

# Basic Points

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The Music of the Metal Markets

February 19, 2008

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# Basic Points

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An Investment Journal

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## The Music of the Metal Markets

# Overview

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It is BMO Capital Markets' Global Metals and Mining Conference time again. Each year, attendance at the conference breaks attendance records as the industry's fortunes climb.

It is an anniversary for us. Six years ago, we were asked to deliver the keynote speech for the conference. We surprised attendees by proclaiming "The Birth of the Greatest Commodity Bull Market of All Time."

We have been asked to deliver the keynote each year since, and they were all bullish—even in 2006 when all commodity stocks were getting blasted, thanks to the Bank of Japan's surgical assault on the global carry trade.

The base metal companies have enjoyed amazing growth since 2002. Yet there is uncertainty as industry leaders and institutional investors head for Florida. Is that all there is? Will a Wall Street-spawned financial crisis derail the astounding Asian economic growth that turned around the industry's fortunes so dramatically?

We shall address these concerns by reminding the industry and investors that both the growth and a temporary slowdown were predictable: Each decade has some sort of pause. What will follow this one will be, we believe, an even greater boom—that will last for many, many years.

To understand where we are going, it is wise to review where we came from. That is why we have decided to do something we have never done before: We are publishing an issue in two parts and two time periods. The first part is an unedited reprint of our October 2003 issue that set out our predictions for a three-stage long-term future for the mines, *A Major Investment Sonata In A Miner Key*. We urge clients to read it, before looking at our update. It sums up our *current* views.

We chose a classical music form as the model for our forecast because we wanted clients to understand the sweep and scope of the once-in-a-millennium metals market that is unfolding. The return of China and India to the leadership of the global economy they enjoyed for the first 18 centuries after the birth of Christ is what historians will write about long after the term "subprime mortgages" has disappeared from the lexicon.



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In the second part of this issue we update our views at a time of dramatic financial turbulence. We remain most bullish near-term on the precious metals producers. The Wall Street-spawned US financial crisis has gone global, increasing the chances that the US slowdown will pull Europe into lassitude—or worse. That outlook is powerfully bullish for gold, but poses problems—in the near term—for industrial metals.

As for the overall outlook for markets, inflation rates in the US and Europe are at multi-year highs, driven mostly by foods and fuels. A recession could bring down oil prices, but grain prices are in a new bull market that will remain rampant through any recession.

We are leaving our cautious Asset Mix unchanged.

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	Published October 17, 2003	
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	Third Movement— <i>Allegro con Brio</i>	

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# Recommended Asset Allocation

<b>Recommended Asset Allocation (for U.S. Pension Funds)</b>		
	<b>Allocations</b>	<b>Change</b>
US Equities	26	unch
Foreign Equities		
European Equities	7	unch
Japanese and Korean Equities	5	unch
Canadian and Australian Equities	8	unch
Emerging Markets	11	unch
Bonds		
US Bonds	7	unch
Canadian Bonds	4	unch
International Bonds	11	unch
Long-Term Inflation Hedged Bonds	10	unch
Cash	11	unch

<b>Bond Durations</b>		
	<b>Years</b>	<b>Change</b>
US	4.50	unch
Canada	4.75	unch
International	4.25	unch

<b>Global Exposure to Commodity Stocks</b>		
		<b>Change</b>
Energy	29%	unch
Agriculture	28%	unch
Precious Metals	25%	unch
Base Metals & Steel	18%	unch

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

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Part I A Major Investment Sonata in a Miner Key  
– Published October 17, 2003

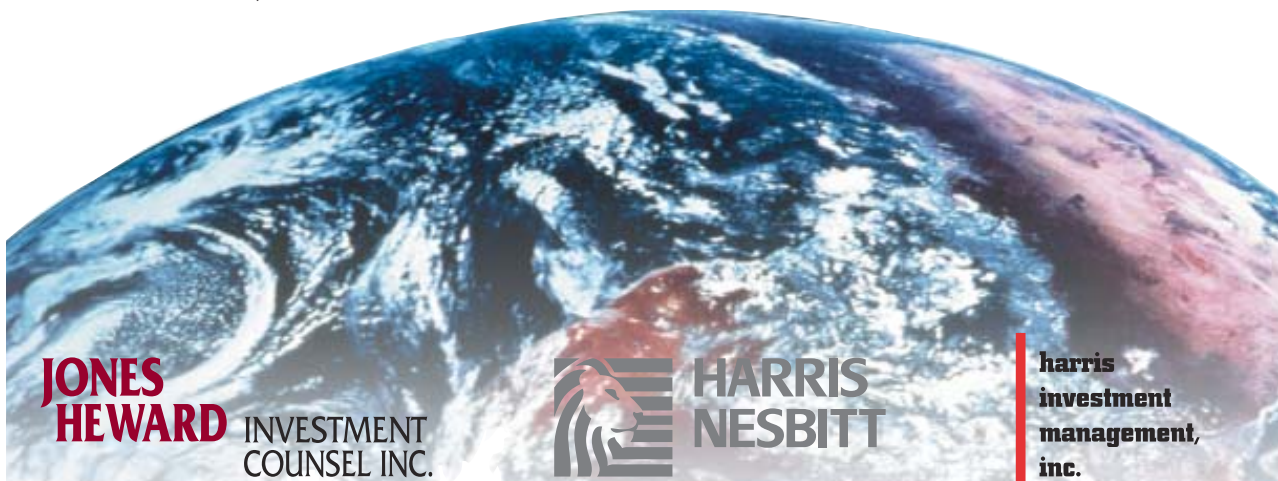
# Basic Points



## A Major Investment Sonata In A Miner Key

October 17, 2003

Reprinted – Basic Points: October 17, 2003



**JONES  
HEWARD** INVESTMENT  
COUNSEL INC.

 **HARRIS  
NESBITT**

**harris  
investment  
management,  
inc.**



## Recommended Asset Allocations

### American Portfolios

#### U.S. Pension Fund

	<b>Allocations</b>	<b>Change</b>
Domestic Equities	30	unch
Foreign Equities	25	unch
Domestic Bonds	25	unch
Foreign and Foreign-Pay-Bonds	10	unch
Cash	10	unch

#### Foreign Equity Allocations

	<b>Allocations</b>	<b>Change</b>
European Equities	9	unch
Japanese and Asian Equities	7	unch
Canadian & Australian Equities	4	unch
Emerging Markets	5	unch

#### Bond Durations

	<b>Years</b>	<b>Change</b>
Global	3.75	unch
U.S.	3.50	unch
Canada	3.75	unch

## Overview

Mark Twain observed, "History doesn't repeat itself, but it sure does rhyme." Discerning the poetry of the market is *Basic Points'* *raison d'etre*.

Where there is poetry, there will be music. And so to this month's theme—the unfolding three-part story of the next mining boom. The sonata—the classic instrumental form—is the structure chosen for this analysis.

We are still in the First Movement. According to *The Wall Street Journal*, mining stocks were the top-performing industry sector in the US during the Third Quarter—with its constituents up a mere 43.4%.

That statistic, included in a small chart in the special supplement to cover stock and bond returns in the Third Quarter, was ignored by *The Journal's* tubthumpers. To read their rapturous commentary, the only way investors made real money during the quarter was with tech stocks.

Stock markets have been buoyant, reflecting the global liquidity explosion and the growing conviction that the US will lead a global economic recovery.

Although I remain cautious about the valuation of US stocks in general, I continue to believe there are great opportunities among the commodity-producing and dividend-paying stocks. I continue to believe foreign markets—particularly emerging markets—will outperform the S&P 500.

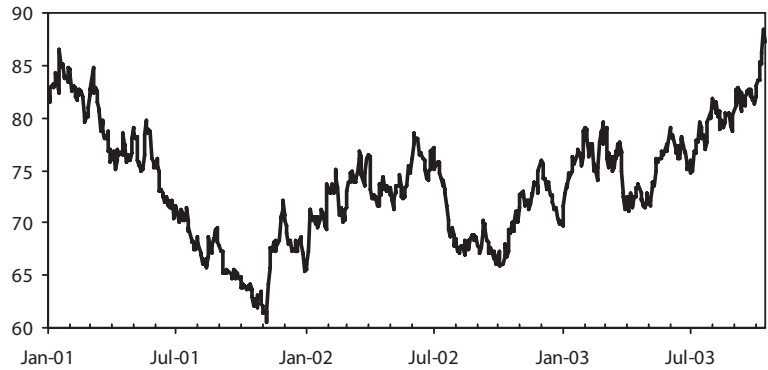
This issue will focus on one commodity group, the base metal stocks, which are recovering from a near-death experience.



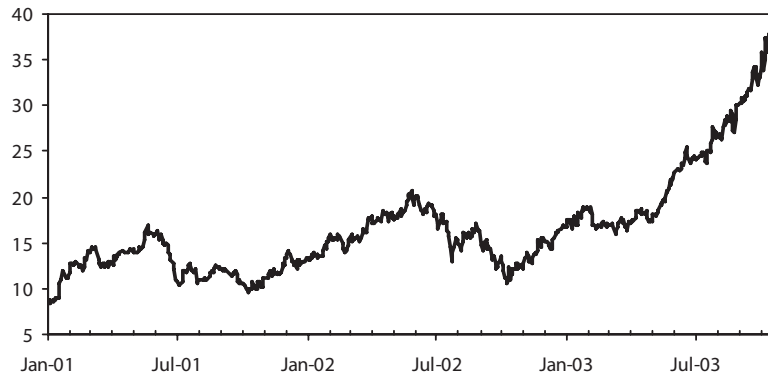
**“Those were the times when the delusional Club of Rome theories of the 1970s came back into vogue...”**

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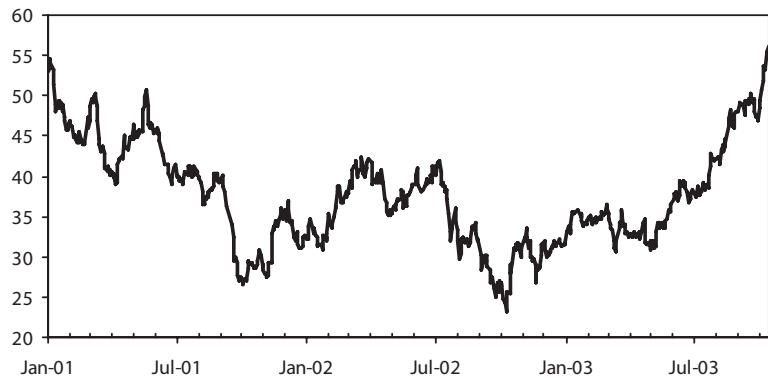
**Copper Futures**  
January 2001 - October 2003



**Freeport McMoran**  
January 2001 - October 2003



**Phelps Dodge**  
January 2001 - October 2003



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Those were the times when the delusional Club of Rome theories of the 1970s came back into vogue; they had spawned the Triple Waterfall runups and collapses of the inflation-hedge companies and their durability during an era of falling inflation and falling interest rates was remarkable. Copper prices soared from 70 cents a pound in 1987 to \$1.60 in 1989 before collapsing when it was revealed that Asian trading houses had been manipulating the metal. Phelps Dodge, the "pure copper play," earned \$13.15 a share in 1988, up from 21 cents in 1985. It would lose \$3.64 a share in 1999, \$3.51 in 2001 and \$3.43 in 2002 as the Triple Waterfall flowed on.

So what has been happening lately to turn these woebegone stocks into above-average investments?

As the copper chart shows, base metal prices are rebounding strongly. (Nickel is the best performer, but skeptics point out that the metal's price would not have risen so dramatically had the Canadian Steelworkers not shut down the company's Sudbury operations for the fishing and camping season. This is the third time that the Sudbury unions have turned Inco from a poor earner into a rich company by drying up metal inventories at the cost of months of strike pay survival rations for the miners. Inco should bless its unions.)

