MONEY, METALS AND MINING

THE MORGAN REPORT

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Quote:

"The CFTC reports data only for the U.S. silver futures market, a small corner of the global derivatives market for the precious metal, which is centered in London and largely traded via private over-the-counter deals."

~ *Financial Times*, December 13, 2010

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In the past we have presented our January issue as an overview of almost every company we have followed for the past year or two. It was our opinion that this might be a road map for our members to use for further analysis on companies of all ranges, top tier, mid tier, speculative, and those we consider to be "honorable mention," which is basically our watch list.

However we received enough negative feedback from our members that this year we are giving a different approach to the January report. Most of the feedback was that our information could be obtained from the Internet by going to the respective company Web pages and reading/studying the material.

At first glance this might appear true and in a few case it actually was—but this was the exception not the rule. What we actually did for the past several years in the January issue was to personally phone each and every company and ask questions. There were two primary questions:

- What did you accomplish this past year (i.e., 2010)?
- What will you accomplish in the new year?

It might seem very basic, but the idea was that we at The Morgan Report could really hold the management to account for the company since this process went on for a few years. For a quick example, if a company told us in a January issue that they were going to spend x amount on a drill program and they did not do so by the next January issue, we had some good justification to probe pretty deep.

This task became so cumbersome that your editor hired help, yet even with this it was much more difficult than it may appear. We would send the previous year's work for review and then follow up with a phone call and proceed. However, very few ever responded and some never did. Additionally, some used our "idea" and ran it as their press release to perhaps bolster their image. Bottom line, our intent was to provide a great look over the year just past and a hard core evaluation into the next. This was accomplished in about 90% of the cases involved but the amount of

procrastination made it impossible to have a 100% success rate.

The Big Picture

For this issue we are going to look at some of the classes of investments from a longer-term perspective. This is an overview from an annual perspective and in most cases far longer.

Rare Earth Elements

Rare earth elements, or REEs, have been around since the 1800s. Brazil and India supplied REEs from 1800 to 1964, Mountain Pass in California supplied REEs from 1964 to 1984, and in 1991 China became the main supplier of REEs worldwide. By 1999, 90% of the REEs used for technological applications were imported from China into the U.S. Our readers were some of the first to know about the merits of REEs, due to Clint Cox and his vision about the subject matter. This update is general in nature and although we did consult with Clint, he was not able to give us an update at this time.

REEs are rare elements that chemists and physicists are still finding uses for. They are used to promote fuel efficiency and pollution control; to produce strong permanent magnets used in cell phones, DVD players, turbines for wind power production, and guided missile systems; and they are used in batteries and paint because they are non-toxic. China recognized the profitability and the necessity of the REEs and has cornered the market!

China made its move in 1991 to begin taking over the supply of REEs. It has strategically placed itself as the sole supplier by offering REEs at a discounted price, putting other companies out of business, buying up other companies, requiring companies that want REEs to move their facilities to China, and finally by buying interest in two mining companies in Australia. In 2002, Mountain Pass closed its doors due to the outrageous low prices China was offering for REEs. Inner Mongolia, a Chinese mine, now supplies half the world with REEs.

Ever more frightening is the fact that REEs play a critical role in our future, with all the diverse uses as well as the critical role they play in engines for fighter planes, electronic warfare countermeasures, underwater mine detection, antimissile defense, range finding, and satellite systems. China has the monopoly on the existence of REEs at the moment.

When Jeff Christian spoke at the most recent Silver Summit here in Spokane, Washington, he stated that there was nothing to fear—that the United States had a thousand years' worth of REEs available. Although this sounds great we still need to ask, at what price? There is tons of gold in seawater but the cost of extraction makes it far from economic at this time. This is similar to the REEs currently as well.

Nations that need REEs are implementing plans to develop their own mining operations of REEs. Savvy countries like Japan have already put into effect a plan to research alternatives to REEs, recycle REEs components, help make operations more efficient while using REEs, funding companies that will mine REEs outside of Japan, and stockpiling REEs inside Japan. Joint ventures are popping up all over the place, Toyota with Vietnam, Toyota with India, Toshiba and Sumitomo with Kazakhstan, and Samsung and LG with South Korea.

Smart money should be placed in the rare earth elements mining industries. China's monopoly on REEs isn't good for global industry, but it could be good for smart investors. Holmium and thorium are just a couple of examples of REEs that we have yet to find commercial uses for; these two elements would be great investments. Holmium absorbs dangerous neutrons given off by nuclear reactions; thorium is safer with less atomic waste than uranium is and is easier to mine.

Basically, we need to invest in REEs mining companies in nations other than China. Helping ourselves to be self sufficient will be the only way to protect ourselves in the long run from China taking over everything. Australia, the United States, Japan, and India, just to name a few, could all use help in mining REEs. This would end China's monopoly on rare earth elements. China will no longer be able to drive price or decide where businesses are built or who REEs will be shipped to.

We admit again that we were too conservative in this space and, looking back, could have suggested some areas that might be speculative in nature and yet profitable. The Dacha suggestion is a conservative manner and another reasonable approach is to look at the REE ETF. Yes, we know there is an ETF for almost anything, and of course this hot sector now has one available.

