Monday, November 7th 2008

Hallgarten & Company

Regional Review

Christopher Ecclestone
cecclestone@hallgartenco.com

Losers & Bigger Losers

Country by country across LatAm sifting through the wounded

Losers & Bigger Losers

Surveying the Carnage

- Some countries are relatively unaffected by the metals price retreat. The ones largely immune, or unconcerned, are Argentina, Venezuela and Paraguay
- Brazil will see its nickel possibilities largely thwarted and faces a tough battle of the wills with China over iron-ore pricing. Gold prices are good enough (and the currency slump in the real large enough) that this activity should be sustainable.
- Bolivia, Mexico and Peru are going to encounter social pressures because of the important role that mining has in job creation and the sustaining of isolated communities.
- Mexico could do with more currency relief to help out miners on their average dollar production costs.
- Ecuador's slowness in approving legislation means that the train has not left without it but has rather been permanently cancelled
- Peru is going to face big decisions once the Chinese come a'hunting after distressed Canadian-owned assets. They had better get some quick lessons in how to say "no" in Mandarin.
- Colombia is actually fairly well off. Coal prices remain firm and the internal dynamic means improved margins in this business rather than worsening margins. Gold is still in its formative stage there and so little was going on that the economic effect of lesser activity will scarcely be noticed
- We remain bulls on metals prices. The liquidity splurge to solve the financial crisis is here to stay and has produced a tidal wave of money that is yet to hit shore. Precious metals in particular will be beneficiaries of this squandering of monetary resources without commensurate creation of assets to back the extra money supply.

- Base metals are subject to some brutal manipulation at the current time combined with a liquidity crunch. Basically once the non-trade players are removed (already achieved in our opinion) then the eternal supply/demand factors will come into play. Capacity is being closed down left and right with commensurate supply reduction. This lays the ground for price spikes and, further down the track, the derailing of so many projects means an even tighter supply situation two years out for almost all metals we could imagine.

End of reflation or just a headfake?

The dramatic collapse in base metals prices can be one of two things. The first would be an end to the reflation that has reigned since 2002. The second would be a transitory reaction to the liquidity crisis with some semblance of normalcy restoring some but not all of the shine that the base metals have enjoyed in recent years. We are of the opinion that the last few years have not been "just an economic upcycle" in the commodities space but rather that the upcycle finally exposed the years of under-investment in the mining space which has resulted in a severe supply/demand imbalance. Metals are returning the age before 1973 when they had real value. They are no longer the poor relatives of the economic system. They are finite resources in a resource-limited world.

On the second point we would agree that the liquidity crunch produced massive distress that went to the core of even the most convinced commodity groupies. When push came to shove, the baby went out with the bathwater (if we can mix our metaphors). While some commentators have grasped onto the Baltic Dry Freight Index as an indicator of impending doom, one can't do much better in base metals than looking at

LME, however imperfect and manipulable those numbers are. The key factor to note here is that stocks have really not gone ballistic as in the past when there has been a slump in demand. While they have moved up, and by sizeable percentages off their lows we would note that zinc going from a stockpile of three and half days of global usage to 4 days of global usage, scarcely ranks as a deluge of supply. The stocks are minimal compared to the "bad old days". Some metals, like zinc and nickel are trading at "bad old days'" levels without the stocks reflecting any commensurate "collapse" in demand.

Call us conspiracy theorists but the commodity space has been one of the easy spaces to rig prices to send signals to the market. If one has a goal of pumping the dollar to produce a false sense of security when it should be plunging then is it easier to short gold using massive CB gold holding as the backstop for the shorts or spend hundreds of billions buying treasuries? In this case they seemed to do both and it worked… for as long as it works. It is a Sisyphean task indeed but indicative of the PTBs desperation. On the other hand we have our old friends the Chinese working the metals prices for all they are worth. To buy cheap metal (like they have done in quick dumping operations over recent years)? No, to buy cheap miners.. its even better. Kill the metal and the owners of the mines will roll over to the minimal level of pressure when the Chinese come waving a checkbook (and a much thinner one than was waved at Peru Cooper and Northern Peru Copper). To believe current bad vibes out of China that production is slowing dramatically would also imply that one should be hacking Chinese growth expectations from a "modest" 10% to negative territory. No one is doing that, least of all the Chinese, so someone is speaking with forked tongue here.