Such sudden rallies in metal prices have occurred many times since the great days for base metals—the 1950s—most recently 1996 and 1997. They have always been succeeded by grim times. A half-century ago, when Inco was known as International Nickel, it was a member of the Dow-Jones Industrials and was considered one of the bluest of the blue chips. For Canadian investors, it was ranked just behind Bell Telephone as a "widows and orphans stock" that could be held by the most conservative investors.

Inco's stock price is up 55% this year, and trades at a Nasdaqian wannabe 44 times this year's expected earnings, but just fifteen times next year's consensus. Phelps will lose money this year, but trades at a hearty 27 times next year's expected earnings.

Is this splendid surge in the metals stocks just another of those doomed rallies of the past four decades, or is something else unfolding?

**"Is this splendid surge in the metals stocks just another of those doomed rallies of the past four decades, or is something else unfolding?"**

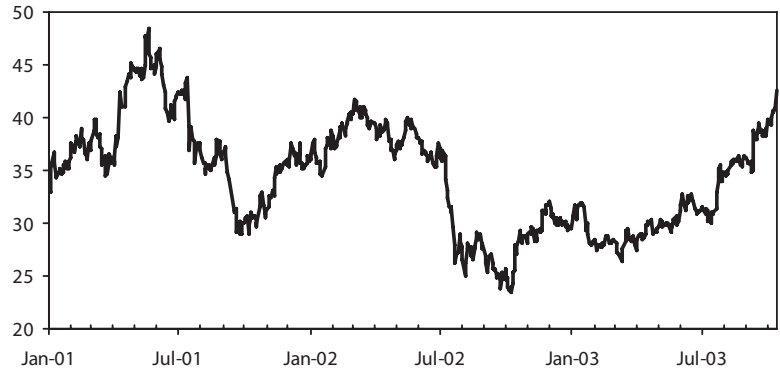
Reprinted – Basic Points: October 17, 2003



**“So why discuss a classic music form in an investment journal?”**

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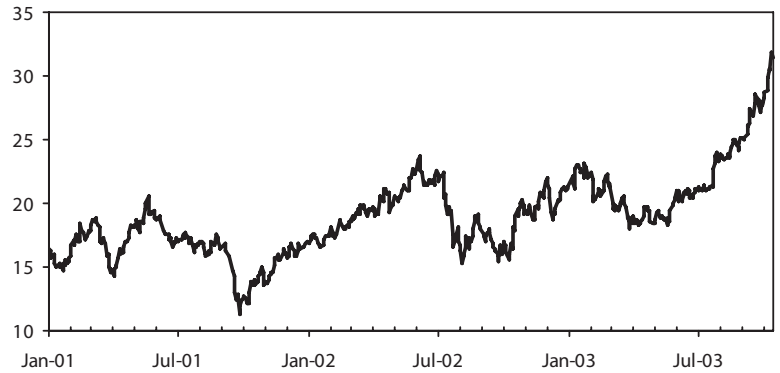
**Alcan**  
January 2001 - October 2003



**Alcoa**  
January 2001 - October 2003



**Inco**  
January 2001 - October 2003



## The Classic Music of the Market

We have entered what I believe is a multi-year rally for mining stocks. I expect three phases, and they will likely resemble the three movements of a symphony written in the classic sonata form.

So we need to discuss the sonata, the form that defined the classic era of music (1750-1825).

Haydn is generally credited with the invention of the sonata form, which became the basic structure of the symphony, string quartet, and concerto. The typical sonata is a three-part composition, based on one theme. That theme is stated in the first movement, usually at moderate speed; it is restated, often in a minor key, in the second movement, which is usually slower; it returns with vigor in the final movement, where it re-emerges in different form, often at high speed. (Think, for example, of the irresistible rondo in Beethoven's Violin Concerto.)

So why discuss a classic music form in an investment journal?

Because it's a convenient metaphor for visualizing an extended, powerful bull market for an asset class that should reach its climax years hence, amid enthusiasm investors can barely imagine at this stage. (No, this process of growing understanding about the reality of economies and markets in this decade will not be transmogrified into a new Triple Waterfall: the classic form of music was an attempt to revive Greek delicacy and restraint, not to create emotional frenzies. That was left to the Romantics who came next in musical history—the later Beethoven, and Schubert, Chopin, Tchaikovsky and Wagner.)

What is the theme of this three-part major bull market?

**It is:** The evolution of metal markets from oversupply to scarcity amid insatiable demand for durable goods from a new, huge middle class that has savings, a rising propensity to consume, and access to credit. Result: demand for primary metals vastly exceeds supply *for years* until finally the mining industry is able to bring on enough capacity to meet demand. Shortly thereafter, consumer demand peaks and subsides, no longer driven by growth in the numbers of consumers, but by replacement.

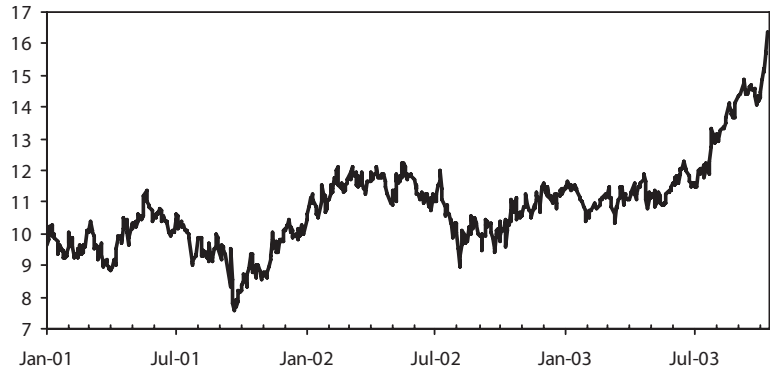
**“...the classic form of music was an attempt to revive Greek delicacy and restraint, not to create emotional frenzies.”**



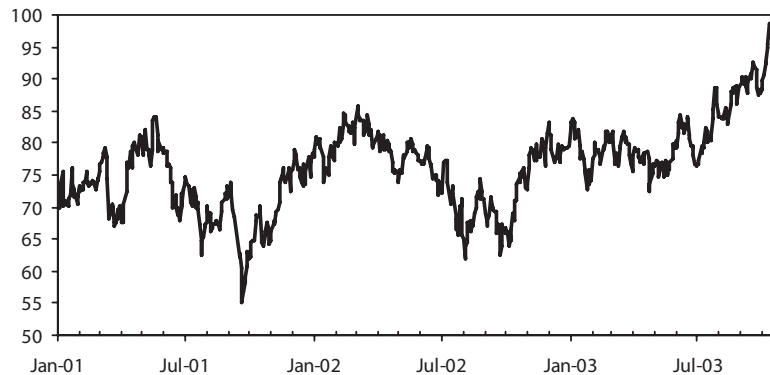
**"...although  
Nasdaq wants to  
repeat its  
unmitigated  
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Reprinted – Basic Points: October 17, 2003

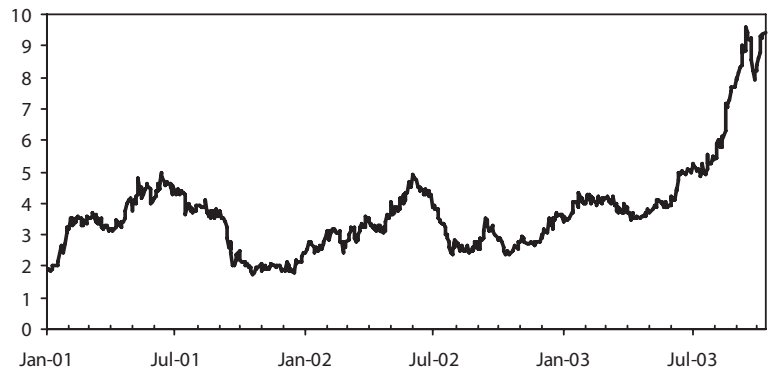
**BHP Billiton**  
January 2001 - October 2003



**Rio Tinto**  
January 2001 - October 2003



**Major Drilling (TSX)**  
January 2001 - October 2003



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That was the story of base metals in the 1950s, as they adjusted to a new demographic and a new dynamic.

I believe that stock markets in this global recovery will more closely resemble North American stock markets during the 1950s than in any intervening economic cycle. This will not be a reprise of the 1990s: although Nasdaq wants to repeat its unmitigated idiocy, it won't be given completely free rein this time. This recovery will not look like the Reagan economy, which was a disinflationary recovery driven by falling interest rates. It will not look like the inflation-ridden economies of the 1970s, because double-digit inflation is no more likely to return than Nasdaq 5000.

What made the 1950s so special? They were driven by the spectacular growth of the middle class and its incredible appetite for durable goods. That was a unique confluence of economics and demography, which had its roots in the two terrible decades that preceded the 1950s.

During the 1930s, the middle class with the wherewithal to buy durable goods was a small percentage of the North American population. Most people were poor. There weren't enough rich people to keep factories humming—or even to bring the US and Canada out of Depression.

Then came the war. Soldiers went overseas, and their paychecks were, to a considerable extent, banked by their wives and sweethearts. At home, women entered the workforce in record numbers, taking the place of the departed men. They also saved heavily. Not only were foods and fuels rationed, but so were clothing and other personal goods, as governments allocated available production to the needs of the troops.

Then the soldiers came home. Government aid sent an unprecedented number of soldiers to colleges and universities, helping to expand the middle class. But millions of those who never received advanced educations also discovered the joys of middle-class incomes as the housing boom and car boom accompanied the baby boom. In 1954, the Interstate Highway Program, President Eisenhower's pet project, an undertaking of the historic importance of the Normandy landing, was born. It would reshape American geography, demography and

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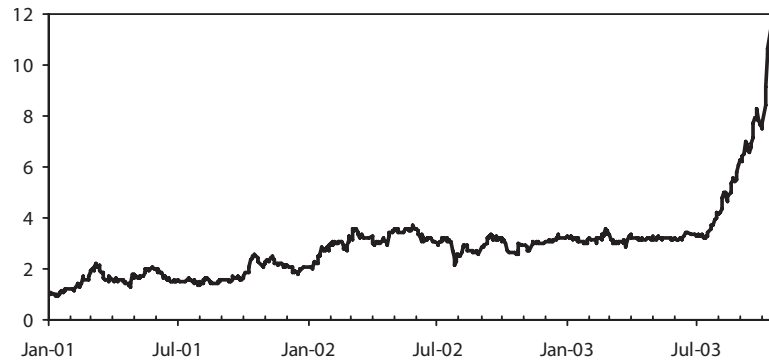
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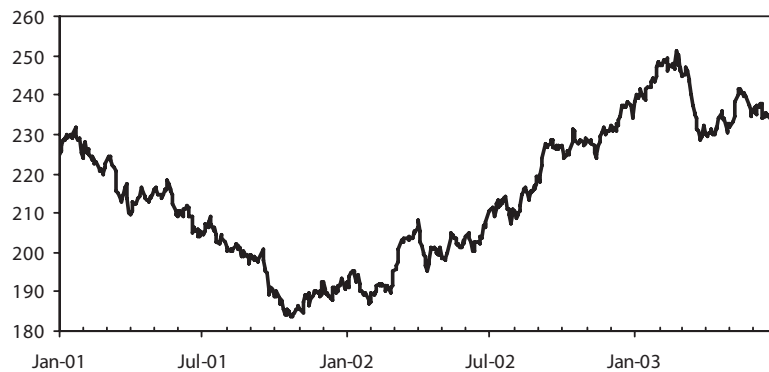
**“The car became a necessity, not a luxury. And soon the expression “two-car family” had entered the language...”**

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**Ivanhoe (TSX)**  
January 2001 - October 2003



**CRB Futures**  
January 2001 - October 2003



culture by creating suburbia and exurbia—communities from which one drove to work, often over vast distances. The car became a necessity, not a luxury. And soon the expression "two-car family" had entered the language as the description of a defining characteristic of millions of households.

