July 30, 2006

July 2006 Market Update

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Economic Overview:
My earlier sentiment was confirmed Friday in the release of the preliminary Q2, GDP figure of 2.5%. This is significantly lower than the reported 5.6% GDP number for Q1. There are several causes for the slow down but I believe the two biggest reasons are the cost of energy and the rapid slow down in the housing market. Two weeks ago the Housing Market Index produced by the National Association of Home Builders came out for June. In general, a number above 50 is bullish and below bearish. The number for June was 39. In June 2005, the number was 72. The decline is the sharpest since the index began in 1985. There is now a 15 year high in the supply of homes for sale, the most since the recession of 1991. Both new and existing home sales are declining and the national average price appreciation of 0.9 %. Gone for now are the days of double digit price growth.

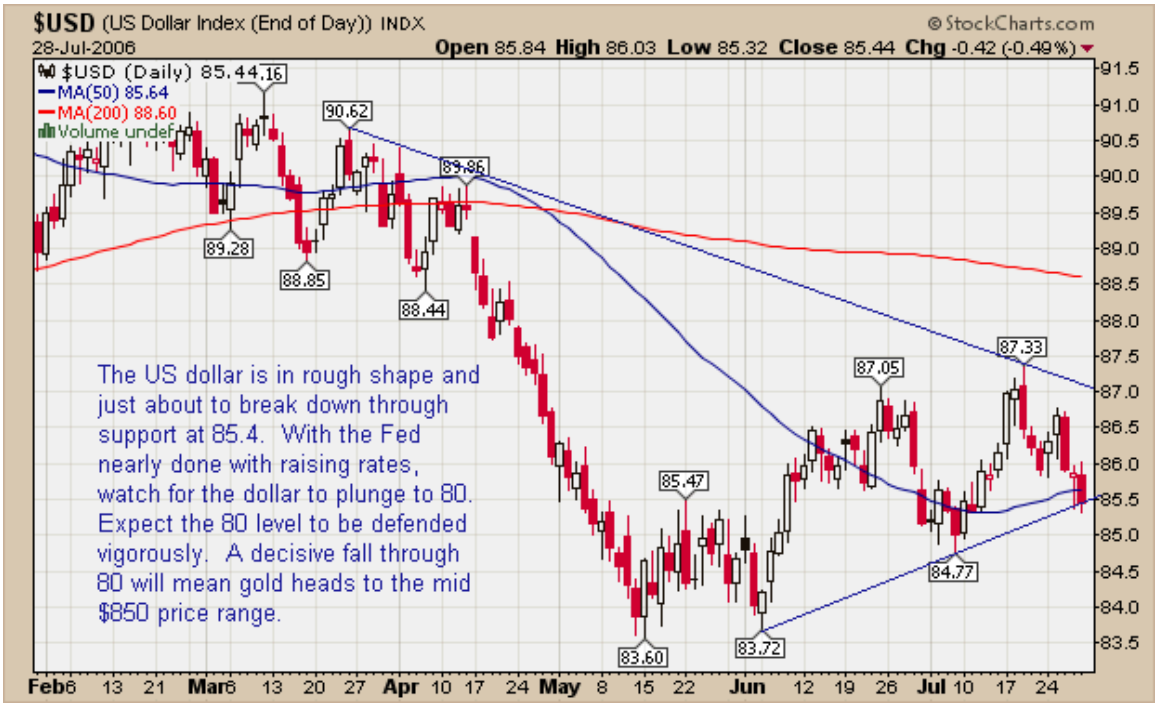
Americans today accept government figures as gospel. Few in recent years have come out to challenge inflation or GDP reports, until now. What is well understood is if the price of gasoline is going up, consumers are going to feel the pinch. The Consumer Price Index, CPI, for the month of June came out recently. The government still shows tame inflation but we all realize the picture is different. One notable figure in the CPI you have to laugh at, is the government said the price of energy dropped 0.9% in June. Hmmm, the price of the most used energy commodity, gas, goes up $0.20 - $0.30, yet energy inflation falls? Despite statistical shenanigans, the heavily indebted American consumer is feeling the pinch and the economy is slowing.

I noted in a Market Update a few years ago we would find our way to stagflation. What's stagflation; it's when an economy has increasing inflation while economic growth slows. This is exactly what happened in the 1970's. What Fed Chairman Paul Volker did to stop inflation and get the economy growing again in the 1980's was to rapidly raise interest rates. Many people remember 15 %+ mortgage interest rates. Volker could answer stagflation in this manner as the US had a relatively low budget deficit and was a net creditor to the world. Now we are entering stagflation with a much weaker financial situation. Presently we are heading towards $9 Trillion in national debt and an annual trade deficit approaching $800 Billion.

The Federal Reserve is now in a real pickle. Elections are coming in November and the economy is slowing. Late June the Fed raised rates for the 17th time to 5.25%. Data out this past week showed GDP falling rapidly but inflation rising. The Fed's choices are limited. They can raise rates to control inflation or stay at 5.25% waiting for more data. The problem is if they don't tame inflation the bond market will begin to push up interest rates. Mortgage interest rates depend on the yield of the 10 year bond. If the housing market is stalling out at 30 year interest rates of 6.75%, just think what will happen if they were 8.75%? Either

