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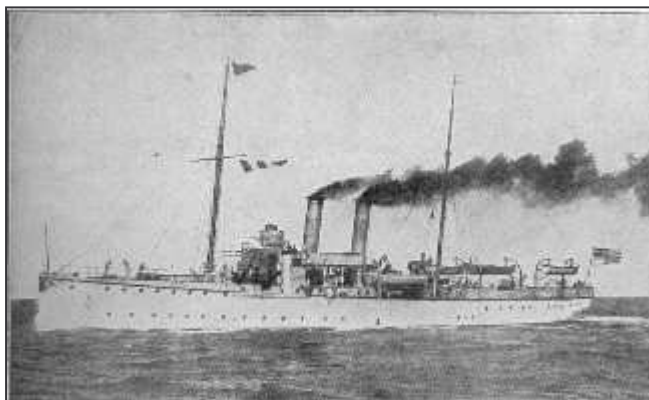
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**Think Piece**

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## REE – China’s “Boycott”

An Agadir Crisis for our time



# The REE Embargo on Japan

## “Sparking” a Crisis

- ✘ The kaffuffle over the Japanese seizure of a fishing boat captain in disputed waters resulted in China playing the REE card in a hostile manner.
- ✘ The Japanese caving so rapidly set a VERY bad precedent letting the Chinese think that strategic metals are so desperately needed that virtually anything can be negotiable upon their withholding
- + The event was a big wake-up call making Western governments see that the REEs and all other metals where China has dominance (e.g. Antimony, Tungsten) are open for use as bargaining chips and they WILL be used as such
- + The REE sector, which was already electrified, got a further kicker from this event. Hopefully the vulnerability of other specialty metals will also receive awareness
- + The US Congress hurriedly passed the Rare Earths and Critical Materials Revitalization Act of 2010, a light version of the RESTART Bill
- + We suspect other Western government’s will be fomenting their own REE strategies in a more *sotto voce* manner
- ✘ The wake up call has come at a time when immediate replacement at any level of the Chinese source of REE is impossible. There is potentially a gap of several years before even a small portion of China dependency can be replaced

### Fishing Boat “diplomacy”?

There is very little that we can see that is “diplomatic” about the Chinese actions in recent weeks in the fishing boat and Rare Earth space. Heavy-handed might be a better word. That there is no chemical relation, or otherwise, between a fishing boat and those elusive objects of desire known as Rare Earths almost goes without saying.. or at least did until the Chinese decided to change the game plan in its struggle with Japan over some uninhabited rocky islets (the Senkaku Islands) in the East China Sea.

### Agadir Parallels

While the Agadir Crisis was not the first use of gunboat diplomacy (that had originally surfaced in the 19<sup>th</sup> century largely as colonial muscle-flexing in Asia), the incident in question was one of the most portentous and essentially presaged the First World War (hence its *de rigueur* presence in all books on the theme).

The Agadir Crisis, also called the Second Moroccan Crisis, was the international tension sparked by the deployment of the German gunboat Panther (pictured on the front page of this note), to the Moroccan port of Agadir on July 1, 1911. This ship was sent to make a German presence felt at the time that the French were suppressing an uprising against their “client” the local Sultan. In a spiral of events the Spanish seized two ports and the British then threw its support behind France despite having not wanted the French to send troops to help the Sultan in the first place. The British feared the Germans

seizing Agadir and making it an enclave port. Such is the potted version. It was a dry run for the haggling in the weeks that preceded the First World War three years later.

For desisting the Germans were given Cameroon as a colony. So a gunboat on hand can be a useful thing! However Germany's goal was really to scare France into turning to Germany, the main result was to increase British fear and hostility and to draw Britain closer to France. British backing for France during the crisis reinforced the Entente between the two countries (and with Russia as well) and added to Anglo-German estrangement, deepening the divisions that would culminate in World War I.

Some think that it was this incident that led Winston Churchill, then Britain's Home Secretary (and shortly after made First Lord of the Admiralty), to the conclusion that the Royal Navy must convert its power source from coal to oil in order to preserve its supremacy. Commodity replacement as a strategy... sound familiar?

