

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Morning Bullet Points December 14, 2005

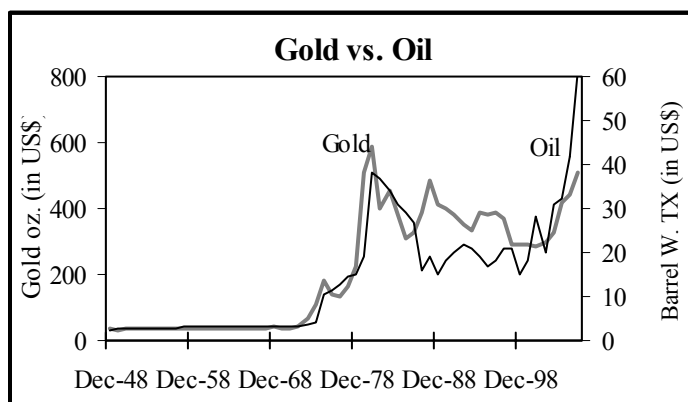
We have been receiving a lot of client questions in the wake of gold's move to the \$500/oz. range:

1) You guys seem to base everything off the gold price. Can you tell me again why a rising gold price should cause other commodities to rise as well? I've never been 100% clear on that. I mean, gold is useless. Why should it matter?

It's not really gold itself we care about. It's the dollar. Gold just happens to be the purest measure of the real value of the dollar. The fact that gold is "useless" is actually a huge part of its appeal in this regard. Gold serves no real function *beyond* being a store of value. It's liquid. It's fungible. It's portable. Over the last 4,000 years or so, gold has won a kind of competition with other potential stores of value. It has emerged as the purest, simplest, most reliable and easiest to deal with.

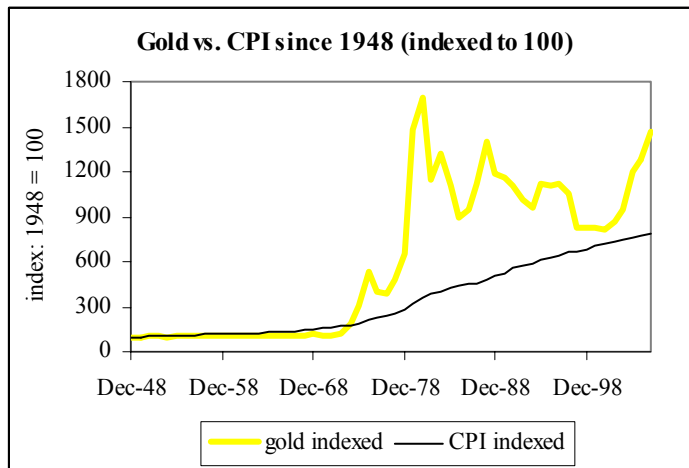
You could also derive a semi-decent monetary signal by monitoring the performance of a broad basket of commodities, but this approach has flaws. Industrial commodities and grains only give you a diluted signal of changes in the value of money, in part because these commodities *are useful*. They get consumed and must constantly be replenished. As a result, their prices are subject to constant volatility caused by imbalances of physical supply and demand. If you dig a ton of coal out of the ground, it will be burned up in six months, and then you'll have to go dig another one or else the coal price will shoot up. With gold, there is no issue with supply and demand. Nearly all the gold that has ever been mined is still sitting around somewhere, above the earth. (This is why gold-mining production is totally irrelevant as an indicator of the gold price. Every year's new mine production is equal to about 3% of the existing above-ground gold stock. So whether it's a good year or bad year at the mines is a non-issue.)

In early 1995 I saw two charts that had a big impact in convincing me that gold mattered. The first was gold vs. oil. The U.S. went off the gold standard in 1971 and gold ultimately went up about 1000%. Oil also went up 1000% -- almost in lock step with gold. What are the odds of that having been a coincidence? I calculated them at roughly zero. If the dollar had been the center of the monetary universe (as most believe, consciously or unconsciously), oil would not have risen when gold did. It would have stayed at \$3/bbl. The only intellectually coherent definition of 1971 was that it was a devaluation of the U.S. dollar, no different from the Mexican peso devaluation of 1994 or the Indonesian rupiah devaluation of 1998.



The second chart was gold vs. CPI. As the chart below shows, street prices started to take off after the 1971 devaluation. However, it took about 25 years for the great bulk of the impact of the

1971 devaluation to flow through the U.S. price stream. Street prices don't move as fast as commodities do, because there are many contractual elements in the cost of making them. Take ketchup. Tomatoes trade on the spot market but they are a small portion of the cost of making ketchup. Most of a ketchup company's costs are contractual in some respect: labor, rent, loans, electricity, trucks, etc. These prices can (and do) take years to adjust to a change in the value of money. Looking back over the past 35 years, the best time to have owned ketchup companies (and consumer-goods makers generally) was the 1980s and 1990s, when street prices were rising solidly every year – but commodity costs were subdued.



