

## **'Gold's been naughty but now it'll be nice-CIBC'**

In a recently published analysis, CIBC asserts that gold equities still remain below fair value for gold prices.



CIBC World Markets has increased its 2009 gold price prediction from \$900/oz to \$950/oz and introduced a 2010 gold price of \$1,050/oz. In a recent report, CIBC metals analysts Barry Cooper, Brian Quast, and Cosmos Chin said, "We further expect pure gold plays will outperform gold/base metal mixed plays in the current environment especially since the latter has not suffered full adjustments to the lower pricing regime for copper and zinc." Top picks in the sector include pure gold companies Kinross, Centerra, and Eldorado, according to the analysts, who "find valuations and growth prospects attractive for Goldcorp and Yamana. CIBC noted that Franco-Nevada held special status as the best royalty play, but downgraded Royal Gold to sector underperformer, citing price appreciation and valuation.

The analysts asserted that gold equities are 40% undervalued relative to trading levels in the first six months of 2008. "The events of 2008 should have pushed gold to higher levels than \$1,000/oz in our opinion," the analysts said, citing the collapse of Fannie Mae and Freddie Mac, multiple bank failures, \$50 billion in swindles, the collapse of the Big 3 automakers, and the downfall of the housing market. Instead, they noted, gold performed as "what every insurance policy does; it maintained the owner's wealth and certainly outperformed all other commodities during the crisis."

CIBC anticipates that gold production will continue to decline "as mines have moved into a very mature state from which there is little hope for a turnaround or new discovery. The evolution of discovery has gone from reserve growth to reserve replacement and has now entered into the realm of deserve drop-off.



Nowhere is this more evident than amongst the largest producers that account for some 25% of world production. Ironically these same companies are the very ones that can best afford to build mines but they are not accelerating projects to fill a production void that is fast approaching."

Suggesting that recession "hollow" will last two years, the analysts forecast that gold will also show strength for those two years. "It is our contention that regardless of the economic conditions, it is the uncertainty factor that drives gold's appeal," they said. "That uncertainty factor we believe is at an all-time high and unlikely to dissipate in 2009." Meanwhile, CIBC assured investors that the threat of central bank gold selling is less of a concern in the current environment. "To those that are worried about 400 t of IMF gold sales, we say bring them on. They are more likely to be absorbed as they were 30 years ago in today's market." However, they added, "While the selling of gold reserves seems to have been capped and is under control, the buying of gold reserves has so far eluded the thought process of central bankers. We believe this vacuum of ideas could come to an end as countries consider the hazards of holding only U.S. Treasury bills or other financial assets that have taken a totally new level of risk."

## 2009 GOLD EQUITY DRIVERS

CIBC's analysis found several catalysts that should help gold equities perform better this year than they have in the past including:

- Not many alternatives

Noting that other equity opportunities seem plagued with either individual financial issues or poor earnings potential, the analysts suggested "that it is likely that insurance in the form of gold holdings will play a bigger role going forward than it has in the past, be that bullion itself or the equities."



- Small-cap rebound in the works?

While the small-cap companies "have been decimated in 2008 not only on a relative basis but also historically," the analysts suggest that "should money inflow accelerate as we expect, it is local that this group should offer the great returns. The timing of such an event however is the key unknown factor."



- Pure plays to outperform producers enhanced by base metals

"We think there is both a current opportunity afforded pure gold plays on a relative valuation perspective as well as going forward we expect that pure plays will outperform producers with base metals contributions."

- Costs down

The analysts estimated that the world cash cost curve has already corrected by \$70/oz to \$400/oz. However, they advise that the full effect of this change is not expected to be seen until the first quarter of this year "and we also believe is not factored into the share prices of gold equities-look for a rollover of the world cost curve in Q4 gaining momentum into 2009 results."

- Reserves flat-good for gold less so for equities

CIBC's expectations for year-end 2008 reserve changes are modest. "While not good for gold companies, limiting future supply should underpin gold prices," the analysts noted. "In part we expect the declining reserve picture is a combination of mature mines and unsuccessful exploration." "Some of the differences will be made up by smaller discoveries and incremental ore found around existing operations but for the most part we believe that the world has crossed the threshold of lower total reserves for gold," they forecast.

- M&A to accelerate out of necessity

Noting that 2008 "lacked the usual frothiness of corporation action," the analysts, nevertheless, forecast that mining M&A activity will return in the second half of the year as the pressures for reserves and development projects becomes more acute. "By then we think that CEOs will have established some



confidence in the gold market although broader markets (particularly for debt financing) may stay elusive for a while."



