



## **2009 Montreal Investment Conference**

# **“Interest Rates (Liquidity) and Currencies**

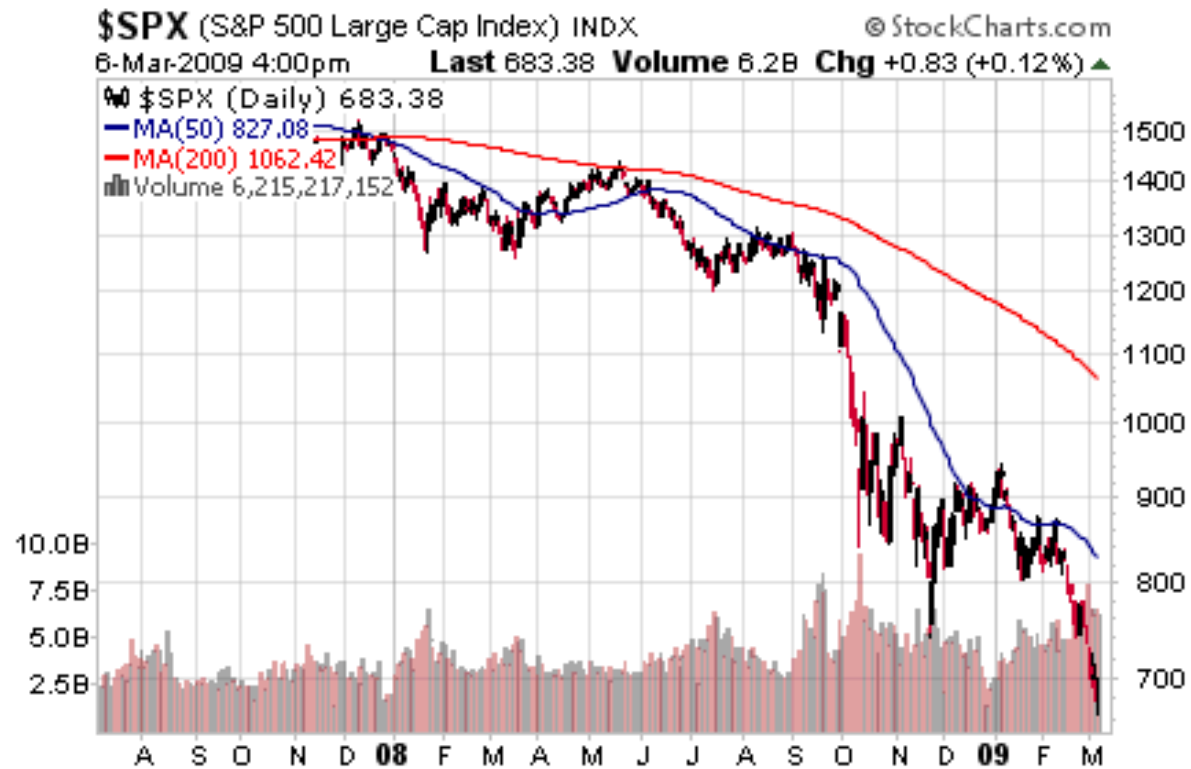
# **Driving Metals and Markets”**

***Eric Coffin; Co Editor, HRA Advisories***

*(I have added comments to this slide presentation so that those who could not listen to the talk can get more detail on the main points covered. If you were there and note some discrepancies, my apologies. I don't "script" these talks in the literal sense and*



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So now what?

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The debt crisis and its aftermath will reverberate in international markets for many years to come. The combination of traders parking money in the bond market as insurance against an uncertain future and direct and indirect purchases in the Treasury market by the US Federal Reserve has led to historic low rates across all markets in the G7.

The Fed recently announced it would be winding down its TARP program bond purchases, which the market took in its stride. Indeed, short term Treasury rates have moved even lower since those announcements. Similar moves have been taken by most central banks, generating one of the largest floods of liquidity in recent memory,

This flood of money has helped generate large scale buying across a number of asset classes like equities and commodities. Is this just another bubble that is going to blow up or will the world's advanced economies be able to navigate this crisis successfully. In other words, is the worst behind us and, if it is, what can we expect from the markets in coming months?