Europe followed with its own recovery, a few years later. First, Continental Europe had to be secured against further Communist conquests, which was achieved by the Marshall Plan and NATO—against the opposition of local Communist and Socialist parties. (Thus organized anti-Americanism was born, a psychosis that would metastasize across the globe when the international Left switched sides in the Arab-Israeli dispute during the late 1960s; as Israel's only all-out ally, the US would thereafter be hated both for keeping Communists

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out of countries they had not grabbed right after World War II, and for helping to keep Arabs from control of the nation they had vacated and attacked after Israel became a sovereign state.)

By 1965, the great new middle class that would characterize the Western world already owned its homes, cars, and boats. Yes, there would be rising demand from a combination of scrappage, rising incomes, and immigration, but the boom conditions were over. It was a once-in-a-century event.

Meanwhile, the global mining industry was on a tear, exploring and developing mineral deposits across the globe. This new global boom was born in the bush, where prospectors with their picks, and kits for soil and chemical sampling, scoured the landscape on a scale that made the historic accomplishments of the 49ers and Klondike sourdoughs look small-scale. But it wasn't just people power: technology became crucial in identifying orebodies where outcrops and other surface evidence were unavailable, (such as the major copper-zinc orebody near Timmins, Ontario, discovered by TexasGulf). New geophysical exploration technologies meant that airborne magnetometer surveys could cover millions of square miles. New metallurgical technologies allowed the exploitation of lower-grade deposits, and those having complex metallurgy, such as lateritic nickel deposits.

But Cold-War politics was also a factor. The US government's Paley Report (1952) suggested near-permanent scarcities of base metals and other metals deemed "strategic for national security." Stockpiling programs begun during the 1950s to ensure Pentagon supplies gradually morphed into price support programs for the American mining industry, as Western congressmen ensured that Washington kept buying stuff to keep the nation safe (and the mines working). It took Reagan to take American mines off this subsidy system. On the other side of the Wall, the USSR energetically developed its vast metals reserves, often using slave labor (as in the case of Norilsk nickel, which was a monstrous Gulag operation) and a Stalinist costing system that meant endless production, regardless of market conditions. Whatever the military couldn't use was dumped abroad. Marc Rich, famed FOB (Friend of Bill) became a billionaire largely by his skill at purchasing and offloading minerals the Communists were

**"This new global boom was born in the bush, where prospectors... scoured the landscape on a scale that made the historic accomplishments of the 49ers and Klondike sourdoughs look small-scale."**

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**“The huge runup in metals prices and mining stocks after the Fall of the Wall was sheer stupidity.”**

selling for whatever they could get, at a time of American embargoes. Rich, according to reports, rarely saw an embargo—or tax—he couldn't evade.

The end of the Cold War meant that internal USSR demand for base metals collapsed: the military accounted for roughly one-third of Soviet GDP during the years Western liberals were preoccupied with railing against the US military-industrial complex, which was consuming a "scary" 4%-5% of US GDP.

The huge runup in metals prices and mining stocks after the Fall of the Wall was sheer stupidity. The "reasoning" was that this would mean massive rebuilding of East Germany, and that would mean huge metals demand. Yes, West Germany did spend hundreds of billions trying to revivify an economy that Marxism had mutilated, but that didn't create a strong, self-reinforcing capitalist economy.

What was far more important was that once the Soviet Army no longer had the funds to buy all the arms it wanted, domestic demand for metals within the USSR collapsed, forcing the mines to dump metals abroad in a boycott-free global economy. Within the US and across the west, the peace dividend meant a sustained plunge in spending on war materiel, thereby slashing metal prices.

I turned negative on base metal stocks right after the Fall of the Wall and only turned bullish again after 9/11. For someone who had grown up in Ontario, such a negative attitude toward companies I had followed for years was a new experience. But it was obvious that we were entering an era of postwar deflation for metal prices. It had happened after every other war back to and including the Napoleonic Wars. Making military hardware starts with digging metals from the earth. I thought that was pretty obvious to anyone. But, then, a decade later, I thought it was pretty obvious that assigning a triple-digit multiple to companies who didn't report the costliest component of their personnel expenses made no sense either. I guess I should learn.

#### **First Movement: Moderato**

The First Movement of the Mining Sonata is the restoration of cheer after all those years of disappointment, bankruptcies,

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mergers, mine closings, and cancelled expansion plans. But it needs a theme of a huge middle class that will be buying consumer durables.

Where will such buyers be found?

Not in the industrial world. There are more cars than drivers in the US. Yes, there's a housing boom, but the supply of new houses is tiny in comparison to the existing housing stock. Overall growth in metal consumption in the US is modest, except for whatever hardware spending the Pentagon can get approved. Even if US GDP were to grow at 5%, it wouldn't create big demand for metals. When Americans get more money, they spend it on health care, leisure, travel, elections, tort lawyers, and gambling at casinos and Nasdaq. Not on durable goods.

Yes, there will be demand for basic materials in Central and Eastern Europe as the former Communist states become part of the European Union, but the declining demography of Europe precludes a new middle-class boom.

So where does the mining industry find 300-400 million new middle class buyers of durables?

Answer: South and East Asia—the new East Asia Co-Prosperity Sphere. According to some demographers, there are today roughly 350 million people in India, Malaysia, Thailand, and China whose collective per capita income is equal to Portugal's level. That number will be close to 500 million by the end of this decade, and their per capita incomes will by then be closing the gap rapidly with Singapore's, Taiwan's and Korea's, which are already at Eurozone averages. The population of that emerging new middle class is up from roughly 50 million at the time of the Fall of the Wall.

These people have been accumulating savings at prodigious rates. (China's is roughly 40%). They will soon be the most hotly-contested new-car markets in the world. They are already beginning to buy houses with copper plumbing and stainless steel sinks. (Stainless steel accounts for roughly two-thirds of all demand for nickel.) In other words, they are the Asian restatement of the Baby Boom families of the West in the late 1940s. I was told in Houston recently that when the

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**“...the world will need two new Saudi Arabias to satisfy their petroleum needs.”**

residents of the coastal regions of China reach the same automobile ownership level as today's Koreans, the world will need two new Saudi Arabias to satisfy their petroleum needs. Long before then, these new-rich will have produced metal demand far beyond what today's mines can meet.

A measured obbligato in minor chords to this lyrical theme is the ongoing emotional impact on people in the mining industry and mining communities from the decades of disappointment and despair. Those who today still have top jobs in executive suites are men (yes, overwhelmingly male) who replaced the 1980s generation of high-testosterone builders of big mines. They nearly destroyed the mining industry in their frenzy to build bigger mines than their competitors. The survivors are mostly cautious, prudent, and dubious of arguments that a new boom is around the corner. They've heard that before—from men forced from their jobs in ignominy.

A personal anecdote will illustrate this collective caution. I spoke to the Annual Prospectors and Developers Association Convention in Toronto this April. It's the world's biggest gathering of those colorful characters—prospectors and promoters—who look for new mines and develop existing orebodies. I was the first speaker, chosen because of my bullishness for gold mines *and* base metal mines. (The organization was awash with speakers bullish on gold's outlook, but there was apparently no great oversupply of those who thought things looked great for the other metals.)

After I finished my presentation, I left for the airport. I was stopped in the hallway by a gentleman who identified himself as a senior officer of one of the world's seven biggest-cap base metal mining companies. He apologized for stopping me, but explained that I had given a set of reasons why the outlook for his company was suddenly so wonderful and he wanted to understand them. He advised that he'd been with the company for 24 years. During that time, management often heard from so-called experts that a boom was coming for base metals, and his company should ensure it was gearing up production. "Every time we acted on those forecasts, it hurt us. If we had believed all those stories, we'd have gone bankrupt. So I want to understand why you think that it's truly better this time," he said.

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I went through my arguments: mine shutdowns worldwide, cutbacks in plans for new mines, a new kind of war, and rising demand from China and East and South Asia. I told him that his company's shares were headed hugely higher—soon.

He stroked his chin. "I'd like to believe you, but frankly, what I care about most is that the company is still there when I start my pension in four years," he mused, and, after thanking me, walked away.

His company's stock price is up 60% since that day. Senior officers of his company have been prominent in the Insider Selling lists, with sales that are (for them) extremely heavy.

So what, you say? Don't I routinely cite the shrewdness of tech insiders who are selling their stock at a 350 to one ratio compared to buys? Why shouldn't the people who know their beleaguered industry so well like it less than those who, in their view, couldn't tell a stope from a stoop or an adit from an add-on?

This deeply-rooted survivalism is a form of Shared Mistake. In my book, I discuss the power of bullish Shared Mistake—when absolutely everybody who matters, inside the industry, in government, on Wall Street, and among the intellectual community—agrees on the fabulous outlook for an asset class. And they prove to be wrong.

Bearish Shared Mistake is the antimatter of Triple Waterfall forces. It comes during the Third Cascade of a Triple Waterfall and is formed from the congealed pessimism of those living in survivor mode. When this stage arrives, there are, on Wall Street, few analysts left to cover this losing industry, and those analysts who still have jobs have been successful at getting investors out of the stocks whenever one of those brief, failing rallies materialized. Among the institutions, there are few buy-side analysts left, and they've kept their jobs by keeping their portfolio managers from becoming too enthusiastic about an asset class in extended decline, interrupted by brief, misleading periods of bliss. Who wants to bet heavily on a 44-year-old pitcher who hasn't had an ERA below five for years just because he has managed to win two consecutive games against weak opponents?

**"Bearish Shared  
Mistake is the  
antimatter of  
Triple Waterfall  
forces."**

Reprinted – Basic Points: October 17, 2003



**“Those who have loved it most and lived it longest must love it least.”**

Bearish Shared Mistake is the condition precedent for a long, sustained bull market in a beaten-up asset class. Those who have loved it most and lived it longest must love it least.

As for the Street, at times of major turning points, buy-side players should play the weighting game, weighting their portfolios inversely to the weighting of Street analysts in major research departments. If the weight of analysts covering an industry on the Street is heavy in relation to the weight of that industry in the S&P or the Morgan Stanley Index, beware. Conversely, if the weight of analysts is featherlight compared to the group's weight, give that asset class a long look.

Wall Street's policies for the weighting of analysts tend to resemble the French Army's record of preparations for the next war, based entirely on the last war. If you doubt the wisdom of Maginot Line investing, don't buy the Street's line, whether on tech (where analyst overweighting reaches adiposity on a scale that makes sumo wrestlers seem svelte) or on basic materials (where the underweighting ranges from Atkins to anorexia).

The man I met in the hallway is doubtless finding the recent price action of his company's stock astounding. But I doubt that he has changed his mind. He's just been through too much for too long.

What about those fortunate few who bought his stock early this year and are delighted with the runup? Shouldn't they be taking profits?

The esteemed Ned Davis has taken issue with my argument that the rise in base metal prices signals a global economic recovery. He points out that, apart from nickel, prices for the rest of the group (copper, lead, zinc and aluminum) have collectively risen just enough to offset the fall in value of the dollar. There is no true bull market, he suggests.

What he's telling me is that we are well along in the First Movement of this Symphony. We've had a fast runup in prices of metals and stocks, as consuming industries scramble to get raw materials inventories in line with their forecasts for rising sales. Right on schedule, the dollar has entered a bear market

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and commodity prices generally are responding to the global deflation.

What is lacking is a consensus that things have really changed for the better. There have been so many false starts, followed by new agonies, that miners and investors alike will resist adopting the concept that something sustained and momentous is unfolding.

Within months, this Movement will probably end. Whether it will come from disappointing economic news or from a tech-led stock market correction, or simply because mining stock prices have gotten ahead of themselves, one cannot know at this stage.

## Second Movement: Largo

The Second Movement will mean further development of the theme, but will be more stately, and will frequently be in a minor key. At each of those intervals, the miners will rediscover their primal fear: they must not be up dancing when the music stops.

The Second, or middle movement of classic symphonies has characteristically been a shorter movement that gives the orchestra a chance to cool down between the more vigorous outer movements. Since stock prices for the leading mining companies will be up so hugely as this movement begins, there will be itchy portfolio manager fingers to take profits as the rest of the stock market encounters downdrafts.

