BLACKSUMMIT FINANCIAL GROUP, INC.

A REGISTERED INVESTMENT ADVISOR
132 RIVERVIEW DRIVE, SUITE D FLOWOOD, MS 39232
601.714.1034 OFFICE 601.714.1038 FAX
WWW.BLACKSUMMITFG.COM

REMEMBERING THE FUTURE
VOL. 2, ISSUE 11, MAY 2011

BASE METALS: THE BUILDING BLOCKS FOR A NEW ECONOMIC REGIME

John E. Charalambakis, Ph.D., Chief Economist

Introduction

This month we will chronicle the reasons base metals can play and support a robust role in a portfolio. As always our analysis and projections for this class of commodities fits in with our take on the global act that is unfolding. Namely, a global diffusion as to which actors will power worldwide economic activity. First, we will recap the pressures from beneath the global economy's surface which led to a systemic rupture in the old order of things catalyzing the birth for more balance in global development and consumption trends.

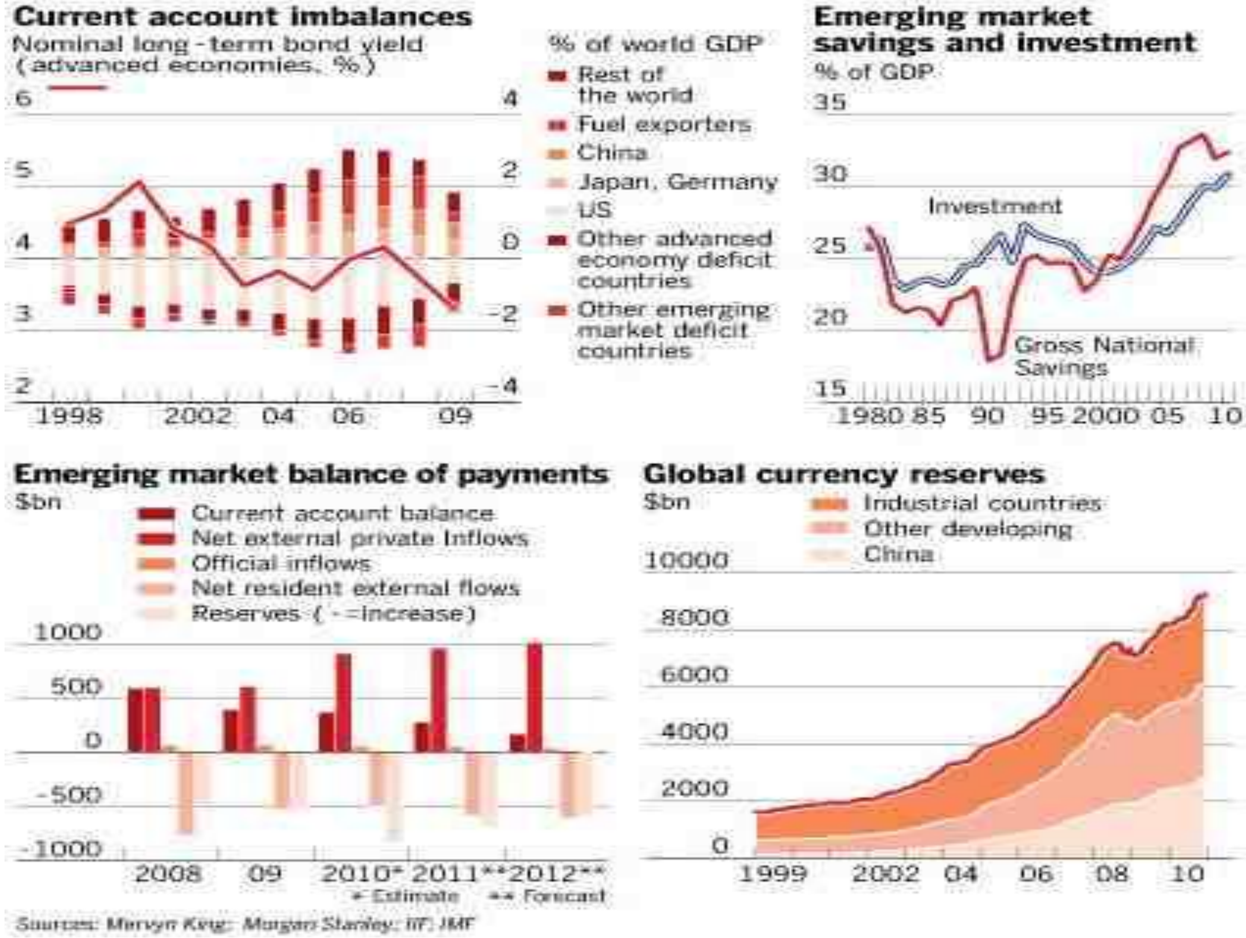
A New Growth Story Unfolding

Both the financial crisis and the responses to it from the emerging world signal, in our belief, the dawn of a new economic story for the world, one where growth's sources are diffused among a greater number of actors while giving new meaning to what constitutes a real asset. Our position is not a result of some partisan rhetoric (as is becoming more common nowadays) nor out of a cynicism regarding the ability of the developed world, but rather that this growth story is a natural flow from trends that pre-date the crisis and which trends keep warning investors that assets are projected streams that are no one else's liabilities.

In looking back to the period of growth prior to the crisis of 2008, a number of articles, studies, and other publications have described of what was essentially a grand bargain between creditor and debtor countries, with the U.S. and China serving as the poster model for such an arrangement. Martin Wolf of the Financial Times recounted the recent history in a piece to the paper on April 5th. As Mr. Wolf describes it both sides benefitted under this creditor-debtor relationship, at least for a while. The U.S. and debtor nations were given access to credit of global proportions thanks to the savings patterns of the developing world. This "uphill" flow of capital as Bank of England Governor Mervyn King describes it, from the poor to the rich boosted asset prices, lowered interest rates, and sparked the minds of Wall St. to cook up new "safe" financial instruments to acquire even more capital and keep the wheels spinning.