Very few have written to us to express that their sole interest in *The Morgan Report* was REEs, but the few who have were promptly refunded their money. Our objective is to help you create wealth with a balance of risk to companies of merit. Since we are still of the opinion that most of these projects are not economic currently and the sector has risen so much, it might be best to wait for a pullback.

For those who are very interested in this investment arena, we suggest you look to either the *Dines Letter*, or *Kaiser Bottom Fish Review*. Both of these gentlemen are covering many companies in this space and have devoted a great deal of time and energy to this resource sector.

Although not a rare earth element, an area to watch in the future is the graphite market. Graphite is a growth market today and is projected to be the quintessential growth market of the near future. Used in steel and iron industries and now used in brake linings, it is also used in the manufacture of the lithium-ion battery.

The correct type of graphite deposit that is most desirable is the high quality known as "flake" graphite, not the amorphous type.

Future demand for graphite will develop as the fuel cell market evolves. Graphite is used in the field flow plates of a cell. Each fuel cell stack for one automobile uses approximately 100 pounds of graphite, according to our sources.

Assuming a continued growth rate within China, expect continued expansion of their iron and steel industries. This could decrease the volume of graphite on the open market, as, like the REEs, China is currently the major producer and exporter of graphite.

The Unexpected Coal Crisis

"Mr. PS Bhattacharyya, Chairman of Coal India Limited, said on November 25th 2010 that India's annual coal demand will exceed output by 100 million tonnes in four years. Coal India is studying the purchase of five mines in the U.S., Australia, and Indonesia, to help plug the deficit. Coal prices are being driven by Asian demand that's soaking up Pacific region supplies of the fuel and boosting purchases. South Africa shipped 3.32 million tonnes of the fuel to Asia in September as compared with more than 1 million tonnes sent to Europe." –Bloomberg, 2nd December 2010

Mining coal is a dangerous business to be in because of the flammable nature of the material! Many companies are close to bankrupt with large fines and downtime of production due to the many disasters that seem to follow the business. As disaster strikes a mine, the effect on the rest of the nation is unbelievable at most! What affects India affects Australia, affects the United States, affects Russia, affects China affects Indonesia, and so on and so forth . . . the domino effect at its best.

As countries such as India and Russia close down coal mining productions due to disasters, they begin to import more coal than they produce, causing coal prices to increase at an alarmingly fast rate! While India and Russia depend on coal as their energy source, countries like China need to import from other countries, as well causing a shortage.

As we begin to face a coal shortage at an alarmingly fast rate, Australian firms seem to be the companies to invest in, according to the mainstream. It is true their ability to produce enough coal for at least five years and maintaining control of the coking coal supply puts Australian companies near the top in this industry. These firms will be deciding the prices and quantities. Investors would be smart to do a thorough analysis of any company before investing! Wealth will be made by smart investors in coal and related businesses.

As our members (especially long-term subscribers) know, we look throughout the mining sector to find value for our members. We are NOT a silver-only letter, although many who are not members perceive us in that light. This is not to diminish the fact that most of our time and energy is devoted to the macroeconomic picture and the precious metals; we have suggested copper, manganese, moly, uranium, lithium, and other types of resources for investment.

Steel prices will rise as coking coal prices rise, leading to an increase in the automotive and construction industries. British automobile component manufacturers have already seen a 20% rise, and steel component suppliers with contracts to supply steel in the future will more than likely take a loss on those contracts. China is expected to enter a fight with Japan and South Korea for coking coal. Unfortunately for Japan and South Korea, China has a knack for cornering the markets, and last year had already increased its coking coal imports by a factor of 12.

Coking coal will likely rise between 23% and 38%, and thermal coal will likely rise about 14%. In other words, steel prices will rise and energy costs will rise.

Coal shortages mean energy shortages for many countries. China already put its customers on a rotation of blackouts to keep them supplied with heat last winter. India has been operating at a 10% annual shortfall and is predicted to have a 15% shortage in the next year and a half.

China is increasing the demand for coal with its stimulus package encouraging spending, which increased the demand for energy, and by building on average one coal-fired plant a week. China burns 3 times as much coal as the United States and possesses only half the reserves. China imports most of its coal from Australia, consuming 60% of that nation's production. China is forecast to double its electrical production by 2018, which means it will consume all of Australia's coal output. China will eventually demand the entire global production of coal.

India runs on 70% of coal for its energy as well; between India and China, our coal is quickly diminishing. In the United States our two biggest power companies are running on debt, bringing them closer and closer to bankruptcy with the increasing coal prices. Peabody Energy Corporation, the largest coal producer in the U.S., exports to China, Korea, and Chile.

The big picture is we are running out of enough coal to supply all the users. A new energy source needs to be found, China needs to quit building coal-burning factories and make do with what they already have, India needs to build the infrastructures to transport coal, and investors would be smart to invest in coal-producing companies that are nearby or export to China.

