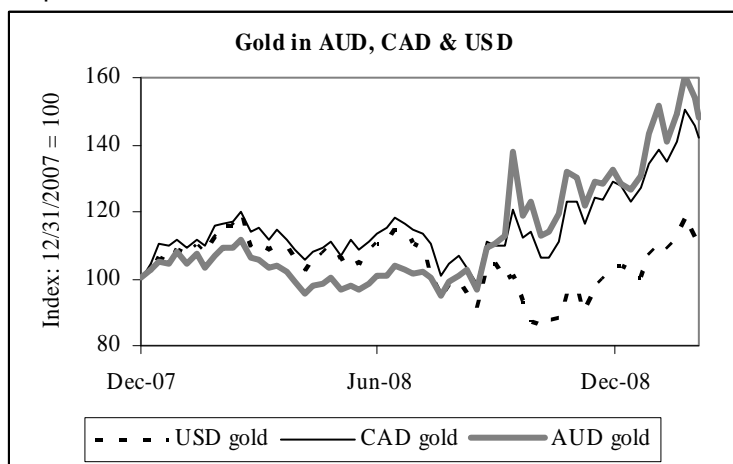


Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points March 3, 2009

1) Gold has lately risen to new highs in Australian and Canadian dollars, but gold mining stocks don't seem to care. As the chart below shows, gold has risen 40%+ in CAD and AUD terms over the past six months:



Meanwhile, mining costs have fallen. By our estimates, cash costs per oz. have fallen about 17% since the start of 2008:

Gold mining margins in Canada, Australia and Brazil

Revenues (in local currency)			
	Chge since 1/1/08		Total change
Gold price	44%		44%
Cash COGS (in local currency)			
	Chge since 1/1/08	% of COGS	Total change
Deisel	-30%	35%	-11%
Steel	-25%	6%	-2%
Chemicals	-20%	12%	-2%
Labor	-8%	30%	-2%
Equipment & tires	-7%	7%	0%
Total cash COGS			-17%

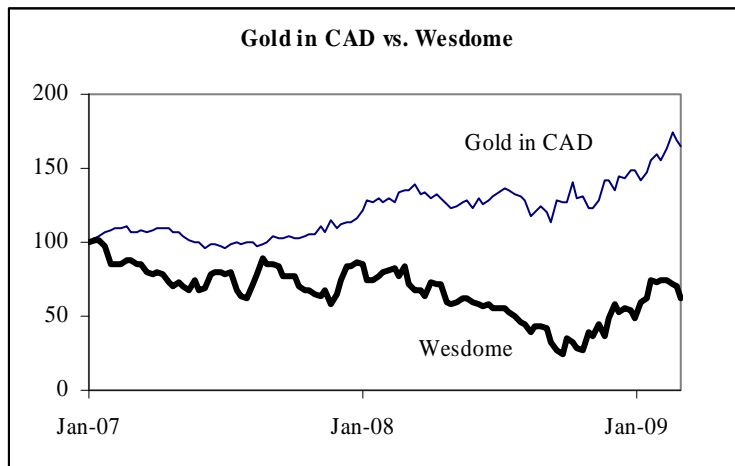
Sources: Bloomberg, Churchill Research estimates

For miners, rising gold + falling costs = better margins and higher earnings. Consider Acme Gold Mining Canada, a hypothetical gold miner with yearly production of 300,000 ounces and cash costs of C\$525/oz. (as of January, 2008). As the table below shows, the firm's EPS could rise 370%+ this year due to the combination of higher gold in CAD terms and a 17% drop in cash costs, to C\$436/oz.:

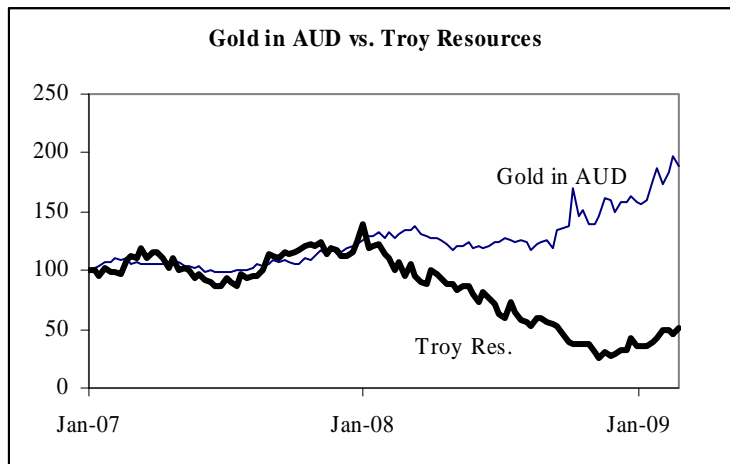
Acme Gold Mining (Canada)

