Basic Points

The Metals Take Center Stage

February 1, 2011

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Consolidated Thompson	CLM.TO	3, 4
Deere	DE	
Freeport McMoRan	FCX	
Goldcorp	GG	1, 3, 4

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Don Coxe

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The Metals Take Center Stage

OVERVIEW

In keeping with tradition, this issue constitutes our recognition of the great challenges and even greater accomplishments of the companies presenting at two great mining conferences—the BMO Global Metals & Mining Conference in Florida and the Prospectors & Developers Association Conference in Toronto.

We have been delivering bullish presentations at those events since 2002, and our annual enthusiasm for the industry has been vindicated each year (except 2008). Last year, shares of both the precious metals and base metals miners were among the world's top performing industry groups, with the precious metals leading the pack in the first half of the year and the base metals moving to #1 ranking in the second half.

The outlook this year is more complicated, although we still believe both sectors will do well on a year-over-year basis. Through January, the precious metals were selling off sharply as fears of a eurocrisis that would disable much of the world's financial system faded, and economic optimism returned with a rush—except in Britain and in the US housing sector.

Conversely, that same optimism, coupled with the flood damage to major Australian coal and iron ore mines, sent investors eagerly into the shares of companies whose production was unaffected—and whose profitability climbed along with resource prices.

Then, as we were going to press and Davos was closing its discussions about the issues its attendees considered important, riots broke out in Egypt, and the world—including the commodity world—was stunned.

We have incorporated this historic event into our commentary—where relevant—particularly our recommended weightings in commodity stocks.

We are leaving our Recommended Asset Mixes unchanged, however we are adjusting our weightings within the commodity sectors.

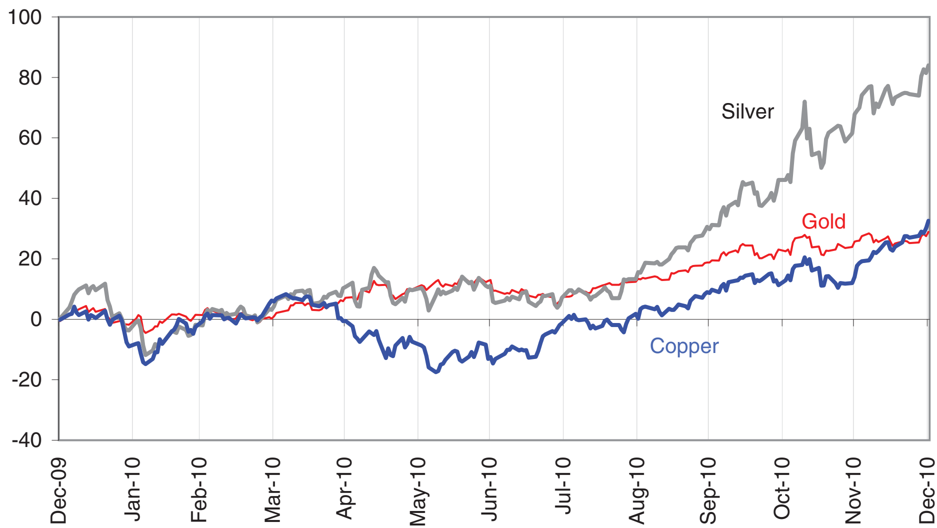
The Metals Take Center Stage

The story of the global economy of the past year is, in great measure, displayed in the relative performance of three metals.

That may sound absurd to those who analyze reams of economic and financial data to make their forecasts. How significant in global GDP is the total value of these metals?

As 2010 dawned, the economies of the industrial world were recovering from a near-death experience...

Gold, Silver and Copper
Percentage-based
January 1, 2010 to January 1, 2011



As small as they are in GDP terms, they give us insights about what businesspeople actually do and what investors actually fear most.

- Demand for copper (and other industrial metals) is driven by the pace of basic economic activity.
- Apart from jewelry sales, which are driven by a wide range of human emotions, demand for gold and silver is driven mostly by fear—a purely mental activity.

As 2010 dawned, the economies of the industrial world were recovering from a near-death experience, rallying on continual injections of what we have dubbed "financial heroin" in the form of zero or near-zero interest rates, and economic stimulus in the form of record deficits.

Beware of Greeks baring fangs.

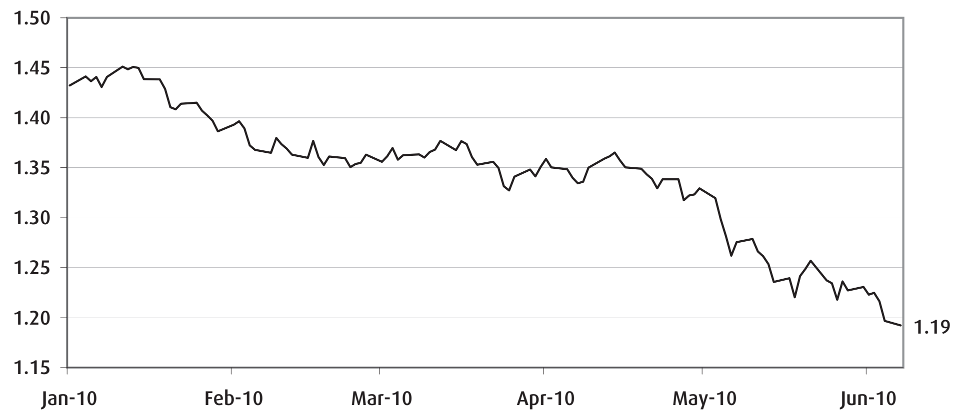
As for the financial systems and economies of China, India, and Indonesia, what near-death experience? The new global economic stars that had led the world's economy out of the tech-collapse recession put on a dazzling display of strength during 2008-9, continuing their strong growth despite the global recession. In 2010, they continued that dynamism, moving up in the global GDP rankings, pulling ahead of long-established OECD economies. Momentously, China moved ahead of Japan into the #2 global ranking.

The strong economic growth and the powerful performance of G-7 equities and corporate bonds in late 2009 had economists and investors issuing increasingly optimistic forecasts for 2010. But growth rates in most of the battered OECD economies slowed last year, once the snapback of inventory rebuilding from crisis lows was completed. The reality of the unreality of the real estate "recovery," in the US and some of the weaker Eurozone economies reminded investors that many major financial institutions were still wallowing in putrescence of their own creation that they could not unload. PT Barnum's operating principle—"there's a sucker born every minute," which Wall Street had adopted as Rule #2 of its business model (Rule #1 being the Black-Scholes models that had decapitated Long-Term Capital Management) apparently no longer applied to offerings of its vast holdings of Collateralized Mortgage Obligations that had been rated AAA by well-paid bond raters, but were now recognized as toxic trash.

As doubts about the US recovery began to grow faster than green shoots, a new crisis emerged in the eurozone. Greece finally confessed that the financial data qualifying it for admission to the eurozone were false, and that it was facing serious challenges in issuing new debt. When the European Central Bank and the International Monetary Fund agreed to bailouts, they insisted on budget cuts in the bloated compensation and benefits programs for Greece's over-large civil service. Result: riots and screams of hatred against Germans as Nazis. Beware of Greeks baring fangs.

Initially, investors in eurozone bonds and banks comforted themselves that letting Greece pay the penalty for its own fraud and folly would not be a real challenge to the eurozone, because it only accounted for 2% of the zone's GDP. But as global investors began to review their huge direct and indirect exposures to other overindebted underachievers—Portugal, Italy, Ireland, and Spain—they began unloading bonds of what came to be labeled "PIIGS." Then came heavy selling of shares of banks across Europe.

Euro vs. US Dollar
January 1, 2010 to June 7, 2010



...a thoroughly modern meta-currency: one backed by no government, no taxation system, no army and no navy.

Europeans—particularly Germans—began to worry about what it meant to have all their assets denominated in a thoroughly modern meta-currency: one backed by no government, no taxation system, no army and no navy. Many of them came to realize that a discount coupon from a reputable store or manufacturer had more intrinsic and enforceable value than a euronote, backed by a promise from nobody.

Result: many of those Europeans—and people elsewhere—decided the time had come to acquire something of value—hard money.

This first-ever existential challenge to the euro was a blow to the European financial system and a blow to economic growth across most of Europe. The exception—to date—has been Germany, which is putting on its best display of relative strength within the G-7 since the Fall of the Wall.

With precious metals climbing, the euro fibrillating, and the last of the Pelosi-Obama stimulus billions flowing into various unionized workforces and various green projects without reducing the unemployment rate, optimism about a sustained US recovery dwindled—as did prices of base metals.

But the second half of the year delivered a dramatic reversal:

1. After many huddles, conclaves, and promises, Germany and France, with the strong support of the European Central Bank and the International Monetary Fund, lined up enough monetary firepower to scare the speculators against PIIGS banks and bonds. The euro stopped plunging.

2. Although China, India and other Asian economies were raising interest rates and tightening their monetary systems to fight commodity-driven inflation, there was little evidence that the new global leaders were going to drag the rest of the globe back into recession.

The Republicans came back from the crypt...

3. With the House of Representatives falling to Republicans, it was obvious that the Pelosi-Obama "stimulus package" wouldn't be repeated. Because of what that meant for state and local governments' budgets, there was even more pressure on the Fed to revive the flaccid US economy. Ben Bernanke obliged with a promise of $600 billion in bond-buying under what became known, affectionately, as QE2.

4. The most dramatic reversal came in Washington. The Republicans came back from the crypt the liberal establishment had prepared for them after the 2008 Obama landslide. They gained control of the House, and picked up seats in the Senate, while winning governorships and state legislatures across the land in one of the biggest nationwide swings in modern history. This was a massive repudiation of the big-spending liberalism that the mushrooming Tea Party was born to fight. But it raised questions about the ability of the nation to function with divided government. Happily, President Obama suddenly transformed himself into a dealmaker. He negotiated brilliantly with the triumphalist Republicans, who were so dazzled by the glare of their own brilliance that they gave him almost everything he asked, including extension of long-term unemployment benefits and a 2% cut in workers'—but not employers'—contributions to Social Security, in return for merely extending the Bush tax cuts. Most impressive: he got them to ratify his controversial missile treaty with Russia as being a matter of backing the Presidency globally—yet he refused to bring up for a Congressional vote the long-dormant treaty with Colombia—a key US ally in Latin America—negotiated by Bush, which is bitterly opposed by unions, and by the Chavez-sympathizing wing of the far left in the US. By stiffing Colombia and getting Republican consent to repeal of "Don't Ask, Don't Tell," he simultaneously gained huzzahs from his base and proved Republican leaders weren't ready for Prime Time.

Obama's approval rating, which had been declining for a year, bottomed out, and climbed strongly. It had reached a Gallup low of 43 in late August and is now back to 49—and CNN has it at 55. The last time any major poll had him that high was in November 2009.

No surprise that other sentiment indicators—including confidence levels among small businesses and small investors, climbed sharply. When Americans feel better about their President, they feel better about their economy.

