

Cyclical, Secular, or just Bull?

(Feature Presentation and the Cambridge House International Vancouver
Resource Investment Conference January 26, 2004)

Eric Coffin, HRA Subscriber's Service

www.hardrockanalyst.com

Secular – (adjective (s k y -l r)) Middle English,, meaning “Of an Age”
from old Latin, *saeculum*, meaning “ a generation, an age”

There's been a lot of talk lately about the bull market in Commodities. Since 2001, most of the major commodity indices have risen by over 40%. That, in itself, is not unusual. Commodity prices are cyclical by nature, moving with the ebb and flow of the world's economy as a whole. It's wasn't very long ago that commodities in general were relegated to the dustbin of history, old economy relics that would scarcely be needed by the “new paradigm” world that would, presumably, survive on nothing but air, water and an AOL account. For those who take the long view however—the real long view, not the Saturday supplement variety, this sort of talk was welcome news indeed. Bull markets are sired by Bear markets and those who pay attention to cycles knew that the distain shown for anything non “new age” was a sure sign that it's time was at hand.

No one doubts any more that we're in a bull market. *HRA* stated calling for one back in 2001 when we could see that the US Dollar was finally, (finally!) starting to show some signs of weakness. Now that we have the market that so may waited for, we have to climb the wall of worry every rising market faces. Being a cyclical sector, this wall is even taller for most investors. They know that commodity prices move both ways and no one wants to be the last one to leave the party. The question facing us all right now is: Just what kind of bull market are we in?

Charles Dow, the namesake for the famous index felt there were a number of different trends that could be classified based on duration and size. **Primary Trends** are broad movement lasting 4-6 years, where each successive rally reaches a higher (or lower) level and each decline ends at an higher (or lower) level, depending on weather it's a Bull or a Bear trend. **Secondary** trends are much shorter, counter-cyclical moves (the bear market rally, or bull market decline) that are not large enough to violate the overall Primary Trend. The Granddaddy of them all is the **Secular** trend, which is made up of two or more Primary trends in

sequence and lasts 5-20 years. The bull market in equities from 1982 to 2000 is the best known example of a secular trend.

Of course, the story was a little different for most commodities, and especially gold. While the equities markets were celebrating the “greatest bull market in history” (ending in the greatest investment bubble in history) gold was going through a seemingly endless bear market of its own.



To us at HRA, the evidence clearly indicates this is a SECULAR Bull Market. We won't know until it's over how long it will last, but we expect it to be long and its effects to be dramatic before its over. There may be Technical Analysts who can chart it and point to tops and bottoms and resistance levels and breakout points but our conclusion is based on fundamentals. Secular markets are always based (Bull or Bear) on a confluence of events that have the strength and duration to move a market one way for a very long time before they run their course. We are in such a period.

What's driving it?

•**The US Dollar** - most commodities will move against the Dollar, though they all have their particular supply/demand factors. As the dollar weakens, commodities, priced in Dollars themselves, rise. The more “precious” the commodity, the more it has a tendency to act like a currency itself, giving it a stronger inverse correlation to the Dollar. Gold is the best example of this, though the move in the Dollar is strong enough to pull most Dollar denominated commodities in its wake.

An often ignored side effect of this “Dollar driven” bull market is that in regions where the home currency has a strong negative correlation to the Dollar (i.e. Euro Zone, South Africa) capital intensive new resource developments are often actually inhibited. The strong local currency drives up costs in relation to the US Dollar price of the commodity being produced. You need only glance at a chart for gold in Euros or SA Rand to see how strong this effect can be. Another effect of this, if the commodity is one where there are enough producers willing to act in concert, is attempted re-pricing. There are few commodities that have a market with any sort of true oligopoly. The only widespread current example might be oil. Americans may find it confusing and view with hostility the comments by OPEC about either changing the base pricing currency for oil, or cutting back supplies. To those who think in Dollars, oil looks expensive—to many who produce it however it has, at best, gone nowhere in price in the past three years or, at worse, dropped. If nothing else the current global situation may force a lot of “Dollar Chauvinists” to start seeing how the other half lives.

