

MAEDEL'S

EQUITY MARKET ANALYST

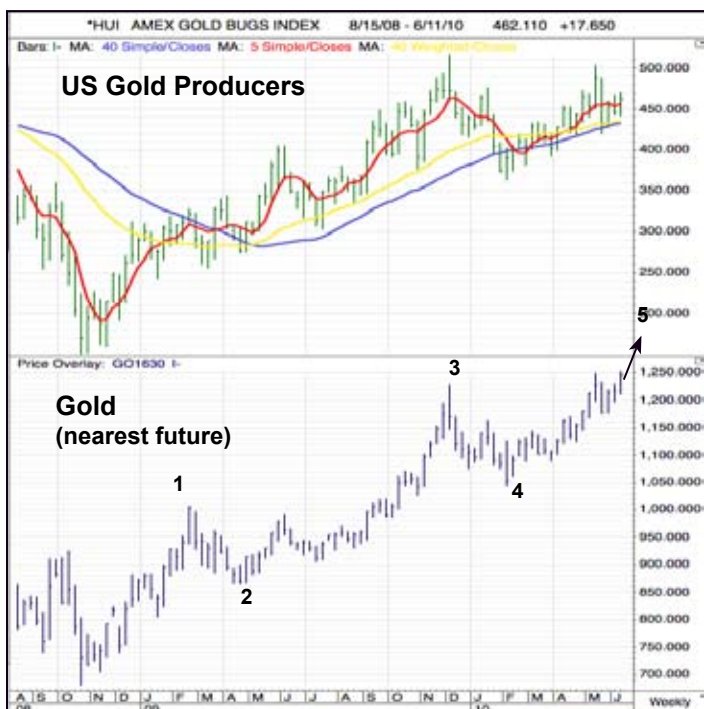


Editor: Neil Maedel
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June 11, 2010 Bulletin

“The collapse of the financial system as we know it is real, and the crisis is far from over,” George Soros

Predicting a bottom...



Last Month, your commentator was busy analyzing reams of data at his Thailand office while reassuring associates that, in reality in most of the country it was very difficult to tell there was any insurrection.

This month I am back in Switzerland tending to my teenagers, going to a birthday trip to watch the Champions league final in Madrid and for my daughter's birthday shopping in Lugano. Both duties were welcome diversions from the ongoing corrections and as I write from my mountain Chalet I am encouraged by the way events have unfolded. In my previous post, just as the Dow Jones Industrial Average was approaching my upside target (see chart left) I warned that the equity market was “ripe for a correction”.

The lack of naivety of that statement in regards to exactly what we were

about to experience reminds of when I stood on the beach near Phuket in 2004. The Ocean had simply vanished and we could see stranded fish flipping in the sand. A father next to me said to his little boy “look son, this is a Tsunami you'll probably never see another one for the rest of your life.” Fortunately I am pretty sure they escaped the coming cataclysm just as the gale force 4 correction we just endured may have left our positions largely intact. Still close calls are not to be taken lightly. Fortunately I can report with confidence that the worrying abundance of bullish investors and advisers has turned into a stampede of sellers.

Lipper FMI reported a \$16 billion outflow from equity funds and equity ETFs had occurred the week ending May 26th - the most in its 20 year history.

The Investment Company Institute, noted that during the same week U.S.-focused funds saw \$13.4 billion head out the door and international funds lost \$3.9 billion -- the largest outflows in each category since the week ending March 11, 2009.

Fibtimer.com which was dead on in predicting the 2007-2009 market crash noted in a bulletin June 6th: *"Last Thursday the NYSE had up volume exceeding down volume by 36 to 1. It is historically rare for such trading days (better than 9 to 1) to occur and if it happens twice within two months it usually marks the beginning of a new bull market. This Wednesday we had the second such bullish day with up volume exceeding down volume by 20 to 1 on the NYSE. Historically such action results in about a 14% advance in the next six months."*

Meanwhile the proverbial wall of worry has grown to a very bullish height. **Mark Hulbert** reports that the average recommended equity exposure by short-term stock market timers has plunged from 20.3% on February 8th (the previous

correction low) to last Tuesday's minus 8.8%. This fall is after his NASDAQ Newsletter sentiment index also plummeted from 80% recommended equity exposure first week of May to a recent -45.

This translates to a negative sentiment regarding equities so great that most newsletter advisers are recommending subscribers sell stock they don't even have (go short) which leads to the question of who's left to sell?

Finally Insiders' sales compared to buys have plummeted from over 7 sales for every 1 buy last February, to only 1.2 sales for every buy. What do they know that we don't? Clearly, they can't be too concerned about predictions of a profit-growth-halting slowdown. This looks like a bottom and we are adding to our positions.