Energy/Nuclear Power/Uranium

The United States is far behind Asia in the quest for nuclear power. This is primarily based on fear, which went into overdrive in 1979 when two events occurred almost simultaneously. On March 16, the movie *China Syndrome* was released, showing a nuclear power plant meltdown, and pitted the "environmentalists" against the evil power companies. Within a couple of weeks, the nuclear reactor at Three Mile Island in Pennsylvania actually did experience a partial core meltdown.

Between 1963 and 1979, the number of nuclear reactors being built had increased steadily in the USA. After 1979, orders were cancelled, fear grew, government regulations tightened, and costs increased.

However the need for energy is ever increasing, and the greater the requirement, the more efficient and powerful the source, the better the solution. Therefore, wind, solar, and many of the proposed solutions are not sources that are dense enough to provide a real solution.

There are about 52 new nuclear reactors under construction around the world right now, according to the *Guardian*. As of 2010, 439 nuclear reactors were in operation worldwide, yet only 16% of all the energy used is electricity. As the move toward electrical transportation increases, the demand will accelerate.

Two roadblocks stand in the way:

1. How to deal with nuclear waste
2. How to contain fissionable materials to prevent proliferation

Other concerns include the fact that there are very few companies making the components for nuclear reactors anymore. It has been so long since any new nuclear plants have been built in the USA that there are only a few that know how to regulate nuclear reactors and how to inspect them for safety.

People are still unsure about nuclear power, especially in the United States. At present, most nuclear power plants are of the type known as light water reactors. They use uranium, with most of the uranium being wasted. existing designs for fast reactors would increase efficiency by 15 times. In addition, the plants could be designed with replaceable parts, adding a very long lifespan to the plant.

In our view there will be a turnaround for nuclear energy in America. Americans are good at monumental efforts, and there's evidence accumulating that the national will to build a nuclear energy infrastructure is solidifying. *Scientific American* ran an article about two new nuclear power plants that are being built in Georgia by Southern Company; the Obama Administration announced an $8 billion loan guarantee for the project.

It will be a big challenge for the United States and Europe to catch up with Asia's aggressive use of nuclear energy. China, India, Japan, South Korea, and Taiwan are rushing headlong into the nuclear power era. However, once the USA gets busy building out this industry, it could do wonders for the economy, not to mention the employment picture.

Actually, building nuclear reactors will be the only choice, as the U.S. electrical grid is based on a 24/7 base-load design. The only alternative to coal and hydroelectric power for supplying such a system is the nuclear reactor. If the U.S. does not design and build its own nuclear reactors now, they will be importing them from China later.

The real key for the U.S. to catch up quickly is by using nuclear mini-reactor power plants that will bring electricity to developing areas of the world, as well as to remote areas of the United States. Mini-reactors are built in factories and then shipped to the location where they'll be used. They remain closed and operate for several decades without refueling.

These reactors solve many of the problems mentioned earlier; they use off-the-shelf components, such as General Electric standard turbines. Bill Gates has partnered with a start-up called TerraPower to build a mini-reactor that runs on depleted uranium fuel; it is a so-called "traveling wave reactor."

The TerraPower technology is called "4S," which stands for "Super-Safe, Small and Simple." It is reported that this technology was spun off from a research program at Oregon State University. Additionally, numerous other designs for "mini-reactors" are being designed.

Believe it or not, we can expect mini-reactors to proliferate in the United States starting around 2020. Once these small, safe, simple devices prove themselves in remote areas, it is going to become apparent that distributed nuclear power is cheaper and smarter than continuing to rely on the grid. Local smart grids, each serving about 50,000 homes, will begin to appear, as municipalities move to secure their own energy future.

At one time there were over 50 operating conventional mills processing uranium in the U.S.; today there is one. The only operating conventional uranium mill in the USA is in southern Utah and has been operating since 1980.

Modern uranium mills can avoid many of the problems of the past and thus the liabilities, by

- Using modern design for the tailing storage facility (TSF) incorporating a high level containment application for the liquid
- With increased quality control, leak detection systems are far advanced over previous models
- Closing tailing facilities as they fill—using small cells
- Aggressively controlling all contamination during the process of mining and transportation

There are still liability issues, according to the U.S. Department of Energy, revolving around control of radon emissions and contamination to groundwater, surface water, and land (dust). In some cases, tailings have been completely relocated.

Certainly conventional uranium applications remain an option but it seems that the 4S methodology is a superior methodology. We are favorable to uranium investment but were one of the few newsletter services, if not the only one, to warn at the top of the uranium bubble about many of the issues that were in play at the time.

Not only did we suggest a top, we also cautioned our readers that "staying" too long in the sector might end up costing them. We were actually threatened with a lawsuit for telling the truth as we reported the facts as set by the Canadian government on land positions and what was required. Without the details, suffice it to state we held close to the facts, and the results speak for themselves.

Of course we are not and never have professed to be a uranium newsletter, but we do look at the resource sector from a very serious perspective and therefore felt it was our duty to advise our readership of the consequences, as we forecast at that time.

