

MAEDEL'S

EQUITY MARKET ANALYST

May 2010



Editor: Neil Maedel
Uncompromising analysis
exclusive advice beginning 1987.

Debt Crisis: is the 30 year bond bull market over?

Crude calculations

- Gold and gold stocks have broken out to the upside we expect new highs in the coming months.

- US equities remain in a bull market although sentiment readings indicate the market is now ripe for a correction.

- Dollar should continue to fall against Asian (ex-Japan) and commodity currencies (Krone, Canadian/Australian Dollar) while gaining in terms of the Euro and pound.

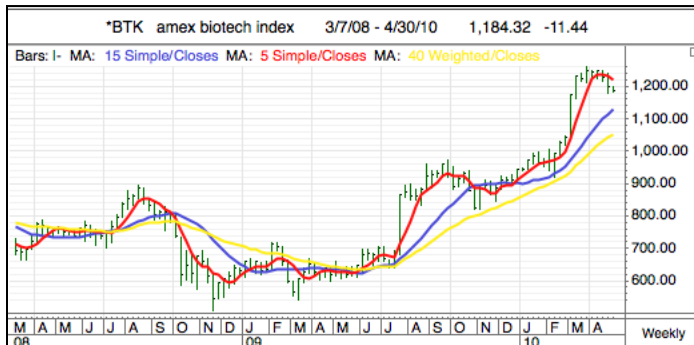
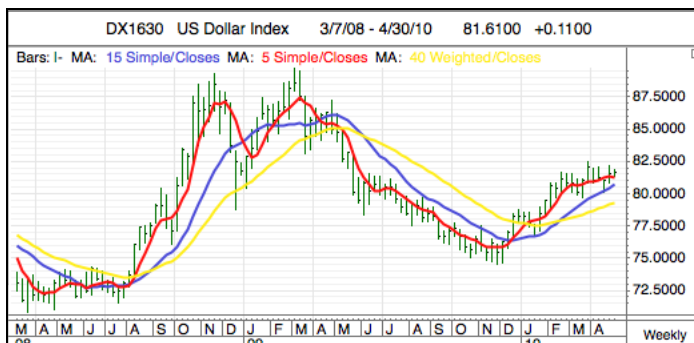
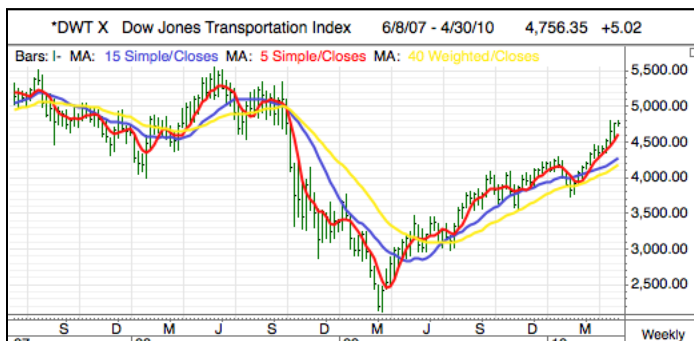
- Buy oil and oil stocks as the upside far out weighs the downside.

- Sell US treasuries

The Silver lining...

The slow motion train wreck that is the Euro continued to derail during the past weeks. In the latest development the bond market reacted negatively to the announcement of an IMF and European Union Greek rescue package and Greece's subsequent request

that it be implemented. In the midst of the crisis **European Central Bank** council member Axel Weber warned that "Greece may require assistance of up to 80 billion euros (US \$108 billion) far more than the 45 billion Euro package on offer. Moody's then helpfully down-graded Greek sovereign debt from A2 to A3; barely in-



The silver Lining continued...

vestment grade, just as Greece admitted its budget deficit was not 12.7% but 13.6%. Greek 10 year bond yields then shot up to almost 9%, exceeding even Indonesian government 10 year yields which unlike Greek sovereign debt, are not investment grade. Greek yields have now inverted in that its two year notes have jumped to an astronomical 13.5%. According to bond yields investors rate Iraq or Venezuela a better bet than Greece. **Financial Times** Associate Editor and EU specialist Wolfgang Münchau calculates that:

“Greece needs to raise around €50bn (\$68bn) in finance for each of the next five years to roll over existing debt and pay interest. That adds up to approximately €250bn, or about 100 per cent of Greek annual GDP” and warns that in effect the bail out package (if it is approved by the German parliament) only “buys time for an orderly default”.

In the book *This Time is Different*, authors Carmen Reinhart and Kenneth Rogoff describe Greece as being in a “perpetual state of default” since its independence because they spent 50.6% of those years in default or rescheduling. Knowing this we can hardly blame the Greeks for fiddling their books - its like blaming a duck for quacking. That’s what they do. More to blame are the Euro elite which thought, to borrow from Rogoff “this time was different” and let Greece join the EU. More critically Reinhart and Rogoff observe that over the past eight centuries, whenever a country’s external deficit exceeded 73% of GDP and 239% of exports, hyperinflation or default was assured. At a respective 161% and 832% Greece’s Renhart-Rogoff moment has clearly arrived.

The silver lining in all this

Though contagion from Greece to not

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Points to Ponder

Ronald Reagan, 40th president of the United States:

“There are no great limits to growth because there are no limits on human intelligence, imagination, and wonder.”

Steven Leuthold, CEO, The Leuthold Group (who closed his bear fund at the bottom of the 2008-09 crash) on why the stock market looks higher:

“Individual investors, as measured by mutual fund flows, have absolutely no current enthusiasm for equity investing. As a contrarian, I view this environment of disbelief and skepticism as quite bullish.”

Arthur Kroeber, managing director of Beijing economics research firm Dragonomics on real estate speculation in China:

“The Chinese aren’t exposed to the low-to-no-down-payment loans once popular in the U.S. Down payments in China average 40% to 60% of the sales price. That is more than the legal minimum for first homes. Additionally, many banks are barred from writing a loan if a mortgage equals half or more of a customer’s monthly income. The amount of buyer leverage is far, far lower (in China) than in the U.S.,”

The Great Inflation William Guttman & Patricia Meehan on Germany prior to the 1923 hyperinflation:

It was fortunate for Germany that in that period foreigners were still willing to buy the paper marks that the Reich printed in order to pay for its large purchases abroad: they still had the confidence in Germany and its economy. But should that confidence wane, the accumulation of paper marks would be a time bomb ready to explode the value of the mark.

Goldman Sachs VP Fabrice Tourre who helped market the Abacas Collateralised debt obligation (cdo) which Goldman client Paulson & Co made \$1 billion selling short in a 2007 email predicts the coming CDO market collapse and admits his own lack of foresight about the consequences:

“More and more leverage in the system. The whole building is about to collapse anytime now... Only potential survivor, the fabulous Fab[rice Tourre]...”

so stressed Portugal or Spain remains a real and apparent danger, the most impressive fact is the muted reaction of equity market's outside of Europe and the UK .

The Greek drama has been largely ignored, telling us that unlike in 2007-2008 global leverage is employed principally by those that can afford it, that the weak investors are long gone and that the underlying stock market is a lot stronger than many believe.

Three out of four

On the cover of the March issue of *Maedel's* we noted that gold's correction was nearly complete and that it should soon begin

a new major bull leg; that US equities should begin moving higher with Biotech stocks as the leaders; just as the US dollar should rally to 82.50 before resuming its downward trend.

The jury remains out on our fourth prediction as it is for a slowdown in OECD growth beginning September (too early to tell) which will prompt further government and central bank support. Our view of the dollar is now mixed (reasons to follow).

Since the March issue the DJIA has rallied as expected (about 10%) compared to the leading Amex Biotech Index which gained about 20%. During the same period the US dollar rallied to our 82.50 target (actual high 82.52) before testing 80.00 and gold broke out from a consolidation pattern which began last December 2009.

Gold looks to be forming a classic bullish reverse head and shoulders and we note though the US dollar index may look strong, it is important to keep in mind that as a bench mark it is old school in that the index comprises a basket of currencies dominated by the mortally weak Euro and British pound.

Debt trap

It is critical to the long term economic health of a country that its compounding tax receipt growth exceeds the

standing in the middle of all these complex, highly leveraged exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!"

Jens O. Parssons, Dying of Money: Lessons of the Great German & American Inflations:

"Everyone loves an early inflation. The effects at the beginning of inflation are all good. There is steepened money expansion, rising government spending, increased government budget deficits, booming stock markets, and spectacular general prosperity, all in the midst of temporarily stable prices.

Everyone benefits, and no-one pays. That is the early part of the cycle. In the later inflation, on the other hand, the effects are all bad. The government may steadily increase the money inflation in order to stave off the latter effects, but the latter effects patiently wait.

In the terminal inflation, there is faltering prosperity, tightness of money, falling stock markets, rising taxes, still larger government deficits, and still roaring money expansion, now accompanied by soaring prices and an ineffectiveness of all traditional remedies. Everyone pays and no-one benefits. That is the full cycle of every inflation."