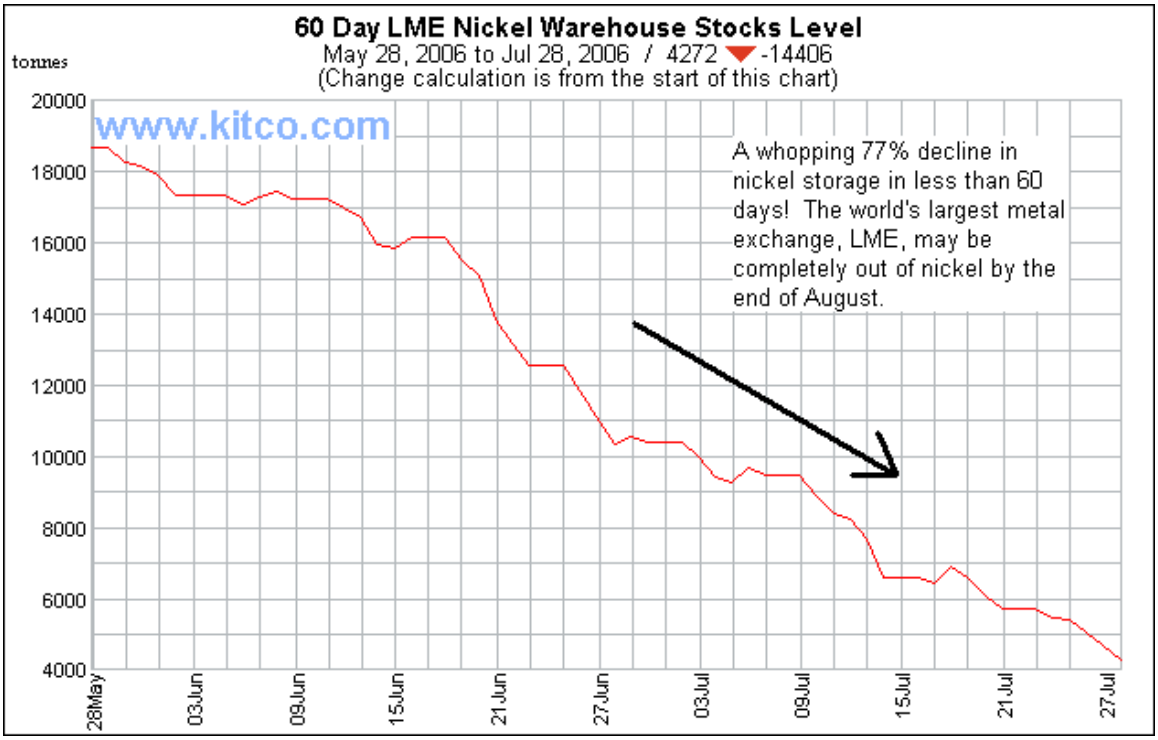
way the Fed moves on August 8th, they will have effectively lost control of the dollar and gold. The currency trading crowd has bid up the dollar since May 2004 because the Fed was going to continue to raise interest rates. The Fed tightening campaign has raised the Fed Funds rate from 1% in May 2004 to 5.25% today. The US dollar index was around 92. Now after all this time, the US dollar index stands 7% lower at 85.4. Our trade and Federal budget deficits are worse now than 2 years ago with no sign of abating. Just think where the dollar is going to go now interest rate tightening is soon to be over? One fundamental truth is if the dollar goes down, commodities go up.

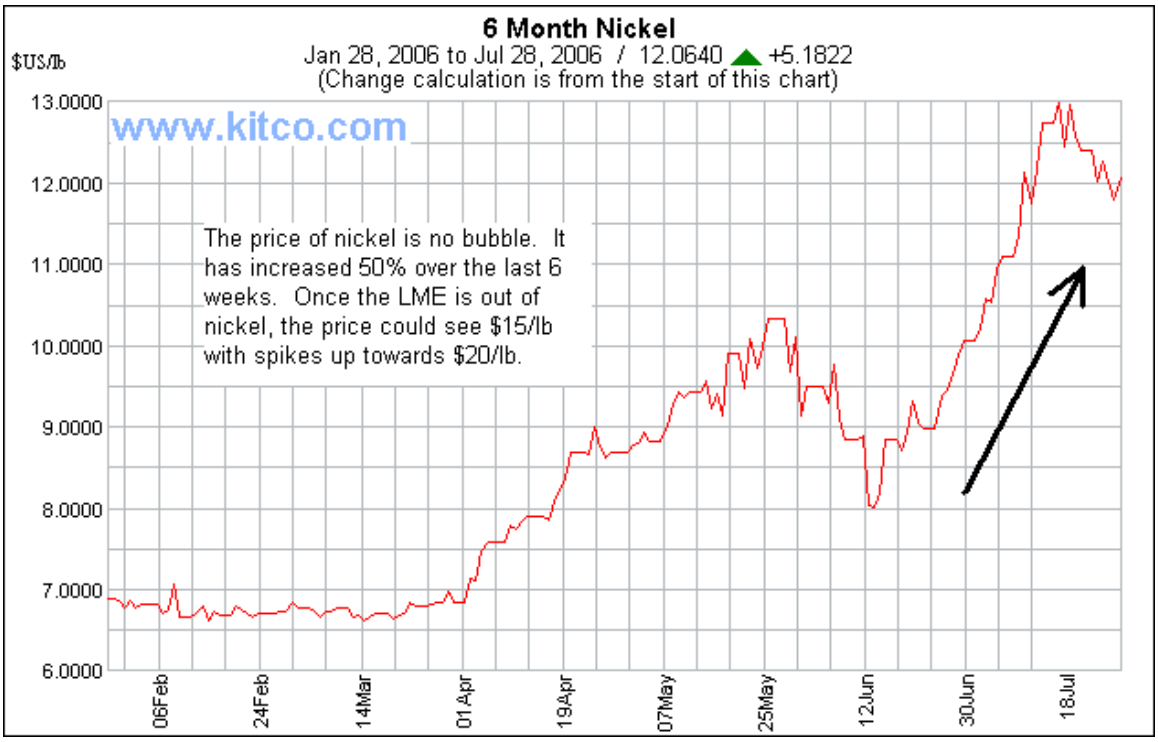
Here's the latest chart of the dollar:



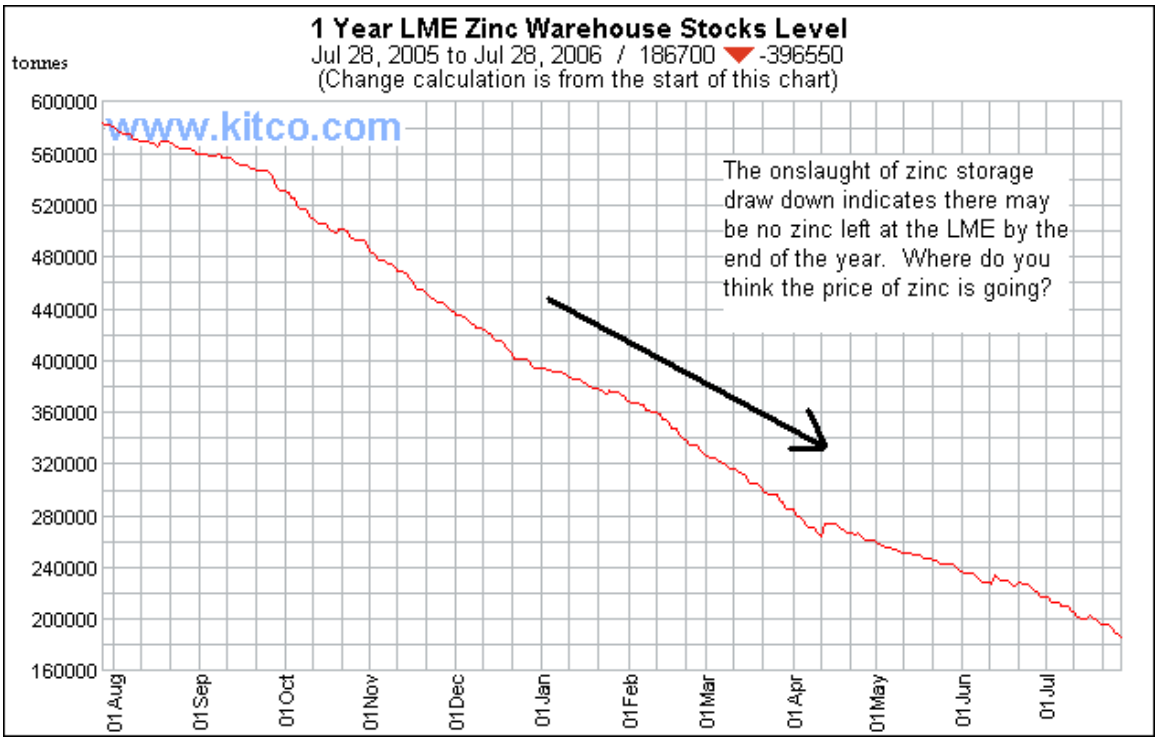
A weakening dollar is very bullish for commodities. As can be seen from the above chart, the dollar is just about to break support for another run to the down side. What adds fuel to the commodity fire is demand has been absolutely insatiable. China, India and the rest of South Asia are rapidly growing and building infrastructure. What most people do not realize is how tenuous commodity supply has become. I brought to your attention how rapidly Zinc and Copper storage levels have been depleted. Time to add another to your awareness: Nickel. China's output of stainless steel has increased 30% year over year. Most alloys of stainless have 5-12% nickel added to make them corrosion resistant. Recent data has shown nickel concentrate imports into China are up 1200 % y-y. That is no typo folks, 1200%. The London Metal Exchange has seen a run on supply. In the last 60 days, the amount of nickel in storage has plunged 77% and looks to be going to zero within the next month.

Supply is so tight that Inco's (2nd largest supplier of nickel) marketing executive was quoted last week saying Inco is now turning away customers!

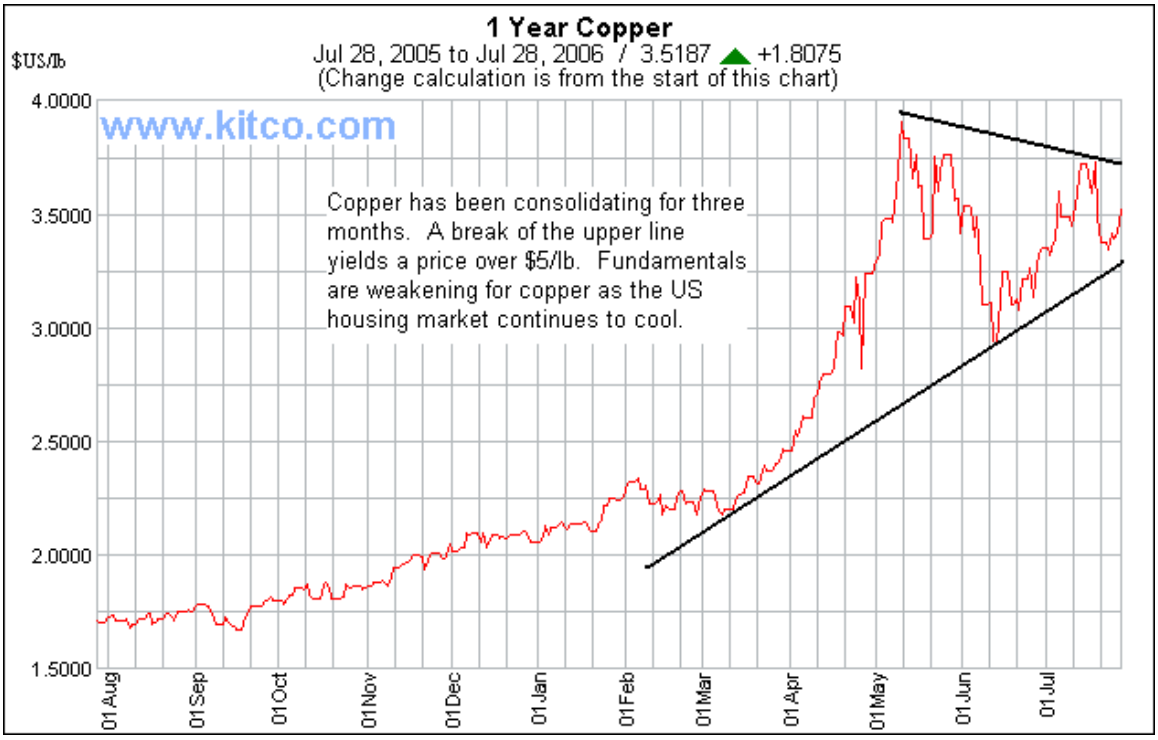




Now what about Zinc? Zinc storage has continued to rapidly deplete and may be heading to zero by year's end. The following charts illustrate the LME storage draws and the subsequent price action attributed to demand.



