

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points October 22, 2008

1) One way to think of the credit crisis is to view it as a roving tornado, blasting through every sector, country, currency, and company. Those that are weak (Iceland, Bear Stearns, small zinc miners) get blown over. Those that are strong (some regional banks, the Thai baht, steel mini-mills) survive. Everything and everyone is tested. Once they show they can pass the test, confidence returns. That is the message being sent by the high-grade credit markets, where key indicators are showing improvement (albeit partly due to government support):

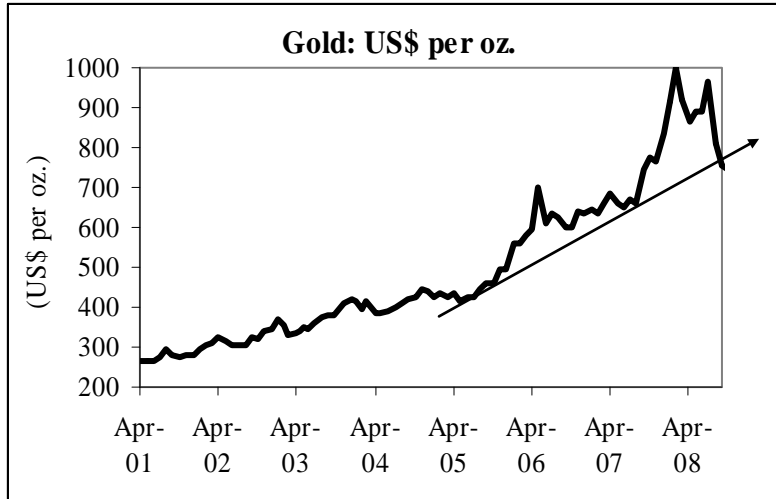
- Two-year swap spreads are back down to September levels at around 100 bps over Treasuries;
- Thirty-day AAA commercial paper is now at a four-year low yield of 1.92%;
- Three-month LIBOR is at 3.54%, down from 4.19% 10 days ago.

The tornado analogy helps show the path by which the global economy can eventually return to growth. As the tornado passes through ever more sectors, countries and companies, and as trust in each of these is tested (successfully or not), growth can gradually resume.

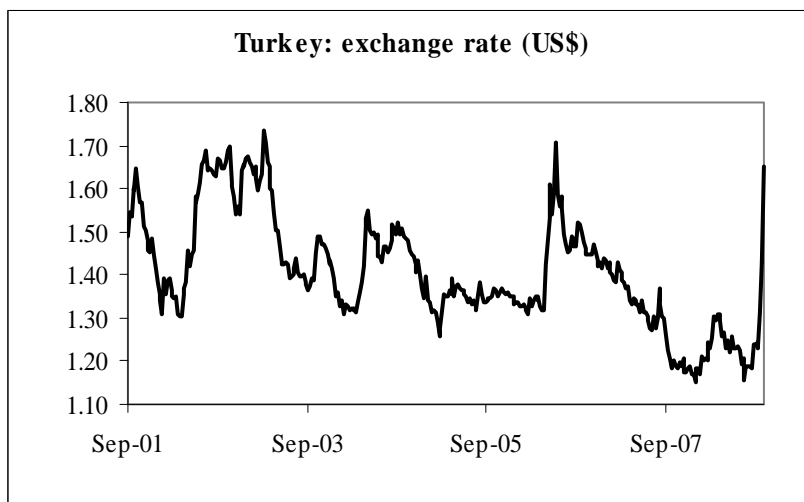
Still, the Dow is down hard today. More damage has been uncovered in the CDO market, and discoveries like these set back the pace by which confidence returns. Meanwhile, investors are still ratcheting down earnings estimates. Hopefully, this will turn out to be just a bump in the road. But the key risk to the relatively upbeat outlook laid out above is simply that the banks are more damaged than generally realized. Banks are naturally levered at least 10-to-1, so if defaults turn out to be twice as bad as expected, we go through the whole ringer again. More bailouts, more defaults, more all-night sessions in Washington, more stock market declines.

Home prices (the core of the problem) are still falling, but the beginnings of market-clearing activity can be seen in California, where September home sales rose 65% YoY. More than half the sales of existing homes were foreclosures. Prices are down 30%+ YoY, but at least there is now a market. And as foreclosed properties move, defaulted mortgages start to take on real value, re-liquefying the holders.