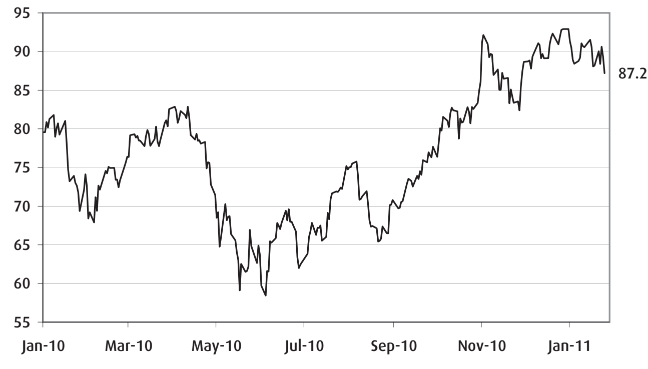
Therefore, despite the sickening sellout of Colombia, the whirlwind activity of the “lame duck” Congress was great news. America cannot afford a failed Presidency. The lowly lame duck became a white swan—the finest hour of the 111th Congress.

The lowly lame duck became a white swan—the finest hour of the 111th Congress.

Result: climbing stock markets, climbing base metal prices—*and sagging precious metal prices.*

So how did the mining stocks respond to this two-act play of Fear followed by Favor?

BHP Billiton (BHP)
January 1, 2010 to January 28, 2011



VALE (VALE:NYSE)
January 1, 2010 to January 28, 2011

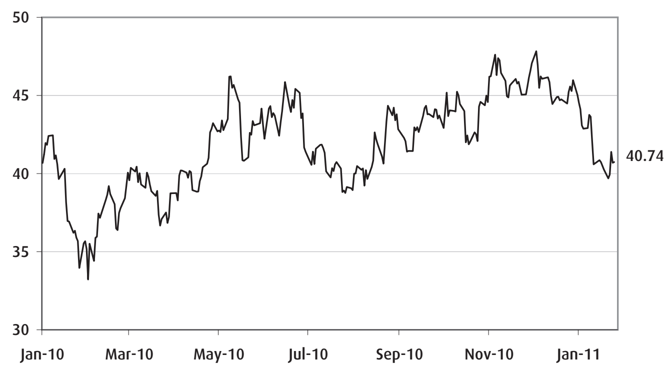
Rio Tinto (RIO)
January 1, 2010 to January 28, 2011

Teck (TCK:NYSE)
January 1, 2010 to January 28, 2011

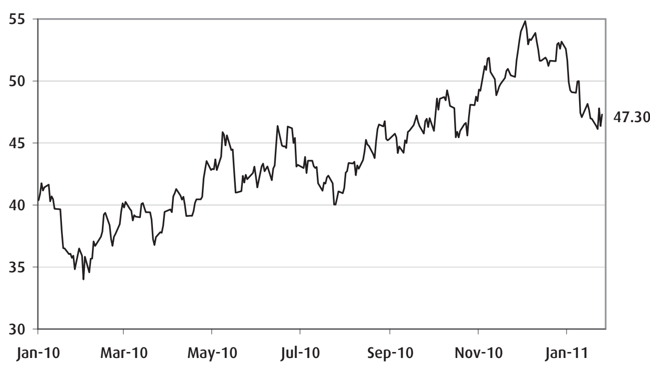
The Metals Take Center Stage

Freeport McMoRan (FCX:NYSE)
January 1, 2010 to January 28, 2011

Goldcorp (GG:NYSE)
January 1, 2010 to January 28, 2011



Barrick Gold (ABX:NYSE)
January 1, 2010 to January 28, 2011



Silver Wheaton (SLW)
January 1, 2010 to January 28, 2011

Newmont (NEM:NYSE)
January 1, 2010 to January 28, 2011

China and India Face Their Inflation Challenges

A major concern for investors in base metal producers is the sustainability of the booms in the economies of the new global powerhouses.

Their stock markets have given worrisome signs.

Don't laugh: India's biggest food inflation challenge comes not from meat prices, but from the astonishing leap in onion prices.

Shanghai Composite Index
January 28, 2010 to January 28, 2011

Bombay Sensex 30 Index
January 28, 2010 to January 28, 2011

Because food makes up roughly one-third of the CPI in these economies, and fuel prices have been rising significantly, they are experiencing serious inflationary pressures. (Don't laugh: India's biggest food inflation challenge comes not from meat prices, but from the astonishing leap in onion prices.)

India is constraining some food exports, has raised interest rates seven times, and has been reduced to agreeing to a deal with arch-rival Pakistan on onions.

...meat prices have quietly begun to put on a remarkable move of their own...

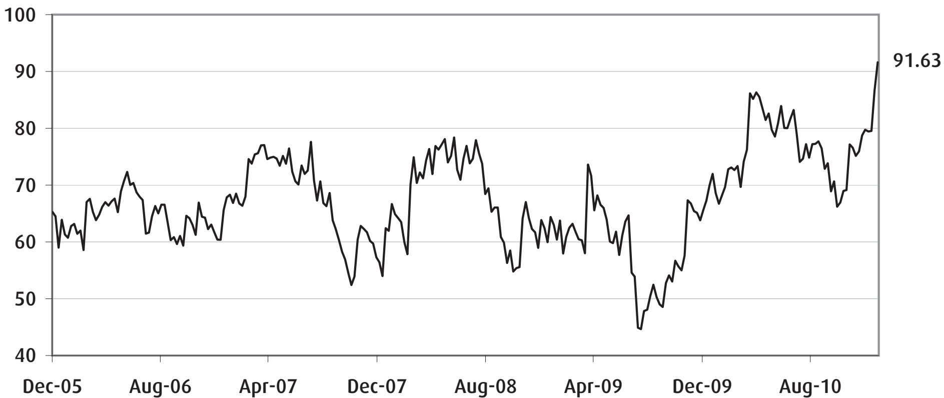
China has responded to rising inflation by embarking on a multi-pronged strategy, including rapidly-rising interest rates, rapidly-rising bank reserve requirements, constraints on some forms of capital spending, and various renminbi-strengthening maneuvers, including encouragement of domestic saving through precious metals, which have the indirect effect of giving some form of metals backing to the renminbi. (See discussion on page 27.)

To date, most of the publicity about global food price pressures has been on the grains and some of the softs—notably coffee. But meat prices have quietly begun to put on a remarkable move of their own:

Live Cattle
January 1, 2006 to January 28, 2011

Feeder Cattle
January 1, 2006 to January 28, 2011

Lean Hogs
January 1, 2006 to January 28, 2011



Soaring food, fuel and fiber costs could crimp base metal demand in the Third World and among the emergent powerhouses.

On the other hand, precious metals could ultimately win from food inflation, if fuel inflation follows, and those with wealth to conserve decide that low-yielding bonds are seriously risky.

As usual, there are numerous "experts" predicting a coming collapse for China. Year in, year out the naysayers assert the inevitability of a bust.

The Outlook for the Metals in 2011

1. Base Metals

Copper

The knock on copper is that too much investment money has flowed into the metal—and maybe not enough real purchasing.

Copper
January 1, 2000 to January 28, 2011

That move from June's $2.85 low to an all-time high above $4.25 could be, depending on one's biases, either (1) something wicked the regulators should thumb, or (2) a sure sign that the pause in the global economy in mid-2010 ended by Hallowe'en.

Copper was a beneficiary of the pickup in US and European economic optimism late last year, but actual demand for the metal will continue to be driven from Asia, not the OECD. Its price briefly touched an all-time high last week, signaling a complete recovery from the shock of the global recession.

We remain of the view that China's various restraint programs will not turn its boom into a bust—or even into a slow-growth economy. Personal savings rates remain—in global terms—astronomic. It must sustain its awesome program of expanding small urban areas into major cities to absorb immigrants from impoverished rural areas.

As usual, there are numerous "experts" predicting a coming collapse for China. Year in, year out the naysayers assert the inevitability of a bust.

In the early years of the commodity boom, they predicted that the Chinese banks would implode. Instead, those banks became world leaders, displacing such supposedly reliable banks as Citigroup; Industrial & Commercial Bank of China is the biggest bank in the world, and the 6th largest corporation in the *ft* Global 500. (Citigroup is 32nd.) Their balance sheets look formidable compared to those of some of the very American banks which published warnings about the coming decline of China—and they don't hold hundreds of billions of dollars' worth (at cost) in US mortgage-based products. Yes, some of those Beijing shopping centers' liens might be a tad dubious, but as long as the Chinese economy continues to grow at 9% or so, we believe the Chinese banks' assets are far more trustworthy than the typical US bank's mortgage portfolio.

"China's forex reserves continued—right through the global recession—to grow more than four times faster than GDP."

As the cottage industry of Chinaskeptics keeps having to dredge up new recruits to replace those whose credibility has crashed, the latest headline-grabbers have focused on the nation's stimulus program that kept the economy humming while most economies of the West were plunging. Today's *soi-disant* seers cite the scale of government financial support and predict doom.

Not one of this year's flock of fools has noticed what the shrewd contrarian Stephanie Pomboy of MacroMavens tells us:

> *China's forex reserves continued—right through the global recession—to grow more than four times faster than GDP*; the nation's long-term *savings* have been increasing even faster than the national debt of leading Western economies. With more than $2 trillion on hand, China remains the largest creditor to the world's largest debtor.

(A friend sent us a clever college student's internet explanation of the extent of the Washington's debt challenge. To explain the US crisis, he covered a table with piles of pennies, each penny representing $400 million in federal deficit spending. President Obama had given a speech in which he talked of the need for restraint, and, to show his commitment to deficit reduction, he was cutting $100 million out of the budget. The student lifted one penny, split it into four pieces with a cutter, removed one of those fragments, and returned the rest to the table.)

China is a far better credit risk than the US, and the metal miners shouldn't be losing sleep that their biggest customer is going to disappear into a debt hole.

US housing starts are at such miserable levels that they probably have nowhere to go but up—even if not very soon and not very much.

What about copper demand from the biggest debtor?

We are old enough to recall that one of the key statistics copper traders used for decades was US housing starts. Any monthly surprise in either direction meant immediate large copper price moves on the LME and Comex.

Were the copper industry still reliant on US homebuilding, its performance would have been disastrous.

That said, any unexpected pickup in demand now from the US housing sector would be welcome icing on the copper cake.

Is that possible?

The few—and mostly quiet—US bulls on the homebuilders offer a modestly encouraging forecast: US housing starts are at such miserable levels that they probably have nowhere to go but up—even if not very soon and not very much. At the moment, the US housing sector may actually be a net supplier of copper: homeowners by the millions are defaulting on their mortgages, and banks constrained by legal and political problems (of their own making) cannot move fast enough to save their properties. Result: many vacated houses lose their copper to looters, and others simply decay so badly they have to be demolished—and the contained copper goes to scrap dealers. This week's Case-Shiller report on US home prices showed that prices are sliding anew. Prices are rising nicely in only one city—Washington D.C.

We recall from our British vacations in the 1970s the fund-raising appeals from many small town and village churches pleading for donations to restore their roofs after thieves had torn them off for the value of their copper. During the metal boom of that era, the lowly manhole cover became another popular theft item, and serious injuries were reported from people falling down manholes. One entire bridge in the Ukraine was hijacked and sold for scrap.

At the time of copper's recent peak (2009), thieves stole a valuable Henry Moore bronze sculpture from a museum; estimated scrap value: 1500 pounds.

