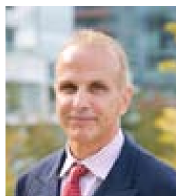
MAEDEL'S

EQUITY MARKET ANALYST

November 2009



Editor: Neil Maedel
Uncompromising analysis
exclusive advice beginning 1987.

Inside:

Black Swan? An Iran Attack is the furthest thing from everyone's mind...

Betting on Mexoro the next gold stock super-star?

The Bubble That BrokeThe World

ANDEAN INVEST

After an 8 year hiatus, Maedels, which published from 1987 to 2001, is back. This newsletter is known for introducing to its subscribers some of the mini-cap sectors more spectacular performing stocks. As before Maedels also performs corporate advisory services. For our gold holdings please go to page 14.

Previous subscribers will recall some of Maedel's most spectacular recommendations were in the resource sector: an area the editor has spent much of his career working in. The most spectacular examples include energy pick **Ultra Petroleum** which rose a mind boggling 40,000% and-gold explorer **Arequipa Resources** (subsequent rise 4,923%). Maedels assisted in raising money for numerous companies during the period and like his subscribers was an early investor in Arequipa and one of the original shareholders of Ultra. Mexoro Minerals is our latest resource stock bet. Mexoro has been added to the portfolio of his Bahamas based holding company **Andean Invest Limited** which has bought 1.55 million units for $310,000 of private placement totalling 12.5 million units. Each unit consisted of 1 share and one share purchase warrant exercisable at $0.30 for a period of 2 years. Andean Invest has also been paid a $150,000 fee by Mexoro for

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In 1931 **Garet Garret** published "*The Bubble That Broke The World*", which chronicled the global private and public debt bubble which preceded the great crash and depression. Its message is highly instructive even though our present financial system is infinitely more complicated. Mr. Garret's opening observation that "*Mass delusions are not rare. They salt the human story*", rings especially true in today's world. In this issue what we will attempt to address is: will history repeat? How will the West's bankers react? With much larger government and central bank intervention, what will the final monetary reckoning be?

History rarely repeats...

Why? It is only human to avoid the last great pain. For most Americans the catastrophe of the Great Depression looms above almost all else. In many American high schools **John Steinbeck's**, *Grapes of*

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Gold breaks out to new highs... see market matters page 2..

"The economic historian in me cringes everytime I hear mention of "exit" from fiscal stimulus and rescue operations in the current situation" ***Christan Romer**, Chairwomen, Council of the President Obama's Economic Advisors.*

"Contrary to official claims the Federal Reserve does not target inflation or react to inflation signals. Rather the Fed reacts to the very real signal sent by unemployment" ***Levy Economics Institute** of Bard College, Working paper 511*

"We have to regain our ability to produce goods. Moving money around does not necessarily provide dinner on the table," Volcker said. "You can't run an economy where the financial sector is making 40 percent of the profits." ***Paul Volker** former Chaiman of the Federal Reserve*

When I... observe the "stimulus" black hole, and think about our short-termism and lack of fiscal discipline and political will, my instinct is to want to short the dollar. But then I look at the other major currencies. The Euro, the Yen, and the British Pound might be worse. So, I conclude that picking one these currencies is like choosing my favorite dental procedure. And I decide holding gold is better than holding cash, especially now, where both earn no yield. ***David Einhorn**, Greenlight Capital*

Wrath, a depression era classic, is required reading. The sad and desperate picture of a migrant mother by **Dorothea Lange** is among America's most well known.

Perhaps tellingly America's current Federal Reserve Chairman **Ben Bernanke** made the deflation which occurred during the 1930s his academic focus. Mr. Bernanke seems prepared to avoid a repeat of the depression at all costs. In his words, "*the government can always avoid deflation by simply issuing more money*". But is deflation the only precipice he needs to avoid falling into?

And what about the rest of the world? Surely not everyone thinks like an American central banker. Probably the most different are the Germans. Etched in the German psyche are not only two great wars but the catastrophe of the great inflation.

As a consequence, their response to deflation in the coming years is likely to be quite different. The German's tragedy is reflected in economist **Constantino Bresciani-Turroni's** words: "*It is easy to understand why the record of the sad years of 1919-1923 always weighs like a nightmare on the German people*". Knowing this I think it is fair to say inflation is the precipice that most mortifies the German folk.

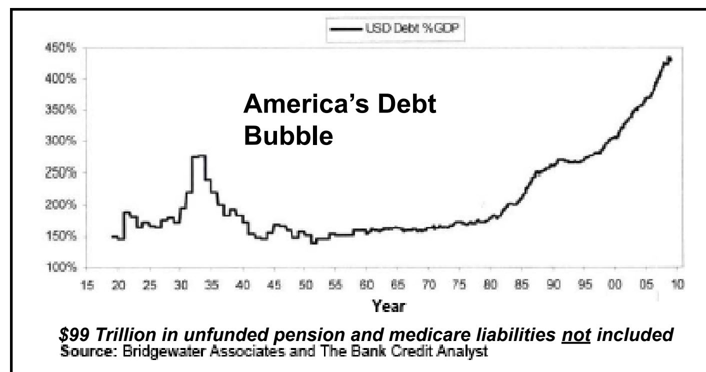
Prior to World War One, Germany produced more inventions than the rest of the world combined. It vied with Britain for economic dominance. Like American's familiarity with the depression Germans are equally schooled with regard to their inflation. They know its chimera nature and that, for example, during WWI Germany's' inflation rate stayed roughly the same as Great Britian's. That it remained seductively restrained, even though the Reichbank's debt had increased nearly 2000 percent.

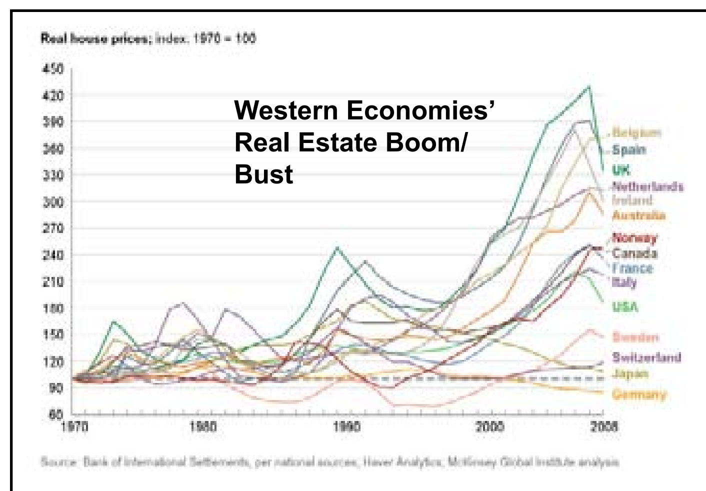
In 1920 the reichsmark actually went up in sterling terms while German wholesale prices rallied. The Reichsbank however issued 100% more debt and increased the currency in circulation by half. The increases turned out to be the German currency's hyperinflation tipping point. Notably, during the ensuing catastrophe, basic industries prospered while consumer goods (and employment) were in a severe depression.

East verses West

Half of the Asia we refer to was until only two decades ago, restrained by the yoke of communist central planning. For all of Asia however, one its most defining collective traumas, was more recent: the emerging-market boom and bust which occurred in the late 1990s. It provided a lesson from which they have clearly learned.

This time around as world trade was booming, the Asian tigers paid down debt, increased savings and raised their banks' capital reserve requirements. Sadly the opposite was true in developed economies such as the United States, where banks' capital ratios were allowed to deteriorate, loan standards were relaxed and debts ballooned.





Asia's war chest

China's central bank is the region's top tiger and by virtue of receiving more dollars from exports to the US than its economy could comfortably absorb, it has amassed a $2 trillion war chest. Its citizens save almost $0.50 for every dollar earned, a stark contrast to America where the savings rate has fallen relentlessly for 20 years, bottoming at zero in 2008.

India and China's Confucian habits are also reflected in their respective $2.13 trillion and $262 billion foreign exchange hoards. The reserves of the world's top 10 totalled, as of last July, $5.05 trillion, of which 7 are from the East.

If money talks its time for the West to start listening. These Asian Tigers' combined reserves add up to $4.3 trillion, or roughly 80% of the total world reserves for the top 10 countries.

Asia's habit of saving for a rainy day paid off when the global collapse hit. For example China's well financed government started massive infrastructure spending when exports withered and as a result its economy continued to grow even during the collapse.

According to a UBS study, China's exports now account for less than 10% of its GDP. (Germany on the other hand depends on exports for 40% of its GDP).

The result is China's GDP growth never went below 6% during the 2007-2009 crisis and already looks set to

reach the government's 8% target. Smaller Asian Tigers now count China as their largest export market.