In particular, this will be the time when the next decline in tech stocks takes hold. As noted earlier, Wall Street tends to operate on the basis of the number of mouths that need feeding. Until it has scaled back its overcommitment to tech and telecom analysts, it will be eagerly looking for portfolio sectors in which virtually all institutional clients have substantial profits, to generate the funds that will be traded into the stock sectors in which it has substantial staff and investment banking investments. It has, for example, been conducting its recommended portfolio strategies in this fashion since oil company profits began to surge far past its own forecasts, and it continues to recommend selling oil stocks to buy techs.

**“At each of those intervals, the miners will rediscover their primal fear: they must not be up dancing when the music stops.”**

Reprinted – Basic Points: October 17, 2003



**“A ‘growth cyclical’ (which could be more accurately termed a ‘growth cynical’)...”**

It is unwise, as I have learned to my cost, to underestimate the Street's capacity to recalibrate its message to meet new needs. During the 1990s, it reclassified techs as growth stocks, after decades in which they were considered cyclicals. Now that cyclical stocks are in vogue, it has reconsidered and calls techs "growth cyclicals." Investors are urged to dump oils to get increased cyclical exposure. A "growth cyclical" (which could be more accurately termed a "growth cynical") is a stock peddled by the heaviest-weighted sections of Wall Street research. Such a hybrid can justify a skyhigh p/e ratio because it is a growth stock, but deserves a stratospheric multiple because it is also a cyclical stock at a time one must absolutely, definitely own cyclicals. (Oils are "commodity cyclicals," but not "industrial cyclicals. Commodity cyclicals" are unappealing slow-growth companies who produce things whose prices are destined to fall sharply as the economy recovers, whereas "industrial cyclicals" produce commodities whose prices are destined to rise as the economy recovers. For seven straight quarters the Street has predicted a plunge in oil prices. Just keep the faith: Godot is coming.)

Metal prices will continue to rise in response to Asian demand as the global recovery unfolds, and more and more observers will suggest that prices are likely to be significantly higher in this cycle than at any time during the 1990s. Against a backdrop of rising institutional investment in commodity futures (as discussed in the current issue of *Barron's*), metals will start to gain respect.

However, the Street will publish warning memos that show the perils of owning mining stocks during years of "peak earnings." (It failed to publish any such studies when tech stocks were at their peak earnings level, because it projected endless earnings growth. Now that techs have been reclassified, it will exempt them from the comparison with mining stocks, claiming that any earnings pullbacks will be so modest as to make it unwise to lighten up.)

When I visit institutional managers in their offices. I am struck by the demographic challenge I face. Average age levels in most gatherings of portfolio managers and analysts are under-thirty, and all those smart, skeptical, computer-savvy people have Blackberries. They are, at heart, technophiles. They love to communicate with analysts who share their love. They

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came into the business at a time when the only way to deliver strong performance was to overweight techs, and, despite the crash, their hearts tell them that no real economic recovery can come without Nasdaq leadership. They are reinforced in those sentiments by Wall Street's continued preaching of that message. As Nasdaq soars anew, their conviction grows that really big gains can only come from really big exposure to those really exciting stocks. No wonder Nasdaq is up 40% this year while Nasdaq margin debt is up 450%. Ya gotta believe.

Besides, when I tell them about commodity stocks, and argue that the investment model for this global recovery is the stock market of the 1950s, I might as well be talking about the time of the Pilgrim Fathers. (Or earlier. At one gathering, I was asked, "Are you going to tell us about the fall of the Roman Empire?") They are politely prepared for a discussion of history—as long as it doesn't go back to pre-history—the dark ages before Nirvana.

Or, to be almost paleontological, when the Cubs played in the World Series.

So the demography of the market for metal stock investing includes those too young to have seen a true bull market for mining stocks, and those who remember all too vividly the ghastly bear market of the 1990s, and the ups and downs of the 25 years before then. Within the mining industry, the aged players are battle-hardened and cautious. Youth doesn't understand, and age doesn't believe.

Long-term bull markets form amid the detritus of such emotional bearishness. The bull markets aren't really born: they collect, like the sludge at the bottom of a beer barrel.

### **Third Movement: Allegro Vivace**

Some time in the middle years of this decade, the Second Movement will conclude. The orchestra will pause, retune its instruments, and then the music will resume with fire and joy.

By then, disbelief will have given way to belief. Boredom will have given way to enthusiasm. Mining companies will be announcing major new projects, and their stock prices will rise in response to announcements of plans to spend billions, rather than in response to news they are closing mines.

**"They are politely prepared for a discussion of history—as long as it doesn't go back to pre-history—the dark ages before Nirvana."**

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**“Previously closed mines—and previously closed minds—will have reopened.”**

Previously closed mines—and previously closed minds—will have reopened.

Investors will have signed on to Sinology, as promoters and investment bankers announce big deals with China; *Business Week* will publish not just one, but two cover stories within a year about the fabulous new global boom in base metals; Wall Street will be publishing book-length analyses of the powerful long-term fundamentals for metals; portfolio managers will be taking adventure trips to minesites in remote locations in exotic countries, and will return spouting statistics about absolutely sure net smelter returns.

Mining stocks will be relabeled 'growth cyclicals', thereby deserving a double-digit multiple on peak earnings. Some churlish soul will note that in 1991, Intel sold at 11 times earnings, because it was regarded as a cyclical, but its multiple went to 71 nine years later when it was reclassified as a "can't miss growth stock." Are investors making the same mistake again? His skeptical observations will be published by a Street firm that has lost both its mining analysts when a rival firm offered them a spectacular package six months earlier.

A Symphony, like all musical works, is subject to Stein's Law: if something cannot go on forever, it will stop.

And so it will.

Eventually.

## THE INVESTMENT ENVIRONMENT

The action of the metal stocks is confirmed by the action of metal prices, and by such indicators as the Baltic Freight Index, global money supply growth, and the declining value of the dollar. Asian stock markets have been strong, led by the Nikkei and Kospi. Japanese bank stocks have more than doubled this year, an almost-sure sign that reform has actually begun.

For the thesis of this essay to be validated in coming years, China will have to continue to roar ahead. India is on its own, unique growth track, bedeviled by bureaucracy, fractious state governments, and the heavy weight of custom and history, but still progressing satisfactorily. If China stays on course and

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Japan gets back on track, the symphony will be performed in full.

There is growing debate about the sustainability of the Chinese juggernaut. Critics point to China's apparently precarious trade balance, and the problems of its banking system.

From my perspective:

1. Japan was the fourth-biggest contributor of Foreign Direct Investment into China three years ago: it is now #1. China's slender trade balance—the subject of economists' handwringing—comes because when FDI pours into China in the form of machinery and equipment from the global firms, those capital goods show up in the imports. It takes a lot of sales of small consumer goods to Wal-Mart to offset a top-of-the-line Japanese machine. But once that machine is installed and the Chinese workers are trained to operate it, it becomes a money machine. The operators will become members of the new middle class.

It won't be long before those machines are producing new torrents of consumer goods to swamp competition in markets across the world.

2. I never thought I'd see a banking system worse than Japan's, but China has moved into the lead. Because the government compels the banks to make bad loans to absorb the immigrants from the rural areas, the chaotic situation continues to worsen. But that doesn't necessarily mean disaster, Japanese-style. A nation with a 40% savings rate that is running a current account surplus can get away with such an appalling system for as long as it continues to grow at a rapid pace. The problem will come with something approaching maturity: the rider of this bicycle risks falling off as he slows down. But China need not face a crisis: its foreign exchange reserves are on a scale that would permit the government to bail out the banks using a triage system such as Japan has recently adopted with some leading foreign investment banks, including Goldman Sachs. (In these arrangements, the external investor takes on a share of the loans that are troubled, but not hopeless, and the government absorbs those that

**“It won't be long before those machines are producing new torrents of consumer goods to swamp competition in markets across the world.”**

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**“Managing a booming capitalist economy through a professedly Marxist dictatorship is the equivalent of having atheist MBAs run the Catholic Church.”**

should have been proclaimed dead by financial coroners years ago, if such officials had existed.) Using that model, China could clean up its banks without resorting to taxes or fiscal deficits. What good is its foreign exchange hoard, anyway? It is being accumulated to hold down the renminbi, not because the nation needs the world's biggest holding of foreign currencies.

Yes, China could fail, because its political-economic model is built on contradiction. Managing a booming capitalist economy through a professedly Marxist dictatorship is the equivalent of having atheist MBAs run the Catholic Church. But the Maoists have managed this contradiction since Deng's days, and maybe they can extend it to the time when it's no longer necessary to pretend that the system is run by the Little Red Book. The Hegelian cycle of thesis-antithesis-synthesis that Marx adopted as the basis of his theories could actually play out in ways Marx would have never imagined.

## INVESTMENT RECOMMENDATIONS

1. Overweight commodity cyclicals, with special emphasis on the base metals. At the moment, the attractiveness of the metals is roughly in this order: nickel, copper, zinc, aluminum, and lead.
2. Overweight gold stocks. When the yen broke 110 against the dollar, it signaled the next stage of dollar devaluation.
3. The interlisted Canadian bank stocks keep setting new highs almost daily at New York, as American investors eye the high after-tax yields (compared with money market funds) these companies offer—in a currency whose value is going higher. This new class of US investors should ultimately deliver a higher p/e ratio to the Canadian banks. It is already upwardly repricing such dividend-rich American stalwarts as Bank of America.
4. The word "inflation" has been spoken occasionally—almost surreptitiously—in recent weeks. I don't think budget deficits cause inflation, but I do think that a seemingly endless war accompanied by dollar devaluation and aggressive monetary policies could combine to revive inflation to levels that bond investors with long memories would find worrisome. Keep bond durations below benchmark.
5. Emerging markets continue to be a splendid asset class. Overweight these volatile markets within international accounts.
6. Where possible, switch high-grade debt investments out of US dollars into Canadian dollars or euros. Where possible,(if you are a CFO), switch your debt into US dollars out of Canadian dollars or euros.



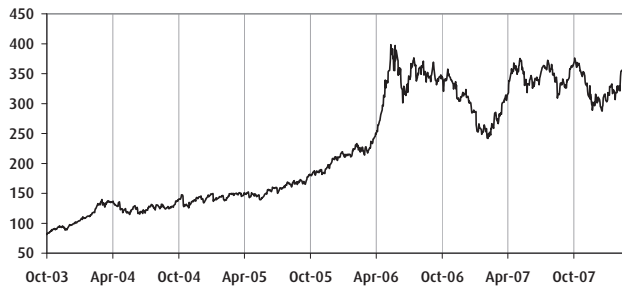
## Part II Second Movement—*Largo*—and Third Movement—*Allegro con Brio*

You have now read where we were—in the First Movement—*Moderato*—of the Mining Sonata. We have entered the Second Movement: *Largo*. It should be brief.

The longest and most spirited movement—*Allegro con Brio* will follow. It will be the most rewarding to investors.