2) At the moment, the focal point of the tornado is emerging market currencies. The U.S. dollar is strengthening rapidly on flight from risk. Gold broke through its uptrend line this morning and may be headed as low as \$625/oz. One of the messages contained in the gold price decline is that the various bailout actions by Fed and Treasury have not been inflationary. Excess money has not been created (at least not yet).

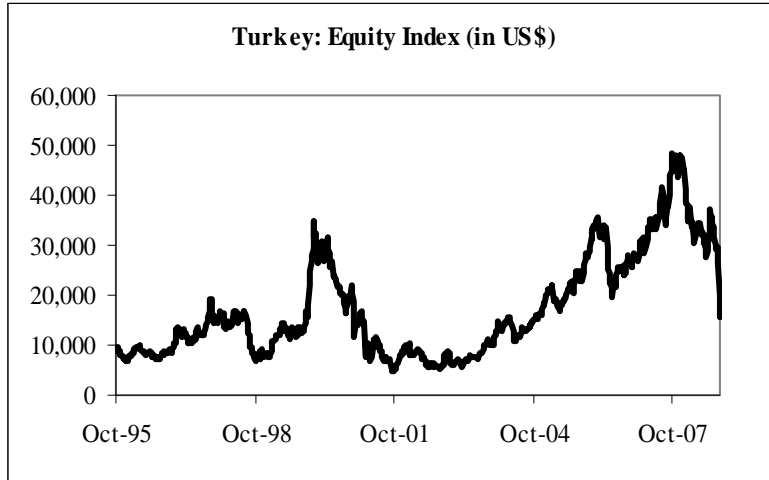


3) The Turkish lira and Brazilian real are falling hard. Turkey is in the process of negotiating a \$10 billion loan agreement with the IMF. The funds may be used to help corporates roll over debt. That would make sense, and would restore confidence in domestic companies (and thereby ease pressure on the currency). Turkey faces currency attacks every two years, like clockwork, so policymakers know how the process goes:

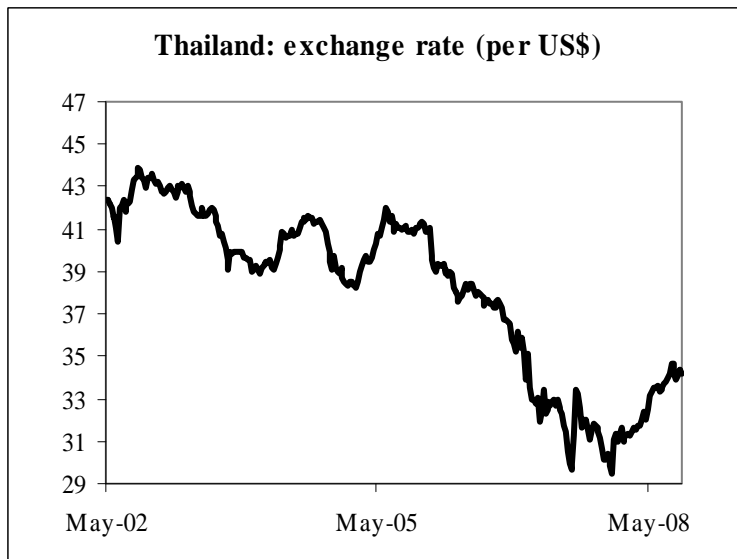


This attack is more intense than most and may take longer to abate, but several factors should prove helpful in Turkey's currency defense: Bank lending standards are far more strict in Turkey than in the U.S., and bank leverage is much lower there. The declining oil price will help the current account deficit. The 20% tax rate keeps Turkey an inherently attractive destination for capital. Still, Turkey faces one key problem: its primary trading partners, Europe and the Middle East, are both slowing rapidly.

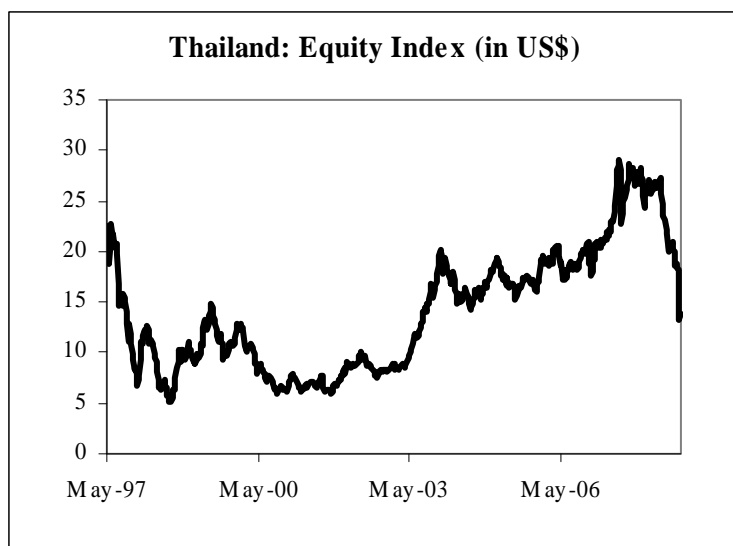
Turkish equities are now trading at 1998 levels in US\$ terms. Some names are back down near the lows reached in the aftermath of the currency board collapse in 2000. If Turkey gets through this mess in one piece, there should be a huge rally in Turkish stocks. P/E's on many names are 2-4x.