Our bullish case for copper over the longer term remains what we have been saying month-in, month-out since 2001: the growth in demand as Asia industrializes will continue to support the industrial metals. Those economies are compressing—into forty years—the economic growth we achieved over two centuries. They kept growing even as the West was experiencing its worst downturn since the Depression. That global crisis that would have crushed those economies if—as the doubters maintained—all the emerging economies had going for them was Western demand. Their over-dependence on exports was, we were assured, their Achilles' Heel.

Some dependence.

Some Heel.

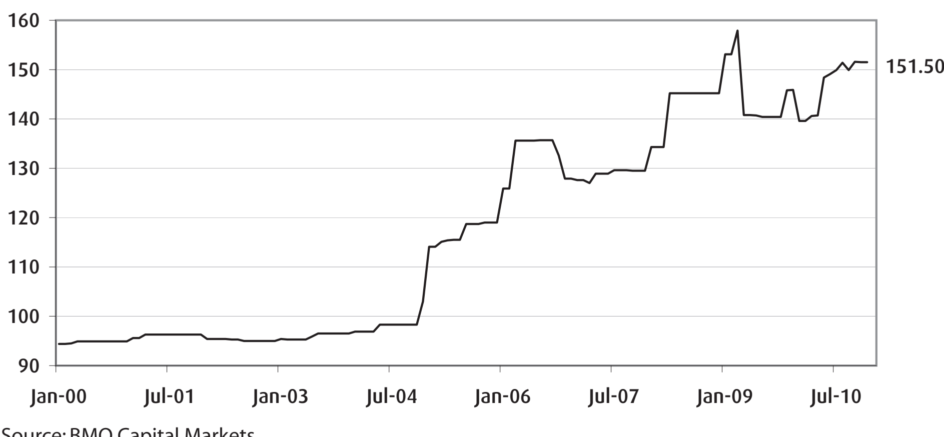
[Asia's] overdependence on exports was, we were assured, their Achilles' Heel.

Some dependence.

Some Heel.

Iron Ore

Iron Ore
January 1, 2000 to January 28, 2011



Source: BMO Capital Markets

Bismarck would have understood—and applauded.

German steel production was up 34% last year, yet actual production from the storied land of ThyssenKrupp doesn't compare with China—producer of 44% of the global output, even though its tonnage rose just 9.3%—even with the nation's overall GDP growth. Meanwhile, Bismarck would have chuckled at the pitiful performance of the steel industry in the nation on which he modeled his strategy: Britain was one of only two nations to report declining steel output.

According to an *ft* survey, steel prices could leap as much as 66% this year. The 16 experts reporting from across the world disagreed only as to how high the double-digit price leaps would be.

Worldwide steel output was up 15% last year—*its greatest gain in fifty years.*

That means iron ore producers will be enjoying a fabulous year. (The numbers aren't in yet for 2010, but China's iron ore imports in 2009 were 627 million tons—up from 443 million tons in 2008; that meant its rate of dependency on imports was 70%—up from 50% in 2008.)

Contrast those remarkable data from China with the state of steel in the US. The rusting American steel industry in the US was by 1980 a symbol of national competitive decline. (The Super Bowl-bound Pittsburgh Steelers keep their name and steel industry emblem on their helmets out of respect for tradition, but Pittsburgh's economy hasn't been based on steel for decades.)

Worldwide steel output was up 15% last year—*its greatest gain in fifty years*. At 1.4 billion tons, it was 100 million tons above the previous peak—2007.

Those decades of US decline for this basic ingredient of national economic and strategic power must inevitably create a problem of maintaining global relevance as a major power without steel. Last year's remarkable 38% leap in American steel production was from a depression-level base. The good news is that US still ranks third in global steel production.

The US steel industry's postwar leadership eroded from managerial complacency and over-generous settlements with the Steelworkers at a time Europe was still rebuilding. The tipping point came from the consequences of its stupid betrayal of President Kennedy's intervention to prevent yet another excessively costly deal sixty years ago. (We recall the reaction from some members of the financial community to Kennedy's enraged comment, "My father always told me all businessmen were sons of bitches, but I never believed it until now." The Street felt it was unfair to be lumped in with politically insensitive basic industry troglodytes. How times change: today, a steel executive would naturally be insulted to be compared to a bailed-out, big-bonused Wall Street banker.)

Stalin "The Man of Steel" built the USSR on steel. Mao Zedong sought to emulate the Bolshevik model but chose to grow steel production through vast numbers of backyard blast furnaces. These low-cost, low-output, large scale polluters produced steel in unpredictable quantities and unpredictable quality, a deficiency that led to predictable punishments. Mao was a master of executing people, not executing business models. His power grew out of the barrel of a gun, not a blast furnace.

Deng Xiaoping's revolution wasn't built on Stalinist steel monstrosities, backyard furnaces, or murdering millions. It was a sustained liberalization and stimulus program aimed at a continually improving economic environment, without worrying overmuch about a continually deteriorating atmospheric environment.

Deng Xiaoping's revolution wasn't built on Stalinist steel monstrosities, backyard furnaces, or murdering millions. It was a sustained liberalization and stimulus program...

By the early years of this millennium, China's iron ore appetite was so voracious that the Australian and Brazilian iron ore giants—BHP Billiton, Rio Tinto and Vale—began to base their business models on Chinese demand. India is the third-largest exporter to China, but its output available for export has been declining because of rapid growth in domestic demand.

For years, the major iron ore producers set industry prices after negotiation with a few leading Chinese and Japanese buyers. This process worked reasonably well until serious ore shortages began to develop because the major producers were behind the curve in making needed expansions. Then, (as it was alleged in some high-profile prosecutions in China), some desperate smaller steel producers bribed representatives of the iron ore companies to get a share of the majors' allocations. The core of the allegations appears not to have been any price discounts—which would have been noticed by company auditors—but getting access to small shares of total Chinese imports. Rio Tinto employees were charged and jailed in what may well have been show trials—and Rio Tinto officers were unable to get adequate legal defense for them or even interview them. Traces of Mao's footprints remain in the Chinese justice system, although his largest-scale memorial rests in the tens of millions of funerary urns for his victims across the land.

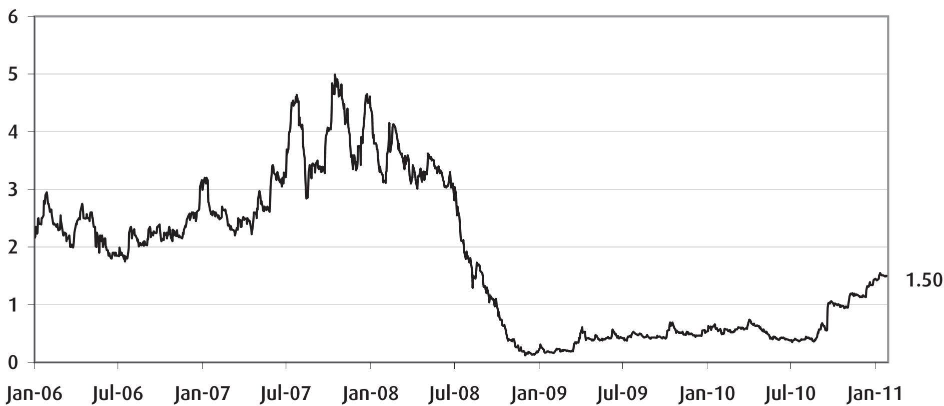
BHP spearheaded the recent change in iron ore marketing and pricing to open markets which means vastly greater transparency (and elimination of prosecution risk for the miners' marketers from The Great Pall of China).

But the transforming of Asian economies means that global steel demand will continue to pressure available supplies of iron ore. Such success stories as Canada's Consolidated Thompson (CLM, recipient of a friendly takeover from Cliffs Resources), and the recent proposed takeover of Baffinland Iron Mines (BIM) by ArcelorMittal and Nunavut Iron Ore show that an iron ore deposit no longer has to have proximity to China or the Suez Canal to attract serious attention. (Incidentally, Vale could be the biggest single beneficiary of the current major widening of the Suez Canal.)

...Vale could be the biggest single beneficiary of the current major widening of the Suez Canal.

Consolidated Thompson Iron Mines (CLM:TSX)
January 1, 2006 to January 28, 2011

Baffinland Iron Mines (BIM:TSX)
January 1, 2006 to January 28, 2011



Aluminum

Aluminum is an industry which has had few big winners and even fewer heroes during this historic base metal boom, even though its annual growth in unit sales has outpaced most other metals.

Alcoa has managed an amazing feat: *its stock price is lower today than at the onset of the Greatest Commodity Bull Market of All Time.*

One need look no further than the share performance of Alcoa (AA).

Alcoa (AA)
January 1, 2000 to January 28, 2011

Indeed, perhaps the only three reasons people *have* looked at Alcoa is because (1) it has managed to maintain its membership in the club of thirty in the Dow-Jones Industrials, and (2) is the first to report earnings each quarter, and (3) is a regular candidate for inclusion in the contrarian portfolio of investing in "The Dogs of the Dow"— an annually rebalanced portfolio in which an investor buys the worst Dow performers of the previous year.

Alcoa has managed an amazing feat: *its stock price is lower today than at the onset of the Greatest Commodity Bull Market of All Time.* Its shareholders constitute one of the few long-suffering groups left behind in the American economy which hasn't been the beneficiary of some government handout program.

Contrast this tale of hard luck with the experience of those who had the good luck and/or good sense to invest with our friend Dick Evans and his colleagues in Alcan when the boom began. Same industry: different results. Dick managed to negotiate a sale of his company to Rio Tinto at a price that made it seem as if Alcan were in some other industry or from some other

Longtime Alcoa stockholders dream of the day when there's no more cheap, subsidized energy to compete with their facilities.

Longtime Maple Leaf fans dream of the day when there are no better-managed hockey clubs to compete with their team.

world. Alcan has some marvelous assets, including access to cheap reliable power provided by Hydro-Quebec, and a fine management team, but it is in a tough industry. Other base metal companies are valued primarily by their ore reserves. But aluminum is just about the most common metal in the earth's crust and the supply of reliable bauxite globally is enormous. The value of aluminum comes not from its ore, but from its refining. It's a high-energy-consuming process —The Hall or *Héroult* process: (an American and a Frenchman discovered it coincidentally in 1886—a feat recalling Newton and Leibniz simultaneously creating the calculus.) The Hall process was first commercialized by Alcoa, which for many decades was the world leader.

But cheap energy is what dictates aluminum competitiveness, and China is just one of the many nations which have subsidized aluminum production for many years, contributing to sustained global overcapacity.

Aluminum competes with steel in many applications, and copper in others. It keeps gaining market share against them, based on its lightness, strength, and cost, but the growth in global production keeps growing at least as fast as demand.

We remember when Alcoa was—briefly—a growth stock, in part because of its success in the introduction of aluminum beer and soft drink cans. The machine tool technology involved was remarkable, and for years this was a product line characterized by growth and high profitability.