Asia Decouples from the West

"The economic center of gravity has been shifting for some time, but the recession marks a turning point" says **Neal Soss** the Chief Economist for **Credit Suisse**, "*it is Asia lifting the world rather than the US and this has never happened before"* he added.

America's unemployment and contracting consumption is a stark contrast to the Indian and Chinese experience. Asia for the most part continues to boom. Since 2000 China and India have added on average almost 60 million individuals to their middle class every year, a trend set to continue.

America in comparison is starting to look somewhat elderly, its labour force is roughly the same size as it was in 2000, while median household income in 2008 fell to an (inflation adjusted) $50,303, which is 4% below its 2000 level. Developing Asian countries clearly have a very different outlook compared to the Developed.

Another day older, and deeper in debt

In 1946 *Merle Travis* wrote *16 Tons*, a song about a coal miner whose debts always grew faster than his income. This increasingly looks to be the future for most developed economies, especially its largest the US.

One looming problem lies with Japan, which while Asian, it has a fully developed economy and is somewhat American in its spending habits. As a consequence of its growing debt, Japan may be on a collision course with the US in the world's bond markets.

Japan's central government debt was at 64% of GDP in 1990 when its stock market and real estate bubble burst. Maedel's (then called The ProTrader) had been following that market closely and our prediction of the imminent collapse of Japan's stock market (Earthquake in Tokyo; The Globe & Mail) received national coverage in Canada.

Earthquake in Tokyo II

Our latest prediction regarding Japan now focuses on its government debt market or JCB market which is largely financed by the savings of its population.

Financing Japanese deficits domestically was not difficult in 1991 when the average Japanese was saving more than 16% of his or her income. Fast forward to 2009 however, and not only have the Japanese government's borrowing needs grown logarithmically but the erosion of its citizens' savings habits has been as extreme. The outcome is likely to eventually roil debt markets world wide.

Death and taxes...

According to The statistical hand book of Japan, the country's working-age population has been declining since 1996. By 2012, 25% of its population will be over 65 years old and by 2022 that number will reach nearly a third. The consequence is likely to be declining government revenues as its tax base grows smaller, just as increased medical and pension costs from a growing number or retirees ensures even larger deficits than what the government is currently experiencing.

An added complication is the risk that the government will soon no longer be able to rely on domestic savings to finance their deficits. The question then arises: "what happens when an increasing number of Japanese retirees cashes in JCBs to pay for their retirement?"

As a tsunami of Japanese looks set to begin redeeming their savings bonds, the county's cities, towns and prefectures, (similar to what is being experienced by towns

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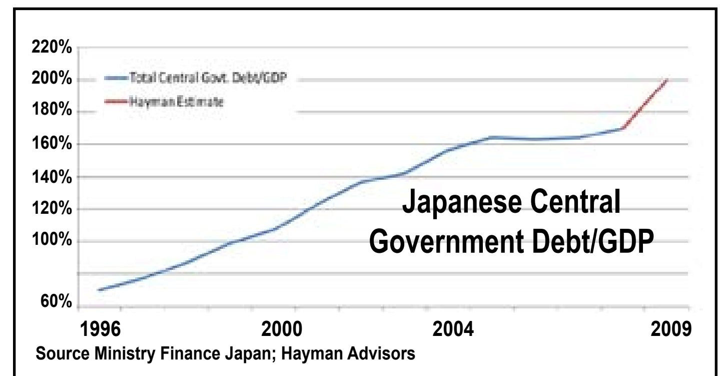
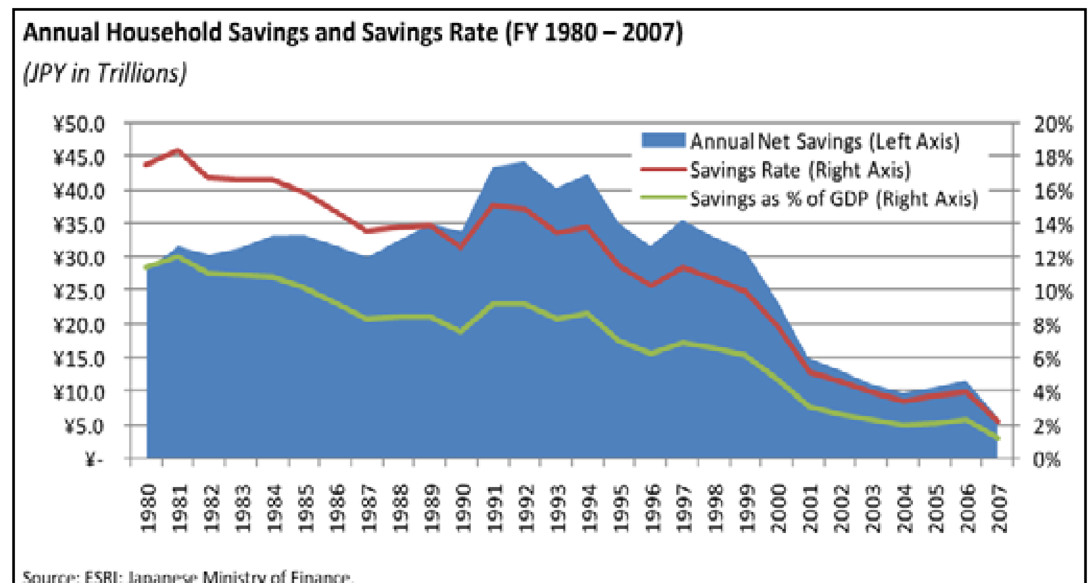


Source Ministry Finance Japan; Hayman Advisors



Source: ESRI; Japanese Ministry of Finance.

and states in the US), are experiencing large funding deficits and will likely require bail outs from the Japan's Central government - further adding to the country's financing needs. **Moody's**, usually the very last to act (it considered AIG debt investment grade right up until weeks prior to its collapse), has already put on review for possible downgrade 26 regional and local government-related issuers. Further smoke-on-the-horizon comes from magazine **Fukuoka Now** which says of Japan's 47 prefectures, 40 are reporting significant deficits.

Combine the fact that Japan's pool of savers is shrinking while its government's borrowing needs are growing and the all the ingredients are present for an economic crisis. The principal questions are: when and how would a Japanese debt crisis effect America's growing need to finance its deficits?

The making of a fiscal crisis

Adding to the long term bearish JCB scenario is the catastrophic risk that Japanese debt gets re-priced. The salient question is: how much would their borrowing costs increase if the yield on a 7 year JCB rose from its current 1% to a more reasonable 5% - 6%? And "what would the consequent increased debt servicing costs do to their credit rating?"

It would not be the first time that a long-stable country shocked the world with a major debt or currency repricing: think **George Soros** and his successful assault on the British Pound.

In a 2008 **Reuters'** article, the cost of paying interest and redeeming bonds was estimated to be more than 20 trillion yen, about the same as the economy of Venezuela. In the same article a 1% gain in the yield on benchmark 10-year government bonds was estimated to increase costs by about 1.4 trillion yen.

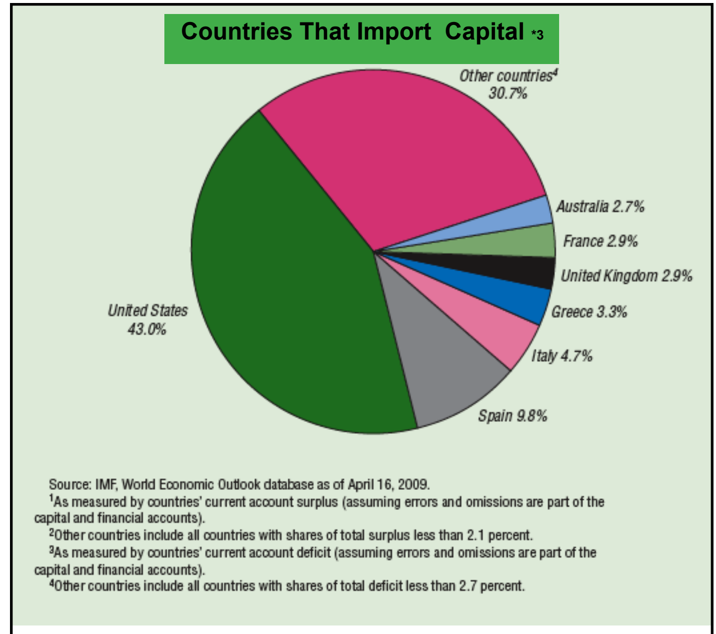
Debt servicing costs already absorb about 20% of the Japanese Central Government's budget. Yet Japan's new finance minister **Hirohisa Fujii** warns of plans to borrow a record ¥50 trillion, or $553 billion, more.