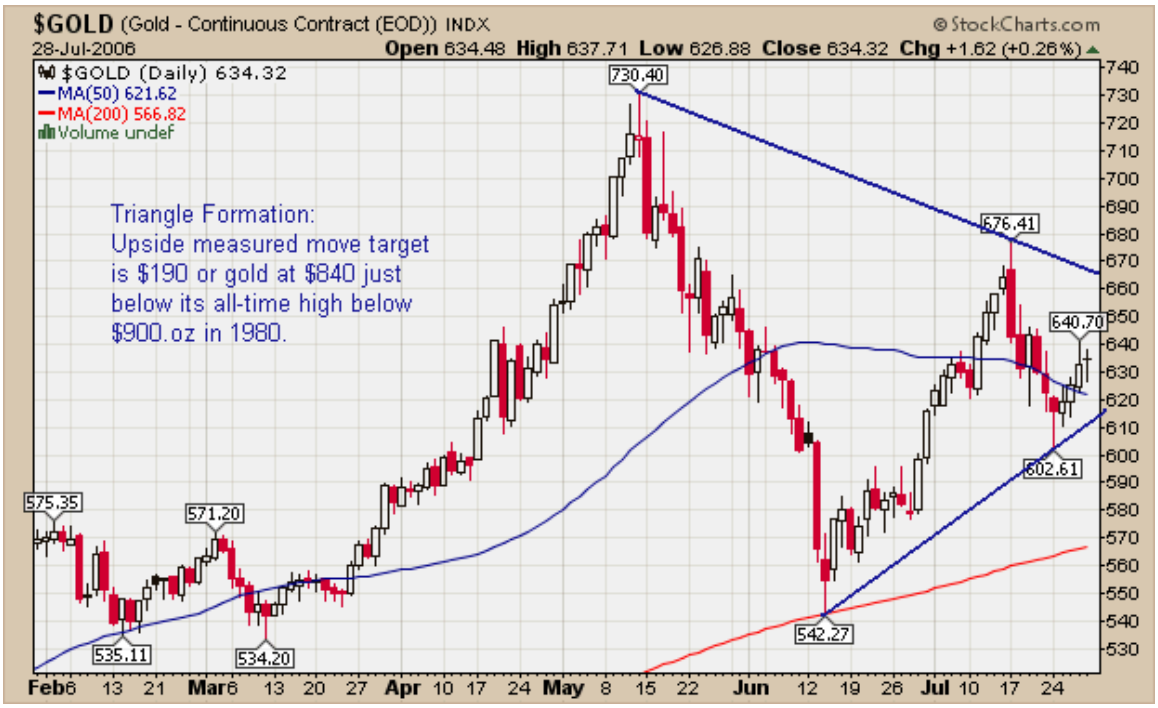
Copper had a tremendous run since my last update in March. It nearly doubled before consolidating. I am less bullish for copper continuing a rapid increase. Its price has been high for so long that a fair amount of demand destruction and material substitution has taken place. Here's a 1 year copper chart.



The charts of Copper, Nickel, and Zinc are fairly representative of the base metal complex. Other metals such as Indium, Rhodium, Molybdenum and Cobalt have seen as much as 20 fold increases in price during the last five years.

Now for the king of commodities: Gold. It has had a tremendous run since my last update touching a 26 year high at $730. We collectively have had exceptional gains in our portfolios. Then, in mid-May the LME was rumored to be approaching default. The Bank of England dumped a huge amount of leased gold on the market causing Gold and several other commodities to plunge. Both Gold and Silver have been recovering from the coordinated attack.

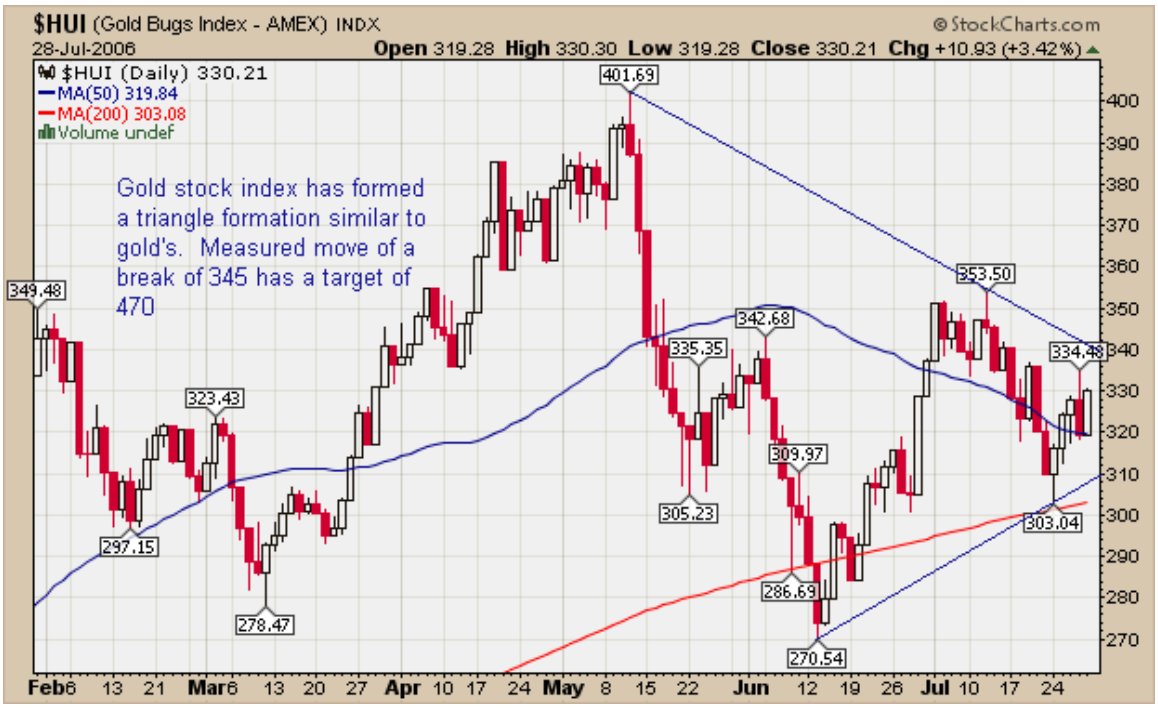
The charts for both Gold and Silver are looking bullish, after forming Symmetrical Triangles. Typically these formations break to the direction of the previous trend, which both is up. My suspicion is Gold will not be allowed to break out over $670 until after the FOMC meeting on August 8th. The primary reason is they will want to halt raising interest rates and signal inflation is contained. Nothing would put more egg on their face than have gold soaring while putting on an inflation happy face.