But then the recyclers took over and, spurred by green enthusiasm, most of those drink cans were reclaimed and recycled. We recall the ecology-minded founder of one of the world's pre-eminent actuarial consulting firms who built a small peninsula on his retirement property on Vancouver Island entirely from crushed aluminum cans. (After his death, that ecopeninsula was bought by an ecokeen German rock star.)

Longtime Alcoa stockholders dream of the day when there's no more cheap, subsidized energy to compete with their facilities.

Longtime Maple Leaf fans dream of the day when there are no better-managed hockey clubs to compete with their team.

We have friends in both groups and hope that their dreams will come true... someday.

2. The Precious Metals

It might be argued that the weakness in gold and silver was inevitable because there was so much media hype about "soaring precious metals" even when they were getting a tad toppy.

Mr. Paulson, the noted hedge fund proprietor, is said to have personally earned $4 billion from his gold bet—a sum which, we are told is greater than all the major league baseball payrolls combined.

If it had become *that* easy to make *that much* money, perhaps some setback was in order.

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Gold

January 1, 2000 to January 28, 2011

Silver

January 1, 2000 to January 28, 2011

On that basis, gold could be headed back toward $1250 before stabilizing and launching a sustained rally to new highs. Such a pullback could castrate many a levered gold bull.

As this was being written, most speculators and many investors were exiting from gold and silver in favor of economy-driven metals...until the sudden shock in Tunisia turned into a major rebellion in Egypt.

We have been expecting some sort of correction for some time: ten straight 'up' years for any commodity is astonishing, but especially for gold, which tends to rise sharply when (1) inflation is rising sharply, or (2) when the dollar is falling sharply, or (3) during a gut-wrenching economic and financial crisis. All three of those conditions applied at various times during gold's last major bull market, 1971-1980. Silver was in oversupply for most of the 20th Century, and the US was a continuous seller at fixed low prices until it ran out of silver dollars in 1963 and stopped issuing currency exchangeable into silver. Its run from $1.50 to $48 from 1971 to 1980 was driven primarily by the outsized inflation of the Nixon-Ford-Carter eras, but also by the bizarre cartel of the Hunts and Saudis, which was based, in significant degree, on a (mis)interpretation of a Biblical text.

Ned Davis notes that silver has its usual leadership role, leading the gold plunge. Silver, for whatever reasons, seems to move first and most when the precious metals are making a major move.

On that basis, gold could be headed back toward $1250 before stabilizing and launching a sustained rally to new highs. Such a pullback could castrate many a levered gold bull.

If the Egyptian crisis is resolved without global consequences, what could make precious metals soar anew?

Although inflation—starting with food and maybe fuels—is likely to return within the next two years, that may be too long a wait for gold speculators who jumped aboard because of the banking crisis that began in 2007 and stayed when the eurocrisis began.

In an *ft* interview, Bill Gross, "The Warren Buffett of Bonds," says he is bearish on developed-countries' bonds. He ridicules central bankers' idea that "food and energy prices will mean revert"—returning to the average of long-term levels.

"If you think we've mean reverted in oil after two recessions then you must be living on Mars. China is a structural long-term phenomenon that offers no promise of mean reversion. Countries are walking up the protein trail from rice, beans and corn to poultry and ultimately meat and beef. To assume mean reversion is to diagnose wrongly the developing world."

For gold investors, this means that, barring a deep double dip recession, inflation is coming back soon.

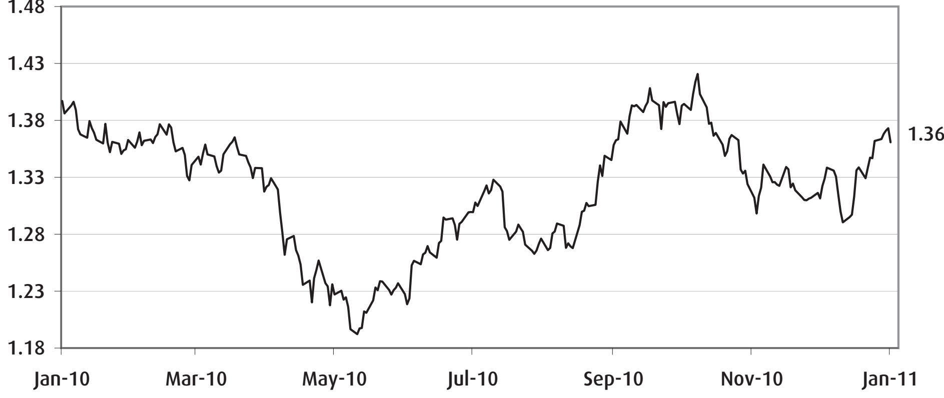
The markets do not agree—with 10-year Treasurys yielding a paltry 3.31% and gold, even after its slight Egyptian-driven recovery, trading at merely $1341.

What the gold speculators needed in late January was an onset of grim, gnawing *Fear*. Egypt may have supplied just that.

What the gold speculators needed in late January was an onset of grim, gnawing *Fear*. Egypt may have supplied just that.

At the moment, the Euro-elites, backed by huge reserve funds, seem to be managing the PIIGS pollution problems:

Euro vs. US Dollar
January 28, 2010 to January 28, 2011



But those problems aren't going away.

Greek debt has recently been downgraded to junk status by all three ratings services. That it took those raters so long reflects their style: they resemble the ECRI, which only proclaims the onset and end of recessions many months after the event has passed. They are the equivalent of an internist with an inferiority complex who, when agonizing about the cause of a patient's symptoms, leaves the task of diagnosis to a pathologist, whom he asks—after the autopsy: "Was it cancer, diabetes, gastritis or a severe allergy?"

To date, the euro has survived the Greek and Irish collapses, and the seemingly endless train of strains in Spain and Portugal. Last week's sale of eurobailbonds backed by all euroissuers was oversubscribed thirty to one.

But there are political casualties far beyond the PIIGSpens. While Germany puts on its best economic performance in 25 years, the political strength of its Chancellor, Angela Merkel, has been seriously eroded. Most conservative and moderate voters remain angry at her willingness to pour money into all those underachieving and ungrateful economies; however, the Left, from its base in Berlin, is furious at her for not taking the lead in generosity toward the poor and the public sector unions in the PIIGSties. Her coalition is in trouble.

There is no permanent solution to the problems arising from the Roach Motel design of the euro: you can get in, but you can't get out.

Nicolas Sarkozy's problems in France spring not only from his decision to try to tweak the nation's hopelessly underfunded national pension system, and to his tendency to commit memorable gaffes, but to his on-again, off-again support of the bailouts, followed by a full commitment to the ECB that many of his countrymen and women thought was purely political. (His most-remarked recent gaffe was telling a group of French farmers in Alsace that they were in Germany.)

When the leaders of France and Germany are in trouble with their electorates and are publicly dubious of each other, the underpinnings of the basic partnership that gets the big things done in the eurozone erodes from reliability to liability. That is not a reassuring situation for holders of euros: if the management group behind the faith-based currency is publicly dysfunctional, suddenly a dollar begins to look attractive, even with all those multi-trillion-dollar deficits. The yen's fundamentals are no great threat to the euro's image: the ever-changing management team behind the yen—and the gerontocrats behind those faceless faces—make the uncomfortable Sarkozy-Merkel partnership look dazzling in comparison.

In other words, investors will probably be reading unpleasant or downright scary news affecting perceptions of eurorisks frequently. There is no permanent solution to the problems arising from the Roach Motel design of the euro: you can get in, but you can't get out.

We remain doubtful that the euro will survive the next recession and global financial crisis—whenever they arrive.

If the existing problems are systemic—e.g. the national accounts and the banking systems of Ireland, Portugal, Spain and Greece simultaneously slide into worse conditions, with further bond downgrades and credit default swaps show that investors see defaults as inevitable—then the euro could enter a full-blown crisis within a matter of months—and precious metal prices would again be climbing.

At the moment, the eurozone's sole cause for rejoicing is that Britain didn't join, so its fourth-quarter plunge into negative economic growth doesn't put the euro at even greater risk.

So what is the case for precious metals in the time between now and the next global financial crisis or the onset of worrisome inflation in the OECD if Egypt's crisis is quickly resolved?

...gold goes down when there is blissful peace and improving prosperity.

In the case of gold, $1300 bullion didn't seem to spook jewelry buyers last year: According to the World Gold Council, in the first nine months of 2010, they bought 1,468 tonnes—up 18% over 2009.

Central banks were, on balance, net *buyers* of gold last year for the first time in two decades. The IMF, which needed to sell some of its gold to help bail out the eurozone, sold 403.3 tonnes, without disrupting markets.

More and more gold is coming from the cash-strapped sector of the middle class, as the chic new Tupperware-style parties are get-togethers to sell old gold. That new social trend naturally evoked sneers from some of the elites, who cited this phenomenon as evidence of how stupid it was to invest in gold. They didn't remark that gold was doing what it has always done—being a readily acceptable savings vehicle that can be used at any time to buys goods and services or discharge debts.

The gold owner's visceral reason for hanging on even when its price is plunging is that bad things are sure to happen eventually: across most of the OECD the demography goes from bad to worse, debt-to-GDP ratios go from bad to worse, and the list of nuclear-weapon-owning powers goes from bad to terrifying.

Last Friday, gold was falling to new quarterly lows until world TV screens showed that the riots in Egypt were reaching a potentially revolutionary stage. Already, an autocrat had fallen in Tunisia, and there were riots in routinely unstable Yemen, and Hezbollah was seeking to destabilize Lebanon.

Why should gold go up if Mubarak goes down?

Because gold goes down when there is blissful peace and improving prosperity.

A revolution in the most important Arab state that could conceivably end with the Muslim Brotherhood in effective charge would surely be bullish for gold.

The New-Old Case for Gold (and Silver)

One argument against gold is that the price can't keep rising unless whole new groups of buyers come in. Where could they be?

How about a whole, huge new set of buyers of gold who might, within a few years, dominate the gold market?

Let's start with a flashback:

Photo credit: Henri Cartier-Bresson/Magnum Photos

This picture was taken by the great French photographer, Andre Cartier-Bresson, in what was then called Peking, in 1948.

The Nationalist government of Chiang Kai-Shek was going to fall within hours and Mao's army was marching toward the city. Nationalist banknotes had long been convertible into gold.

Everyone knew that Mao would not pay for Nationalist notes and wouldn't think of giving up any gold he won by conquest.

This is the scene of the panic-stricken lineup of paper money holders desperate to get gold before it was too late. Many people died in the crush. Most didn't make it to the bank window before Mao's troops arrived, and the imprisonments and slaughters began.

Flash forward to 2010, the Industrial and Commercial Bank of China (ICBC), and the World Gold Council developed a gold-based savings plan allowing small investors to make modest regular deposits and build up savings convertible to physical gold. As of January, ICBC reported that the Gold Accumulation Program had sold ten tonnes of gold in its first three months of operation.

Gold's next move could come from the atavistic memories of hundreds of millions of Chinese people about the latest paper money annihilation in Chinese history—1948.

In recent years, the Chinese government has made it possible for citizens to purchase and trade physical gold and silver—now, there are options even for small and medium-sized savers who are unhappy with the 2.75% interest on RMB deposits when Chinese CPI is rising by more than 5% (and many skeptical Chinese think the actual inflation rate is much higher).

