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GENERAL OUTLOOK

- I still think that the BRIC-driven commodity supercycle is intact. I think that Brazil, Russia, India and China will be 'Westernizing,' so to speak, as they develop in the next 10 years, and that will give a positive vibe to commodities. There won't be a lot of help from the Western World, but I still think that we're generally in a positive commodity environment for some time to come. And there may be a positive kick to that as well by any generic debasement of the U.S. dollar going forward.
- I'd like to reiterate the view that I gave back in 2004: that the Federal Reserve will never run tight monetary policy again. Bernanke's stated objective of printing money to solve all problems is going to be a massive failure, but it's going to be very conducive to hard assets doing well.
- I do think that another formal round of quantitative easing is going to occur. Yesterday, we noticed the Fed put \$2.4 billion into the \$6 billion T-Bill option. So that's printed money. At the margin, that raises the intrinsic value of gold by \$10. This \$6 billion daily borrowing requirement is pretty much status quo. This is what they need every day to pay their bills. The rate of increase in federal borrowing is about \$2 trillion dollars a year, so you divide by the number of days and that's what you get, \$6 billion a day.
- That's the backdrop for what I'm thinking about when I look at metals. I'm going to start talking first about the non-precious metals, and I'm going to finish up with the precious because I think they're more important perhaps or more attractive on a risk-reward basis.

GOLD

Long-term outperformance

- I'm going to start off by looking back 10 years and telling you that the gold price in Canadian dollar terms over that period has risen by approximately 280%. Over the same 10 years, the CRB Index, the commodity basket, rose by about 38%, the Morgan Stanley World Equity Index fell by approximately 17% and the S&P 500 Index fell by about 9%.
- Ten years from now I suspect that those asset class returns will be very similar. I think gold can easily triple this decade. I think commodities will do okay, but will pale in comparison to what gold does, and I think equities will be labouring in this post-credit-contraction environment, and possibly be impacted at some point this decade by yield curve issues, which raise the discount rate on cash flows.

Supply/demand: still the story

- In 2009, we set a new high for gold supply by 36 tonnes over the 1997 high. In 1997, supply peaked out at approximately 4,251 tonnes. Last year, we hit about 4,287 tonnes. That new record was facilitated primarily by a surge in scrap, which accompanied the massive liquidation that occurred in the first quarter of 2009 as we came to the bottom of the sell-off related to the credit crisis. That surge in scrap is about 600 tonnes above the previous four-year average, and it's clearly unsustainable unless you have a rising gold price. I think that supply number will drop sharply this year. It could easily drop a few hundred tonnes from what I've seen to date and with anecdotal feedback from bullion trading desks.

- The other bit of a surprise was that mine production grew last year to 2,572 tonnes. Still flat over a many-year period, but we did have a bit of growth in China, which is hard to forecast. Some growth in Russia from the new Kupol mine that Kinross Gold Corp. operates. We had a surge in Indonesia, primarily from a high-grade cycle at the Grasberg mine that Freeport operates.
- Year-to-date 2010, just looking at the first quarter alone, I can tally up about 87 tonnes of lost production. That production is not coming back due to mine closures or from high-grade cycles that have wound themselves down, such as at Grasberg. That 87 tonnes is about 3.5% of mine supply. There will be some new mines coming on stream this year from Agnico-Eagle Mines Ltd. here in Canada, and Newmont Mining Corp. in Australia, Barrick Gold Corp. and a couple of others, but I don't think that will offset the closures, the grade cycle declines, or the chronic South African operating problems and associated production decline. I do expect mine production to be back on the downside again this year, by a percent or two.

The world is buying gold

- Turning to central banks, what we see Year-to-date is that Russia has bought 72 tonnes in the first half of the year. That's about 75% of the production rate of Russia as a country, so they're tucking away most of the gold they produce. In China, we can't get numbers since China doesn't report its activity to the International Monetary Fund (IMF). Rather, it hides its gold purchases in subsidiary banks and brings it out and tells the IMF about it whenever China feels like it. But, anecdotal feedback from those who operate in China, particularly Eldorado Gold, is that the Chinese central bank is buying gold and buying whatever is not needed by their domestic fabricators, then tucking it away. It is hard to say what the number is, but they're clearly not keen to have any gold leave China, and they've actually been very proactive in encouraging Chinese

citizens to buy gold as well. China is a net importer of gold this year, and from time to time China is surpassing India as the number one consumer.