Here is what happened during the concluding years of the First Movement:

**Copper**  
October 2003 to February 2008



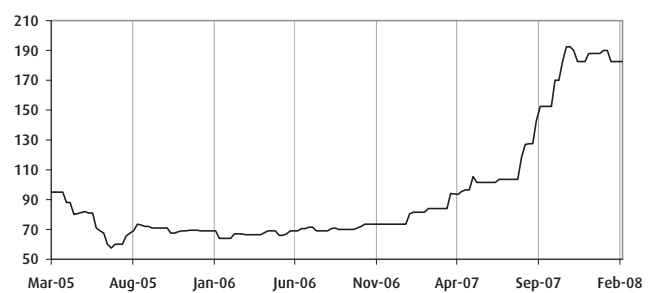
**Aluminum**  
October 2003 to February 2008



**Nickel**  
October 2003 to February 2008



**Iron Ore – China**  
March 2005 to February 2008



**Zinc**  
October 2003 to February 2008



**TSX Capped Metals Index**  
October 2003 to February 2008



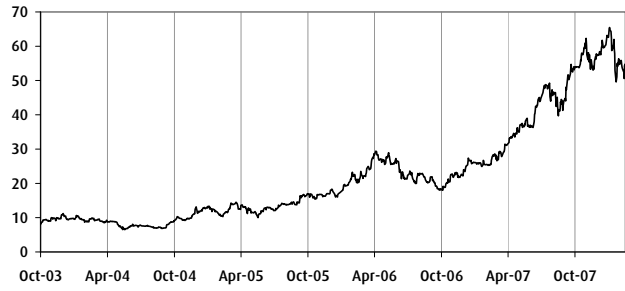
# Basic Points

Here is what happened to the companies whose charts were included in Part I:

**Freeport-McMoRan (FCX – NYSE)**  
October 2003 to February 2008



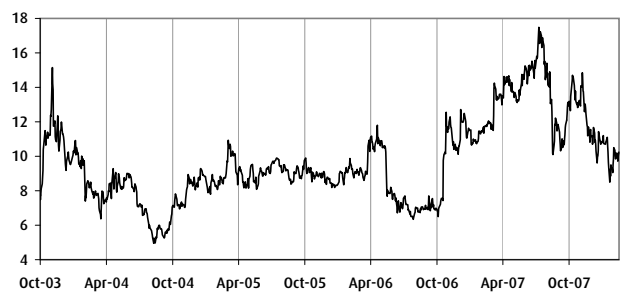
**Major Drilling (MDI – TSX)**  
October 2003 to February 2008



**Rio Tinto (RTP – NYSE)**  
October 2003 to February 2008



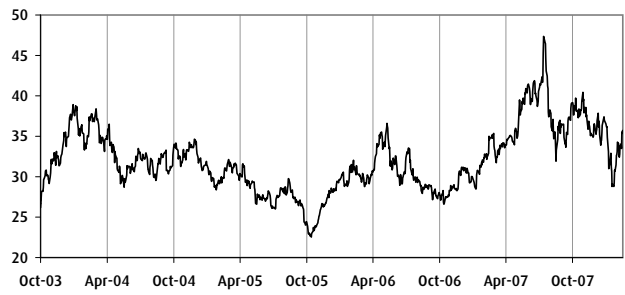
**Ivanhoe Mines (IVN – TSX)**  
October 2003 to February 2008



**BHP Billiton (BHP – NYSE)**  
October 2003 to February 2008



**Alcoa (AA – NYSE)**  
October 2003 to February 2008



Phelps Dodge, Alcan and Inco, whose charts appear in Part I, are no more. They were taken out at large premiums, at prices vastly above their 2003 levels. Along with Falconbridge, they succumbed to the process of consolidation we predicted in our next major mining issue, *Hard Rock Rocks*, published in August 2005.



**This is no mere hiccup, but a hinge of history.**

In that issue, published when Hurricane Katrina had driven oil and gas stocks to Page 1 and record prices, we recommended clients emphasize base metal stocks, at the expense of energy companies, we wrote:

“We think that mining industry majors are beginning an historic reappraisal of their prospects and opportunities. That process is unlikely to lead to an exploration binge. More likely, it will lead to consolidation, including some takeovers, friendly and otherwise, at significant premiums to current stock market prices.”

Nor has that process ended. The current BHP Billiton-Rio Tinto drama has meant that investors are being forced to rethink their valuations of the miners based on a flood of optimistic projections of the industry’s future profitability, prepared by a new generation of industry leaders who are not permanently traumatized by the 21 years of the Triple Waterfall Crash.

Those who know it best no longer love it least. That is a huge change from the earlier years when we were able to argue that, because of the Commodities Triple Waterfall, those who knew it best loved it least.

Now, what is needed, is to get the investment community to share the industry’s new-found convictions about the impact of the Chinese-Indian renaissance. Already, China’s consumption of copper is roughly twice America’s, and its demand for iron ore dwarfs US demand. This is no mere hiccup, but a hinge of history.

Our early and sustained enthusiasm for the miners began with 9/11. It came at a time that commodities were completing their Triple Waterfall Crash.

Our approach to setting investment policy has been based on discerning major long-term trends. We concluded that the re-entry of China and India into global prominence would be the next over-arching investment thesis. Those giants would be accompanied by other emerging economies, and the world economic power balance would move away from the industrial nations, which had already begun to enter demographic decline, led by Japan. The new hordes of consumers of energy, metals and high-protein foods would be the billions of formerly-poor people in formerly-poor countries.

Investors looking for the next great growth story amid the wreckage of their high tech fantasies would go back to basics. Productive commodity enterprises based on “reserves in the ground in politically-secure regions” would be the next great winners.

# Basic Points

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Looking back, we realize:

- We *underestimated* the growth in demand for commodities in the Third World outside China, particularly India; those long journeys that began with a single step took little time to switch to automobiles;
- We *underestimated* the scale and duration of this historic shift in global economic power: we told investors to prepare for a commodity boom that would last into the next decade; it has become clear that this is a once-in-a-millennium commodity boom that will last at least as long as the commodity crash—two decades; and
- We *underestimated* the gloom among managements in the mining and oil industries. Two decades of decline, disappointment and despair had proved more devastating than even we realized. We had simply exited those industries many years earlier when we could see few interesting investment possibilities, so it was no emotional problem to come back. Not so for those who had been struggling for so long. It would take us a year to formulate our maxim: “The greatest investment opportunities come from an asset class where those who know it best, love it least, because they’ve been disappointed most.” (That was a winning investment concept as long as the leading miners and analysts were of the generation that had suffered so much for so long. Their successors have, in most cases, adjusted to the new realities of a post-Crash era.)

**...this is a  
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commodity boom that  
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crash—two decades...**

We also found that this same gloom was pervasive among an endangered species—Wall Street mining analysts. Those who had survived the two decades of declining prices and declining interest in their stocks were close to the managements of the surviving companies, and shared their fear and pessimism.

One result—which would last until 2006—was that Wall Street’s earnings forecasts dogmatically proclaimed that metal prices would soon fall back to 1990s levels and stay there. We were arguing that investors should value the stocks based on unhedged reserves in the ground. This valuation metric actually operated against attracting investor enthusiasm, because the Street’s most prominent firms continued to use forward values such as 75 cent copper and \$2.75 nickel. With production costs soaring, those reserves in the ground didn’t look like money-makers.



## Our Financial Obesity Index...

Which was one big reason why...

- We *overestimated* the potential supply of enthusiastic institutional investors in mining stocks. In retrospect, we were distressingly naïve to believe that hordes of value-seeking American investors would readily flock to these stocks. We figured, more or less correctly, that Canadian institutions would have to look at them seriously because of their large relative weights in the TSX: Canadian portfolio managers must therefore consciously reject them not to buy them. We should have realized the flipside for US clients: Commodities, other than shares of the Big Oil companies, were trivial weights in the S&P 500. There were only two base metal mines—Phelps Dodge and Freeport-McMoRan—(and one gold stock—Newmont).

(As recently as 2005, we were visiting a well-established US firm, and recommended Inco. The managing partner asked, “What’s that?” When told it was the renamed International Nickel, and was the world’s second-largest nickel producer, the boss asked the research director if they had a file on it, because it had once been one of the Dow Thirty. The answer, “They took it out of the S&P so we closed the file.”)

- We had also *underestimated* the impact of demography on US institutional investing. At one meeting in Boston in 2006 with more than a dozen investment professionals, the firm’s founder introduced me, and then said, “Don, you and I are the only people in this room who can remember what it was like to make money investing in a commodity stock.”

We were pitching “sunset polluting industries” to young people who had entered the business to buy real cool companies which made real cool stuff. Tough sell.

One successful explanatory technique we developed was our Financial Obesity Index. “Avoid investing in sectors where the weight of analysts on Wall Street is heavy in relation to the weight of that group in the index. Look for the anorexic group—a few skinny analysts who are too scared to issue a bullish forecast.” I pointed out that, in 1982, there were more oil analysts than tech analysts on the Street. Investors should have sold oil and bought tech. But, despite Tech’s Triple Waterfall Crash, by 2003, there were still more semiconductor analysts than commodity analysts on Wall Street.

# Basic Points

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As the months and years rolled by, we told the story of the base metal companies in increasingly glowing tones, but we found early on that most US accounts were only mildly interested. The commodity story they were willing to hear, and the stocks they were willing to think of buying, were oil and gas.

This willingness to look at oil stocks was due, in part, to a widespread belief that high and rising oil prices were bad news—for the US trade deficit, the dollar, inflation, consumer disposable income, and the US stock market. Some investors bought oil stocks as partial hedges against major exposures elsewhere in their portfolios.

The exception to this pattern has been hedge funds. Because (1) they were so eager to find new stories, and (2) they could rapidly shift investment emphases to winning themes, and (3) they loved to own what mainstream long-only firms overlooked or despised, and (4) many had access to the yen carry trade, they swiftly became the American institutional group that was most enthusiastic about our work.

Even today, it is very difficult to interest some leading mainstream US equity investors in mining stocks. When the only remaining US base metal companies of investment size are Freeport and Alcoa, and the only gold miner is Newmont, the mining stocks tend to be of real interest only to global funds.

Alcoa was always well-known, and it was possible to get US clients mildly interested in aluminum's outlook, because AA remained in the Dow, and attracted media coverage each quarter by being the first Dow company to report its earnings.

Unfortunately for our story, Alcoa was the only major metal producer whose share price went nowhere during the greatest sustained commodity boom of all time. That is such a fascinating accomplishment that the company deserves to become a fixture in B-School textbooks. It continues to amaze us with its unique approach to building shareholder value: it recently appointed Stan O'Neal to its Board—as a member of the Audit Committee. He is, of course, the purged ex-CEO of Merrill Lynch, whose most notable achievement were buying a large subprime mortgage issuer when the housing bubble had already begun to shrink, and adding vast quantities of subprime CDOs to Merrill's balance sheet. What does a man who was dumped when his schemes threatened to castrate the Merrill Bull bring to Pittsburgh? Given that Alcoa's failure to participate in a record run of profitability for metal companies could be called sustained destruction of shareholder value, maybe Mr. O'Neal's record of doing it better and faster made him noteworthy.

**...a man who was  
dumped when his  
schemes threatened  
to castrate the  
Merrill Bull bring to  
Pittsburgh?**



**...bank stocks should be valued by their earnings statements in good times, and by their balance sheets in bad times.**

His joining Alcoa could be called “The Subpriminum Merger” between aluminum and Wall Street, and it leads us naturally to look at the financial mess that has so seriously damaged investors’ perceptions of the base metal stocks...

### **Mining Stocks and Wall Street’s “Putrid Mess”**

A year ago, we wrote of the subprime debacle (*DON’T ASK! DON’T TELL! IT’S SUBPRIME TIME!*). We were so scornful of the acumen and integrity of the leading Wall Street banks that we received some criticism for getting carried away by sensationalistic journalism. What made us think that we—and a few columnists—knew more about such a complex subject than Wall Street’s top analysts?

Our skepticism was rooted in three decades’ experience. The Street’s finest had collectively failed to warn investors of the financial crises of 1973, 1982, 1987, 1990 and 1987. The best minds routinely based their appraisals on their earnings forecasts—which made the stocks look cheap, rather than on the mines hidden in the balance sheets. We stuck to our belief that bank stocks should be valued by their earnings statements in good times, and by their balance sheets in bad times. Each time the bank stocks started to sharply underperform the broad market, trouble lay ahead. That underperformance wasn’t a ‘buy’ signal—it was a ‘sell’ signal.

This time, it turned out that no matter how dubious we were of the banks’ financial projections, the reality has always turned out worse.

As in previous cycles, some intrepid financial columnists have succeeded in alerting investors to the risks where Wall Street’s experts failed. We learned that when the stocks are flashing a “Sell!” signal, prudent investors should immediately look for help in the newspapers. (We confess that we could be biased: we have always been newspaper junkies.)

Among those columnists who have been most reliable about the CDO and CLO-based banking crisis are Gretchen Morgensen of *The New York Times* and Gillian Tett of *The Financial Times*. We have also received help from some of our US hedge fund clients.