•**The preceding bear market.** Markets sow the seeds of their own destruction. The long bear market in commodities led to widespread consolidation, the cutting or elimination of exploration and development budgets - new sources of supply were not getting found. Few large projects are in the pipeline right now. It's important to note that while some commodities have proven deposits that are available at high enough prices (copper and zinc come to mind) there have been very few new finds so far in this cycle. Many junior companies have just completed their first real financing phase, based on long held projects. The real grassroots work in new areas that often leads to the “world class” discoveries is just getting started.

•**The “bear mentality”** - still in existence among management groups at the production level. Companies are not ready to assume higher prices will last - won't commit to development of marginal assets. We have been cautious on some commodities where we know from our industry

contacts that there are some large deposits waiting in the wings. So far, we've been impressed by the self restraint many companies have shown. They avoiding rushing projects to market and most companies are still shying away from projects that are not in the bottom quartile of production costs. This sort of "rational" behavior may help extend the bull in commodities even more. Keep in mind too that those who have to build and run mines, not just trade on them, have to think in terms of 10,20 or 30 year price cycles. The bear mentality is a reaction to many companies getting overenthusiastic in past short cycles, building at the top and having a bankrupt operation on their hands three years later. The history of mining is littered with the carcasses of mine operators who built mines thinking the cycle highs would be the long run averages. It takes time to change that sort of psychology.

Demand Side

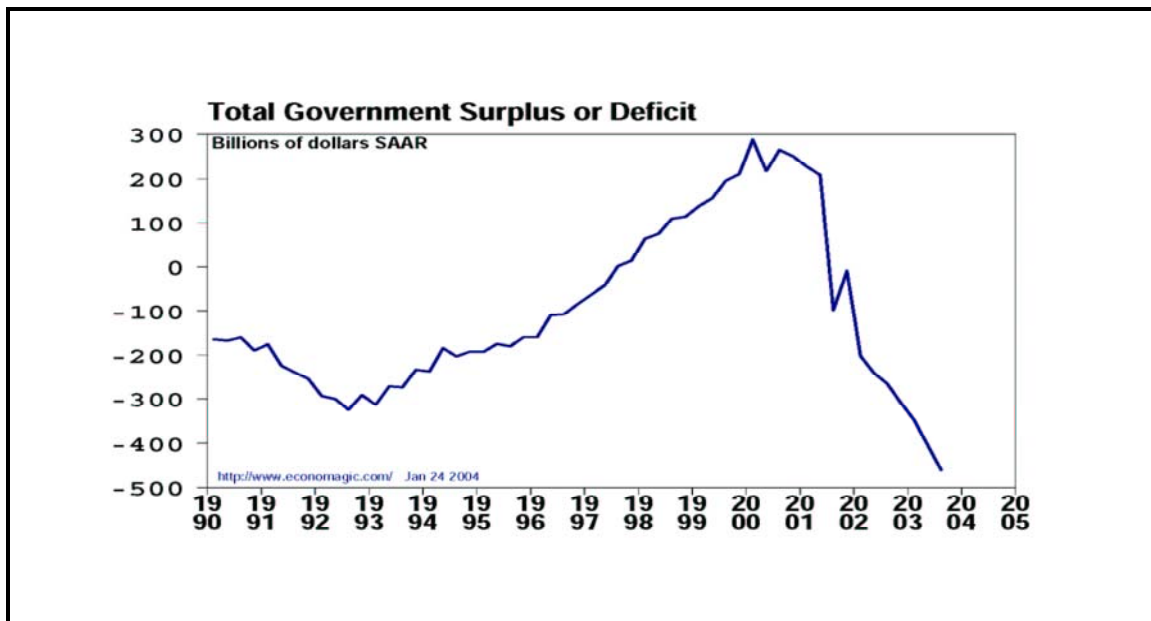
- China and East Asia undergoing huge growth - developing a middle class with a taste for consumer goods.
- Infrastructure build out in many areas of the world, demand for basic materials. Its hard to overestimate the scale of this without seeing mainland China for yourself. The country is one large construction site. China's growth rate seems unsustainable but other countries have managed to carry 7-8% rates for several years during a similar periods in their economic maturity.
- China has gone from net exporter to net importer for several metals, both oil and coal now following the trend.
- Just in time inventory practices. Most industries have given up the old practice of stocking several weeks or months of needed supplies. This was inefficient, especially so when commodities were in a bear phase and you could buy most things cheaper tomorrow than you could today. Just in time practices mean there is less in the supply chain that can either hold back purchasing or even be fed back into the markets during times of high prices.

