

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points October 2, 2008

The credit market contraction is now feeding a downturn in the real economy. This is becoming a self-reinforcing dynamic: As the real economic outlook dims, lenders' willingness to extend fresh credit dims too. Things are rough out there.

Points:

1) Gold is falling on flight to the dollar. This has become the norm for gold on particularly grim days. Usually, these downturns reverse themselves when things calm down. We see gold as being on a gently-rising tack, driven by the negative real fed funds rate. However, we disagree with the gold-bug argument that a \$700 billion bailout would reduce U.S. creditworthiness, thereby weakening the appeal of the dollar. The Fed is having no trouble selling bonds, and the U.S. debt-to-GDP is still in the 60-75% range (which is average by international standards).

The real bullish argument for gold is that the Fed will resort to some form of quantitative easing. Things would have to get pretty bad for that to happen, but it's not out of the question. Fed Chairman Bernanke clearly is open to the concept, having written and spoken about it at length in the past.

2) Copper is in free fall and stocks are getting hammered. Copper is now at \$2.64/lb. In a sharp slowdown such as is now evolving, one would have to think copper could fall to \$2/lb. – or lower. We will need to re-do our copper models to reflect a lower price, at least for the near term. However, copper stocks have already cratered, and many already reflect copper prices below \$2/lb. Quadra Mining is now effectively discounting the closure of the Robinson mine. (It may come to that if copper falls to \$1.75/lb.) Thompson Creek Mining is discounting \$14.50/lb. moly. (Moly is currently \$33.50/lb.).

3) The Nouriel Roubini scenario – falling home prices, defaults, bank failures, and recession – is unfolding before our eyes. I had been pooh-poohing the parallels to 1929, but the more I think about it, the more I see them. Supply-siders correctly fault the Smoot-Hawley tariff for the Depression, but the dry tinder for the 1929 crash was (like today) tremendous investor leverage. Stocks could be bought at 10-to-1 margin in the 1920s. This time around, we haven't had 10-to-1 leverage on stocks – but we sure have had 10-to-1 margin on derivatives! Meanwhile, the fallout from the sub-prime mortgage debacle can be viewed as Smoot-Hawley-esque. Just as Smoot-Hawley depressed the price of commodities and other exports (by shutting down world trade), the sub-prime implosion has sharply depressed the value of housing (and largely shut down the homebuilding trade). The impact on individual balance sheets has been severe enough to impact the real economy. That being said, the current downturn should be much shorter. The Fed learned a lot from 1930s and is taking proactive steps to heal the credit system. Also, the housing problem should prove less intractable than did Smoot-Hawley.

4) Another key difference between 1929 and today is that the Federal Reserve devalued the dollar in the years leading up to this crisis, which should lend support to commodity prices going forward. The gold price in 1932 was essentially unchanged from 1850, at \$20.67/oz. When commodity demand plummeted in the early '30s, there was nowhere for commodity prices to go but down. Today, though, the gold price is 25 times higher than its level of 50 years ago – and yet the vast bulk of commodity prices are 6-10x higher (except oil and gas). Thus, most commodity prices are still in a structural hole from a nominal-price perspective. Also, it remains unclear whether emerging markets, which are far more commodity-intensive than the U.S., will be impacted to the same degree that the U.S. has been by recent events. Mortgage penetration is much less in emerging markets than here.

5) The one *potential* bright spot in an otherwise grim outlook is airlines, but even they will struggle in a sharp downturn. Most of the airlines are seeing double-digit RASM growth for Q4 based on early bookings. That's way better than we had been expecting. The capacity cuts now being undertaken by airlines are truly Draconian – on the order of 9% of the US fleet. Even still, the preliminary Q4 RASM readings probably won't hold up in light of the rapid slowdown in the US economy. If it gets bad enough, some of the heavily-indebted airlines may run into cash trouble this winter. That would be too bad. For, if the real economy recovers in (say) nine months, double-digit RASM gains may indeed start to materialize in H2 2009. That would have major implications for our EPS estimates. In the case of Delta, for instance, we are currently modeling \$100/bbl. oil and 8% RASM growth in 2009. If instead we use \$95/bbl. oil and 11% RASM growth, our annualized EPS estimate climbs to \$2.03/share from \$0.87/share. Earnings would approach \$3/share in 2010 (assuming a further 5% RASM increase). If this sort of scenario develops, the stock could climb to \$20/share next summer

One other point here: The airlines aren't completely exposed in the event of a sharp downturn. They have an implicit hedge with the oil price. If the economy really goes in the tank, the oil price should go down with it, helping keep airline COGS under control even as RASM underperforms expectations.