The photograph is part of Chinese memory—what it was like to own gold before Communism came—and how paper money became instantly worthless. (The Chinese first developed paper money nearly a millennium ago, and all the experiments with it failed—with disastrous consequences for those relying on the paper.)

The Chinese can see how rapidly food costs are rising. They know how rapidly rents have risen—and have seen the appreciation in real estate prices.

What the Industrial and Commercial Bank of China, the government, and the World Gold Council have launched could be the most momentous development for gold since people began to realize that most of America's biggest banks and investment banks were over-levered and over-invested in overvalued paper.

Gold's next move could come from the atavistic memories of hundreds of millions of Chinese people about the latest paper money annihilation in Chinese history—1948.

Everyone is familiar with the oft-quoted Chinese aphorism about the commencement of a long journey. Could it actually have originated from the mistranslation of some long-dead historian's account of Genghis Khan's memorable trip of conquests across Asia, which began with a single steppe?

That most certainly was the route for the Black Death in the 1340s. It could be the travel plan for the next global gold rush.

Commodity Manipulation?

"$60 billion was injected into commodities in 2010." From that kind of statistic, any leftist demonologist can construct— with righteous enthusiasm—a bill of indictment against speculation.

Skeptics, particularly those on the Left, are inclined to ascribe any sharp price increase in commodities—particularly foods and fuels—to the greed and immorality of those shadowy creatures of darkness—speculators. A recent *Financial Times (ft)* survey quotes a Barclays estimate that "$60 billion was injected into commodities in 2010." From that kind of statistic, any leftist demonologist can construct—with righteous enthusiasm—a bill of indictment against speculation.

When the London Metal Exchange (LME) looked at the amounts of metals on hand controlled by large speculators, they found that JP Morgan held nearly half the supply, which it claimed was for clients, particularly a proposed Copper ETF.

A Commodity ETF's impact on prices is palpably different from large speculative holdings of commodity futures or even speculative ownership of actual commodities.

An ETF is fully backed by actual ownership of the commodity, which is, therefore, withdrawn from the market. The phenomenally successful GLD (SPDR Gold Trust) has sparked copycats, including mighty BlackRock, and, according to the World Gold Council these ETFs held 2,167 tonnes of gold at year-end (worth $98 billion—more than the holdings of all but a few central banks).

A large-scale copper ETF would assuredly influence copper prices in the coming year, because various supply constraints and setbacks have been limiting copper output, and metals forecasters estimate a small deficit this year. A big sequestration of copper for a fast-growing ETF would mean that visible copper could contain a huge amount of metal unavailable to users at almost any price.

That *ft* article listed the swings in speculators' net long positions in contracts and options on gold, which were as high as 220,000 ounces last summer, but had fallen to 160,000 ounces by January 11th—down 18.5% over a year earlier. That contrasted with a 19.7% gain in oil exposure, a 63.1% increase in corn, and a 74.6% increase in soybeans.

In other words, commodity speculators hop from one kind of bet to another, and at any given time the purely speculative aspect of the pricing of a commodity can be negative to nil to large, but over a longer term, these trading maneuvers probably cancel each other out.

The big passive commodity investment funds which stick with a given commodity and roll exposures over as they near expiry doubtless have some impact, but because they are, in effect, long-term investors repricing their exposure in response to the frequency of expiries, it is hard to make the case that they have been big factors in last year's commodity bull market. Most of them rode the bull market up in 2007-08, then rode the bear market down and just kept rolling their exposures, so they doubtless contributed to the bearish phase modestly and—presumably equally—to the bullish phase.

...farmers were reminding the city folk that the Chicago Board of Trade was set up to provide farmers with capital and liquidity, thereby reducing their risks.

We were interested to read reports of a somewhat emotional US public meeting about grain speculation. Consumers' advocates bemoaned the speculators' attack on the poor, and the National Farmers' Union, a leftist farm group, delivered its ritualistic denunciation of the denizens of the grain pits. However, several farmers said they were afraid the government might over-react and drive the speculators away, and they needed them to sell their crops forward to raise money for expenses and reduce their risks. Those farmers were reminding the city folk that the Chicago Board of Trade was set up to provide farmers with capital and liquidity, thereby reducing their risks. Through hedging, individual farmers have been able to protect themselves against the financial impact of bad weather, disease, or big bumper crops. Initially those bumper crops would come only from within the US and Canada, but it wasn't long before there was substantial globalization of the grain trade—which meant farmers' and meat producers' and bakers' incomes were at risk from bumper crops or crop failures anywhere.

There were—it will be recalled—absolutely no demands for government action against greedy speculators (or hoarders) when commodity prices were tumbling.

There are—it will be recalled—almost always demands for government action against greedy speculators (or hoarders) when commodity prices are soaring.

Nothing succeeds in resentment like success.

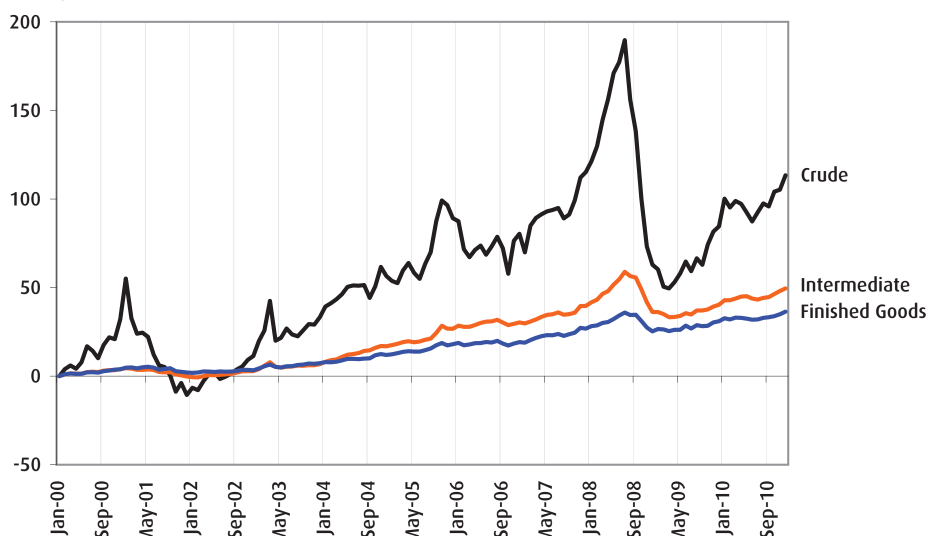
After all the fuss and fury and investigations, we expect further regulations involving disclosure and on position limits, but expect that commodity markets will continue to attract capital from urban investors and speculators to make farming less risky and more profitable.

Why Are Mining Stocks Ranked Lower Than Oil Stocks as Long-Term Investments?

Any business that depends on junkyard dogs is far from the business models of Wall Street and the futures exchanges...

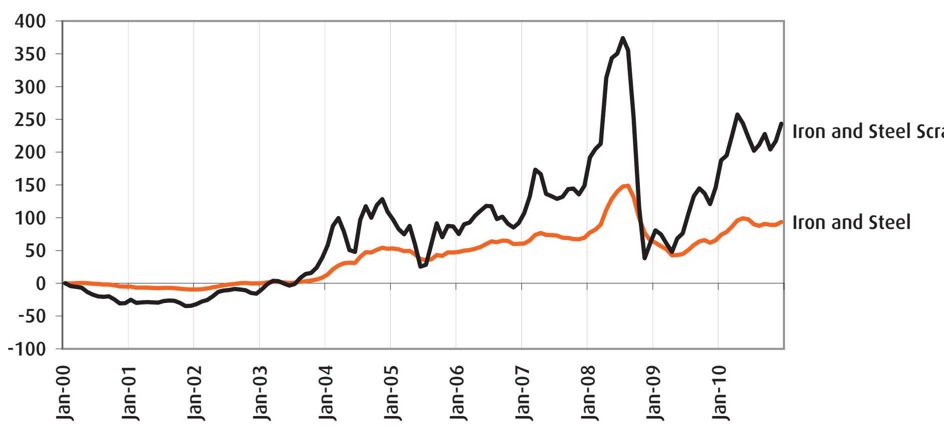
One of the most useful rules we learned from managing portfolios during the 1970s was that, while most investors look at the CPI, commodity investors should look more closely at the PPI. Specifically, they should be looking at the relative performance of crude goods to finished goods.

US PPI – Crude, Intermediate and Finished Goods
January 2000 to December 2010



The crude component of metal prices includes scrap. In our experience the behavior of scrap prices is, quite often, a more reliable indicator of future metals prices than the action in spot prices for pure metals on the exchanges. Scrap dealers operate almost entirely at the margin. From our experience in talking with Midwest scrap dealers, they are among the first Americans to hear when China is changing its policies about economic stimulus vs. restraint. In the past decade, Chinese scrap demand has largely taken over from American demand with the leading scrap dealers. Any business that depends on junkyard dogs is far from the business models of Wall Street and the futures exchanges, but it is well worth following.

Iron and Steel Scrap
September 2006 to December 2010



Source: US Bureau of Labor Statistics: PPI, Inflation & Prices

There is no scrap gasoline or natural gas: that is the big difference between the valuations of oil & gas producers and mining companies.

The December 2010 Producer Price Index reported annual increases for iron & steel scrap of 39.5%, copper scrap 22.8%, aluminum 20.9% and stainless steel at 53.5%.

A study reported in the *Financial Times* a few years ago revealed that, over the previous 40 years, oil stocks were the top-performing equity industry group when reinvested dividends were included.

Mining stocks were 'way back in the pack.

Why the difference between the two extractive industries, each of which faces the challenge of replacing its production in a world of rising political risks for resource companies?

We suggest the difference is scrap.

Since the Industrial Revolution, the constraint on sustained metals price gains has been the supplies of scrap from products sold in earlier cycles.

There is no scrap gasoline or natural gas: that is the big difference between the valuations of oil & gas producers and mining companies.

The precious metals miners face the overhang of nearly all the gold and silver produced over the millennia which isn't in the remains of ships at the bottom of the Caribbean or Atlantic: as bullion it is found in the vaults of central banks, the savings of the great, the gross and the cautious, and in manufactured form in jewelry and coin collections across the world.

There's a new era dawning: After all those decades of competing with well-used offerings, the virgins will be winning the beauty contests.

Iron ore, copper, nickel and aluminum producers have faced perpetual contests between virgin metals produced by the miners and recycled metal from scrap.

We believe the scrap/virgin ratio will be more favorable to metal miners in this and future cycles than it has been throughout the past.

Why?

Because the ratio of scrap metal to current consumption is so minimal in the powerhouse Asian economies which are buying the most metal, and because after more than a decade of drawing down junkyards in North America and Europe to fill ships bound for Asia, scrap is becoming—and will remain—scarce. We have been told by junk dealers that the competition between them to get access to municipal landfills and rights to scrap from metal stamping operations has been intensifying since "The China Boom" became decisive as the source of major demand.

Result: in this and future cycles, the rusted hand of the past shall be a dwindling constraint on profitability of the industrial metal miners.

Once investors realize that a world in which more than half of the demand for industrial metals comes from countries which have minimal supplies of scrap, they will be ready to revise upward their forecasts of longer-term metal prices and to assign a higher investment rating to the shares of the metal miners.