### The current situation

This is becoming one of the most well-known fishing stories in recent times, almost beating out *The Biggest Catch*. Usually this profession doesn't figure on Bloomberg screens. Essentially a Chinese fishing boat "going about its business" was harassed by Japanese patrol boats. Some sort of altercation ensued and it "rammed" the Japanese ships and the Chinese captain ended up being arrested. The Chinese government demanded his freedom. When they didn't get it the rhetoric was stepped up and then the Japanese claimed that REE shipments to Japan had been unofficially frozen, something which China denied, but which many traders corroborated. Much to the surprise of many, the Japanese did not tough it out (though in retrospect they probably wished they had) and instead, with rather unseemly swiftness, let the fisherman go. We had thought that they could have used intermediaries and transshipping to get REE from China through other means if they had decided to hang tough, but clearly they rushed to save their REE supply before thinking of saving face.

The Chinese, still not satisfied, demanded apologies and other reparations while the Japanese said they wanted China to pay for damage to their vessels by the fishing boat. The issue can be allowed to fade away because the "hostage" is no longer in the middle but the real hostage was patently clear to the economic community. In various key metals the Chinese have the rest of the world over a barrel. Without stockpiles or alternative sources (or even recycling processes) the West is at the mercy of China's mood swings and grandiose machinations.

Japan - REE Imports 2008 (gross tonnes)	
Yttrium Oxide	1,673
Cerium Oxide	8,883
Cerium Compounds	7,924
Lanthanum Oxide	3,617
Rare Earth Metals	6,306
REE Compounds	5,927
Ferro-cerium	997
<b>Total</b>	<b>35,327</b>

Source: IMCOA

### The Parallels

Obviously here we don't have colonies or quasi-colonies (like Cameroon and Morocco) in contention but we do have oil (as these rocks create a zone of influence to claim suspected undersea oil reserves ). And

we do have the Chinese rankled at the Japanese and conjuring up the bogeyman of Japan's actions in the 1930s and 1940s. Ironically one lesson from that time was that the Japanese push across the region was made in the name of the Greater East Asian Co-prosperity Sphere, which many in Asia now see being revived with the Chinese having purloined the notion and doing its best to make its own version.

A few rocks in the ocean don't seem much, but provocations don't need to come in large sizes (or of Archducal status). The Nazi's invaded Poland on the pretext of a stooged raid by "Polish" troops on a German radio station in August 1939. Thus rocks and suchlike can have their nationalist uses.

### **The RESTART Bill – a new urgency**

The Chinese may come to regret their hasty playing of the "taking home the ball" stunt. In March, Rep. Mike Coffman (R-Colorado) sponsored the Rare Earths Supply-Chain Technology and Resources Transformation Act of 2010 (H.R. 4866 see text [here](#)). This was later introduced to the Senate by Senator Murkowski (R – Alaska) as S 3521. This Senator however had the rug pulled from under her by the Tea Party troglodytes and is now a write-in candidate at the mid-term Senate elections in November. However, the bill was shunted off to various House committees back in mid-March to "freeze in hell".

The Act was being sponsored by the US Metal Magnet Association, a trade group with seemingly less than a handful of members (two magnet manufacturers, Lynas and Avalon). We had expected the bill to wallow in pre-election shallows and miseries, which it has done. However the effect of the "fishing boat incident" was that it revived interest in the theme and a "light" version, the Rare Earths and Critical Materials Revitalization Act of 2010 (H.R. 6160 – [text here](#)) was raced through and passed (Yea 325 – Nay 98) by the House last week. This makeshift bill was strong on warm and fuzzy, with the only grit in it being a ban on loan guarantees to any REE project (mining or processing) that is NOT in the US.

The RESTART Bill has a "mom and apple pie" feel to it with a "how could you deny this?" tone to much of the promotion. As with everything in US politics it is important to seek out the real beneficiaries of any piece of legislation rather than those ostensibly are promoting it. Scuttlebutt in the REE industry at the current time is that Molycorp (MCP) is the real beneficiary of this legislation.