Bill Gross, CEO Pimco on the Obama Health Care Plan:

"No investment vigilante worth their salt or outrageous annual bonus would dare argue that the current legislation is a deficit reducer as asserted by Democrats and in fact the Congressional Budget Office."

Professor Cai Fang, Head, Institute of Population and Labor Economics, Chinese Academy of Social Sciences, on the developing labor shortage in China:

"it is certain that the migrant worker shortage is here to stay"

King Abdullah of Saudi Arabia regarding the Kingdom's oil reserves:

"When there were some new (oil) finds, I told them, 'no, leave it in the ground, with grace from god, our children need it',"



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growth in its compounding debt servicing costs. As government debt grows for the first few years a country's GDP growth often actually slows and this in turn reduces interest costs. Thus at least initially the crowding out of the private sector by public spending and borrowing reduces borrowing costs and allows governments to borrow even more while spending less. Japan has certainly accomplished this with its near zero interest rates. The US is a more recent example. Last year the cost of servicing \$11.9 trillion in debt was \$383 billion. Compare this to the approximately \$130 billion it spent servicing its by comparison puny US \$1.5

trillion in debt in 1983 when the government was a small fraction of what it is today and GDP grew by over 7%. If we were to return to 1983's record rate of 10.25% the cost would balloon to US \$1.2 trillion.

A return to 1999's moderate 6% rate translates to over US \$700 billion in costs or about 40% of the government's total spending. Would this also mean borrowing would become even more expensive as the inevitable rating downgrades occurred? Thus with the leverage of giant debt and low interest rates the most dangerous aspect to a sovereign debt trap looms.

Compared to America, Japan's government already spends 20% of its budget servicing debt and that is at an average interest rate of around 1%. This year 48% of Japanese government spending will be funded by issuing new debt.

Worse yet almost one in four Japanese are now retired compared to 13% in America an amount expected to rise to 33% by 2030. The consequences are already being felt as Japan's government pension fund recently became a net



seller of government bonds, reflecting both its aging population is the consequent plunge in Japan's savings rate from 18% in the early 1980s to 3.3% today.

As Japan's population grows older and its population draws down its savings, Japan will eventually be forced to look overseas for financing-- then the real trouble will begin. In what would be a miniscule rise by normal standards from 1% to 3% Japan's debt costs would exceed 60% of its current budget. Thus is the dynamic of a debt trap.

A world divided

The Euro has a 57% weighting in the US dollar index so the recent Euro rout is largely the reason for the apparent dollar strength. But its

a big world and better managed countries such as India, China, Brazil and Canada all have very strong currencies in comparison to the US dollar. Compared to the Brazilian real or Australian dollar the US dollar has lost more than a third of its value since Jan. 2009. The Goldman Sachs broad dollar index shows the US dollar is barely 2% off its lows. A mixed dollar performance, that is a weak US dollar compared to Asian currencies (ex-Japan) and a strong dollar compared to countries such as the UK and Europe which proportionally are even in worse off fiscally is why gold no longer trades inversely to the dollar index.

According to their respective central banks American and Eu-

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Well-managed and resource rich...



The more things change...

Houston America endures an overdue correction made worse by a short attack...

The more things change the more they remain the same. So goes the saying. **Houston American Energy** (AMEX:HUSA \$14) shares plunged last week after reaching a lofty \$20. In our last issue we highlighted the company as that "month's star" because of its exceptional performance having already doubled in the past three months. But we remain the first to admit to being surprised when Houston's share price rocketed a further 75% to \$20 in the ensuing 4 weeks. *Maedel's* originally added Houston's shares to its portfolio last January at \$6.50.

Houston's share price was definitively overbought in terms of its relentless rise (owing largely to a lack of insider selling) and were certainly overdue for a correction, but the company certainly does not deserve the swarm of negative blogs by person or group of short sellers who have chosen to conceal their identities.

All we really know about the bloggers is what they are legally forced to tell us: they have sold HUSA shares short. What

they are also happy to make clear is that they would like investors to sell too presumably so that they might profitably cover their short positions at a lower share price

The first sign of trouble occurred when the self proclaimed "**Shareholder Watch Dog**" an incognito blogger with only three other recommendations, (none which if held until today would have made money for investors) predicted Houston's imminent collapse just as a barrage of selling hit HUSA's market.

Buyins.net which tracks illegal short selling (naked short selling) calculates that 38.8% of the recent selling was from short sellers. In other words according to Buyins.net much of the selling which drove the share price down was by people who did not own the stock. Too often, from my trading experience (In the 1980s your editor was a senior floor trader for a major brokerage firm), these sellers will deliberately "lead" a company's share price lower in an effort to trigger margin calls, spook shareholders into selling and make a profit on their overall short position.

We don't know if it was just a coincidence but the hidden authors of a short selling outfit called **Citron Research** simultaneously launched their own HUSA attack



by dredging up a minor infraction which occurred more than 10 years previous by an analyst named **David Snow** who had recommended Houston.

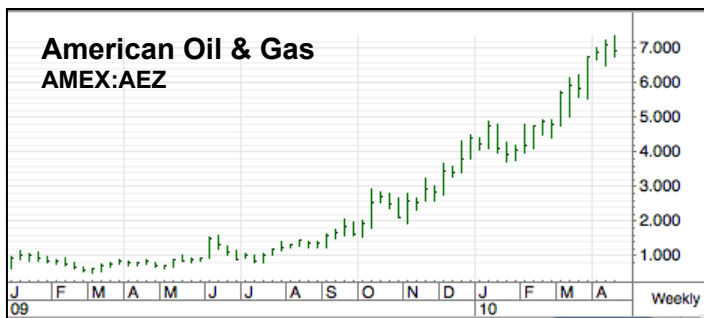
Last time we checked Mr. Snow had nothing to do with Houston's management, board or operations and he is not the only analyst to recommend Houston. But when you are desperate for bad news you take what you can get and stretch reality as much as possible, including associating the analyst with resource stocks which have not recovered from the crash, while overlooking those which he has covered extensively such as **Ameri-**

can Energy (see chart on next page) and a major success story, **Triton Energy** which was eventually sold to **Amerada Hess** for \$2.1 billion.

In any event to read Citron's take, Snow was as guilty of fraud as Enron's Jeffrey Skilling who they draw parallels to. The record is that Snow who has been quoted in Business Week and the WSJ received one of the mildest penalties the SEC metes out.

So who knows better? The SEC or Citron? All we know for sure is that the SEC does not short stock and Citron does.

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The assault on Houston's share price is reminiscent of the 2007 attack by short sellers on **InterOil Corporation's** (NYSE:IOC \$72) market. **InterOil's** shares were mauled after a series of negative but as it turned out largely irrelevant stories circulated on the internet regarding the company's management and promoters.

The bloggers ramped up the innuendo and attempted to connect for investors as many unflattering dots as possible. The principal focus was the activities of InterOil CEO Phil Mulacek and company backers including Carlo Civelli and Clarion Finance. Similar to Houston's attackers they failed to disclose anything relevant or significant or find any fault with IOC's core value - its Papua New Guinea exploration play.

At first glance the bloggers also looked to be right judging from InterOil's share price rout from \$42 to below \$20.

But the fundamental play (drilling the step out of what appeared to be a giant gas discovery) was never successfully

impeached. Nor could it have been. In fact billionaire oil and gas tycoon T. Boone Pickens subsequently bought about 9.9% of InterOil.

And, when the PNG structure was ultimately tested it resulted in the largest producing gas well in the world - propelling InterOil's shares to more than \$80. Incredibly, some sites such as "**White Collar Fraud**" refuse to give up, and are still attacking IOC with blogs sporting such sensational titles as "*Anatomy of a Stock Market Manipulation Scheme*" and "*Did InterOil commit securities fraud?*".

Heart surgery pioneer **Dr. Christian Bernard** once remarked to a friend who was under a

similar attack "*don't worry only the tallest trees catch the wind*". And perhaps that is the price of success. And also perhaps, colorful characters with a smattering of controversy are more common than not when I think of resource stock promoters. Who else would have raised the money and had the chutzpaz to be among the first to operate in Columbia where there is an ongoing insurgency, or Papua New Guinea which in 2007 was considered more corrupt than Sierra Leone (Think Blood Diamonds) and despotic Zimbabwe?

To the Watch Dog and Citron the principal red flag is the sudden appreciation of HUSA's CPO-4 interest from \$15 million to \$500 million as implied by the company's peak market capitalization. They make it sound like this is impossible and thus dangerously suspect.

Instances, howev-

er of a discovery propelling neighboring yet to be explored oil lease values into the stratosphere are a lot more common than the bloggers would have you believe.

Just follow the lease rates offshore Angola or in the Gulf of Mexico or so many companies shale gas holdings. After drilling in only a few distinct areas, Pennaco Energy's shares implied a gigantic value for its once worthless gas real estate which it then sold (for over \$400 million) to Marathon Oil, all in 25 months from start to finish.

So what the bloggers are careful to not detail is how Houston's Colombian real estate has been upgraded by neighbor Petrominerales (PMG-T) giant oil discovery.

