Sprott Money Managers Share the Secret for Surviving the 'Bernanke Put'

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COMPANIES MENTIONED

- Arch Coal Inc.
- Long Run Exploration Ltd.
- Potash Ridge Corp.
- Stonegate Agricom Ltd.
- **Virginia Energy Resources Inc.**

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The "Bernanke Put," or promises of quantitative easing, has become the standard government response to economic uncertainty. But while the powers that be insist everything's fine, Sprott Resource Corp. Founder Kevin Bambrough and COO Paul Dimitriadis see financial deterioration around the globe. Only one thing is for certain: Taking the contrarian view provides the best opportunities to buy low and sell high. In this interview with *The Energy Report*, they explain why they expect energy assets to perform better in the long haul, cluing us in on a few names they are considering for big returns.

Source: Zig Lambo of *The Energy Report*

The Energy Report: How would you characterize the current economic background? Are things really looking better in your view?

Kevin Bambrough: Markets typically peak when fear is low and complacency is high, and bottom when fear is rampant and people are extremely worried. The U.S. markets in general have performed quite well this year, but the U.S. bond markets have started to see a lot of hiccups. The European debt market still remains on very shaky ground. The Chinese debt market is now showing major problems in the banking system and the Japanese are still trying to find a solution to their debt woes with increased monetization, and have started an aggressive currency devaluation exercise. Debt levels for governments and individuals around the world are still at unsustainably high levels relative to GDP or individual incomes.

Bankers and governments continually lie to the public and pretend that things are better than they are. If they told the truth, no one would own a bond or keep money idle in cash. These days, the government guarantees and what people have referred to as a "Bernanke put" are the only reason rates are low and the bond market doesn't crash. The Federal Reserve must talk tough from time to time and pretend it's going to curtail its quantitative easing. The fact is it can't.

Curtailing quantitative easing would force interest rates back up significantly, increase the government debt burden and raise the deficit. At the same time, it would crush the housing market and over-levered consumers already struggling to pay off their mortgages. The increased debt burden would bankrupt governments, individuals and the entire financial system.

TER: So realistically we're stuck with low interest rates for the foreseeable future?

Paul Dimitriadis: There's no way that rates, in my view, are going to rise anytime soon. The Federal Reserve knows it can't allow them to rise materially. Americans may have an egocentric view that everything is fine because the S&P 500 is at a new high. Globally, the situation is not that great. The emerging markets have performed terribly this year and we're starting to see unrest in a number of places around the world as social situations deteriorate rapidly, mainly in Brazil, Turkey, Egypt and such. All is certainly not well and I don't expect the situation to get better anytime soon.

TER: When will everybody realize this is all a big charade?

KB: I often try to predict the catalyst that breaks the bond bubble. Government bonds are primarily held by mega funds, and sovereign banks. The banks around the world do it because they can lever up and play the carry-trade game. Most governments do it to keep their currencies low and support their export economies.

If interest rates rose, banks would be bankrupt, so they have no interest in seeding their demise. Governments try to pretend that deficits are going to eventually be brought under control, and continually make statements that there is no inflation, so they can prevent their currencies and bond markets from collapsing. Whenever economies slow as a result of higher interest rates, consumer confidence drops and interest rate-sensitive sectors like housing slow. Central bankers, or shall we say central planners, will become more aggressive with quantitative easing and bring the rates down to try to kick-start the economy again. That's the delicate game they have to continue playing.

I expect this will continue for many years until the systemic U.S. trade deficit stops being funded by foreigners. It could be a few months from now or a few years, but eventually foreigners will come to understand the stupidity of buying U.S. government bonds to try to help their economies. I believe this is the Achilles heel of the system, and the U.S. dollar reserve-based global financial system's days are numbered. The U.S. dollar will lose its reserve currency status when the Chinese, Japanese, Koreans and other major purchasers of U.S. bonds decide it's not in their best interest to continue doing so. For the longest time, China and other countries have viewed purchasing U.S. bonds as an effective way to keep their currencies relatively stable. But at some point they're going to give up on the foolishness of supporting the U.S. trade deficit and focus more on their domestic economy, rather than on competitive devaluation to support exports. The fact is, they collectively have been giving the U.S. over $500 billion worth of goods and services per year for over a decade. They will recoup little from these "loans" in the future. When they try to cash in their bond holdings, they will find there is no buyer other than the Federal Reserve, which will deliver them freshly printed currency that will only be accepted in the U.S.A. because no foreigner will want to accumulate more. When the trillions sent overseas come home to the U.S., inflation will explode and trade restrictions will rise.