For the poor, this grand bargain granted them cheap exchange rates and the opportunity for export-led growth. This was the core of the global economic arrangement but when joined with the explosion in foreign currency reserves (as a means of protection against hot capital flows that doomed Thailand in 1997) and meager safety nets that led families to put aside more of their income, a glut of savings and consumption in different parts of the world emerged as Mr. Wolf eloquently explains. This unequal weight distribution not only snapped the global economy but also created a systemic case of contagion throughout financial markets and the economies of the world. Moreover, these misallocations created global trade imbalances which were also part of the crisis, and all of these developments can be seen in the following graphs

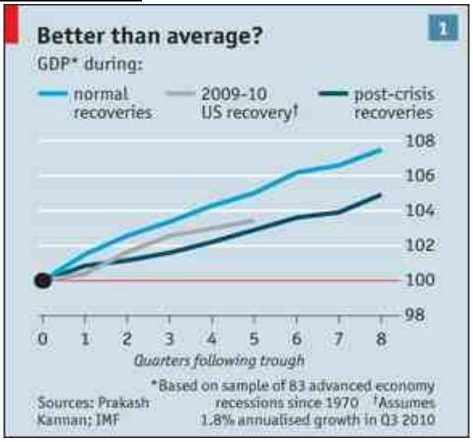
Figure 1: Global Divergence in the Run up to the Crisis



During 2009 and 2010 policymakers frequently made headlines over dynamics that set up this web of exposure. Talk of "currency wars" and symbiotic battles over trade competitiveness surged in the fall of 2010 thanks to Brazil's government, President Sarkozy's priorities for the G8, and more recently due to new guidelines from the International Monetary Fund on capital controls for the purpose of correcting trade imbalances. As a result of such proposals, the jargon of "rebalancing" entered the everyday lexicon among economists, journalists, academics, and politicians.

While there may be debate, depending who you ask, regarding how fast rebalancing needs to take place and what countries need to take the lead, little argument has been made that some sort of robust recovery across the globe will entail a rebalancing that possesses a more equal distribution on demand's sources. This will be desperately needed given the nature of catastrophe that the globe, particularly the West, is attempting to recover from.