In any case the USMMA have published a six-point manifesto that will be the initial talking points. These are:

- Establish a baseline - Studies by affected agencies to establish a baseline of rare earth usage and dependence and any economic or national security issues that result, as well as an action plan to restore specific holes in the domestic supply-chain, to include mining, refining, alloying and manufacturing
- Obtain raw material necessary to resume defense critical rare earth manufacturing in the face of a pending worldwide shortage - A program whereby the Defense National Stockpile purchases existing rare earth supply to support the US Government's critical needs while the domestic supply chain is rebuilt over the next 5 years
- Government initiated action to ensure fair trade - A government initiated action to investigate potential foreign government market manipulation or dumping in the rare earth market, as a means of leveling the playing field for domestic competitors

- Investment in a globally competitive rare earth supply-chain - A \$2B DOE led grant and loan guarantee program to support the reestablishment of mining and refining operations in the US that will support the domestic supply-chain
- Specific focus on defense critical components - Numerous Defense Production Act programs (\$10-50M each) to support establishment of domestic manufacturing capability in critical segments of the rare earth market
- Investment to ensure future innovation - Support of innovation, training and workforce development to support the rare earth element supply chain by providing base budget funding for academic institutions, government laboratories, companies, non-profits and industry associations

However, as is well-known, legislation can come out of Washington totally unrecognizable from that which went in for consideration. It is during this transformational process that the special interest groups (beyond the USMMA) get to tag special benefits onto the law. It might be useful then to go through the six-points and examine how they might play out.

Before anything else though we might note that both the House and the Senate sponsors are Republicans and that the Act is being couched in terms of Defense policy before any other broader industrial uses of REE. We would also note that with a generalized mood of budget-balancing in the air, it would be very easy for the Democrat majority (or minority post-November) to shuffle this Act to the side if it is perceived to have too much budgetary impact. We might also note that the prominent Democrat Senator with REE interest in the past, Senator Evan Bayh of Indiana (the state with most magnet producers) is standing down from the Senate from November. It should be recalled that all the legislative branch has done on this topic so far was to commission the almost “no-cost” GAO report.

As for the six-points, the **first** seems to cover much of the territory of the GAO Report. We would not be surprised to see a more extensive report covering all the US’s industrial REE needs being commissioned. It could however be a lucrative and drawn out assignment for a consulting firm which could merely delay decisions being made on more crucial areas.

The **second** point is the “stockpile” clause. The advocates for the strategic stockpile option would claim its aim is to ensure that the government has a supply of REE (or whatever) for when it needs it. But governments never need REE themselves because they procure all their military supplies from suppliers. It is the suppliers who must buy and stash the stuff or, perish the thought, invest in mines upstream (or finance them) that would ensure that there are orderly markets and adequate supplies of their raw materials. The US and other countries do not need taxpayer supported strategic stockpiles, they need commercial accumulation of adequate supplies.

Presumably when the Navy signs an agreement with a supplier for a new missile system, the supplier has to commit to have spare parts almost immediately available in any circumstance. That is relatively easy for the supplier to commit to. It has control of its manufacturing process (or at least thinks it does). But can the supplier also commit to ensure that the raw material inputs for the spare parts are available to keep the supply chain intact and make good on the supply commitment? The GAO report made clear that supply-chain bottlenecks are already appearing in the works and no adequate response is available to explain why if China were to ban all non-elaborated heavy REE exports tomorrow then there would be absolutely no alternative supply. A stockpile proposal might get some traction but in the current tight

supply situation this might work against the interest of magnet and other industrial users as it is likely to make prices rise higher. The mood in Washington is not kind to stockpiles for they did not work out for the government during the Cold War, moreover with almost no US or even North American production, such a stockpile would end up buying Chinese REE exports, unless of course this proposal is designed to make a captive market for Molycorp's products when it returns to production.

The **third** point is a call for something like a WTO inquiry. This would appear to be a case of too little too late. The Chinese have managed to corral the global industry since the 1980s and can now justifiably claim that they are keeping a scarce resource for their own future usage. If that forces up prices then it is only capitalism at work. Either an internal or external inquiry would be doomed to make the finding that the Chinese have a Rare Earth policy while the US does not. Moreover many countries restrict exports or exploitation by non-nationals of resources and thus any action in external forums would not gain international support for the US stance. The Congress might hold committee meetings on the subject but we feel that is as far as this would go.