Moving on, we want to stress that energy is key to a better future for all of us, and the denser the energy source the better. The "revolution" in shale gas will be a large benefit to North America, the USA in particular.

Daniel Yergin of Cambridge Energy Research states that America's exploitable shale gas resources are sufficient to support current consumption for 100 years.

Before going further, let us state that this is a top view only and we are not professing to be experts in energy or uranium. Our purpose is to be of maximum service to our readership and provide a balanced and informed viewpoint of our current and future economic and investment opportunities.

Shale, like the Canadian oil sands, has been known for a long time to contain large amounts of trapped gas, but until recently no one knew how to tap into this resource in an economic manner. This is where computer controlled horizontal drilling made a breakthrough. The other main method that produces good results is hydraulic fracturing, which is forcing a sand/water mixture at high pressure into a well to fracture the shale and release the gas.

How significant is this shale gas revolution? According to our sources, less than 1% of the U.S. natural gas output was from shale gas in 2000. By 2005, the shale gas output halted the long decline in U.S. natural gas production. Today, the United States has surpassed Russia as the biggest producer of natural gas in the world.

Gas to liquid fuel conversion technologies exists to turn competitively priced natural gas into standard gasoline and/or diesel fuel. A more direct approach is to convert or build automobiles that will burn natural gas directly.

This is not to imply that America's energy dependence is over, and as stated previously, it is our view that the USA is way behind in the energy race and modernizing its electrical grid. But doing our best to be objective, we can clearly state that the big picture for energy looks better at the present moment than it has in the past.

Although we have studied the "peak oil" question, we are still undecided at this point. We recently were introduced to John Walker. See www.trueresults4us.org. We have not had time to verify it, but according to his research the United States still has abundant conventional (oil) resources. Those interested are encouraged to read his Web site.

The bottom line is that the control of energy is the ultimate weapon that can be used between countries or even against a population. Regardless of how much energy might be available it is the control of the resource that will determine price and could cause conflict in the future. Watch oil and energy prices; as oil moves to more than $100 per barrel there will certainly be increased tension on many levels.

The Economic Outlook 2011 (Precious Metals)

For endless months we have stressed the death of the dollar, and it seems the mainstream press has certainly taken up that mantra recently, talking about currency wars, currency crisis, and emergency "sessions" or meetings taking place all over the globe. In fact, we sent out a piece from the MSM (mainstream media) about China and Russia agreeing to do business in each other's currency instead of using the U.S. dollar.

The never-ending debate revolves around inflation and deflation, but to our thinking the discussion could revolve around default. When a debt becomes too cumbersome a default is inevitable. For example, if you borrow "money" for a house purchase and lose your job and cannot afford the payments (debt service) you have defaulted on the debt. In the worst-case scenario, a sum is borrowed, no payment is made, and a total default takes place. In simple language, the money is borrowed and never paid back. There is also a partial default, where perhaps a third party will come in and pay 20 cents on the dollar to extinguish the debt.

It is no different for a nation state, and this has taken place in recent history, so the idea of a government default is valid. The inflation argument maintains that governments or specifically the U.S. government or the "Euroland" government (there is no euro government just a currency) will continue to make good on their debt obligations. In fact, this is the basic premise we have offered from the beginning—we are nearly certain that governments will do everything in their power to keep inflating (printing) to prevent a default.

This has been the case with QE2 and other efforts so far on the part of the U.S. and other nations around the world. The problem is that by continuing the game they too are defaulting. What are we discussing? Look at the end point where the currency—the euro or U.S. dollar—becomes worthless (worth = zero). You as a lender (you bought T-bills or T-notes, or T-Bonds) are "repaid" but were actually defaulted upon because the payment you received was the same as if you received no payment at all. To our thinking, an outright default is more honest because you know that your holdings devalue immediately. Whereas in keeping a time obligation, you are stuck guessing and hoping things will get better in the future.

This is the dilemma faced by the world. Those in the know can do the math; it is currently impossible to pay back what is borrowed and maintain all the current services provided by the modern state. So, currency destruction continues, while the chances of any economy being able to grow their way out of this problem become dim indeed.

However, the velocity of money is still low enough so as not to concern the debt markets greatly. This means that currency destruction is not a function of how much debt exists; more than enough debt (that cannot be paid back) exists currently without adding a penny more in interest, but at what rate is the debt exchanged (velocity) for money. In other words, as long as China, Japan, and other holders of U.S. bonds are willing to hold, the problem can be delayed, but once the sale of new debt becomes impossible (currently this is close to the case) and the Federal Reserve is buying the new debt offered by the U.S. Government, the game is getting closer to the end.

As the market to buy this debt is poor, the offering must provide more yield to entice buyers. This drives interest rates up (this has happened since QE2) and that drives bond values down.

Let us look at a hypothetical situation on a partial default. The markets demand very high interest rates over the next six months, pushing bond values down considerably. This in a way is a partial default, as the current value of the bond would be much less than the face value, and this in theory takes a great deal of wealth out of the system.