Figure 2: Financial Crises v "Normal" Recessions

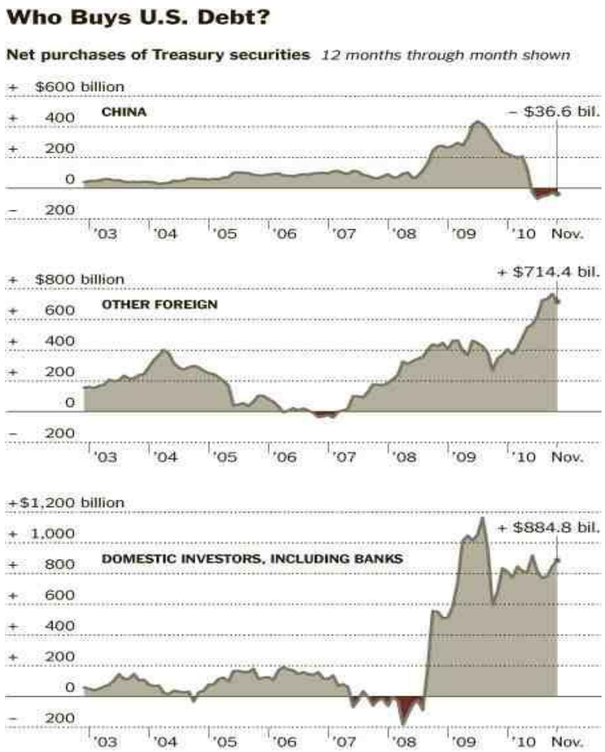


Research by the IMF and other global institutions has contributed to a growing body of research that suggests financial crises are far more detrimental and take longer to get out of compared with "normal" recessions. As Figure 2 above presents the current U.S. recovery, though better than post-crisis recoveries, has not reached the level of stability needed to provide confidence. As a result, deleveraging is likely to continue among the private sector and corporations are likely to maintain higher than normal levels of retained earnings in the United States. Thus, for the emerging world to grow and maintain the confidence of their citizens (which, as the Arab world is demonstrating, is a critical socio-political commodity) they will have to make up for some of the slack that currently is weighing down traditional demand markets by turning inwards and boosting demand and consumption at home. Some signs of such a trend are already evident, as we have frequently pointed out. Trade among the developing world has exploded in recent years, growth in emerging markets is certainly stronger, and emerging-market governments are taking measures to strengthen safety nets. This latter factor not only helps the governments of emerging markets, pertaining to their own credibility, but also to the private sector as their savings can now be directed towards consumption with the full security that services, such as medical care, will be provided for without having to dip into their own pockets. In addition, broader and deeper financial markets in the emerging world offer greater returns and protect incomes. Finally, as the recovery becomes more and more stable "safe" assets will make up a smaller piece of global reserves and instead funds will be directed towards investments that offer higher returns.

As the emerging markets experience greater rates of growth and as they strengthen their positions, funds will be spent on safeguarding their growth via infrastructure spending (something we will touch upon more in June's commentary). That will certainly advance some export and infrastructure-oriented developed markets' companies while it will also advance a geopolitical alliance with the US that will secure US interests, as the figure below partially shows.

The figure below, shows that while the Chinese are net dis-investors in US bonds, other foreigners are picking up the tab, and the events in N. Africa and the Middle East should be co-mingled into this picture especially when the new day dawns upon them with their needs of infrastructure

Figure 3: Who Is Buying U.S. Debt?...Not China



12 months through November 2010

Countries that **bought** $10 billion or more of Treasuries

	BILLIONS
Britain	$356.3
Japan	122.9
Canada	84.0
Thailand	36.1
Singapore	21.9
Brazil	18.6
Taiwan	15.7
Egypt	14.8
Germany	11.7
Norway	11.2
Switzerland	11.0

Countries that **sold** $10 billion or more of Treasuries

	BILLIONS
China	$36.6
Russia	28.9

Note: Treasury securities held by U.S. government agencies, including the Federal Reserve and the Social Security Administration, are excluded. Figures for China include Hong Kong.

