

# Metals and mining update

June 2011

## **Sentry Precious Metals Growth Fund Sentry Mining Opportunities Class**

Kevin MacLean P.ENG, CFA *Vice-President and Senior Portfolio Manager*  
Peter Bures *Associate Portfolio Manager*

### **Market overview**

*"If you don't know where you're going, you might end up some place else." – Yogi Berra*

With quantitative easing about to run its course, let's take a look ahead at what may lie in store for precious and base metals, and related equities. We believe the starting point for analysis is the macro environment we entered in 2007 with the first asset-backed commercial paper roll-over failure in Canada. This situation morphed into a full-blown credit deflation a year later. Leveraged, uncollateralized real estate speculation was at the heart of the problem, and the unwinding of that bubble continues to drive down US and PIIGS (Portugal, Italy, Ireland, Greece and Spain) home values. The rapid transfer of bad credit from banks to central banks and the related economic malaise have simply repositioned the crisis from the private sector to the world of sovereign credit. Lingering threats to tier I capital in European banks are more immediate issues than the junk balance sheet of the US Federal Reserve. Problem deferred – not solved.

*"The future ain't what it used to be." – Yogi Berra*

If the Federal Reserve truly shuts down its digital dollar dumping, we expect a return to deflationary pressures. And why not, as global real estate, mortgage and banking liquidation redirects to risk-sensitive private buyers from the risk-indifferent Fed. We would remind our readers that the scale of that problem threatened to take down the global banking system. Only massive liquidity injections with freshly digitized dollars, pounds, euros and yen – as printing them would have taken too long – saved the day.

With renewed deflation in view, we trimmed our base metal exposure in January, while retaining precious metal exposure. Precious metal exposure was retained as quantitative easing is not the driver for gold's rally. The driver is the deterioration of the US balance sheet relative to GDP. In other words, like any equity that we analyze, debt to cash flow is a key parameter that triggers an exit at a very low multiple. With US debt at \$14.3 trillion and cash flow at negative \$2 trillion per annum, it would take a huge GDP rally to improve the ratio to infinity times cash flow!

*"It's tough to make predictions, especially about the future."  
– Yogi Berra*

The bond market seems to agree with us and the equity markets are decidedly anxious as well. With Fed treasury auction participation estimated at over 60% of the total bid, one thing is certain: the Fed did make a difference in the treasury market over the course of QE2 (second round of quantitative easing). Post June 30, the best outcome would be that bond yields remain stable, implying a slowing economy but no-risk premium attached to US sovereign debt. The worst outcome would be that bond yields rise while the economy continues to slow, implying a market downgrade of the US credit rating. The latter conclusion would be baked in the cake in our view, should 10-year bond yields rise through 4% in the next 18 months without benefit of 2% GDP growth.

Of course, we expect gold to outperform US bonds on a total-return basis this decade. Perhaps surprisingly to some, we also expect commodities in general to offer positive returns this decade with the potential to dramatically outperform US bond returns should the US continue to drift rudderless with respect to fiscal policy. We are not, however, going to abandon base metals, despite their higher sensitivity to global GDP. The producers of commodities should be standout performers in the equity space despite the current divergence between rising margins and cash flow, and falling equity prices.

In the face of economic weakness, we see potential for another round of quantitative easing perhaps toward the end of the year, and this would be another signal to reduce portfolio risk (which should already be low). We note the housing and job markets (generally perceived as the key drivers of the US economy) remain stubbornly uncooperative. The latest S&P/Case-Shiller composite suggests house prices in the US stand at an inflation-unadjusted level last seen in 2003. The employment numbers so far this year imply the US economy is losing roughly 23,000 jobs per month (allowing for birth/death model adjustments). Clearly, this data does not paint a bullish picture for holding US assets, including the dollar. With this as a backdrop, no fiscal plan from Obama and friends, and an election looming in 2012, we deem it difficult for the Fed to abandon its stimulus measures. We will watch the Fed's balance sheet to see if an unannounced stealth QE3 appears.

