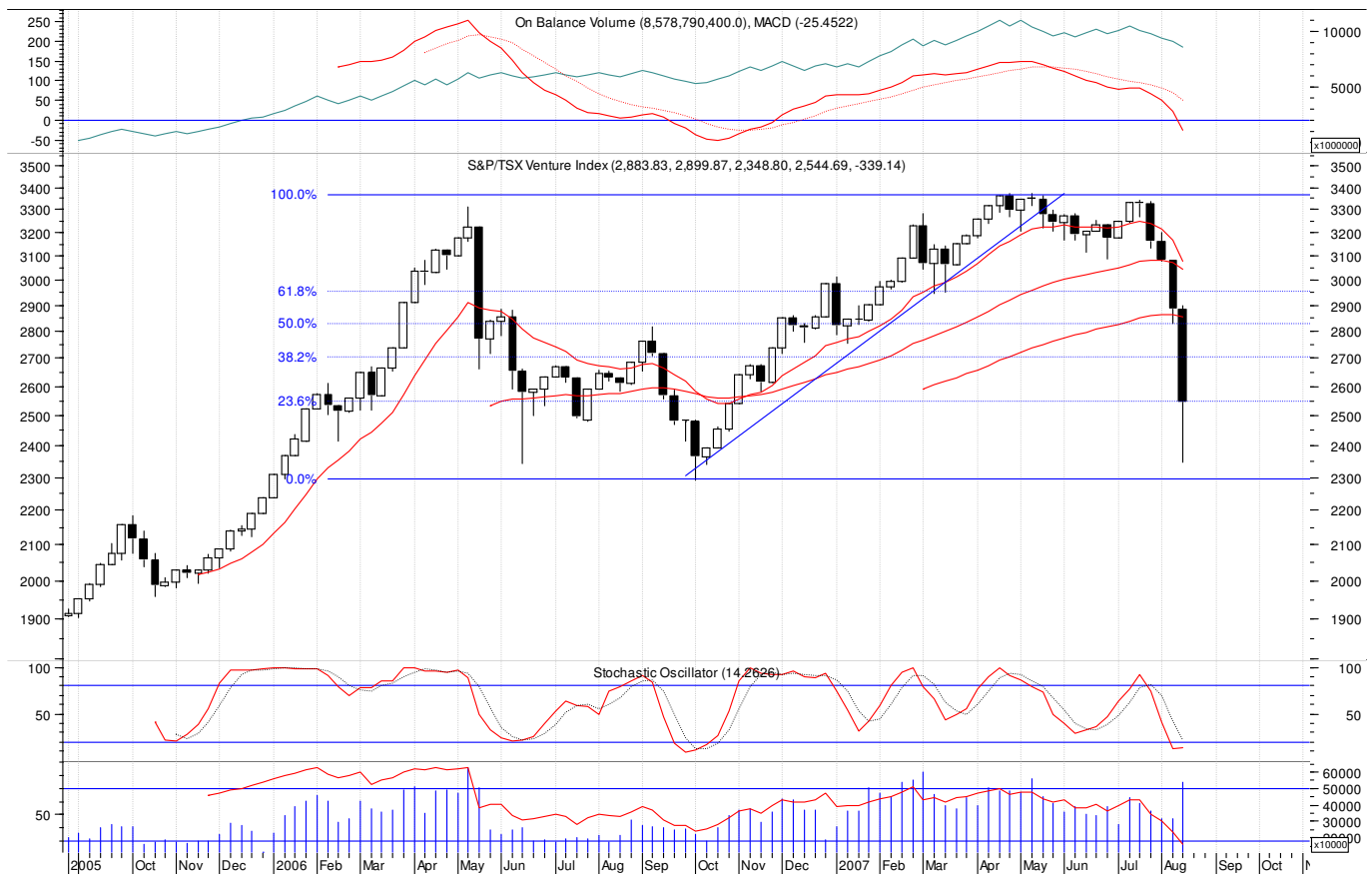
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Performance: Year ended April 1996 116.9%; 1997 28.1%; 1998 36.4%; 1999 39.4%; 2000 180.9%; 2001 -50.5%; 2002 18.7%; 2003 28.8%; 2004 166.7%; 2005 28.2%; 2006 153.3%; 2007 8.8%

Junior Gold and Natural Resource Sector Report August 21, 2007

Backing Up the Truck (Finding Value Amongst the Debris)

S&P/TSX VENTURE INDEX – WEEKLY CHART



The Debauchery of Debt

Back in the '50's being free of funded debt was a leading business virtue. The bluest of the blue chips had no bonds outstanding. Memories of the Depression were still so strong that investors insisted stocks have higher dividend yields than available from bonds to compensate for their inherent risk. Later in the '60's the conglomerates used relatively conservative capital structures: the debt markets would never have absorbed debenture issues totaling six to nine times corporate cash flows so prevalent today.