Source: U.S. Treasury, via Haver Analytics

development that will support a functioning and viable middle class. The process of balanced, domestically stimulated growth from the emerging world is in a stage of infancy with enormous investment potential. With the exception of China and its bloated rates of expenditures on capital formation, investment rates in the emerging world should boom with infrastructure construction being one logical outcome. The need to prop up demand and grant consumptive power to her people is one reason why India's government has been profiled in publications such as the Financial Times for not intervening in capital markets and preventing a rise in the rupee. Higher exchange rates and greater consumption capabilities should be a feature in many other emerging economies as well. When these effects will bloom into full swing cannot be determined with certainty; talk of global rebalancing has been nothing but rhetoric now for a few years. However we believe quibbling over your exact entry point into these markets and their investment and consumption markets is akin to fighting over pennies in the long term.

Basic Metals and the New Era

The above analysis outlines our reasoning for the future using historical and present events to guide us forward as we always maintain the spirit of tangible, productive assets when it comes to our investment opinion and ideas. The base metals class fits into such a philosophy. They are the essential and literal building-blocks of industrialization and modernization. From infrastructure projects, to cars, power grids, homes, factories, wiring, to a number of other applications base metals will be at the forefront of growth developments in Asia, Latin America, Africa, and everything in between as these emerging countries look to solidify their growth positions, address inequalities, and take control for themselves the means to a better life. (As we were drafting these lines Barrick Gold Company announced its acquisition of a copper company, possibly for the purpose of taking advantage of the forces at work described in this issue).

Mining companies, such as corporate giant Rio Tinto, have publicly stated the degree to which 2011 is experiencing new highs for capital expenditures on behalf of firms to keep up with demand. Rio Tinto's CEO Tom Albanese has said that new projects are costing four times as much as similar projects from just five years ago. Rio Tinto specifically has projected to increase capital expenditures by over 15% in 2011.

Given these wider macro trends and the construction/production processes that will follow, the remainder of this newsletter will discuss basic metals in their respective fundamentals but the broader narrative of the global economy should not be demarcated from the metals' projections.

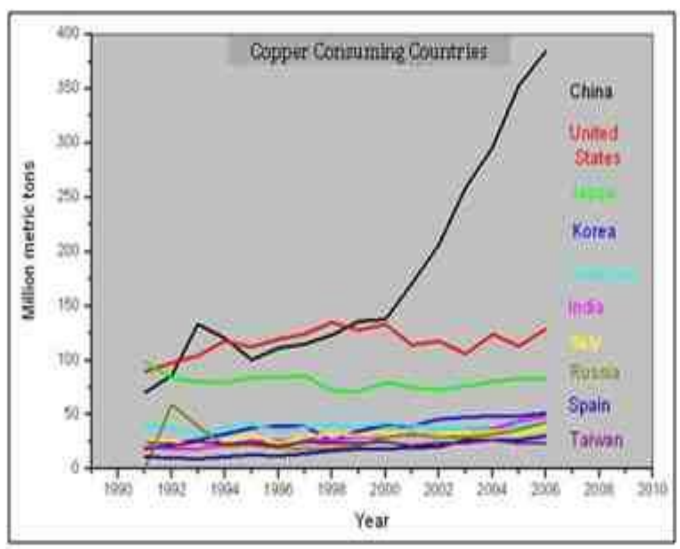
Copper

Copper is an asset that like energy touches every fiber of economic life. 75% of copper production goes into electrical applications. It is a vital component of goods ranging from power grids, to hybrid cars, to electrical wiring, to plumbing and much more. Its intimacy with so many aspects of economic life over the past 100 years has given it the nickname of "Dr. Copper," since its Ph.D. in economics serves as a predictor of general market sentiment.

A further factor in copper's record high prices is restrictions in supply. In late March Bloomberg published an article naming Barclays, Rio Tinto, and Brook Hunt as firms who were forecasting substantial shortfalls in copper supply relative to rising demand in the emerging world. The latter predicts a 570,000-ton shortfall in copper supply this year. Vehicle sales, housing construction, and other growth-related developments in the emerging world may cause the red metal to rise further. Standard Chartered is of the position that copper will continue to have supply shortfalls through 2014 and also backed the metal. Also, in the past couple of years greater amounts of the red metal have gone to storage as copper ETFs have become a new source of demand, where the metal is seen as an asset-class by itself. However, these shortfalls could be compensated for with talk of storage in China as well as a potential economic slowdown in the Middle Kingdom.