The "Big Picture" on the US Dollar.

Currencies can behave like commodities and commodities can behave like currencies. Currencies are subject to the same supply demand factors as any economic good. In the past few years a number of factors have come together to reduce the demand for US dollars at the same time that the market is being flooded with them. We've written in the past that we consider that "Dollar production" to be a premeditated act. The joint trade and Government deficits are forcing the US to supply dollars

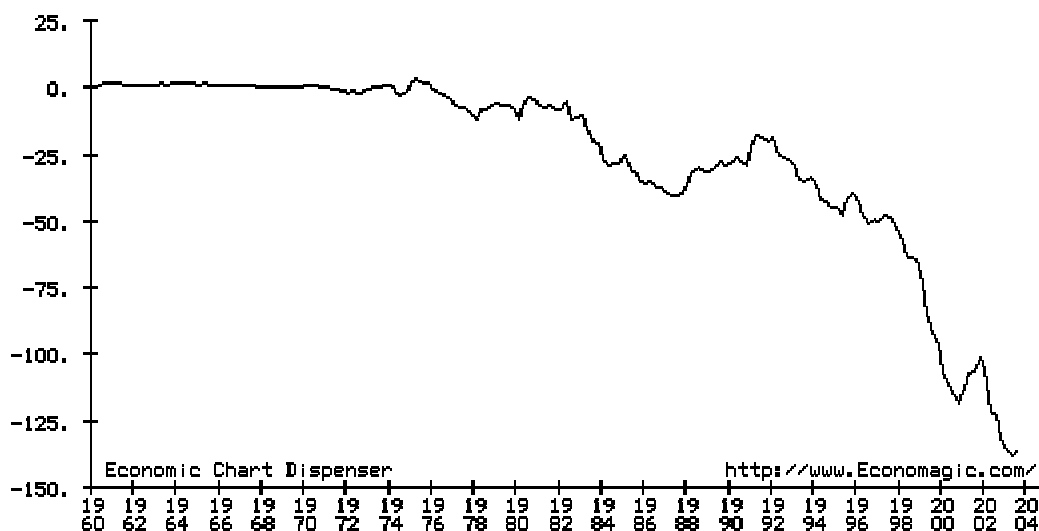
through loan creation to cover the shortfalls. The charts below indicate how strong these deficit trends are.

1. Government debt. The chart below gives a 15-year history of the federal governments surplus or deficit. The trend since 2000 is unprecedented in steepness of the plunge to deficit and the depths it's attaining. Even this year's election year budget projections (which are notoriously inaccurate) don't show the government getting back to breakeven for several years. We doubt they will be able to manage even that, much less get into a position to generate surpluses.