Fast forward to the paradigm of the new millenium, where greed is good, money is cheap, and complacency rampant. Suddenly there's a crisis of confidence. Record debt levels, the use of derivatives, new ideas in structured finance, the Yen carry trade and excessive levels of greed conveniently using other peoples' money has accelerated the shift in expectations and rush towards the exits. With so many 30-something-year-old MBA's responsible for billions to invest and only theoretical knowledge of the past financial panics, this rapid de-leveraging is certainly something of a wakeup call.

The rush into cash these last two weeks was evidenced by the unprecedented demand for three-month U.S. Treasury notes and a massive liquidation of all things uncertain, reminiscent of the '87 crash and the Asian Contagion of '97, certainly to those of us who were there. The 2000 "tech wreck" and 2001's "911" will be more familiar to younger investors, and equally humbling to Wall Street wizards and Howe Street punters alike. Fear rules once again, and is a much stronger emotion than greed.

Finding value amongst the debris

This too shall pass, but history tells us there are timely opportunities to be grasped, and that a proactive approach is well rewarded. Perhaps the saddest-but-true Wall Street maxim is to buy "when there's blood in the streets." In the heat of a market downturn, when investment accounts have been halved, it can be difficult to keep our heads about us and focus in on finding value. In heavy downdrafts, the rubber ducky gets thrown out with the baby and the bath water. The lines between excellence and mediocrity are smudged. It is within this chaos that the best opportunities are created.

Forced and untimely liquidation is the added risk for using leverage. Capitalism naturally punishes those who have made financial mistakes. This unwinding process is the economic equivalent of natural selection, whereby the weak and unfit are eliminated. Survival of the fittest is a universal law that may be delayed but cannot be over-ridden forever, even by a powerful central bank with the full backing of the U.S. economy and reserve currency status as its ace-in-the-hole. In fact, the burden of responsibility entrusted to the U.S. by the rest of the world via the Bretton Woods system now seems seriously frayed and even abused.

The world's central banks are busy pulling out the stops in an effort to block the forced liquidation process now underway, injecting new 'liquidity' into world markets. Cheap money is being made available, security requirements are being waived, once again shoring up the careless and bailing out the fools, frauds and inept.

Like in 1987, 1997, and the early 2000's there will be a relatively brief period of liquidation before a bottom becomes obvious and stability returns. The Fed has quickly and very publicly shifted from an inflationary stance to one of deflation avoidance. With the example of Japan's 20-year-plus bout of stagnation and falling prices, inflation suddenly looks to be a lesser evil. The U.S. simply cannot afford the risk of a systemic spread of lower asset prices. Confidence will slowly return and the additional liquidity sloshing around will once again be out seeking superior returns.

Underlying demand intact

The most powerful force behind these periodic episodes of global money mania is demographics. The industrial world is aging. Average incomes in the U.S. have fallen every year from 2000-2005 while those in Asia are rising rapidly. The average baby-boomer, part of the largest and wealthiest demographic bulge in the western world, is facing retirement age. A huge, growing pool of money earmarked for retirement is scouring the world looking for profitable investment opportunities. The supply of capital is far greater than the available investment opportunities in the developing world, a classic recipe for continued financial booms and busts.

Of course, money manias are not all bad. In a sense, manias are an inevitable part of the risk-taking that creates wealth and higher living standards - manias are in the nature of capitalism. Many of America's leading high-tech companies and downtown office towers were financed during money manias. Similarly, overseas investors financed a lot of productive investment in Asia.

Largely unaffected during this toxic-debt-driven crisis of confidence are the mouth-watering returns being generated around the rapidly expanding Asian markets. There, debt is largely unavailable or even conveniently non-repayable for the well-connected, and the personal and corporate savings rates are staggering. China's foreign reserves are now in excess of US\$1.5 trillion and rising, and in search of investments that provide much-needed resources in scarce supply, and an alternative to a rapidly eroding U.S. dollar.