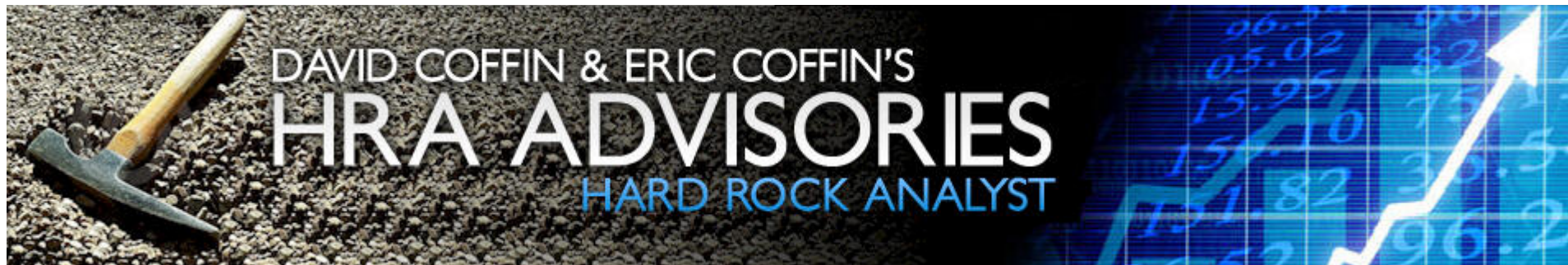
- The largest fiscal stimuli in history. Every G20 country with borrowing ability or cash on hand has undertaken stimulus programs.
- Macro adjustments like spending and interest rates have significant time lags.
- Market clearing prices for assets will speed the eventual healing - if it's allowed to happen. It is happening in some markets.
- The US still needs to raise and expend A LOT more money.
- The scale of the stimulus and extent of US money creation are unprecedented.



Major markets have now seen rallies of 60% which is large by historical standards for the first rally out of a serious bear market decline. Markets in general seem to be far ahead of the economy. While this is a concern and we are on the lookout for a correction, its also the normal state of affairs when markets are recovering from a crash.

Markets look forward and discount anticipated events. The rise in broad market indices is a reflection of what traders think will happen over the next few years not a measure of current events. Fiscal stimulus like government spending and interest rate cuts take several months to filter through an economy and reach their full effect. The interest rate cuts should have had much of their impact but a number of different governments stimulus programs are only starting to get spent. Those, and an inventory restocking process that is also normal coming out of a recession should help support corporate earnings.

The strength of the central bank response can be seen in the following slide that has a chart displaying a couple of recent US Treasury yield curves and one from the fall of 2008. You can see how the “short” end of the yield curve has been pushed down dramatically. In effect, market participants are willing to park money in US short term notes for essentially zero interest. Zero rates are a powerful stimulus, but also a sign there are many in the market that are still worried about what may happen and prefer “no risk-no return” to higher risk assets.