4) It's interesting to note that the Thai baht – the epicenter of the Asia crisis 11 years ago – isn't really doing anything. The baht has been tested. It passed. There is no problem there.



Still, the SET index is down nearly 50% over the past five months in US\$ terms. Thailand would seem a good place to look for equity ideas.

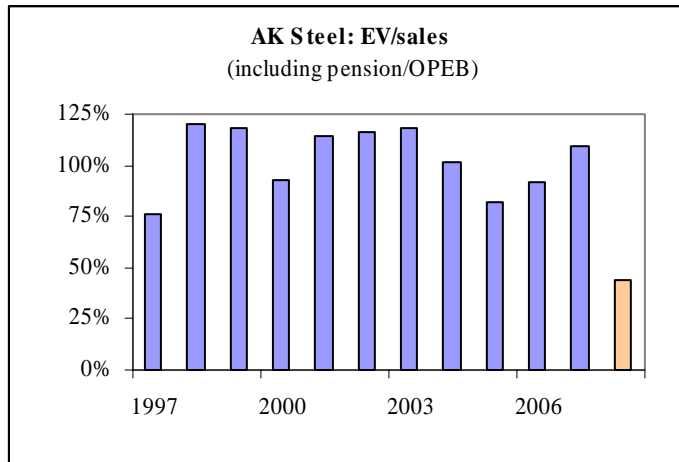


5) The combination of lower gold and weak global growth continues to drag down the oil price, and we continue to think crude can go to \$60/bbl. or less. If the oil/gold ratio returned to 15-to-1 (which would be in keeping with much of the post-1971 period), crude would be almost exactly \$50/bbl. In modeling junior E&Ps, we find that they work at \$60/bbl. but aren't very attractive at \$50/bbl. Saudi Arabia has a critical motive to want to cut production (save its aging fields) but also has motives for allowing the oil price to continue falling (set back competition from alternative energy sources such as oil sands and biofuels). So we'll see which path it chooses.

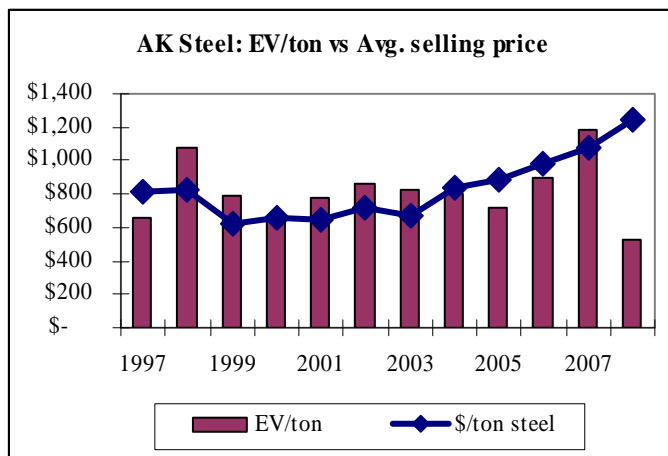
6) Airlines are soaring. Investors are betting that lower fuel costs will offset weakening RASM. This calculation is very sensitive to small changes, so it's not clear how it will play out in the near term. However, if the U.S. stages a strong recovery in 2010 and oil stays at \$70/bbl., airlines could mint money.

7) It's time to put on the "deep-value hat" when analyzing steel and aluminum stocks. Despite all the carnage, there remains a core intellectual arbitrage that can be exploited in commodity stocks: To some degree, investors are confusing a contraction with a deflation. In a contraction, activity slows and prices dip some. *But when business bounces back, prices come back too.* That's what we expect, given that gold is still \$750/oz., up from less than \$300/oz. six years ago. It's entirely conceivable, then, that even if the steel industry has an abysmal 2009 (which seems increasingly likely) earnings in late 2010 could rival those of 2008. Here is a look at four steel names we cover.