Scarce resources you can touch and feel

With the U.S. Fed confirming its resolve to avoid deflation and exacerbating the unwinding of the real estate boom, investors have a narrow window right now to position into companies that are well positioned to lead the recovery of confidence. The fact is that commodities remain strong, even while the emerging miners have been crushed, and there really is little risk that the world economy will appreciably slow down. The U.S. is still an influence of course, but the world and particularly China and India have the momentum and the demographics that virtually ensure continued hyper-demand for most of the world's resources for years to come.

The markets are offering the opportunity of the decade to back up the truck and position for a resumption of the resource-sector bull market at a significant discount. Where we want to invest today is not with the crowd. The U.S. dollar has significant downside risk as rates come off, and 3-month Treasury Bills are simply a place to lose purchasing power.

Successful resource stock investing means investing in companies that may be headquartered in Canada, the U.S., Australia, Britain, France, Brazil, Italy, South Africa, Norway or China, to name only some of the nations with established, publicly-traded, commodity producers. Investors benchmarking to major stock indices such as the S&P have only modest exposure to commodities, which means the energy stocks dominate their commodity weighting. There is now only one base metal company

in the S&P 500 and 400 combined, so U.S. investors who are restricted to American stocks simply have no ready opportunities available in the metals. Eventually they will feel compelled to expand their horizons.

Even in Canada investors have had to rethink their commodity exposure since Inco and Falconbridge were deleted from the TSX, and with Alcan being courted. Consolidation and takeovers are contracting the available investment vehicles. Commodities and commodity stocks are where you find them, and Canada still offers some of the best of the world's emerging producers – those very companies that will be sought and bought as the resource sector continues to enjoy windfall earnings.

Canada – a double win

Canada is a leader in mining innovation and capital raising, and has a strong currency and economy. As I outlined in my April 30, 2007 Portfolio Review Edition – <http://www.growthstocksweekly.com/pdf/GSW043007PortfolioEdition.pdf> – the best place for U.S. and Canadian investors to place aggressive investment dollars is within the Canadian resource sector – garnering exposure to a strong currency, finite resources and exceptional management and mining expertise.

Arguably, the resource sector's best opportunities are found with fully funded near-production juniors with assets in place, strong economics modeled using low deeply discounted assumptions, and proven management. With a half-dozen of these in our model portfolio, and several others having maybe two out of the three elements in place, we have been busy adding to our holdings given the recent buyers strike.

Yes, investors have now woken up to how global risk has been mispriced in recent years. Markets became too greedy in selling collateralized debt obligations and financing leveraged buyouts, and investors under-appreciated the hazards. All we got from the U.S. leadership were boilerplate and hollow calls for flexible exchange rates. There was no demand for Japan to reduce incentives for the so-called yen-carry trade. Borrowing cheaply in Japan and investing the funds in higher-returning assets elsewhere fueled many of today's riskiest hedge-fund trades. Yet Japan is reluctant to let the yen rise, and global policymakers continue to wimp out on demanding it.

Asia has come a long way since the 1997 Asian Contagion. Banks are far more stable, currency reserves have been amassed, and governments are modernizing and integrating financial systems. Asia's post-crisis recovery is a work in progress, though, and one shouldn't overstate the extent to which Asia has de-coupled from the U.S. economy. While Asia's rapid growth and booms in both China and India mean it's less reliant on the U.S., the region isn't ready to live without U.S. demand. Likewise, the U.S. isn't ready to wean off large screen TVs, computers, or all things priced at a fraction of anything made locally, anytime soon.

Assuming that the write-downs to the investment banks are in the \$150-200 billion range, this will prove to be a painful, but mostly manageable flogging on Wall Street. Much of the poisonous paper was distributed to institutions abroad, and, as the recent bailout of a small Dusseldorf bank which gorged on subprimes demonstrates, the costs are disseminated globally, which means they should be absorbed without creating serious systemic risk.

Most resource companies' earnings and cash flow are correlated to the growth of China, not the collapse of America. The same could be said for most of Canada's resource sector. In a world of integrated financial markets and a synchronized bull market in all asset classes (fed by the credit bubble), you can expect all assets to correct as the bubble collapses. But the good thing about metal is that it's hard – it doesn't go to zero value. It goes clunk when it hits the ground. Tangible assets will find a floor sooner than financial assets because resource companies are backed by demand in the real economy. The real economy will chug along in fits and starts, even while the financial economy goes up in flames.

The U.S. dollar is commodities' benchmark

When money is created out of thin air it tends to force down the value of your currency against everyone else's. With practically the whole world printing money to put the crisis at bay, how can the dollar go down against the euro when the CBs in charge of the euro are printing just as much currency as the Fed is dollars?