The bottom line is PMG's Guatiquia Block is located directly next to Houston's (25%) CPO-4 Block, and PMG's Candelilla- 1 & 2 wells are only about 3 kilometers away from the CPO-4 block. As for timing, the magnitude of the PMG discovery was not apparent until drilling was completed on the first well only last December 16th, 2009. HUSA was both fortunate and savvy enough to have acquired a 25% interest in what looks to be an extension of the play.

In the end we cannot say for certain whether the Houston CPO-4 interest will turn out to be





a success, but we do not doubt it is a very advanced and compelling exploration play just as InterOil was prior to its Antelope-I well.

We also have the same faith in the staying power and acumen of its principals as we did in Messrs Civelli and Mulacek.

As a going concern Houston's strong position is clear: the company has no debt and burns about \$500,000 per year while it holds about \$14 million in cash and looks set to be cash flow positive in 2011.

If actions speak louder than words, the activities of management also tell us a lot. According to Houston Chairman John Terwilliger:

"since the inception of the company neither I nor any member of our management or board has sold a single share in our company".

Too bad, if they had been sellers they might have moderated the company's share price rise and then with the proceeds reduced its tumble by being big buyers.

Technically, Houston shares were clearly overbought after rising from \$12 (when Maedel's last wrote about the company) to \$20 with basically no correction. That it was ripe for a fall played into the hands of short sellers and its subsequent correction was as a consequence far greater than it needed to be. I would expect several months of consolidation in the \$13 to \$15 range is what we are in store for.

There are three catalysts for a resumption of the HUSA bull market.

The first and most immediate is the completion of 205 square miles of 3D seismic which is to further define the size and closure of prospects already identified by earlier 2D seismic on the CP-

04 block. Roughly 60% has already been acquired and the balance is expected to be completed by mid May with processing around June.

One HUSA structure is said to have been mapped 500ft high to Petrominerales' Candelilla-1 & 2 wells at (and may even be connected) which are only 3 km away from and are producing roughly 37,000 barrels per day.

The Petrominerales production is expected to increase as the company further develops the field in step with added pipeline capacity. Clearly further definition in the form of 3D will bring in another wave of buying from deeper pocketed more conservative oil investors. Any short sellers are likely watching this approaching milestone with deep concern as it could easily cause a dramatic upward revaluation of HUSA.

After this the next approaching milestone is the drilling of the first two wells on the 110,000 acre Serrania block (HUSA has a 12.5% working interest) which is in the Columbian department of Meta. The Serrania is adjacent to Ombu field which has an estimated potential of 1 billion barrels in place. Seismic indicates the field extends onto the Serrania acreage. Sinochem Resources recently bought a 90% interest in the Ombu

via its purchase of Emerald Energy, for \$836 million. This is clearly another near term catalyst for HUSA.

Finally the ultimate catalyst begins this December when Houston and the operator South Korean conglomerate SK Energy at CP-04 plan to spud the first well as the ultimate test of the seismically defined structures. All fingers will be crossed for an InterOil like performance. If it happens it will not be the first Maedel's pick to go into the stratosphere and we hope it won't be the last.

Maedel's primary focus is finding little-known companies which trade at bargain prices with a very high potential to move 1,000 percent or more.

Early January 2010 Maedel's added HUSA to its portfolio at \$6.50 as we saw its shares as having the right combination of being significantly undervalued and having a very well developed story with the evolving Petrominerales discovery as a short term catalyst and a major upgrade to its story. We think it is early days for Houston and for investors looking to add to their position the current \$13 is a great entry point thus we are continuing to hold 100% of our position.

MAG Silver

Often some of the investing world's best opportunities are right under one's nose.

Houston American Energy (NASDAQ: HUSA \$17) is a prime example of knowing a company well, long before investing (*we added it to our portfolio January 4th at \$6.50*).

Often, as was in the case of Houston American and a more recent pick, **Wave Front Technology Solutions** (TSX:WEE \$2.41), the final trigger was an evident bullish psychological tone in share price action: clear out-performance compared to their peer groups and better still, their shares frequently moved higher when the overall market was correcting.

As the charts right show MAG Silver's shares have risen more than twice as much as the **AMEX Gold Bugs Index** which is composed

of 15 precious metals producers. Silver producer, **Coeur d'Alene Mines** NYSE: CDE \$15) makes MAG look even better. It rose almost 25% during the same period but is now only up 8% compared to MAG's 40%.

Noticing its relative out performance prompted your editor to re-visit the MAG story and see how things were developing. Here is what I found and why we have added it to our portfolio.

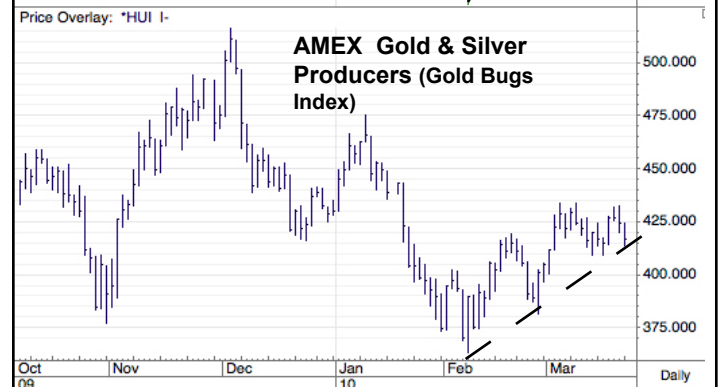
MAG has been known to *Maedel's* for some time. Especially since the newsletter's sister company *Adean Invest* worked with MAG Silver founding President and Director **George Young** to organize a total management and financial make-over of **Mexoro Minerals** (OTC:MXOM \$0.49) which, as part of its restructuring, is changing its name to **Pan Ameri-**

can Goldfields. (Mr. Young, a metallurgist and specialist in mining law, is now President of Mexoro.)

Mr. Young played an essential role in MAG's early days when together with geologist Dr. Peter Megaw, they executed the deal which changed control of MAG's predecessor company, a \$0.50

a share penny hopeful called **Mega Capital Investments.** The crux of the deal was the simultaneous purchase of Mexico-based **Minera Los Lagartos** which holds MAG's now hugely successful **Juanicipio** silver project. Immediately following the transaction Mr. Young spearheaded the acquisition of MAG's

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It's all relative...

MAG PROJECT LOCATIONS



De Mayo's potential and it was up to the soft spoken Mr. Young to acquire it.

Of interest to Dr. Megaw was the property's location along the *Chihuahua Trough*, the same NW trending structure which hosts several major carbonate replacement deposits (CRD's).

Dr. Megaw's interest in CRD's is easy to understand considering that they are responsible for roughly 4 billion of the estimated 10 billion ounces of silver produced in Mexico to date.

The Cinco De Mayo property also contained numerous lead-zinc, silver mine workings. These provided further evidence which showed the area had many of the

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Why Maedel's Bought MAG

On March 11th Maedels added MAG Silver (TSX:MAG \$7.82) to its portfolio these are the basic points:

- HUGE Upside**
Exploration potential is massive with a very realistic chance of success especially at the Cinco De Mayo property (beginning with the Pozo Seco) while Juanicipio looks to be a lot bigger than advertised. Expect the news flow from the development of these plays to accelerate.

- Bargain priced**
MAG trades at a hefty discount to NPV for its Valdecañas Vein reserves making its major Pozo Seco, molybdenum discovery practically free.