After the pounding we took in our investments in May, people are wondering if we are done seeing the good times. My answer is a resounding NO. The happy

time in Gold, Silver and the Shares for the last three years running is the August to February time frame. There is typically a mild correction in the first week of December, but otherwise seasonality plays very well for the sector. Add to the fact commodity demand remains strong and in less than two weeks the Fed will be neutered in their effort to prop up the dollar, this season may be our best.

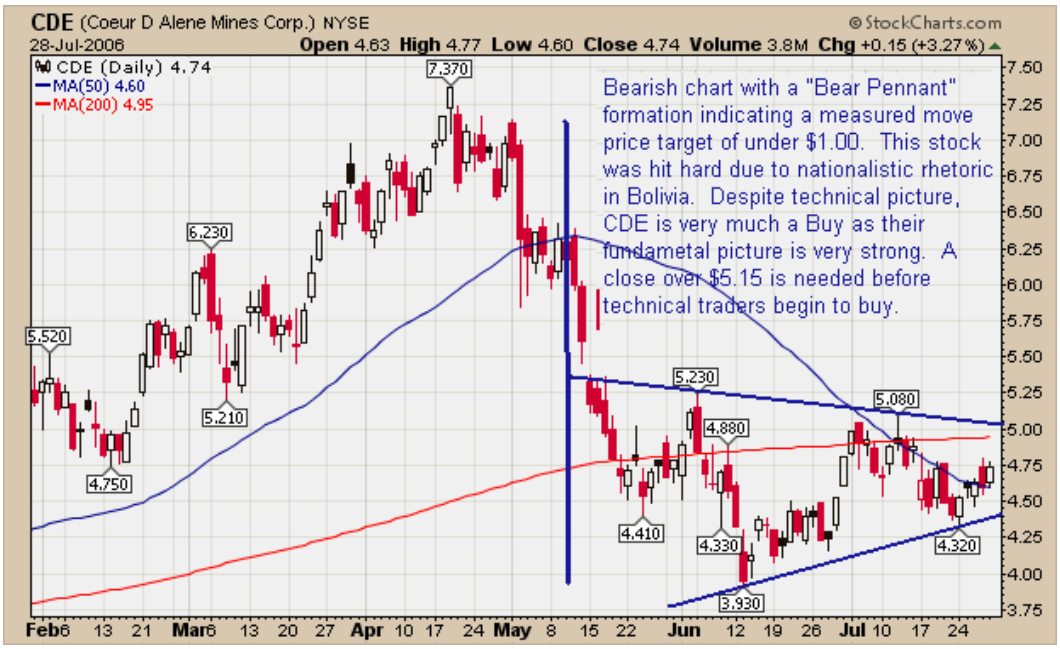
My last chart of this section is the AMEX Gold Stock Index, HUI. We are looking at a bullish chart. A close over 350 will be the green light for much higher mining stocks. Gold stocks are much more easily manipulated than Gold itself. Look for a pull back on Monday, August 7th, as the Gold Cartel will want to hammer the shares to influence a downward price in Gold the following (FOMC meeting) day. That day may be the one last great buying opportunity of the year.



Stock Recommendations:
We have had a tremendous run and pull back since my last update. Gold and mining stocks have plenty of upward potential as Gold eventually goes to $1000/ounce. You should always do your own research before investing in any of my recommendations despite my track record of finding stocks getting double and triple digit gains. I've also named a few turds over the years. Here are recommendations with commentary:

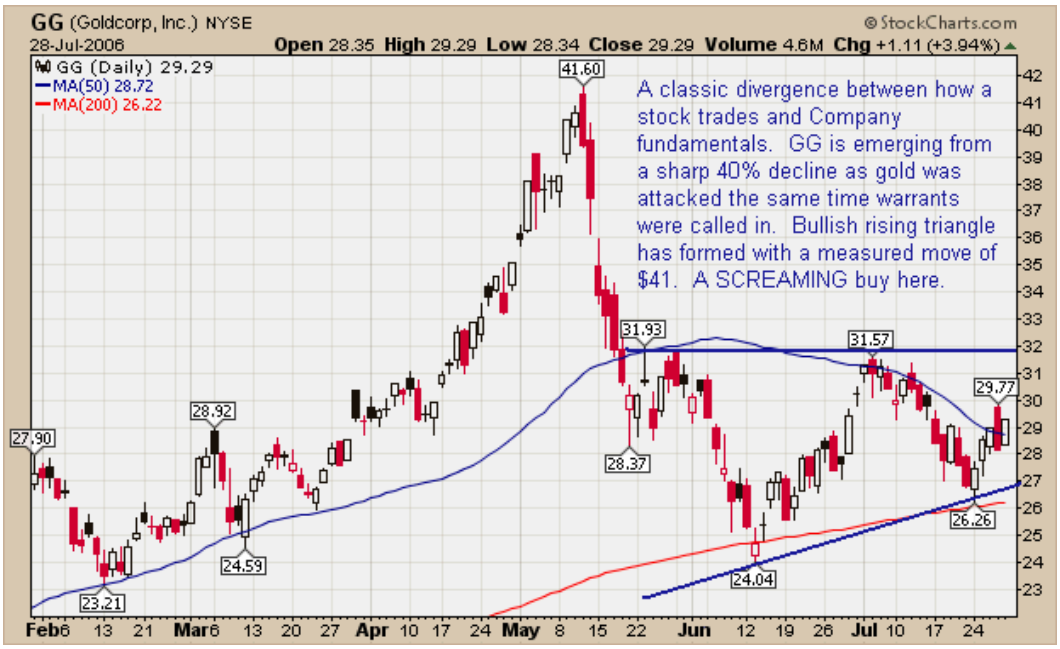
1) **Yamana Gold (AUY)**: Yamana is rapidly growing gold production and could be the next Glamis (with a high P/E). 2006 production is slated to be north of 350,000 ounces at a cash cost of under $280/oz. The $12 stock target in my last update was met followed by a correction and consolidation. Look for Yamana to challenge its lifetime high of $12.42 soon, unless they should disappoint on the earnings front. **NOTE: Q2 earnings should be out the week of August 7th.**

2) **Coeur d' Alene Mines(CDE)**: Coeur's stock has been taken to the woodshed by dropping almost 50% in two months. They were caught in the general down draft in May, but rhetoric from the newly elected Bolivian government provided a big push down. Bolivia was threatening to nationalize all mining operations, i.e. take them away from their owners. Coeur is developing a large 8 million ounce a year silver mine there. The market was worried that would go away. Bolivia knows who butters their bread and has since dropped the idea of nationalizing mining as it is a big source of income. The price drop has provided for an exquisite buying opportunity. I have calculated Q2 earnings to beat the street at $0.09/share. If you have some dry gun powder, I'd add CDE to your portfolio before earnings release. **NOTE: Q2 earnings will be released before market open on August 1st.**



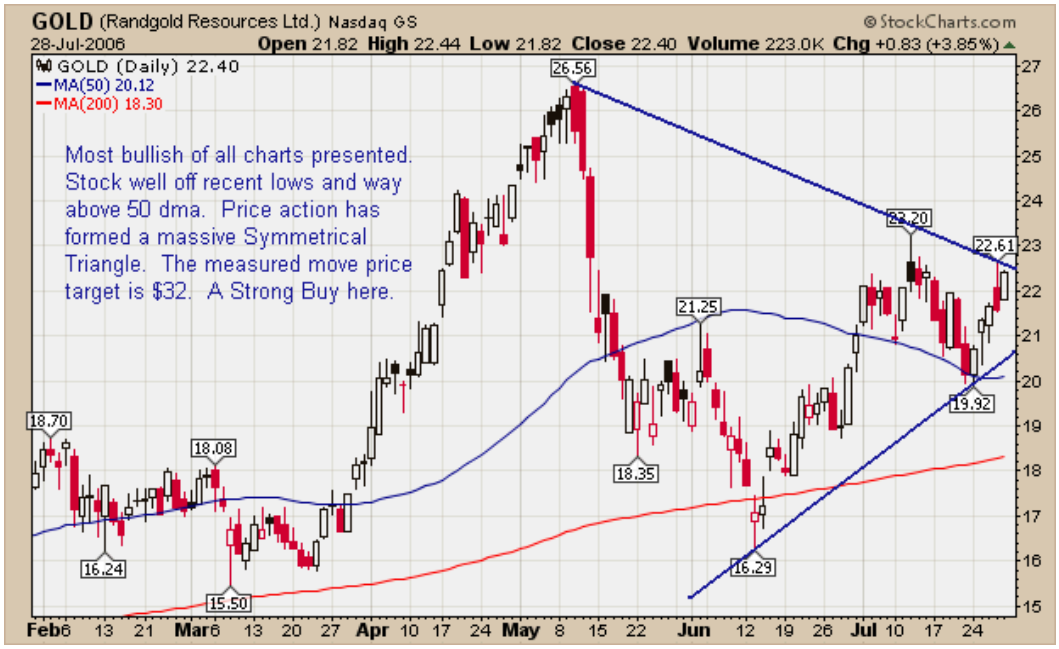
3) **Century Mining (CMM.V):** Century is a small cap gold producer trading on the Canadian Venture exchange. You can buy Canadian stocks in the US by using their pink sheet tickers. This company will produce about 100,000 ounces of gold this year. Miners are valued at $400 - $500 million when producing the 100k level of gold. Century's market cap is approximately $120 million. The reasons for the low market cap today are it is under the radar of most investors and they need to have 1 – 2 quarters of earnings out. **NOTE: Q2 earnings should be out the week of August 14th.**

4) **Goldcorp (GG)**: Goldcorp's stock has been pasted recently without any fundamental reason. If you only want to invest in one mining stock, Goldcorp is it. They will again report earnings and cash flow much higher than their peers.
NOTE: Q2 earnings will be released after market close on August 10th.