- In the Middle East, I was at a conference in Dubai in March speaking about gold. I chatted with a fellow after the conference who is a chief investment officer for a Middle Eastern country. He indicated to me under anonymity that his country was converting 200,000 barrels per day of oil production into gold. I asked him what price they were doing it at, and he said, "Whatever the price is." Clearly, they're not price sensitive. They're doing that with a view that the U.S. dollar is somewhat challenged and that gold is going to do quite well in the next few years. Their 200,000 barrels per day works out to about a half a tonne of gold per day, 180 tonnes a year. That's a big number; it's comparable to sterilizing most of Australia's gold production for example.
- Iran came out a few weeks ago and said it wanted to convert 45 billion euros of their reserves into a combination of U.S. dollars and gold. It would be tough to figure out what they actually do, but as a starting point if they converted one eighth of that amount into gold, it would be 160 tonnes a year, again equivalent to the output of a small country.
- It's not hard to see that there's significant tonnage being tucked away by official buyers around the world. It's hundreds of tonnes, and it's probably going to grow. My gut feel is that there's essentially infinite demand for gold as money at this point, and the big players are just trying to squeeze the gold into their possession without spooking the market. Even China comes out every couple of months now and bad-mouths gold in some way. Even though they're encouraging their citizens to buy it, whenever it comes to a public comment about their central bank policy they pooh-pooh it. They're playing poker, they're bluffing.

- In terms of other investment flows we had approximately 617 tonnes of gold tucked away into the various ETF products around the world last year. This is a 4,000 tonne market, so it's a big number. Year to date, it looks like about 250 tonnes, a little bit less than last year's run rate but still a big number.
- We hit a record in 2009 for official coin sales, about 228 tonnes. We're running at a similar pace this year. I would mention that I happened to catch a YouTube clip that my son pointed out to me about gold coin sales in New Zealand. This fellow who runs the mint down there was being interviewed and the reporter was asking him why gold coin sales are so spectacular in New Zealand and why New Zealand citizens were so anxious to own the stuff. And he said, "Well, actually we sell 90 percent of our gold coins to Russia." Not to Russian central banks, but to Russian citizens. So they've got that desire in Russia as well. They can't get it at home. They buy it in New Zealand, so an interesting sign of the times.
- In terms of fabrication demand, I would still characterize it as being in a severe depression. We ran at about 2,400 tonnes last year. That's 700 to 800 tonnes below normal pre-credit crisis normal, and we're still running in depressed mode this year. Clearly, that differential was being sucked up by other players. I think looking at the collective ETF, central bank, Middle Eastern activity, etc., it's not hard to see that fabrication demand is being comfortably replaced and the gold price is acting well.

Extremely bullish on gold

- For the past, almost six years now, I've been suggesting that gold should rise about \$100 a year based on it being an inelastic commodity. As the price goes up, there's no increase in supply. In fact, until last year, it was experiencing a multi-year decrease in supply. I think that in 2010 we're going to see that the supply to the market this year will be less than supply to the market was 10 years ago. So that

\$100 a year was a good guideline. It seemed to work pretty well, but I don't think it's going to work anymore. I'm officially revising my gold forecast; I'm going to say 10% to 15% a year increase in U.S. dollar terms.

- The rationale for that is that the U.S. fiscal position is so alarming that it's going to have an impact on the way people behave in the marketplace and clearly it already is. We've made an attempt here to quantify how fast the deteriorating U.S. fiscal position should push gold up. And what we found is a couple of data series that go back several decades, which have remarkable correlations. The first one is the total debt-to-GDP ratio in the U.S. so corporate and government debt relative to the size of the economy that supports that debt. It's running at about 220% at the moment, but it's rising at about 6% a year based on federal debt increases alone as corporate debt increases are pretty much non-existent these days. If you plot the inverse dollar purchasing power against that rise in debt to GDP, it's a tight correlation and it's rising at 6% a year. It suggests that the U.S. dollar should be depreciating in purchasing power by about 6% per year based on what's happening with debt in the U.S. That data series would suggest that gold might rise 6% per year. With a 6% per year increase, it would be less than \$100 gain each year.
- The other data series that I'm going to put more weight on is the twin deficit-to-GDP ratio in the U.S.; you're looking at federal deficit plus trade deficit. And the trade deficit is a half a trillion dollars per annum. It moves fairly slowly up and down, and it's not the tail wagging the dog here. It's the federal debt increases that wag the dog. The U.S. GDP is running at about \$14.6 trillion. The rate of increase of debt is about \$2 trillion a year. Two divided by 14.6, it's about a seventh, so call it 14% or 15%. In the context of a stalled gross domestic product in the U.S., that ratio is rising at about 14% to 15% per year.