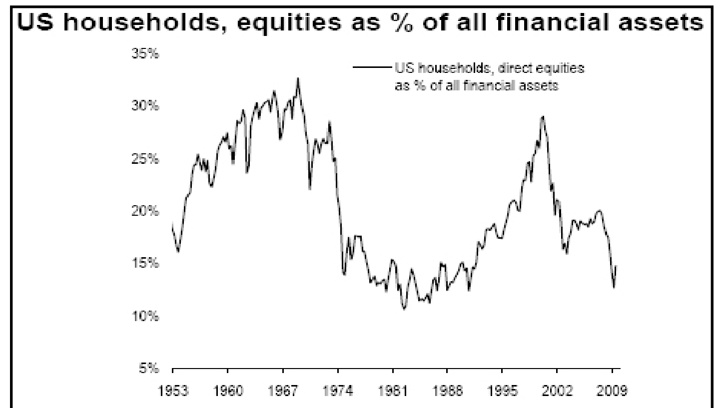
The reaction of analysts should serve as a warning: "Public-sector finances are spinning out of control — fast," said **Carl B. Weinberg,** chief economist at **High Frequency Economics**, in a recent note to clients. "*We believe a fiscal crisis is imminent.*"

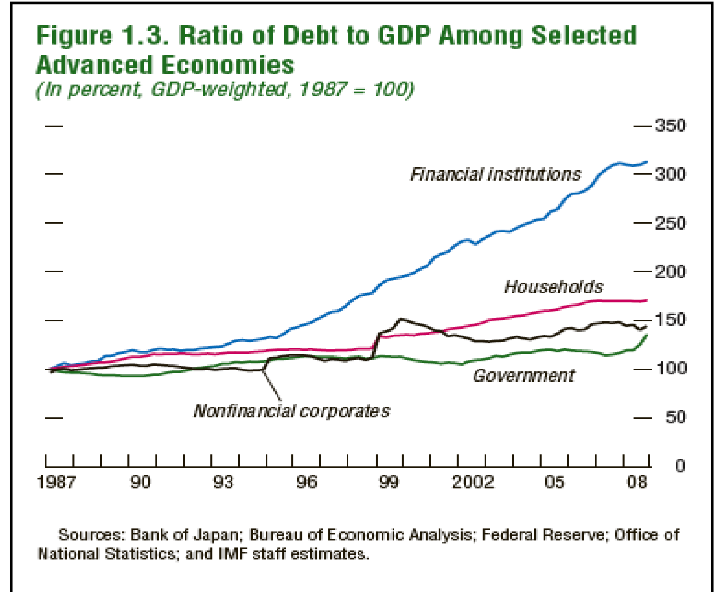
Akito Fukunaga a fixed income strategist at **Credit Suisse** says Japan may get away with selling more bonds "*this year and next*" and after that: *"If you ask me what Japan can resort to after that, my answer would be, 'Not very much* '".

Japan and the world

So once again, why do we care about Japan, other than a potential chance to sell short its currency and bonds? Principally, the international bond market is looking increasingly crowded as developed governments look to finance more of their deficits.







America dominates international borrowing. According to the IMF it was responsible for 43% of international borrowing during the past year. Japan as of yet, is not even on the chart. And that's a good thing because unlike Japan when its real estate bubble popped, the West's real estate implosion is not accompanied by a giant untapped pool of thrifty Americans waiting to finance the subsequent bailout-related government deficits.

America's savings rate may have recovered from zero in April 2008 to almost 7% currently, but its pool of household wealth is hardly a picture of health. According to The Federal Reserve, household wealth plunged by more than $12 trillion since its 2007 peak. Nobel Prize winner, **Columbia University** professor, **Edmund Phelps**, estimates it may take as long as 15 years for households to rebuild what they lost in the collapse.

The solvency crisis

Developed countries' central banks, governments and their respective work forces appear to be near the upper limits of their credit and depend on a low interest rate regime to remain solvent. The logic of this statement is seen just by looking at the record debt levels and the fact that most financial institutions have already been almost insolvent despite near zero interest rates. The chart at the top of page 1 show's America's total debt which has nearly tripled in the past two decades to almost 450% of GDP.

Unhealthy share

The most recent consequence, the real estate boom and bust, is well known, but not as watched, was the unparalleled growth in borrowing by developed countries' financial institutions, which is illustrated in the chart on page 3.

These same institutions delivered a record 41% of all US corporate profits in 2007, double their historic average. In GDP terms it works out to 7.5%. As **Jeremy Grantham** the cofounder of $102 billion investment management company **GMO** points out: "*The drastic expansion of the US financial system as a percentage total of total GDP in the last 20 years has been a drain on the health and cost structure of the balance of the real economy.*" Based on the recent collapse it would appear 7.5% is the economic tipping point.

The end to deflation?

The collapse officially ended in the second quarter of this year when for the first time since the 2007 peak, American household net worth finally rallied 4% from its $53 trillion crisis low. The largest gain was from equities (US$1.12 Trillion) as Fed liquidity found its way into the stock and commodity markets. According to polls by **Investor Intelligence, Market Vane,** and **American Association of Individual Investors** most small investors were absent from the rally. This may be good news from a contrarian point of view, but its principal message is that Joe average American did not benefit from even a small fraction from the increase in American household net worth.

The only investors participating in commodities and stocks are principally bank's prop desks and financial institutions' trading departments (many including banks which are now supplied with nearly zero interest, government backed money) and high net work individuals. *Boom Doom and Gloom* author **Mark Faber** describes the scenario succinctly: "*the weaker the economy, the more the stock market will go up because the money that is being printed will go into speculative assets*". Agreed and a reread on the cover of the **Levy Institute's** conclusions regarding Federal Reserve Policy" tells me we should expect the flood of liquidity to continue for a long time yet.

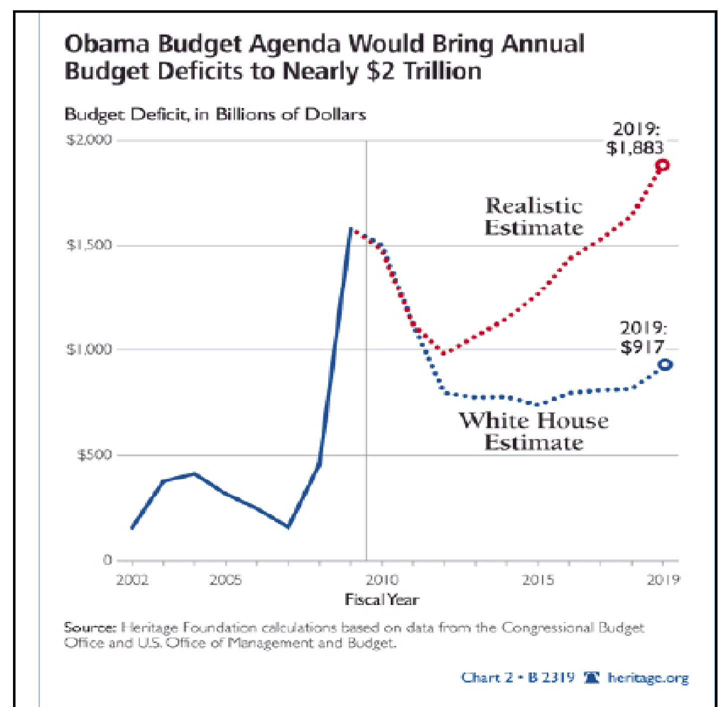
Based on the relentless rise in unemployment, and depressed earnings, the stock market rally is likely a product (as is the commodity rally) of the FED's continued expansion of its balance sheet via the purchase of mortgage backed securities and agency debt.

As long as unemployment stays high so will the abundance of government-supplied near zero cost liquidity for the financial elite. **Simon Johnson** the former chief economist for the **International Monetary Fund** asks: *"Is a two track economy emerging from the rubble... where the elite live well and seem not to mind repeated cycles of economic -financial crisis"*

Negative Equity

Critically, the one investment where the Joe average

"Bubble" Continued on page 8



Black Swan?

Once again the Iranians have reneged on agreements regarding their nuclear program. Deja Vu? Gold in the 1970s

Nassim Nicholas Taleb coined the term "black swan" when he described high impact hard to predict events. Sometimes they can be good (collapse of the Soviet Union) and others (September 11, 2001 attacks) catastrophically bad.

Operation **Juniper Cobra**, is a joint military exercise between the US and Israel and it is of unprecedented scale and scope. The just completed exercise integrated the latest US and Israeli defense systems while sending a signal to Iran that not only is the US willing to defend Israel with its military but it is only a hair trigger away from doing so.

