

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points November 18, 2009

Here are six points on gold, copper and mining stocks:

1) Copper has risen to \$3.10/lb. and there are several reasons to think it will remain above \$3 (and potentially rise to \$3.50+/lb.):

- Gold's rise to \$1143/oz. has left copper very cheap in gold terms. My nine-input copper price-forecasting model now generates a figure of \$4.32/lb. Importantly, this model is heavily-weighted toward monetary (i.e. gold) measures of value. When gold is soaring, copper definitely tends to lag – sometimes by quite a bit.

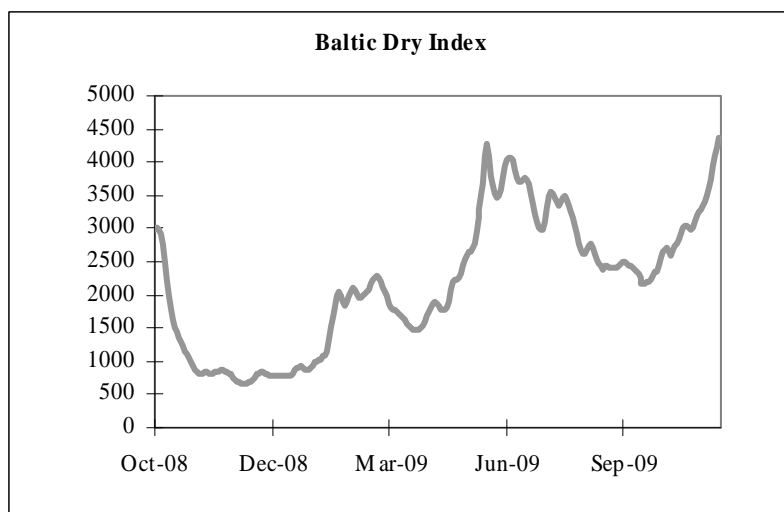
Copper: Nine forecast methods

(based on \$1143/oz. gold)

Pre-1971 copper/gold ratio (mean), applied to today's gold price	\$7.52
Pre-1971 copper/gold ratio (median), applied to today's gold price	\$9.00
Post-1971 copper/gold ratio (mean), applied to today's gold price	\$3.24
Post-1971 copper/gold ratio (median), applied to today's gold price	\$3.48
Spot LME copper	\$3.13
Feb 2012 LME future	\$3.07
Price implied by post-'73 gold/copper chart	\$6.97
Price implied by 50-year copper/CPI	\$2.45
Price implied by 50-year copper/CPI	\$2.45
Average	\$4.32

Sources: Bloomberg, LME, USGS, Churchill Research ests.

- The Baltic Dry Index is now up to 4381, which implies strengthening global economic activity (and rising physical demand for copper in coming months).



- Copper traded just under the \$3/lb. level for four months before authoritatively breaking through it this week. If I were a technical analyst I'd view that as a meaningful breach of a key resistance level.

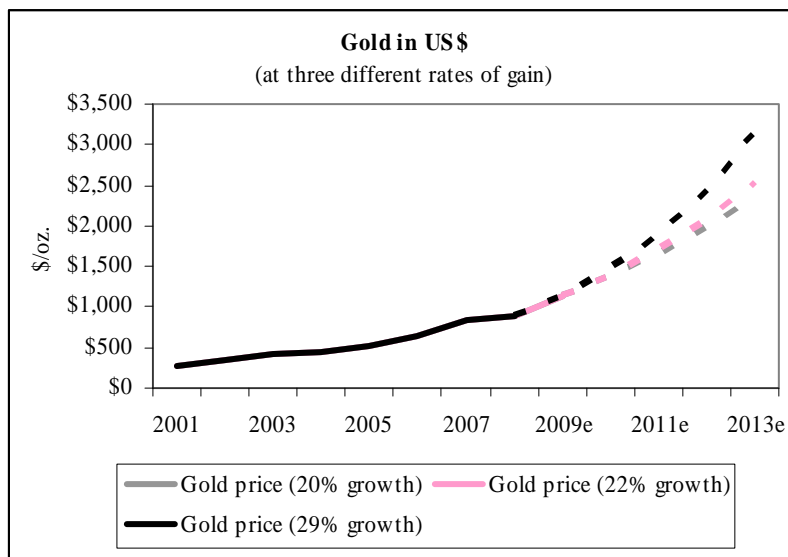
2) The gold chart is starting to show early signs of parabolism. The defining feature of the 2001-09 gold bull market – so far -- has been its plodding, incremental nature. By contrast, gold's behavior from 1972-74 and 1979-1983 was marked by sharp, violent moves.