Bill Gross, well known "bond king," recently commented on QE2, stating, "Check writing in the trillions is not a bondholder's friend; it is in fact inflationary, and, if truth be told, somewhat of a Ponzi scheme. Public debt, actually, has always had a Ponzi like characteristic. The Fed, in effect, is telling the markets not to worry about our fiscal deficits; it will be the buyer of first and perhaps last resort. There is no need as with Charles Ponzi to find an increasing amount of future gullibles, they will just write the checks themselves. I ask you: Has there ever been a Ponzi scheme so brazen? There has not."

At this point it is too difficult to predict how the system will unwind exactly, but as concerned as we are with the bond market, in our view, it is still the derivative market.

As bad as the mortgage market is/was with all the derivatives that exist, this market pales in comparison to the biggest sector of the derivates market, which is bets on interest rates! Since we witnessed what happened to this market, be prepared for what lies ahead. And if you thought the "subprime" situation was painful, wait until these interest rate bets start to move more "too big to fails" to the front pages of the financial press.

Wishing not to belabor this ongoing discussion further, the crosscurrents still exist and therefore the metals markets will continue to reflect the uncertainly in the debt markets. At this point in time, it seems likelier that the euro will fail before the U.S. dollar, but make no mistake—any perceived "failure" of the euro will ripple across the markets, causing huge distortions in the currency and other markets. Unless a very strong "solution" is provided that the markets really believed in, the results would be a move to areas of trust and confidence and this means commodities in general and the precious metals in particular.

Will the euro last until the end of 2011 in its present form? At this point we are not too sure that it will, but never give up on the world bankers coming up with interesting solutions to these problems.

We have received many new members the last few months, due primarily to the increased price in silver. This is typical and we are hesitant to state the market can only go up from here. Usually any market that has moved to the level that silver has recently would see a correction or sell-off at some point. This is primarily what we expect, yet it is most difficult to give a solid opinion. Why?

Because we study the fundamentals as hard as any commentators in the silver space, we know the physical market is extremely tight and therefore any new buying, even a small amount, leads to higher prices—assuming that that are no massive sales at the same time. In other words, if there is more or slightly more buying pressure than selling pressure, the price will be forced higher.

We noticed a shift in the way silver was trading in late August/early September and in fact your editor made a brief video declaring this fact. We have consistently stated that at some point the physical market would trump the paper pushers and it certainly seems to be the case now.

A question we have received from time to time is a concern with the amount of silver held by the main silver ETF, the SLV. Yes, it is possible that some of the market makers could take their physical silver off the SLV and "dump" it on the open market, which could drive the price down; however, we see this as unlikely. The reason we see this as unlikely is the recently announced lawsuit involving the SLV itself. What this means to us is similar to what we have stated about the Comex: too many eyes are now watching silver trading across the board, London, New York, Chicago, and the silver ETFs.

Regardless, all prices move up and down and silver could see some consolidation in the months ahead. The best approach is to plan your investments to take place over time. If a huge opportunity presents itself (a very large dip) you might use some common sense and buy more on the dips. The most frustrating position to find yourself in is to commit your invested funds into this sector only to see the market move against you for weeks or months.

In 2009, the total output of China's mineral silver and regenerated silver was 10,348 tons, maintaining No. 1 in the world, according to a press release published *by Research and Markets.* It is interesting that, when your editor toured China several years ago and met with many in the industry, including the mining bureau, government agencies, and some of the top banking entities, all informed us that China produced more silver than reported by either the CPM Group or by GFMS, which produces the annual report for the Silver Institute. There is no way to verify this information, yet it does raise the question of how accurate the data is regarding mining, supply and demand, etc. Our approach has always been that the overview using both reports gives us a general idea and it is impossible to get exact figures, as there are just too many variables.

It is primarily the commodity boom in general (base metal mining) that caused the rapid increase in output of China's silver. This is due to China's large smelting capacity and so much concentrate from around the world going to China to be refined. A very important point was made by this press release, and that is that China's domestic price is higher than international market price. This portends the idea that a silver futures market will be established in China.

According to this press release, China did not use all the silver produced by the processing of all the imported concentrate. This may be true, but our initial study did determine that China all by itself did not mine enough silver to meet internal demand. Since that study, both Silvercorp and Minco Silver have made great strides in silver production, one producing and one nearing production. The real unknown is investment demand in China. This is "tipped" for a big future, according to this analysis, and we agree. China was the last to go off the silver standard and is more affordable to most Chinese. As an aside, the China Panda (Chinese minted coins) market has such huge demand that the premiums for all Panda products are literally off the charts.

A major problem now is that silver products suitable for public investment are relatively few and we verified with three of our direct Chinese contacts that, with some silver purchases for investment through the banks in China that offer such a service (some not all offer this), the investor receives a paper certificate for his or her silver. This is not to state that some Chinese, just like other people around the planet, demand silver in hand. It is just to point out that the "paper" market for silver is bound to increase dramatically by way of a proposed silver futures market and silver certificate programs.

Silver consumption mainly concentrates on industrial applications and investment demands. Currently, 65% of the world's total silver consumption comes from industrial fields. Accordingly, with the recovery of the world's economy, the silver demand from industrial fields is expected to increase steadily.