- If you plot gold adjusted for any dollar weakness against the basket over the past two decades, you get a remarkably tight correlation of the world or global price versus that twin deficit to GDP ratio. That ratio is rising at 15% a year in the context of a flat GDP. If you assume GDP is going to struggle up 2% to 3% a year, as it hopefully will, that still leaves you with an 11% to 13% rate of increase in the debt-to-GDP ratio. This suggests that gold should keep rising at that rate. It doesn't mean gold is going to \$2,000 tomorrow but it suggests that gold can rise, about \$150 to \$170 a year, and we should make new highs in the gold price every year.
- Now, if Obama and friends come out next week and say, we're going to raise taxes by \$1 trillion and slash spending and do all the things that they might want to do, that would certainly change my forecast again. However, I would point out that government borrowing is what's keeping GDP positive. It has been for the entire last decade and actually beyond that. If you significantly curtail government borrowing you'd have to have a rapid economic response to offset the damage to GDP. I think if they're going to do anything like that, they'd have to tread very carefully. I'm not too worried about them doing that in the near future but it's something that you should be aware of: that if the U.S. tries to correct its fiscal position in a dramatic way, it will knock gold lower.
- Back in the 1990s when Clinton was in power, the congressional budget office was actually starting to forecast surpluses at the government level instead of deficits. I remember sitting in the trenches running gold portfolios thinking, "Oh, great. Surplus is not good for gold." Gold suffers under surpluses. It does very well under deficits. I think deficits are actually here for many, many years to come. And I'm not even including in my analysis anything at all about the unfunded healthcare, or social security promises that the US government has made, and they're in excess of \$100 trillion. They'll likely all be reneged upon in some way or paid with

vastly depreciated dollars. But I'm not even counting that. Just based on steady state numbers that I'm seeing right now, which I think will persist for at least a few years, then gold has a very steady climb ahead of it.

- I'm not going to sit here and pound the table and say that gold is going to be \$2,000 per ounce next week. That's not my style. What would cause that might be an event that we're not even thinking about, or it might be an economic deterioration that's hard to forecast. I don't know the timing. I'm just saying that at the moment, everything I look at is a green light for gold to go higher.

Impact of a double dip or deflation

- We all worry about double dips and how they might impact our portfolios. A double dip is actually good for gold. Debt to GDP goes up faster so it's good for gold. Even if there is some short-term market pressure taking things down, the prospects for gold get better in a double dip.
- In terms of the potential impact on my portfolios, consider this. Over the past five years, the correlation of Sentry Precious Metals Growth Fund to gold was about 74%. The correlation of the Fund to the S&P/TSX Composite Index was about 54%. And the correlation of the Fund to the S&P 500 Index was about 30%.

OTHER PRECIOUS METALS

Platinum/Palladium

- Platinum is going to receive a little bit of a boost because of changes in the mining code in South Africa. This is going to slow down platinum mining for some of the players down there because of safety concerns. Having said that, the platinum and palladium markets are running small surpluses, but nothing that can't be offset by a little bit of investment demand or any kind of optimism on the economy, strong car sales in China, etc. The main issue with

those two metals is how you play them on the equity side – not many names to choose from. So it's not my focus.

Silver

- There have been no significant changes to my view on silver from past presentations. I do think it will generally keep up with gold. The fundamentals aren't quite as good due to modest silver production growth. You'll notice that the gold/silver ratio has widened out as economic concerns come to the forefront; that's completely normal. I wouldn't get overly fussed about it. We are in a precious metals bull market and silver will be fine, but it could lag gold for extended periods of time as the economic issues become centre-stage concern.

BASE METALS

Uranium

- Uranium has been hovering just above \$40. I'd like to remind everyone that \$40 is an inflection point in the recovery cost for uranium. If uranium drops below \$40, you physically get less uranium out of the ore that's put in the plant into the refinery because it just costs too much to get it out at sub \$40; so this is probably the floor. There have been some headlines recently because the Chinese have started to come into the market and buy some material for stockpiling. They're still leading the way for nuclear reactor build-out over the next decade. It's probably a wise thing for them to do since this is probably as cheap as it's going to get. Particularly if you're somewhat concerned about the integrity of the dollar, why not buy it now. Even if you're just stockpiling it for later years, it's a good time to pick it up.
- It is impossible to say how determined the Chinese might be at accumulating metal, but we're probably at the floor. The question is, "When do we come off the floor?" Given production growth out of Kazakhstan and out of Namibia and

Malawi, in particular, the market is well supplied. There is no need for the price to go up at this point. There's still 550,000 pounds of Department of Energy material that's up for sale. This material is being sold to fund the clean-up of a refinery that made a bit of a mess in the U.S. This should be the last tranche of Department of Energy material sold. Once it's gone, the market could strengthen. We may have to wait a year or two though for the market to significantly strengthen based on a fundamental shift in supply. We have to look forward to 2013, the month of February, when the Russians stopped giving us 20 million pounds of highly enriched uranium – over a 10% reduction in annual supply.

