

Today's Notes:

1. Silver

1. SILVER

Yesterday Harvard Professor Martin Feldstein said, in a Bloomberg interview,

“by 2010 ... banks will have enormous raw materials for ... inflation.”

Dr. Feldstein is one of the economists (there are many)¹ concerned that the Fed will follow form and not be able to handle the expanded money supply once money multiplier (velocity) turns up. As I pointed out on Monday's Morning Note, the St Louis fed multiplier has fallen 40%, the same decline as during the Depression. Now most believe, including Dr. Feldstein, that the global economic recession will run “somewhere into 2010.” In the meantime there is more than a hint of disinflation in the global “air.” In Spain it is outright deflation with 35% unemployment in the under 25 age group.

With a strong dollar, also a precursor of deflation and low and falling interest rates it is difficult for any industrial metal to succeed. Silver of course is fortunately or unfortunately a hybrid. It has both precious and industrial applications. In a delcining growth environment, particularly a global contraction, silver has more than braved the headwinds to date. Gold on the other hand is not reacting to inflation at all. Neither is oil. Gold is reacting to danger signals and it is simply a flight to safety asset at present.

Feldstein's recent article in the Financial Times (April 19th) ***“Inflation is Looming”*** represents what the economics community, Fed Reserve bank presidents and even the Administration's economists are really worried about. **There is a consensus among the solons of the dismal science (Economics)² that inflation is a sure thing in the not too distant future.**

Much of the concern relates to the 2001 experience of Japan in the lost decade of the 90s. Japan also was forced into “quantitative easing” to restore growth in its economy. The Bank of Japan never figured out when to withdraw the QE fuel from its deflationary malaise

¹ Kansas City Fed Bank President Thomas Hoenig said, ***“We know it (Ed: recovery) has to happen, but the timing I can't tell you. Nobody knows. We will watch every indicator of data that suggests a recovery is on the way ... Failure to do that at the right time means you risk a much higher inflation environment.*** April 9th White House Economic Adviser Lawrence Summers, said that there were ***“substantial downdrafts”*** hindering a US recovery. ***“Economies don't go from losing 600,000 jobs a month to a terribly happy path overnight, ... I think we can be reasonably confident that that's going to end within the next few months.”***

² It is often stated that 19th century historian Thomas Carlyle gave economics the nickname “dismal science” as a response to the late 18th century writings of The Reverend [Thomas Robert Malthus](#), who grimly predicted that starvation would result as projected population growth exceeded the rate of increase in the food supply. Carlyle used the word 'dismal' in relation to Malthus in his essay *Chartism* (1839).

– still has not. With US Fed funds target rates at zero percent (the bank of Canada reduced target rates to .25% yesterday and vowed more fiscal spending) QE , essentially the printing of dollars to buy bonds and reduce market interest rates further, is now “game on” in Washington. As Dr. Feldstein proclaims, we agree, there is a great deal of inflationary fuel being applied to the world’s greatest economic and banking contraction since 1929. If inflation resumes in 2010/2011- as we expect – gold and silver will “go bid.”