• Weightings for sector will force buying

The analysts advised that "generalists can no longer ignore the gold group and will need to hold close to market weightings for fear of being caught offside from strong relative movements. This should create further buying interest amongst the gold sector as it is out contention that on average generalists are underweight the sector."

"In part we think the process has already started and that is why there has been general outperformance from the senior producers compared to smaller names. We also believe that traditional valuations will play a role in generalist's decisions and for the most part bigger companies trade a lower cash flow multiples. The reason for this is that larger companies have a greater problem showing growth either in production or reserves."

## **China Cabinet to Hear Plans for Boosting Steel Industry**

China State Council, or the cabinet, holds an executive meeting Wednesday to hear and examine a plan on boosting steel industry, according to China Securities Journal.

Jia Yinsong from the Ministry of Industry and Information Technology disclosed that the plan is expected to adopt following measures to solve various problems faced by China's steel industry:



-- To ensure a stable domestic market and regulate market circulation;

-- To control steel output and eliminate backward steel capacity;

-- To promote technological innovation;

-- To optimize industrial layout;

-- To encourage enterprise reorganization;

-- To further adjust product mix and increase efficiency;

-- To explore resources at home and abroad.

According to Jia, steel industry is urged to implement tax reform, raise building steel standard, encourage the use of local steel by household appliance makers, ship makers and automakers, restructure enterprises, and expand their overseas markets. Wu Xichun from China Iron and Steel Association (CISA) said that the plan would bring opportunities for the development of China's steel industry.

## **China to Halt Steel Mill Expansions to Help Stabilise Market**

The Chinese State Council has said it will not allow any new steel mill expansion projects and try to help stabilise the domestic and global steel market.

China vowed on Wednesday to stop its steel mills from expanding further as industry figures showed the sector carrying massive overcapacity which risks swamping domestic and foreign markets. The State Council, which also agreed measures to support its carmakers, said it would allow no new steel capacity expansion



projects and would adopt a flexible tax policy on steel exports to "stabilise" China's share of the global steel market. China has the world's biggest steel sector, with rampant growth fuelled by an economic boom that ran out of steam over the last few months. Steel capacity reached 660 million tonnes at the end of 2008, a China Iron and Steel Association official said at an internal government meeting on Tuesday, the China Securities Journal reported. CISA officials later told Reuters the proper figure should be 616 million tonnes.

Industry analysts said both figures are plausible.


Either way, 2008 showed strong growth despite the weakening market. Chinese steel capacity at the end of 2007 is estimated at about 550 million tonnes. "Everyone keeps saying the steel price has recovered, but this overcapacity is still there. As soon as the price improves a bit, they'll start up again," said analyst Henry Liu, of Macquarie Research. "It's not good for the industry." Nor is it good for relations with trading partners, whose own steel mills have cut output aggressively as the global financial crisis decimated demand. Chinese output rose only 2 percent in 2008 to 500 million tonnes, according to CISA estimates.



For several years Chinese mills relied on export markets to take about 10 percent of their output. China sold a net 52 million tonnes of steel into world markets in 2007, feeding a building boom in Dubai but enflaming trade sensitivities. Although China's domestic steel market was showing signs of weakness in May, it was masked by export demand until after the August Olympic Games. When export markets crashed, China's steel industry reeled. Net exports shrank to 45 million tonnes in 2008.

## LOBBYING

Record raw materials costs combined with plummeting prices have hurt returns, even at model national mills

like  **BAOSTEEL**, which includes Baoshan Iron & Steel Co (600019.SS) where profits dropped by 32 percent in 2008. China's policies to rein in capacity have been mostly ineffectual over the last few years. Some in the steel industry expect the government to add financial incentives to encourage medium and large size mills to merge, while forcing smaller mills with outdated, polluting furnaces to shut. The state council's measures, which were not released in detail, could compound the challenges for 2009. "All in all, things aren't looking too good for the steel industry this year," said Yuan Hui, steel channel director at industry website Umetal.

## ***The China Factor and What It Means for The Copper Price***

Global copper prices rising, and then falling back very sharply, as large copper production surpluses materialise during the year could be the scenario ahead.



Back in December 2008, SHSS suggested that world refined consumption probably fell by between 10-20% so creating a surplus of 740kt to 1,180kt in that quarter alone, using its definition of consumption being material going into furnaces. Current global consumption is no better, either in China or elsewhere in the world. Thus, a monthly surplus of between 250kt to 400kt is being built up in January. In China, scrap merchants lost so much money in the second half of last year that many are idle; scrap is, therefore, tight in China. Some smelters have also been forced to cut production, led by Jiangxi Copper, who has had a blow-out in their

oxygen plant, so we hear which will take 6-7 months for reparations to be completed. Until 2009, importers had difficulties in opening Letters of Credit; now banks are enabling LCs to be given and opened.