Woody Brock, a brilliant independent economist who has been helpful to us for many years, told his clients in December that the outlook for the US economy was now utterly unknowable, because no one—absolutely no one—knew the extent of the mortgage damage to the big banks.

# Basic Points

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The US recession has been caused by a handful of wealthy men. They authorized and financed a large-scale debauchery of the US home mortgage market. (We concede that it would be unfair of us to suggest that men of such distinction only made bad mortgage loans. Obviously, they made other investments. They also financed this decade's special mania—the Private Equity Leveraged Buyout Craze. Result: their balance sheets have been left with more than \$100 billion in highly-scented loans that are now rotting rapidly. In their seeming zeal to participate in all real estate bubbles, they also plunged deeply into commercial real estate financing late in the cycle and were unable to dispose of most of their exposure before commercial real estate prices entered a bear market.)

**...this decade's special mania—the Private Equity Leveraged Buyout Craze.**

Nevertheless, the signature sin in this cycle has been the creation and marketing of the complex Collateralized Debt Obligations that packaged home mortgages.

Who would have thought that institutional investors and banks as far away as Norway, Germany and Australia could be going under because of participation in US residential mortgage loans?

In past financial crises, the defaulting debtors were big corporate borrowers, or commercial real estate developers, kleptocratic Third World nations, or a hedge fund (mis)managed by Nobel Prize economists and other egomaniacs.

As an asset class, residential mortgages enjoy a higher quality rating according to the rules of the Basel Accord than paper issued by AAA borrowers such as GE or Exxon Mobil. That is because, since the Great Depression, losses from home mortgage lending have been so modest, even during recessions.

Home mortgage lending was long handled by hundreds of thousands of mid-management level employees in American banks without ever creating an economic or financial crisis. (The S&Ls were another story during the 1980s, of course, but few banks chose to compete with them in making dodgy home loans.) So how can a few big banks suddenly lose \$200 billion or more in home mortgages? After all, as the cliché would have it, mortgage lending isn't rocket science.

Problem is: this time it *is* rocket science. These greedy geniuses deliberately set out to create the most mathematically-complicated mortgage products ever sold, relying on the Greater Fool theory that they'd be able to peddle them



**...before the necrotic stench reached the higher floors of Park Avenue.**

off before the necrotic stench reached the higher floors of Park Avenue. In his testimony to Congress, Governor Eliot Spitzer summed up the monoline mess with structured products with the classic tech phrase: “Garbage in, garbage out.”

In discussing Wall Street’s “begging bowl” campaign to line up major equity infusions from Asia, Gillian Tett recently noted that the bankers’ glee at getting help from Ben Bernanke is evoking a backlash: “The dramatic scale of Fed cuts has prompted concern that Wall Street is still sitting on a putrid mess—contrary to what the US banks told the sovereign wealth funds late last year.”

She observed that in China there are growing complaints about the use and abuse of their national funds after their ill-considered investment in Blackstone, (ridiculed in *Basic Points* at the time). The critics argue that the sovereign funds should be used to buy commodity resources, rather than prop up sagging US financial institutions.

The mining stocks have been hurt by the mortgage mess in three ways:

1. The plunge in prices of bank shares has launched a worldwide equity bear market. When stock prices are sliding, and the margin clerks take charge, even companies with rising earnings and great balance sheets get hurt. Stocks that have sharply outperformed for a few years can be particularly vulnerable, because they lack a widespread base of serious investors who strongly believe in the fundamentals. The believers are a minority, and they are already heavily invested.
2. The bursting of the real estate bubble (which was itself the product of subprime and other mortgage excesses) has pushed the US—and possibly the Eurozone—into recession. A recession has always been punishing to prices of industrial metals. Naturally, this time the Street rushed to warn commodity investors that The End Was Near. Copper briefly sold off sharply, and *Forbes* highlighted the plunge, “Credit Crunch Cuts Into Copper.” (It has since fully recovered, but few Wall Street analysts noticed.)
3. If the US and Europe enter recession, exports from China and India will suffer. That means, Wall Street believes, that the two fastest-growing large-scale commodity-consuming economies will no longer be supporting raw material markets.

# Basic Points

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We have declined to join the consensus about the terrible impact on metal demand in leading emerging economies from a mortgage-backed recession in the US and some EU countries. We have advanced the argument that most of the metal demand in those export-oriented economies comes from domestic sources—construction, infrastructure, capital spending, and consumer durables. Exports from China and India don't tend to be of the heavy-metal variety. We haven't convinced many skeptics. Time alone will tell whether “decoupling” is in fact, just wishthink.

**Time alone will tell  
whether “decoupling”  
is in fact, just wishthink.**

Because of the new cyclical risks, we have been maintaining for a year that clients should modestly underweight their base metal exposure in favor of (1) Agriculturals, (2) Golds, and (3) Energy. We have, however, recommended that clients with long-term investment policies sit tight with their high-quality base metal companies. The mines' long-term outlook is better than ever—if one accepts our Three-Part Sonata analogy.

No one knows how deep and how long this totally unnecessary financial crisis will last, or the extent of the damage it will inflict on the global economy.

Therefore, no one knows how much it will hurt the stock market performance of the base metal companies.

What is clear is that the base metal stocks are the commodity group deemed most at risk from the financial crisis and recession.

We remain convinced that this new gloom will prove to be the Second Movement of the Mining Sonata. This is often the subdued interval—frequently in a Minor Key—between the cheerful First Movement, and the fast-paced excitement of the Final Movement. (We suggested it could resemble the Final Movement of the Beethoven Violin Concerto—the Rondo—which is among the most exuberant finales in the Sonata canon.)

Impatient investors may decide to leave the symphony for the lobby bar during this phase.

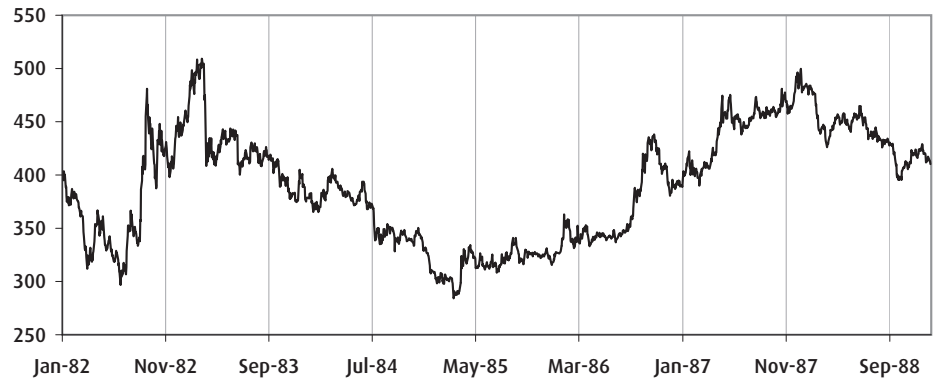
Patient investors, like real students of music, will stay, listening as the theme of the symphony recurs in different melodies, tempos, and chord structures. They won't want to miss the opening of the Final Movement. Their patience will ultimately be richly rewarded.



## Gold and Other Precious Metals

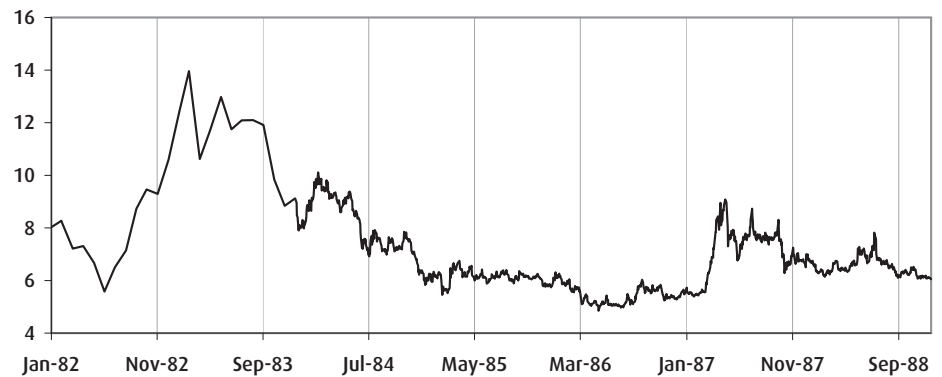
### Gold

January 1982 to December 1988



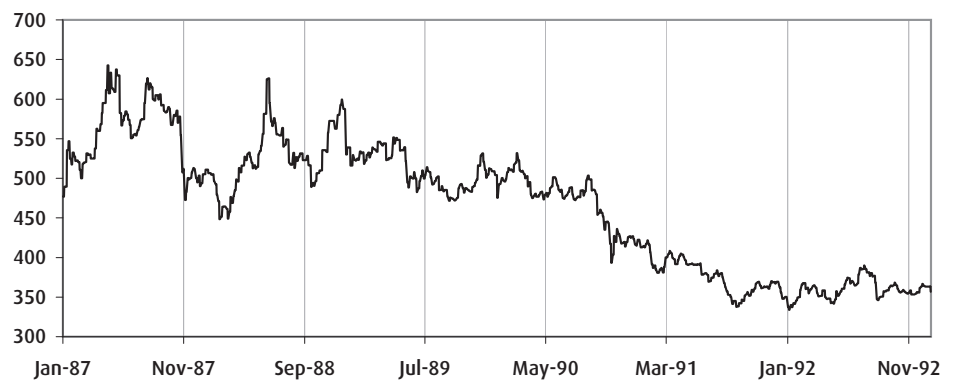
### Silver

January 1982 to December 1988



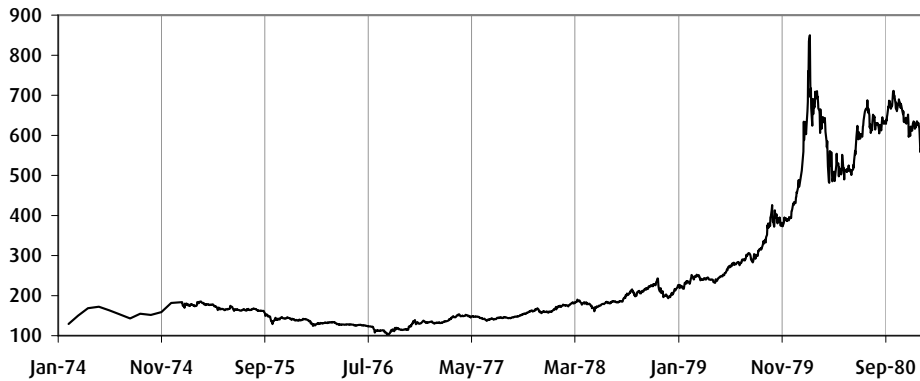
### Platinum

January 1987 to December 1992



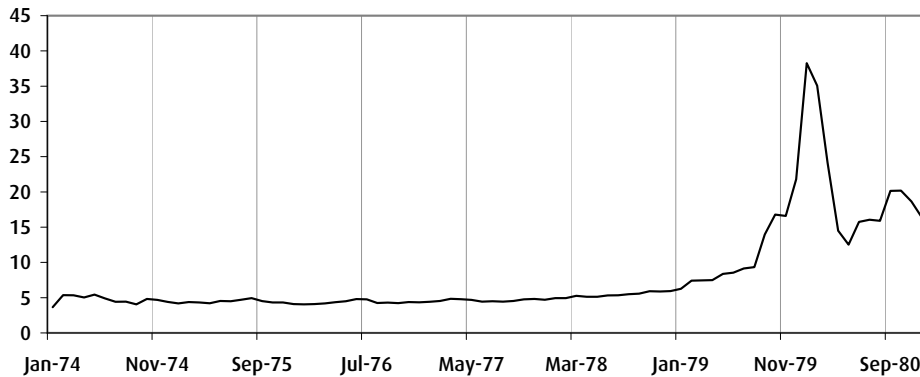
# Basic Points

**Gold**  
January 1974 to December 1980



**What happened then  
was hellish for Hunt...**

**Silver**  
January 1974 to December 1980



The only other time gold and silver performed so well was in the late stages of the run-up to the Commodity Triple Waterfall peak.