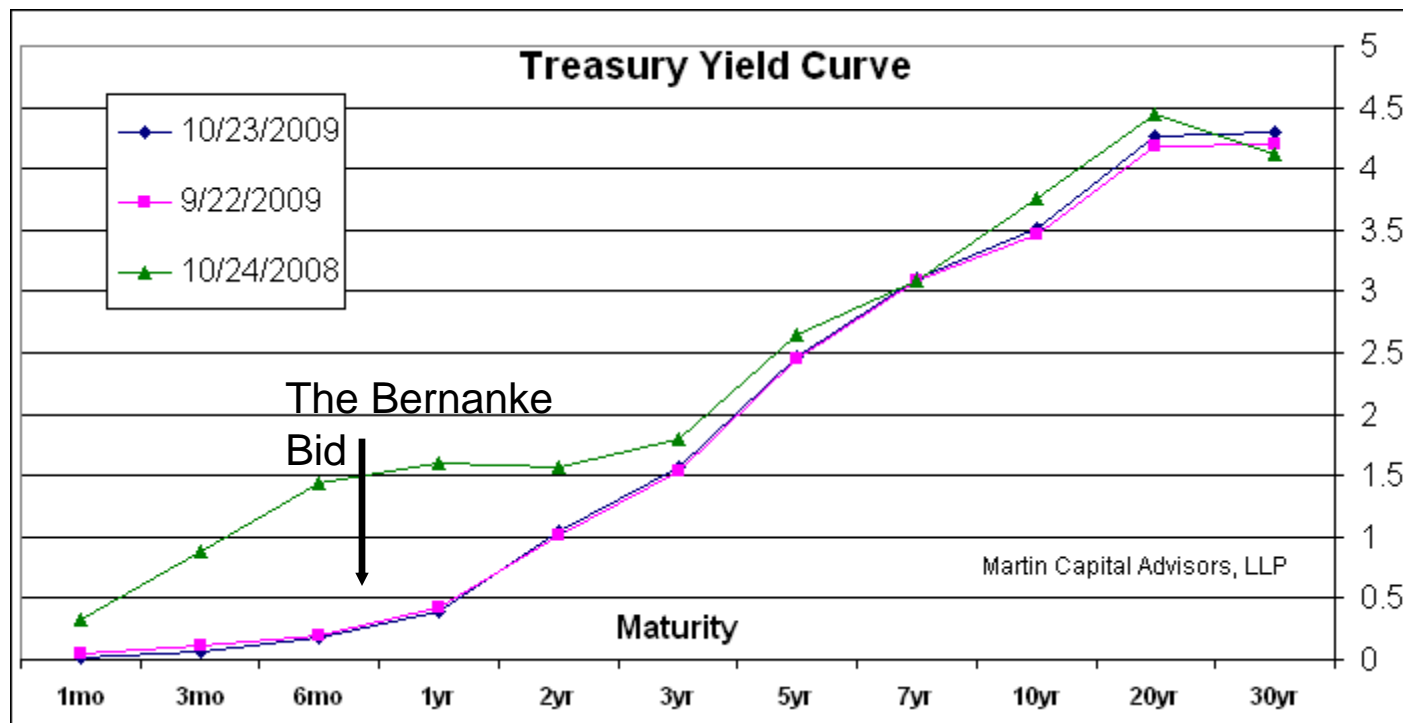


## Central Banks Respond:

- Massive liquidity injections
- Cut rates to zero - Negative real interest rates in some cases.
- Quantitative easing – The US Fed as direct market participant i.e. “the Bernanke bid”
- Extended periods of fiscal deficits across the G7



US Fed (and others) Buy the short end of the curve.





Real (inflation adjusted) interest rates are now negative in the US and several other G7 economies.

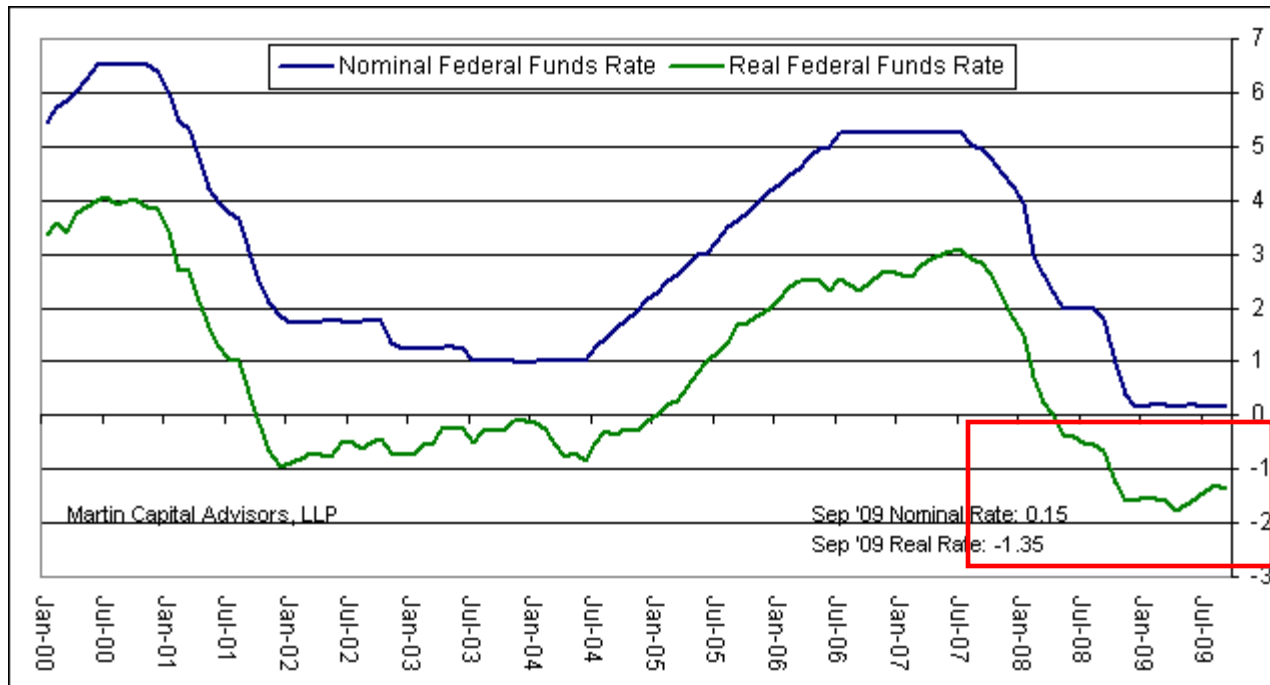
There is evidence of deflation, or at least disinflation, in a number of economies that could lead to positive real rates later though inflation rates do appear to be starting to bottom.