So metals prices have been ground between the two millstones of two different sets of PTB.

Argentina

Frankly Argentina couldn't give a damn about metals prices. Neither Bajo de la Alumbrera nor Cerro Castillo rank high in the thought processes of the Argentine economics ministry officials. The new mines coming on in the last year (Hochschild/MAI's San Jose and Coeur's Mina Marta amongst others) have added some small extra income and their start-ups have been graced, with enthusiasm, by the Kirchners (any peasant worth his salt has a perception of gold's relevance). However, Argentina will neither live nor die (nor boom or default) on the back of lower or higher metals prices. Indeed, a pause (strike?) by mining companies in their investment programs may serve to focus the minds of some of the provincial administrations that tried to play the role of dog-in-the-manger or experienced overnight conversions to Greenness. A few have been showing signs of relenting… our words to you.. too late!

Lets put this in some perspective. Argentina's chief mining output has been gold and copper so far with a modicum of silver. The biggest project nearing completion is Silver Standard's Las Pirquita's in Jujuy. Silver is creeping back up. We perceive its problems were with its dangerously incestuous dependence for momentum upon the silver ETF (SLW). The panic selling cleared most of this crowd out and we feel a new ratio to gold is in the making. While the price has gone back above $10, we could see a firm gold price (trending towards $800 but not above) pulling silver back towards $13 where a lot of silver players are still doing very nicely. The addition of SSAM's mine will add Jujuy to the ranks of provinces that are doing a nice sideline in royalties and economic trickledown. This reinforces pro-mining sentiment in the province while making some of the more sniffy provinces all the more irate because they cant have their cake and eat it too.

While seeing SSAM going forward the ones that are in trouble are Exeter's promising finds and Aquiline's two projects. The latter should have made more hay while the sun shone with the market cap kicker that winning the La Navidad lawsuit gave them.

Having said all that we repeat that Argentina the country should weather any metals storm with little impact (though other storms might sink the ship of state).

Bolivia

The Latin leader who has expressed most openly his concerns on metals prices has been Evo Morales, supposedly the "enemy" of miners in the popular vilification. Tumbling zinc was his main focus, but well may he concern himself with any number of metals that Bolivia produces. Mining is a major source of jobs (30,000) in the upland areas of the country from which he draws most of his support. As we have noted in our recent exposition on Bolivia, the Morales regime has not shown itself to be aggressive towards foreign miners and in fact is regarded as pro-mining by those in the know. The country still has its natgas exports going for it, but obviously there will be lower incomes for individuals and the state from the main export categories (silver, zinc, led, tin and antimony). The El Mutun iron ore mountain might have provided some consolation if it wasn't in the hands of the slowest moving pack of Indians on the planet. Bolivia knows how to tighten the belt but the tightening doesn't come easy when the metals bonanza had just started to trickle through (Apex etc) and so few had yet to scramble onto the gravy train before it derailed.

Brazil

There is more to the Brazilian economy than iron ore though one would not have known this from the furore of recent years. The rising Brazilian *real* over the boom period was having a deleterious effect on just about every Brazilian export sector excepting iron ore and soybeans, both of which could outrun the currency due to outsized price gains. Most other export categories went to hell. The shoe industry was pushed off the global store shelves by Chinese product on every battleground. Little concern was raised due to the booming domestic economy, fed by massive cash inflows, taking up the slack. The retreat in the real now gives industry a chance to start exporting again, and it will need to considering that the domestic economy will now need to revert back to being powered by its own financial resources rather than the fleeting yen carry trade. Brazil's mining sector consist of three elements with substance: iron ore, gold and nickel. Starting with the gold we would note that while there are a few substantial names producing (Yamana, Jaguar and Eldorado springing to mind) most of the players linked to Brazilian gold in recent years remain in the explorer category and none we know of are in the imminent production category. In any case gold is not too bad in its current price range and all the current producers are still viable with the added kicker of lower costs due to the real dive and the retreat in oil prices (though the latter's benefit was somewhat blunted by the currency move).