Note that silver's price appreciation this time is modest, compared to the mania of the late 1970s. We would later learn that Bunker Hunt convinced a few rich Saudis that a text in the Old Testament which compared the price of gold to the price of silver was a sign that silver was headed for the heavens. What happened then was hellish for Hunt and his partners, as silver fell to as low as \$4.



**At some point, the catalytic converter in a scrapped car could be worth more than the rest of the wreck.**

Platinum is the current commodity star. Roughly half the world's production goes into automobile engines as a clean-air catalyst. Most of the world's production comes from a few very deep mines in South Africa. The labor unions that have been disrupting production in some of those mines may not have helped their members, but they have certainly enriched holders of platinum futures. More recently, prices have soared as production has slumped due to recurring power failures. Ominously, the South African government's repeated failures to implement a program of strengthening the state-owned electricity system mean that such production cutbacks will last for years. At some point, the catalytic converter in a scrapped car could be worth more than the rest of the wreck.

Warren Buffett was briefly the most famous silver speculator since the Hunts, but he got in too early and out too early and learned the wrong commodity lesson from his venture. (He has avoided commodities since, thereby missing out on this bull market.)

Part of Buffett's reasoning was his conviction that the dollar was headed down sharply. Silver was an odd—and inefficient—way to bet against the greenback. He got it right the next time: he bought Canadian dollars and rode the rising loon to a big profit.

Although gold stocks have not, as a group, performed as well as gold in recent months (largely because of perceived political risks), shares of many junior, speculative gold and/or silver companies have produced rich rewards for their backers. It is paradoxical that the collective market value of the hundreds of gold exploration companies that trade in Canada, Britain and Australia has risen so sharply, while the value of the companies that collectively produce most of the world's new-mined gold has increased so moderately.

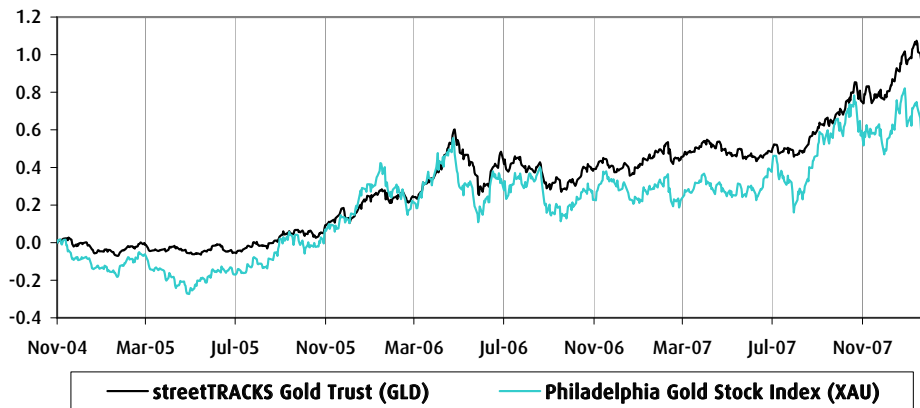
According to people we have talked to in the contract drilling business, most of the mining world's exploration drilling is aimed at gold. The revenues of companies such as Major Drilling have soared along with gold.

We have been encountering increasing skepticism from clients about the investment merits of the leading gold mines. They say it makes far better sense to buy the Gold ETF than to buy the miners. They cite growing political risks and soaring production costs.

# Basic Points

We respond that the least-risky investment strategy is to own both the Gold ETF and the well-managed mines. Here's a comparison:

## streetTRACKS Gold Trust (GLD) vs. Philadelphia Gold Stock Index (XAU) November 2004 to February 2008



**...the least-risky investment strategy is to own both the Gold ETF and the well-managed mines.**

The XAU is the Philadelphia Stock Exchange Gold Mining Index and is the longest-established benchmark. Today, investors have other alternatives to the XAU.

As clients are aware, we have been consistent since 9/11 in recommending investing in gold and gold mining. Initially, the reasoning was based on war risk—Afghanistan and then Iraq. But we preferred base metal and oil shares in the early years of the commodity bull market, and, after our trip to India, we preferred the agriculturals to gold. Global grain demand had exceeded supply for four years, crop carryovers were the lowest in decades, and the new Asian middle class's new addiction to meat and dairy foods meant that global food inflation was inevitable.

Gold, we felt, would continue to climb to new peaks, driven, in part, by fast-growing demand for dowries for Indian brides.

Then the financial crisis exploded. We immediately recommended significantly greater exposure to gold stocks—at the expense primarily of base metals stocks and energy stocks.

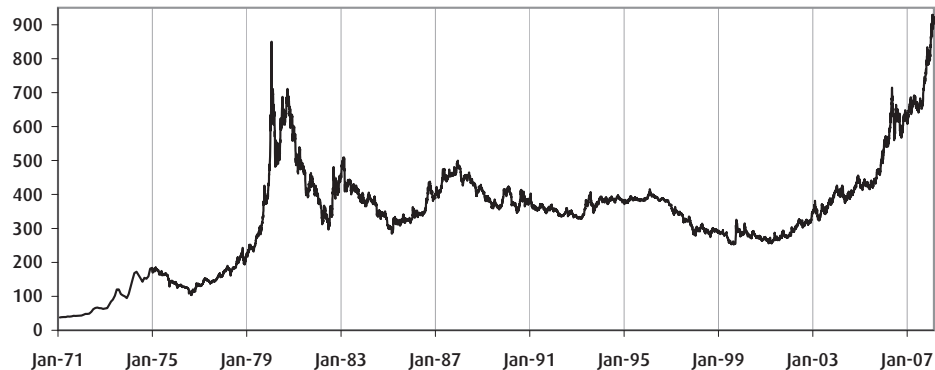
(Why the either-or? Why not just recommend boosting gold exposure while maintaining portfolio positions in the other groups? Answer: because most clients hold commodity stocks within diversified investment portfolios, and have formal or informal caps on total commodity commitments.)



**...Keynesianism,  
the Phillips Curve  
and many popular  
economics textbooks  
were exposed as bilge.**

The following chart will help explain the differing factors driving gold's valuation.

**Gold  
January 1971 to February 2008**



Gold was dethroned at Bretton Woods in 1944. Its tie to the new global store of value—the dollar—was severed when Nixon closed the gold window 27 years later. As gold bugs had prophesied, nine years of runaway inflation ensued, triggering a Triple Waterfall runup in most commodity prices, notably gold and silver.

The inflationary binge did not end, as gold bugs had prophesied, with a return to the gold standard. The problem did not lie with paper money, one lonely genius asserted amid the chaos of the early 1970s, but with the central bankers who followed the nostrums of the leftist-liberal economists. When Milton Friedman won the Nobel Prize during a stagflationary recession that was supposedly impossible according to all establishment economic principles, Keynesianism, the Phillips Curve and many popular economics textbooks were exposed as bilge.

All that was needed was to have leading governments deliquify the system by pumping out that bilge and impose Friedman-style monetarism. Thatcher was first, followed by Volcker, reinforced by Reagan.

The two extremes in economics theory were equally horrified. Liberal economists, realizing that their entire *weltanschauung* was threatened, united to sign costly full-page ads demanding that Reagan repeal his tax cuts and increase taxes to fight inflation. He stood his ground, knowing that monetarism was killing inflation, while tax cuts, deregulation, the defense buildup, and the impact on rent-seeking public sector unions from his victory over the air traffic controllers would soon revive the economy.

# Basic Points

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The other extremists—gold bugs—were equally discredited: Inflation plummeted, along with commodity prices. Gold prices entered a two-decade-long Triple Waterfall collapse. Abroad, Japan, the miracle economy of the 1980s, built on the internal contradiction of inflationary monetary and banking policies that spawned absurd valuations for stocks and real estate, and the world's most competitive industrial economy, imploded, entering its own deflationary Triple Waterfall Crash.

Nasdaq sent the millennium out with a bash and a crash, unleashing deflationary forces around the world.

And gold, the supposed eternal store of value, reached a 28-year low of \$250.

So why is it now \$900, a level that the newly revived and raucous gold bug claim should be thousands of dollars? (To justify that forecast, they use the alltime high of \$850 and then adjust it for intervening inflation. That is really an attempt to retroactively justify their advice to investors to buy gold at the peak of the bubble, because it was the only true store of value. Stores of value shouldn't, one would have thought, fall 70%. At times, gold bug can even make leftist economists such as Paul Krugman look prudent and sensible.)

A better way to value it is to use \$35 (the 1933 price set by Roosevelt as part of his reflationary agenda, up from the long-established level of \$20.67) and add in the intervening years' US CPI inflation. By that measure, gold should be trading somewhere north of \$650 an ounce.

Although fixing gold's true value may well be an exercise in fantasizing, futility or fanaticism, all serious investors should follow gold's short and medium-term moves, because they give useful—and sometimes critical—information about the economy and financial markets.

Since Nixon closed the gold window in August 1971, gold's price movements have been driven by four sometimes-overlapping forces:

- changes in the value of the dollar,
- the outlook for inflation,
- financial crises, and
- a consumer good and store of value that has long had special appeal to Asians.

**Although fixing gold's true value may well be an exercise in fantasizing, futility or fanaticism...**



**“Grab a blonde, a gun,  
a bar of gold and a  
goat, and head for  
the hills.”**

Unless one is an investor in gold or in other commodities, a substantial gold price move might not seem to be of any significance.

Not so.

*All financial assets are subject to currency, inflation, and financial risks. Gold's action is therefore instructive for all investors.*

Here are the primary vectors:

### 1. The Dollar

In recent years, changes in the dollar's value have accounted for more than three-quarters of all changes in bullion prices. Since the dollar was established as “paper gold” 64 years ago, and since many central banks still retain substantial gold holdings, the inverse correlation between the dollar and gold is obvious—and rational.

### 2. Inflation Forecasting

When gold ran from \$36 to \$850, we were told by those who had long predicted the collapse of paper money that it was headed far higher and that the dollar would become worthless, because an era of Weimar-style hyperinflation loomed. Their hairy-chested survival strategy was summed up pithily, “Grab a blonde, a gun, a bar of gold and a goat, and head for the hills.”

Those who lined up to buy gold as the Triple Waterfall was peaking were wiped out by disinflation, or, at times, outright deflation. Thirty-year *noncallable* Treasuries, yielding 14 to 15%, (which could be called the perfectly inverse assets to gold), outperformed all other major asset classes for the next quarter-century.

Although gold's predictive qualities have long been dismissed by most economists, the Bank of Canada recently issued a detailed study that showed gold was a good predictor of CPI—with a lead time of 13 months—for *economies whose currencies were pegged to the dollar*.

China has, of course, become the most conspicuous of those economies.

No wonder the Beijing bosses have been frantically hiking reserve requirements and imposing price controls and export taxes on foods. Tiananmen Square's protestors called for greater democracy, but they were also demanding that the government curb inflation.

# Basic Points

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Gold's ability to predict US CPI has proved more erratic, but few respected economists believe that a sharp rise in gold prices means lower inflation. Indeed, one of the arguments used by those who defended the wisdom in Alan Greenspan's pricing of fed funds at a paltry 1% was that gold prices had been going down for years. (Today, there are fewer defenders of that bargain basement rate policy in light of the mortgage disaster, which is heavily concentrated in teaser and adjustable rate loans. Greenspan famously admonished homeowners not to lock themselves into long-term loans, because they would be paying excessively high rates. Better, quoth the maestro, to borrow at low floating rates and rely on the Fed to keep both inflation and interest rates low. Since he retired from the fray, Mr. Greenspan's personal income has risen even higher in percentage terms than have mortgage borrowing rates, but fed funds rates are now heading back toward the Greenspan Glory level. His fees are not set, we are given to understand, by a committee that includes distressed mortgagors.)

