



Reboot...

May 26, 2009

The greatest economic realignment since Genghis Kahn took over Eurasia's trade routes is continuing apace. The west remains mired in an assets contraction of its own making, and the east is refocused on channeling its growth engines into domestic consumption. The resource sector, which is our focus and which has been governed by those growth engines for a decade and half, is indicating at least the expectation of continuing gains in the east. That does not mean we ignore what is going on the developed west, plus Japan.

Most of the planned bad news on the US banking system is now on the table or at least anticipated, in some form. The stress test requirements for US banks at \$75 billion of new capital required are workable, though heavily dilutive. There are legitimate doubts that this will actually be sufficient given the depth of the hole these banks have dug. And, there is still much to be done on making various derivatives markets more transparent so that can be properly figured into the mess. More shoes may drop on western banking, and particularly in Europe that has been less willing to write down its losses. At best a long period of capital accumulation is still ahead in order to deal with the over leverage that caused the problem. However, the LIBOR rate has shrunk enough to indicate commercial banks feel they are sorting each other out, and the TED spread between US T-bill and Eurodollar rates has slipped back below 50 basis points that is the top end of "normal" risk. So while some banks are still of necessity scooping up capital to their own accounts, it's clear others believe they can gauge how to risk the capital that they do have for lending, and that they are finding non-government homes for capital that they are again comfortable with.

European economic stats continue to look worse than hoped for, in large part on the back of weak German exports. Japan's numbers are equally awful, and for much the same reason. Both Germany and Japan do have workable banking systems, and a fair bit of cash in their economies (actually a lot of when the trillions of dollars in Japanese have been stashing in their Postal accounts for nearly two decades are included). Both Germany and Japan have focused on selling finished goods to, primarily, their higher income "developed" peers. It will take a while yet before the efficiencies this particular export focus has required of these economies can be translated into workable gains selling to lower wage emerging markets. But, both Germany and Japan do have the pieces in place with which to do this revamping. The same can not be said of Russia, which is seeing its GDP simply crashing. This is being blamed on weak prices for commodities, and oil in particular. It has as much to do with hubris during the good times when the oligarchs grew a serious indebtedness on the back of inefficient industries. Finding the capital to repair this will now be much tougher, and especially given Moscow's penchant for reacquiring workable projects, with or without owner consent. Russia is now seen more as a gauge of growth rather than one of its engines. It plus the aforementioned "developed exporters" are the three economies that will offer the best view of trade-flow changes in higher wage economies.

On the demand side of the resource equation, we are looking at a number of geopolitical waypoints with as much interest as we are bare statistics. The most important this year has been the recent solid gains for the ruling Congress party in India's national election. This outcome included a down turn for regionally based parties that have been important to forming a government on the subcontinent. We consider this important for several reasons. It indicates that the world's largest democracy senses the road to continued growth is paved by a national consensus. Though we tend to use "nation" and "economy" as interchangeable geographic units, this is really only so when all of a nation is singing from the same songbook. Furthermore, the continuity of government in a country where this has been difficult (understandably given the breadth of India's culture), is a signal that this electorate is comfortable with a status quo that has been generating growth, and is looking forward hopefully to the future.

Also to the good is the increasing thaw between mainland China and Taiwan. The 60 years of angst and Cold War rhetoric that has forced these “two Chinas” to conduct relationships through Hong Kong has needed to find some realistic endpoint. Whether the thaw is partly due to the debt crisis changing priorities, or is more simply a time-has-come event, those who watch the cross-straits patter increasingly consider it to be real. This has been a major thorn in the side of regional relations. Some may argue that it means Communist China will just be that much more able to throw its weight around. We would reply that China is growing into an increasingly important player regardless of its border outline, and that doing so with the fewest irritants is the best way to ease everyone into the new reality.

Attitude is a major ingredient of growth, or decline. The surge in Mumbai’s stock exchange after the election, which held at a 17% gain after a week of trading, underscores India determination to maintain its growth path. Add to this a newfound desire in neighboring Pakistan to sort out its own, and still very threatening, internal political problems and you see the makings of South Asia’s continued economic rise. The decline of “two Chinas” rhetoric is equally a signal that East Asia wants to heal old wounds in the cause of a better future. These moves in the globe’s two most important growth centers result from the belief that prosperity can be internally governed.

Even rising tensions in Peru’s Amazon region where indigenous peoples seek some greater say in the region’s natural gas sector weighs to progress. Peru is the strongest growth economy in Latin America. Brazil’s gas importers would rather not have to deal with this, but Peru’s indigenous groups are seeking out a better deal rather than a halt to the new prosperity. Though the HRA focus in Peru is Andean hardrock potential rather than Amazonia (at least at this point), this is a new irritant we are watching with interest, and some degree of concern. That said, we do sense this is another old wound that may finally be dealt with now that Peru sees itself on a growth path. It is during periods of great change such as the one we find ourselves in when a myriad of old disputes can finally be laid to rest and allow a stronger focus on more productive pursuits.

Now for some even more Pollyannaish musings, right? Not so much. We have watched recent discussion of “green shoots” with some interest, while wondering at their focus on this or that bit of statistical input for meaning. The numbers do have meaning, and in particular for the Western economies in which most of them are generated. They will be important for gauging the mood of western markets for some time to come. But real economic impetus remains in those areas where the “shoots” began to sprout long before western banking killed off its empire. India, China and Peru are all expected to sustain decent, positive growth rates this year by even the dourest of prognosticators. There is no pretense, from us or these economies’ own seers, that the fragile West couldn’t still wreak serious damage to their growth. However, a belief that working around the West Mess is the best way to ensure growth is building outside of the industrialized nations. That is the most important green shoot we see at work, at least from the perspective of resources and in due course for the global economy as a whole.