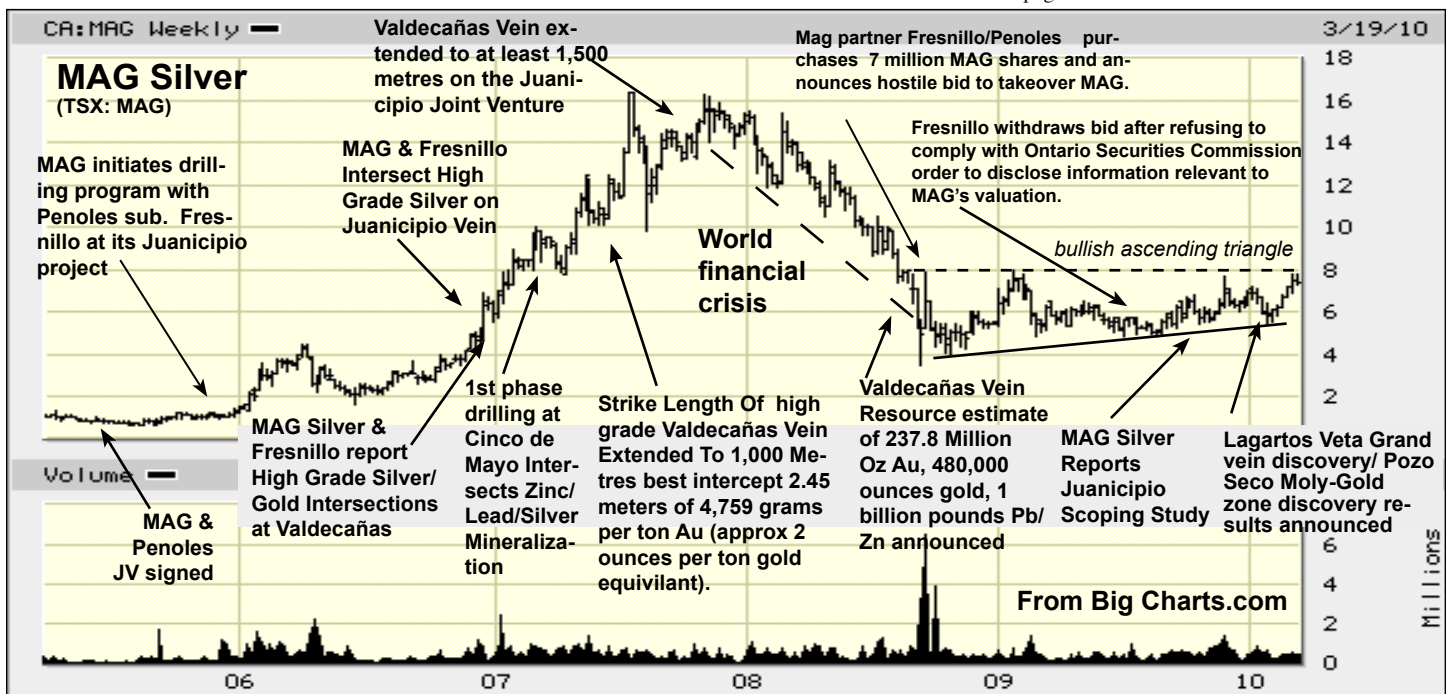
- Takeover candidate.**
Penoles already tried once to take over MAG - right in the midst of the crash - we won't be surprised if they try again.

Cinco De Mayo property or as Dr. Megaw recounted when I was learning about the project, "George optioned it for MAG in the first place". (Mr. Young also negotiated for MAG its pivotal \$5 million Juanicipio joint venture with **Industrias Peñoles**, the world's largest silver producer.

Peñoles has since earned its 56% by spending the \$5 million and MAG retains a 44% interest via a JV company called **Minera Juanicipio S.A.**)

Cinco De Mayo

In the decade and a half prior to the Cinco De Mayo acquisition, Dr. Megaw had completed a regional study which honed in on the Cinco



key geological features as parts of the Santa Eulalia silver district - tantalizing given that the Santa Eulalia has produced in total 450,000,000 ounces of silver from a series of high-grade CRD deposits.

The Pozo Seco Discovery

Since MAG acquired the 22,000 hectare (55,000 acre) property, it has evolved into the company's second flagship project but not for the reason we would have expected. Though the company's focus is silver they were also on the alert for the variety of metals typically found within the district.

In Dr. Megaw's words *'If you are deer hunting and you see an elk you shoot it'*.

Instead of a silver deposit, the initial drilling turned up a major molybdenum-gold discovery called the **Pozo Seco** whose world-class size was made clear last January.

The most recent drilling has outlined the moly-gold zone to be (so far) 1,700 metres strike, across 250 to 350 metres width with an average of 50 metres thickness. It's latest set of results, include 116.9 metres averaging 0.098% molybdenum and 0.25 gram gold, beginning at a depth of 39 metres. The intercept included a section of 13.6 metres of 0.239% moly and 1.1 grams gold. The stepout is 600 metres

northwest of hole 144, which returned 44 metres of 0.16% moly and 0.27 gram gold - making it a dramatic expansion of the discovery's size.

The same flexible thinking was evident when in 1994 **Diamond Fields Resources'** diamond hunting geologists discovered the giant Voisey's bay nickel-cobalt deposit, driving its shares from pennies to over \$40.

Critically MAG's Cinco De Mayo, Pozo Seco moly discovery looks to be very economic, principally because it is near surface, flat lying, is in bulk minable widths, and is about triple the grade or richness of most of the world's moly producers.

In the 1990's I got to know **Dr. John Guilbert** who together with **David Lowell** developed

the Guilbert -Lowell copper porphyry zonation model which led to their discovery of some of the world's largest copper porphyry deposits including Kalamazoo and La Escondida. MAG's Dr. Megaw is clearly on the same scientific and practical explorationist level. His focus, however, is on a different kind of zonation model, one which indicates the potential for a giant silver-lead-zinc deposit to exist in the vicinity of MAG's recent molybdenum discovery.

Carbonate Replacement Deposit zonation

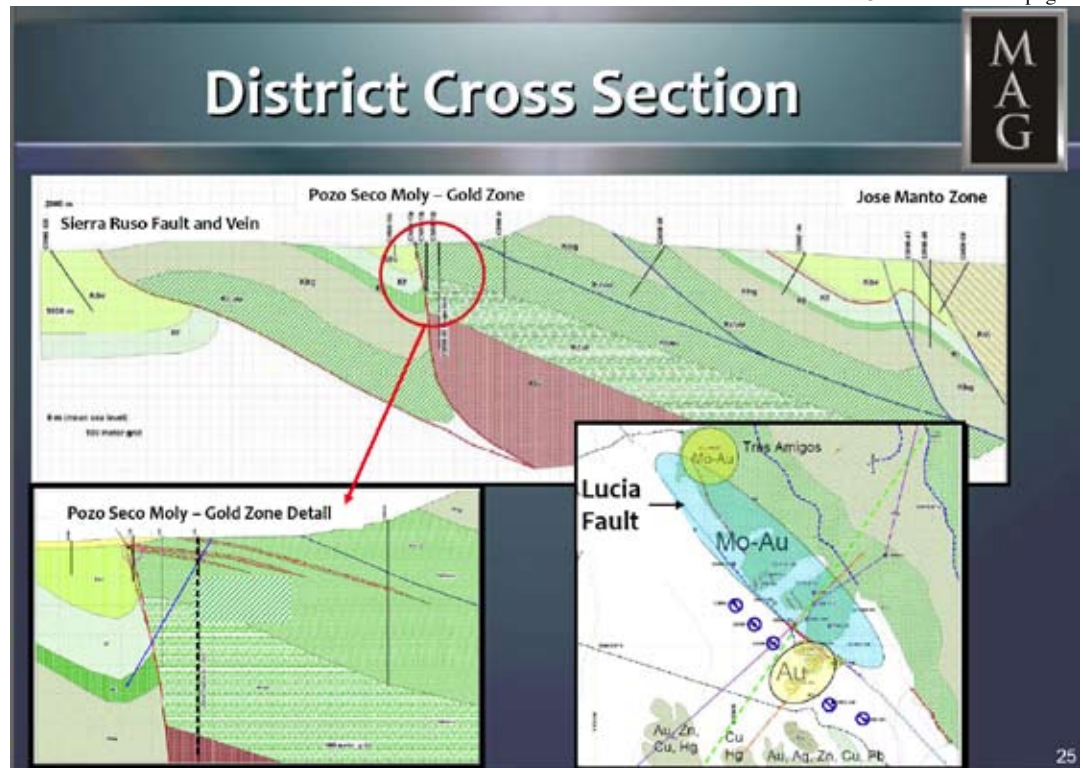
Carbonate replacement deposits' lead, zinc and silver rich ores are deposited by high-temperature fluids which transport the metals away from molten rock and into carbonate rocks

such as limestone. As these fluids move away from the intruding molten rock along faults, fractures and layers in the limestone, they precipitate out of solution while at the same time the super heated water dissolves portions of the limestone, thus replacing it with the previously dissolved metals.

Because the metals have varying characteristics, some will precipitate out of solution at higher temperatures and pressures than others, during each succeeding pulse of mineralization; meaning that some are likely to be deposited closer to the source and others further away.

The real life consequence is that if MAG has located the feeder or original conduit for the system's super-heated fluids then they can

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roughly calculate where metal enriched zones are likely to be. Also the discovery of the molybdenum rich zone tells them they are likely right in the midst of the feeder zone adding to their ability to calculate where an associated silver-lead-zinc CRD is likely to be.

Another area which has a very similar zonation to the Cinco De Mayo is the **San Martin-Sabinas District** in Zacatecas Mexico. The district contains Peñoles' **Sabinas** silver mine, the largest skarn replacement deposit in the country. It is also Mexico's largest underground mine - no small thing when you consider that Mexico is the world's largest silver producer.

Pozo Seco indicates potential for giant silver-lead-zinc CRD

This is where the impact of MAG's Pozo Seco discovery could increase dramatically. The first important implication of the Pozo Seco's existence is that if Dr. Megaw's zonation model is correct, then it should be very close to a large silver-lead-zinc CRD.

The second implication is even more eyebrow raising. CRD research has shown that the amount of molybdenum mineralization that is found varies with a specific ratio to the size of the neighboring silver-lead-zinc CRD. Basically the more moly the bigger the silver-lead-zinc CRD.

'The Pozo Seco is approximately 8 times the size of the known moly mineralization which occurs outside of the San Martin-Sabinas District's silver-lead-zinc deposit - it is Mexico's largest CRD - implying a truly astounding CRD discovery is possible.'