	Year 0	Year 1		
		Same production	10% more ozs.	20% more ozs.
<i>Gold ozs sold</i>	300,000	300,000	330,000	360,000
<i>Gold price (C\$/oz.)</i>	825	1175	1175	1175
Sales (C\$ mln)	248	353	388	423
<i>Cash COGS/oz. (C\$)</i>	525	436	436	436
Cash COGS	158	131	144	157
Depreciation	20	25	28	30
Gross profit	70	197	216	236
Exploration	15	15	17	19
SGA	18	18	20	23
Operating profit	37	164	179	194
Interest	3	3	3	3
Pre-tax income	34	161	176	191
Tax	12	56	62	67
After-tax income	22	105	114	124
Mcap @ 12x P/E	265	1254	1372	1491
Change in stock price		373%	418%	462%

Gold stocks (especially smaller ones) just don't seem to care about this margin expansion, however. Here is Wesdome (WDO CN):



And here is Troy Resources (TRY AU):



Why are investors ignoring the implications of wider margins for gold-miner earnings? There are several possible reasons:

- They are expecting the gold price to fall;
- They expect the Australian and Canadian dollars to strengthen vis a vis the US dollar;
- They expect input costs to rise;
- They are fed up with gold companies because so many have failed to hit production and cost guidance in recent years;
- They just aren't paying attention;
- P/Es have contracted for all sectors, and there's no reason gold should be different;
- Perhaps the entire gold sector is transitioning back to market P/Es and will no longer get the premium P/Es it has enjoyed in recent years. (Apparently back in the '80s gold miners traded at market P/Es.)

My view: If miners can genuinely put up good earnings in Q4 or Q1, the stocks should rally – but it's a valid concern that the days of 20-30x P/Es on gold miners may be over. The logic for those multiples was always a little sketchy to begin with.

2) Gold and suits: Remember the old adage that an ounce of gold should be worth one good man's suit? Well, that relationship has broken down – at least for the moment. I was suit shopping recently and suits by Calvin Klein, Ralph Lauren, Perry Ellis etc. are going for \$250-400 – the same price as 25 years ago. We're not talking fancy suits here, but they do meet the definition of "good," as opposed to cheap, ratty, ill-fitting, etc. There are three possible interpretations of this:

- a) The gold price is too high;
- b) Suit prices are too low (implying rising CPI in coming years);
- c) The gold/suit relationship has been permanently altered due to efficiency gains in suit-making (computerization of design, outsourcing to low-cost countries) and distribution (internet, the Wal-Mart purchasing model).

I think it's a combination of "b" and "c" – though "a" can't be ruled out.

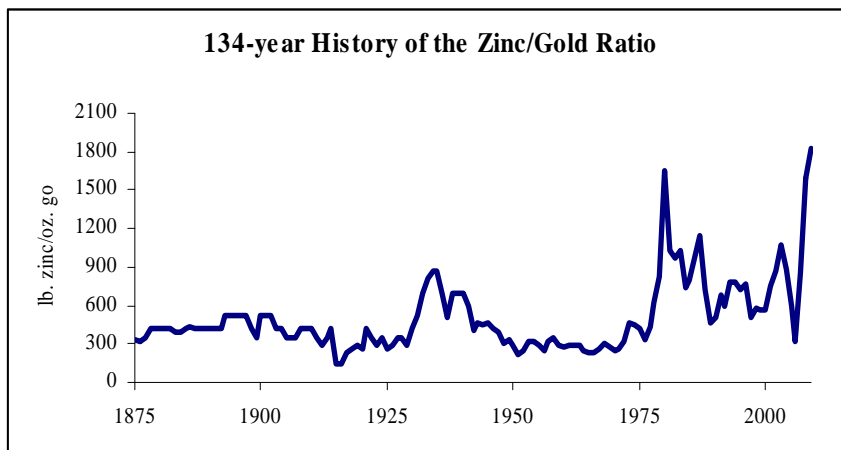
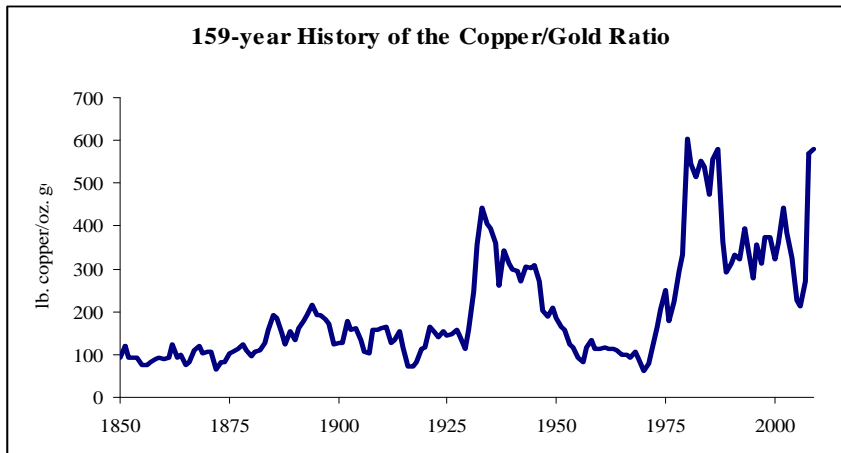
3) This brings us to the crucial issue of the transmission mechanism for inflation: When does the high gold price and expanded Fed balance sheet translate into higher prices elsewhere in the economy? It's an open question. Gold really isn't up *that* much – especially not when compared to the 1,000% increase seen in the '70s. Gold is up about 175% over the past 6 years. If we assume the entire 175% flows into CPI over the next 30 years, we would see CPI increases of just 3.5%/year.