When all is said and done, this bailout will translate into a massive depreciation of the world's major currencies against goods and services globally (read commodities, gold and inflation). In other words, inflation is about to erupt higher - much higher than expected, and globally.

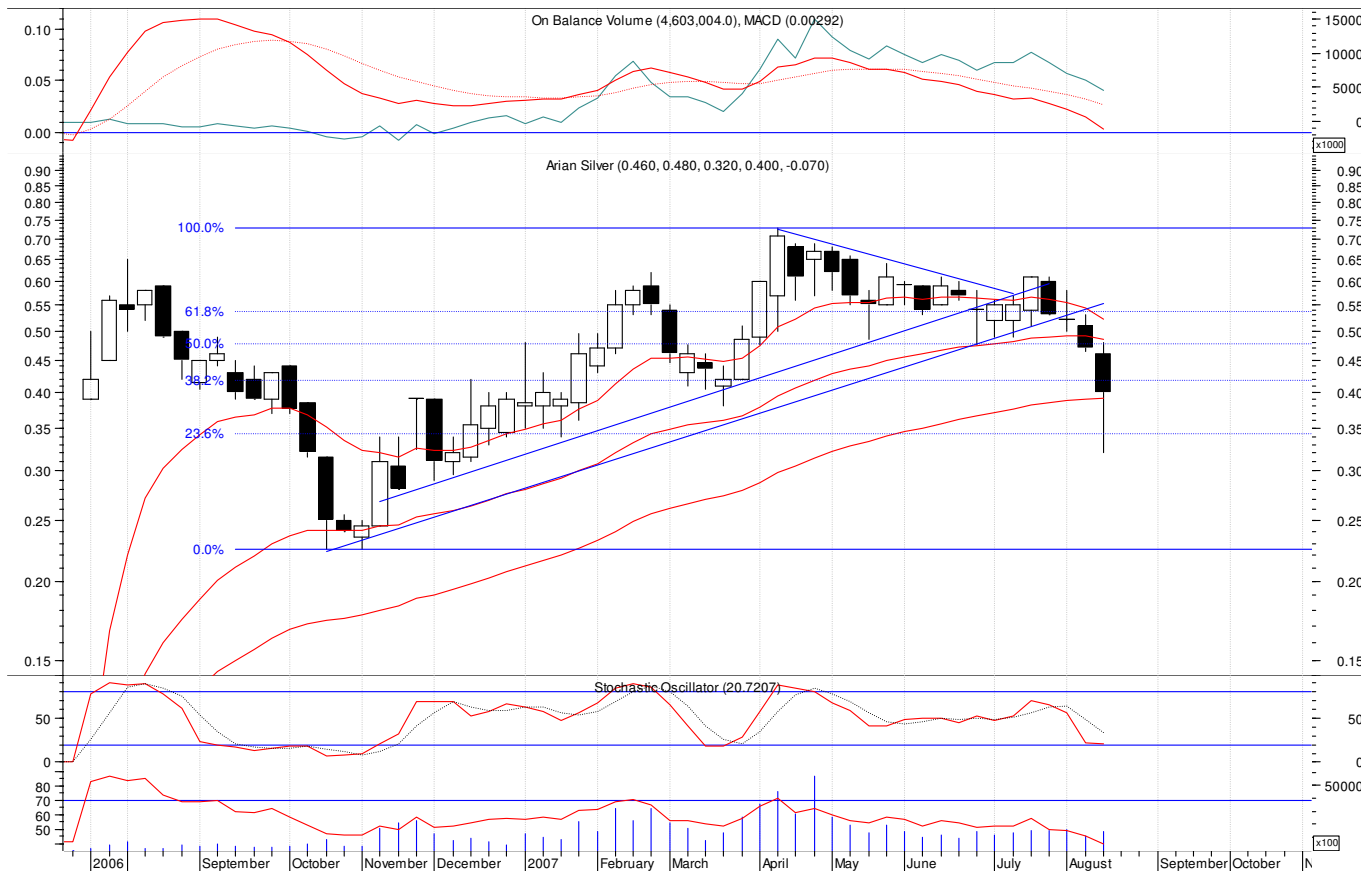
We will continue to see a dollar appreciation in most assets, in particular commodities, especially precious metals and the general stock markets will rise to new highs again. This is another correction in an ongoing bull market. There can be no doubt that the U.S. will inflate to avoid a recession that could result in a debt implosion, the Fed is scared to death of this because they know the overly extended debt situation the country is in.