Last August in a Wall Street Journal OpEd, former US Ambassador to the UN, and Senior Fellow at the American Enterprise Institute, **John Bolton** argued that (Israel) "*will have to make a decision soon and it will be no surprise if Israel strikes by year's end.*"

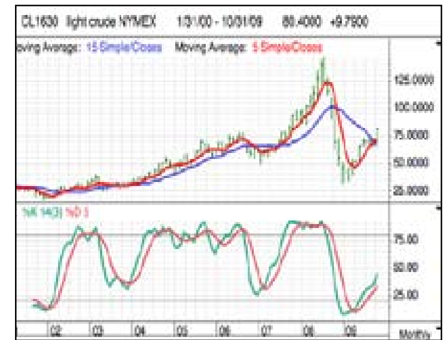
As occurred decades earlier with a similarly behaving President Jimmy Carter, Obama is not being taken seriously by Iran's leaders. The result of his "engagement" policy is to allow the Iranians to buy more time as they have missed UN deadline after deadline for the defanging of their nuclear program. As *Maedel's* was going to press a report was leaked that inspectors from the International Atomic Energy Agency (IAEA) had discovered evidence of Iranian two-point implosion experiments indicating that Iran is even closer to a nuclear weapon than previously thought.

Justifiably, Israel regards a nuclear Iran as an existential threat. The Iranian regime's leader **Ahmadinejad** has made Israel's (and America's) destruction an ideological platform as he refers to the Mideast's only genuinely democratic country as "*the true manifestation of Satan"*. Using the despot's own words: "*Israel must be wiped off the map*".

Armageddon

Combined with his prediction of Armageddon (which should concern all of us) and his regime's anticipation of the coming Mahdi, a nuclear Iran would allow Ahmadinejad and his followers to make their Armageddon prophecy self-fulfilling. The West's reaction so far may end up looking as negligent as the Guyanese following the cool-aid and cyanide fueled massacre at Jonestown. Many warnings preceded that apocalypse too. Only this time the consequences are of a nearly inconceivably inhuman scale.

"Our revolution's main mission is to pave the way for the reappearance of the Twelfth Imam, the Mahdi" declares **Ahmadinejad** adding to a string of similar statements and actions that reinforce the observation that Ahmadinejad believes he is destined to bring about the "End Times" - The end of the world.



We should not forget that the regime currently ruling Iran is the same one that sent thousands of Iranian children as human (suicide) mine sweepers during the Iran-Iraq war (In fact with Ahmadinejad as a Basji member). This martyrdom continues to be celebrated every year. That they would be so ruthless with their own innocents, never mind ours, should give us all, and not just the Israelis, reason to ensure a non-nuclear Iran.

Two weeks ago former Israeli deputy Defense Minister **Efraim Sneh** warned that if toughened sanctions do not occur by Christmas Israel will have to attack Iranian nuclear facilities. Meanwhile the Russians hold the key to any real sanctions against Iran. And that government is not cooperating at all but instead appears to calculate that as long as America has any influence on their former Soviet satellite countries, the more preoccupied it is in the Mideast the better. Instead of embracing Obama's dialogue and nuclear disarmament proposals, the Russians are actually rewriting their own military doctrine in what could allow the use of tactical nuclear weapons in conflicts such as what occurred in neighboring Georgia. They are, according to Pravda, considering (we are not making this up) 'preemptive' nuclear strikes. The

Point of contention: an Iranian nuclear facility

Russian's latest Obama-slap occured just after the American President bowed down to the Russians regarding their objections to America stationing part of their ballistic missle sheild in Poland. The day after Obama announced the Polish missle sheild's cancelation, Russia and Belarus began war games which simulated the invasion of Poland. The games were the Russian's largest in almost three decades. To emphasize the point that "this is our turf" the massive military maneuver's start coincided with the anniversary of the 1939 Soviet invasion of Poland. So much for the *Carter/Obama* talk technique.

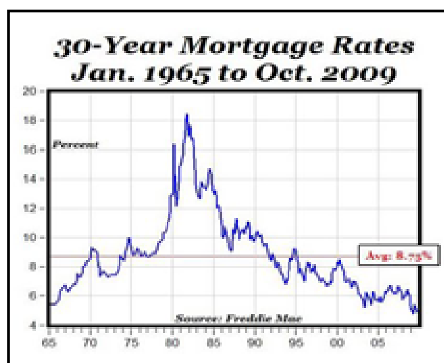
As the nuclear risks escalate Israeli Intelligence now estimates Iran has enough fuel to build two bombs. And this is on the heels of the discovery a second nuclear enrichment site near Qom.

So is an attack imminent? In a recent interview Admiral **Mike Mullen**, Chairman of the Joint US Chiefs of Staff confirmed that Israel has all the resources necessary to successfully strike Iran. Both **Shimon Peres** and prime minister **Binyamin Netanyahu** have emphasized that if the latest diplomacy failed the only option left would be "*a military one*".

What would an attack mean to the equity markets, oil, gold and world stability? In terms of stability we agree with the assessment of Former US Defense Secretary Robert Gates who recently said: *"The reality is there is no military option that does anything more than buy time"*. Intelligence estimates are that Iran would be prevented from getting the bomb by a further three years at most.

Crude reality

On an investing level the mystery of crude oil's rally despite its over supply may be answered in part by the apparent re-envigoration of the world economy and by the growing risk of an Iranian-Israeli confrontation. That is a geopolitical risk premium is being built into oil's price.



The World's Oil Choke Point

What is logical is that should an attack take place Iran is likely to immediately mine the straight of Hormuz, stopping the shipment of more than 16 million barrels per day of crude oil. This would eliminate roughly one fifth of the world's daily oil supply. Much of that oil would be from Persian – Shiite Iran's hereditary enemies: Arab-Sunni-dominated Saudi Arabia and Kuwait who similar to Western

countries are at great risk if Iran becomes a nuclear power.

But for the West the most likely immediate effect of an Israeli-US attack on Iran would be a skyrocketing oil price - and a resumption of the recent economic implosion.

The probable effect on oil's price has its precedents. At the beginning of the 1978 Iranian Revolution oil was at $14 per barrel and by the time the Iran-Iraq war had started in 1980 its cost had almost tripled reaching $35. Gold also rose dramatically. During the same period it rocketed from $240 to $850 – over 340%, while at the same time gold stocks soared to unprecedented levels.

What stopped the gold boom? First supply - unlike today, in the late 1970s a new low-cost type of mining - cyanide heap leaching - had been developed. It translated into a dramatic increase in gold supply. But US Fed Chairman Paul Volker also had a significant influence. Chairman Volker successfully ended the previous decade of accelerating inflation by dramatically increasing interest rates. This result was the end of a 30 year bond bear market and at least temporarily, the need for hedging against inflation and currency depreciation.

Is this time different?

In recent speeches Volker is already critical of the Federal Reserve's handling of the 2007 - 2009 crisis and worries about future inflation. Consider that T-bills are now at 2% not 14% where they were when gold peaked three decades ago. At such extremes it is not hard to see, as the chart below of mortgage rates shows, that the monetary pendulum has swung all the way back to the 1960s – the very early stages of the last gold bull market. Mortgage rates have been depressed even further by the fact that the US government's Federal Housing Authority dominates the mortgage market making low cost government funded (deficit increasing) loans a matter of government policy.

If Paul Volker was in charge perhaps the outlook would be different. Clearly the current Fed Chairman Bernanke is no Volker. In

Bernanke's world a helicopter brimming with cash remains on standby for the next emergency.

Whether Bernanke or Volker the question is what would be the economic effect of a 1970s-like oil shock in the current environment?

Most economies are less sensitive to oil's price than in the 1970s because they use less oil per unit of economic output. In Motown terms its the difference between a '67 Chevy and a 2009 Prius - the Prius drives a lot further on the same gallon of gas. The real effect would be felt by the sudden absence of 20% of world supply. Worse yet the world's only swing producer, Saudi Arabia, would also be cut off as the procession of tankers carrying middle east crude oil through the Strait of Hormuz would be cut off.

The amount of daily production lost by the time the 1980 Iran-Iraq war erupted totalled 6.5 million barrels or 10% of world consumption. In the event the Strait of Hormuz was mined by the Iranians tomorrow, 16 million barrels per day or 20% of supply would be stranded. The Saudi's have built a terminal at Yanbu' on the Red Sea which could divert about 2 million barrels per day of the stranded oil, but as the figures show the effect would be significant.

As worrying is that the global economy is only just exiting a major economic calamity, the recovery is fragile and in the West unemployment is near record highs and while the majority of governments are already running massive deficits.