2) I know you don't predict the gold price, but surely you must think about it. Why do you think gold rose to \$500, and where do you think it's going next?

Yes, we do think about what drives the gold price. All the time. The truth, however, is that I don't fully trust my own thinking on this subject (or anyone else's) because I've never developed or been presented with a bulletproof model for what moves gold. There is a core group of supply-side economists who've been grappling with this question for years. I've been watching how they attack it and working with some of them to back-test and critique theories. In the late '90s, many of us thought the 1996/97 Clinton tax-cut package was the key factor driving down gold because, by reducing barriers to entrepreneurial risk-taking, Clinton's tax cuts increased demand for dollar liquidity. However, this theory went out the window in 2003. When the Bush tax cuts of 2003 were passed, gold "should have" stabilized or fallen, but it didn't. It kept on rising. With that theory shot, attention turned to the yield curve. Perhaps, we thought, it was the slope of the yield curve that moved gold (steep slope = rising gold, shallow slope or inversion = falling gold). This eventually may prove to be a relevant metric but it's definitely not working now. The slope is practically flat and gold keeps rising.

The current favorite candidate for what drives gold is the relationship between the fed funds rate and the invisible "neutral" rate. The concept here is that if the funds rate goes above the invisible neutral rate, the dollar will strengthen (i.e. gold fall), and *vice versa*. This may ultimately prove to be the winning theory, but it's too soon to tell. The problem, of course, is that the invisible neutral rate is just that – invisible. Thus, you never know when you've hit it (or if it even exists). If this theory is correct, then at some point the Fed will raise rates enough to "catch" gold and make it stop rising. At that point, if the Fed continued to raise rates further, gold would decline.

We view this as a reasonably likely scenario, and thus are always on the alert for a turn in the gold price. It's entirely possible that at some point in 2006 and 2007 we'll flip the entire portfolio and be out of commodities and basic industries altogether.

3) If gold keeps rising, won't that cause CPI – and thus interest rates -- to rise? And won't that slow the economy?

Yes, that's absolutely a concern. We expect both CPI and the funds rate to go higher than consensus expects. The economy can probably absorb more rate hikes than consensus believes, but obviously at some point higher rates would have a dampening effect on growth. That's a key risk for 2006.

4) Isn't there some point where the relationship between gold and commodities would break down? If gold rose another \$150/oz., thereby pushing up CPI and interest rates and causing the economy to slow, couldn't commodities lose some ground relative to gold?

That's a great point. The relationship between gold and commodities could indeed weaken if gold continued to rise, for three reasons:

* As you say, higher interest rates (a consequence of higher gold) could at some point become a drag on growth, weakening demand for industrial commodities. Whereas commodity prices are driven by *two* factors (changes in the real value of money and changes in the relationship between physical supply & demand) the gold price is only driven by *one* factor (changes in the real value of money). Thus, the gold price would be impervious to the negative effects of economic slowdown, but commodity prices wouldn't be.

* Certain costs involved in mining commodities are contractual, especially labor, capital, some types of equipment. Since these costs rise fairly slowly in response to a change in the value of money (i.e. a gold move), the cost of mining commodities could be expected to rise more slowly than would gold if indeed the gold price were to keep rising. This delay would create a window of opportunity in which above-market returns on capital would be available in the mining industry *even at commodity prices below monetary equilibrium*. As a result, new capital would be drawn to the mining field. Currently, however, most industrial commodities are already in shortage and the world is booming. Since it takes years to start a new mine, the most likely scenario is that the balance of supply and demand tips in miners' favor for longer than consensus expects despite a steady flow of new capital into the industry.

* The experience of the 1970s, '80s and '90s demonstrated quite clearly that commodities can indeed lag gold for a long period of time due to weak global growth and cheap labor costs (the latter being a function of chronic currency devaluation).

5) Are you worried about another big sell-off in basic industries in early 2006? In each of the last two years, like clockwork, commodities and basic industries got destroyed in the early part of the year.

Yes, we're definitely concerned about that. In fact, *we sort of expect it to happen*, especially given the huge move in basic industry stocks in recent months. Any number of things could trigger a big downdraft. Three likely candidates are a) much-higher-than-expected CPI numbers, b) a sharp drop in the gold price or c) another China economy scare.

6) In your Phelps Dodge piece yesterday, it looked like you raised your copper-price forecast to justify holding onto PD instead of selling it. What's up with that?