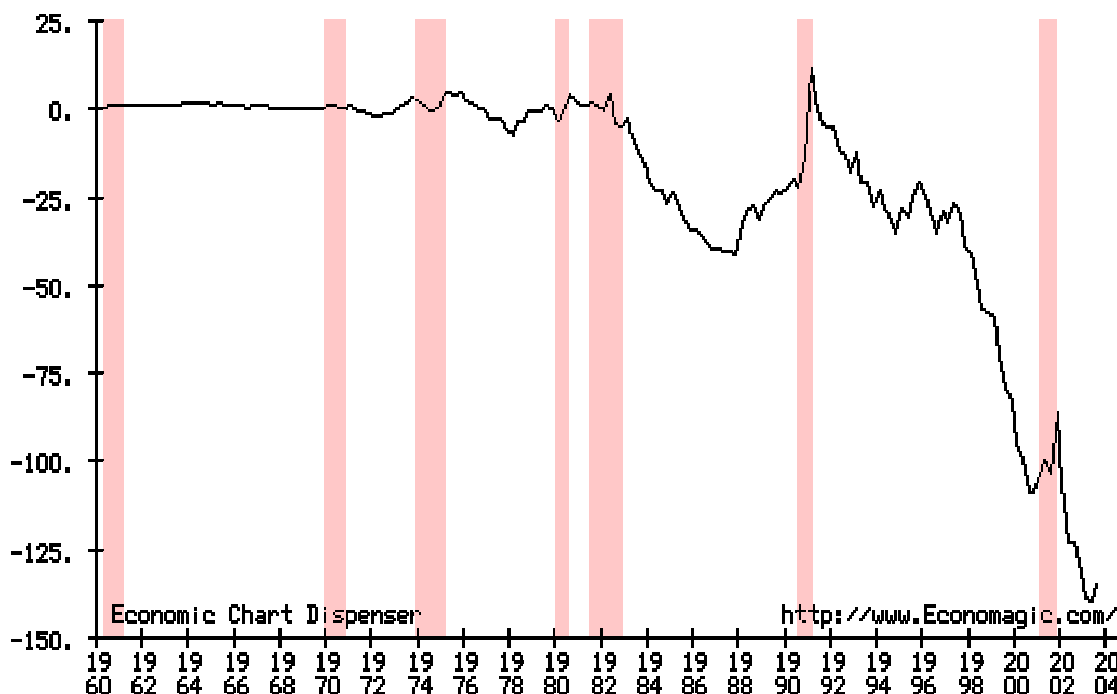
2. The trade picture. Just as bad. America is exporting Dollars (borrowing abroad, actually) in order to sustain levels of consumption that it cannot afford. The chart below displays a 44 year history of US merchandise trade balances. Again, the breakdown is both dramatic and unprecedented. Note that this chart was extracted before the latest quarterly data was available. Based on preliminary numbers the small upturn in the trade balance shown at the right side of the chart is probably just another in a series of "blips". The major bearish trend is unchanged. This chart is important since currency value is often the most important variable when it comes to correcting trade imbalances. The fact that the drop in the Dollar to date has had little impact on the trade deficit implies the US Dollar still has not dropped enough.

Balance on Merchandise Trade; Billions of Dollars (Quarterly Data)



The Current Account, which is the summation of the country's trade in goods and services as well as interest costs (payments from foreign sources for debt held by Americans or returns on external investments add to the Current Account—interest paid to foreigners on US debt held outside the country or returns to foreign owners of US domiciled investments or business detract from the Current Account). The chart below shows the quarterly current account balance since 1960 and it, of course, displays the same sort of deterioration. It's interesting to note that periods of recession (the dates shaded in pink) tend to improve the balance of payments picture, thanks to decreasing imports and a reduction income flows offshore. Obviously, it's not in the Administration's plans to try and induce a recession during an election year, so we can't expect much "help" in that direction. We think the US, like many nations before it, will find its much harder to get out of a current account trap than it was to get into it. We expect the amount of foreign held debt to keep increasing. Its already beginning to reach levels where debt service costs will be adding materially to the balance of payments deficit. Much of the government paper being bought offshore is short duration. An inevitable rise in rates may worsen the current account situation if interest payments to foreigners overwhelm increased investment in the US to capture those higher rates.

US Balance of Payments (Current Account) Quarterly Amounts



SUMMARY OF EFFECTS ON THE DOLLAR

The Dollar is subject to negative factors that are not both powerful and premeditated. Washington is not only blasé about the Dollar dropping—its actively pursuing its fall.

The current liquidity trap forces the Fed to create Dollars, and trading partners to attempt their own currency deflations to counter it.

The election year political agenda precludes “old fashioned” remedies for the govt./current account deficit i.e. spending cutbacks and tax increases. The “sure fire “ solution to CA deficits (a recession) is not in the playbook.