Meanwhile, the auto sector contraction does continue apace, and the various western housing bubbles haven’t deflated enough to bottom prices. Stressed US banks have been sourcing the capital they need, while those in the UK have been dealing with warning of a potential downgrade by Moody’s on their country’s sovereign debt ranking. Whether that potential loss of AAA status for the UK government is because of or despite of its bank nationalizations will be souring a lot of gin & tonic patter over the next few months. It is already having a broader impact on markets.

The stretching out of Britain’s debt mess augured by a lower sovereign ranking is already being reflected across the pond. US T-bill rates are already shifting upwards in expectation that Washington is in for similar treatment. This is another chink in the greenback’s reserve currency armor. Calls to reorder the global currency system by shifting it away from the US\$ as the reserve currency are already on the table. A re-ranking of US government debt would surely increase these calls, and we expect to see India soon join China and Brazil in calling for trade arrangements using their own currencies. It will take a while before the move away from reserve-currency pricing of trade is replaced by a meaningful number of bilateral pricing schemes. It is not however too soon to view some commodity moves in these terms.

No one questions that the gains for copper since February resulted from Chinese buying, nor would many question that it has been copper’s gains that pulled other metal prices higher. There has been a nearly continuous decline since mid March of London Metal Exchange (LME) stockpiles that are the most important gauge of excess supply for base metals. This inventory has already lost over half of the excess copper that began building in it as last autumn’s debt crash approached, and it now sits at about seven days of global demand. Even though we are

comfortable stockpiling of copper in China is not likely to exert downward pressure at some future point, copper does simply need to consolidate this year's gains. For that reason we are focusing accumulation in the copper space on growth stories in that are still playing price catch-up from last autumn's trouncing, and we are not yet ready to move too far down the food chain in the base metals space. But we do think there is reason to be in copper stories. A weakening US\$ could put some upward pressure on most commodities, though this may be limited given the economic times. As significant this time around are signals from China of a stronger Yuan. Price support for the red metal has been at the 30,000 Yuan/tonne level that Shanghai buyers have been using as a base, which is about \$2 per pound. If the Yuan does strengthen to a meaningful degree that will support copper's dollar based pricing without an actual cost increase for its main buyer.

Gold has gained 4% through the past week. The yellow metal is moving from its recent role as a fear barometer back into its traditional pastime of trending in opposition to the US\$. We expect that to continue, and we watch the strengthening Indian Rupee as an important harbinger of gold's price potential. India has long been the most important physical market for gold and silver. It was the destocking of gold out of India that held its price in check during the first quarter despite the increased investment buying of the metal in other markets. There has been support at the Rupees 1400/gram level in India, which has been an upward shifting target level in Dollars of late that currently equates to about US\$930 per ounce. Just how an improved mood within India will impact that economy's gold habits is an open question. Crisis selling in India does not mean buying will resume now because Indians are feeling better about things. It may however mean they will again be gold holders rather than sellers. That would smooth the way to a higher gold price as the dollar weakens.

There has recently been a greater shift towards asset rich juniors and some target rich gold explorers that are both funded and active. When the gold price is rising, it is normal to see longer term gold players shift some gains on more senior stocks in the sector to these riskier gold equities. If the weakening US\$ pushes gold back towards its recently established highs some of these companies will become take-over candidates, and others will be seen in expectation of further take-over. The pieces have already been put in place for this to happen.

The resource heavy Toronto Stock Exchange wrote almost as much business as the New York Stock Exchange did in the first quarter of this year (when the C\$ was weaker than it is now). The first and largest chunk of that went to gold players, and the expectation now is that some of those funds are about to be used for shopping. As a closing note, there has been a more recent dollop of funding into the copper space since most of the gold player coffers have been filled. We are just now starting to see expectations for that cash tickling the price of low hanging red metal fruit. Ω

David Coffin and Eric Coffin produce the Hard Rock Analyst publications, newsletters that focus on metals explorers, developers and producers as well as metals and equity markets in general. If you would like to learn more about HRA publications, please visit us [HERE](#) to view our track record, see sample publications and other articles of interest. You can also add yourself to the HRA FREE MAILING LIST to get notifications about articles like this and other free analyses and reports.

The HRA – *Journal*, *HRA-Dispatch* and *HRA- Special Delivery* are independent publications produced and distributed by Stockwork Consulting Ltd, which is committed to providing timely and factual analysis of junior mining, resource, and other venture capital companies. Companies are chosen on the basis of a speculative potential for significant upside gains resulting from asset-base expansion. These are generally high-risk securities, and opinions contained herein are time and market sensitive. No statement or expression of opinion, or any other matter herein, directly or indirectly, is an offer, solicitation or recommendation to buy or sell any securities mentioned. While we believe all sources of information to be factual and reliable we in no way represent or guarantee the accuracy thereof, nor of the statements made herein. We do not receive or request compensation in any form in order to feature companies in these publications. We may, or may not, own securities and/or options to acquire securities of the companies mentioned herein. This document is protected by the copyright laws of Canada and the U.S. and may not be reproduced in any form for other than for personal use without the prior written consent of the publisher. This document may be quoted, in context, provided proper credit is given.

©2009 Stockwork Consulting Ltd. All Rights Reserved.

Published by Stockwork Consulting Ltd.
Box 85909, Phoenix AZ , 85071
hra@publishers-mgmt.com <http://www.hraadvisory.com>