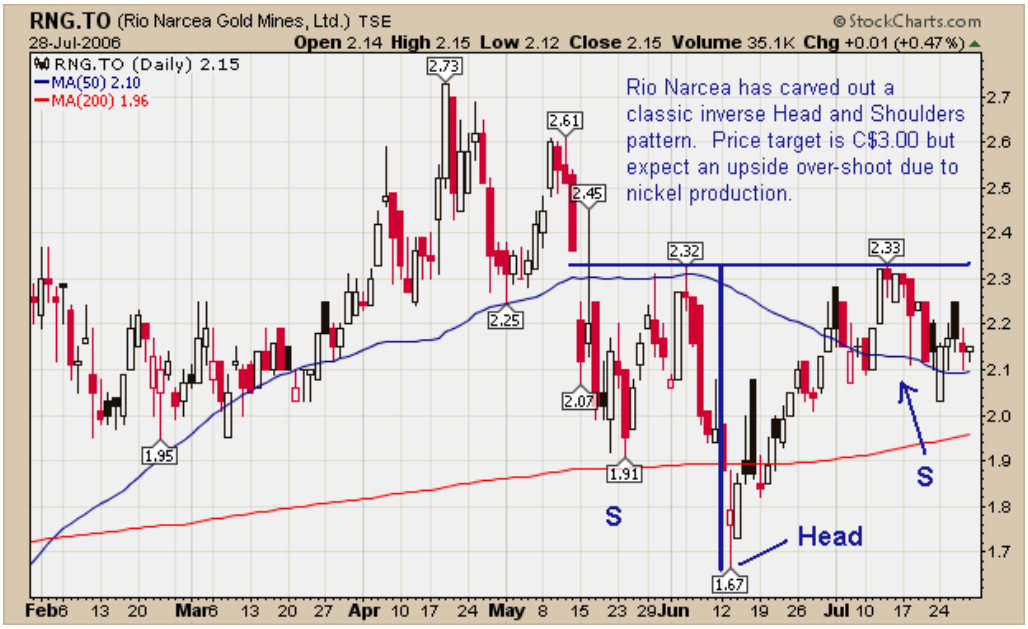


5) **Northgate Minerals (NXG)**: Northgate has finally lost its Rodney Dangerfield status since the last update. Eventually the market will reward companies, like Northgate, producing great earnings, cash flow and with a strong balance sheet.
NOTE: Q2 earnings will be released after market close on August 10th.

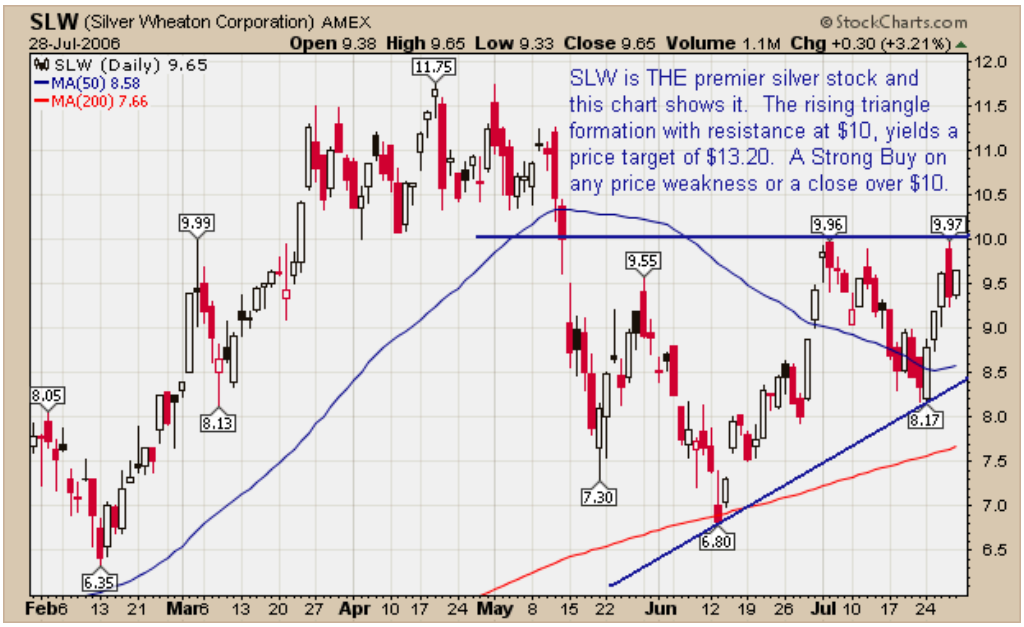
6) **Randgold Resources (GOLD)**: Randgold also left Rodney Dangerfield behind. Behind Goldcorp, Rangold is a must have gold stock. The market has begun to recognize this earnings machine and the stock is the healthiest of all the gold's I follow. I like to value miners by how their market cap and earnings compare with their peers. On these two metrics, Randgold offers an exceptional opportunity. Meridian Gold (MDG) has a market cap of $2.75 Billion and just reported earnings per share of $0.18. Meridian's annual gold production for 2006 is forecast to be 260,000 ounces. Compare this against Randgold. Randgold has a market cap of $1.5 Billion, 2006 production should be north of 450,000, and, Q2 earnings should be above $0.25. **NOTE: Q2 earnings will be released before the market opens on August 7th.**