Regardless of those talks, the long run fundamentals remain strong when so many other rapidly growing emerging markets are far behind China's influence in the copper market as Figure 4 says. Moreover, mining activities have resulted in lower quality ore being extracted from mines opened in the 1980s, meaning companies have to spend more to extract the same amount of material according to Tony D'Altorio. Since a typical copper mine can take up to 15 years to open, this dynamic of quality affecting cost expenditures could be something that effects the market as a whole in the next several years.

Figure 4: Copper Consumption

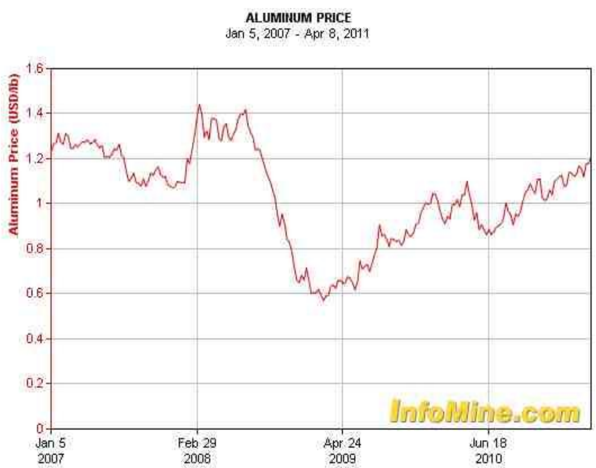


Source: Seeking Alpha

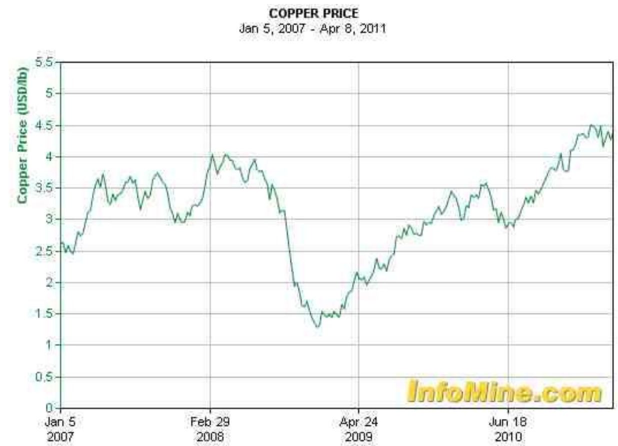
Aluminum

Aluminum is a metal, like copper, that thrives in periods of economic expansion as it too possesses a wide variety of productive applications such as automobiles, air conditioners, and of course as a popular conductor of electricity, among others. The growing consuming power of a new class of economies should see demand rise for a number of products that entail concentrations of aluminum.

Figure 5: Aluminum and Copper Prices Jnuary 2007-April 2011



Aluminum also has a couple of other factors going for it into the near and medium future. For one, aluminum is currently undervalued relative to copper given the relational history of the two metals. Like gold and silver, copper and aluminum have a stable, historical ratio which usually fluctuates between 2:1 and 3:1. However, that ratio has been bumped up to 4:1 in the aftermath of 2008's turmoil thanks to greater demand for the red metal. Figure 5 demonstrates the gains made by copper and aluminum in the past few years and how copper's rise has been greater, which leads to the second and more important dynamic surrounding aluminum's prospects. (Let's not forget that it was -among other things - the gold/silver ratio historical abnormality last June that led us to advocate silver investment positions).