Here is a good debate between Art Laffer and Steve Liesman (transcribed from last Thursday's Kudlow show) on the question of when CPI might (or might not) rise and what might trigger it:

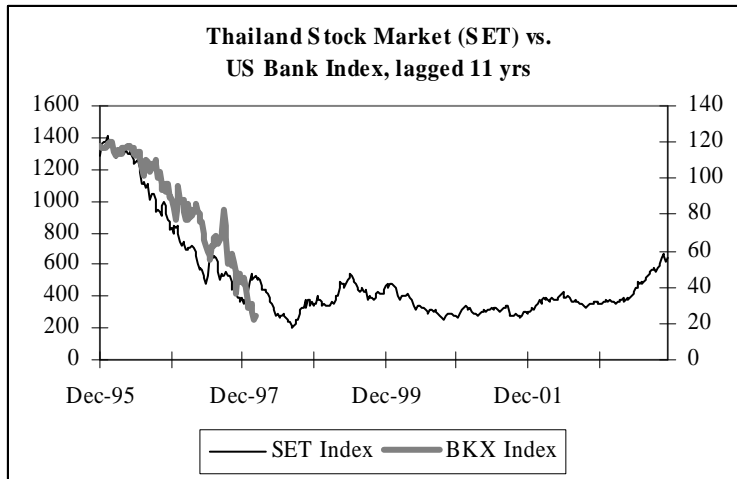
<http://kudlowsmoneypolitics.blogspot.com/search?q=laffer>

At the core of the debate is the issue of whether prices can rise in a dead economy. We know from the historical experience of countries like Brazil and Zimbabwe that prices most definitely *can* rise in a dead economy. However, in those cases, central banks were monetizing debt. In contrast, the Fed is in sort of a gray zone: it is doing quantitative easing "light." Laffer argues that the huge expansion in the Fed's balance sheet to date will inevitably lead to higher prices, just as night follows day. Liesman argues that that isn't possible without a pick-up in demand. It's a key issue.

4) One thing we can be reasonably sure of is that commodities should be among the early responders to the gold rise to date – and on this point, this week's mini-rally in copper is interesting. Copper is up to \$1.58/lb. amid increasing evidence of rising Chinese demand and weak scrap collections. (When I was in Toronto and Vancouver last month, mining-company managers could not stop talking about China's impact on all aspects of base-metal mining.) As the charts below show, the copper/gold and zinc/gold ratios are near or at all-time highs:

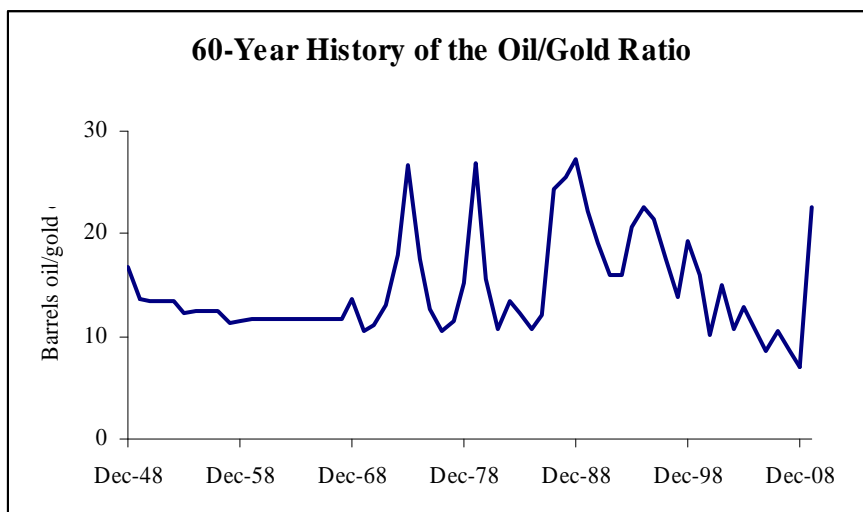


The charts above suggest it might not take too much for copper and zinc to move higher. The problem is that while China is a big part of global metal demand, the U.S. and Europe *cumulatively* still matter as much or more than China. And the U.S. is the midst of a Thailand-style bank-and-property meltdown of unknown length:



These things don't blow over quickly. Thus, I'm still not sure what to make of this nascent copper rally. There are plenty of copper miners who are cash flow positive at \$1.30/lb. copper, though, so one could wait out the downturn in some of those names without undue risk.