The European situation (read: Greek debt) has not been resolved over the last two months. The latest figure for a potential bailout is in the 45 billion euro range. The debt situation in Europe is so intertwined, that we find it difficult to believe there will not be a bailout of Greece

when what's at risk is the collapse of the euro. Greece, Ireland, Italy, Portugal and Spain (the proverbial PIIGS) owe each other almost \$1.5 trillion. A Greek default would result in a chain of events that would likely bring the rest of PIIGS down along with it. Further, PIIGS debt held by less-threatened economies (namely Germany, France, US, UK and Canada) amounts to another \$1.5 trillion. An across-the-board devaluation of Greek debt would be akin to removing a Jenga block from an already destabilized tower. If you lived in Europe, would you be switching some of your portfolio into gold?

We will also note that China, which from an economic perspective continues to expand at a very high clip (north of 9% GDP growth), is not immune to a pullback in the US 'economic recovery.' China's new five-year plan calls for growing both domestic consumption and the services sector. Granted, these activities are more labour intensive; however, they don't contribute as much to the growth in GDP since not as much infrastructure and machinery is required as would be the case for an economy gearing up to meet the world's wants and needs. Putting further pressure on base metal equities may be the perceived slowing of China's GDP in the future. But we are not overly concerned about China; years of rising per capita commodity consumption are still ahead of us.

Over the last two months (indeed since the start of the year), gold equities have underperformed the gold price. There are a few drivers behind this:

- The market's incorrect view that the end of QE2 is negative for gold;
- The perceived political risk in stable jurisdictions because of rebellion and government overthrow in the most distasteful jurisdictions;
- The unwinding of serious overvaluation in senior gold equities;
- Cost input pressures especially in strong currency countries such as Brazil, Canada, Australia and, surprisingly, South Africa;
- And, lately, general US equity market weakness.

Nonetheless, intrinsic value is rising in our portfolio while public value falls. Deviation from the mean reverses over time.

## Portfolio review

Sentry Precious Metals Growth Fund is down 3.6% over the last three months, while Sentry Mining Opportunities Class is down 1.6% over the same period. We have been rotating the portfolios at the margin from advanced, but not yet commercial-sized exploration stories, to cheap cash-flowing names. Those who need a steady dose of market capital to succeed have been first to go, despite the fact that we think they will ultimately be successful. As well, we continue to diligently avoid country risk as much as possible, and are pleased that there has been no meaningful impact on day-to-day mining operations in our portfolio holdings.

## Performance as at May 31, 2011

### Sentry Precious Metals Growth Fund

#### AVERAGE ANNUAL COMPOUND RETURNS (SERIES A)

3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	10 YEAR	S.I.
-3.6%	-7.5%	30.6%	25.9%	20.0%	23.7%	15.8%

### Sentry Mining Opportunities Class

#### AVERAGE ANNUAL COMPOUND RETURNS (SERIES A)

3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	S.I.
-1.6%	7.7%	54.3%	10.7%	14.1%	13.4%

## Summary

If one desires to participate in an upside move in the price of gold, a simple dartboard with gold equity names would now suffice – pretty much everything is cheap. (We are still indifferent about the seniors.) Nonetheless, we continue to ferret out the super-cheap and the super wealth creators. While the market drifts lower, it does so with volatility and we continue to capture as much volatility as we can to enhance returns. We have recently conducted mine-site visits to Peru, Guyana, Mexico, Arizona, Nevada, Timmins and Malartic, Quebec, and are off shortly to the Yukon and Ghana.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compound total returns net of fees (except for figures of one year or less, which are simple total returns) including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

Certain statements in this document are forward-looking. Forward-looking statements ("FLS") are statements that are predictive in nature, depend upon or refer to future events or conditions, or that include words such as "may," "will," "should," "could," "expect," "anticipate," "intend," "plan," "believe," or "estimate," or other similar expressions. Statements that look forward in time or include anything other than historical information are subject to risks and uncertainties, and actual results, actions or events could differ materially from those set forth in the FLS. FLS are not guarantees of future performance and are by their nature based on numerous assumptions. Although the FLS contained herein are based upon what Sentry Investments and the portfolio manager believe to be reasonable assumptions, neither Sentry Investments nor the portfolio manager can assure that actual results will be consistent with these FLS. The reader is cautioned to consider the FLS carefully and not to place undue reliance on FLS. Unless required by applicable law, it is not undertaken, and specifically disclaimed that there is any intention or obligation to update or revise FLS, whether as a result of new information, future events or otherwise.