

Managing Director's View

As all our clients should well know, here at MPS we are very bullish on resources and in particular gold. The presentation given last week on 17 May pointed that out very strongly, despite that 'flash crash' that happened of a 1000pt intraday fall in the Dow Jones Index.

The gold price recently made new all time highs in most currencies except for the strong resources currencies such as the A\$ and Brazilian Reals and it is telling us all very clearly that the net effect of worldwide government deficits and bail outs is debasement of currencies and the expected rise in inflation.

The Rudd Government's proposal of the new Resources Super Profit Tax has also spooked the market by increasing Australia's sovereign risk profile and creating great uncertainty. The MPS considered view (after nearly 35 years in mining finance) on this new tax is that it will fail because it is very poorly conceived, has not had proper industry consultation and is probably unconstitutional. Another Rudd backflip is likely and could be terminal for the Rudd Government in this year's election. It is very clear to MPS that the new tax would have the following effects:

- Major negative impacts on NPVs (down 30-40%) would push marginal corporate tax rates to 55-62%; would raise 'cut off grades' in mines so mineable material would be reduced (leading to a reduction in resources); make project financing very much harder with more equity required; and
- Foreign investment component would be cheaper and would get larger share of the projects; interest rate costs would attract a higher borrowing premium; equity values would be reduced so dilution to shareholders would increase; low cost and/or high grade mines would be penalized for excellence; poor projects would be rewarded.

The Super Tax at 40% also cuts in BEFORE interest costs so in the higher interest rate environment of the next decade many projects could be simply unviable. Furthermore the proposed rebate of tax to exploration companies is just laughable. Why should taxpayers reimburse bad or unsuccessful exploration projects?

The issue of royalties imposed by State Governments is being distorted by the Rudd Government. It is the considered view of MPS that State royalties are a cost of production paid to the Crown (State Govts) for extraction. When prices are high, royalties are high, when prices are low then royalties are low. Royalty income should be spent in the region where the extraction is taking place not redirected to a central fund to be spent elsewhere. Ross Garnaut's Bougainville Supertax did exactly the opposite – sent taxes from the Bougainville Copper mine away from local recipients and on to central Port Moresby. The Bougainvillian rebels reacted by closing the mine - and so everyone lost.

MPS believes the issues are so great that the mining and finance industries will make it very hard for Rudd and Swan to proceed much further.

The moves in the markets over the past two weeks seem so similar to the Dec Half 2008 sell off and the panic is being most felt in the Euro and in equities. MPS believes this has brought the best opportunity since Dec 2008 to enter the resources market cheaply ahead of the major new upleg.

It is important for investors to understand that the volatility caused by hedge funds and the like is not correctly reflecting the underlying features of global economics. The OECD West is being overtaken by the East (China, India, other Asia, Middle East North Africa) and South (Brazil, Australia, Africa, etc) where strong growth in basic industries is driving the demand for commodities. The current Chinese steel production rate of 675mtpa (*cf* USA at 83mtpa) is up from 620mtpa in January and is the best indicator of growth in the real economy. The supply side issues in commodities that MPS has emphasised for years are still with us and evidence is mounting that major corporations in the US, UK and Europe (even Japan!) are turning up with the economy. There is no possible 1930s style Depression when economies are growing, governments are pumping liquidity, US corporations have very strong balance sheets and earnings are growing.

Inflationary pressures are building and the MPS view of the sea change in bond yields is still thriving. The volatility in markets can be best explained by just observing the rearguard action of the financial sector after almost 30 years of bull market to smash down the emergence of the inflation beneficiaries being gold, commodities, resource currencies and resource equities. This volatility is marking the turning period.

MPS is also greatly encouraged by the subtle changes in market character of the past few months. Interest from the UK in Australian resources stocks has traditionally been at the early stages of strong markets and it has been glaringly absent in this great commodities bull market that began over 11 years ago in Dec Qtr 1998. This together with another subtle change in Traders Commitments on COMEX (after a decade where bullion banks have been attacking gold and silver from the short side) suggests that shorts are being aggressively covered and action may now be to play gold from the long side.

As suggested in the invitation to last week's Gold Outlook the misery of the past two years for small cap resources should now be overwhelmed by a very strong period as we continue on the Optimism Upleg! Stay the course!



BARRY DAWES
Managing Director
B Sc F AusIMM(CP) MSDIA

Barry's expertise in the resource investment sector is based on his knowledge from his original career as a geologist and over 30 years' experience in the resources investment sector. Prior to founding MPS in 2000 Barry had worked in senior executive roles of investment management with BT Australia, equities research for Bain Deutsche Bank and equities research and corporate finance for Macquarie Bank. He is also currently a Director of ASX listed Uranium Exploration Australia Ltd, of Superior Coal Ltd, of several investment companies and of a number of unlisted public operating companies. He has also arranged development finance for many listed resource companies.

DISCLAIMER: *General Securities – Advice Warning*

Martin Place Securities Pty Ltd makes no representation and gives no warranties to the accuracy or reliability of any information contained in this document and does not accept any liability for any loss caused by representations, errors or omissions on the part of Martin Place Securities Pty Ltd or by any of their respective officers, employees or agents. This report is not a disclosure document and is not an offer of any securities. In preparing this report, Martin Place Securities Pty Ltd did not take into account the investment objectives, financial situation and particular needs of the reader.