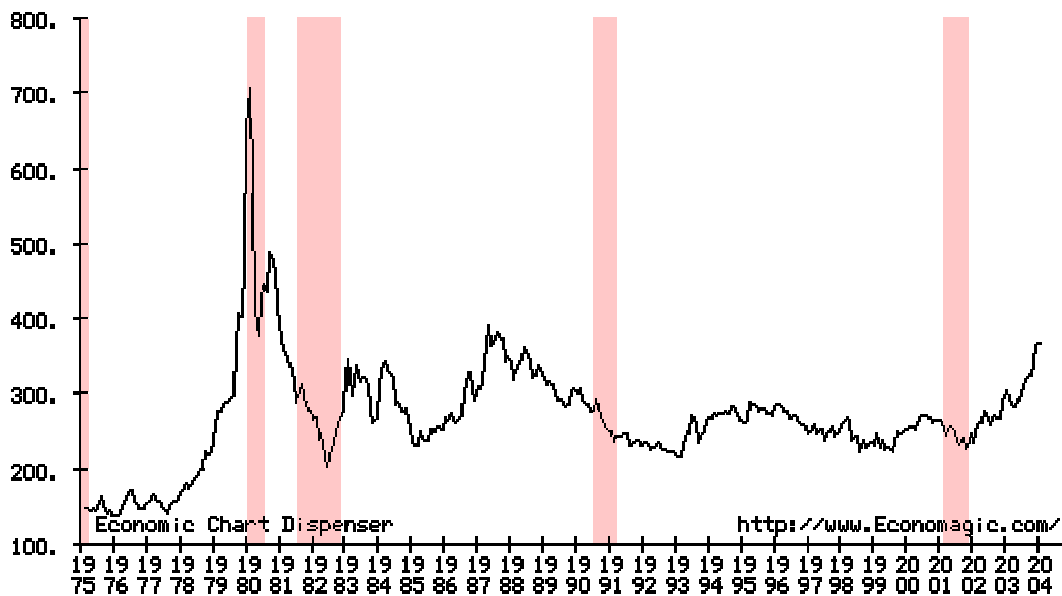
These are LONG TERM TRENDS that are not easily reversible even if the political will exists, and there is no indication that it does. Similar situations with other currencies in the recent past (The British Pound in the 1970’s) lead to currency declines of 50% plus - roughly twice the loss in value the Dollar has seen to date.

A long bear market and changes in the production sector have altered the supply/demand picture exclusive of the Dollar. This hasn’t been factored into price yet.

The Dollar and Precious metals prices.

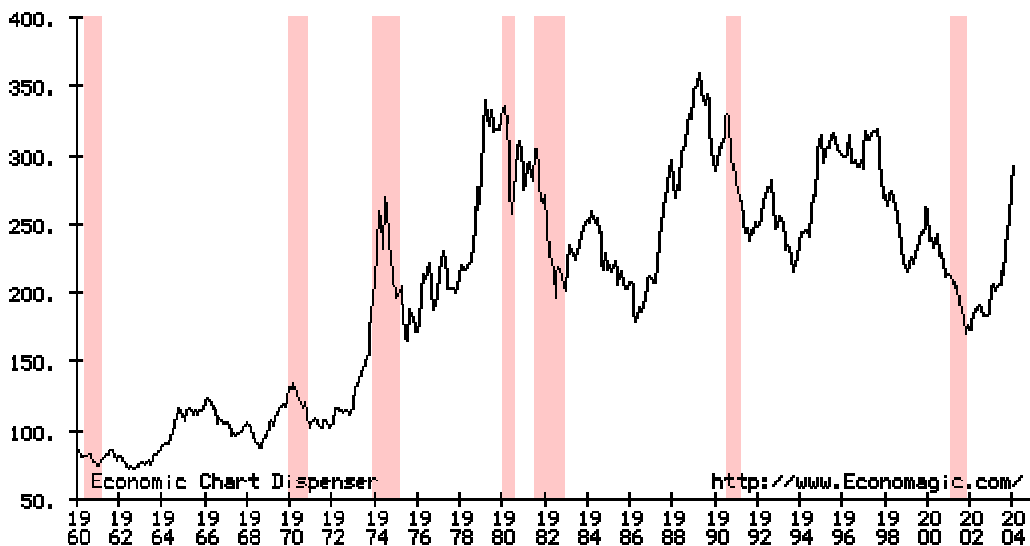
The chart below depicts the US Dollar Index and the CRB Precious Metals index. The effect of strong moves in the currency can be clearly seen—in the run up to the Plaza Accord and in the current bear market for the Dollar. It can also be seen that there is not always a strong negative correlation and that other supply demand factors also drive the market, such as the 1990's hedging binge by the major producers that helped to cap the gold price even in the face of the Dollar's decline.