Big Upside

This certainly gives the MAG story the kind of Diamond-Fields-like share price impact we look for.

Going back to January's oil pick *American Houston*, it also has the same serious massive potential. It had a highly developed oil play with a giant discovery next door and its shares were cheap and relatively unknown. We expect MAG's shares to do at least as well.

In a research paper published by Dr. Megaw he notes that CRD's "vary from 10-13 million tonnes and up to over 50 million tonnes and the high grades (ranging from 2 to 12% lead, 2 to 18% zinc, 60 to 600 g/t silver, up to 2% copper and up to 6 g/t gold) make them extremely desirable targets to explore for".

To date drilling at Cinco De Mayo has confirmed the CRD modelling as hoped. We expect the Cinco De Mayo story will just

keep building and adding to share value from here.

Peñoles, MAG and the World Financial Crisis

Prior to 2010 the principal MAG story was that it looked likely to be developing one of the world's the highest grade silver resources at its Juanicipio property. The events leading up to this conclusion were hardly straight forward. The company began a JV with neighboring Peñoles' subsidiary Fresnillo on the Juanicipio in 2005 after initial exploration had resulted in the two discovery of two bonanza veins the most important as of yet, being the Valdecanas.

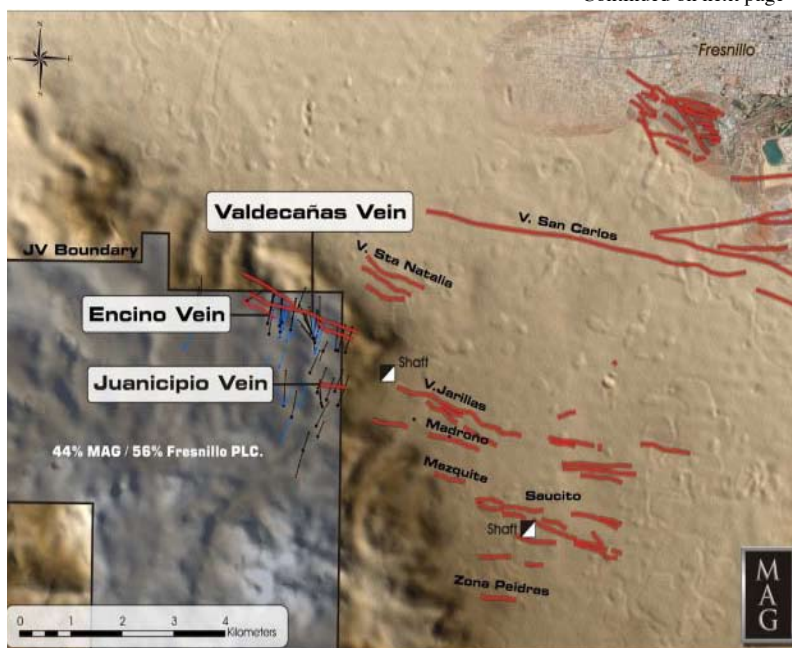
Hats off to Dr. Megaw for successfully developing an accurate geological model for the region despite the fact that much of the trend is buried under sediment, thus hampering geologic

understanding until now. Consider that Fresnillo had been mining and exploring only a few kilometers away for over 100 years and some how missed the Juanicipio's elephant potential.

Fresnillo had been operating and continues to operate the world's richest silver mine approximately 5 km from MAG's property, The 2005 discovery of the Saucito vein by Fresnillo was the first substantial indication that MAG's Juanicipio property was likely to contain a major silver find. The Saucito/Jarilles was only 1.5 km (0.9 miles) from the Juanicipio, a dramatic indication that their Mine's super-rich epithermal system was likely to trend across MAG's Juanicipio property.

Subsequent exploration has shown the Valdecanas geologically and mineralogically similar to Fresnillo's Santo

Continued on next page



Nino vein which produced over 250 million ounces of silver from its 4 km length except that MAG's Valdecanas is richer.

The Valdecanas carries 4 to 8 times as much gold - up to 4 grams per ton, and its average silver grade is around twice that of Fresnillo's mines. Currently, the discovery's drill indicated and inferred resources total 150 million ounces a number that is expected to increase.

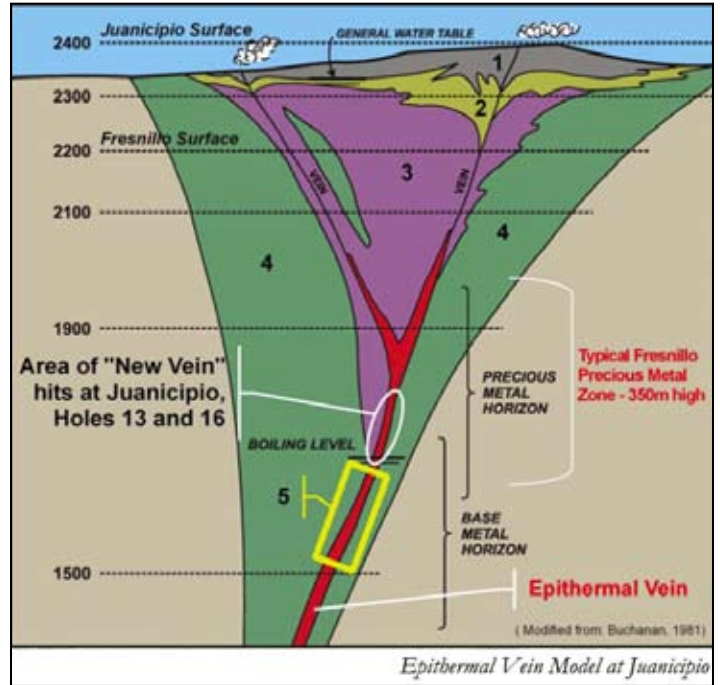
Two years ago as the World Financial Crisis resulted in a global collapse in share prices and an evaporation of risk capital, it is easy to imagine a more than 100 year old cash-rich company, like Peñoles, jumping at the potential opportunity to acquire a major asset, like MAG, at a deep discount knowing that most of the world was desperate for liquidity and thus MAG shareholders might jump at the opportunity to sell

if it meant a way to raise cash.

Peñoles' plays hardball
A wholly unfriendly takeover bid by Peñoles for MAG is exactly what happened. It began when Peñoles announced (at the very depths of the world financial crisis) that the two companies' Valdecanas silver discovery was uneconomic as a stand alone project. Despite the enormity and conflicting nature of this claim, they refused to supply any data to justify their opinion.

Instead, Peñoles most revealing activity was their simultaneous purchase out of the open market of more than 7 million MAG shares, which increased their total holdings to 19.8% of the company.

Shortly afterwards Peñoles announced a hostile takeover bid for MAG which MAG's Dr. Megaw indignantly referred to as a "Take under bid".



MAG's immediate defense was to demand they justify their position while insisting on an independent study regarding the Valdecanas economics, they also challenged Peñoles purchase of shares pointing out that it overtly violated the JV agreement.

Cat's out of the bag: scoping study indicates Valdecanas likely to be wildly profitable.

Month's later the study indicated that, as a stand alone project, mining the Valdecanas vein was likely to be exceptionally profitable. As this occurred, the **Ontario Securities Commission** stepped in and demanded information from Peñoles which could have brought into the open the entire situation. But instead of complying with the OSC order, Peñoles dropped its takeover bid of MAG.

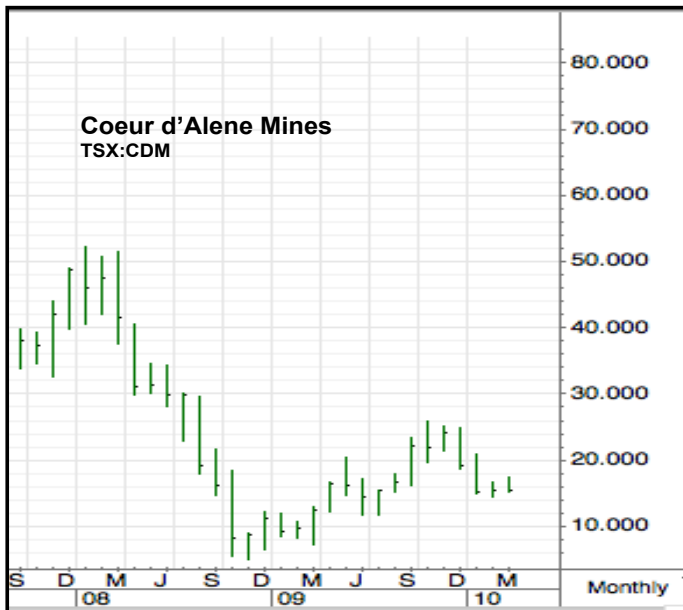
If an avalanche of selling from liquidity desperate investors had occurred, the takeover of MAG by Peñoles would have been a fait accompli, with few left to complain.

Instead the Valdecanas has advanced to a new radically more transparent and robust phase and that combined a greatly improved financial environment and now a major discovery at the Pozo Seco will make a still compelling acquisition of MAG considerably more expensive.