Nickel miners and wannabes received no such joy. As we noted in our piece on Brazilian nickel earlier this year there are not a lot of players but the one's that there are signal Brazil's appearance as a major new nickel province. However, the cataclysmic fall in the nickel price does not bode well for the wannabes or the producers. Mirabela Nickel, the Australian company was the one most likely to add to production in the very near future. It had been seeking a US$280mn senior debt financing (being underwritten by Credit Suisse and Barclays) but recently announced a two month extension to this syndication's original December deadline. We feel ominous rumblings on this one unless the nickel price rises from the dead in pretty quick time. The company does however have an offtake deal with Norilsk which may yet result in Mirabela falling into the bear's arms.. Bears have done enough damage already with the 12mth high being $8 and the current price being $1.60. Being on the most slippery part of the explorer to producer time continuum how only taught Mirabela a lesson in Newton's Law of Gravity.

Gravity has extracted an even heavier toll at wannabe, International Nickel Ventures. The stock has melted from $1.20 when we wrote of it last to around 17 cents at the current time. That is not likely to be doing much for the near future.

So iron ore is the great hope. Only one month ago, Vale was riding high.. strutting about all cashed up and ready to share down the Chinese on price rise resistance. Sure it had been mauled price-wise but that too would pass. No such luck. Whether by accident or design the rumour got going that the Chinese were not only seeing big rises in steel inventory but that renegade buyers were defaulting on contracts. Suddenly Vale went from rooster to feather duster and started talking about cutting production (though not prices). This all remains to be seen. We repeat again that we think the Chinese are perpetrating many and various head-fakes through the commodity space at this time to further their long term goals. The financial community belives the bad vibes, some miners do not. Vale cutting production was the right approach to take. Better to leave it in the ground than let the Chinese get away with the current manouevre. Still the production scaleback should reduce Brazil's foreign earnings form iron ore, if only temporarily. In its own head fake MMX announced its delisting from the Toronto Stock Exchange. We couldn't help but suppress a smaile at this and recall from the 1990s how certain Latin American empresarios like to have their stocks in the market where they can manipulate them best.

Chile

There was more panic in Chile a year ago at the danger of energy crises, water crises and a super expensive peso sabotaging the real economy. Copper is largely the unreal economy in Chile as so little of its benefits seep down to the 14 million people who aren't on that gravy train. We could muse that the pressure on the water and energy resources is off (if only temporarily) while the peso has corrected nicely giving the exporters who really do produce jobs (agricultural mainly) a bit of breathing room.

Still bad news for copper is bad news for Chile. Codelco announced last week that its output was down 7.83% YoY, in the January-September period, to 1.12 mn tonnes mainly due to conflicts with contractors, environmental issues at El Teniente and Andina and lower grades. Meanwhile Minera Escondida, the world's largest copper mine, reported its production in the first nine months of this year fell 10.4% year-on-year to 997,000 tonnes due to lower grades, less availability of ore for cathode output and problems related to a SAG mill failure. In a more dramatic, but lesser scale, sign of the times the ASX-listed Tamaya Resources, a copper miner, went into administration last week claiming it was unable to repay its debts in light of falling copper prices. The company is the owner of the Punitaqui mine in Chile. The company reported a AU$141.2 million loss in the first half of the 2008 calendar year.

Away from copper, in another announcement in late October, Coeur d'Alene Mines (CDE) said that it had placed mining activities at its Cerro Bayo mine on standby, tactfully rationalizing it as being due to "an immediate focus on expanding and upgrading the mine's mineral reserves and resources and developing a three-year, sustainable mine plan with lower costs and higher production rates". CDM claimed it was in the best interests of the company's shareholders to preserve the valuable mineral reserves and resources at Cerro Bayo and not continue selling the silver and gold production at a loss. Chile is much more accustomed to the slings and arrows of fortune in the mining space and should weather the current downturn just fine. This process however will cause damage to the hordes of smaller miners that have been looking to provide the partial replacement (on a smaller scale) for some of the mega mines in Chile that are seeing falling grades or face the prospect of exhaustion over the coming decade. It is a great pity that Chile never bothered to develop its own mining capital market (in contrast to Lima's push) while the going was good.