After World War II, the smart socialists in Saskatchewan got the bright idea that the provinces' biggest eyesores were the rusting combines and spreaders left across the land from the Depression. They organized a company to set up a steel mill that used scrap instead of iron ore—and IPSCO—a splendidly-managed company—was born. It eventually ran out of Depression-era scrap and had to compete with other mini-mills for feedstock. (And, as a sign of the times, it was recently acquired by a Russian company.)

Captain Ahab compared himself to Adam struggling under the weight of all the piled centuries since Paradise. For decades, miners must frequently have moaned that they were struggling against the accumulated weight of years of all the economic cycles since World War II.

There's a new era dawning: After all those decades of competing with well-used offerings, the virgins will be winning the beauty contests.

One other thought about mining stock price behavior: the Street's fixation on short-term earnings has a little-remarked side effect: the share prices of the best-run mining companies are frequently victims of that fixation.

...the Street's fixation on short-term earnings has a little-remarked side effect: the share prices of the best-run mining companies...

Example: some leading Wall Street analysts downgraded Freeport McMoRan recently after its announcement that 2010 copper deliveries were below previous projections and that trend would continue in 2011.

Why?

Because Freeport is taking advantage of sky-high copper and gold prices to mine lower-grade sections of the great Grasberg mine—the world's third-biggest copper mine—which also contains the world's largest supply of gold.

Freeport is doing precisely what it should do—for long-term holders of its shares and—more importantly—for the communities that are near-totally dependent on that mine. (If you want to understand the pain that closure of a major mine does to people in Papua New Guinea, read the splendid novel *Mister Pip*, by Lloyd Jones.)

Leftist critics of the mining industry routinely cite the devastating impact on mining towns from mine closures—which typically occur during or immediately after a recession. By harvesting all the contained metals over a longer period of time, great mining companies display a social responsibility that those captious critics never notice.

When mines shut down, and the media are filled with sad stories about the economic and human impact of the closures, the publicity is, we believe, one reason why long-term investors eschew mining stocks.

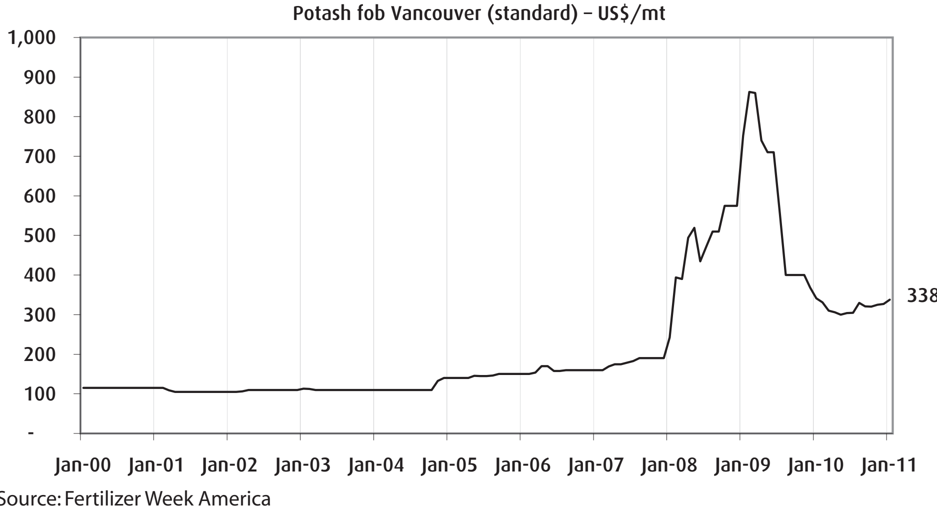
Well-run mining companies that aren't being operated to deliver upside earnings surprises that trigger enthusiastic buy recommendations from the Street that give insiders superb opportunities to exercise stock options are superior long-term investments and deserve equal respect with leading oil companies.

There is, however, one small group of companies engaged in mining which don't have to fret about running out of ore and don't need to think about concentrating on lower-grade stopes during boom times for their product...

BHP has made it official: potash, which is a metallic oxide, is produced from mines.

Potash

Potash Prices
January 1, 2000 to January 28, 2011



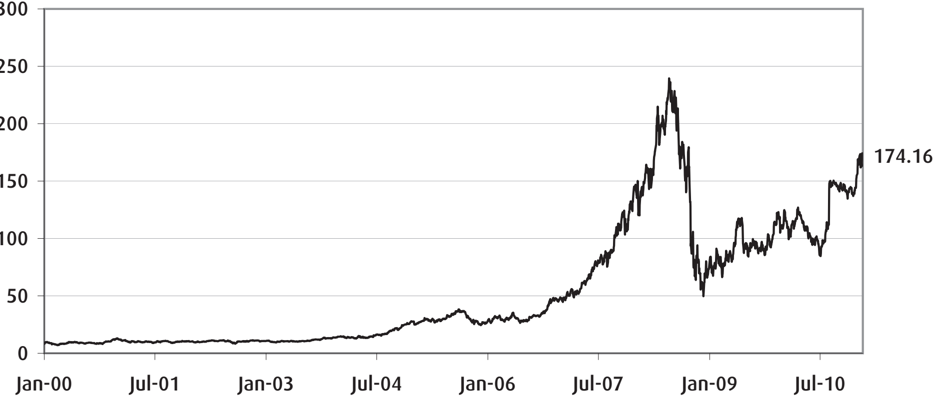
Source: Fertilizer Week America

BHP has made it official: potash, which is a metallic oxide, is produced from mines. Therefore, it deserves to be covered in this mining issue of *Basic Points*.

Like most of the Street, we have discussed potash's investment attractions in comparison with other fertilizer companies, and under the heading of agricultural stocks that includes such notable companies as Deere, CNH Global, Monsanto, Syngenta, and Tyson Foods.

But when the world's biggest mining company makes the world's biggest takeover bid for the world's biggest potash deposit—and loses—it is time to reconsider our taxonomy.

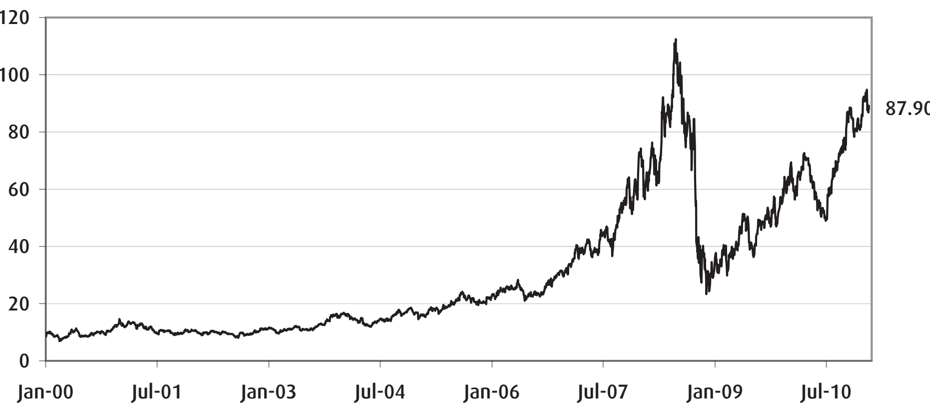
Potash Corporation (POT)
January 1, 2000 to January 28, 2011



Mosaic (MOS)
October 25, 2004 to January 28, 2011

Potash Corporation—which has the world's longest-duration economic reserves of *any mineral resource.*

Agrium (AGU)
January 1, 2000 to January 28, 2011



Longtime readers know our affection for agriculture (dating back to our days as General Manager of the Ontario Federation of Agriculture). They also know of our admiration for Potash Corporation—which has the world's longest-duration economic reserves of *any mineral resource*. They also have probably guessed of our deep respect for Potash Corp's charismatic CEO, Bill Doyle. So we could hardly pretend to complete neutrality during those weeks when the future ownership of POT was in doubt.

We have also been, however, admirers of BHP since the days when it was being led by the brilliant "Chip" Goodyear, and it has always been one of biggest positions in the portfolio of our Fund. So, as investors, we found ourselves on both sides of that dramatic struggle.

From where we sat (uncomfortably), BHP lost for three major reasons.

1. ***One of History's Biggest and Fastest Grain Rallies***

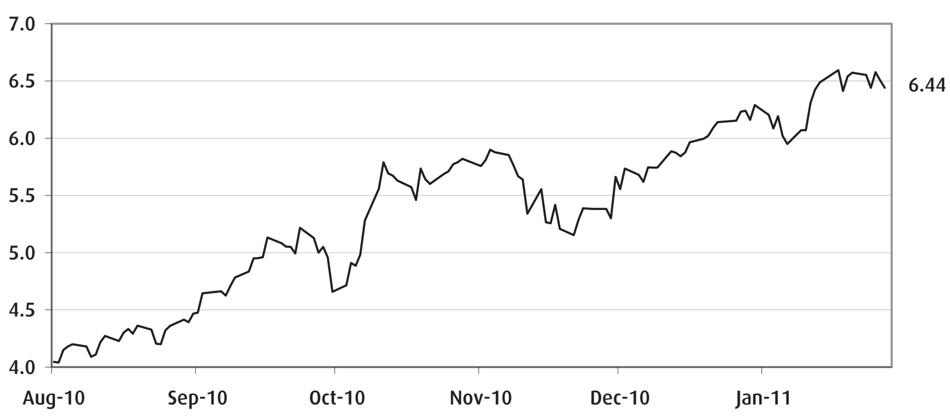
On August 16th POT closed at $112.15. The next day BHP bid $131 for all its shares—*which have never once traded as low as that bid price since the bid was announced—and which went to a new recovery high after the bid expired.*

How could that be?

Here's what happened to the key grains in that time:

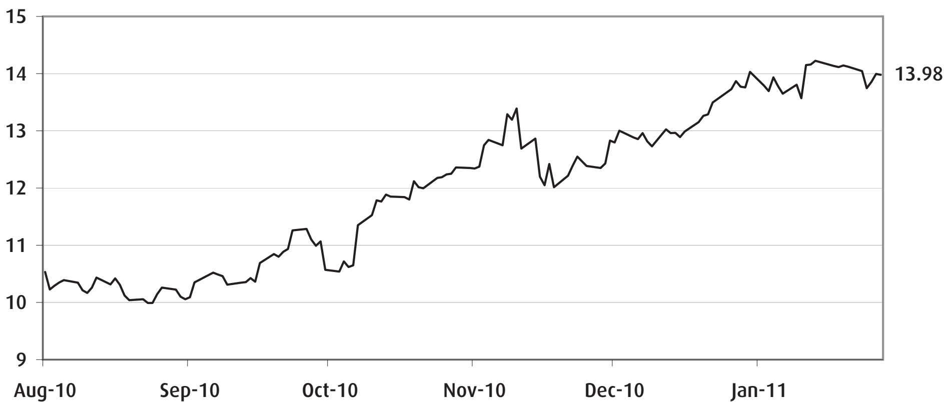
Corn

August 1, 2010 to January 28, 2011

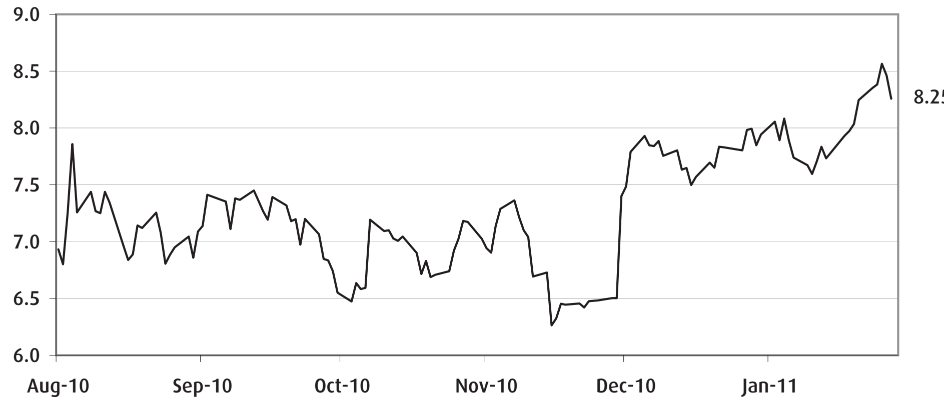


Soybeans

August 1, 2010 to January 28, 2011



Wheat
August 1, 2010 to January 28, 2011



It seemed as if some of those mining analysts had to google potash to find out what it was and how it was used.