Sunny days

The bottom line is that the cloud which hung over MAG during its mauling by Peñoles is rapidly dissipating, while the weight of evidence is that Valdecanas is likely to provide a major lift to the company's share price.

Continued on next page



Our bet is that the Valdecanas and the associated potential of neighboring veins within the Juanicipio property, justify a significantly higher MAG share price.

Shares still a bargain

For example using a \$7.50 share price, MAG's fully diluted market capitalization is US \$397 million. The results of MAG's company-saving, independent scoping study by **Wardrop, (Tetra Tech)** regarding the viability of a stand alone mine at the Valdecañas, estimates a CAPEX of \$217 million with a payback of 2.2 years, a pretax IRR of 48.4% and a cash cost of US \$1.77 per ounce of silver using a 4 year trailing (US \$12.43) silver price. Consider that **Coeur d'Alene's** Palmarejo deposit, which just began production last year, had a cash cost of \$10.48 per ounce of silver and it becomes evident how compelling the Valdecanas' economics actually are.

Using the same \$12 silver price, the net present value (NPV) for the Valdecanas is \$967 million of which MAG's 44% share equals \$425 million or about \$8 per MAG common share. If we use silvers actual \$17 market price, MAG's Valdecanas NPV per share jumps to closer to \$11.

The real upside

But the real upside comes from its future cash flow from the operation and the multiple it would get because of the high prob-

ability that its reserves and production will grow. As it stands (using the low silver price) MAG's share of cash flow should be about \$50 million per year from the operation.

Considering the likely high growth profile, our take is that a cash flow multiple from its Juanicipio operations of around 20 is reasonable. Based on this, we get a three year target market capitalization of \$1 billion or a \$20 per share solely from its Juanicipio operations.

The tip of the Iceberg

This is pretty attractive considering that what has been evaluated so far at Juanicipio looks to be the tip of the iceberg. One must also consider the developments at the Cinco De Mayo too. The moly discovery, though early days adds considerably to the share price upside.

The billion dollar question

The real question is will Dr. Megaw be as right about the Cinco De Mayo's CRD zonation as he was about the model for the Juanicipio? If he is once again correct and MAG ends up with a giant silver deposit then we should expect Diamond Fields like share appreciation. That is the high risk part of the story. Critically, the share price is supported by the low risk Juanicipio development story with the added bonus of the high potential of reserve growth from within the Juanicipio property. Finally, their is the potential of more discoveries from the company's other high impact exploration plays.

Take Over a definite possibility

The principal short circuit to the whole play we see is if Fresnillo/Penoles

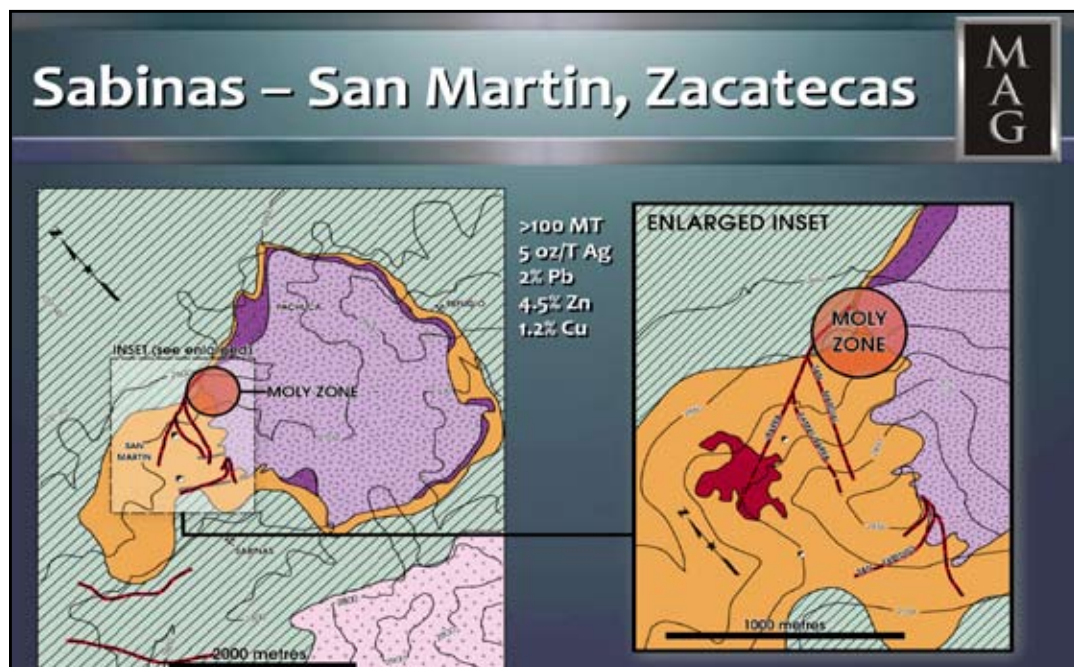
takes another run at the company and successfully takes it over. Aside from MAG management, few know the Juanicipio better than Fresnillo. They were willing to bid for the company when money was nearly priceless. What would they be willing to pay now that capital markets have unfrozen and through leverage they could literally buy it with other peoples' money.

I think it is a safe guess that this is a topic of discussion amongst the Fresnillo - Penoles management, especially now.

The right combination

MAG has the right combination of low share price downside and massive upside that we look for together with several very solid reasons for us to profit in the future which is why we have added it to our portfolio.

• • • •



Wavefront Technology Solutions

Early last March *Maedel's* added Wavefront Technology Solutions (TSX:WEE) to its portfolio at \$2.40 per share. The company's Powerwave technology has been shown to more than double both oil production and the ultimate amount of oil recovered. Critically, for our readers, its adoption by the industry has just begun to accelerate making Wavefront a potentially giant growth story.

In early March Wavefront signed up an "integrated global oil producer" to use its Powerwave technology in West Texas' Permian Basin. That field has over 700 water injection wells which could use the technology at \$36,000 to \$48,000 per tool per year. WEE has just added another major client to its portfolio. Its latest customer is a Houston based independent which is installing 16 powerwave systems at an undisclosed field

in Utah.

The potential for further orders is similar to the previous major customer: very good as the field covers 180,000 net acres with more than 2 billion barrels in place and 500 water injection wells and 1,400 producing wells - all which could use the technology. The independent also has fields which are prime candidates for Wavefront's technology worldwide.

Typically the users of the Powerwave do not wish to be identified as the resulting improved production and recoveries in some cases also dramatically improves the economics of not only the clients current oil fields but fields they may wish to acquire. Keeping tight lipped as they increase their revenues and add to their locations is a logical characteristic of the industry.

Just as we have seen major improvements in shale gas fracking completely changed economics and produc-

tion rates over the past 5 years, Wavefront's Powerwave promises to become part of standard practices in oil production in an industry where just in North America there are over 200,000 injection wells.

An acceleration in the adaptation of the powerwave appears underway. In 2009 there were about 50 licensed - proving the technol-

ogy. That number has already jumped to 166 with another 93 pending. The company is appointing representatives and agents in North Sea region, South America, Australia, Asia Pacific and the Middle East.

We think it unlikely that Wavefront's shares will remain at the \$2.50 level much longer and are continuing to accumulate its shares.



Maedel's Portfolio

Equity	symbol	buy price	subsequent high	latest price
AngloAmerican	AAUKF -OTC	37.80 USD	46.00	45.00
BNK Petroleum	BKX-TSX	1.30 CDN	3.10	2.77
Goldfields Ltd.	GFI-NYSE	14.65 USD	15.88	12.87
Houston Am. Energy	HUSA-AMEX	6.50 USD	20.36	14.33
Ivanhoe Mines	IVN-NYSE	16.43 USD	18.94	17.71
JA Solar	JASO-NASDAQ	5.06 USD	6.93	5.91
Lynas Corp.	LYC-AU	0.51 AUS	0.66	0.55
MAG Silver	MAG-TSX	7.50 CDN	8.25	8.10
Mexoro Minerals	MXOM-OTC	0.41 USD	0.58	0.46
Nanoviricides	NNVC-OTC	1.30 USD	2.50	2.15
Wavefront Tech. Sol.	WEE-TSX.V	2.40 CDN	2.67	2.29

Updates...

Rare Earth Metals

"There is oil in the Middle East; there is rare earth in China" said former PRC Chairman **Deng Xiao Ping**. Rare earth oxides such as neodymium and praseodymium are critical in making the latest generation of high performance batteries and magnets that are, for example, essential in such explosively growing sectors as hybrid vehicles and wind power.

Note that a single nickel metal hydride car battery uses over 12kg of REOs and a typical utility scale wind turbine uses more than 300 kg of the rare earth neodymium. China currently has control of 93% of production making their industry vulnerable to supply disruption.

Lynas Corporation Limited (Australian Stock Exchange: LYC or

on America's OTC: LYSCF) has the richest rare earth oxide (REO) deposit in the world. It raised AUS \$450 million last October roughly a month after **China Nonferrous Metal Mining Corp.** abandoned its \$505 million (US \$414 million) bid for a controlling stake in the company.