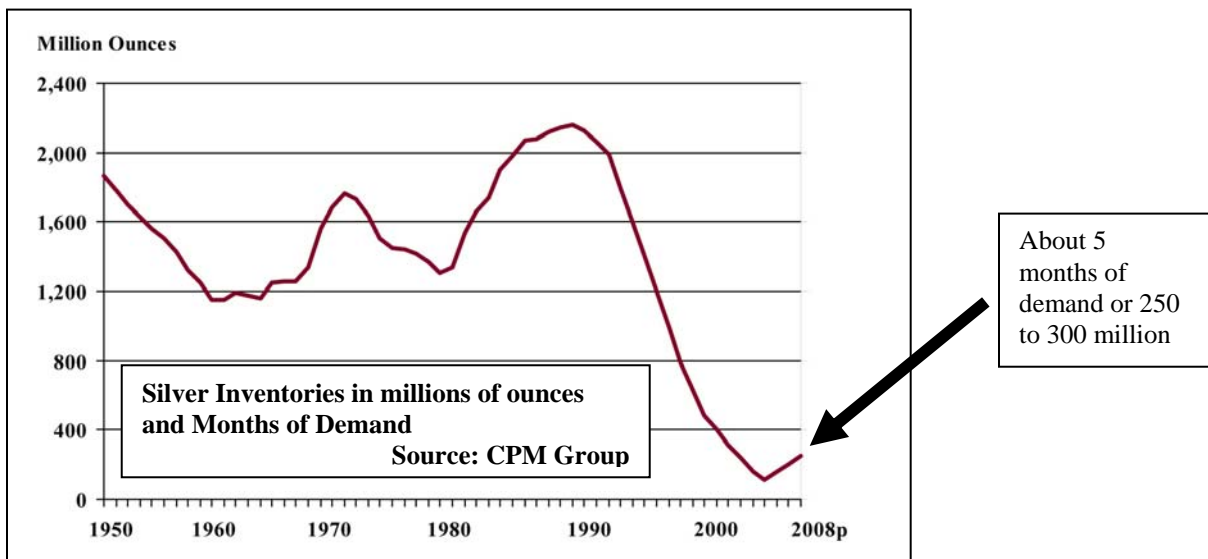


Silver is one commodity other than gold that we like. Last year silver’s price fell from \$20.38 (April) to \$8.79 per ounce (October) a 57% decline. Today it sits at \$12.86, 41% off its peak of last year. Gold in the same time period is only down about 8%. So gold has been a real outperformer. This is not unexpected. Gold may not be reacting to inflationary expectations (except amongst economists) but it attracts those investors who fear the worst – whatever the worst may be.

Gold outperformed silver during October 2008 by 75% and still shows a 47% advantage since silver’s peak price in April 2008. Currently the gold to silver ratio is 70 times, or 70 ounces of silver buy one ounce of gold. We think this ratio is far too high. Silver often lags gold and then is forced to rally relative to gold. If you believe that inflation is in the future, silver appears to be a very good opportunity at this time.



The fundamentals of silver are also excellent. According to the CPM Group, silver inventories were 110 months of supply in 1950 and 60 months of supply in 1980. Today they are less than 5 months of supply. In addition, with base metal prices in the tank there has been much supply destruction in the silver space. In other words we think there is the potential for the perfect storm in silver pricing. This decline in inventory occurred in spite of the move from silver used in photography.



suggested that silver could show late game strength in its catch-up with gold.

“GFMS argued in the report prepared for the Silver Institute that the metal, which is used for industrial and jewellery purposes, normally underperforms gold when prices move up and then outperforms gold as the rally continues. “This is essentially what we have seen in the first few months of 2009, with silver generally responding with a lag to renewed rallies in gold prices.” This phenomenon coupled with silver’s comparatively low starting point at the beginning of the year could well result in silver outperforming gold on an intra-year basis in 2009”.

A table showed silver underperforming gold in 2008. Gold put on 4.3% or a \$36/oz gain during the course of last year, while silver shed nearly \$4/oz or 27%. “Since December 2008 to date, investors, spurred by a renewed rally in gold and heavily oversold conditions in the silver market have bought aggressively, pushing the metal’s price higher and thereby gradually narrowing the gap between gold and silver indexed prices.”

Last Friday I attended a presentation by Endeavour Silver. They are mining a resource of 62.1 million ounces (in all categories including gold credit) at two mines in Mexico, Gaunacevi (Durango) and Guanajuato (Guanajuato). In 2008 the company produced 2.3 million ounces of silver. Endeavour expects cash costs of production to decline to \$7.50 per ounce in 2009 and fall to \$6.75 by 2011. The shares were trading at \$5.50 - now \$1.51 and much undervalued even after an 80% jump. These are primary silver mines and so have no fallout from lead and zinc credits. Guanajuato is smaller in tonnage but boasts gold grades in the 2 to 3 gpt range. The strategy of Endeavour is to acquire pure silver properties. They are on the look for them now. The company has working capital of \$15.2 million (\$11 million convertible debt) and 69.3 million shares outstanding, fully diluted.



The similarities between the Endeavour Silver story and Quaterra's Nieves property are stark. Of course Nieves is still only in the exploration stage. Only 82 holes have been drilled there. However QMM recently published a 43-101 with close to 30 million ounces of silver in all categories. We think more drilling at Nieves (only 1/3 of 1 vein has been drilled) has the potential to expand resources to 50 million ounces or more. I believe with more exploration the QMM prospects may turn out to be excellent at Nieves. In fact, compared to Western Silver's progress at Peñasquito, I think QMM may have a similar potential at Nieves. Nieves is owned 50% by Quaterra Resources and 50% by the BlackBerry LLC.

If gold has \$1200 potential (33%) in the next year or so (end of 2010) silver could rise 40% to the \$18 - \$20 range. This would make both Endeavour's current production and Nieves in the ground value increase substantially based only on the current resource. Please have a look at both companies

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