Negative real rates are usually associated with periods of rapidly accelerating inflation. They don't cause it; they are more an indication that a central bank is "behind the curve" and not raising rates quickly enough to stay ahead of inflation. Periods of negative real rates tend to be very positive for both commodities and equities. Although the current situation is obviously much different negative rates still have an effect. Lack of returns for competing assets (bonds and fixed income investments) drives money into "riskier assets" like stocks and commodities.

The 10 year chart on the following page shows nominal and real rates for the US Fed Funds Rate. As you can see from the area enclosed in the red box on the right side of the chart, rates went negative at about the same time the major equity markets bottomed and have stayed negative since then. How long this lasts no one knows.



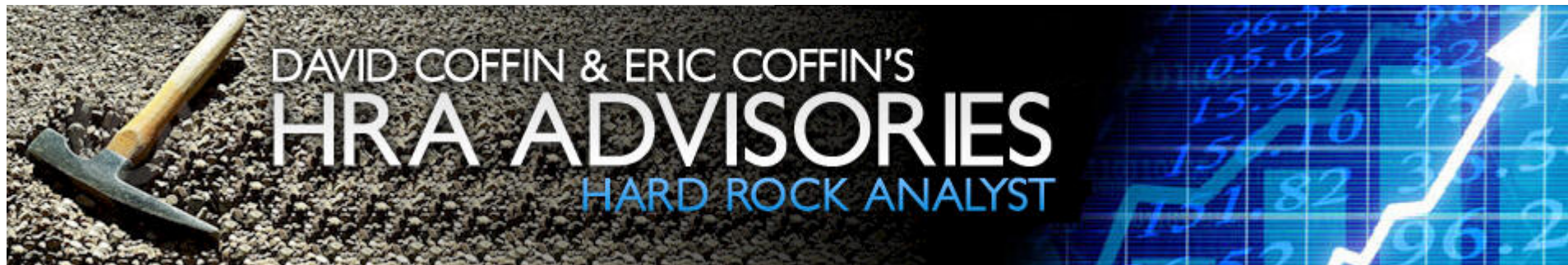
# Central Bank Rate Targets go Negative





## Negative Real Interest Rates

- Normally seen when central banks are “behind the curve” in a period of rising inflation.
- This time - in a period of lowering inflation in the short term – *maybe* higher inflation later but not until economies improve.
- Negative interest rate environments are very positive for hard assets and commodities. Historically, they perform very well during these periods.