6) Two months ago I wrote a piece called "P/E hell and the booming bust." I really should have called it "P/E limbo," because *this* is P/E hell. Fertilizers are 3-4x earnings (even assuming continued declines in fertilizer prices) and even some of our oil stocks also are trading at 3-4x earnings, assuming \$80/crude. We face exactly the same strategic challenge today as two months ago: Equities are discounting far lower commodity prices ahead, and we don't *think* commodity prices will go as low as the stocks are signaling. Thus, we continue to stick with our positions. Either we will be proven wrong by continuing declines in commodity prices, or we will be proven right and the stocks will recover.

It's worth noting that commodity prices over the past two months haven't performed nearly as badly as equity prices suggest. Some commodities have fallen hard (copper), some have declined but are still well above our forecast levels (oil, phosphate & urea), some have fallen down *to* our forecast levels (steel) and some are unchanged at high prices (moly, potash). Equities, meanwhile, have fallen 30-60%.

With the caveat that we've been wrong on a lot of things this year, our view is that the commodity-stock bear market is not a repeat of the internet bubble, when stocks were trading at 150x earnings and 20x sales. I did a lot of work on internet stocks in 2000 and 2001 and concluded they were nonsense and couldn't work. By contrast, many basic-industry names today are trading at 3-5x earnings and less than 1x EV/sales. That's a huge difference. One wonders if it's partly the *specter* of the internet crash that is haunting commodity investors today and prompting some of the selling. Nobody wants to be like one of those tech fund managers who lost 97% peak-to-trough in the internet bust. Nor does anyone want to end up like the old patriarch in *Gone With the Wind*, sitting at his desk in the closing days of the war, clutching a handful of Confederate bonds.

One could argue that stock prices were telling us something last summer and we should have listened. Maybe so. The challenge with the argument, though, is that commodity stocks have discounted *six of the last one recessions*. In the commodity realm, one can't just take one's cues from the behavior of stocks and expect to make any money. One has to independently make one's own commodity-price forecasts and stick with them until events warrant otherwise, or until stocks reach full value. Some stocks did get to full value and give us a chance to sell down our positions (i.e. US Steel, Olympic Steel, Reliance Steel, Century Aluminum, Mosaic). Even the zinc stocks provided a window to sell last summer. But others – especially the small E&Ps and the many of the smaller copper and moly names – never presented an obvious sell opportunity.

The way to have avoided this downturn would have been to internalize the Roubini argument – that declining home prices were destined to unravel the sub-prime lending apparatus, bring down the banking sector and pull the economy into recession. We just missed that call. There have

been many bear arguments for the real economy put forth over the past five years, and I've rejected them all. They were all wrong, too ... except this one. But it only takes one correct bear thesis to wreak a lot of havoc. Until very recently, it didn't strike me as logical that a slowdown in US homebuilding and related industries (which, combined, account for 1% of global GDP) could create such chaos around the world.

7) This raises the question of whether there's a flaw in our intellectual model. For the past six years (really the past 14 years) I've basically used a three-input model: gold, tax rates and interest rates. I've studiously avoided worrying about arguments bemoaning "the tapped-out consumer," trade deficits, current account deficits and growth-driven inflation. We've had five 20%-plus drawdowns in the Classical Insights portfolio since 2003. Each time I just pushed ahead, ignoring warnings of impending doom (which always turned out to be wrong). At the peak last summer the portfolio was up 1400% in four years.

So is there a flaw in our model? Do we need to start taking demand-centric indicators into account? Clearly we need to broaden the way we think, but the classical model really does include all the concepts relevant to this crisis.

In classical economic theory, all growth is the result of risk-taking -- the combination of an entrepreneur (with an idea) and a capitalist (with financing). At present, the financing half of the equation is breaking down due to the weakening of the banking system's capital base. That, in turn, has weakened the desire of potential risk-takers to do anything other than hunker down and wait. A weakening in growth has resulted.

In retrospect, it's fairly straightforward to dissect the causes of this mess with classical economic theory. Most obviously, bad regulation and chronic interest-rate volatility led to an explosion in bad lending. As a result, capital allocation became radically inefficient due to the creation of artificial (i.e. inflated) price signals in the home market. Now we're in a period of adjustment. The big lesson we will take away from this will be to pay far more attention to potential threats to banking system capital. Without healthy banks, nothing else works.

8) In recent months, as economic risks have risen, we've shifted a bit more into sectors that are more insulated from economic decline: particularly oil and agriculture but also airlines (since they include a *de facto* oil put). In principle, these moves have actually worked: fertilizer prices are still very strong and oil is above our forecast prices (yet still low enough for airlines to make money). From a portfolio perspective, though, we've been crushed across the board. We may need to do some selling soon to avoid a margin call. What started off as 20% margin has now become 50% margin (and a lot of our stocks are non-marginable).

The Classical Insights portfolio holds all names mentioned above except ZEUS and RS.

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