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" WHAT IS BEHIND THE RALLY IN MINING STOCKS? "

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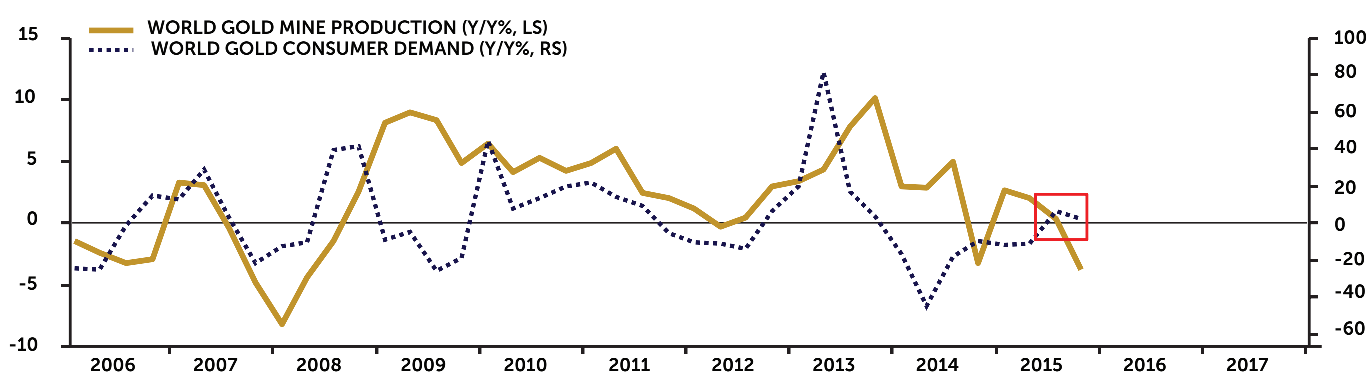
The mining sector, lead by the gold stocks, has strongly outperformed the rest of the market so far this year. The S&P/TSX Global Gold Index and the S&P/TSX Global Mining Index have gained 39% and 15%, respectively, compared to the S&P/TSX Composite Index's decline of 0.3%. Is this performance predicting a fundamental recovery in the mining sector? We think so.

The mining sector is trading at historically low valuation levels from which recoveries typically occur and we believe the fundamentals are set for a significant improvement over the next year. There are four components of mining sector margins that have set the stage for this improvement :

- Since the peak of mining sector share prices in the first quarter of 2011, the Canadian dollar has declined 30% from $1.05 US, dramatically improving margins for Canadian mining companies as their cost base is in Canadian dollars and their products are sold in US dollars. The gold price, for example, has declined 21% in US dollars since the first quarter of 2011 while gaining 3.4% in Canadian dollars.
- The largest cost factor for the mining sector is oil. Since the peak in mining share prices, the price of oil has declined 58% in Canadian dollars, having a significant impact on reducing costs.
- Mining exploration and construction costs have declined significantly as the availability of skilled labour has improved and the prices of equipment and other inputs, like steel and pumps, have plummeted. As importantly, the delivery times of equipment and services have vastly improved.
- Lastly, the weak commodity prices have forced the mining sector to rationalize costs, restructure corporately and shut down unprofitable operations. In addition to the reduced cost of operations, these actions, which are now being applied pervasively across the industry, sow the seeds for a recovery in commodity prices as supply/demand factors realign. Gold is the first metal commodity to see this improvement as year-over-year global production has declined over 20% while the annual growth in demand has recently turned positive, as noted in the charts below.

World Gold Production VS Demand



Source: Thomson Reuters Datastream, Canaccord Genuity estimates

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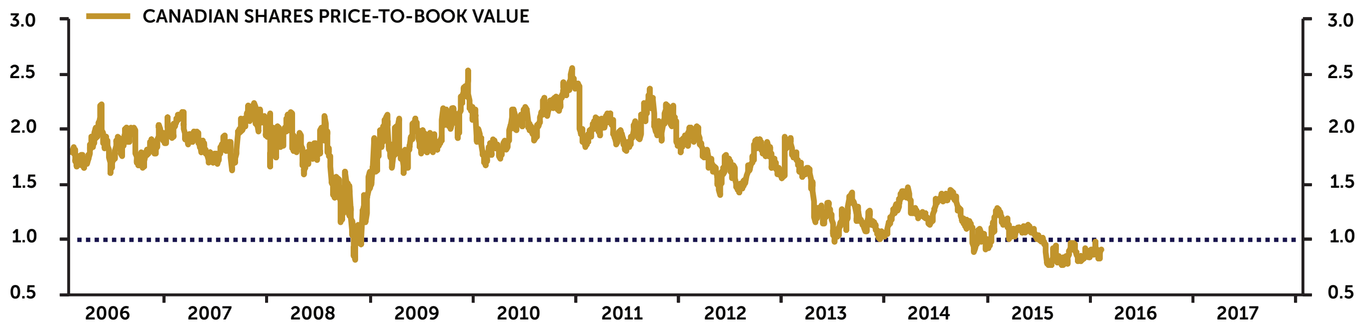
S&P/TSX Gold Index Price-to-Book Value



Source: Thomson Reuters Datastream, Canaccord Genuity estimates

Given the historically low valuations and the dramatically improved margin components, a minor increase in commodity prices and/or volumes will produce a marked improvement in industry cash flows. The positive performance in the mining sector since year end is consistent with this potential improvement in mining industry fundamentals.

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