The **fourth** point is the slush-fund. This is unlikely to get any traction in the current political/budgetary environment. This is directed towards Molycorp and less than a handful of players with exploitable properties in the US. This would also go down very badly with competing REE countries (Canada and Australia) that could file at the WTO that the US was subsidizing REE mines and industrial users at the expense of competing nations.

The **fifth** point is the slush-fund watered down option. This is directed towards the military supply chain and directly answers to some of the valid concerns of the GAO Report. However this also has an element of "playing God" to it with the very well-padded suppliers in the defense chain seemingly being targeted to receive subsidies, which they of all people least need, to fund development of REE vertical integration. This does not address supply issues as contractors are not willing to add mining to their skillsets while declaring miners to be part of the defense supply chain would necessitate some form of qualitative decision being made by the government on the virtue, or not, of different projects.

Finally the **sixth** point should be read as research grants and subsidies. Ironically much of the work on applications of REE is being done in US educational institutions and by US corporations. Thus we might be tempted to think that this will actually morph into an R&D subsidy in some form. It is very possible that Congress might fund the issuance of grants for REE research as a sop to the Act's promoters.

### **A Shooting War?**

As many pundits have pointed out the likelihood of a "shooting war" over scarcer commodities becomes more likely as the years go by and resource depletion increases. Ironically the well-armed West, despite its profligate reputation, has been winding back its consumption of most of these potentially scarce commodities for decades as growth has been sluggish and recycling provides most of the needs (ex-oil). We would note that it is specifically those metals with little recycling underway that are now also the most craved. If there were a big pool of recyclable REE or lithium materials available then these would scarcely be subjects of discussion.

## Deviating from the Script

The Chinese “party line” in recent times, particularly after the export quota reductions, has been that they are not hoarding REE to stoke prices or to manipulate prices (when the word manipulate is on everyone’s lips in various contexts related to China) but instead they are protecting their patrimony in REE for future generation etc. We took all this at face value. We even ascribed philanthropic motives such as wanting to warn the West to get its own supply because they (the Chinese) knew what they had and knew that there was not enough. Essentially “get your skates on” because there is a supply crunch coming.

The whole PR machine came undone though when some heavy in Peking decided that the Japanese needed to be hit where it hurt. Finally a *frisson* went through the normally torpid Western industrialists. Those that hoped that governments would build them a stockpile, so they didn’t need to take commercial risks themselves, suddenly realized that the governments may not be able to build a stockpile if for geopolitical reasons the REE supply is withheld. Who is not to say that behind closed doors at this very moment when Tim Geithner speaks of floating the yuan then the subject of REE supply is blithely (and disingenuously) inserted into the conversation. Who knows whether the Japanese were not threatened with more than the withholding of REE supplies? REEs (or other commodities or other actions) may be being used as a threat and none of us mere mortals are any more the wiser.

## Drawing a “line in the sand”

As a trump card, cutting off REE supply only goes so far. The US or Europeans might forsake their wind generator or hybrid auto ambitions for a few years until Mount Weld and Mountain Pass come to the party. Certainly these two sites (and in fact most of the other mooted projects) might find it hard to plug the gap left by Chinese supply being choked of. In hostage crises the official line is “no negotiation” therefore in REE the misstep of the Japanese in caving so fast might be noted by others for future cognizance and a line might be drawn in the sand. “Things we might concede and things we will not”. On the scale of things, a few weeks or months of lacking REE supply would have been a small price for the Japanese to pay to stand their ground over their precious rocks. Indeed if the unofficial embargo had gone on for a few weeks more then it would have become proven and the Chinese could have been hauled before the WTO.

Trade wars will happen and humble and previously unknown Rare Earths might be the spark to light the fire. After all it was Cerium *mischmetal* used on lighting flints that first “sparked” practical demand for the Rare Earths in the 19<sup>th</sup> century.

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