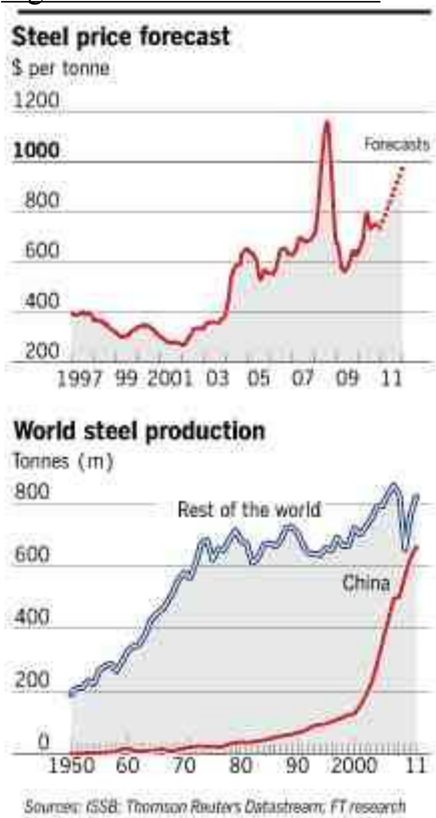


Given copper's increased price and its record highs there is an increased likelihood that companies will begin to substitute aluminum for copper in some of their uses though not all. The wider the gap in price between and aluminum and copper the greater the odds that this actually happens, as aluminum's bargain value can offset costs of changing production processes. Rio Tinto has gone public this year stating that they expect aluminum substitutions to be greater than they have been in recent years, although not by an alarming margin. Speaking more generally, Chief Executive Klaus Keinfeld of Alcoa, a major aluminum producer, has already cited "big time replacement going on" and mentioned that China's growing needs for energy could cause the metal to "skyrocket."

Steel

Analysts in the basic resources industry have gone on record with some wide ranging opinions on just how fast steel will grow in 2011, but as the Financial Times'survey revealed they all expect some substantial growth in the near future. The average expected growth according to the survey published this past January was 32% with some of the top experts in the field predicting growth rates as high as 66%. A boom of that magnitude would be the second largest in 70 years, however we are cautious that overall, we may not see double-digit gains until next year.

Figure 6: Steel Price Forecast

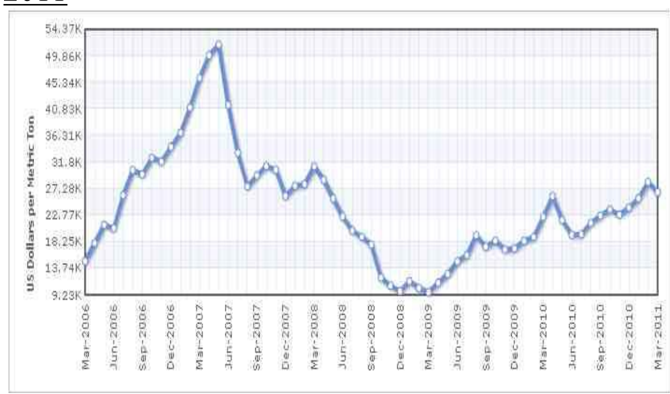


Steel prices are being propped up due to the massive industrialization process in Asia as well as other parts of the globe. The development of the New Silk Road that will encompass the new Middle East and Africa, will enhance the prospects for steel and all the other base metals. In addition, coking coal and iron ore, the two fundamental inputs into producing steel, have also been rising significantly due to global demand as well as supply constraints, such as the massive flooding that hit Australia earlier this year and forced companies to close down mines.

Nickel

Nickel is a metal intimately connected with the steel industry. Most estimates place some 80% of nickel use going to produce steel products, primarily stainless steel which is used in cars, homes, and cell phones, among other things. It will be a key component of infrastructure development going forward as well. Nickel has posted quite high returns since January 2010 but as the following chart shows the metal is quite a ways away from its high of 2008. Hence, as the growth story unfolds, we are expecting it and other metals to reach an all new-time high in the next few years.