The construction of a REO processing plant in Malaysia is on track for first production in June 2011. Mining at the company's Mt. Weld deposit in Western Australia is to resume this month while over 700,000 tons of ore is already stockpiled and ready for concentration prior to its shipment to the Malaysian processing plant. Lynas has 70% of its phase 1 production and 25% of its phase 2 production pre sold covering the first 5 years. The REM contracts have price floors

resulting in a minimum US \$12.50 per kg but have no ceiling prices. Since the contracts were established REM prices are up by over a third.

Lynas has considerable potential for reserve increases beyond its current 1.2 million tons of contained REO at the Mt. Weld when the +400,000 ton Crown or +100,000 ton Malawi Kangakunde deposits are included.

We expect Lynas shares could easily be trading in the AUS \$1.00 range as the startup of REO processing in Malaysia nears. Gearing on any further REO appreciation is approximately 2 in other words every 10% rise in REO prices increases projected cash flow by 20%. We are continuing to accumulate the company's shares.

The Shale Gas Revolution

Where there are dramatic supply issues with REO's the exploding growth in shale gas production promises to secure giant supplies of natural gas near European and American end users. Tony Hayward CEO of **British Petroleum** calls shale gas a "game changer" because it could revolutionize America's energy policy by dramatically reducing its reliance on fuel imports. Given that the US imports roughly \$900 million worth of oil per day it could also dramatically improve the country's trade balance.

mittee (PGC) a nonprofit organization associated with the **Colorado School of Mines** says the United States' total gas resource base rose 35% between 2006 and 2008 to 1,836 trillion cubic feet (Tcf). This is the highest resource evaluation in the Committee's 44-year history and most of the increase is from the re-evaluation of America's shale-gas producing regions. At the same time there is the "Picken's Plan" as championed by its author billionaire oil maverick T. Boone Picken. Picken's points out that almost 20% of every barrel of oil we import is used by 18-wheelers meaning converting to natural gas could reduce imports by as much as 2 million barrels per day.

Both America's House of Representatives and Senate are expected to double a 2005 tax incentive to use natural gas to fuel trucks. Kenworth's Peterbilt, Volvo and Cummins all produce gas powered semitrailers. Peterbilt is the latest in the US to begin taking orders for natural gas truck models made in Texas that use Cummins Westport engines.

The credits are expected to be as high as \$12,500 for cars and light trucks and as much as \$64,000 for heavy vehicles. Gas stations which supply natural gas could get tax credits as high as \$100,000. So America has an abundance of gas and a need for it.



In Europe there is also a pressing need for an alternate source of energy, especially since natural gas reserves in the North Sea have been declining resulting in 70% of European supplies coming from Russia, which has demonstrated it is very willing to cut off gas supplies to reach its political goals.

Again shale gas looks to be a panacea for European energy consumers. Peter Voser the CEO of Royal Dutch Shell calls shale gas the biggest hope for the future decades. JP Morgan estimates shale gas reserves in Western Europe will reach 510 trillion cubic feet - enough to supply Germany at present rates of consumption for 175 years.

Poland's shale gas potential is considered to be the largest and majors such as Conoco-Philips Exxon and Chevron are there. The polish shale reservoirs are considered geologically similar to the Barnett shale in Texas except that at 200 meters thick it is consid-

erably larger.

Also natural gas prices average around \$9 per TCF in Poland compared to \$4.50 in the US. Corporate taxes and royalties are also more favorable in Poland at a respective 19% and 1%.

We added **BNK Petroleum** (TSX-V: BKX) to our portfolio last January, when we were alerted by a sudden spike in insider buying last Christmas. Our examination of the company showed that it was accumulating a major stake in the giant Polish shale gas play where it holds three major concessions adjacent to lands Conoco Philips is developing. Including its holdings in the Western EU the company has 2,645,000 net acres in 4 natural gas basins.

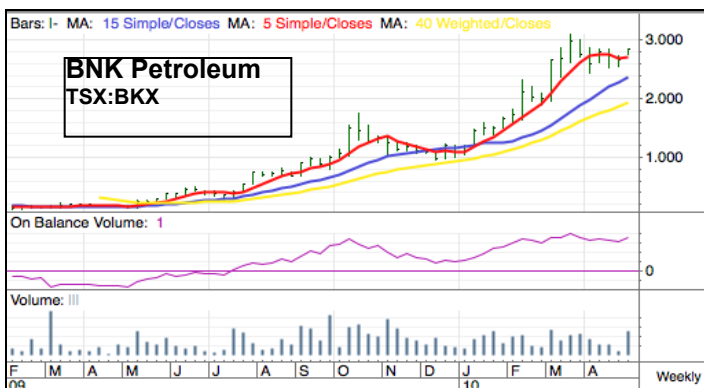
The company has farmed out 195,000 acres to RAG Austrian Energy and Sorigenia Energy who are expected to drill the first well in the third quarter of 2010. BNK's shares have since been as high as \$3.10 and we have taken profit on 50% of the position and are holding the balance.

Blockbuster? Nanoviricides anti viral medicine

Last March Maedel's added NanoViricides (OTC:NNVC \$2.60) to its portfolio at \$1.30 per share just after the company announced a R&D agreement with Dr. Eva Harris at University of Berkeley to evaluate the effectiveness of nanoviricides against Dengue fever. The agreement was further validation of Nanoviricide's potential blockbuster antiviral drug platform which tricks viruses into binding onto a custom designed anti-viral nanomicelle instead of its targeted cell. Because human or animal cell surfaces don't change, mimicking the cell surface could be an effective strategy in designing an antiviral drug. Once the virus has bound to the nanomicelle - in effect covered in a nanomicelle slime, the virus thinks it is infecting a cell and harmlessly releases its RNA and DNA which is then easily destroyed by the host im-

mune system. Nanoviricides product pipeline includes Influenza and Bird flu (Flucide) External eye viral infections (EKcCide) HIV/Aids (HivCide) Rabies (RabiCide) Dengue, together with Ebola and Marburg (with the US Military to counter potential bioterrorism). Because viruses are shown to cause cancer of the cervix, connective tissues (sarcomas), immune system (lymphoma), and other organs and recent research implicates retroviruses in prostate cancer, using NanoViricide's technology for preventing viral transmission to prevent infection and thus cancers in people opens another giant application for the technology. It is early days and tests, while extremely positive, are limited to animal studies a stage which in the development of drugs has its share of false starts. Human clinical trials are planned to begin this year and because many of its targeted viruses are active infections (such as influenza) phase I (safety) and phase II proof of concept

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can be combined and the clinical trials including phase III could be shortened to as little as three years. Critically, the actual polymer used to build the nano-micelle has already been used in humans for years with zero toxicity. In total the possible market size is mind boggling at over US \$20 billion for HIV where in animal studies use of its nanoviricide has resulted in a "functional cure". Consider that over 175 million people are estimated to carry the hepatitis virus and more than 50 million people are infected with Dengue every year and the potential for as-

tronomical share price appreciation becomes evident.

The company's drug development strategy is to design the nanoviricides for specific applications and then to license them out.

Nanoviricides is currently collaborating with academic labs, government labs, as well as external service providers in order to minimize its capital requirements. These include animal tests by the US Center for Disease Control and Prevention and Vietnam's National Institute of Hygiene and Epidemiology for Rabies, with NIHE for

H5N1 Avian Flu.

The Walter Reed Army Institute of Research (WRAIR) and the Eva Harris Lab at the University of California Berkeley are investigating its application for Dengue viruses. United States Army Medical Institute of Infectious Diseases (USAMRIID) is developing nanoviricides for Ebola/Marburg family of hemorrhagic viruses, and the Long Island Jewish Medical System, Feinstein Institute of Medical Research (LIJMS) is testing it for viral eye diseases such as epidemic kerato-conjunctivitis (EKC) and herpes kerati-

tis.

The next important milestones will be licensing the technology to large pharmaceutical companies such as Gilead the producer of Tamiflu and HIV products. NNVC has 130 million shares outstanding which at its recent \$2.40 share price translates to a US \$320 million market capitalization.

BOND WATCH

Since the financial crisis began in the summer of 2008, unprecedented amounts of OECD government stimulus has been pumped into economies around the world. Unlike last decade's recession and wave of defaults, stronger Latin American and other emerging markets have performed relatively well this time, avoiding large scale bailouts and ballooning deficits. In addition, many emerging market local currencies have outperformed, as their economies sustain strong growth and fiscal discipline. In our view these divergent trends strengthening emerging economies and a stagnating OECD will continue. Why is this happening and, on the basis of this trend,

how can the shrewd bond market investor profit?

We have seen what is happening to Greece with their government borrowing costs skyrocketing and their refinancing difficulties worsening by the day. Let's remember, that Greece is only the first of the "PIIGS", there are still Ireland, Italy, Portugal and Spain to come.