CRB Precious Metals Sub-index, copyrighted by Bridge Commodity Res



The picture for base metals is slightly different:

CRB (BLS) Metals Sub-index, copyrighted by Bridge Commodity Resear



The movement of the CRB metals index against the Dollar can be a little more clearly seen—as can the cyclical movements in the index in relation to periods of recession and economic expansion. The strongest moves took place, as you would expect, when there was more than one positive force was at work. Periods of strong expansion and Dollar weakness display the longest and strongest up trends. The current environment has all the makings of a historic cycle. The Dollar is fading rapidly, and has much farther to go. The US current account is in deeply negative territory and there is no political will in Washington to impose conditions that might change it. The G7 meetings will come to nothing since the US clearly wants a weaker Dollar. At the same time, an economic expansion of enormous proportions is gripping much of Asia, driving up demand for the whole commodity complex.. Changes in the advanced economies have made basic materials a smaller part of the economy with a smaller effect on final pricing. In other words, these economies are able to bear higher prices than before without many ill effects.

The Bottom line? A bull market based on long term price and demand drivers combined with a supply side that is likely to remain cautious and slow to respond with production growth.

The stage is set for continued currency based price increases coupled with increased demand and a production sector that will be slow to respond with new production.

In other words - **A SECULAR BULL MARKET**

The Fun isn't over by any means. These long-term factors will take quite a while to work through the market. Many people (even us) will probably be surprised at the heights some commodity prices achieve before this bull run is over.

But still - be cautious - ALL stocks are trading stocks, even those in a bull phase. .

Take the profits the market gives you - generate zero cost positions when you can. In a strong bull cycle for any sector many stocks will get overpriced. Trade from overvalued to under valued or undiscovered situations when possible.

Be aware of potential problems – a US Recession (though you should note that in the case of the last secular commodities bull market—the 1970’s—recessions gave the market a pause but only a pause—before upward momentum resumed. Expect concerted effort by trading partners to drive the Dollar up at some point. Somewhere above \$1.30 to the Euro, the Euro Zone countries are likely to try some intervention. It probably won’t work in the long run but could create a pullback. If Asia ever decides it has all the US debt it wants interest rates will start to rise, regardless of what the Fed or Washington want. Expect some “jawboning” before the Miami G7 meetings next month and traders testing central banker’s resolve. Expect to see more instances of central bankers trying to sway traders—though they have almost never succeeded at this in the past.

All markets have reversals, so will this one. Use pull backs wisely to average down or open new positions.

(The preceding is a copy of the feature talk given by Eric Coffin at the Cambridge House International Resource Investment Conference in Vancouver in January. David Coffin gave a separate talk on current exploration hotspots and some of the companies covered by the HRA news services. Many of the companies mentioned have seen large gains in the short period since the conference.

Eric and/or David will be speaking at the PDAC in Toronto, Cambridge House Conference s in Calgary, Toronto, and Vancouver and at several resource and gold conferences in the United States this year)

Now in our ninth year of publication, the HRA family of publications delivers superior gains and insight on gold, silver, metals and diamond stocks from editors with combined direct industry experience of over 40 years. Experience counts. The average gain for over 50 open positions (stocks we’ve discussed in the past three years) is over 150%. Want to know how HRA can help YOU profit from the bull market in commodities? Please visit our website at www.hardrockanalyst.com and scroll down to the “Articles” section on our main page. There you’ll find a description of our services and complimentary excerpts from past HRA Dispatch and HRA Special Delivery issues as well as a free copy of a recent HRA Journal