

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points March 18, 2009

Six points on commodities and monetary policy:

1) Wow. The DXY dollar index is down 2.3 points and gold is up \$45/oz. on the news that the Fed will expand its balance sheet to buy up to \$750 billion in additional agency mortgage-backed securities, \$300 billion in longer-term Treasuries and another \$100 billion in agency debt.

This is a classic currency devaluation. As such, it bodes positively for commodities. The Fed's move reflects a realization that the U.S. is suffering just as much (and probably more) from a solvency crisis as a liquidity crisis. There are two ways to fix a solvency crisis: slash tax rates to improve the present value of future cash flows (not happening), or print money to boost the nominal price of all physical assets (happening).

This is fascinating stuff – and it validates the concerns of the \$2,500/oz. gold crowd. While it is tempting to say this move improves the outlook for a variety of industries, from homebuilding to banking to chemicals, it's not entirely clear that it does. The problem is that CPI is destined to rise in such a devaluatory program. At some point, long Treasury yields will break higher in anticipation of rising CPI. Using Fed money to buy Treasuries is the Zimbabwean approach to monetary policy. Perhaps we'll do a mini-Zimbabwe and it will work out okay. Or perhaps not.

2) Commodities make the most sense in this environment, and there are three ways to win with oil, copper and probably zinc:

- Monetary inflation (creation of excess money by the Fed);
- Economic rebound;
- A tightening of the supply/demand balance due to insufficient capital investment.

If any of these three things happens – and the first appears to be happening in spades -- the prices of oil, copper and/or zinc should pop. The only bearish scenario for these commodities would be a prolonged *deflationary* downturn – and today's Fed announcement pretty much takes that risk off the table. A deflationary downturn would be too hard on banks, and the Fed seems to know it.

Nickel and natural gas are not included in this list because supply appears plentiful for both (at least at the moment). Aluminum and steel are not included because both are manufactured products, for which there is plenty of installed capacity. These commodities all should work eventually, but they won't necessarily be early movers.

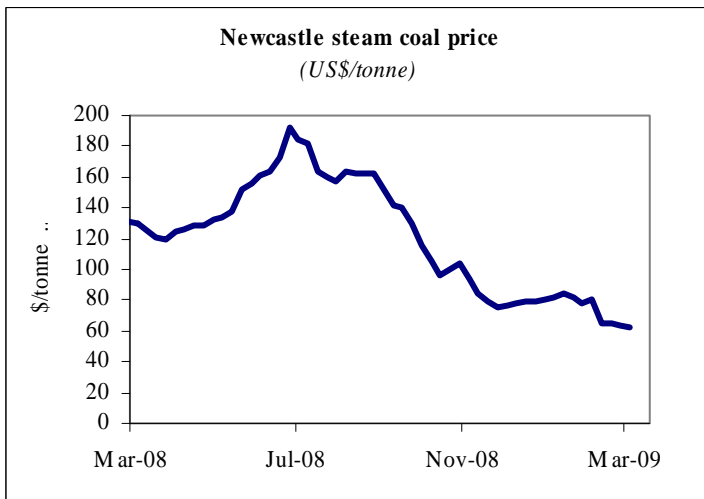
3) One theme that came up from the Houston trip was the concept of "sleeper" oil companies. Certain E&Ps look gas-heavy when you use the traditional 6-to-1 gas/oil ratio, but they are in fact much more "oily" if you use the 13-to-1 ratio that exists between the oil and gas *prices*. We identified W&T Offshore as such an oily sleeper – and yet it's priced like a moribund gas E&P. There are definitely more of these out there. The rationale behind using the 6-to-1 ratio in the calculation of reserves is that this reflects the relative energy content of the two fuels. But that assumes perfect substitutability between them, which of course doesn't exist (and won't exist for years to come). The advent of shale drilling has created a gas glut, but no parallel development has occurred in oil. We're going to look for more oil-intensive E&Ps, both in the US and emerging markets. Two that we used to cover and found interesting are Petrominerales (PMG CN) and Petro Rubiales (PRE CN). Both operate in Colombia.

4) The copper rally is nice to see, though it's pretty clear (to this point at least) that it has been driven by Chinese stockpile building rather than any nascent boom in economic activity. If the

world (or even China) were really on the cusp of a boom in copper consumption, we would be seeing corroborating data from the iron and steel markets. But it's not there. The news flow in *American Metal Market* is all doom and gloom, day after day. Among the most important leading indicators for China's economy is the price of iron ore imported from India. This has rolled over in recent weeks and is back almost to its November low:



Another useful leading indicator for Asian economic activity is the Newcastle coal price, and it has fallen to new lows as well:



With the Fed pushing further down an overtly inflationary path, it will be interesting to see what some of these series do. Most likely they will begin to climb. Will that signal increased economic activity or just monetary inflation? Perhaps some of each.

5) The Chinese are thinking longer term in their copper purchases – and they're thinking about the dollar as much as copper. Copper works as an inflation hedge because it has many of the same monetary properties as gold. Copper also is still quite cheap relative to gold, at 550 copper lbs. per gold oz. The Chinese have been burned on U.S. equities and real estate – and they are beginning to sense that they are going to get burned on their U.S. Treasury investments too. Thus, they are stockpiling commodities – both for future use and as a hedge against Fed money-printing.

One obvious concern is that when China finishes its stockpile build, the copper price will roll over and fall – perhaps back below \$1.50/lb. This is a legitimate concern, though today's move by the Fed reduces this risk somewhat. We continue to like copper miners with a gold angle, such as Taseko Mines, Imperial Metals (III CN) and Quadra Mining. Another copper miner with gold exposure is Inmet Mining (IMN CN). Inmet also has lower cash costs than most of the names we are actively covering now.

6) In retrospect, we may have gone overboard on the early-stage gold exploration companies last month. A more cost-effective way to do early-stage gold exposure is to buy one of the copper/gold miners with a big early-stage project. In most cases if you buy the copper mine you get the copper/gold project for free. That is particularly true in the cases of Taseko (the Prosperity project is being valued at zero) and Imperial (Red Chris is being valued at zero). We're going to sell Brett Resources (BBR CN), buy more Taseko and add Imperial Metals (III) to the portfolio. We'll have more on Imperial tomorrow.

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