BHP's bid became hopeless and irrelevant as stock prices of all leading agricultural companies surged higher almost as rapidly as grain prices—with many companies' share prices rising far more rapidly than POT. What the community of agriculture investors and companies knew was that those monstrous grain gains had changed the game of valuing POT.

Most Wall Street mining analysts didn't seem to know that…

2. Irrelevant—but Influential—Wall Street Mining Analysis

BHP had the misfortune that its biggest equity analyst boosters in the US and Britain took away much of its flexibility to revise its bid upwards because they were collectively too ignorant to understand (1) what had changed, and (2) what POT's four-century duration ore reserves were worth. Many of them were very disappointed that BHP was getting into a business whose customers were farmers. It seemed as if some of those mining analysts had to google potash to find out what it was and how it was used. They knew that something had replaced manure but weren't all that clear about the three key crop nutrients—and none of them seemed to have ever heard of Liebig's Law of Limits. It was as if leading classical music critics were responding to the shocking news that Placido Domingo was going to do a tour devoted to country music, which would be kicked off at the Grand Ole Opry.

As our clients are probably aware, we are unimpressed with much Wall Street research on the commodity companies we tend to like most. Most Street analysis treats established mining and oil companies on an earnings multiple basis—as if their real business models closely resembled the other groups in their country's major stock indices.

Our core doctrine is that first and foremost one looks at a company's "unhedged reserves in the ground in politically-secure areas of the world."

...POT is to almost every other mining stock as gold is to silver: they're both precious metals...

By that test, POT is to almost every other mining stock as gold is to silver: they're both precious metals, but one doesn't tarnish or decay and the other does and one is far rarer and costlier than the other. No other mining company has four centuries of reserves. Admittedly, the present value in mathematical terms of ore to be mined in 2345 is minute—except that it guarantees that it will be there when needed with no future exploration risk involved.

There is a story of a French nobleman who was re-landscaping his estate. He conceived of the idea of a line of slow-growth ornamentals at a point distant from his castle. His gardener said, "My lord, it will be fifty years before anyone could stand on this balcony and see those trees."

The lord replied, "Then we must start planting this afternoon."

Had BHP won its bid, it would own the world's finest potash reserves for four centuries (at current rates of production). That would mean that, on a blended basis, its *total company reserve life index* had increased dramatically, and that it deserved a pre-eminent investment rating compared with Xstrata, Rio Tinto or Vale.

Believe it or not, some well-known street analysts criticized BHP for even making the $130 bid and warned against boosting it at all—because of how many pennies in per-share earnings it would cost between 2011 and 2013. They can breathe a sigh of relief: they're back to their earnings models and need only plug in the prices of iron ore, copper, coal, nickel, oil and gas.

By the time they published those earnings forecasts—of which they were so inordinately proud—they were already outdated: with crop futures prices soaring, potash prices would be headed much higher—as would the value of the company's reserves. Not one top Wall Street *mining analyst* (as compared with *agricultural analysts*) we follow devoted a report pointing out that if POT were worth $131 with corn at $3.75, it was easily worth $175 [its present price] with corn at $6.00.

BHP's bidding hands were effectively tied by uninformed Wall Street analysts who couldn't tell a heifer from a steer.

3. ***BHP didn't discuss its bid with Saskatchewan's Premier, Brad Wall, Until Too Late***

Under Canada's constitution, mineral reserves in a province are the responsibility of its legislature. Ottawa has jurisdiction over interprovincial and foreign trade. Therefore, the Province of Saskatchewan had full constitutional right to announce it was convening a select legislative committee to review the propriety of the bid, its impact on the Canpotex potash sales agency, and its overall impact on the future of Saskatchewan.

...the fertilizer industry has gone back to Page One with the announcement that Cargill is unwinding its 63% interest in Mosaic, the #2 potash producer.

By the time Marius Kloppers of BHP sat down with Brad Wall, the Premier was already dubious about the company's attitude on a variety of issues and unready to rely heavily on any protestations about what great corporate citizens they would be. BHP's avowed corporate strategy of producing minerals flat out regardless of market conditions was a clear threat to the Saskatchewan potash industry's business models. The Saskatchewan government's rejection forced Ottawa to kill the deal—even though Ottawa did not have—constitutionally—the primary jurisdiction.

Since then, the fertilizer industry has gone back to Page One with the announcement that Cargill is unwinding its 63% interest in Mosaic, the #2 potash producer.

This is a complex series of transactions and a potential buyer would have to pay the seller's extra income tax if they bought the whole company at once. Investors are obviously having trouble figuring how they should respond.

We remain of the view that the fertilizer industry is headed for a truly great year and that the long-term future for its best companies is more attractive than the outlook for all but a few base metal producers—primarily because the metal mines' reserve life indices are much shorter.

INVESTMENT ENVIRONMENT

With the BP battle mostly over, the oil sands are once again the Global Left's major rallying point in its ongoing war with the oil industry.

1. The Most Controversial Mining Projects

The Alberta oil sands contain roughly half of the world's proven oil reserves that aren't owned or controlled by governments. Apart from reserves harvested through Steam-Assisted Gravity techniques involving injections to the reserves from the surface, those massive reserves are harvested in huge open pit mines. When Teck Corporation announced participation in a major new oil sands project, it rightly claimed that its extensive mining experience gave it a body of knowledge and experience that would be extremely useful in building and operating this new oilfield.

With the BP battle mostly over, the oil sands are once again the Global Left's major rallying point in its ongoing war with the oil industry. It has been successful in convincing various US states and municipalities to pass edicts forbidding the use of "dirty oil." Many major pension and hedge funds have been ordered by some of their public fund investors not to own shares of oil sands companies, and to assist them in their public campaigns to block development of pipelines and refineries using oil from the sands.

The Economist recently published a detailed, dispassionate study of the oil sands, which reviewed all the environmental complaints and accusations, and considered the long-term economic importance of these resources.

We advised clients after the US elections that the oil sands producers may have been the biggest industrial winners from the Republican takeover of the House; Henry Waxman, who loathes the oil industry and longs for green fuels, was no longer Chairman of the House Energy Committee, and his replacement is a Texas Republican who had the temerity to say something polite about BP.

As *The Economist* noted, the companies are making great progress in reducing the environmental damage from the projects and much more progress is inevitable: the higher oil prices climb, the more the reserves are worth, and the more cash is available for prevention and remediation of environmental impact. It made the point that China is making many moves toward acquiring oil sands properties and buying oil sands oil. At some point, the magazine remarked, will Americans be really glad that their greatest rival is acquiring a huge stake in long-duration reserves that are currently there for American buyers' taking?

We believe that American energy security concerns will carry the day. Clients should be building the oil reserves in their portfolios by owning the companies with the world's longest-duration reserves.

2. Rare Earth Companies

There may be a shortage of rare earth deposits outside China, but there is assuredly no shortage of companies aiming to be rare earth producers.

We wonder how much of the research many of the penny stock buyers have conducted is based on the idea that they are buying *unobtainium*.

Deng Xiaoping trumpeted the enthusiastic forecast that rare earths would be China's oil. That meant that China went all-out to develop its resources, and now has a near-stranglehold on rare earth production.

Worldwide demand for rare earths is estimated at 134,000 tons per year, with global production of 124,000 tons. Estimates of 2012 demand range to 180,000 tons, soaring to 200,000 tons by the middle of this decade. So this looks like a miner's dream.

The sheer number of suddenly-expensive small companies with big dreams of rare earth production suggests that investors should take more than ordinary caution. We have not made a detailed study of this new mining boom, but we know the history of the uranium boom, and how few of those projects turned out to be great investments. We wonder how much of the research many of the penny stock buyers have conducted is based on the idea that they are buying *unobtainium*.

Our other concern is the ancient truth that, as rule, the cure for high commodity prices is high commodity prices. Tech engineers who have designed products based on cheap, readily-available lanthanides may be forced to do some re-engineering.

Nevertheless, we wish the speculators and the companies well. Not all booms end in busts for most of the well-managed players. There will doubtless be some huge winners, and we hope to know enough about this new mining industry to be able to make some recommendations in the near future.

3. Problems for the Rosy US Economic Forecasts

We believe the US economic recovery is proceeding, but we find it difficult to accept those expected 4%-5% 2011 GDP gains proliferating on Wall Street these days.

Two areas of special weakness concern us.

(a) The Roadblock on the US Road to Recovery: The Greek Model and State and Local Governments' Compensation Programs

The various cyclical components of US GDP are, collectively, back in gear. Factory production has been climbing smartly and steadily; net exports continue to climb, meaning that the US trade deficit is, statistically, a smaller

percentage drag than it has been for years; consumer spending growth has slowed, but continues to grow; farm income growth far outpaces GDP growth, which means much of the Rust Belt is gaining in relative prosperity (from a low base).

...in many states and municipalities, their employee benefit programs look like they were designed—and costed—in Greece.

Based on this overall cyclical growth, then in almost any other postwar cycle, economists would have confidence projecting 4-5% GDP growth for the next two years.

But this cycle is different: 15% of US GDP comes from state and local governments, which are collectively in their weakest financial condition since the Depression.

How important are the states to the state of the US economy? A report by analyst Steven Malaga in *City Journal* shows that, from 2000 through 2008, annual state spending rose from $700 billion to $1.1 trillion. If it had been constrained to growth equal to CPI increases plus population expansion, it would have been roughly $925 billion.

Where did that excess spending go?

Primarily into expanding payrolls.

The state and local government sector was the biggest contributor to US employment growth during the Bush Presidency, adding employees by the millions and putting them into the very kinds of benefit plans from which the private sector was fleeing—employer-pay for most or all of health care, and employer-pay for most or all of defined benefit pension plans, with, in many cases, pension eligibilities at ages that, in the private sector, were available only to professional athletes.