Yet another Mideast War

In their game of brinkmanship the Iranian leadership must ensure that the West knows the real cost of an Iran attack would be a rocketing oil price and, very likely, a consequent crippling of the world economy – potentially tipping the world into a depression and collapse.

It may be their calculation that America and its allies have no stomach for this possibility. The Iranian leadership have already established they are prepared to impose on their subjects the unthinkable (think of marching your little ones off to trigger land mines) so economic hardship is really a non-event. But for the US and most other nations it is another story.

Armageddon
The Fear Factor

So what would happen if an attack occurred as Ambassador Bolton warns it could? Is it reasonable to expect the world's central banks to increase liquidity to far greater levels than even the 2007 collapse?

Would they aggressively add to the giant rescue packages which are already underway. The concensus, at least for the short term, is that bank and government intervention works. Of course no one has yet to figure out how the bill will be paid. We venture that in the event of another 1970s-like geopolitical emergency, Bernankes helicopter and a monetary air force comprised of the West's central banks would flood the world with dollars, British Pounds and Euros. The race to the monetary bottom would begin as governments piled on debt and central banks monetized it. Picking a currency would be like an extreme version of what David Einhorn (who made billions predicting the recent collapse) describes as: "*like choosing my favorite dental procedure.*"

Hedging Iran

So maybe Einhorn is on to something. He's investing big in gold and gold stocks just like (pre 2007) he shorted real estate. This time he is hedging both a worst case possibility (Iran with nukes) and an inevitability (currency debasement and devaluation).

Consider that the potential for yet another Mideast conflict is not all that remote. There have already been nearly a dozen (including the 1981 Israeli surprise attack and distruction of the Iraqi Osirak nuclear reactor) major military events since 1948. That is about one very 5 years.

Diminishing gold production, and increased demand is already a pretty good reason to own gold and gold stocks. The apparent mismanagent of money supplies by the world's central banks adds to golds allure as a currency hedge. The not-so-long shot of yet another Mideast bust-up also makes gold good geopolitcal insurance. Added all together and we think the case for owning gold and a major bull market for gold and gold shares is compelling .

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Andean

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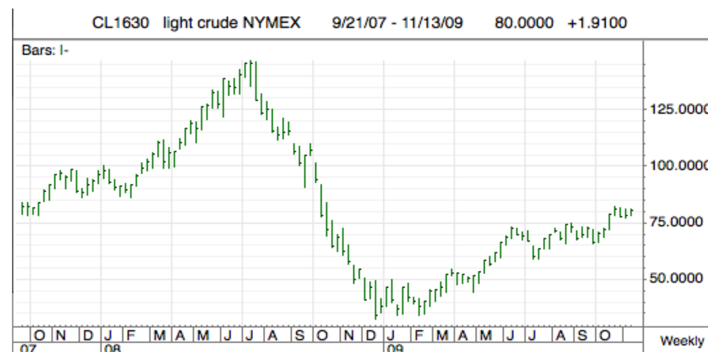
acting as advisor in regards to its debt restructuring, corporate reorganization and subsequent US $2.5 million financing. Andean for providing these services has the right to purchase 5 million shares at $0.50 per share until September 19th, 2011. Andean Invest is a Bahamas-based holding company and Corporate Advisory firm which is wholly owned by Neil Maedel. As an editorial policy any changes in strategy or positions will be published on the day changes occur. Maedel's Equity Market Analyst is for information purposes only it is neither a solicitation to buy or sell securities. For further information please contact Andean Invest at POB N 3937 Four George Street, Nassau, Bahamas Tel:+44 207 193 6467



"Bubble" Continued from page 4

American is a big investor, real estate, remains in intensive care as defaults continue to rise. **Deutsch Bank** warns that the number of mortgages which have negative equity (the house is worth less than the mortgage) could rise from 30% to 48% by 2011.

Moratoriums on foreclosures and new programs to rent foreclosed houses out to their former owners may have stalled the next avalanche of distress selling, but it is coming. Even **Fannie Mae**, a government sponsored enterprise (GSE) predicts the real estate market will get worse. In a recent release it warned " *We expect that our credit losses and credit loss ratio will continue to increase during the remainder of 2009 and during 2010.*

Fannie Mae also reported an $18.9 billion loss compared to a $14 billion loss in the second quarter of this year and noted $164 billion in delinquent off balance sheet loans (Mortgage backed securities held by third parties) while reporting a further $34 billion in non-performing on balance sheet mortgages.

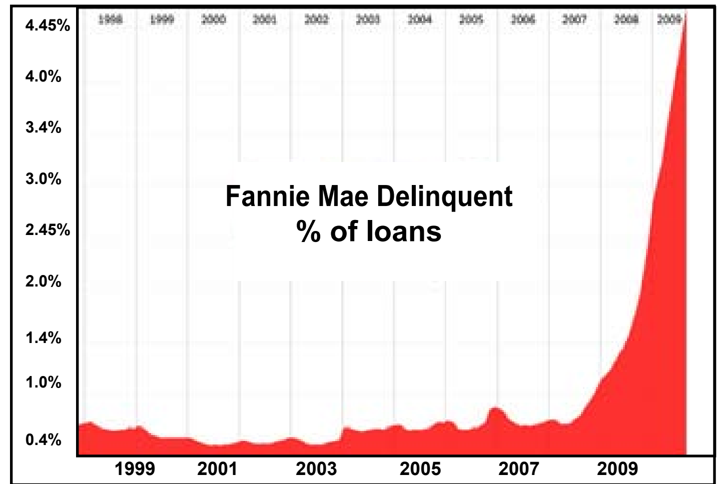
Currently Fannie Mae and the **Federal Home Loan Mortgage Corporation** (Freddie Mac) owns or guarantees almost half of the U.S.'s $12 trillion mortgage market. But here is the clincher: of roughly $400 billion in new mortgages have been issued to date in 2009. Virtually all of them were GSE related or tied to some other government program. The Federal government is not just assisting borrowers in America's real estate/mortgage market: *it is the mortgage market.*

Life-support

It is hard to image the US Treasury ending its life-support for the sector as long as unemployment stays high and real estate continues its downward spiral. As with many Government economic life-support programs the FHA focuses where, probably for good reason, the private sector fears to tread. Even with this massive government support, 12% of all US mortgages are already in foreclosure or are behind in payments. Once behind, (i.e. Fannie Mae's $164 billion worth), on average 93% are eventually seized and sold.

Get ready for the cure

Naturally there will be a limit to the ongoing deflationary carnage. But considering the demonstrated creativity and willingness of the government and FED to throw US $ trillions at the sector, its end is academic. The real question is when (see the 30 year mortgage chart on page 6), will see the cure: inflation. The interest rate cycle is clearly at its nadir just as sure it was at a peak in 1982. Is gold and the plunging dollar signalling the interest rate cycles ultimated end? Or even inflation?
Are American's about to begin enduring the consequences of what has become an epidemic of Keynesian intervention.



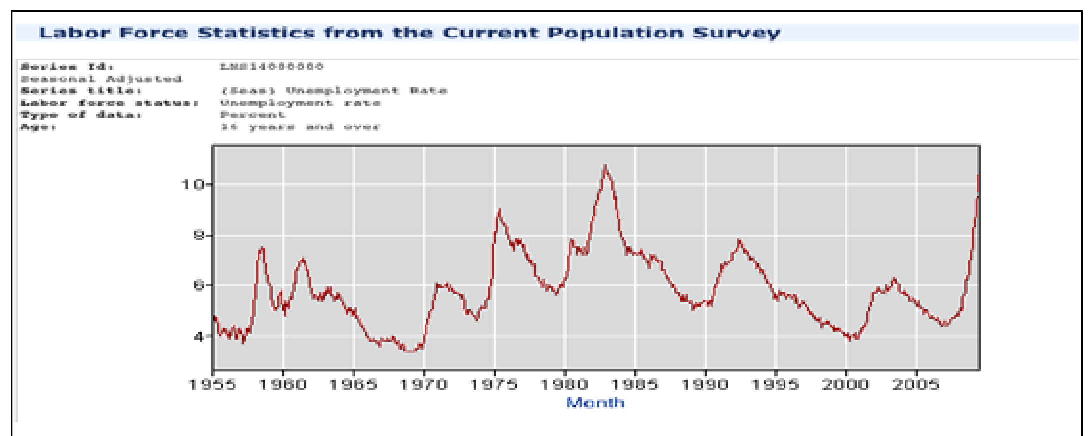
The return of Keynes

Admirably, John Maynard Keynes detested the policy of impoverishing Germany following WWI and resigned from the British Treasury because of it. Keynes argued that without government intervention via deficit spending, periods of high unemployment could become chronic. President's Hoover and Roosevelt adopted Keyne's deficit spending ideas. The Obama administration and Federal Reserve are currently employing Keynesian theories like never before.