Of course the Fed could blow it and we fall into a deep recession before inflation goes much higher. This is highly unlikely though as they stand ready with massive amounts of dollars they can readily create out of thin air. Like Japan, they will lower interest rates to zero if necessary and continue to massage and cloud their statistics to bolster their case. The CPI numbers can and will be easily manipulated over a course of the year to help justify their actions, but over the long term the debt markets will not be fooled - meaning long term rates will need to go higher. Although stocks and the indexes will make new highs, when adjusted for inflation and the depreciation in the dollar their returns will be poor or negative, as we have seen over the past few years.

Yes, some of the base metals have sold off because investors are expecting weaker demand from a slowing U.S. economy, but in the end it is the consumption from Asia and investor demand that will drive these prices back up. Even with a U.S. recession, people still have to eat and we are competing with a rising living standard in Asia that is driving demand for foods higher. This correction has not seen any appreciable sell-off of precious metals and commodities. Hard assets like commodities will be the premier asset to own in the years ahead, just like the '70s, and periodic corrections offer windows of opportunity for positioning portfolios.

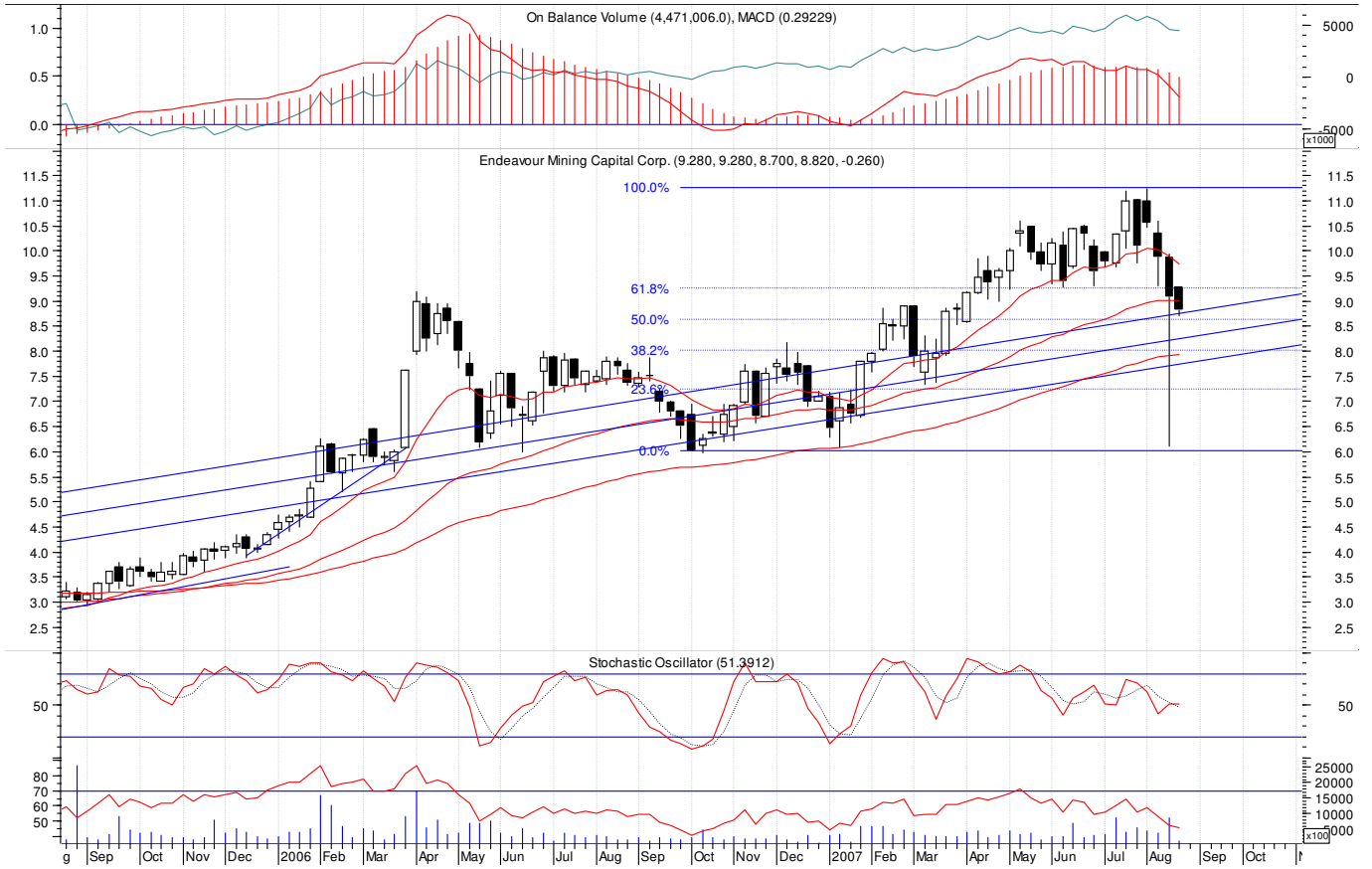
The Candidates

ARIAN SILVER (AGQ-TSX)



