

Today's Notes:

1. China Reacts

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We think geopolitics is beginning to impact economics. That should not be too surprising, however, because the economic life of a country or region is oft intertwined with politics. For reasons, not fully apparent, Secretary of State Hillary Clinton decided to give China a good poke in the eye last week. The issue was sovereignty of the Yellow Sea, the South and East China Seas and the islands therein that will yield significant oil discoveries by China's fledgling oil industry. We must focus on two issues. China has been spending double digit percentages of GDP on its military for two decades. In that time she has developed the largest and most powerful navy in Asia. Protecting her sea-lanes means protecting her access to the world's commodity markets, particularly those in Africa. This is crucial to China.

Gone are the days in 2009 when Secretary Clinton proclaimed a bi-polar world with America and China as the world's new leaders. Today the American government wants to assure the rest of Southeast Asian countries that this oil rich region is not sovereign Chinese domain.

The new U.S. political position is somewhat unusual given the recent entreaties between the current administration and China. One could certainly take Secretary Clinton's aggressive stance as politics as usual were it not for the Chinese reaction and the fact that China has a hoard of \$2.454 trillion in foreign exchange and gold reserves at the end of June 2010, 50.3% of her GDP. Much of this is denominated in US dollars.

This blunt US political effort was preceded by Treasury Chief Geithner who most recently indicated that despite Congressional disquiet over a very clearly undervalued Yuan, China is not a currency manipulator but is allowing the Yuan to appreciate. The Yuan has definitely appreciated from 6.82 (to \$1) two months ago June 7th to 6.7644 this day. This currency move is not significant except in the sense that China is acting, perhaps in her own interest, to control her inflationary problems and not in response to US Congressional concerns.

But the access to "domestic" oil supplies is an entirely different playing field for China, just as it should now be for the United States. Russia is playing the same political card in the arctic. No matter how quickly Americans want to move to an alternative energy economy, such a move is at least a multi-decade process. Were it not for the 1.9 million barrels of Canadian oil imported each day (about 1.2 million bbl. from the Canadian "Tar" sands) Uncle Sam would be even more exposed internationally to political blackmail. But we think that the significant change at the US State Department toward China's sovereignty of the seas may revolve around the upcoming November elections as well. If so this is a dangerous ploy.

Enough said. But the story is not yet complete. China has reacted quite rightly. For two years now China has allowed ("encouraged") its citizens to buy gold and silver in what we believe is a "home-

made” diversification effort. China’s extensive exposure to dollar and Euro bonds is a problem for its leaders.

As Richard Russell so rightly argued Tuesday, the only way out for the US, in his view, is to inflate and that means using Chairman Bernanke’s printing press. That, in turn, means that Dennis Gartman’s “things that hurt” must appreciate in value. Having developed this hypothesis it remains to be seen how long and how difficult it will be for the Fed and Treasury to induce inflation.

As we recently wrote President Roosevelt attempted to inflate the US economy and win political favor by allowing the Fed to purchase silver I the open market in 1934. This caused a deflationary spiral in China (at the time still on a silver monetary standard) and eventually a massive hyperinflation that many believe brought Mao and the Communists to power.



China’s reaction to all this past and recent history must be one of distrust of the US and its currency. There have been less subtle warnings from Beijing for at least 3 years. Bloomberg reported Tuesday that China will move to free up the gold market even further¹.

“China may “increase foreign members on the Shanghai Gold Exchange and will also study ways to allow foreign qualified bullion suppliers to deliver to the exchange,” the People’s Bank of China said yesterday. The country is the world’s largest gold producer and second-biggest consumer after India.

The plans are ***“extremely encouraging”*** and will boost Chinese demand, George Milling-Stanley, the World Gold Council’s managing director of government affairs, said yesterday. Bank of Shanghai Co. received approval from China’s central bank to import gold.”

¹ *“Gold Climbs For Sixth Day as China’s New Rules, Lower Equities Spur Demand”*

Under these circumstances gold and silver must now have significant upward price mobility. Is a gold and silver monster about to be unleashed to diversify Chinese exposure to the US currency?

More to the point, and thanks to Tom Turner, China reacted directly to Secretary Clinton's ocean sovereignty "stick." Bloomberg reports this AM,

"China has to depend more on demand and supply in the foreign exchange market for the determination of the Yuan exchange rate ... Only God knows how much value that China has stored in the U.S. government securities will be left in the future when China needs to run down its reserves."

The cost of pegging the Chinese currency to the dollar is "intolerably high" and threatens the welfare of Chinese people, [Zhang Ming](#), deputy chief of the International Finance Research Office at the Chinese Academy of Social Sciences, [wrote](#) today on the website of China Finance 40 Forum.

"The U.S. government has strong incentives to reduce its real burden of debt through inflation and dollar devaluation," he said. "Whichever way it is, the Yuan-recorded market value of Treasuries will fall, causing huge capital losses to China's central bank."

This eventuality is anathema in both Washington and Beijing. This is now geopolitics with enormous consequences. Perhaps it signals competing goals for each side. The current US Administration is concerned as it approaches November's elections. China needs commodity security, particularly steel, copper and oil access. That means control of its sea lanes and sovereignty in the South China and Yellow Seas. An escalating but controlled disagreement may be in the future.

Yesterday Pentagon analysts announced that China's Dong Feng 21 anti-ship missile, which may be ready in one year, is a "game changer." The conventional missile can accelerate to Mach 10 and hit a ship with pinpoint accuracy within 900 miles. Apparently there is currently no effective anti-missile defense against the DF-21.

Former Navy commander James Kraska, a professor of international law and sea power at the U.S. Naval War College, recently wrote a controversial article outlining a hypothetical scenario set just five years from now in which a Deng Feng 21D missile with a penetrator warhead sinks the USS George Washington. That would usher in a ***"new epoch of international order in which Beijing emerges to displace the United States."***

As a result this AM, here at Discovery Investing, we reinforce our bullish commodity posture particularly with respect to gold, silver, copper, diamonds, rare earths and, on the energy side uranium, gas and oil. Discovery will become increasingly important.

Lest we forget, Japan found herself in exactly the same situation in the 1930s when President Roosevelt cut off supplies of commodities, principally iron ore, steel and oil, to Japan who was then ravaging China. In the global conflagration that resulted the U.S. established her naval supremacy. That has persisted for 70 years. This though sole US supremacy on the high seas may be ending soon.

China no longer must take these pokes and jabs from anyone. She has at least two powerful weapons at her disposal to ensure her commodity access to the world. One is the advent of cheap but powerful cruise missile technology and the rare earth elements that make them work. US aircraft carriers, such as the USS George Washington, will become vulnerable

within a very few years. Second, and equally important, China is slowly appreciating her currency and opening her gold markets. Her reliance on the US dollar will wane – we believe within a decade or two or sooner. Already she has allowed her citizens to trade paper for silver and gold and eased banking rules for gold markets.

Slowly but surely the global winds of change are blowing.

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