Lesson not learned

In 1968 Economist Milton Freidman correctly predicted that the Keynesian policies that were widely employed at the time, would lead to stagflation. The 1970s marked the beginning of a period of high unemployment and accelerating inflation that did not end until 1982. Paul Volker is credited with successfully choked off inflation by raising the Fed Funds rate to 20% and the prime rate to

see: Bubble continued on page 12



Betting on Mexoro

Mario Ayub's latest gold mine is unlikely to be his last and that's very good news for Mexoro and its shareholders.

Mario Ayub

At Maedel's our Mexoro strategy is to play both the gold bull market, buy assets at a deep discount while anticipating their upward revaluation as the typically reliable (and profitable) mining cycle kicks in. We also estimate that the company has some significant growth potential ahead of it and, as an added bonus, some rather spectacular exploration upside. Critically, the company has recently recruited a team of proven mine finders and developers which both increases our confidence in the company's mineral assets and that the company has the right management to execute Mexoro's business plan.

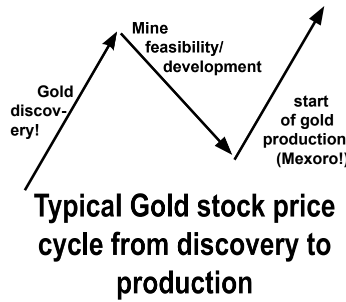
Playing the mine cycle

My favorite example of playing the "mine discovery development cycle" is **Prime Resource Group** which had made the fantastic Eskay Creek, BC Gold Discovery. Following the discovery and in the ensuing quiet period where its actual size, economics and mining plan was developed its shares dropped by over 80%.

I began buying them at around $1.90 and having just moved to Switzerland recommended the shares to every money manager that would listen. The logic was simple - the company was going into production, and anticipating the usual mine discovery, feasibility and production cycle, Prime's shares were likely to begin moving appreciably higher. They quickly rose to over $10 and like another of my big investment successes, **Arequipa Resources**, the company is now owned by **Barrick Gold**.

Targeting the next big play

The key strategy is to narrow our search down to juniors that are capable (and likely) to begin producing gold immediately and have a large (organic) growth potential from both known resources and exploration. We knew that if there was an opportunity, it would likely involve a financial reorganization which is what our group specializes in. Mexoro immediately appeared an ideal candidate because despite its assets and developmental time line, it trades at a dramatic discount to its apparent value.



Typical Gold stock price cycle from discovery to production

Fact finding

In our initial due diligence we sent one of the gold industry's more capable (and an expert on precious metal mining in Mexico) PhD geologists to investigate Mexoro's potential. He gave high marks to the company's Cieneguita gold discovery, and its exploration assets and reported that Mexoro's projections were reasonable, based on the extensive drilling metallurgy and other results to date. From a strategic perspective he advised that much of the company's success was due to Mario Ayub the Mexican metallurgical engineer who acquired and sold the original gold assets to Mexoro.

The mine finders

Our strategy was to ensure Mexoro's success by building a team that had the proven and unquestionable ability to both find and develop gold mines. We wanted Mario Ayub at the helm as Mario had already discovered and put into production 7 mines- an incredible record. The Cieneguita would become his 8th. He was also the president of Mexico's National Miners Assoication. His family has been mining and logging in the area for generations. It be-

Why Mexoro?

1 Timing

The timing is ideal: Gold is in a bull market and the start of mining at Mexoro's first mine also means cash flow begins and share price should rise (dramatically) - a classic, "mine cycle" bet.

2 Growth

Mexoro's just-starting gold mine is the eighth mine the company's chairman Mario Ayub has discovered and put into production - its a safe bet he will find more gold mine's for Mexoro.

3 Valuation

Using Mexoro's peer group's cash flow and market-cap per oz/gold valuations, the company's 6 month share price target from development of its gold mine already exceeds $1.50 per share.

4 Upside

Lets face it making money is why we are here and with at least $1.50 from the development of its mine and a multiple of that based on both the mine's growth, exploration success and the proven ability of its management to acquire company building assets we have every reason to invest.

Mexoro continued from page 9

came eminently clear that Mr. Ayub is both a hands on mine finder and developer and is very connected in the business and with the community - Exactly what we were looking for.

Once we had Mario's commitment our next task was to ensure F**rancisco Quiros** joined the board and continued to spear head Mexoro's exploration activities. Prior to Mexoro, Mr. Quiroz had been in charge of **BHP Billiton's** exploration activities in China. So lets face it - if BHP thought him good enough to run their entire China exploration activities we were lucky to have him. An alumni of University of Tucson's geology department (under **Dr. John Guilbert**) he was the ideal exploration manager.

As we were investigating Mexoro's potential we asked **Mr. George Young** for his advice on the project. Mr. Young was an American from Utah who was a metallurgist and specialist in mining law. He had worked extensively in Latin America and was a co-founder of Mexican success story **Mag Silver**. Mr. Young was also the VP and a founding Director of mine investment specialist **International Royalty Corp.** (IRC has interests in over 85 deposits worldwide). So his advice and expertise was very important to us. That George is considered instrumental in getting IRC's interest in Barrick's giant Pascua-Lama (35 million ounces) gold project added to his credentials. Once George confirmed that Mexoro was a serious opportunity we asked him if he was convinced enough that he would consider becoming the projects Chief Operating Officer, a member of the board and President. His willingness to devote the next few years of his life working to ensure Mexoro's success further illustrated the opportunity.

Mexoro's final board addition, **Mr. John Clair** reflects the potential that Mexoro, may make a major acquisition that would require further funding. Formerly an **Goldman Sach's** investment manager and associate, the idea is that in the event of a major financing Mr. Clair's New York GS alumni will be a major help. I think this just the begining of a formidable mining team and we should expect more great "minefinders" to join the company as the it evolves.

Gold Production begins

In the mean time the company's Cieneguita mine is already funded through feasibility and is just beginning gold production. While mining the western section of the deposit is underway more than 60,000 tons of rock averaging more than 3 grams of gold (equivalent) per ton has been stockpiled. Processing it through a flotation circuit is expected to begin within the next week and the resulting gold concentrate will then be shipped weekly thereafter (Approximately US $700,000 worth of test concentrate from the deposit has already been produced, shipped, smelted and sold).

Crunching the numbers

With every estimate the most important question is the data reliable? Are the estimates realistic? Hiring top geological talent to assess a project is crucial and I believe Mexoro has done this and so the following are the calculations which form the basis of our decision.

To begin with, what we know is that Mexoro has a Toronto Stock Exchange 43-101 compliant resource estimate of 1.24 million ounces of gold (an amount which we expect to imminently be increased by over 200,000 ounces owing to the adding of 50 additional assays). We also know that prior to Mario joining the company (and in the midst of the financial collapse) Mexoro entered into a joint venture for the development of the Cieneguita with MRT a Chihuahua Mexico based company owned by Mario Ayub's family. According to the JV agreement MRT is spending up to US $9 million in a program that includes immediately producing approximately 60,000 ounces of gold over the next two years (expected cash flow net to Mexoro is approximately $3.6 million annually) and completing a feasibility study to develop the operation into a much larger 100,000 to 120,000 ounce per year mine. Following the feasibility study, Mexoro will have a "net" 33% working interest this would equal approximately 30,000 to 40,000 ounces per year net to Mexoro annually.

Using the 2010 $3.6 million cash flow projection we then need to decide what a reasonable multiple would be. In the junior gold producer sector the cash flow multiple ranges from 5 (**New Gold** TSX:NGD) to an emerging junior level of 40 (**Minefinders** TSX:MFL) to a high of 134 (**Centamin Egypt** TSX:CEE) as factors as political risk, life of mine, and likely and potential growth rate are reflected. Because we anticipate Mexoro being soon listed on the Toronto Stock Exhange (which is a natural fit for a junior gold producer) these metrics are in our opinion the most appropriate.

In Mexoro's case we consider a reasonable expectation that once listed on the TSX and *after a several months of production its shares could trade at a multiple of 20 times its expected $3.6 million cash flow* giving it a market capitalization of approximately $72 million (using its 56 million shares outstanding) translating to an **immediate share price target of $1.25 per share**. But the $1.25 should be just the beginning.