Why the difference this time around? I have been attributing it to the fact that the Federal Reserve worked in a monetarist policy framework for parts of the '70s and early '80s, whereas from the mid '80s onward the Fed has used interest-rate targeting. In a monetarist system there can be, on any given day, a large *gap* between supply and demand for dollars at the core of the banking system. In an interest-rate targeting framework, by contrast, it is not really possible to have such large gaps: Every day the Fed puts out exactly as much money as is demanded at a particular interest rate.

This brings us to the present day, and the 0.25% fed funds rate. It seems to me that with the funds rate so close to zero, it may cease to have meaning as a reference point for supply and demand for money. If money costs nothing, what will be the determinant as to how much is supplied?

Perhaps, then, we are entering an environment that is closer to monetarism than one might think. As such, the potential for mismatches between supply and demand for money may be greater than at any time in the last 25-30 years -- and so too the potential for a parabolic move in gold.

Of course, the gold chart will start to look parabolic by default if the gold price continues to climb at its current rate in percentage terms. So far in 2009, gold is up 29%. Over the past three years it has averaged 22%/year. Over the past 8 years it has averaged 20%/year. The chart below plots paths for gold based on those rates of advance.



As long as the fed funds rate remains close to zero, one would have to view the most aggressive rate of advance (i.e. 29%/year) to be the most likely. That would put gold at \$1,472/oz. at year-end 2010, \$1,899/oz. at year-end 2011, \$2,450/oz. at year-end 2012 and \$3,160/oz. at year-end 2012.

3) Van Eck Global has launched a new small-cap gold-miners fund (Market Vectors Junior Gold Miners ETF, ticker GDXJ) but I am not wild about it. I cover four of the stocks in the fund (Northgate, Jaguar, Minefinders and Great Basin) and think the first three are either fully valued or expensive. The weakness with GDXJ is that while the stocks are billed as juniors and “up-and-comers” they’re actually fairly established names – and they’re not cheap. Jaguar trades at 19x 2010 earnings and Minefinders trades at 14x. I don’t think this is where the real action is. These stocks are likely to rise if the gold price rises, but I want to own things that can rise sharply *even if*

gold is flat. For that, one generally has to go smaller: usually sub-\$500 million (and preferably sub-\$300 million).

If I were to create a junior gold miners ETF, it would look like this:

My hypothetical gold miners ETF

Name	Price (US\$)	Mcap (US\$ mln)
CGA Mining (CGA CN)	\$1.88	\$542
Great Basin Gold (GBG)	\$1.65	\$520
Gold One (GDO AU)	\$0.32	\$275
Crocodile Gold (CRK CN)	\$1.23	\$228
Victoria Gold (VIT CN)	\$0.64	\$157
Timmins Gold Corp (TMM CN)	\$1.07	\$153
Orko Silver (OK CN)	\$1.07	\$123
Northern Star Mining (NSM CN)	\$0.44	\$89
Carpathian Gold (CPN CN)	\$0.31	\$89
Maudore (MAO CN)	\$3.32	\$63
Hambledon Mining (HMB LN)	\$0.12	\$58
Orezone (ORE CN)	\$0.60	\$35

Sources: Bloomberg, company data

Van Eck chose his names with an eye for liquidity, which is entirely understandable if one is running an ETF. Perhaps the best place to be in the gold universe is precisely at the cap at which money managers *en masse* can start buy a stock. I would put that figure at about \$350 million.

4) Goldcorp's (GG) pending acquisition of Canplats (CPQ CN) offers a nice benchmark for other potential takeouts. Goldcorp has offered \$257 million for Canplats, which on a dollars-per-ounce basis works out as follows:

- \$67 per ounce if you include all measured and indicated ounces at Camino Rojo;
- \$137 per ounce if you only include the ounces included in the open-pit design.

(In both cases I value the silver at a ratio of 1-200 relative to gold, because silver recoveries will be just 25%.)

The acquisition was a lay-up for Goldcorp. GG shares are valued in the market at about \$500/oz. and management is using those \$500/oz. shares to buy Canplats' ounces at \$67/oz. -- which then will be magically transformed into \$500 ounces. Not a bad racket! This deal illustrates, once again, the profound valuation disparity that exists between gold majors and gold juniors.

