

Stealthling Toward Profits

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This week we wade into one of the most contentious issues of our day. The inflation versus deflation debate. This is a charged conversation to say the least. I have seen discussions on this topic nearly come to fists at recent conference appearances (okay, not quite fists, but very heated).

The question is a critical one to our investing future. Will asset prices continue the fall that started last summer? Or are the last few months' rally on the stock and commodities markets telling us that deflation has been banished and our homes, shares, metals and fuels are on the way back up in price? Those who get this call right will make a lot of money. I'll offer some thoughts on where I think we're heading (debt-driven deflation), and discuss one investment strategy that I think will do well regardless of what happens.

We'll also take a trip into the darker side of petroleum accounting to find out why U.S. natural gas producers had an absolutely horrendous round of quarterly financials this week. (Chesapeake Energy reported a quarterly loss of \$9.63 per share. The company only trades at \$24!) This is an important lesson in how accounting rules can distort corporate valuations. If you're investing in the oil and gas sector, this is a must-read. But first, let's talk deflation...

Deflation 101

I've said several times over the last few months that I believe North America (and much of the world) is headed for deflation. So much of global growth over the last 8 years was driven by debt. Americans in particular borrowed so heavily that they pushed the effective savings rate into negative territory. For the first time ever, consumers were borrowing more money than they were saving.

This was good for the world economy. Americans bought more televisions, cars and running shoes. Many of these products were produced by Asian exporters like Japan and China. Because of increased sales, China accumulated \$2 trillion in foreign exchange reserves. Chinese companies used their savings to buy capital equipment (stuff used to

build factories and assembly lines) from America. Everyone prospered. Global GDP soared. Stock markets followed.

Consumer debt was the foundation of this "virtuous circle". Between 2003 and 2008, U.S. commercial banks lent out \$3 trillion in new credit. To put that in perspective, total lending for the previous 30 years (1973 to 2002) was \$3 trillion. Americans borrowed three decades' worth of credit in just five years. These numbers aren't adjusted for inflation, of course. But the bottom line is this decade has been a period of unprecedented credit creation. Credit fueled the economic boom as more money was "put to work" buying things rather than sitting in savings accounts.

That credit creation is now over. Today we are witnessing the first prolonged period of credit *destruction* in the last 35 years. As we discussed last week, \$300 billion in outstanding loans and leases has been paid back (or defaulted on) during the last six months. A 4% contraction in credit. Total bank credit at U.S. commercial banks (a broader measure of money available for lending, including outstanding loans and other financial assets held by banks) has fallen by \$450 billion since last October. A 4.5% decrease. Again, there has *never* been a fall in bank credit of this magnitude since we started tracking the data in 1973. Never. This past week alone, the Federal Reserve reported a drop in bank credit of \$77 billion. The fourth-largest weekly drop ever.

The Fed isn't the only one reporting economic news that points toward deflation. There was a very telling Q1 earnings report this week from Vale, the world's biggest iron ore producer. As we discussed last week, steel and iron ore are two commodities that give an "unblemished" view of the world economy. Unlike copper and zinc, these metals are not being stockpiled by China (that we know of!), and so these markets give a more accurate view of current industrial demand around the world. And the view is not pretty.

Vale reported in its quarterly that the company expects global mining investment to fall \$60 billion in 2009. The company itself saw iron ore sales drop 27% year-on-year in Q1. A large decrease. And that came even as China made record purchases of iron ore. This shows how poor industrial demand is throughout the rest of the world. And it's likely to get worse. Vale said that preliminary indications are China is slowing iron ore purchases in Q2. Brazilian analysts Brascan Corretora drew a gloomy picture for 2009 from Vale's data. "We don't believe the scenario will improve in the medium-term, in the second or third quarters of 2009," said Brascan. "There are no clear signs of recovery in world industrial activity, which would lead to increased raw materials demand."

The Rule of 60/40

This is not an environment conducive to inflation. Money is being pulled "off the streets". Rather than spending, consumers and businesses are paying back loans and growing their savings. Either way, this money ends up in bank vaults (or the electronic equivalent). And banks need money in their vaults to meet capital requirements and stay solvent. They are unlikely to lend the money they are taking in from the public.