The Ultimate Upside

According to our calculations, taking into consideration the known continuity of gold grades, geology and the dimensions of the Cieneguita, there is a very credible argument that the Cieneguita will end up containing around 2 million ounces of gold. This increases the ultimate Cieneguita-driven, share price target to well over $2 per share. The calculations are based on the junior gold sector's current market capitalization/per ounce valuations, which range from US $227 per ounce (Centamin Egypt) to US $1,133 per ounce (**Eldorado Gold**) again reflecting such factors as political risk, mine life and growth potential. Continued on page11

Mexoro continued from page 10

In Mexoro's case using the current resource of 1.24 million ounces or 360,000 ounces net to Mexoro and assuming that this is the minimum amount to be upgraded to the reserve category, and then using $400 per ounce as its value (chosen because of the Cieneguita's apparent growth potential combined with the Mexoro's other exploration properties) we then calculate Mexoro's potential market capitalization as follows: 400,000 ounces multiplied by US $400 to get US $160 million or more than $2 per share fully diluted. If in fact 2 million ounces are developed the amount of gold credited to Mexoro would then be 660,000 ounces with a corresponding increase in value.

Currently mining at the Cieneguita is estimated to have a cash cost of $350 per ounce of gold. Costs are expected to decline as economies of scale, and typical equipment and design improvements are incorporated following feasibility, potentially reducing costs to around $250 per ounce.

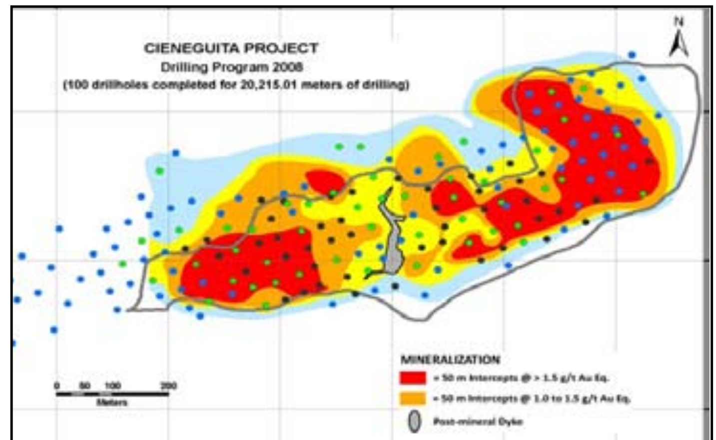
The final result is "if" production is in fact increased as planned, and the cash cost is $250, Mexoro's share would be around 30,000 to 40,000 ounces annually with a potential net yearly cash flow of $22,500,000 to $30,000,000. Using a 10 times cash flow multiple (we reduced the multiple because the Cieneguita's cash flow would be unlikely to grow further) Mexoro's potential market capitalization works out to between $225 million to $300 million. Divided by its current 56 million shares, its share price target is within the Arequipa /Magsilver range that motivates us.

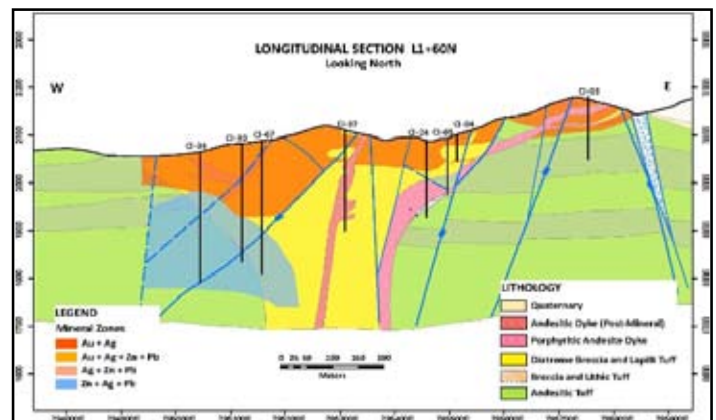
Exploration quick notes

As I spelled out early in this report the Cieneguita is the principal reason for our investment. A second gold discovery has been made half a kilometer to Cieneguita's south. While early days, the size approximates the Cieneguita and even more tantalizing is that together with high grade copper zones it appears to be part of a large copper/gold porphyry system. The development of such a play, if it occurs I expect will involve farming out the porphyry potential to a major with deep pockets - giving Mexoro great exposure to the giant upside it implies but none of the costs (or share dilution)

. The next most developed exploration project is the **Sahuayacan** which is on trend with Gammon Gold"s 4.5 million oz. gold (equivalent) Ocampo mine. The least developed is Mexoro's Encino Gordo project which is less than 5 kilometers from Bolnisi Gold's (now owned by Coeur d' alene) +3 million oz/gold (equivalent) Palmajero operation. Both projects are given high marks by our independent experts.

Pads are being built in anticipation of drilling at Mexoro's Sahuayacan Santa Teresa zone, where one of only two holes drilled intercepted 7.5 meters averaging 56.01 grams per ton gold and 283.22 grams per ton silver. The property is considered to have the potential to contain more than 1 million ounces of gold - it is however very early in the program and the only thing we can confidently say is that it should be very exciting. Our Mexoro bet really is all about the Cieneguita.





"The Risks"

Despite the fact that management has developed mines many times previous, there remains the risk that the Cieneguita mine could end up smaller, less rich and less profiable (or not profitable at all) than management expects. There is normally great risk involved in making a production decision based on resources as Mexoro has. They have not developed, in the strict mining sense, indicated or measured mineral resources or a large scale feasibility study as a basis for an overall economic analysis of the entire project. They have done a lot of metallurgical work (remember both Mario and George Young are metallurgists - Mario did the work and George confirms its realistic) and have drilled extensively (about 100 holes) and have developed a comprehensive mining business plan.

Oct 09 - gold ore being unloaded into the grinding circuit as analysts watch

Mexoro continued from page 11

This is where the track record of management is critical and from our experience the results show that if anything Mario Ayub is being conservative with his plans we think will exceed expectations. If you go to the site the ease of mining and its logic becomes apparent. They just start at the bottom of a hill where the deposit begins blast the extremely friable rock and keep working their way up the hill. In this scenario gravity and the soft rock is making the mining of the gold and silver relatively easy. As the mine goes deeper copper, zinc and lead will also become a more important part of the ore. It is early days and investors must be aware that there is a lot yet to be accomplished. Time will tell and we remain confident.

Most important is the stock is undervalued and has some serious share-price-moving events on the horizon. And the company is (we think temporarily) unknown to the investing public. The company has not yet changed its name to **Pan American Goldfields** to reflect what in essence was a takeover (the name change awaits shareholder approval) but, its website has already been changed and is found as: **panamericangoldfields.ca**. Few know, at least not yet.

We look at this momentary transformation as a great buying opportunity. From our experience as the story gets out the shares will move alot higher. *"As they keep producing more gold and as they keep growing their deposit, its shares should move even more."* Its team of proven minefinders and developers joined for good reason. We think it only gets better, a lot better, from here.

*****

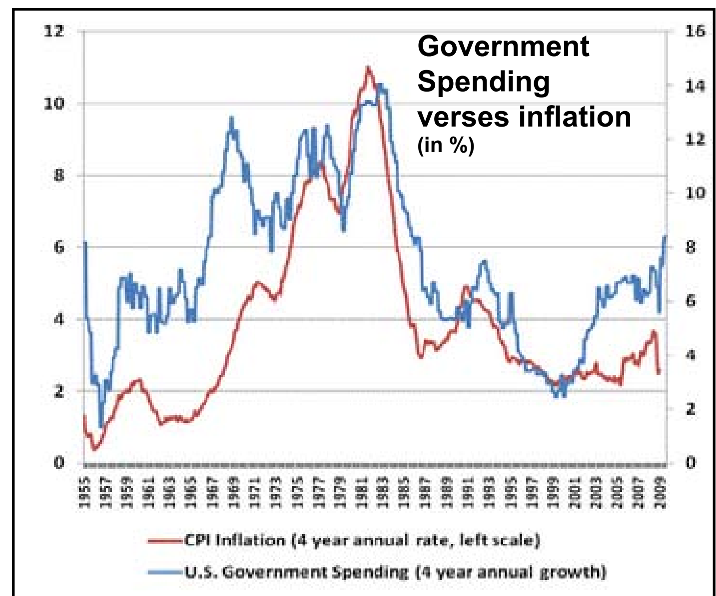
Bubble from page 8

21.5% (currently a respective 0.25% and 3.25%).

The chart above right illustrates the reality: the more the government spent the higher inflation went. Look to the chart on page 8 to see the cycles of unemployment, which during the 1970s no amount of Keynesian tinkering could fix. The current Fed Chairman and Obama administration, despite the historical evidence are employing Keynesian solutions to combat the current crisis.

