

# Classical Insights

Global Investment Analysis Based on the Classical Economic Model

## Classical Insights Afternoon Bullet Points December 9, 2008

1) This really is the craziest market ever: Over the past 58 years, there have been just 68 sessions in which the S&P gained or lost more than 4% -- and 28 of those have occurred in the past three months (as per Saturday's *Barron's*). A key factor driving these insane levels of volatility is the 150% rise in the gold price over the past six years. This has introduced a *much wider spectrum of potential nominal prices* for all items. With the gold price moving around so much, nobody knows what money is really worth, so people can't know what *goods* are really worth (in dollar terms) either.

For instance, it's quite easy now to visualize \$900/tonne steel, but it's just as easy to visualize \$500/tonne steel. One could envision copper at \$3.50/lb. or \$1.50/lb. One could see oil at \$100/bbl. or \$40/bbl. without creating intellectual dissonance in one's brain. One could see molybdenum going to \$40/lb. or \$9/lb.

This is price schizophrenia. At the moment we are probably close to the low extreme of price potentialities for \$770/oz. gold. Put differently, we're having a fire sale within a monetary inflation. It's a mind-bending concept, but that's what's happening. One should probably be on lithium when trying to make sense of this market precisely because it is inherently schizophrenic *and* bipolar. It's not difficult to envision two parallel realities for how the world may evolve -- and both would be internally consistent. This panoply of possibilities definitely has hindered my ability to model individual companies: I sat down last night to model Shaw Group and ended up watching *Harold and Kumar Escape From Guantanamo Bay*. I thought it would clear my head and I guess it did, for by the end of the movie I found myself better able to grasp the monetary craziness looming all around us.

An economy can't function smoothly when nobody knows what things are worth within some reasonable range. This is a critical downside to the whole Keynesian conceit that the consumer is the driver of the economy. When entrepreneurs don't even have a *rough* idea of what the price of something will be two years down the road, how are they supposed to rationally plan capital expenditures? They can't -- and as a consequence the hurdle rate for new investments goes up. Capex thus declines and shortages ensue. Jim Rogers has been on the wires lately warning of coming shortages in commodities -- even if the economy remains mired in recession -- and, conceptually at least, he is spot on. That said, these shortages may take a couple of years to develop if the economy remains mired in deep recession.

2) When nominal prices are bipolar, it goes without saying that equity prices will be even more bipolar. If the fire sale on commodities comes to an end, many commodity stocks will rise 1,000%. However, in the near-term most commodity firms will bleed cash and some will go bankrupt. Below is a list of names we've followed over the years that *could* rise 500%+ if commodity prices spring back to the high side of their manic-depressive range. *This is not a buy list!* As many as half of these companies could cease to exist over the next two years! We own only a few of these: Century, Chariot, Mercator, Quadra and Thompson Creek. Some others that might be interesting here are Candente, Gobimin, Legend, Los Andes, Phosphate Holdings and Revett.