Yes, that's basically what I did. Our approach is to use the most conservative commodity-price forecast possible and yet still make the case for a stock. In forecasting the copper price, the most conservative approach is to benchmark on the 1990s-era copper/gold ratio of 340 lbs. per ounce (which gives you a copper price of \$1.50/lb. at today's gold price of \$511/oz.). Holding PD doesn't make sense anymore if one assumes \$1.50 copper (in part because of molybdenum risk). So one either has to abandon the conservative copper-forecasting approach or sell PD. Either approach is valid. One reason I chose to abandon the conservative approach is that so many other commodities have already risen back near their pre-1971 ratio with gold (iron, nickel, scrap steel, molybdenum, oil, gas, metallurgical coal, zinc). Conceptually, there's no reason copper can't do the same – putting it at \$4/lb. What I really did is *shade* our forecast a little more toward that pre-1971 number, by moving the forecast to \$1.95/lb. I still don't think PD is all that interesting

though, because earnings are hugely vulnerable to a plunge in the molybdenum price (which we expect to fall by 40% over the next two years). Other miners are more interesting.

7) Did you see the interview with David Ranson of Wainwright in this weekend's Barron's? He was making a lot of the same points you do.

It was a good column. It's worth reading. Every once in a while Barron's gives voice to a supply-sider, as some of the people on their editorial board are sympathetic to the supply-side worldview. There was one point in Ranson's piece with which I disagreed, though. He argues that home prices are now cheap due to the recent gold rise. The implication is that homes are a commodity, just like oil, coffee or zinc. However, I don't think that's precisely the way to think about it. Housing is most definitely a contractual purchase. Thus, interest rates are a critical component in home prices. Over the loooong term, home prices should rise *more* than gold, because the real value of land should rise with population growth. That said, the primary trigger for the recent housing boom was the sharp drop in mortgage rates, which made the all-in burden of buying a home (house + interest) much easier to bear. Also, the 1997 law that provided a \$500,000 capital-gains exclusion on the sale of a home was a HUGE positive factor for home prices.

Home prices are probably within 10-15% of where they should be. Looking ahead, higher interest rates should offset the positives of strong growth and higher gold. The most interesting trend in the housing market is actually the arbitrage between city prices and rural prices. The soaring value of city homes is pushing communities to expand horizontally. Teachers, policemen, firemen and other medium-wage workers can't afford to live in cities anymore, so they leave. For this reason we're not actively hostile to homebuilding stocks even though we think interest rates will go higher than consensus believes.

8) U.S. Steel is showing a lot of tensile strength considering it has been downgraded by CIBC and Citigroup/Smith Barney over the past three days. It looks poised to go higher.

I agree. The bidding war for Dofasco is a very big deal, and X is the prime beneficiary of it. X's biggest segment is U.S. auto sheet steel – which we've long considered the dullest portion of the American steel business. The fact that two big European steelmakers are brawling with each other to gain control of Dofasco (which is sheet steel + iron) completely changes the perception of what X's sheet-steel assets are worth in the open market. I read the Citigroup report on X and it wasn't all that hostile. Most of the reasoning was calm and not-unfair. Citigroup maintains a \$52/share target on X and the analyst points out that his model doesn't include a take-out premium. Citigroup's concern is that they think the hot-rolled coil price is headed for a \$30/ton drop (to \$530/ton). That's of course possible but our view would be that it remains stable at \$560/ton. Given X's exposure to the booming tubular market and the good outlook for its Eastern European operations (plus its low valuation) we maintain our \$64.68/share target.

6) Did you see the news about those riots in China? They seem pretty disturbing.

I agree. They are disturbing. We're always mildly uneasy about China because it's a command economy, which creates both political and economic risks. The economic risk is that capital can be allocated badly, creating gluts, scarcities, bubbles, etc. Some of that might be happening now in steel, as it appears a good portion of Chinese steel production is occurring below cost. On the political side, the problem is that the decision-making process is not inclusive. Obviously, if you exclude people from the table and give them no avenue for redress of grievances, they get mad. This is what's happening with China's farmers and peasants. George Friedman of Stratfor has as good an analysis as I've seen of the China riots. I can't seem to link to it but it's available as part of their free email service at www.stratfor.com. Importantly, China's macroeconomic decision-making has been very good for years and we expect it to continue to be good. They are smart operators. Also helping is the fact that countries don't tend to crack up during periods of global reflationary expansion. China's problem is at the microeconomic level, where decision-making is subject to perverse incentives. We'll continue to watch China for hints of an implosion, but don't see any imminent problems.

The Classical Insights portfolio holds PD and X.

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