From a press release issued by CPM Group on December 9, we cite the following, "Silver prices are projected to remain at historically high levels over the next ten years. That is the primary price conclusion of the 2010 edition of CPM Group's 'Silver Long-Term Outlook,' released today by the New York commodities research and advisory firm."

Agreeing with us, the CPM press release stated that high investment demand for silver was a key in keeping silver prices high. They also noted more silver mining production the next few years, and a continued increase in fabrication demand.

Another very important key outlined in this press release is, "Silver use in China is estimated to have risen around three and a half times over the last decade, from 40.8 million ounces in 2000 to 139.2 million ounces in 2009. As mentioned above, CPM's work indicates that silver use is roughly twice as large as had been suggested by commentators in the western market. Chinese silver fabrication demand is projected to account for nearly a fifth of global silver fabrication demand this year."

This report is available at... store.cpmgroup.com/lotere.html. The cost is US$7500.00.

We have one final thought on the silver market for this issue and a subject touched on only briefly by your editor and seldom mentioned by anyone else, and that is simply the need of silver for a war effort.

In my early travels, a gentleman whose family was involved in the manufacturing of metals explained that "war" put one of the largest demands on the silver market known. Now to be fair, this is going back to WWII and just beyond, yet we must admit that no silver study ever discusses the amount of silver used by the Pentagon, for example. This is most likely classified, yet common sense also demands that solar battery arrays in field communication, military satellites, weapons, and even military clothing use silver.

Remember at one time the silver held by the U.S. Government was a "strategic" stockpile, needed in the time of national emergency—read war! So this is just another important demand for silver that may or may not be accounted for in the data we are able to obtain.

Our thoughts on the gold market have not changed substantially, meaning that any big money from institutions, nation states, and managed money will continue to fuel the gold market. Our initial forecast for gold was a minimum of $2500 per ounce and we made that forecast almost a decade ago. We still think this price will be achieved and do not rule out far higher prices than that at this time.

Further, as we all know, it is not necessarily the price of gold going up, but the value of the U.S. dollar going down further. Will the U.S. dollar lose half of its current value over the next two years? Will the U.S. dollar exist in its present form in two years? Is the global monetary system in the process of an accelerating breakdown crisis?

As these types of questions continue to build in the collective conscious of the investing population, more and more money will be moved into the gold market in all forms, physical, futures, ETFs, and bank certificate programs.

Portfolio Review

This year we are going to restructure our portfolio from what it has been for a number of years in the past. We will keep the top-tier companies and as always these are "buy and hold" stocks for the long term until we call the top of the entire precious metals bull market! This has not happened yet and as of this issue we do not anticipate this will occur for a few more years.

As we have stated, *ad nauseam*, these companies do change from time to time but it does NOT mean to sell them. It only means the current list is performing better at that moment in time. If we want you to sell a top-tier company we will tell you and report why. Aggressive accounts can move in and out, but this is not necessary for doing well in this category.

At this point in time our outline on how to use *The Morgan Report* is a guideline and not gospel. In other words, there are certain rules that are absolute musts to do well with our work. We will come back to this later; for now, let us state that large conservative accounts and managed money can stick pretty much to the top-tier category and do well.

However, now we are adding a mid-tier/growth category. In this section we're going to follow companies that have matured enough to mitigate much of the risk, especially exploration and/or financing risk, yet still offer substantial upside going forward. We believe that such segregation of growth companies is useful as we intend to allocate a portion of our investment capital to them. This is basically where we began years ago; at one time Pan American Silver, Goldcorp, and almost all that are now top-tier companies were actually mid-tier growth companies that have grown into substantial mining companies. This is a slightly higher risk category but the gains in this section will generally be better than those of the top-tier category.

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We are keeping our speculative category and here is where we cannot stress enough that investors MUST spread out. In every issue, we print, "Put in money you can afford to lose and use 10 percent of your capital, spread out." Since this list contains ten companies maximum, that means one percent in each company. We still receive letters from people who pick one from this category and think we are perfect—for the record, we are not. Yet no one in the industry has picked more speculations that actually went on to become actual mines than this report.

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We are going to show our "watch list"; these are basically companies that we think have good merit, but in some cases are too small a market capitalization for us to recommend. Why? As explained in earlier reports, our suggestions can move micro cap stocks and that is not our intent. But there are many reasons—management unknowns, amount of money in the treasury, burn rate, a vague mission statement, geopolitical risk, and several other reasons. At this point it may be obvious that this category is designed primarily with you, our members, in mind, to do much more due diligence on your own and perhaps consider investing. Each of you has a different risk tolerance and different goals, so we do our best to provide ideas that you can choose to investigate or not.

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We will be adding companies throughout the upcoming months, but those who have followed our work extensively know we do our homework. This writer was resistive to this idea because we know some of our members will be flooding us with their ideas of "great" companies and speculations. We really do not need or want help; we get pitched on a never-ending basis and there are not very many "deals" we don't see. Yes, we have missed some good ones, but there is no one writer in this space who has a lock on the very best in each category every time for a decade.