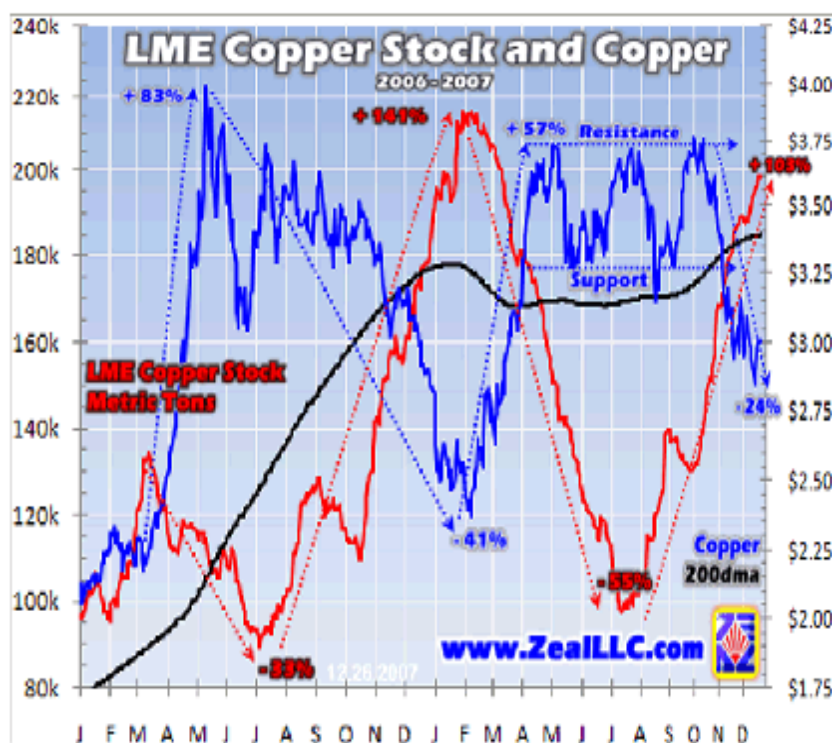
The combination of these developments together with the usual market games being played has given the appearance of tight supplies in China, despite domestic consumption remaining very weak. Now, the arbitrage between SHFE and LME has become profitable for importers, we should expect that cathode imports into China will become significantly higher in coming months. Moreover, we understand that the SRB is buying 20-25kt a month directly from producers/merchants, basis monthly average prices. Clearly, large imports will be greater than will be needed for furnaces, but, then, such a development will be nothing new for the market. Consumption in China remains weak. A modest improvement is being seen in power cable. Magnet wire



remains weak, though some makers see signs of recovery caused by government providing incentives for the rural community to acquire refrigerators, TVs, washing machines and mobile phones. Inputs into the real estate sector also remain weak - some improvement should be seen later in the year.

However, anything to do with exports is a disaster; copper exported in all its forms accounts for around 30% of China's copper consumption and between 60-70% of its GDP, once the feedback loops of investment, employment, consumption etc. are allowed for. Our friends see China's wire and cable consumption being worse in 2009 than last year; brass mills are unlikely to experience a better result.

Global appliance manufacturers have very weak businesses made worse by the Chinese starting to "dump" surplus inventories outside China. With economic activity being so weak and unemployment rising sharply in both the USA and the EU retaliatory action risks being taken since there will shortly be a new Administration taking office in the USA and a new Commission in Brussels.



The collapse in exports and manufacturing reported by so many Asian countries for November 2008 confirms what we hear on the ground. Semi-fabricators have difficulty in planning because their customers have no visibility. Uncertainty and volatility in prices and currencies only add to the difficulties being encountered by manufacturers and semi-fabricators in Asia and elsewhere. In some Asian countries, especially those where a change of government is likely or where there is political instability, there is a sharp drop in domestic business, such as in Malaysia, Thailand. Others are very weak, such as S Korea and Taiwan but for other reasons.

What is emerging out of this credit crisis and global recession is a long period of weak global business activity as the world deleverages and consumers become savers, despite central banks and governments trying to persuade households to spend. In the long run, the collective wisdom of households is infinitely superior to that of central banks and governments. Households have learnt their lesson.

What does this background mean for copper prices? Prices should continue falling, but markets seldom move in straight lines. Despite the cuts in production - with more copper to come - large surpluses will emerge this year as global consumption will fall by at least 2%. Nonetheless, the direction of prices until mid-2009 is likely to be up for hope springs eternal. We could see prices reaching \$5,000 by then which would provide an excellent opportunity for producers to hedge and for others to short. By end 2010 or in 2011, prices should be below \$2,000.