My prediction is that we will see general deflation, driven by debt deflation. But I want to clarify my views on inflation. Some readers assume I believe inflation is impossible. That's certainly not the case. We're living in a time of rapid money creation. The U.S. monetary base has grown by \$1 trillion in the last six months. The story is the same worldwide. Japan's monetary base has grown by \$100 billion since July 2008. Japanese money supply was up 6% year-on-year in April alone. No one knows what effect this new money will have on prices and economic growth.

We can't rule out inflation. If American consumers become optimistic again and start spending more freely, newly-created money will be set loose on the streets. This would be inflationary. This threat is (rightfully) in the back of investors' minds around the world. This week the People's Bank of China warned that, "A policy mistake made by some major central bank may bring inflation risks to the whole world. As more and more economies are adopting unconventional monetary policies, such as quantitative easing, major currencies' devaluation risks may rise."

I agree with the Bank. There's a chance we could see massive inflation. But as investors we have to play the odds. In poker this called "the rule of 60/40". You never know with 100% certainty what cards will be dealt. So you gauge the odds and act accordingly. You bet when the chances of being right are greater than the chances of being wrong. The more certain you are, the more you bet. If you know 90% that the next card will be in your favor (assuming you can count cards!), you might go all in. If you're 60% sure, you'll probably bet a smaller amount.

The 60/40 at the moment favors deflation. Consumers (especially in the U.S.) have been too badly damaged. Consumer sentiment is at record-lows (despite having recovered slightly over the last few months). And with good reason. U.S. household wealth decreased by \$11 trillion in 2008. That's a phenomenal loss of asset value, and now consumers must re-trench. As we discussed above, the public isn't borrowing. It will take a lot more than the current bounce in the stock market to get people "feeling happy" and spending money again the way they did over the past decade. A return to the "good old days" of debt creation is possible, but not likely.

That said, the odds of deflation aren't good enough to go "all in". If we felt 95% sure that deflation was coming, we should all sell our homes, short the Dow and keep as much cash around as possible. But we're not 95% sure. Maybe 70% or 80%. That still leaves a considerable margin for error. We need to design investment strategies that prepare for deflation, but that won't get "hung out to dry" if inflation rears up.

Winning By Not Losing

What investments will do well during deflation? And not get wiped out if inflation does emerge? There's at least one: gold producers.

This is counter-intuitive. We're conditioned to believe that stocks of all kinds will suffer during deflation. But let's take a closer look at what happens when assets deflate.

Deflationary periods are bull markets for cash. Things like stocks and homes and commodities are all getting cheaper. People don't want to own these "falling knives". They sell assets and keep cash on hand so they can buy things back down the road, once prices have settled at lower levels.

Gold is a form of cash. During deflation, some investors choose to hold their money in coins or bullion rather than in paper (or electronic) dollars. Especially if there is suspicion that the currency will lose value (which is certainly the case today with the U.S. dollar, justified or not). Demand for gold increases.

Gold also benefits from "safe haven" buying during deflation. Deflationary periods tend to be unstable. As asset prices fall, businesses suffer. Unemployment rises and social tensions increase. These are time when people buy gold as a neutral and portable currency to prepare for the unknown.

The net result is that gold prices stay relatively buoyant during deflation. Gold may not rise considerably, but it does maintain its value (more or less). We saw this last fall. When the financial kaffuffle really broke in October, most assets plunged. Oil fell 80%. The Dow dropped 40%. Junk bonds fell 85%. How about gold? It dropped from \$900 to near \$700 per ounce. Only a 20% decline. And it recovered all of those losses (and more) by the end of 2008. By contrast, oil is still off 65% from its highs. The Dow is 25% below its September 2008 level. Even amid financial panic and widespread price deflation over the past year, gold has held its value.

If deflation continues (or accelerates) expect more of the same from gold. The price should stay flat (plus/minus a hundred dollars or two). Events like the International Monetary Fund's planned sale of 400 tonnes of gold might cause a dip in the price (if they haven't arranged an off-market buyer, which is likely). And North Korea firing another missile over Japan might cause a spike in price. But these will be short-lived. There will be enough demand for gold that some investors will buy dips. And enough demand for cash (to pay off rising debts and margin calls) that some investors will sell the rallies. In the end it's a wash. The price stays level.