5) A good trip now would be to go to Calgary and meet with some junior E&Ps. Last summer (when oil was at \$140/bbl.), I read Matthew Simmons' *Twilight in the Desert* and his basic claims struck me as pretty much irrefutable. Simmons' book presents graph after graph showing production of the world's big oil fields (North Sea, Cantarell, Ghawar, etc.) and they are *all* in decline. New land-based monster fields aren't being found (though offshore fields are). Somewhere in the oil space there ought to be a way to play this. Oil demand is reasonably inelastic -- and competition from alternative energy sources has been set back a few years by this downturn. As the chart below shows, the oil/gold ratio is now at 22.5 bbls./oz. That is still below the all-time highs in the 28 bbls./oz. range, so there is no urgent mathematical necessity for oil to rally right away. That said, it's not clear what impact oil scarcity – or just plain old under-investment in new production -- may have on the oil price in coming years.



CAL -- \$8.31

Sales and earnings					Target price & valuation data			
	2007	2008e	2009e	2010e				
Sales (US\$ mlns)	14,232	15,155	13,569	14,248	Our 12-month target	\$15.69	(based on 8.5x 2010 EPS)	
Sales growth		6%	(10%)	5%	Upside to target	89%		
EPS	4.18	(3.53)	0.86	1.85	Mkt cap (US\$ mlns)	\$997	Enterprise value	\$11,212
Cash flow	7.65	(0.44)	4.38	5.26	P/sales (2008e)	0.1	EV/sales (2008e)	0.7
FCF	3.75	(5.03)	(0.02)	0.61	P/E (2008e)	nmf	EV/EBITDA (2008e)	nmf
Cons. EPS		(2.89)	4.12	4.66	P/E (2009e)	9.7	EV/EBITDA (2009e)	13.2
					P/E (2010e)	4.5	EV/EBITDA (2010e)	10.7

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

EV data includes pension liabilities and operating lease impact

6) Continental Airlines reported terrible February RASM (down 12%) on a 3.5% drop in load factor. Some of the RASM drop was attributable to dollar strength, however -- and the overall impact of the decline should be almost entirely offset by lower fuel prices. If we reduce our 2009 RASM growth forecast to -8.5% (was -6%) and also reduce our crude-price assumption to \$45/bbl. (was \$55/bbl.), our EPS estimate ends up roughly unchanged at \$0.86/share. For 2010 we are now modeling for \$58 crude and a 5% bounceback in RASM, leading to EPS of \$1.85/share (also roughly unchanged).

7) Chicago Bridge and Iron (CBI) is down to \$5.32/share. It is trading at 1.6x trailing earnings (ex items) and 2.9x expected 2009 earnings. At this price, CBI is trading almost like a warrant. Investors are saying CBI will run off the existing backlog, land very little new business, and then run at a loss for years to come. That is a severe vote of no-confidence in the future of the entire world (since most of CBI's sales are overseas). It's a vision that seems too extreme to me -- and not really compatible with the message of \$900/oz. gold.

8) George Friedman of Stratfor has a great new book out, *The Next 100 Years*. He makes several interesting claims:

- American power is still on the rise. In fact, American power is really just ramping up. No country in Asia or Europe will be in a position to challenge the U.S. for decades. This won't be the Asian century, it will be the American century.
- Turkey is a country to watch. It is destined to emerge as the strongest country in the Middle East in coming years.
- China will probably break up due to an extreme conflict between its rich coastal provinces and impoverished interior.
- The U.S. and Russia will be in a new cold war in 10 years. The U.S. will win, leading to the break-up of Russia.
- The U.S. will do a 180-degree shift on immigration in coming years, from trying to keep people out to encouraging more of them to come in. Demographic changes mean we won't have enough young people to keep the economy going as strong as we'd like. This problem will be even more severe in Western Europe and Japan.

Friedman's most interesting claim is that U.S. power is still on the ascent. I've been downbeat on the U.S. of late but it's actually hard to refute Friedman's reasoning. One interesting (and depressing) aspect of this financial crisis is that it is becoming apparent how dependent even the strongest emerging markets are on strength in developed markets. What is Singapore without a strong U.S.? Much less than it would be otherwise. One potential outlier here is India. It is so big and has such a strong internal market that it may be able to grow throughout the downturn. It

would be nice if it were possible to trade Indian names without having to resort to P-notes, though, as these are a phenomenal hassle.

The Classical Insights portfolio holds CAL and CBI.

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