Latest GSW Report issued: <http://www.growthstocksweekly.com/pdf/GSW-ArianSilver-091206.pdf>

ENDEAVOUR MINING CAPITAL (EDV-TSX)



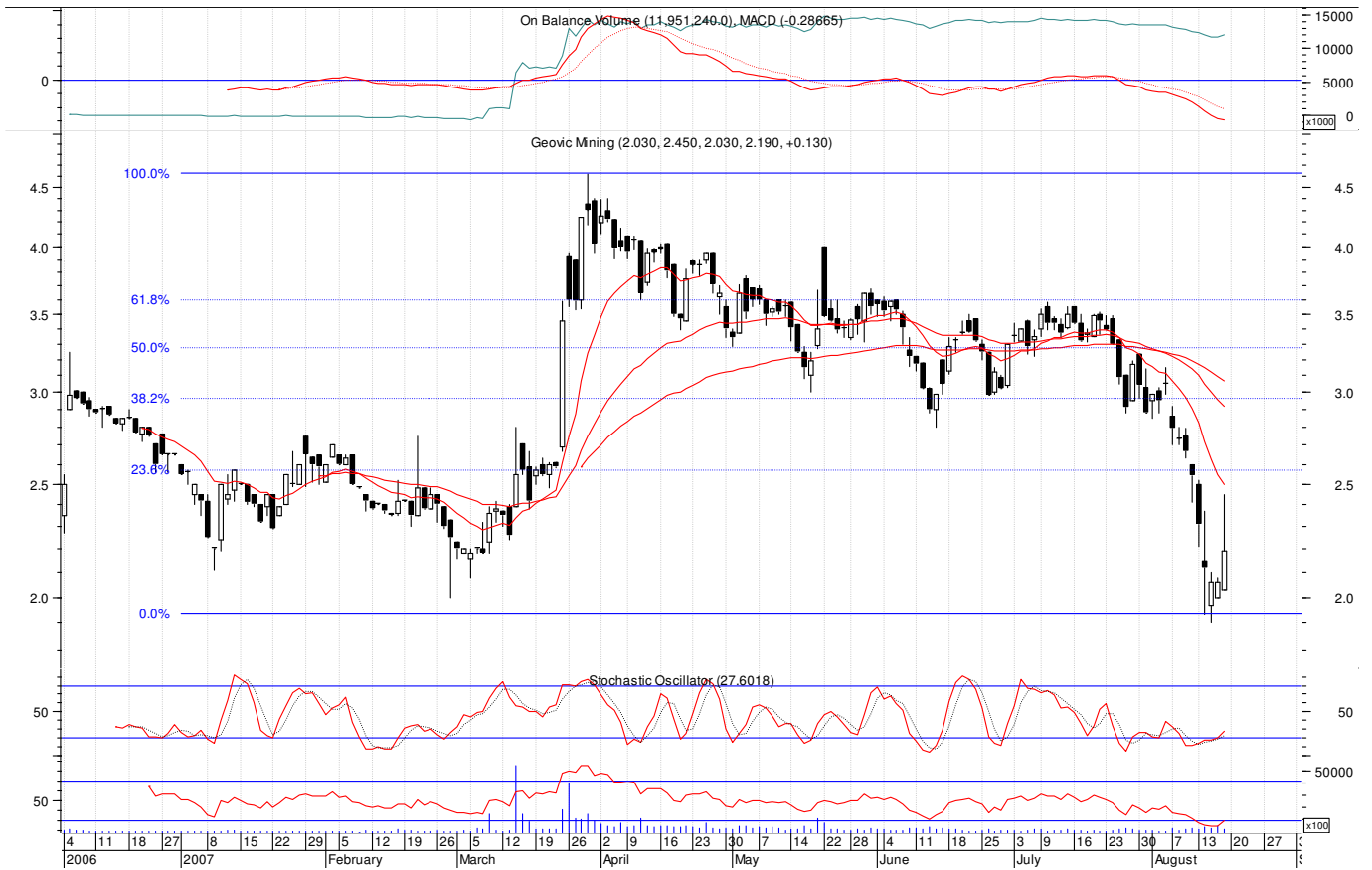
Latest GSW Report issued: <http://www.growthstockswweekly.com/pdf/GSW-EuropeanMinerals-022606.pdf>