**Since he retired from the fray, Mr. Greenspan's personal income has risen even higher in percentage terms than have mortgage borrowing rates...**

### 3. Financial Crises

When gold really glitters, it's time to sell bank stocks and put on puts. There is a powerful inverse correlation between bank stocks and gold when financial crises threaten stock markets and the economy.

In normal times, bank stocks are valued by their earnings statements. In distressed times, bank stocks are valued by their balance sheets—and specifically by how the asset side of their balance sheet is rated according to the formulas of the Basel Accord.

Gold suddenly becomes almost as valuable an investment as short positions in leading American and British banks, once financial disease germs fill the air in New York and London.

*Gold is the only financial asset that is nobody's liability.*

*That's why it's better than cash when financiers are finally forced to face up to their folly and/or fraud.*

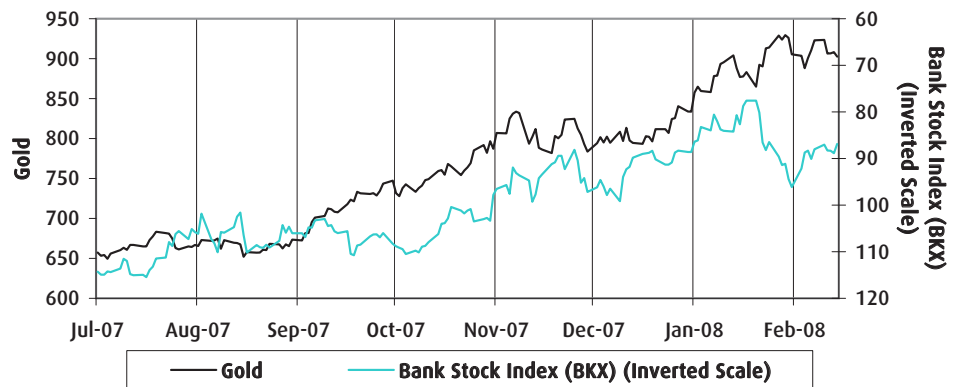
Gold can go up or down in response to geopolitical flaps, bad US trade statistics, electric power disruptions in South Africa, or big increases in sales to Indian brides, or as a portfolio investment for newly-rich Asians.



**...gold doesn't shout,  
scream or screech...**

But if it takes a major leap at a time when the dollar isn't actually plummeting, or published inflation rates aren't leaping like impalas, then gold is *saying* (contrary to some perfervid commentary the investor may encounter at such times, gold doesn't *shout, scream or screech*: It was a desirable investment long before Nasdaq injected sustained shrillness into financial debates) that a banking crisis has arrived.

**Gold vs. Bank Stock Index (inverted scale)  
January 2007 to February 2008**



In 1987, gold leapt 45% in months, even though inflation rates were falling, and the dollar, though ailing, was nowhere near crisis conditions. We predicted that a major market meltdown loomed, because of (1) gold's sudden bull move while in a long-term bear market, (2) the sharp underperformance of financial stocks relative to the S&P, and (3) the sudden, steep climb in the TED Spread.

That memory conditioned us to make the call last summer that this was going to be a very serious financial meltdown—one that would threaten the global equity bull market and the US and European economies.

Gold is signaling a severe slowdown for the advanced industrial world.

Because the oil exporting nations and the Great Symbiosis partners (Japan and China) became major factors in the "global savings glut," the industrial nations were able to intensify their debt buildups—by governments at all levels, corporations at all levels, and households.

# Basic Points

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Now that the fastest economic growth is occurring in Asia, Russia and Brazil, the demands on global savings will steadily become more remorseful. The banking system centered in New York and London that prospered mightily during this seemingly endless liquidity expansion got carried away with its own rapid profit growth, and created tens of trillions in derivatives to lever up their companies' profitability and sustain the mirage that this Amazonian liquidity flood was endless.

Or, in the words of Chuck Prince, "As long as the music is playing, you've got to get up and dance."

The music that is now heard on the Street is more operatic than pop. It is the sound of tragedy and revenge.

As for the classic symphony that is the analogy for base metals, it has entered its Second Movement....slower, with touches of reflectiveness and melancholy. Largo.

**The music that  
is now heard on  
the Street is more  
operatic than pop.  
It is the sound  
of tragedy and  
revenge.**



**Wall Street obliged  
by creating debt  
instruments that were  
the reincarnation of  
the tech-era mania...**

## INVESTMENT ENVIRONMENT

The powerful economic recovery of the 1990s was fueled by falling inflation, falling interest rates, falling raw materials prices, and the remarkable expansion of global trade under WTO. The powerful global economic recovery of this decade was fueled by falling interest rates and quiescent inflation and soaring Third World economies—particularly China and India. As Chris Patten noted in his Oxford commencement address, for the first 18 centuries of the common era, China and India were the world's two largest economies. They did not experience the Industrial Revolution that swept the West into global leadership. He predicted that, in this century, the world would return to normal: by the middle of this century, China and India would be back in the lead.

To get there, they will have to consume—in a relatively few years—nearly as much metal as the West consumed over many, many decades.

The global bull market for metals has just begun.

The advanced industrial world is going to have to rebuild itself to face a world that is short of foods, fuels and metals.

It will have to compete with the demands from the billions of people in the newly-industrializing nations. Betting on their buying is a hard-headed long-term investment strategy; betting on a return to leadership among the aging industrialized nations is a venture in nostalgia.

The commodity Triple Waterfall—which undergirded the plunge in global inflation and global interest rates—enriched the economies, companies and people who were in secondary and service industries, and funded governments that kept issuing bigger and bigger long-term IOUs for pensions, health care and education for people who saw no need to save—and no good reason not to go deeper and deeper into debt. Wall Street obliged by creating debt instruments that were the reincarnation of the tech-era mania—money spawned in software systems that only their creators understood. “Jurassic Park Avenue” achieved the seemingly impossible—creating AAA instruments at a time only a handful of private corporations boasted such ratings.

# Basic Points

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Money manufactured in the purified air of computer banks was this era's equivalent of the Babel Tower construction that another hubristic society undertook to defy the heavens.

As the writers of the great classic texts and plays understood, Pride goeth before a Fall.

None of this means that this bear market will wipe out all the wealth and progress that came after August 12, 1982. At the bottom of the long bear market that followed the decade of stagflation, the Constant-Dollar Dow-Jones Industrials closed at 1929 levels. Fifty-three years of equity progress based on the conviction that equities were always a secure hedge against inflation had been wiped out.

The next day, the Fed cut the funds rate and the greatest-ever bull market was born.

Those, like George Soros, who call this crisis the worst since World War Two, have it wrong. Free Trade, a vast expansion in the population of the educated, and the recognition that capitalism—not Communism—delivers more goods and more personal freedom to more people have created a self-reinforcing dynamic: the newly-capitalist nations will continue to get richer.

The BHP-Rio Tinto-Chinalco-Alcoa battle may end in the biggest merger in world history. That statistic in itself shows how China is changing the global economy. Faced with a takeover of the #3 iron ore shipper by the #2, China authorized a blocking attempt by one of its state-controlled entities. Alcoa, once the world's leading aluminum company, was tapped as the junior partner in the swoop that bought 12% of RTP, giving it potentially a place at the bargaining table—or maybe the dissecting table—where it can scoop up precious parts of Alcan.

When the commodity bull market began, the total global capitalization of mining stocks was less than the market cap of Microsoft and Cisco, even after the early stage of their Triple Waterfall plunge. Now, the major miners are global giants.

That BHP was prepared to increase its already huge bid, after RTP coldly rejected its first offer, could be regarded as a sure sign of a top by the cynics who have on so many occasions proclaimed the bursting of what they considered a mere bubble.

**Alcoa...was tapped as the junior partner in the swoop...giving it potentially a place at the bargaining table—or maybe the dissecting table—where it can scoop up precious parts of Alcan.**



**US banks' exposure to (1) perfumed mortgages, (2) rotting Collateralized Loans that financed manic waves of levered buyouts, and (3) commercial mortgages placed after Sam Zell had sold out of that asset class...**

But the current management teams of BHP, RTP and RIO did not suffer through the two decades of decline. They know that China's future metal consumption would alone justify higher valuations for major mining companies with gigantic reserves. India and other Third World nations will continue to increase their annual metal consumption. Just because the American housing collapse means shrinking demand for copper doesn't mean that metal is headed back to \$1 a pound. In all earlier eras, copper prices were hammered when the US economy got nailed.

Not now.

We have entered the time when Western metal demand will shrink in response to economic slowdowns. That will mean a modest slowing in the growth of total world demand for metals.

It was inevitable this would come...sometime.

When we wrote of it in October 2003, we didn't know that, in hermetic chambers of which we were unaware, squads of Wall Street PhDs had already begun to confect the crisis that would stun investors four years later.

To us, a switch, at some point, from rapture to seeming rupture was inevitable, based on even a cursory review of history since the dawn of the Industrial Revolution.

In the global scheme of things, US banks' exposure to (1) perfumed mortgages, (2) rotting Collateralized Loans that financed manic waves of levered buyouts, and (3) commercial mortgages placed after Sam Zell had sold out of that asset class, are collectively insufficient to bring a global economy now powered primarily by mainland Asia to its knees.

The dramatic plunge in the Baltic Dry Index warns that the global economy is beginning to adjust to a slowdown in the OECD at a time the Chinese economy remains robust. Foreign Direct Investment in China rose a powerful 13.8% last year. The "worst winter storms in a century" have disrupted the Chinese economy as it races toward the Olympics. The vast hordes of workers preparing for that event will doubtless be assigned to new construction and production tasks. If China's export income growth slows because of slumps abroad, the regime will surely allocate funds from its foreign exchange and other reserves to finance infrastructure building that was deferred as long as factory-building was a higher priority.

For miners, the best is yet to come.

Soon.

## INVESTMENT RECOMMENDATIONS

1. Long-term investors should remain heavily overweight commodity stocks, including the base metal stocks. As the bear market grinds on, use days of stock market weakness to add to commodity stock exposure. They not only remain the asset class with the best earnings outlook, but remain the asset class that is least understood by conventional asset allocators, who still see them as cyclical dependent on OECD growth.
2. In the near term, the Golds will continue to outperform stock markets and to act as a form of hedge against two kinds of shocks—financial panics and inflation shocks.
3. Remain heavily underweight bank stocks, and financials tied to “Jurassic Park Avenue” excesses. Within the financial group, overweight high-quality fire and casualty companies, life insurers, and asset management organizations.
4. Retain above-average cash positions, preferably in strong currencies.
5. Where possible, borrow in dollars and invest in assets denominated in strong currencies.
6. The Canadian dollar remains the Western currency with the best fundamentals. Canada’s problems come because the Great Lakes are an insufficient barrier to the flow of bad economic and financial trends from the South.
7. Within the commodity groups, continue to emphasize investment in companies with long-duration unhedged reserves in the ground in politically-secure regions.
8. The growth of sovereign control of energy assets means that the supply side response to record-high oil prices will probably be inadequate to meet relentlessly-growing global demand. Too many Third World governments with rich oil reserves have too many other demands for cash to reinvest heavily for the long term in new production. Retain exposure to the shares of producing Alberta Oil Sands companies with reserves that could outlast this century.



9. Long-term-oriented investors should use any temporary pullback in base metal producers to build their portfolios for the Final Movement of the Sonata—which will be the longest and loveliest performance of metal music in history.
10. The Treasury yield curve is now in recession mode—low-yielding and upward sloping. It is of investment merit only for those who expect a long, deep recession. The Ten-Year note, with a negative real yield of fifty basis points, should appeal only to those who believe the recession will be accompanied by deep deflation. Oddly enough, credit spreads, though they have widened from their record-low levels, do not discount any recession at all.

We think bond investors should go for short and medium-term high-quality non-Treasury paper—preferably in currencies other than greenbacks.

11. Defense stocks remain attractive, even if Democrats win it all in November. The next President may well choose to speak more softly than the incumbent, but if he or she doesn't carry a big stick, the jihadists won't listen.

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