Same Gold Price, Bigger Profits

That makes gold a good store of value. Although not a particularly good investment for anyone looking to grow their capital. But companies that produce gold will likely be a profitable investment during deflation. The key is margins. During deflation, the gold price stays constant, so gold miners' revenues are steady. At the same time, most other commodities are falling in price. Things like oil, chemicals and labor all get cheaper. This means lower costs for miners as they pay less for diesel, sodium cyanide and mine workers. A steady sale price plus lower costs equals higher margins.

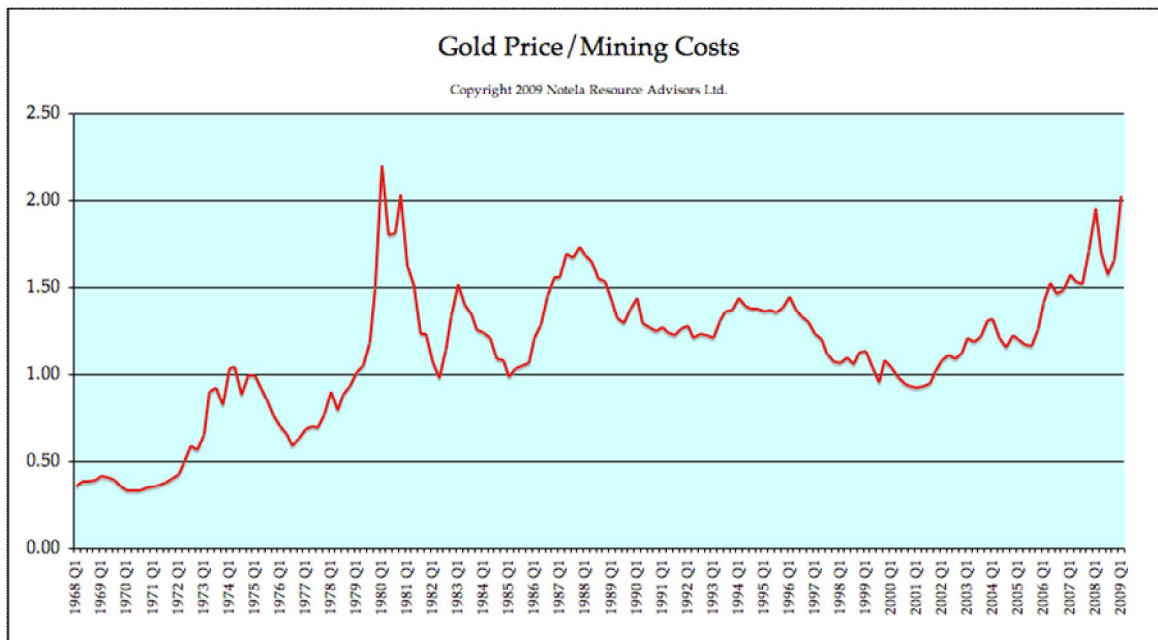
This is a "stealth" improvement in business performance for the gold miners. Most investors expect gold stocks will soar to profitability when the gold price rises. But

falling costs will put more earnings into miners' pockets, even if the gold price fails to rise above the current \$900/oz. And earnings are ultimately what drives share price.

The effects of deflation on gold producers are already showing up in the statistics. Notela Resource Advisors (www.notela.com) produces a custom index of costs for the U.S. gold mining sector. The index tracks prices for fuel, electricity, industrial chemicals and mine labor. The cost index peaked in Q3 2008, indicating that gold miners were paying a lot to produce an ounce of gold. Since then, the index has fallen 20% (as of Q1 2009) in just six months. In the same period, the average quarterly gold price has actually risen 4%. This represents a large improvement in profits for gold producers.

The decline in the cost index is likely to continue. Mine labor accounts for 40% of the index, and labor costs are falling as mines around the world close down. Just this week U.S.-based North Shore Mining announced 280 layoffs at its Silver Bay iron ore mine in Minnesota. The Australian Mines and Metal Association estimates that 12,500 mining jobs have been lost across Australia in just the last three months. That means a big increase in the supply of available mine workers. Which will push down labor prices. This will take some time to work its way through the system as many mine workers are paid on longer-term contracts. But as contracts roll over during the coming months, there will be steady downward pressure on labor costs.

This creates greater profits for producers. The chart below shows a ratio of the quarterly average gold price to Notela's gold mining cost index. A rising trend shows that the gold price is increasing faster than costs (or decreasing slower), leading to higher margins. During this past quarter, the ratio pushed above 2 for only the third time in the last 40 years. The other two "plus-2" quarters were Q1 and Q4 1980, when the gold price was rising quickly. The current strength in the ratio is notable because it's come without any significant appreciation in the gold price.