EUROPEAN MINERALS (EPM-TSX)



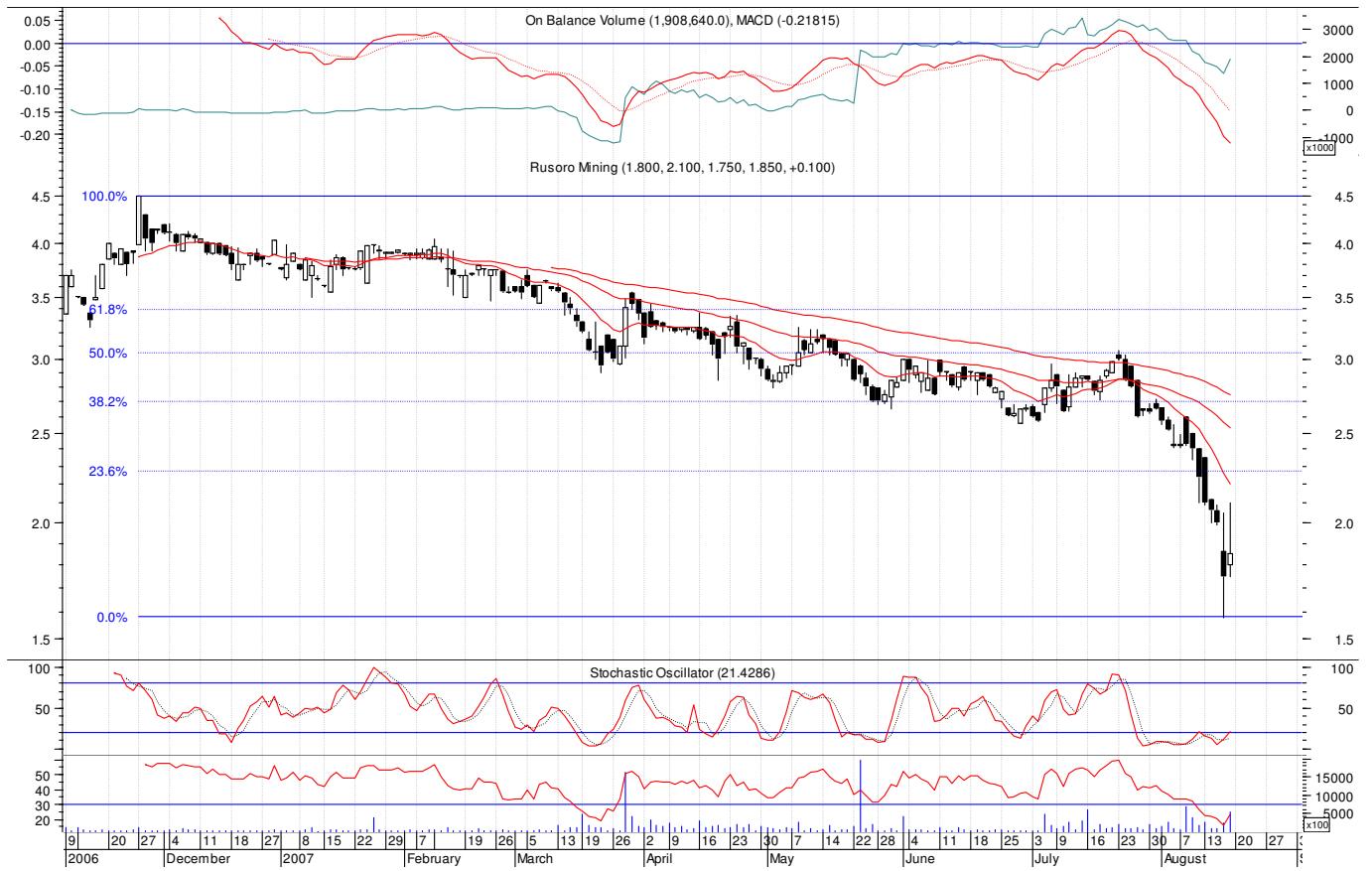
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GEOVIC MINING (GMC-TSX VENTURE)