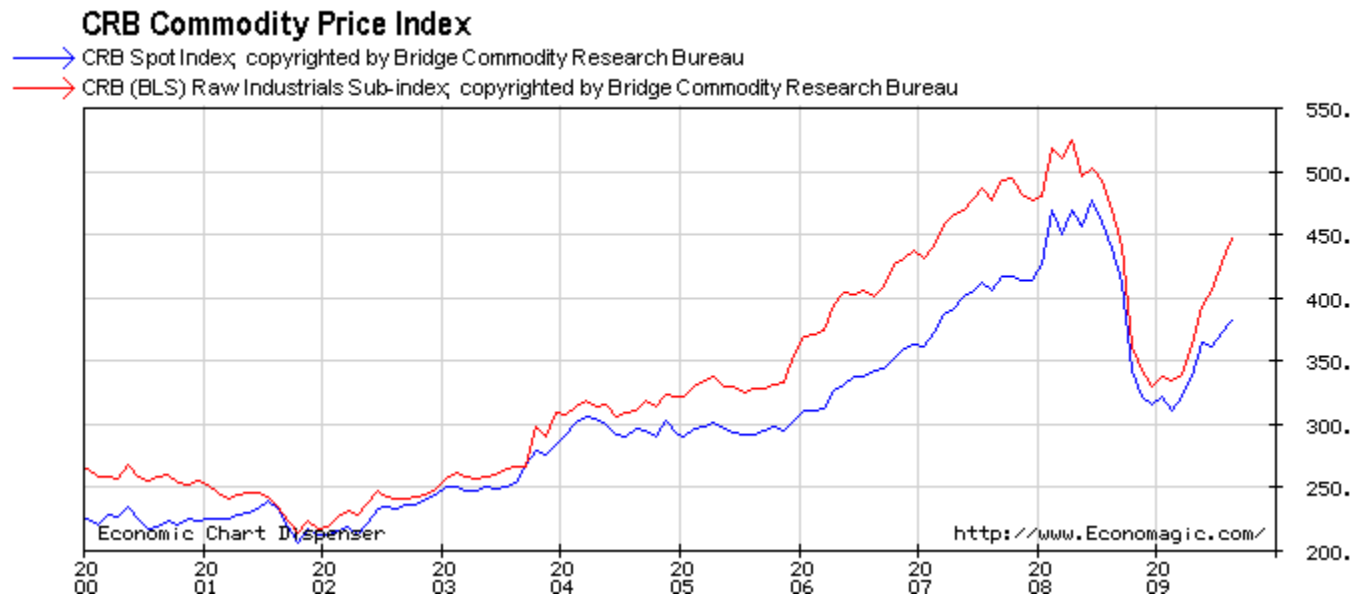


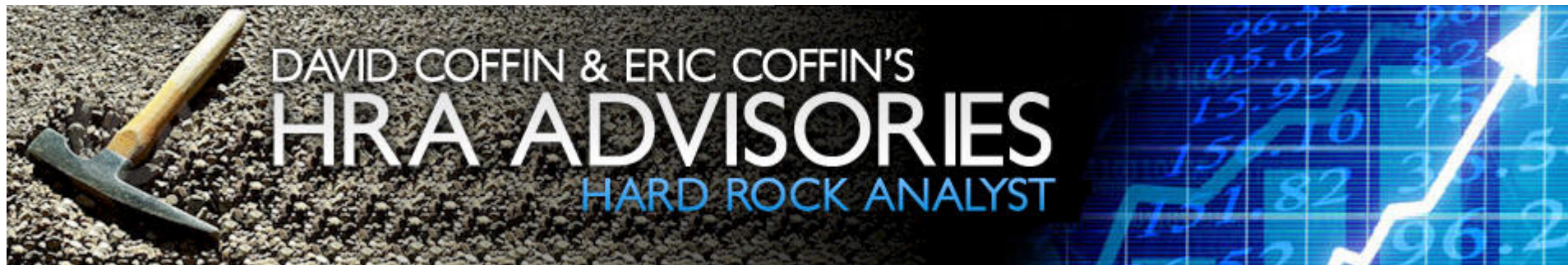
The chart on the following page shows the CRB Spot Index and Raw Materials Index going back ten years. When commodities were getting thrown overboard last fall many were calling it a burst bubble and a new commodity bear market.

There are two important things to note about this chart. One is that commodities bottomed before the G7 stock markets did, which is odd behaviour for a market that is a bubble (think about where the NASDAQ index sits ten years after the internet bubble burst). The second is that, unlike the major equity indices, the CRB bottomed early this year significantly higher than the levels it reached in 2002. The commodity markets are still within a major up trend.