Letters

Please note we are one of the most open and service-oriented newsletter/report services available. However, also please note—we cannot give individual investment advice. Secondly, if you are interested in a company or want an update on a holding we have published, please contact the company on your own. We are NOT an investment relations firm! You are always welcome to e-mail or phone the company on your own, and we encourage this.

Some questions border on pure laziness, where a simple Google search can provide an answer. Example: common financial terms, common mining terminology, or Web site address.

Letter #1: Are there any silver mining companies that you would strongly advise to stay away from—companies in which you think senior management is ethically challenged or incompetent? Robert

Comment: There are some, but putting that in writing is difficult as those types are good at slapping on lawsuits.

Even so, by law I cannot give individual advice, so if you asked about a specific company I would not be able to reply anyway, in keeping with SEC requirements.

Additionally, the "best" at these types of situations can run the stock up very high, making "me" or others look foolish (meaning we could be correct, yet most people only focus on profits).

A good idea is to bet a little to win a lot. In other words, limit your risk. How many people who made money on Bre-X gave back the money they made after they discovered it was a scam? Probably none.

Final point, I have known of a couple throughout my 30+ years who had intentions of pumping and dumping yet actually discovered something of merit and in one case something quite substantial. So, even these folks get it right once in a while—by luck perhaps, but nonetheless right.

Letter #2: I am a new subscriber. I really appreciate all that you do and am enjoying exploring the fabulous resources on your Web site. I have studied the market for a few years, however, I still have the uncanny ability to buy at the top and sell at the bottom. I bought Orko Silver yesterday at $2.80 and as I write this it is down $0.17. Should I buy more or run for the hills? Viv

Comment: All stocks move up and down. No one can pick exact tops or bottoms every time.

If a $0.17 move on a $2.80 stock disturbs you enough to write me, you may not have the temperament to be a stock investor. This is a sincere answer. In fact you may be better off just buying gold and silver coins and/or bullion.

Letter #3: Klondike Silver Corp. volume was 4.5m on Dec. 3, nearly 3m yesterday; together that is 4% of the 186m shares in issue. There have been even higher volumes in the last three months. Sept. 16 & 17 were both over 7m (8% over 2 days). Seems a very liquid stock! Can you suggest any reason for these high volumes? John

Comment: Normally, when a stock leaves our list I stop following it closely. This is the case for Klondike. However, let me see if I can find anything. I don't know how long you have subscribed, but it was a "formal" suggestion for quite some time. Still like the asset, but the management became an issue.

Letter #4: Gday, David: Enjoying my subscription very much and am very grateful for your knowledge, hard work, and commitment. Can you please talk about exit strategies for physical silver in the long term (into different asset classes, like real estate or ????)? Thanks again and kind regards. Rob, Australia

Comment: It is too early in my view to "know" where to put our proceeds . . . but continue to think about it and to look at other opportunities.

At this time, subject to change: Raw land may be a bargain (perhaps improved real estate) at the time the metals are peaking. It may be dividend-paying stocks in companies paying ten percent. Too tough to know at this point, but our thinking is right along with yours, we want something undervalued.

This is one of the reasons I changed our report title from *The Silver Investor* to *The Morgan Report*. It is my wish to continue in the research/investing/report fields and when that day comes, hopefully before it we will have led our loyal members into something that will turn into a tremendous investment over time.

Letter #5: David, I am somewhat of a new investor on the equity side. I understand that the mining shares as a whole have shown strength the last few months. I am wondering if there is a way to analyze which ones on a value basis have more merit than others. For example, First Majestic and Endeavour were roughly trading at the same price a year ago. I'm sure you are aware of what has happened since. I know that you are a rational investor and trade even within the physical when the gold/silver ratios become skewed. Is there anyway to do this analysis on the equity side? Many thanks for your hard work. Kyle

Comment: There are people who think you can, and it some respects it can be done. But if your real question is to analyze which will perform better, that, in my well-more-than 30 years' experience, cannot be done. One might have more value or better assets or more silver per share or ???? And still underperform the other. And that's the bottom line.

Letter #6: Can you update American Manganese, Duran, and Donner Metals, please. (Name withheld upon request.)

Comment: Since my interview with Larry Reaugh, president and CEO of American Manganese Inc., in May 2010, the company has completed 53 reverse circulation drill holes entailing 4,526 meters (14,850 feet).

Utilizing recent drill data a new NI43-101 resource study was completed, resulting in a 45% increase in indicated and inferred resources.

At a .90% cutoff, the indicated resources have moved from 1.068 billion lbs. to 6.686 billion lbs., and inferred resources moved from 9.661 billion lbs. to 8.8881 billion lbs.

The company has applied for patents on their mineral process and will be presenting a paper at the SME Conference in Denver on March 3, 2011.

In the past three months the price of electrolytic manganese has moved from $1.20/lb. to $1.50/lb., and the U.S. price has moved from $1.50/lb. to $1.81/lb.