The "word on the street" tells the same story. Profit margins for U.S. gold miners were near 15-year highs in Q4 2008. Q1 financials released this week were also encouraging. Yamana Gold's cash cost of production fell from \$383 per ounce in Q4 2008 to \$379 this past quarter. Kinross Gold reported record margins of \$478 per ounce. Kinross' cost of production was \$419. The company says 2009 average production costs could be as low as \$390. Goldcorp's cash costs fell from \$323 to \$288 for Q1. Of course, there will be ups and downs in costs over the coming quarters as things like grade control and operating conditions affect output. But on the whole, the industry appears to be trending toward greater profitability. This is the kind of thing investors notice, sooner or later.

The Stealth Bull Market

Interestingly, even as gold producers' profit margins are near record levels, share prices are suffering. True, the S&P/TSX Gold Index has recovered most of the losses it took last October. Yet the index is 20% below the record levels seen in late 2007 and early 2006. Profit margins now are as good or better than during either of those periods. Fundamentally, gold stocks should be trading higher than they are.

The gold sector also looks underpriced on a P/E basis. The average P/E ratio for the S&P Gold Index has rebounded from 10 to 20 over the last few months. But 20 is still the lowest level seen in the last 15 years. Up until late 2007, P/E ratios for the gold mining sector had generally been above 30 since 1995. Reaching as high as 50. The current level is low on a historical basis. Especially at a time when companies are seeing record profits.

Why is this happening? As I mentioned above, reduced costs are creating a stealth bull market for gold producers. Most investors aren't used to the idea of margins improving through declining costs. They expect that gold companies won't do well until the gold price rises considerably. Analysts fall into the same trap. As of April, analysts were forecasting a consensus 3.3% growth in earnings for the gold mining sector. This is fairly meager. In early 2008, analysts were predicting 54% growth in gold miners' earnings. In 2006, the forecast was 74% growth. Yet, as we saw above, the gold price/mining cost ratio is currently higher (producers are more profitable) than at either of those times.

It will take time for analysts to catch on to falling costs and rising margins in the gold sector. Eventually they will. And where analysts and brokers go, the public usually follows. This will be the real "coming out party" for gold producers.

Heads We Win, Tails We Win

Let me circle back for a moment. I mentioned that we need to plan investments that are going to thrive during deflation, but also be protected if inflation arises. This is one attractive feature of gold producers.

At every conference I've spoken at over the last year, a number of analysts always forecast \$2,000 gold. Soon. They reason that the massive amount of money creation

recently (remember, \$1 trillion new dollars in money supply since last July) must lead to serious inflation. My reply to these forecasts is, "I disagree... but I hope you're right and I'm wrong." If inflation does take hold (which is possible) gold would rise significantly. Which would be excellent for gold stocks.

A big rise in the gold price would likely start a "conventional" bull market for gold stocks. Investors usually react to rising commodity prices by buying the companies that produce those commodities. And gold producers would likely see some improvement in margins and earnings because of a rising gold price (although rising costs would eat into profits at the same time). In this way, gold producers are a hedged investment. They succeed during deflation because of falling costs. And they succeed during inflation because of higher sale prices and rising revenues.

Fake Losses in the Oilpatch

Many of the Q1 financials from the U.S. natural gas sector came in this week. The results were dismal. Chesapeake Energy reported a quarterly loss of \$9.63 per share (that's 40% of the company's current \$24 share price!). El Paso lost \$1.41 per share (15% of share price). Devon lost \$8.92 (15%).

What happened? Is the natural gas sector on the verge of collapse? If Chesapeake keeps this up, they'll lose their entire market capitalization (and then some) by year-end. Run for the hills!

The results in fact aren't as bad as they appear. Most of the losses natural gas producers took this quarter were due to "impairment charges" on their gas fields. Chesapeake booked an impairment of \$6.1 billion for the quarter. El Paso \$1.3 billion. Devon \$4.2 billion. These appear to be huge losses. Except that they are "fake losses", fictions created by the odd accounting rules that public oil and gas companies have to live with in the U.S. This is worth spending some time on as it's critical to understand in order to be able to truly analyze the financial health of a gas producer.