AK Steel (AKS) is trading at its lowest level on an EV/sales basis since at least 1997:



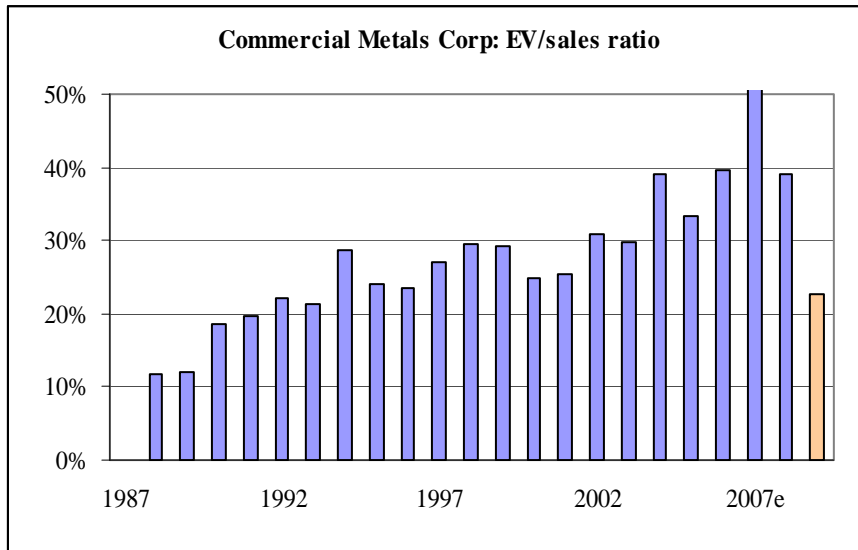
AKS also trading at its cheapest level on an EV/ton basis since 1997 – even though its average selling price is now at its highest since 1997.



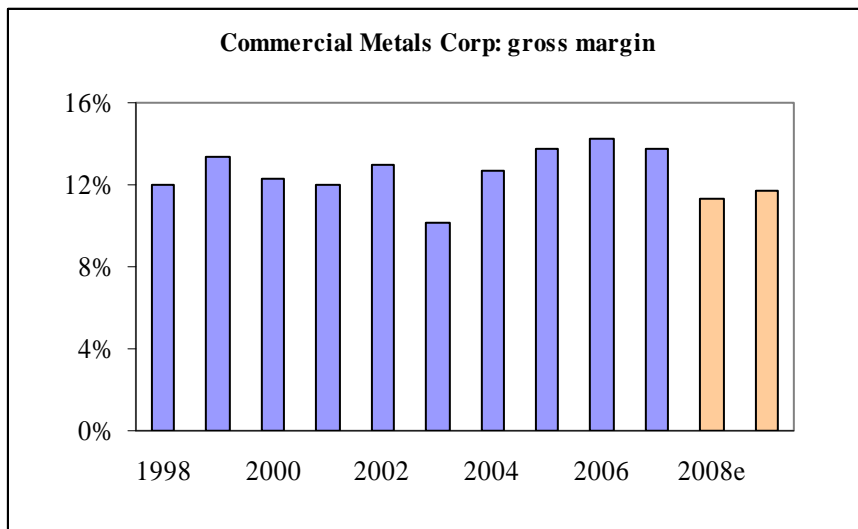
AKS would be an attractive acquisition target. Also, it should benefit from a rebound in auto sales, which would seem likely by H2 2009, due to lower oil and (hopefully) a stronger economy. On its Q3 conference call, AKS management made several points (as reported in last night's *American Metal Market*):

- The firm's headcount is down 30% in the past five years;
- AKS has cut exposure to the auto market to 29% from 60% just over the last year (with the balance going to service centers). That service centers have average inventories at present;
- Scrap costs have fallen more than \$300/ton in the past two weeks and spot iron ore has fallen to \$65/ton from \$140/ton. AKS is the only integrated steel producer that buys 100% of its iron on the open market;
- Although carbon and stainless markets are expected to stay weak, the market for grain-oriented electrical steel remains very strong – and customers remain on allocation for tons.