Many investors ask why Europe doesn't just bailout Greece? The problem is that even though EU members have offered over 45 billion Euros of backstop support, institutional investors who would normally buy Greek debt at 'a price', currently cannot imagine how Greece will ever be able to cut its deficit with-

out rescheduling (i.e. cutting coupons, lengthening maturities etc.). They also believe Greece's problem is so acute (over 40 billion Euros to refinance just in 2010) that its default will become self-fulfilling; that is as bond buyers lose confidence, the country's borrowing costs become so high that these costs render them insolvent.

The other PIIGS have similar problems but they are not all the same. Spain for example, has only about a 50% ratio of government debt to GDP but their unemployment rate is astronomical (close to 45% of people under 26 years of age unemployed!). This means that while Spain does not have excessive debt to service,

the social cost of dealing with their unemployed is unsustainable.

In Italy, Ireland and Iceland the situations are again different but equally unsustainable. The US actually has both problems: high government debt to GDP and high unemployment. Overall it seems that OECD economies are both victims of their own success, of too much borrowing and of globalization.

In the more successful developing economies, the story is almost the opposite. Following the emerging market debt crisis in 1996-97 the high growth developing countries improved their debt ratios, benefited from both export and commodities booms, very high

savings rates just as, unlike OECD countries they were never financially burdened with supporting the unemployed, the retired or providing health care.

We believe that Greek debt crisis is just the tip of the iceberg. One by one, the OECD countries, including the United States will face refinancing constraints in the coming one to two years. In fact, this is already becoming the next macro theme which will hamper economic recovery. Otherwise, why would central banks keep interest rates so low?

Our Low Risk Bet

There are multitudes of ways in which professional bond traders profit from bond market price changes, although until recently, "retail" investors have been excluded or just offered plain vanilla credit products, many of which went wrong.

With the advent of structured products, investment advisors are able to create securities which profit from the same bond market price and spread changes that previously only professional traders could profit from. In essence, structured products are tailor-made securities which banks can create for retail and institutional clients, which split institutional products into retail size units. The challenge for retail investors is knowing which ones to buy.

Our goal is to inform readers with sound macro viewpoints which will help in understanding and choosing bond market structured products. We will also, on a case by case basis, describe structured products and themes which we think will be successful.

One structured product trade we currently like offers little risk but enables an investor to pick-up extra return as interest rates rise. The terms of this product are set out below:

Term: 5 years
Guarantor: Lloyds TSB (Aa3/A+ rated)
Currency: US dollars
Coupon in year one and two: 3.5%
Coupon in years three to five: 5 year US treasury yields capped at 6%.

Why we like this:

- 1. The coupon during first 2 years is well above current deposit rates**
- 2. The coupon will rise as interest rates rise.**
- 3. Product captures the current market anomaly whereby US treasury yields are actually higher than inter-bank Swap rates**
- 4. There is very little risk, given that it matures at 100% in 5 years a Aa3 credit guarantee**

The Silver Lining, continued from page 3

European economic recoveries remain too fragile to risk interest rate increases. **Realty Trac** reports that in the US, 7 million homes are behind in their mortgage payments, **Core Logic** reports that 24% percent of US home mortgages are underwater and the **US Commerce department** says 21% off all houses built since 2000 sit empty. In total America is on track to see 1 million foreclosures in 2010. Also worryingly the recent consumer spending figures have been buoyed by a reduction in mortgage costs. According to Mark Zandi at **Moody's Economy.com** 6 million homeowners not making payments frees up \$8 billion every month which in turn boosts consumer spending.

In Spain unemployment is at 20% and in the UK where the government borrows \$1 for every \$4 it spends, GDP growth has turned negative despite massive government spending and ominously, accelerating inflation. Clearly these countries will be slow to increase their interest rates and as a consequence their currencies will remain under pressure.

In the developing world where India, China and Brazil are clearly booming it is a different story. Ditto for better managed G7 countries such as Canada and

Australia. Last fall Australia became the first country following the global financial crisis to hike interest rates. Last week Canada's central bank warned a rate rise is on the horizon just as India raised its interest rates and China has targeted its overheated real estate market with a no-nonsense mortgage rate hike on investment properties from 4.16% to 6.53% and a jump in the deposit required to buy a second home from 40% to 50%. First time buyers still get the lower rate as China recognizes that the natural demand at a 1% urbanization rate is for around 5 million new homes every year, it is speculators they wisely discourage.

An OECD study calculates that gross borrowing by governments will have reached US \$16 trillion in both 2009 and 2010 - up radically from US \$4 trillion in 2008. Since 2000 government debt in only the US Japan and Europe and the UK has increased from less than US \$10 trillion to US \$27 trillion. De-leveraging by their respective private sectors is being offset by their governments which like a game of musical chairs, are borrowing as much and as quickly as they can before the music stops.

Our point is that the radical growth in borrowing needs is likely to propel interest rates considerably higher. Already signs of trouble

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over and above Europe's wine belt crisis include a failed German auction early this year, rising US long-term yields and an ominous looking head and shoulders pattern for US 30 year treasuries.

Pricing power returns and inflation threatens. For how long will US bonds rates remain at historic near record low yields? Bill Gross head of bond giant **PIMCO** thinks their days are numbered. **Morgan Stanley** predicts that US Treasuries will rise to 5.5% this year, a consequence of huge US \$2.4 trillion borrowing plans. In Morgan Stanley's words:

"Private Credit demand and inflation expectations will rebound more quickly than analysts expect."

We caught the inflation part. So what about inflation? High unemployment is supposed to keep it suppressed although if the 1970s' stagflation is any indication it is not something we should count on for long.

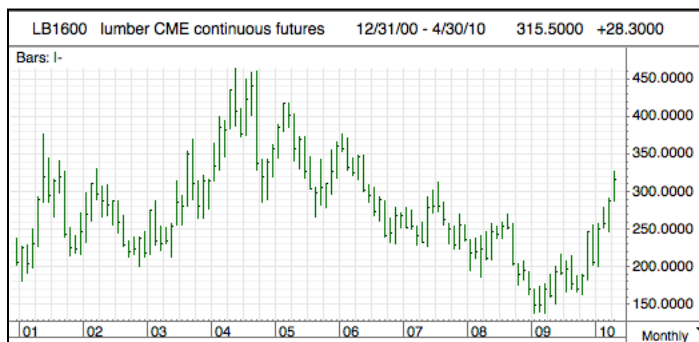
Already basic materials such as coal, iron ore and oil, lumber have moved dramatically higher in the past year. The Commodity Research Bureau's RIND index is near its 2007 record high and the Institute for Supply Management's (ISM) price index has jumped 75% since December 2008.

Virtually all commodities were up in price

in the ISM's March report with only beef and construction labor down. The ISM also reported a strengthening manufacturing sector with a serious shortages in basic electronic equipment.

During 2009 economist Peter Warburton (who predicted in detail the world financial crisis) more recently predicted that the collapse would prove inflationary as manufacturing capacity and services once lost, would be very slow to return. Take a look at the lumber chart to the right. One would think lumbers rocketing price is accompanied by soaring demand but it is not. An **International Woods Market Group** report describes the carnage: 28.6 billion board feet of lumber was consumed by the housing industry in 2005, compared to 6.9 billion in 2009. They 'hope' consumption will reach 19 billion by 2013. In other words the lumber rally is really about low inventories and tight supplies given the number of GFC related mill closures.

We note that most small businesses are also not benefiting from the current expansion. Perhaps as Professor Warburton outlined the global financial crisis has resulted in collapsing capacity and that the remaining mostly large companies, now have real pricing power. It is clear that producers of coal and iron ore are in the drivers seat. At the



producers insistence instead of annually, iron ore prices will now be set on a quarterly basis.

The result is the doubling of iron ore prices in the short term which has in turn caused steel producers to warn that steel prices will rise by as much as a third. Gordon Moffat, director general of **Eurofer** which represents car and truck makers in Europe recently complained that:

"A 100 per cent increase in iron ore [prices] is an insult," He claims Vale, Rio and BHP-Billiton, have "the pricing power of an oligopoly".

That may be true but, as important, the steel producers are also demonstrating they have the power to pass on the price increases. Many such as US based Nucor and Dynergy have contracts that fix profit margins rather than prices.

Be careful what you wish for...

American politicians continue to demonize China for having, what they consider, an unfairly cheap currency. But they forget that a major factor contributing to America's last two decade's of low

inflation has been a tidal wave of low cost Chinese products. What happens when the Yuan rises and exports from China become more expensive? Do US producers step up and produce more? Former Fed Chairman Alan Greenspan warned in his book "The Age of Turbulence: Adventures in a New World, that:

"the increase in the price of imports from China may be a first sign that the dis-inflationary force is receding".

Our expectation is that, at best, the impact of Chinese imports to the US may cancel out part of the inflationary impact of China's dramatically increasing consumption of commodities such as oil, steel and coal. Far more important is that where Chinese exports once helped keep US inflation low and borrowing costs servicable it is on balance now more likely to add to inflation and as a result exacerbate the developing global sovereign debt crisis as interest rates rise and bond markets plunge.

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