In 1980, the Financial Accounting Standards Board drafted a series of "best practices" for oil and gas producers to use in reporting their financial information. The Securities and Exchange Commission adopted these rules (with some modifications) so now all publicly-listed U.S. oil and gas companies are forced to abide by them.

Under those rules, a company that explores for and produces natural gas can "capitalize" all of the money it spends to discover gas fields. Let's look at a quick example. Suppose ABC Energy buys an exploration lease. The drilling rights to the land cost \$1 million. The company then carries out a geophysical program. Cost: \$1 million. ABC likes the play and drills two exploration wells in search of new natural gas pools. Each well costs \$1 million, for a total of \$2 million in exploration drilling. One of the wells is successful in locating a gas pool. The company then determines that three additional production wells are needed to extract the gas efficiently. Each production well costs \$2 million, for a total of an additional \$6 million. Total cost from beginning to end equals \$10 million.

The company has found proven gas reserves, so the \$10 million spent discovering those reserves can now be capitalized. The company can report the \$10 million as "asset value" in their monthly and annual financial statements. The idea being that if a company spends \$10 million developing a field, the contained gas must be worth as much or more than that amount. As ABC Energy produces gas, they can "amortize" their capitalized costs against the revenue from production, resulting in lower taxes.

So far so good. The problem in the oil and gas business is that spending \$10 million doesn't always get you \$10 million in gas reserves. Geology isn't predictable. A well-meaning company like ABC might spend \$10 million exploring and developing a field, thinking that they are likely to generate more than \$10 million in reserves. But after they've spent the money drilling wells and tying wells into pipelines, they might discover that the production rates aren't as good as they expected. Or there simply isn't as much gas there as they originally thought. In such case, the value of the field might turn out to be only \$5 million.

Here's where the problem comes in. The SEC won't allow a company to show \$10 million in assets on its balance sheet simply because the company spent \$10 million acquiring those assets. If you overspend, it's your fault and you (and your shareholders) have to deal with it. So the SEC forces oil and gas companies to perform a "ceiling test" each quarter. Basically, the company compares its assets' capitalized value (the amount spent acquiring the assets) to the "fair value". Fair value is a tricky concept and can be calculated different ways. But usually it comes down to forecasting future revenues from the gas production. Let's go back to our ABC example. Suppose ABC's new gas field produces 1 million cubic feet of gas per day (1,000 Mcf). The company is netting \$3 on each Mcf of gas sold. About \$1 million yearly in profit. (This is very simplified, but it gives the general idea.) The field will produce for 5 years. Discounting the \$1 million in yearly cash flow at 10%, we get a net present value of \$4 million. This is the fair value of the gas field.

When ABC performs its quarterly ceiling test, it finds that the fair value of the gas field (\$4 million) is significantly lower than the capitalized value (\$10 million). Under SEC rules, the company would be required to book a \$6 million impairment charge (the difference between the capitalized value and fair value). This \$6 million is charged against the company's quarterly cash flow. So if the company had \$1 million in cash flow from its wells, it would report a quarterly loss of \$5 million. It's important to note this is a non-cash charge. The company doesn't pay \$6 million to anyone. The loss is simply included in the financials to alert investors to the fact that previously-recognized value in the company no longer exists.

The Price is Wrong

In principle, the SEC ceiling test rules are a good idea. A company should not be allowed to tell investors that an asset worth \$4 million is actually worth \$10 million just because

the company paid \$10 million for it. That would give a distorted view of the company's value.

But here's the problem. The fair value of a gas field (remember, that's the total value of the discounted cash flows from gas production) changes *all the time*. In our example, we assumed that ABC is netting \$3/Mcf on its gas production. All year, every year. But in fact, a company's netback is constantly changing. Sometimes daily. Mostly due to gas prices. If gas is selling for \$10/Mcf, ABC might have a profit of \$8/Mcf. If the gas price drops to \$4, ABC might be making no profit at all. The gas price affects profits. Which in turn affect yearly cash flows and ultimately the assessed fair value of the property.

So when a gas producer goes to calculate the fair value of its gas field in order to perform its quarterly ceiling test, management must make assumptions about gas price. They need to plug a number into their model to get revenues and a valuation. If you use \$10 gas, the property will have a high fair value, probably higher than the capitalized value. You pass the ceiling test. If you plug in \$4 gas, the fair value will probably be below the capitalized value. You'll be forced to take an impairment charge on your financials.