China, which supplies about 98% of the world's electrolytic manganese metal (EMM), is running out of the carbonate ore used to produce EMM and will be restricting exports. Chinese companies for the first time are looking outside of China for future production. Currently, Chinese production has a cash cost of $0.98/lb. before China's 20% export duty versus American Manganese's preliminary economic assessment cost of $0.44/lb.

Duran has raised $7,400,000 from institutional investors. The company will drill the Aguila Cu-Mo to a 43-101 resource and also drill the Ichuña. The JV partner on Corongo has also closed a financing to drill the Corongo.

Donner Metals' new Bracemac-McLeod Mine construction is underway and scheduled to begin production in January 2013; a few weeks ago the Donner/Xstrata team won the Québec Development of the Year Award for this. There are also two drill rigs working on the Matagami Camp Property doing exploration drilling in other areas of the camp and applying to other areas the techniques that led to the Bracemac-McLeod discovery. Also ongoing at the camp is a follow up on a historical resource at the PD1 area that is near surface. Xstrata is paying for this work at the PD1 area in addition to the other exploration. The Matagami Project has a year-round drill program and results are ongoing throughout the winter months, so keep an eye out for more news on that.

Personal Notes

We have very much to look forward to in 2011 and I really do not make New Year's resolutions anymore. However, like many of you, my two main areas of concern are health and finances. Those who have followed these reports for years know that your editor performed triathlons for a few years. For the record, I never did the Ironman distance, only got as far as the Olympic distance. My last race was in 2008 and it seems like eons ago.

Today my fitness routine is much simplified and, as in most of my life, the goal is balance or maximum efficiency. Plain and simple, the tri training was just taking too much of my time.

My speaking schedule will be diminished this year as will my public appearances. Unless you are in the industry, most attendees think that the speakers receive some huge fee for speaking, and this may be because they see how much an ex-President or other celebrity make for giving a speech. In almost all cases, any presentation that I make ends up costing me money and time. Yes, of course there is a benefit to these engagements and those involve many facets, including teaching the subject and gaining a brand name.

However, with the security checks becoming increasingly cumbersome, my decision is to do some paid workshop-type events and a few well-chosen public appearances. Of course I will participate in the main Silver Summit, usually in September in Spokane, Washington.

As far as making money in 2011, it seems silver just continues to gather new interest and we do expect higher prices this year. There are so many unknowns with the euro, the U.S. dollar, and growing tensions throughout the world that there will be increased uncertainty, which means more buying of precious metals.

I will be traveling to London in late January to attend a conference that is going to discuss some possible return to gold and silver in the monetary system. This will be reported in the future. Many notables will be there, such as James Turk (GoldMoney), Hugo Salinas Price (leader to establish silver alongside the Mexican peso), Chris Powell (GATA), Andrew Maguire (CFTC whistleblower), and Max Keiser (*Keiser Report*). Additionally, many fund managers from Europe will be in attendance as well.

Until next month, wishing you health above wealth and wisdom beyond knowledge,

David Morgan

ASSET ALLOCATION

Top Tier: This section is for serious money – Our suggestion is for retired or fund managers to focus on this section it could contain up to 90% of the money allocated to precious metals mining stocks.

Mid Tier: These are serious companies with a higher growth rate but more risk than the Top Tier. Our suggestion is those working with good incomes focus on this list and own two to three from the Top Tier for safe growth.

Speculations: High Risk/ High Reward – only money you can afford to lose- you MUST put equal dollar amounts into EVERY suggestion to diversify properly. No one can pick one company and expect consistent results.

Watch List: Companies that have merit and are brought to your attention so you can perform further research.

Company	Symbol CAD (US)	Initial Date	Initial Price	Profit (Loss)	Comments
TOP TIER SECTION					
Top Tier Gold	Subscriber Only	Subscriber Only	$	+606%	Buy
Top Tier Silver	Subscriber Only	Subscriber Only	$	+731%	Buy
Top Tier Silver	Subscriber Only	Subscriber Only	$	+1482%	Buy
Top Tier Silver	Subscriber Only	Subscriber Only	$	+773%	Buy
MID TIER SECTION					
Mid Tier Silver	Subscriber Only	Subscriber Only	$	+310%	Buy
Mid Tier Silver	Subscriber Only	Subscriber Only	$	+200%	Buy
Mid Tier Mining	Subscriber Only	Subscriber Only	$	+3%	Buy
Mid Tier Mining	Subscriber Only	Subscriber Only	$	+211%	Buy
SPECULATIONS SECTION					
Spec Drilling	Subscriber Only	Subscriber Only	$	+238%	Buy
Spec Silver	Subscriber Only	Subscriber Only	$	+73%	Buy
Spec Silver-Copper	Subscriber Only	Subscriber Only	$	+30%	Buy
Spec Silver	Subscriber Only	Subscriber Only	$	+210%	Buy
Spec Energy	Subscriber Only	Subscriber Only	$	+36%	Buy

Changes: We are changing the portfolio and will be adding to it through the coming months as discussed in the January issue.

Morgan Report Featured Company Log: Complete table above + Watch List - Subscriber Only
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