Colombia

Curiously Colombia misses out on the debacle for two reasons. As far as gold is concerned there are scarcely any companies involved in this area in the country. The rebel activity kept avid goldseekers at bay until too late for anyone to really get involved. Thus there are only a handful of Canadian explorers and no producers we know of.

Coal though is a different equation. This product has remained immune from the commodity debacle, at least thus far. As we pointed out in our recent Coalcorp note the dynamic for Colombian coal is one of tailwinds not headwinds. A major upgrade of the FENOCO rail system is resulting in dramatically improved transport margins for the miners and thus a quantum leap in net margins. Coal in Colombia is something that shall be getting a lot more airtime in the next year or two and deservedly so.

Otherwise, Colombia, for once, gets to stay out of the firing line, literally and figuratively.

Ecuador

Better late than never may turn out to be never for the Correa government that thought it was keeping its cool on its slow moving mining legislation. Instead cool was glacial and now looks like turning into an Ice Age in which Rafael will be the hunter-gatherer found preserved in the permafrost. We noted some months back that certain countries felt that high oil prices gave them the luxury to eschew mining or at least put so many obstacles in the way that they could have “small but perfectly formed” mining industries. This was shortsighted to us because it actually made an economy entirely oil dependent and also it failed to grasp that oil did not provide substantial numbers of jobs and that oil was invariably somewhere else in the country than where the mining was undertaken. Thus in the specific Ecuadorian case the uplands indigenous population would be left to grow yams while a select groups of techies would run oil installations in the coastal and Amazonian lowlands.

We have no doubt that the mining legislation will finally get through and that it will still be usable by the mining industry. The key question is how many of the miners, kept in holding pattern burning cash for so long, will be around to touchdown at their projects when the greenlight appears. A foolhardy policy has meant that Ecuadorian projects are even lower on the exploration/production continuum than those specimens in Venezuela. That implies they are farther from production on average than their peers in other countries that makes them all the less attractive.

The 800-lb gorilla in the sector is now Kinross after their purchase of Aurelian to get their hands on the company’s Fruta del Norte mine. Aurelian has established an inferred resource of 13.7 million ounces of gold and 22.4-million ounces of silver at FDN. Based on initial scoping work and mine planning the project could cost around $500-million. This is not small change even by Kinross’ standards. They are lucky indeed that gold is still in the range where this project looks viable. Ironically, despite the travails of all concerned in Ecuador, this project, even though still formative is more likely to be able to gain momentum than many other projects in many other countries, including those more advanced on the studies’ front. The other interesting project in Ecuador that would “make a difference” globally is the copper-gold prospect of Corriente (CTQ.to, ETQ) in the eponymous copper belt. This has passed the feasibility stage and a starter project at Mirador is on the planning board. This might find itself a non-starter project until copper picks up momentum again.

At least the Correa government will be able to boast of one mine after having effectively sabotaged all the “might-have-beens” by their tardiness.

Mexico

Doom mongers have a field day with Argentina's antics and Venezuela and Bolivia are on the list for vilification of those opposed to their politics but when it comes down to it, Mexico is really the current "country most likely to…" in Latin America. What it is most likely to do is in the eye of the beholder. Our macro risk analyst Armen Kouyoumdjian, who has covered the country since the late 1970s used the words "failed state" the other day to give an idea of the direction in which Mexico is drifting. The metals collapse has come at a particularly bad time for Mexico. It has seen its oil price more than halved at a time of declining production, just as Mexican immigrants are sending home dramatically reduced remittances from the US (if not packing their bags and returning home due to lack of work or tightened persecution). The *maquiladora* industry is joined at the hip with the US auto industry and that is in free fall. One week recently, Mexico spent US$10bn defending the peso. Why bother? Better to have devoted that to make work infrastructure projects than fight the reality. In any case a weaker local currency might help those miners already producing by lowering their comparative costs. We note that it is major Mexican corporations, Controladora and Vitro that have hit the rocks before any corporates in other parts of LatAm.