Author of **The Black Swan**, **Nassim Taleb** makes the following observation: "*look at studies of monetary policy - they don't know what's going on because they have no control over their error rate. They are out of control*". GMO's Jeremy Grantham makes the following critique as he writes in "***Just Deserts"*** under ***"For Missing the Unmissable"*** Federal Reserve Chairman Bernanke: "*failed to see the housing collapse as well as missing on his very own, the 3 sigma (100-year) event in housing and he was completely clueless as to the potential disastrous interactions among lower house prices , new opaque financial instruments , heroically increased mortgages, lower lending standards and internationally networked distribution. For these accumulated benefits to society he was reappointed!"*

If Bernanke had authored the same spectacular failure in China, his next assignment would be herding farm animals, if he was lucky.



But that's why China is booming and not bust.

Similar to Bernanke, Lord Keynes, for all his good points, also completely missed his very own 3 sigma event: the 1929 crash and subsequent depression.

Keynes on Steroids

Tim Geithner and Ben Bernanke may think the failure of Keynesian remedies during the 1970s was in the lack of trying. At their peak during the 1970s America's total debt never got much past 150% of GDP (see chart on page 1). Today GDP to debt is already, and they are just getting started .

Most recently, the FED committed to complete their $1.25 trillion in purchases of mortgage securities and extended that program from this December to March 2010.

Currently one-third of the Fed's balance sheet consists of a $625 billion accumulation of illiquid mortgage-backed securities for which the FED was the buyer of last resort. This is a huge departure from a pre-Bernanke Fed which previously restricted its investments to government securities. And it is not restricted to the US but has become a global phenomena.

In the words of **C. A. Goodhart** of the **London School of Economics**: " *Monetary authorities the world over have crossed a kind of rubicon of intervention, now lending to a widening range of financial institutions against almost any grade of collateral at ever longer maturities*".

The grand total

Commitments by the Treasury and Fed currently total $19 Trillion. Of this $8.2 trillion is for FED for loan and asset guarantees. The Treasury Department accounted for $6.8 trillion; included TARP funds, stimulus spending, and tax benefits, while $654 billion went into the imploding MBS market including $134 bil-

Bubble Continued on page 13

Bubble Continued from page 12
lion for the FHA to guarantee residential mortgages. Another $1.3 trillion was used to cleanse Citigroup of its toxic assets just as the Federal Deposit Insurance Corporation has made $2.3 trillion in liquidity guarantees to banks.

To fund its mammoth spending programs the US Government has already auctioned $7 trillion worth of treasuries. The Federal Reserve in turn has been dutifully supporting the treasury market to keep rates low -thus fueling the stock market rally and supporting the real estate market. For example according to The Wall Street Journal Fed bought nearly *half* of $339 billion in net new Treasuries sold as of the second quarter.

Back to the future

Keynes may not have been able to correctly predict the credit cycle but another economist Ludwig von Mises did and unlike Keynes, in the 1920s Mises correctly warned of a coming crash and depression.

According to Mises central bank and government-induced credit expansions led to imbalances in the economy leading to a boom and bust cycle such as what we have experienced. He summarizes the resulting choices confronting policy makers at the end of an expansion in this now famous quote:

"*There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of the voluntary abandonment of further credit expansion or later as a final and total catastrophe of the currency system involved"*

The message is that their is no way out of the period of de-leveraging except through inflation which the latest administration is doing its best to engineer and a potentially hyperinflation and a monetary collapse.

The current Keynesian attempt to defer the ultimate rebalancing of the economy via massive government spending financed increasingly through the Federal reserve is unlikely to succeed.

Quiet before the storm?

Despite the ultra-wide output gap, near record unemployment the current low inflation could this be "the quiet before the storm", as the dramatic growth in the Fed's balance sheet and massive government deficit spending eventually leads to a plunging US dollar and hyperinflation.

One has only to examine the previous results when high enough deficit spending was combined with too much foreign capital and "quantitative easing.

The US government spending chart on page 4 already implies a link between spending and inflation. The unprecedented increase in money supply should also be of great concern. One study of inflation since 1960 showed a time lag of roughly three years before inflation started with a coefficient of +0.64. Another had a even more predictive response of +0.84. It focused on the correlation between US M2 growth and inflation during the 1930s.

Anna Schwartz who coauthored, *A Monetary History of the United States*, with **Milton Friedman**, recently warned that, "*as a consequence of money supply growth, Inflation is now inevitable*". In another study concerning Germany's hyperinflation, the two economists noted that "*a huge influx of foreign capital accompanied the early stages of the Weimar hyper inflation"*. This should serve as warning given the over US $3 trillion of US treasuries held by foreigners.

Output gap-reality gap

At the same time the anti-inflation effect of a high output gap turns out to be a dangerous illusion. A study by **Northern Trust** shows that there is no correlation between low inflation and a widening output gap. One prominent example occurred during the great depression. In 1934 inflation jumped to 4.6% despite an output gap of 31.9%. According to the Northern Trust study the correlation between the output gap and inflation is negative and the greater risk is that in 2 to 3 years inflation accelerates.

The Hyper-inflation tipping point - are we there?

If the potential for mere inflation does not get your attention: does the risk of hyperinflation?

Basel Switzerland based **Professor Emeritus Peter Bernholz** warns America just passed the hyper inflation tipping point which occurs when a Government's deficit exceeds 40 percent of its expenditures. As described in a **Hayman Advisors** report:

*"There have been 28 episodes of hyperinflation of national economies in the 20th century, with 20 occurring after 1980. **Peter Bernholz** (Professor Emeritus of Economics in the Center for Economics and Business (WWZ) at the University of Basel, Switzerland) has spent his career examining the intertwined worlds of politics and economics with special attention given to money. In his most recent book, Monetary Regimes and Inflation: History, Economic and Political Relationships, Bernholz analyzes the 12 largest episodes of hyperinflations – all of which were caused by financing huge public budget deficits through money creation. **His conclusion: the tipping point for hyperinflation occurs when the government's deficit exceed 40% of its expenditures.**"*.

We are there.

According to the current Office of Management and Budget (OMB) projections, US federal expenditures for 2009 and 2010 are projected at a respective $3.653 trillion and $3.766 trillion deficits a respective $1.580 trillion and $1.502 trillion. The implied deficits work out to 43.3% and 39.9% of expenditures in 2009

Bubble Continued from page 13
and 2010, respectively. The bottom line is America has already reached Rothbard's 40%.

The next great inflation

If it does, when is inflation most likely to begin accelerating? The descent of the dollar and ascent of gold's price could hold the key. **Bill Gross** at **Pimco** says he "*expects dollar devaluation as unspoken policy*". But on the other side of complacent treasury officials are countries like China and Japan who have a trillion dollar stake in the dollar staying stable.

Most of the G20 Central Banks will go to great lengths to slow the dollar's descent so as to maintain their export competitivenes. How long they can stall the dollar's ultimate devaluation is an open question. Studies of money supply and deficit spending inflation correlations, give us a hint. They indicate a probable two to three year lag before inflation kicks in translating to an 2011 -2012 "stagflation or worse", target.

Buy Gold -Gold Stocks

Oil's $20 to $140 bull market was our last big investment theme and for our next big theme we are taking our cue from history, noting that gold and gold producers were among the most profitable investments during the great depression. But we'd rather not depend on that outcome so instead also bet that, bullishly, gold production will fall far short of demand for the foreseeable future. Even with gold at $1000 many producers are not currently experiencing "positive cash flow". That is they don't make enough to cover the cost of finding and developing more gold to replace what they have mined.

As critical, there is little new gold supply on the horizon. We are also impressed by gold's relative strength during the very worst of environments - gold was the first to start moving up in the midst of the recent collapse and its 30% correction was minimal compared to other sectors. Even better gold's recovery occurred even as most other asset classes were still imploding.

Our view that gold is once again becoming an important monetary asset received a boost last week when **India** bought, for $6.7 billion, 200 tons of gold from the IMF. Barely a month previous the IMF had agreed to sell 403 tons to beef up its finances. China was expected to be the buyer and if it buys the remaining 207 tons its $6 billion value would translate to a very small part of China's $760 billion worth of depreciating US Treasuries.

The outside bet is that Professor Bernholz will be correct about a coming American hyper-inflation.

If he is, gold companies producing *outside* of the US would see their values soar. A growing list of the market's savviest investors continue to line up to make a *gold's-going-higher* bet. The latest, Fund giant **Paul Tudor Jones** describes gold as: "*just an asset that like everything else in life has its time and place and now is the time"*. We agree. And now is the time. Our technical 6 month upside target is US $1300. To be continued...

Current long metals positions

Anglo Amer. OTC: AAUKY $20.35
Gold Fields: NYSE: GFI $14.65
Ivanhoe Mns. NYSE: IVN $12.49
Lakeshore G. TSX: LSG $ 3.50
Mexoro Min OTC: MXOM $0.47