Gold breaks out

In the November 2009 Maedel's my "technical 6 month upside target for gold was \$1300. In May I warned gold looked ready to break out to new highs, which has occurred. gold reached \$1251 last week and normally I would not wait for the

last \$50 of a technical move which looks to be in a terminating wave 5 within a larger bull market wave up. However, sentiment is relatively subdued and indicates further upside just as the fundamentals underpinning the metal's rise remain very bullish.

The long term bullish case was recently illustrated when two of the world's most informed gold producers, **Barrick Gold Corp.** and **Kinross Gold Corp.** decided to develop the low-grade \$4.2 billion **Cerro Casale** copper-gold project in Chile. At \$800 gold the project is barely economic with a 5.5% IRR but at current prices its IRR is around 15% which justifies proceeding. Clearly both companies are calculating that gold's price stays at its current level or goes even higher.

Also bullish is that gold supply has yet to react to the metal's historically high prices. In the **World Gold Council's** words:

"Today, the overall level of global mine production is relatively stable, averaging approximately 2,485 tons per year over the last five years. New

mines that are being developed are serving to replace current production, rather than to cause any significant expansion in the global total. The comparatively long lead times in gold production, with new mines often taking up to 10 years to come on stream, mean mining output is relatively inelastic and unable to react quickly to a change in price outlook."

Gold bullion's rise pushed many gold major's shares higher but the ongoing flight from risk and thus equities in general moderated their moves. The recent equity market correction's real damage was done in the small and micro-cap arena as investors' abandoned these higher risk investments for presumed safe havens such as US treasuries, gold and to a much lesser extent, large cap gold stocks.

Compounding the gold sector's challenges, Australia's Prime Minister **Kevin Rudd** added to the apparent risks associated with owning resource stocks when he shocked investors by announcing a 40% Resource Super Profits Tax.

In Africa when



companies such as **First Quantum Minerals** (or more recently **Extract Resources** in Namibia) get their assets arbitrarily confiscated to benefit the interests of others, it becomes just another dreary and somewhat expected "This Is Africa" moment. Not uncommon and a risk which most investors accept as part of the great risks that come with the continent's immense profit potential.

When a modern developed country like Australia confiscates a major part of the earnings of its miners, it is not expected, and because it highlights the very investor unfriendly trend of resource nationalism, it makes physically owning gold an even safer and more attractive alternative. We note that after plummeting almost 25% in the

past month the Australian Mines and Metals index has formed a very bullish reverse head and shoulders. This further supports our "market has bottomed" thesis. The performance of the Australian index may indicate the imminent and radical adjustment of the Rudd tax.

Our favourite in that market remains **Lynas Corp.** (AU:LYC \$0.50) which bullishly, has barely reacted to the market correction. It is slated to become the world's next rare earth metals producer - a sector which, also bullishly looks set to experience increasingly limited supply and higher REM prices. Also dogging gold producer's returns in the mushrooming cost of producing the stuff. There may be no inflation yet in the US but there certainly is in the mining business.

A **Fortis Group** led study estimates average cash costs have risen from around \$450 in early 2008 to US\$544/oz in the first quarter of 2010. This helps explain the large gold producers under performance. It also shows like oil, the age of cheap to get gold is long behind us. Recall that the average grade



mined in the 1950s was 12 grams per tonne or more than one third of an ounce gold and is now around 3 grams.

Harder to find and produce gold makes those juniors with highly developed exploration projects and serious production growth profiles all the more attractive to major producers looking to replace their declining reserves.

For investors it is important to remember that the less diversified a junior's gold production or in the case of pure exploration plays the more

they are dependent on financings, the more volatile they will be as they will be more effected by changes in risk tolerance. Hence the deep correction in many gold juniors over the past month.

The Trickle down effect

As gold's price increases so do gold producers and in an effort to maintain their existing reserves (for example Barrick, the world's largest producer must find roughly 8 million ounces of gold every year just to replace what it produces) ac-



quiring smaller companies such as the recent \$139 million takeover of **Underworld Resources** by **Kinross Gold** are bound to increase.

One consequence of such takeovers is investor's such as Underworld's shareholders suddenly find themselves left with un-deployed cash which they either spend or reinvest. It is only natural for them to redeploy some of those profits into similar exploration stories which often are in the vicinity. This influx of new money in itself underpins the resource stock bull market.

At Maedel's we think we are in the early days of this process and many more success stories and sector propelling takeovers are on the horizon. So it is important to be patient and remember that the foundation of this bull market is the increasing profits of the gold producers and their need to replace the gold they are producing.