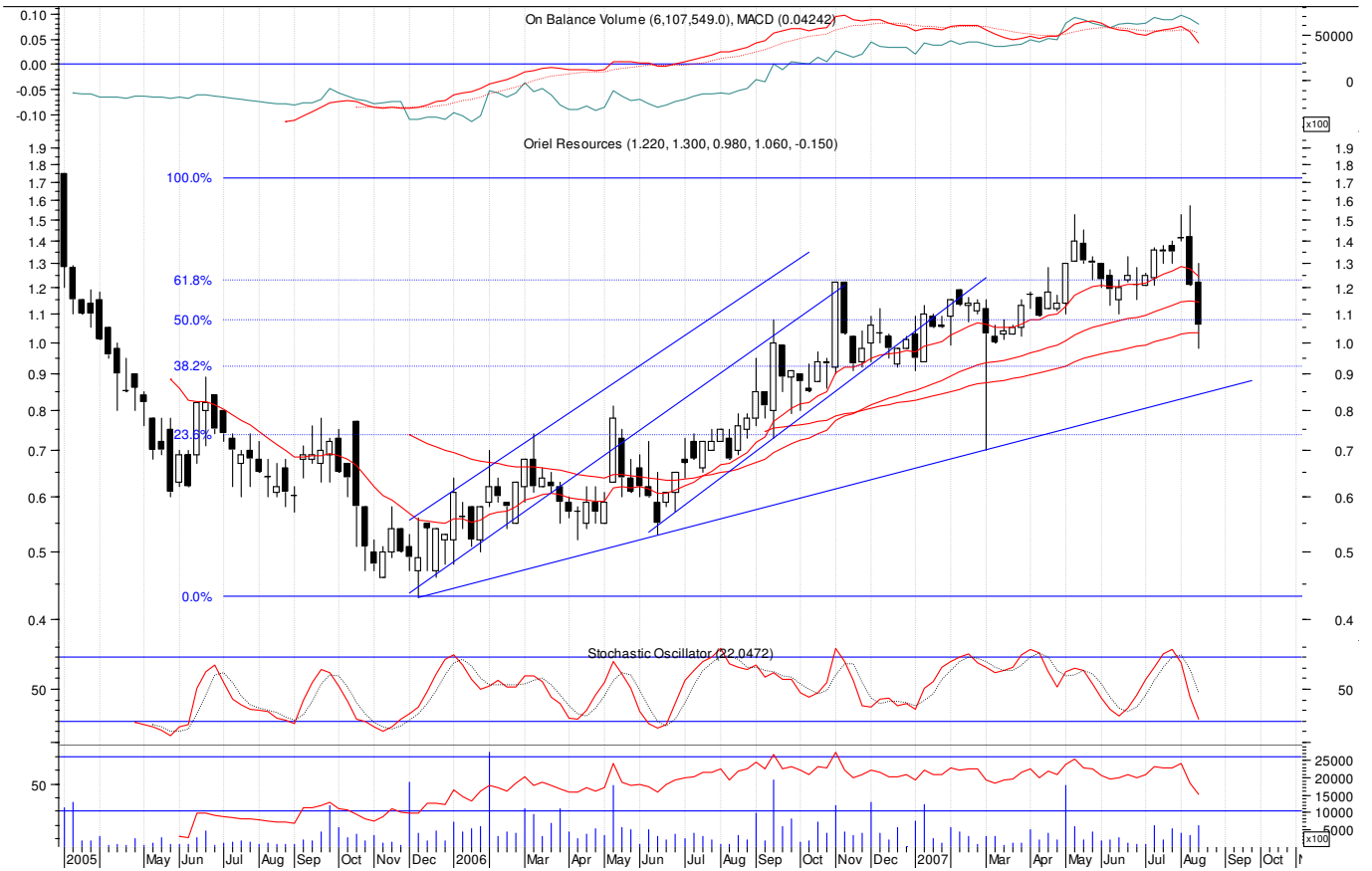
Latest GSW Report issued: <http://www.growthstockswweekly.com/pdf/GSW-Geovic-010707.pdf>

RUSORO MINING (RML-TSX VENTURE)



Latest GSW Report issued: <http://www.growthstocksweekly.com/pdf/GSW-RusoroMining-022807.pdf>

ORIEL RESOURCES (ORL-TSX)



Latest GSW Report issued: <http://www.growthstocksweekly.com/pdf/GSW-OrielRes-061505.pdf>

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