- The markets, being forward looking, will probably tighten up well before 2013. My best guess is that by the second half of 2011, the market will be looking forward to that date. Utilities I think will be very anxious to load up before the loss of that material. As my best guess, I would say that's still a year away but it could happen sooner.
- At this point if you want to be in the uranium names, the primary names, in anticipation of an eventual turn, you have to suffer through unfortunately an expected return environment of pretty close to zero while you wait for the uranium price to rise and give you some return in the uranium producers.

Molybdenum

- There are certainly some economic slowdown concerns that could hurt the molybdenum (moly) price. We have had a couple of dips in the price since we made the bottom during the credit crisis. The lows are getting higher, so to speak. The moly price is not being pushed down as hard when the market gets a bit skittish, and part of that reason is there's not the overhang of trade inventory to be liquidated that there was a couple of years ago. Secondly, I think the world is starting to understand that the marginal production

cost for molybdenum is \$13 per pound, which is what China needs to keep all its production going.

- On the positive front, there's no new primary production coming except for the Endako Mines expansion that Thompson Creek Ltd. is working on. But even if that gets off the ground in a couple of years, that's a 1.5% increase in global supply so it's not material. We own Thompson Creek in Sentry Mining Opportunities Class. It's throwing off over 20% cash flow yield at this price, but we are trading it around. We like the Terrane Metals Corp. bid, by the way. We welcome the exposure to gold. Particularly in a base metals fund we like to have companies that produce non-precious metals with the gold kicker. Thompson Creek did not have a gold kicker, but it picked up a very low-cost, gold-producing prospect net of by-product credits and net of copper credits. It's going to take a few years to build it. It's a lot of capital to invest. They can afford to do it in any kind of normal molybdenum price environment. But more importantly, if the gold bull market unfolds, the market will respond quickly with a higher price for Thompson Creek, reflecting the leverage to gold from this acquisition. It complicates the calculation of value here because mine-building stories are not my favourite, but overall, I like the acquisition.

Copper

- I liquidated my copper stocks some time ago. We have virtually no exposure. We didn't like the build-up in hedge fund positions in the futures market. We were also not keen on the fact that the prices are definitely being supported by non-sustainable stockpile builds out of China. Lately, copper has weakened as China has backed off a bit. The hedge funds have liquidated almost 200,000 tonnes and are now essentially flat.
- Having said that, the price action is actually decent. I thought it would have suffered more than it has. The reason perhaps that it hasn't suffered as much is

that producers of copper around the world, the big guys, are uniformly producing less copper than they or the market anticipated. There are all kinds of excuses for it, which vary from company to company, but at the end of the day, copper production is not really growing. Inventory has fallen 120,000 tonnes to about 420,000 tonnes. It's not yet bullish but it is encouraging.

- Another encouraging observation is that spot market treatment charges to refine copper concentrate are running near zero. This is probably an outcome of large producers not delivering the concentrates to smelters that they have contracted for. The smelters are scrambling around to get material, and to keep the smelters running flat out, they're prepared to take it at cost. So no charges. At the margin, that's encouraging.
- Longer term, the shabby treatment that First Quantum has received by the DRC government I take as bullish for copper. It means that the flow of Western capital into the world's only remaining high-grade source of copper should dry up. If the Congo shuts down, you're going to see curtailed production growth going forward, and with any economic recovery whatsoever, copper should tighten up pretty quickly. I actually expect copper to get to a new high above \$4 at some point in the future, but at the moment I'm not ready to jump back in again. The copper stocks have come down quite a bit, yielding north of 20%. That's okay value but I'm not going to fight summer seasonality, which works against copper through September.

Lead/Zinc/Nickel

- There are not a lot of ways to play lead. The inventories have finally stopped rising. They're plateauing at high levels. Despite the fact that the new 100,000 tonnes per year mine in Australia, called Magellan, is up and running, it's not a big deal. One hundred thousand tonnes in an eight million tonne market is not a big deal but it

has kept inventories quite high. The lead market is estimated to be running a surplus of about 150,000 tonnes per annum, so the new mine wasn't really needed at this time. We think the outlook for lead at the moment is neutral at best and maybe neutral/negative.

- The same applies for zinc. Zinc is running a large surplus at over half a million tonnes per annum. Inventories are high and still rising. There's no comfort there. There should be relief in 2012 as a number of big mines come to the end of their productive lives, but that's still well into the future.
- The pig iron nickel supply with a marginal cost at \$8 a pound is still going to be a problem as long as iron ore prices are firm, so we have no exposure to nickel.

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