So what price do you use? The quarterly average? The rolling 12 month average? Forecasts of reserves engineers? It turns out the SEC tells producers what price to use. The closing NYMEX natural gas price on the last day of the quarter under consideration. That's it. No averaging of prices. Just one single, daily reading. If the price happens to drop \$1 that day because of bad news in the market, too bad. You're stuck with it. And your fair value assessment will be low because of it.

This is exactly what happened to Chesapeake, El Paso, Devon and almost every other gas producer in the U.S. during the first quarter. The NYMEX price on March 31 (the last day of Q1) was \$3.63. All of these companies calculated the fair value of their fields based on this price. And not surprisingly, the fair values came in well below capitalized values. Causing massive impairment charges and huge quarterly losses.

This makes little sense. Under these accounting rules, companies are forced to value their assets using a gas sale price of \$3.63 for the entire remaining life of the field. We're calculating cash flows assuming that one year, ten years or twenty years from now gas will be \$3.63. Gas futures for next January are selling at \$6! We know for certain that gas won't be \$3.63 in just a few months. So why are companies forced to "lock in" this price for years into the future, and take financial penalties because of it? This is exactly the kind of distortion of corporate value that the accounting rules were designed to prevent.

There are a few saving graces. Companies with hedged production are allowed to use their forward sale price in calculating fair value. Which makes sense. And the SEC is reviewing the rules on using quarter-end pricing. The thought is to move to a 12 month average price, which would make much more sense in the gas market, where seasonal price variations are steep.

Introducing Notela Resource Advisors

Thanks to everyone for being so patient over the last several weeks while I've been talking (in rather roundabout fashion) about the new venture my partners and I are launching. As with everything, getting this development "ready for prime time" took longer than expected. I can see why big resource projects hardly ever advance on schedule! Many of you were extremely gracious when I responded to your requests for more information by saying, "Just give me one more week." Repeatedly in some cases. Thank you again.

At long last, I'm very pleased to introduce Notela Resource Advisors Ltd. Notela is a service that my colleagues and I have been talking about for a long while. Seth Godin, the vice-president of marketing at Yahoo, famously said that when launching a new product you should strive to make something that you yourself would consider a dream come true (hopefully anyone creating a product is also a user of that product!). Notela is the service we always wished we could use. It is my dream come true. Hopefully it will be the same for some of you (or failing that, at least be mildly useful).

Notela's mandate is simple: bring together rocks and money. The company is a link between the technical and financial worlds, the two sides needed to make any natural resource project succeed. For our clients in the investment sector, Notela is performing technical due diligence on resource projects and companies. The high-level screen will be performed by your humble analyst and my partner Philip O'Neill. For anyone who doesn't know Philip—to borrow the old axe—he knows more people in natural resources than most professionals in the sector will ever meet. He is an encyclopedia of facts, figures and goings-on in the business (in addition to being a very good friend). I will be sprinting to keep up!

Over the years Philip and I have had the great pleasure to meet and work with more outstanding engineers, geologists and project managers than we deserved to (some of whom are readers of this letter). This network of "brainpower" will be the backbone of Notela's analysis services. Simply put, if we don't know it, we will know someone who knows it. I'm thrilled to be working with this "virtual team". The analysis they produce is top-notch and for years has helped steer investors toward profitable investments. If you're an investment manager or high net-worth individual (unfortunately for regulatory reasons we can only work with accredited investors) considering a move into natural resources, give us a call at 403-614-2552.

Notela's "other face" is working with project owners to secure financing. To get serious for a minute, I've seen far too many great projects (be they mining, oil or renewables) fail because financing wasn't structured properly. You need the rocks and you need the right money. Notela is using its global contacts in the investment community (I'm off to South America at the end of this month) to put the right investors together with the right projects. If you run a public company and need financing, or if you own a private resource project, large or small, call us.

For the complete picture on who Notela is and what the company does, drop by our new website, www.notela.com. And thanks to all of you for making this possible. Seriously. Without your advice, conversations and consultations over the last several years this project wouldn't have happened. I hope you all get to share in it at some point.

The evening latte is wearing off, so it's time to sign off. Sahara, my two-year-old, has gotten into the habit of waking up, and waking the house up, at 3 A.M. nightly. I need to get a few hours sleep in to prepare! Have a great weekend.

Here's to rocks, money and the people in between,

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