Mining could have been (and maybe still will be) a great job creator. It has the benefit of bringing jobs to out of the way places where nothing is going on. Talking to a Canadian mining company this week, we discussed the local village of 250 and asked "what had been done with them?" and the response was "we hired them all" and this is only in the exploratory phase. Conceivably the mine in operation would transform the district and support a town of 1,000 or more. The story is repeated across northern Mexico and down to a few more southern areas like Oaxaca. Mexico was also the country with the most Canadian juniors running loose. This was a product of a great government attitude towards foreign miners and sheer prospectivity of one of the greatest mineral provinces in the world. The government rightly did not pursue a nationalist tack for once in recognition that the few domestic miners that the country has range from the torpid to the blatantly unpleasant in their promotion of improved local communities or worker relations. Of course, the more juniors one has the more inactivity looms as this group run short on cash. The majors in Mexico consist of the big three locals (four if Fresnillo is counted as a truly separate entity to Peñoles) and now a handful of foreign mines making a good contribution to job creation, royalties and the trade balance in world-scale mines.

This crowd are somewhat cushioned by silver staging a rebound and gold having found some footing in the mid-$700 range. Once again we repeat that a weaker currency against the dollar would help. Those with an over-dependence on zinc or lead are over a barrel at the current time and the highly prospective El Boleo of Baja Mining has fallen victim to the low copper price and the financing freeze, despite having a truckload of money in the bank from the deal with Kores. The freeze may eventually ease but the sheer size of this (and a few other projects being mooted like Geologix's San Anton) may make big not beautiful compared to small and doable (like Fortuna's San Jose project in Oaxaca). Thus Mexico may not be an unalloyed disaster if silver can creep back to the $12 range in short order, gold holds its ground and copper tops $2 again. We repeat that we feel zinc could do a spike to over 80 cents on the massive production shutdowns currently in the works. That should at least bring comfort to those relying on by-product credits, though new projects shall remain stuck in the starting gates.

Peru

The members of the Peruvian government had better start learning Chinese or at least come up with a China policy pretty fast because its about to become a major issue for them. Those *Conquistadores* were not mistaken Peru is a treasure trove of minerals. Peru has the most prospectivity for large scale mines in a wide variety of metals than anywhere except Australia. The Australians have already made clear to the Chinese that they can nibble but cannot bite. The Peruvians are seemingly blithely unaware of the attentions being paid to their trove. The mere fact that the assets are largely in Canadian hands (with some serious Brazilian attention from Votorantim) does not make it a case of *six of one half a dozen of the other* when the Chinese come calling. Its all well and good to have customers for one's output but when one is deemed a “sphere of influence” then watch out. The DRC is a sphere of Chinese influence these days and it isn’t pretty. Of course one could always let the Chinese in (via snapping up bargain basement Canadian stocks) and then expropriate them later. This is the traditional treatment for uppity foreigners. But maybe they should throw away the 1950-70s editions of this book and go back and check the 1880s when the British wanted nitrates and Bolivia and Peru were made to disgorge them through the Chilean factotum.

Back to our conspiracy theory. If you feel that the manipulation of the news flow regarding metals “demand” is designed to get prices down and facilitate a grab for copper mines and not just for a few shiploads in the short term then the mines that are in the target range are largely in Peru and they are projects like those of Candente and Chariot Resources. Clearly tired of negotiating for top dollar at Peru Copper and Northern Peru Copper with hard nosed Canadians like the Global Copper team, the Chinese must be licking their chops at the prospect of ravaging some of the mine owners who have seen their prices turn turtle. As any Chinese market stall owner knows the best way to gut your turtle is when its on its back waving its legs in the air. Not a pretty prospect for Candente or Chariot (or their look-alikes). Its no skin off the Peruvians’ nose at this juncture to see a change of ownership (indeed it might even speed development) but it is a serious mistake for institutional holders to not properly assess the longer term values of these projects. Just last week the first shot was fired with Cardero announcing the sale of one of its magnetite “mountains to a private Chinese company. This may be out head-faking the Chinese and we remain to be surprised by seeing this settle, but it just highlights that the Chinese are seeking to secure their upstream supply and intimidate Vale and Rio Tinto into acquiescence on iron-ore pricing.

Longer term the Peruvians may rue the day when the razor-wire surrounded encampments appear with the PLA-seconded security teams roaming around with machine guns. Won’t happen here? Happened in Africa… No somos africanos! To a Chinese mining executive all you non-Chinese *peones* look the same! Keep digging and shut your mouth.. Whether the Garcia regime wakes up or not is not clear. Some say he is a great admirer of Deng Xaio Ping… hmmmm.. These Latin quasi-leftists are nothing if not retro.