That said, the buyout price for Canplats isn't unreasonable given that Camino Rojo had not been advanced to the pre-feasibility stage yet. What did Goldcorp like about the Camino Rojo deposit? I see a number of things:

- Camino Rojo is located very close to Goldcorp's existing Pensaquito deposit. As such, Goldcorp will be to run ore from Camino Rojo through the mill planned for Pensaquito;
- The Camino Rojo deposit is right at surface, so capex requirements will be very low at \$134 million;
- Cash costs are expected to be low at \$340/oz.;
- The deposit is very close to a highway so transport will be easy;
- The terrain is flat and easy to deal with;
- Mexico is a mining-friendly jurisdiction.

The Goldcorp/Canplats deal offers insights on strategies that can work elsewhere in the junior-gold area:

- Buy firms whose projects have truly stand-out economics (low up-front capex and low operating costs);
- Buy ounces for less than \$50 each (and preferably less than \$30);
- Look for situations where there is an obvious synergy with a major gold miner located nearby, who can easily step in and make the acquisition;
- Look for projects that are about to be advanced to either the Preliminary Economic Assessment (PEA) stage or the pre-feasibility stage.

5) Mercator Minerals' recent acquisition of Stingray Copper provides a useful data point in the valuation of in-ground copper resources. Mercator paid 1.7 cents/lb. last month for Stingray's Pilar copper project in northern Mexico, which has a resource of 2.55 billion lbs. Stingray published a definitive feasibility study on Pilar in April. The takeout price seems pretty low to me, all things considered. The economics of the project look very good: 70m pounds a year at a cash cost of \$1.20/lb. and upfront capex of just \$209m.

6) Victoria Gold (VIT CN) is proving to be a very interesting company. Three weeks ago VIT shares posted a huge one-day move (up 55%) on great drill results at its Santa Fe property in Nevada. I had been viewing Santa Fe as an afterthought and hadn't included it in my initial valuation of Victoria. The drill hole was only the second completed by Victoria in the old Santa Fe pit, and it encountered 2.25 g/tonne from meters 0 to 309 (including 3.93 g/tonne from meters 104 to 153). You could practically justify an underground development on that drill hole alone, as the rock would be worth \$80/tonne at current gold prices.

I am raising my target on VIT to \$1.62/share (was \$1.45/share) based chiefly on the new drill results at Santa Fe, though I've made some other changes to the model. I now assume Victoria ends up with 12 million ounces from its existing projects (was 8 million) and then I value those ounces at \$30 each (was \$40).

Victoria Gold (VIT CN)

Shares out (diluted)	243	Gold ozs. (mln, M+I+I) *	12.0
Share price (US\$)	\$0.66	EV/oz. (US\$)	\$12
Market cap (US\$ mln)	\$160	EV/oz. target (US\$)	\$30
Net debt (US\$ mln)	-\$14	Target share price (US\$)	\$1.62
EV (US\$ mln)	\$146	Upside to target	147%

* My forecast for eventual ounces at existing projects.

I'm getting the sense that CEO Chad Williams knows what he's doing. During the 2008 crash he went out and bought 4.4m ounces in the ground for \$3/oz. each, using Victoria stock. Several of the acquired projects were past-producing open-pit mines in Nevada, which I like (low permitting risk, some existing infrastructure and little overburden). Victoria is now drilling at three of these properties, as well as at its big Eagle deposit in the Yukon.

I also like that Victoria has been disposing of non-core assets in South America. Many small miners end up with too many properties and don't push hard enough on the ones they have.

Williams was a former gold-mining analyst at Blackmont Capital and was appointed to run Victoria by Kinross management. Victoria had been the exploration arm of Bema Gold, which Kinross acquired in 2007.

Here are my forecasts for eventual ounces at Victoria's projects:

Victoria Gold Corp. gold resources

Projects	Resources (in million ozs.)			<i>Eventual ounces (my estimate)</i>
	Indicated	Inferred	Total	
Eagle	2.7		2.7	4.5
Cove/Helen				2.0
Summit				1.0
Santa Fe				2.0
Mill Canyon				1.0
Big Springs	<u>0</u>	<u>1.2</u>	<u>1.2</u>	<u>1.5</u>
Total	2.7	1.2	3.9	12.0

For more on Victoria, please see the September 29 bullets, posted in the client section of the website (www.churchillresearch.com).

The Classical Insights portfolio holds all names mentioned above except Kinross, Goldcorp and Stingray.

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