In other words, in many states and municipalities, their employee benefit programs look like they were designed—and costed—in Greece.

And many of those states and municipalities find that their financial crises—because of those platinum-plated plans—are at least as serious as Greece's.

According to the Pew Center on the States, as of last year they collectively had $3.35 trillion in pension liabilities and $2.35 trillion in assets, based on locally-supplied valuations. According to calculations by external experts from institutions such as Stanford, the real unfunded liabilities—based on actual investment returns from public plans—are closer to $5 trillion.

In recent elections, government employees' unions have pulled ahead of tort lawyers as the largest contributors to Democratic candidates. In some of the hardest-hit states, the bargaining about benefit plans has for years been between unions and politicians dependent on those unions for election. Example: in New Jersey in 2009, incumbent Democratic Governor John Corzine told a union convention, "We are going to fight for better pensions!" He himself had negotiated upgrades to the existing plans with those unions.

Public plans typically assume 8% returns, which is what they earned from the onset of the Reagan era to the end of the Clinton era.

Things didn't work out as the cheering throngs at that convention assumed: In one of the most heavily Democratic states in the land, Corzine was defeated by a Republican who campaigned on getting control over runaway pension and health care costs.

The bargaining successes of those unions have caught the eyes of public employee groups which have traditionally been outside collective agreements.

As *The Wall Street Journal* reports, unionization is now growing rapidly among the higher strata of public employees—managers and high-paid workers. They see the fragile position of their private sector counterparts and the seemingly-secure position of unionized public employees and are eager to enfold themselves into the guarantees of taxpayer-funded wealth and security.

This will be a year in which public sector plans receive more real scrutiny than they've ever had. And when it comes, there will be loads of reports of double-dipping and other abuses by some of the highest-paid officials—not the unionized workers. As voters learn that many bosses took early retirement on huge pensions, then took high-paid jobs in other states—with special extra pension accumulations, they will demand action.

Much of the criticism of the public plans will be uninformed: the average voter or civic official has difficulty understanding the complexity of the Project Unit Credit Costing of defined benefit plans.

Much will be demagogic: both political parties signed off on over-optimistic funding calculations and over-generous benefits back when stock prices were going higher every year and all the experts the big plans consulted told them the tech boom would last forever. (Public plans typically assume 8% returns, which is what they earned from the onset of the Reagan era to the end of the Clinton era.)

This is largely a case of shared mistake...

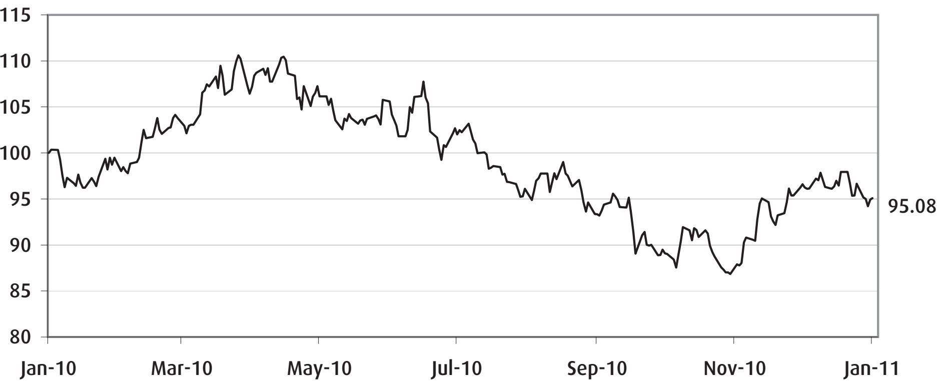
We do not ally ourselves with those who seek to demonize the public sector unions—let alone their members. This is largely a case of shared mistake about the real longer-term costs of public sector pension and health plans in an environment of extremely disappointing investment returns and deteriorating demography. (Had the plans invested heavily in commodity stocks when techs began to crash, they wouldn't be in such parlous condition, but there were few—if any—consultants out there to tell them about this class of equities—which had performed so dismally during the Triple Waterfall Crash of Commodities from 1980 to 2001. Instead, many of the public funds were talked into investing in those terribly-flawed commodity roll funds and managed to make minimal returns during the greatest commodity boom of all time.)

We are going to dig into this complex subject as yearend reports come from the states, and analyze the implications for investors in a future issue.

In the meantime, we simply note that all those state and local fiscal crises will trigger job and spending cuts. That means GDP growth is unlikely to attain the lofty levels projected by some big-name economists.

b) The Housing Horror Story That Won't Go Away

KBW US Bank Index (ETF) relative to S&P 500
January 28, 2010 to January 28, 2011



KBW US Regional Bank ETF (KRE) relative to S&P 500
January 28, 2010 to January 28, 2011

In April 2009, the S&P was at 814, rallying off its March intraday low of 666. The S&P is up 57% since then—yet home prices are up 3.3%.

When we turned very bullish in December, one of the encouraging factors was the strengthening position of the banking stocks compared to the S&P. As clients are well aware, this has been our single most reliable equity indicator for decades of strategy forecasting.

To our dismay, those indicators rolled over in recent weeks. We found out why when the Case-Shiller report came out last week. As we commented earlier, the report showed a fifth month of declining home prices: it covers twenty US cities and it shows that average prices nationwide are now a mere 3.3% above their April 2009 level. (We were naturally displeased to read that Chicago was one of the cities where prices went to a new low.)

In April 2009, the S&P was at 814, rallying off its March intraday low of 666. The S&P is up 57% since then—yet home prices are up 3.3%.

Our enthusiasm for equities has been bolstered by the surge in consumer confidence about the economic outlook registered in the polls since Obama did his brilliant back flip after the election,

But if the US is entering a housing double-dip at a time there are no new Washington-contrived acronymic housing subsidy programs, then investors should beware.

Global investors were shocked at Britain's report of .5% negative economic growth in Q4. It has been blamed mostly on a record-cold December, which takes some cheek, given that the renowned global warmists of East Anglia U. keep insisting that Britain's climate is the hottest in history.

A new US housing crisis at a time Washington's fiscal deficit is $1.5 trillion would be a far more severe blow to the economy than its predecessor.

3. An Islamist Revolution?

In retrospect, the Mediterranean Arab nations' crises may have begun to fester when Iraq resolved its difficulties in cabinet formation after the first-ever election in a major Arab nation.

The problem for democracy-loving people is that this revolt is a spontaneous, largely-leaderless rebellion against an aging, corrupt dictator...

That demonstrated that maybe—just maybe—George W. Bush was right that the desire for democracy is universal, and that most Arabs are dissatisfied with their various autocracies.

The first surprise was in Tunisia, whose autocrat was deposed in days—quite peacefully.

With the Internet afire with enthusiasm and rage, the revolutionary impetus moved to confront the Mubarak Dynasty in Egypt, which has been in power for nearly thirty years.

Egypt has been America's key Mideast ally and a force for maintaining peace with Israel. (Israel was recognized by Egypt after the Begin government's security force uncovered a plot to murder then-ruling Sadat. Begin decided to amaze Egypt by revealing the plot and the evidence the Israeli spies had uncovered. Sadat's security responded forcefully, and disaster was averted.)

The problem for democracy-loving people is that this revolt is a spontaneous, largely-leaderless rebellion against an aging, corrupt dictator who was planning to pass the throne to his son. Any attempts by Mubarak to negotiate with opposition leaders could be futile, because there is only one tightly-organized group of sworn opponents—the Muslim Brotherhood.

Russia's czar was deposed in a pro-democracy coup, but the Mensheviks and other liberals were too disorganized to establish a parliament and take control. Lenin came in, and the small minority of ruthless, disciplined Bolsheviks purged the leaders and established the first Communist state.

The extreme Islamists were nowhere near a majority in Iran when the Shah fell—with a little help from Jimmy Carter.

But they took charge and soon the millions of liberally-inclined Iranians who had cheered the Shah's downfall were in shock, in jail, or on the run.

Will that be Egypt's fate?

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation
Capital Markets Investments
US Pension Funds

	Allocations	Change
US Equities	21	unch
Foreign Equities:		
European Equities	3	unch
Japanese and Korean Equities	0	unch
Canadian and Australian Equities	7	unch
Emerging Markets	14	unch
Commodities and Commodity Equities*	13	unch
Bonds:		
US Bonds	17	unch
Canadian Bonds	6	unch
International Bonds	5	unch
Long-Term Inflation Hedged Bonds	8	unch
Cash	6	unch

Bond Durations

	Years	Change
US	4.50	unch
Canada	4.75	unch
International	4.25	unch

Global Exposure to Commodity Equities

		Change
Precious Metals	29%	–2
Agriculture	31%	+3
Energy	19%	–2
Base Metals & Steel	21%	+1

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

RECOMMENDED ASSET ALLOCATION

Recommended Asset Allocation
Capital Markets Investments
Canadian Pension Funds

	Allocations	Change
Equities:		
Canadian Equities	20	unch
US Equities	8	unch
European Equities	3	unch
Japanese, Korean & Australian Equities	2	unch
Emerging Markets	12	unch
Commodities and Commodity Equities*	13	unch
Bonds:		
Canadian Bonds		
- Market Index-Related	22	unch
- Long-term RRBs	8	unch
International Bonds	6	unch
Cash	6	unch

Canadian investors should hedge their exposure to the US Dollar.

Bond Durations

	Years	Change
US (Hedged)	4.75	unch
Canada:		
– Market Index-Related	4.75	unch
– Long-term RRBs	5.75	unch
International	4.00	unch

Global Exposure to Commodity Equities

		Change
Precious Metals	29%	–2
Agriculture	31%	+3
Energy	19%	–2
Base Metals & Steel	21%	+1

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

INVESTMENT RECOMMENDATIONS

1. Despite their recent run-ups, long-reserve-holding base metals stocks remain very attractive.
2. If Egypt's crisis is peacefully resolved, reduce precious metals stock exposure in commodity stock portfolios but retain these stocks in general equity portfolios as risk-reducers. However, the other commodity classes have superior short-term fundamentals if the global economic recovery continues and the uneasy peace in the Mideast holds.
3. Do not sell the Australian iron ore and coal producers' shares because of the Noahan events there. Their earnings are obviously taking a hit, but the prices of their products have been driven sharply higher, and that means those earnings setbacks will be swiftly recouped. Besides, investors should have longer time horizons than what is needed to clean up after a flood. For investors who missed the big run-ups in those stocks, now is an excellent entry point.
4. Maintain a strong position within the agricultural sector, (assuming that you include the fertilizer stocks in that sector, rather than in your mining allocations). The Obama Administration remains impaled on fixation for ethanol, which means its minions in the Environmental Protection Administration will move forward in their plans to increase the ethanol allotments for gasoline blending. At a time of a global food shock, to be increasing the demand for highly-subsidized ethanol is immoral public policy. However, it is assuredly good news for the leading agricultural stocks.
5. The euro's recent strength is probably unsustainable. Company treasurers should be borrowing in euros and bond investors should be wary of euroexposures.
6. Bond portfolios' durations should be near benchmark levels. The time for extending durations because of an increased chance of a double-dip recession in Europe and/or the US, would also be a time for loading up on gold.

THE COXE STRATEGY JOURNAL

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