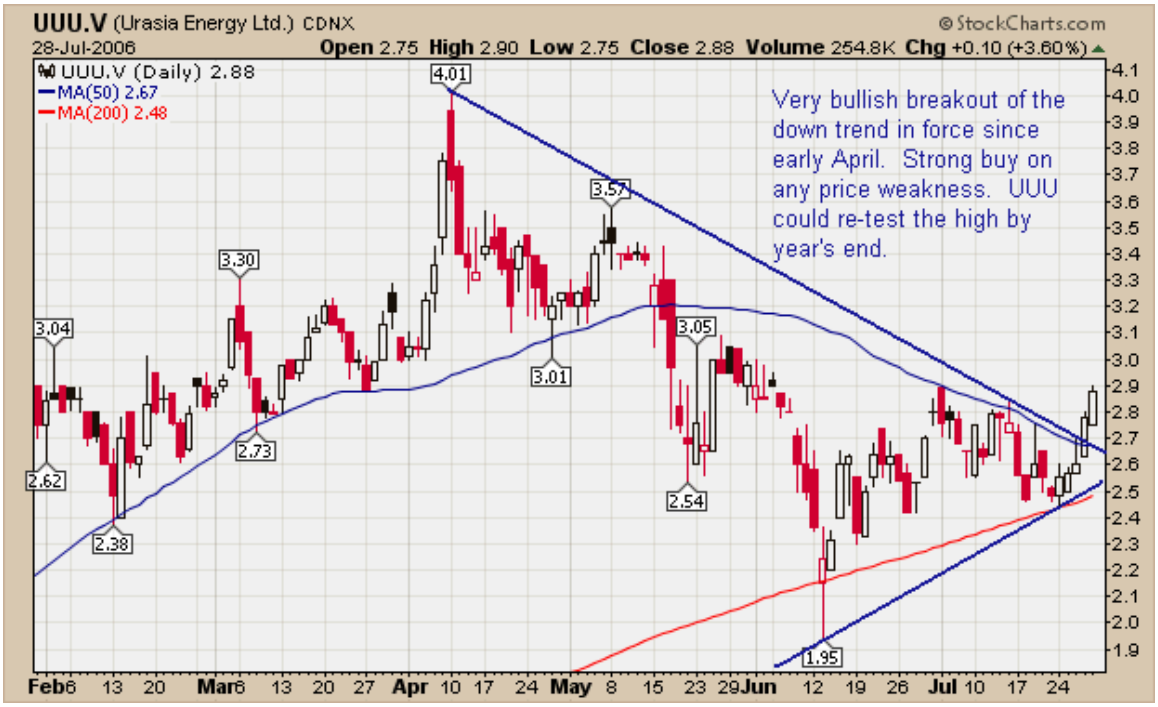
7) **Rio Narcea Gold Mines (RNO):** Rio Narcea has tremendous upside potential this year. They produce 18 million pounds of nickel per year along with copper and gold. The market will begin to reward the stock going forward as more players begin to realize the huge amount of earnings and cash flow coming from their nickel production. I strongly recommend adding Rio Narcea to your holdings. **NOTE: Q2 earnings should be out the week of August 7th.**



8) **Silver Wheaton (SLW)**: Silver Wheaton is increasing silver production by 50% in 2006. Coupled with high silver prices, SLW has the most leverage to silver prices in the industry. I highly recommend the stock. **NOTE: Q2 earnings will be released after market close on August 3rd.**

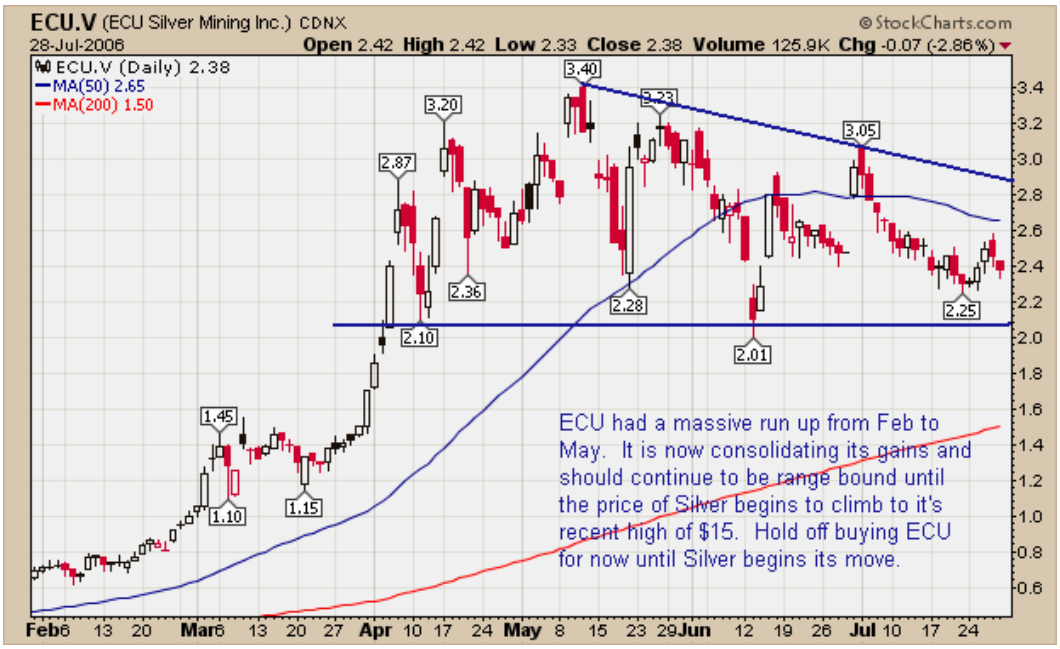


9) **UrAsia Uranium (UUU.V)**: UrAsia has been trending down since my last update. Uranium has gone from $36/lb in January to $47.50 today. UrAsia just broke out of a long term down trend line. It should follow most energy stocks up or down.



Other Stocks with Potential:

1) **ECU Silver (ECU.V):** ECU is a Gold, Silver, Zinc and Lead producer. They have discovered a world class ore body on one of their properties. It had a huge run up in price and is now digesting those gains. ECU will only break out of its most recent trading range once Silver begins to soar again.



2) **Chesapeake Energy**: Just released blow out earnings. They produce oil and natural gas. The stock is an excellent play on energy and is recognized as a blue chip.

3) **Revette Minerals (RVM.TO)**: Revette is a grossly undervalued Copper and Silver producer. They are earnings and cash flow positive with a bright future ahead of them. The stock is largely unrecognized by the market. Its stock price could triple and still be undervalued relative to its peers.

Final Thoughts:
I just can't be much more bullish about the upcoming fall season. We will see violent swings in the price of Gold, Silver and mining shares as the Official Sector counter-attacks commodities to slow investment interest. I believe we will be handsomely rewarded by the end of the year.

Happy Trading,
Toby