**Some stocks that could rise 500%+ by 2011**

Name	Sector	Share Price	Shares out	Mcap (\$ mlns)	Net cash (\$ mlns)	EV (\$ mlns)	Back-of-envelope Upside
Albidon Ltd (ALB AU)	Mining -- nickel	\$0.16	165	\$26	-\$78	<b>\$103</b>	600%
Amerigo (ARG CN)	Mining -- copper	\$0.23	93.4	\$21	\$0	<b>\$22</b>	800%
Athabasca Potash (API CN)	Fertilizer	\$1.27	36.9	\$47	\$38	<b>\$9</b>	600%
Baja Mining (BAJ CN)	Mining -- copper	\$0.14	143	\$19	\$60	<b>-\$41</b>	2000%
Boliden (BOL SS)	Mining -- copper/zinc	\$2.27	273.5	\$619	-\$696	<b>\$1,315</b>	1000%
Breakwater Res. (BWR CN)	Mining -- zinc	\$0.06	446.8	\$25	\$42	<b>-\$17</b>	5000%
Candente Resource (DNT CN)	Mining -- copper	\$0.14	80.9	\$11	\$8	<b>\$4</b>	1500%
Century Aluminum (CENX)	Aluminum	\$7.77	49	\$381	-\$267	<b>\$648</b>	800%
Chariot Resources (CHD CN)	Mining -- copper	\$0.07	328.3	\$23	\$15	<b>\$8</b>	2000%
Condor Resources (CN CN)	Mining -- copper	\$0.05	24.06	\$1	\$2	<b>-\$1</b>	2000%
Crowflight Minerals (CML CN)	Mining -- nickel	\$0.11	270	\$30	-\$33	<b>\$63</b>	4000%
European Nickel (ENK LN)	Mining -- nickel	\$0.04	384.5	\$14	\$75	<b>-\$61</b>	10000%
Frontera Copper (FCC CN)	Mining -- copper	\$0.42	64.52	\$27	-\$54	<b>\$81</b>	1000%
Gobimin Inc. (GMN CN)	Mining -- nickel	\$0.38	71.1	\$27	\$27	<b>\$0</b>	1200%
Imperial Metals (III CN)	Mining -- copper	\$2.02	32.43	\$66	-\$12	<b>\$78</b>	600%
Inca Pacific Res (IPR CN)	Mining -- copper/moly	\$0.14	56.47	\$8	\$19	<b>-\$11</b>	1500%
Legend International (LDGI)	Fertilizer	\$0.34	226.3	\$77	\$120	<b>-\$43</b>	2500%
Los Andes Copper (LA CN)	Mining -- copper	\$0.03	93.6	\$3	\$8	<b>-\$5</b>	3000%
Magindustries (MAA CN)	Fertilizer	\$0.14	197.8	\$28	\$86	<b>-\$58</b>	2000%
Manitowoc (MTW)	Machinery	\$9.38	130.4	\$1,223	\$132	<b>\$1,091</b>	500%
Mercator Minerals (ML CN)	Mining -- copper/moly	\$0.33	74.8	\$25	-\$90	<b>\$115</b>	4000%
Mirabela Nickel (MNB CN)	Mining -- nickel	\$0.49	129.8	\$64	\$35	<b>\$29</b>	1200%
Phoscan Chemical (FOS CN)	Fertilizer	\$0.17	172	\$29	\$60	<b>-\$31</b>	2000%
Phosphate Holdings (PHOS)	Fertilizer	\$5.97	7.65	\$46	\$28	<b>\$18</b>	800%
Potash One (KCL CN)	Fertilizer	\$0.59	51.7	\$31	\$20	<b>\$11</b>	500%
Quadra Mining (QUA CN)	Mining -- copper	\$1.96	66	\$129	\$259	<b>-\$130</b>	1000%
Revett Minerals (RVM CN)	Mining -- silver	\$0.06	75	\$4	\$9	<b>-\$5</b>	2000%
Roca Mines (ROK CN)	Mining -- moly	\$0.22	80.5	\$18	\$0	<b>\$18</b>	2500%
Taseko Mines (TKO CN)	Mining -- copper	\$0.58	144.1	\$83	\$12	<b>\$71</b>	1000%
Teck Cominco (TCK/B CN)	Mining -- various	\$3.46	477.5	\$1,652	-\$175	<b>\$1,827</b>	1000%
Thompson Creek (TC)	Mining -- moly	\$3.10	122.65	\$380	\$147	<b>\$233</b>	800%

*Stock is trading for less than net cash on balance sheet as of last reporting date.*

*Sources: Bloomberg, Churchill Research estimates*

3) Credit markets are improving some – but can we extrapolate that to an earnings recovery for stocks? I'm not so sure. A strategist was on Bloomberg yesterday arguing that stocks should rise because central banks have taken "collapse risk" off the table. With collapse risk gone, his argument goes, stocks should price in a gradual return to normalcy. I'm not 100% convinced that's true. For starters, credit markets are still deeply out of whack. The strategist's argument misses the potential for an extended "gray zone" period of *blah* credit, *blah* growth -- and bad earnings. It seems to me that strategists as a group may be particularly susceptible to missing the implications of *blah* growth for earnings because they generally don't do much bottom-up work. When you think about it, almost every single company carries extreme earnings leverage. Consider the case of Acme Widgets: If the firm's sales decline 8% and its gross margin eases 2 points, then its earnings (and thus its share price) are likely to decline 36%. In a more dire scenario where sales decline 15% and gross margin falls 7 points – par for the course in a recession – Acme shares can fall 87%:

### Acme Widgets

	Year 0	Year 1 (recession scenarios)		
		Mild	Significant	Serious
<b>Sales</b>	<b>1000</b>	<b>920</b>	<b>890</b>	<b>850</b>
Gross margin	20%	18%	16%	13%
Gross profit	200	166	142	111
SGA	80	80	77	73
Operating profit	120	86	65	38
Interest	25	25	25	25
Pre-tax income	95	61	40	13
Tax	33	21	14	4
After-tax income	62	39	26	8
Mcap @ 11x P/E	679	433	289	89
<b>Change in stock price</b>		<b>-36%</b>	<b>-57%</b>	<b>-87%</b>

But haven't equities already priced in the looming weakness in the real economy? In some cases yes, but in other cases no. Some steel stocks, for instance, have *already* been beaten down 87%, and now have stopped falling. But for many of the blue chip names perceived as "safe" some ugly disappointments loom. Last night's Fedex warning was a perfect example. FDX shares are down 14% today on what was a *mild* earnings warning. And it's not likely nobody could have seen it coming, either.

4) How should one invest in such a crazy environment? I can think of six approaches:

a) *Concentrate on relative value.* With stock valuations all over the map, it's almost a given that there will be many valuation *inefficiencies* out there. An ideal strategy might be to ignore macro altogether for a month, lock yourself in a room, pick four sectors you're comfortable with and spend one week on each one, crunching 5 companies per sector. It would be okay to use generic macro predictions (flat gold, gradual economic recovery in H2 2009, 2% GDP growth in 2010). When complete, pick the best company from each group and make that your portfolio. It'll probably do great. Over the years we've probably done the best performance-wise with relative-value analysis. Chicago Bridge & Iron is a recent example of this approach working. It was just obviously mis-priced relative to the rest of the E&C group;

b) *Maintain a high cash level and combine it with a small portfolio of super-volatile positions.* This is the strategy proposed by Nassim Nicholas Taleb, the author of *The Black Swan*, and it makes some sense. The idea is to be 90% cash and 10% invested in the most wildly volatile stuff you can think of. If the world implodes, you're down 10%. If everything turns out fine, the volatile stuff skyrockets and you're up as much as 50%. This approach would work particularly well with a commodity portfolio, because economic implosion easily could occur alongside a sharp rise in the gold price (and by extension other commodities too). So the 10% portion could work in a variety of economic scenarios;

c) *Focus on non-volatile sectors where earnings are more reliable.* We use this approach a lot in emerging markets, where even the defensive stuff is often trading at 2-5x earnings;

d) *Concentrate on gold stocks, which don't correlate to the real economy;*

e) *Take a long/short approach.* From 2003-2007, long/short approaches generally underperformed by quite a bit but it would seem logical that they could work better now, again because there is so much inefficiency in pricing at the individual equity level;

f) *Rely on the message of the calendar and go all-out long.* As noted previously, November to April is the strongest part of the year for equities – by a long shot;

g) *Focus on taking country risks, which may prove easier to deal with than equity risks.* Certain emerging markets are way oversold and just don't have the U.S.'s problems. One has to consider the possibility that the U.S. and Western Europe remain in a slump while other countries get out of this and grow. It's hard to conceive of this possibility now because there is so much focus on the concept of "re-coupling." But what if the financial part of the crisis ends and we get back to regular old hum-drum earnings crunching? And what if the U.S. just grows *slowly* (due to consumer de-leveraging or high taxes or whatever) while the rest of the world grows faster? In particular, most emerging economies have far stronger banks than we do, and many have lower tax rates, too.

Bottom line: The Classical Insights portfolio is nearly 100% long at the moment – but I may need to reconsider that in the wake of this recent rally. With credit markets improving some and equities priced inefficiently in some places, there are definitely pockets of value out there. But the risk exists that earnings simply evolve *horribly*, in which case equities as a class could be dragged a stair step lower.

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