## Commodities Find a Bottom – Quicker and Higher than others expect





- We expect the US will be no better than other G7 for growth in the next few year, probably worse than most.
- Likely to hold rates down longer than ECB and other central banks.
- Negative for the US Dollar – though a weaker currency is to the advantage of the US - as long as interest rates don't rise



Recent economic statistics out of the US show an uptrend in most measures, but a weak one. While we think the recession is over, there is question about how strong a recovery will be, especially with a number of government spending programs like Cash for Clunkers ending.

Robust growth in the US is not likely until there is at least the start of a recovery in employment. Numbers have improved but are still negative and it looks like the US economy will not actually start adding jobs again until well into 2010. While we believe that developing countries are the main demand drivers for metals usage, the level of the US Dollar has a major impact on commodity pricing and even more on the price of precious metals.

Notwithstanding many calls for a bounce, the chart on the following page clearly shows the US Dollar index topping as the US markets bottomed and some of the fear trades ended. It has since moved down from the 90 level to 75 and has breached the lows put in last fall.

Since we expect the US will have one of the weaker recoveries among the G7 (no to mention the G20) countries, there is little reason to expect the Fed to raise rates until other major central banks, particularly the ECB has. Interest rate differentials are a major predictor of future currency moves. There may be occasional oversold bounces but we see more downside for the US Dollar for the next year and maybe longer.

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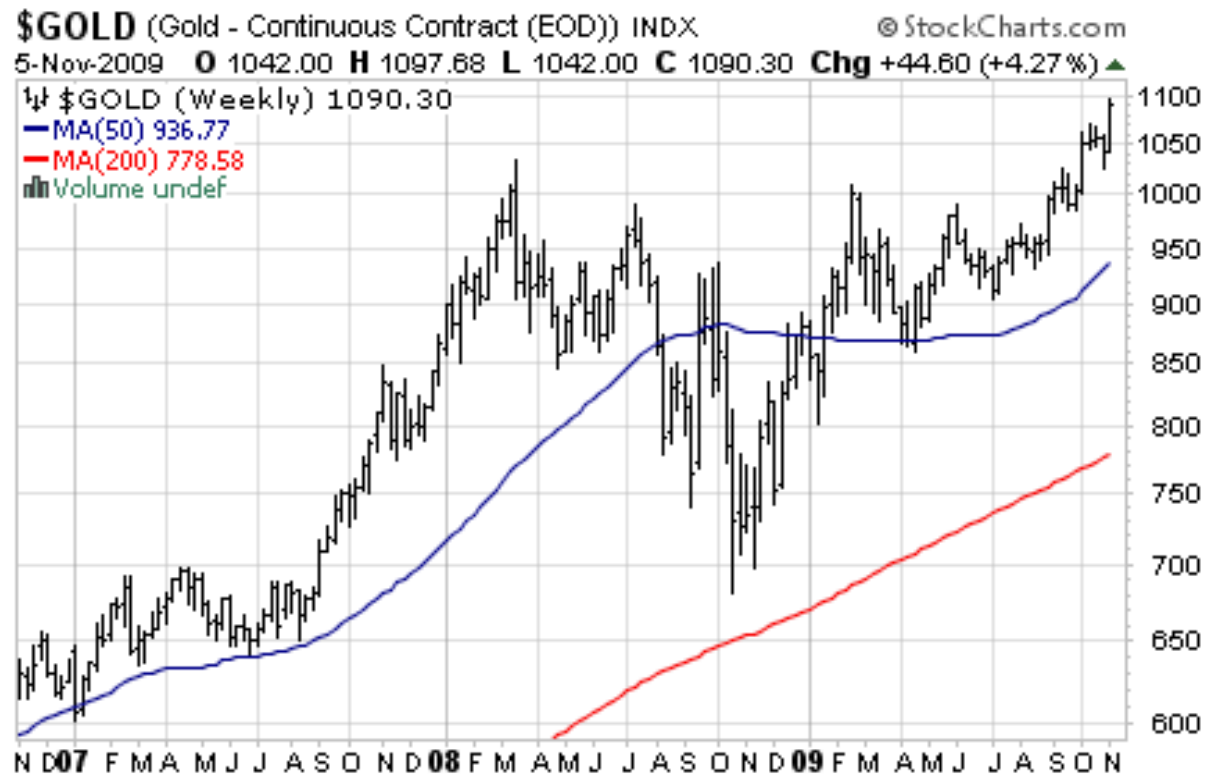
## Fear buying ends – Dollar Decline resumes