TER: So how do we convert this into an investment strategy from a contrarian viewpoint?

KB: It is difficult to try to determine the best asset class to own. You also have to pick a time horizon and focus on what the world is going to look like 10–20 years from now and evaluate the asset classes that could give the best rate of return. Ultimately, we always come back to what we believe—that food, energy and other base and precious metals will do better in the long run. The key to investing in cyclical resource sectors is buying when they're depressed. Now we've got a situation where they're extremely depressed in many sectors.

TER: What are you doing at Sprott to deal with the current market environment for energy-related investments? Has your approach changed since your last interview?

KB: Precious metal equity values have come down substantially this year and we're starting to see some very good value and opportunities in that sector. As for base metals, we still think there's more potential downside.

We're quite optimistic on developments in the natural gas market. Last year's injection season marked the smallest inventory increase in the modern history of the natural gas market. The withdrawal season was also the third largest on record, and that was with relatively average winter weather. At around $4 per thousand cubic feet ($4/Mcf), demand is going to continue to grow faster than supply and that price will eventually be pushed higher. That will create value for companies like Long Run Exploration Ltd. (LRE:TSX), which we own, and which has significant natural gas exposure as well as stable profitability from its oil production.

PD: Purely gas-focused drilling activity is almost down to zero. We need to see higher prices to generate drilling demand from producers, which I think we will begin to see this year.

KB: Another sector that's been quite depressed is coal, mostly as a result of low natural gas prices. A lot of mines have had to close or go through a restructuring. It looks like we're getting closer to a historic bottom in coal equity valuations and so we're looking around for opportunities to get some long-term exposure to that sector.

PD: As an example, Arch Coal Inc. (ACI:NYSE) is down from $28 to below $4 in the past two years. It was up over $70 around five years ago before the financial crisis.

KB: During a boom in any sector, a lot of the big companies are tempted to take on debt and continue acquisitions. Arch Coal still has a significant amount of debt. There are other coal companies that will certainly survive. We may not be incentivized to bring a new coal mine into production today, but there's *great* incentive for us to buy coal mines that have long life reserves and wait.

TER: You mentioned Long Run, which we talked about during your last interview. Where do you think that one's going?

PD: The company merged last fall (Guide Exploration Ltd. and WestFire Energy Ltd. combined to form Long Run) and recently completed its first couple of quarters as a new entity. Production is going well and cash flow is meeting expectations. It's focusing on oil production exclusively this year due to the oil and gas pricing environment. There's a lot of room to pay a dividend later this year or next perhaps, which both we and the market would welcome seeing. Long Run's gas reserves are significant, so there is huge optionality on the gas side. Overall, it's a solid story and it's discounted to its peers, probably because it's a new name and there's currently a lack of fund flows into the general Canadian energy market.

Looking at the various metrics relative to its peer group, you can safely conclude that it's trading at a 30–40% discount. If the sector gets revalued because money starts flying back into it, things can go higher from there. The optionality in the gas market could take the stock even higher.

TER: Sprott Resource Corp. completed that nice deal on its Waseca Energy Inc. holdings last year when it sold out to Twin Butte Energy after four years.

KB: We were very pleased with the performance of that company. Again, we stuck with our strategy of investing in a sector while it was depressed. We bought into heavy oil when it was no bid in Canada, formed the company and ultimately were able to monetize it when margins were significant and the company had grown from zero production into a +4,000 barrels per day company. That delivered another big win for our shareholders with a nearly $70 million profit.