Additional retail investors will flock to the sector as the number of takeovers increase.

Recall the 1970s gold bull market and how rising gold prices were accompanied by

the development of heap-leaching which allowed the profitable recovery of gold from previously uneconomic low grade oxidized gold ores. Gold mining stocks did not begin to take off until the mid 1970s when gold had already tripled to \$500 (adjusted for inflation is about \$1400 today).

The Carlin Trend in Nevada was at the forefront of the gold stock rush and has since produced more than 50 million ounces - more than any other gold trend in the US.

Many investors made a lot of money from gold bullion's rise if they bought gold in 1975 the year US investors were allowed by their government to buy gold. Until then they were restricted to buying jewellery, art or gold stocks. I can still recall in the early 1970s, going to a Reno casino owner's office and seeing a solid gold Rooster weighing at least several pounds - his way of circumventing the rules. From 1975 it rose from a low of \$140 to \$850 five years later. But those 600% gold bullion gains were nothing compared to the action in the junior resource sector. I had



just begun working as a trader at the Vancouver Stock Exchange in 1978 and witnessed some of those spectacular gains made by owning the right junior gold stories. One of the most famous startups was Nevada-based heap leach pioneer **Glamis Gold** which began as a penny stock with a market capitalization of a few hundred thousand dollars called **Rennick Resources** and was bought out by **Gold Corp.** in 2006 for \$8.6 billion.

Critically during the late 1970s in a few short years, a multitude of investors were sitting on enormous profits from investing in small cap gold stocks. This suc-

cess combined with a rising gold price made other types of previously marginal gold resources economic, attracted even more investors which underpinned the bull market. And compared to then we now are at a very early phase.

The additional influx of investors funded exploration (especially by Canadian companies) world-wide which later resulted in huge discoveries such as the **Goliath**, **Golden Sceptre** discoveries at Hemlo and later **Prime Resource Group's** Eskay Creek (eventually taken over by Homestake) and **Arequipa Resource's** Pierena discovery (bought by Barrick for \$1.1 billion after its shares rose



from \$0.40 to \$32).

We can see the market already coming to life in this respect as a new influx on investors funds a wave of exploration which is already starting to reward investors. I think we can be confident that the momentum will continue to build in this highly profitable sector as new discoveries attract more money and new investors just as existing investors reinvest their profits in new gold stories.

Our experience is that when gold's bull market is at a terminal stage gold and gold stocks will move in tandem - Radically higher, very quickly and the difficulty will be having the discipline to chose an exit point. Everyone will be bullish. Remember internet stocks in 1998: we are light years away from that final stage.

Buy on weakness

Our strategy is to continue adding resource stocks to our portfolio with a focus on gold ju-

niors. Our position in the George Young run **Pan American Goldfields (OTCBB:MXOM \$0.30)** the former Mexoro Minerals is being increased. The company has just begun gold production at its Cieneguita gold deposit and they are negotiating the acquisition of a major project in Argentina. This makes sense as Mr. Young is well known for his ability to find and acquire major assets. George was instrumental in acquiring the Gualcamayo gold project in San Juan Province, Argentina for **Viceroy Resource Corporation**. The Gualcamayo went on to be Viceroy's principal asset as it became a huge success with over 11 million ounces of gold. Viceroy was taken over by **Yamana** at around US \$10 per share (.97 Yamana for every 1 share of Viceroy) and according to Yamana it was: "because of the Gualcamayo". When Mr. Young cofounded **International Royalty Corporation**, not only



was he key in its acquisition of an interest in the giant **Voisey's Bay** nickel mine, but more important he was directly responsible for getting IRC's interest in the **Pascua Lama** - a giant 17 million oz/gold 635 million oz/silver mine. The Pascua Lama was one of the principal reasons cited for IRC's later takeover by **Royal Gold**. He also co-founded the major success story **MAG Silver** (TSX:MAG \$6.50), which we are also continuing to accumulate. He acquired for MAG its **Cinco de Mayo** project which is developing into one of the richest molybdenum deposits in the world. Now he's busy working his magic on Pan American's behalf

while we continue to accumulate the company's shares.

We are adding one more gold junior start-up **Rio Novo Gold Inc.** (TSX:RN \$1.28) to our portfolio. It is a Brazil-based new issue which is expected to begin producing roughly 100,000 ounces per year beginning late 2011. The company has considerable production and reserve growth upside and an intensive drill program is currently underway with first results expected late this month. The company has 90.75 million shares outstanding giving it a \$116 million market capitalization. A comprehensive report will be distributed to subscribers shortly.



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