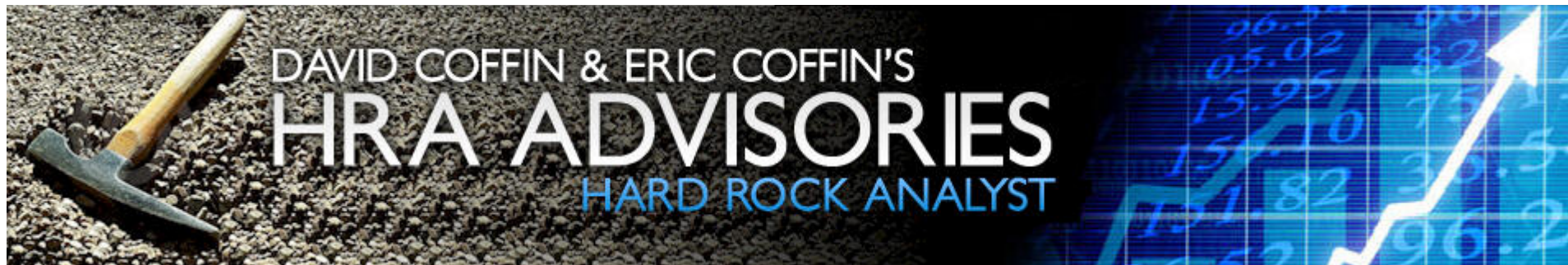


DAVID COFFIN & ERIC COFFIN'S  
**HRA ADVISORIES**  
HARD ROCK ANALYST

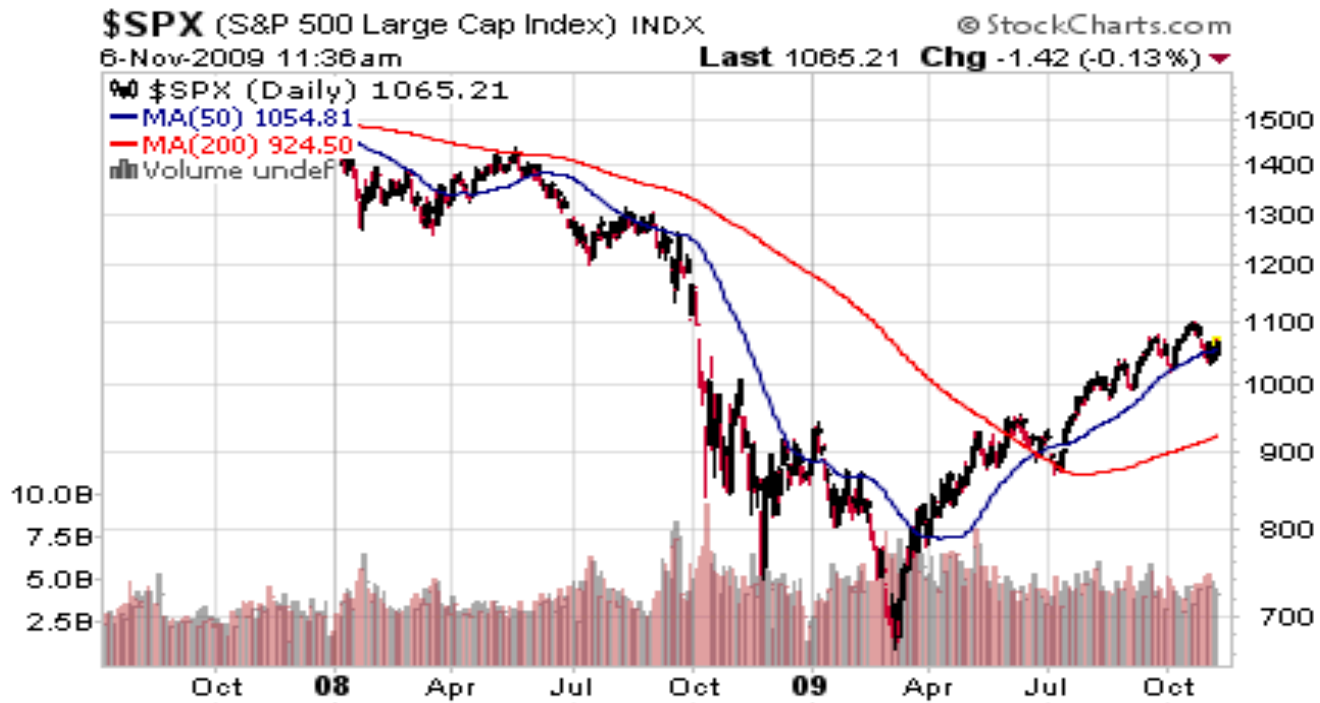
## Gold – New Highs



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- Commodity prices at least partially an “anti dollar” trade.
- Gold itself is trading as a currency
- Also, as a vote of (non) confidence about how governments are doing during the crisis
- Gold has “no counterparty”
- Base metals – especially copper are better inflation hedges



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## So what is Keeping the Markets up?

- Low interest rates – lack of return on alternative assets
- Fund buying – some funds have to be there
- The world is not coming to an end (we think!)
- But there is still a lot of money on the sidelines and many fear and loathe the stock markets now.



After market rallies as strong as the one we have had this year some consolidation is normal. Zero interest rates were a major factor in pumping up the markets. That can go on for a long time and we think year on year earnings comparisons will be favourable for another quarter or two at least. The upside of large scale job losses (if you can call it that!) is that G7 economies and particularly the US have seen large productivity gains in the past couple of quarters. This and a nascent inventory restock cycle should generate good (but not great) bottom line numbers across several economic sectors.

The gains on most large markets have been accompanied by light volumes and many mutual funds are still seeing net withdrawals. Clearly, many traders are not comfortable with the markets and many who are missed the move and are on the sidelines now. Whether we get a moderate or large correction may depend on whether the traders on the sidelines enter the market on a dip or choose to keep waiting. It is of note that the mining sector and the juniors, as typified by the TSX Venture exchange have not seen lighter than average volumes.

We expect precious metals and especially gold to do well. Recent strength during short lived bounces in the US dollar is a sign of strength.

We like base metals a lot longer term but would like to see them pull back again during a market correction before re-entering or adding many new stories in this space.

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- This has been a very long and strong rally. A correction is highly likely in the short term.
- A re-test of the March lows is not expected.
- How the “sideline money” responds will have a major impact.
