

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points March 12, 2009

Christina Romer gave a speech on Monday at Brookings in which she strongly argued for dollar devaluation as a tool to create economic recovery. This is the sort of thing that provides political cover for Fed Chairman Ben Bernanke to pursue a more aggressive quantitative easing policy. Romer, who is chair of the Council of Economic Advisors, praised FDR's 1933 decision to allow the gold price to float up from \$20.63/oz. to \$34.85/oz. That decision offers a template for what the Fed could do today, she said (*italics mine*):

This monetary expansion [in the wake of the 1933 devaluation] couldn't lower nominal interest rates because they were already near zero. What it could do was break expectations of deflation. Prices had fallen 25% between 1929 and 1933. People throughout the economy expected this deflation to continue. As a result, the real cost of borrowing and investing was exceedingly high. Consumers and businesses wanted to sit on any cash they had because they expected its real purchasing power to increase as prices fell. Devaluation followed by rapid monetary expansion broke this deflationary spiral. *Expectations of rapid deflation were replaced by expectations of price stability or even some inflation.* This change in expectations brought real interest rates down dramatically.

The change in the real cost of borrowing and investing appears to have had a beneficial impact on consumer and firm behavior. The first thing that turned around was interest-sensitive spending. For example, car sales surged in the summer of 1933. One sign that lower real interest rates were crucial is that real fixed investment and consumer spending on durables both rose dramatically between 1933 and 1934, while consumer spending on services barely budged.

Romer's analysis of the Roosevelt devaluation parallels Bernanke's almost exactly. Bernanke also has written that loose monetary policy was the key to the economic recovery of 1933-34. Further on in her speech, Romer cautions against letting up on stimulative measures too quickly, lest the economy plunge back into recession, such as happened to the U.S. in 1937.

Bottom line: Bernanke will have political support to keep the funds rate low for a loooong time. That alone should prove bullish for gold down the road. More immediately, the door appears to be open for the Fed to pursue a greater degree of quantitative easing, which would be bullish for gold.

Certain gold miners are now ridiculously cheap. Here is a look at three: Northgate Minerals, Great Basin Gold and Troy Resources. What do they have in common? All three have mines *in the start-up phase*. Studies have shown miners get their lowest valuations during the start-up phase of their mines.

In the case of Great Basin, one gets 300,000+ ounces per year of production from 2010 onward for a price tag of US\$290 million (enterprise value). Put differently, one pays \$967 per ounce of annual gold production. That is less than 1/5th what one pays for an ounce of annual production at Yamana (\$5,363/oz.). Cash costs at GBG's mines should be only modestly above those of Yamana.

Great Basin shares are down 35% just in the last few weeks. Two negative things happened. First, management did a dilutive \$100 million share offering to fund completion of Burnstone. We were hoping the last chunk of funding to finish Burnstone would be done via debt, but it wasn't. That hurt GBG shares. Second, of course, the gold price fell. Still, by our calculations, GBG is trading at a bit over 3x 2010 earnings at \$915/oz. gold.

Northgate now has an effective enterprise value of just \$175 million. (Its market cap is \$275 million cap and it has about \$100 million in cash.) For that \$175 million one gets a firm with 350,000 ozs/year of gold production. That's a valuation of \$500 per ounce of annual production – or less than 1/10th what one pays for an ounce of Yamana production. The knock on NXG is that the Kemess mine will be closing in 2010 (more likely 2011). However, NXG's Young Davidson mine, which is a tad smaller than Kemess but which has 4 million ozs of reserves, should be starting around the same time Kemess closes. NXG plans to move the Kemess mill to YD, saving on start-up costs there.

Here's another way to see the value in Northgate: You could value all three of NXG's producing mines at zero -- and the Young Davidson deposit alone would be left with a valuation of \$44/oz. (i.e. \$175 million EV divided by 4 million ounces). In this scenario, you would get the Kemess mill equipment for free (since Kemess is already being valued at zero). Young Davidson could reasonably be valued in the open market now at \$44/oz. because it's only 2-3 years away from production and it would come with a mill.

Last point: There is always an outside chance Northgate will get a permit for the Kemess North site, which would allow the Kemess mine to continue on for another 20 years.

Troy Resources is trading at an effective valuation of just over zero. The firm has a market cap of A\$90 million, yet it has A\$60 million in cash. Plus, Troy has an entire processing plant sitting in cold storage in Australia, which is worth about A\$20 million. So, that leaves the rest of the company being valued for A\$10 million, or US\$7 million. For that one gets a brand-new 50,000 oz./year, low-cost mine in Brazil, plus another 50,000 ounces (in total) still to be produced from the Sandstone mine.

Bottom line: People are not paying attention to these junior gold stocks. Costs have fallen significantly and gold has soared in CAD and AUD terms (though in recent days that has reversed a bit).

3) We're going to do a small portfolio rebalancing in order to make room for some of the oil companies I'm meeting with in Houston this week. Selling Buenaventura is a tough call (in normal times we'd probably be a buyer of it) but other things are cheaper.

Portfolio Rebalancing Trades

	US\$ price	Shares	Total US\$		Notes
Buys				target	
Troy Resources (TRY AU)	\$0.82	7000	\$5,719		Trades at an effective EV of not much more than zero.
		total buys	\$5,719		
Sells				% selling	
Cia De Minas Buenaventura (BVN)	\$17.42	1250	\$21,775	100%	Other things are cheaper.
Yamana Gold Inc (AUY)	\$7.46	1000	\$7,460	100%	Other things are cheaper.
		total sells	\$29,235		

The Classical Insights portfolio holds all names mentioned above.

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