Peru has done one of the worst jobs in helping achieve trickledown from mining development to the masses. Up close and personal, local communities, like that around Fortuna’s Caylloma mine or Vena’s Macusani prospect have been treated well but others (like those at La Oroya in the fallout zone from the Doe Run smelter) have only received lead poisoning for their troubles. Mining inflation became generalized inflation and the solution from on high was denial with some jiggery-pokery of the statistics with a distinct Argentine flavour to the manoeuvre. The Garcia administration must be hoping it gets a second chance to get this right by mining prices staging a comeback. In the meantime, it had better starting learning the Chinese word for “no” and be prepared to use it.

Venezuela

Like Ecuador, this country has the irony that it might see a major project that has been stalled moving ahead while all around them are in stasis. That said, the two mines (Brisas and Las Cristinas) might have been in production years ago and enjoying peak gold prices rather than being Johnny-come-latelys to the scene. In the meantime, Hugo Chavez has given himself the reputation of being fickle and radioactive towards miners. His latest love affair is the quasi-Russian Rusoro. Embrace the Bear if you dare… Chavez may yet come to regret his latest infatuation. These two mines (one extracted from Gold Reserve and the other from the terminally stupid Crystallex) might be developed as one complex due to their proximity but frankly who cares? Venezuela has shown its disinterest in mining except as a political football. No one new will appear on the scene and what might have been will not be. Oil at the mid-$60s level is good for Venezuela but not as good as at $150. As long as *bread and circuses* keep the rabble from revolting, all is well, but when they actually need some gainful employment, which mining might have supplied, they will need to tone up their basket-weaving skills because mining will not be an option in creating jobs, or perish the thought, a diversified source of foreign earnings.

Conclusion

One imagines from the havoc wreaked on local currencies that the retreat in metals prices (and some grains) is going to ravage the economies of places like Brazil and Argentina. Certainly the earnings and exports from these activities will be less but scarcely a bloodbath. There have been no suggestions that we have heard that there is any lessened demand for the agricultural outputs of either of these places. As for Brazil its iron ore shall see lower volumes but they seem determined to hold the line on price.

The precious metals are battered but unbowed and they make up much of the export output of the mining sectors of many countries. Chile is the prime sufferer from lower copper prices, but we are not perceiving any great suffering in the news flow because the domestic Chilean economy has been seemingly been insulated by distance and design from copper's mood swings. Still there will be a negative employment effect across the region from marginal mines being shut down and the investment flow to exploration drying up. Confidence wise some of the plans of governments on the infrastructure front had mining in the background as the eventual or indirect paymaster. Those plans will now need to be tailored to a lesser quality and quantity of cloth.

Governments and companies need to keep their cool at this time and look back to the fundamentals of their metals, which are almost invariably good. In the meantime beware of Chinese bearing checkbooks, it is not a mutually beneficial trade.

Important disclosures

I, Christopher Ecclestone, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. Hallgarten & Company may have received compensation from any, or all, of the companies mentioned in this report for services rendered, including corporate advice, marketing strategy or other financing endeavors.

Hallgarten's Equity Research rating system consists of LONG, SHORT and NEUTRAL recommendations. LONG suggests capital appreciation to our target price during the next twelve months, while SHORT suggests capital depreciation to our target price during the next twelve months. NEUTRAL denotes a stock that is not likely to provide outstanding performance in either direction during the next twelve months, or it is a stock that we do not wish to place a rating on at the present time. Information contained herein is based on sources that we believe to be reliable, but we do not guarantee their accuracy. Prices and opinions concerning the composition of market sectors included in this report reflect the judgments of this date and are subject to change without notice. This report is for information puposes only and is not intended as an offer to sell or as a solicitation to buy securities.

Hallgarten & Company or persons associated do not own securities of the companies described herein and may not make purchases or sales within one month of the publication (before or after) of this report. Hallgarten policy does not permit any analyst to own shares in any company that he/she covers. Additional information is available upon request.

Web access at:

Research: www.hallgartenco.com

60 Madison Ave, 6th Floor, New York, NY, 10010