- Will they be scared to get in – or too scared to be out?
- We expect gold, precious metals to be strong. Other metals strong medium to long term but we would like to see a correction there.



Look for undervalued hard asset plays

Explorers with strong results still get attention

TRADE! You need to take profits occasionally and trade costs down.

Keep some cash in case there is another mess on the horizon.

Medium to long term we are still very bullish on metals in general

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The pair of charts we have reproduced on the following page are important and worth your consideration. The first chart on the left tracks exports as a percentage of GDP for developing countries and the share of those exports that go to developing, rather than developed, countries. It shows a clear trend of gradual decrease in the dependency of these economies to exports, which is normal as an economy develops and grows. Equally important, it shows that the dependence of developed countries for export earnings is also dropping. While exports have grown overall, exports to developed countries have not. This is one reason many developed country economies retained far more strength than many expected through the last 18 months.

The chart on the right is even more telling. It tracks a five year moving average of the contribution of developing countries to overall growth in the world's economy measure at purchasing power parity. After bottoming below 40% in the late 1980's the share of world growth contributed by developing countries has risen steadily. For this year, developing nations are forecast to generate 80% of world growth. It is any wonder we think the commodity market is in a secular bull market?



*“Its all about US”* (the US, that is)

Not quite. Developed countries did not increase their share of emerging economy exports. (left chart)

Emerging economies share of world GDP *growth* has been increasing dramatically since 1999 (at PPP, right chart)



Charts Courtesy of  
*The Economist*





## Three publications

**The Journal** – monthly newsletter. Editorials, updates, longer reviews of advanced situations

**The Dispatch** - Monthly between newsletters. Additional Editorial coverage. Updates of companies already followed.

**Special Delivery** – Alert Service. Breaking news on markets and companies, new situations, trading and arbitrage opportunities. Most new companies are added at this level.

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