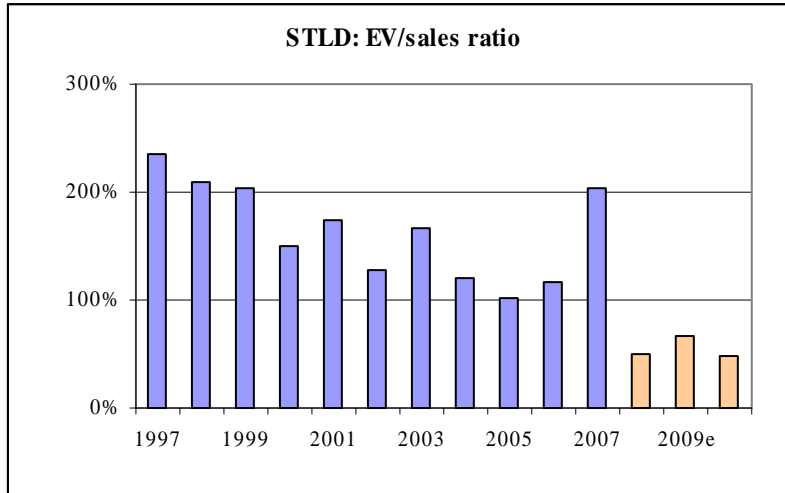
Commercial Metals (CMC) is selling at its lowest EV/sales ratio since 1993:



CMC's vertical integration gives it steady gross margins. Plus, the firm uses LIFO accounting so it won't get slammed with inventory losses in a declining price environment.

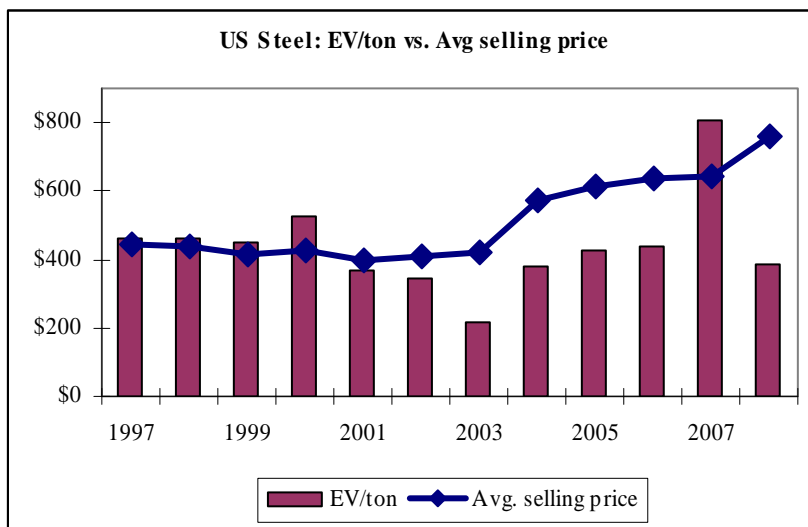


Steel Dynamics (STLD) is selling at its lowest EV/sales ratio by far since the founding of the firm:



In retrospect, STLD's acquisition of scrap firm Omnisource was very ill-timed. The move has left STLD with a debt/market cap ratio of 1 to 1 (and that's part of the reason the stock has fallen to \$10/share). We think it will work out all right, though, as the bulk of the debt is not due until 2012.

US Steel is selling near its all-time lows on an EV/ton basis, and definitely is at an all-time low on EV/ton relative to the prevailing steel price. That said, X was downgraded this morning by Goldman Sachs because a) it has its own coal and iron operations, which are less valuable now, and b) tubular prices are starting to weaken. These are valid concerns. On the plus side, X has been selling flat-rolled steel at below market prices in recent quarters, since a good chunk of its sales have been on contract. So its pricing decline in flat-rolled should be subdued. Also, tubular volumes should remain reasonably solid even if prices dip some. Lastly, the Eastern European market should bounce back strongly in a year or two given the great tax policies in that region.



8) The implosion in the aluminum stocks has been as bad or worse than that which has occurred in steel. Alcoa shares are back to 1995 levels. Century Aluminum has fallen from \$80 to \$12 in the past five months. With gold at nearly double its 1995 level, one could reasonably buy aluminum stocks here, stuff the share certificates into a trunk in the attic and check back in two to three years. By that time the share prices of both should have doubled or tripled.

The Classical Insights portfolio holds all names mentioned above except Alcoa.

Mike Churchill

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Churchill Research, Inc.
105 N. Virginia Ave, Suite 200
Falls Church, VA
22046
(703) 241-0274
(703) 340-4726
(703) 459-0284 (Nick Bundy)
mike@churchillresearch.com
nick@churchillresearch.com
www.churchillresearch.com

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