PD: Along that same vein, we've invested in a drilling company based out of Houston, Texas called Independence Contract Drilling just over a year ago. It drills shale formations and, again, we invested in the sector when it was generally out of favor, and built the company up from book value to probably having above 12 rigs in production by the end of next year. I expect that at that time we will be able to capitalize on its strong cash flow and look for some sort of monetization, whether it's an IPO or sale of the business.

TER: Another area we haven't talked about yet is uranium. I know you're into Virginia Energy Resources Inc. (VUI:TSX.V; VEGYF:OTCQX). What's the update on that name?

KB: The uranium market is similar to coal. Natural gas has weakened valuations and demand in all energy sectors. Fukushima also really upset the short-term demand and created a very negative sentiment in the nuclear space. But demand for physical uranium for nuclear power production is going to grow over the next decade or two and mine supply will fall short with $40 per pound ($40/lb) uranium. When we look at overall planned, permitted nuclear facility growth and as well as extensions of the existing facilities, we see robust demand and we see very little supply coming on the market.

PD: We will see large supply shortfalls emerging in the next few years. The market's going to have to catch up on funding mines, because funding has been scarce over the last few years. We believe a uranium price north of $75/lb is going to be required to balance supply. Although the Commonwealth of Virginia has not yet passed legislation that would provide a framework for permitting uranium mining projects, we are hopeful it will in the near future. At that point the company would be greatly positively revalued.

KB: Regardless of the uranium market, Virginia Energy Resources is one of the largest undeveloped uranium projects in the United States, and major producers will likely try to take out Virginia Energy Resources when the permitting framework is in place.

TER: Where you see opportunities in the fertilizer/potash markets?

PD: Potash prices have softened a bit lately. We've invested in one potash company that produces SOP potash, called Potash Ridge Corp. (PRK:TSX; POTRF:OTCQX). It is developing a project in Utah, we think has very favorable economics based on the preliminary economic assessment. A prefeasibility study is expected in the next couple of months, which should give greater clarity on that project. The project's key benefits are the byproducts in the deposit, which lower the production cost dramatically. It should be one of the lowest-cost producers of SOP potash, which is a growing market globally. We're optimistic that someone is going to have an interest in an offtake agreement and perhaps assist with the financing in the next 12–18 months.

The phosphate market has been more stable than the potash side. In the U.S., there is some risk for domestic producers due to potential shortfalls in their mines over the coming year. The phosphate market could be in very good shape over the next five years as those companies seek to replace their production. We're quite optimistic about one of our investments in a company called Stonegate Agricom Ltd. (ST:TSX, SNRCF:OTCPK), which is developing its potash project in Idaho. That should come into production in late 2014 or 2015.

TER: Do you have any final thoughts you'd like to leave with us?

PD: The resource sector, generally, is probably the most out-of-favor it has been in a long, long time. If you're ever going to put money to work in this sector, right around now would probably be an opportune time to do so.

KB: This is the kind of market that really allows those who are willing to step up and invest to make a lot of money.

TER: Thank you gentlemen, for your updates and insights today.

Kevin Bambrough founded Sprott Resource Corp. in September 2007. He is a seasoned financial executive with more than a decade of investment industry experience and is a recognized leader in the commodity investing space. Since 2009, he also has served as president of Sprott Inc., one of Canada's leading asset managers, which has more than $8 billion in assets under management. Between 2003 and 2009, he held a number of positions with Sprott Asset Management, including market strategist, a role in which he devoted a significant portion of his time to examining global economic activity, geopolitics and commodity markets in order to identify new trends and investment opportunities for Sprott Asset Management's team of portfolio managers.

Paul Dimitriadis is Chief Operating Officer for Sprott Consulting and Sprott Resource Corp., where he evaluates and structures transactions, coordinates and conducts due diligence and is involved in the oversight of subsidiaries and managed companies. He serves on the board of directors of two of Sprott Resource Corp.'s subsidiaries, Stonegate Agricom Ltd. and Long Run Exploration Ltd. Prior to joining the Sprott group of companies, he practiced law at Blake, Cassels & Graydon LLP. Dimitriadis holds a Bachelor of Laws degree from the University of British Columbia and a Bachelor of Arts degree from Concordia University.

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