Figure 7: Price of Nickel March 2006-March 2011



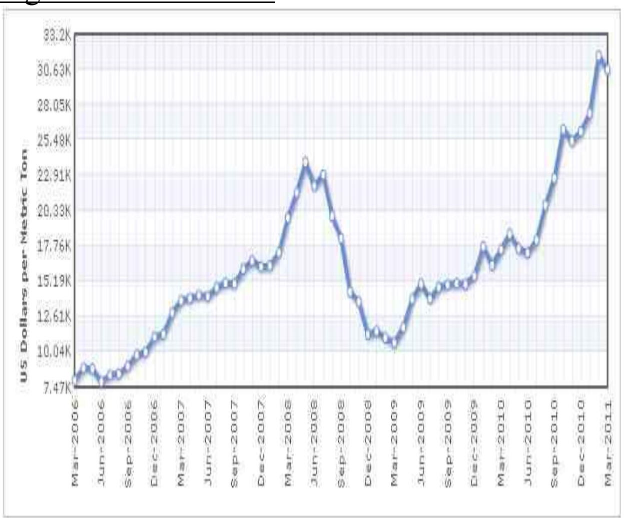
Given the ongoing global consumption and production fundamentals in the emerging world, as we outlined in the beginning of this newsletter, nickel currently offers a prime entrance opportunity with little downside risk. Demand growth is strong and inventories for nickel are not nearly as plentiful as for aluminum.

Tin

Tin is a much different story than that of nickel when evaluating its price behavior.

Since bearing the full brunt of 2008's storm, tin has outgained its high by 50% as the following graph demonstrates. While stimulus measures and growth stories in the emerging world justify some upward price pressures on tin, due to its purpose in producing bronze and other alloys, this metal has some unique supply pressures that have given it an added premium over the last year and an half, and may continue doing so in the future.

Figure 8: Price of Tin



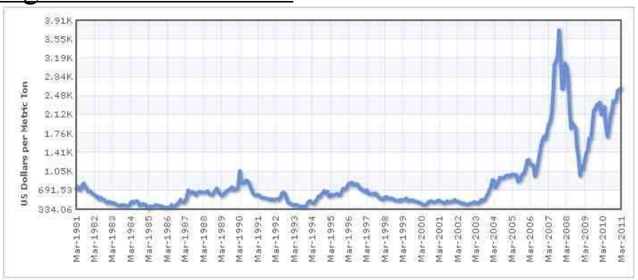
First, traumatic weather patterns in key producing countries have significantly altered mining processes. Second, the fact is that 33% of global supply comes from Indonesia, where destructive typhoons plagued extraction activities. However, like other metals, extracting tin is becoming a more expensive process. Companies are having to go deeper into mines with more expensive equipment and technology, often due to the inferior quality of ore. Third, some geologists estimate that global supply in tin may be so tight that we may run out of it in 20-40 years time. While supply should stabilize over the near term, the long run pressures could make tin an interesting play.

Figure 9: 1 Year Tin Inventory

Lead

Lead is a metal that should certainly see its popularity and demand rise in the future. What often fails to be mentioned in the global growth story that is taking place in the emerging world is how countries such as India and China are in many instances trying to avoid a full duplication of the way in which countries like the U.S. became prosperous. Specifically, nations like Brazil and others are preparing themselves for 21st century competitiveness by making sure they do not neglect investments in alternative energy (including wind, solar and even nuclear), soft infrastructure (broadband connections for example), and modern power grids. Many policymakers and academics in the U.S. in fact complain about how several of these fast growing economies are doing more than the United States and are leading the way in terms of research, design, and application of new technologies. Lead will play prominently in such an environment given its concentration in devices such as electric car batteries and cell phones.

Figure 9: Price of Lead



Conclusion

The unfolding story is that of redress where growth prospects in the emerging world will surpass that of the developed. Small companies in the emerging world will reap significant rewards as our March newsletter explained. During these times of growth for the emerging world, base metals will be at the core of the development process. Our newsletter this month, has not been an exhaustive exploration of each and every base metal. Prominent ones such as zinc have not been covered, but the general principles and larger narrative both translate well into these uncovered commodities: booming demand in the emerging world is real, productive, and here to stay.

The force of this class of emerging powers should be enough to push prices higher while the developed world stabilizes a recovery where they too will join as players propping up demand for base materials. Infrastructure construction should be a strong theme in both the developed and developing world over the next couple of decades with the former performing maintenance and the latter starting new projects. Cohen and Steers, a firm known well for its analysis of infrastructure, projects that the world will spend $40 trillion on infrastructure over the next 25 years. Demand for basic metals should coincide with such a boom in global activity.

Ode then, to base metals!