

**Today's Notes:**

- 1. The Great Unknowns**
- 2. Strategy**

## **1. THE GREAT UNKNOWNNS: GOVERNMENT INTRUSION, TAXES**

There must be some light at the end of this tunnel. There is, of course. But one must ask just how long that "tunnel" will be. The banks continue to be sick, you see. The economic contraction that now engulfs the world was begun many years ago. Michael Steinhardt believes that this current economic situation including the Madoff tragedy is a "watershed event" for public perception. Changes are in order and changes are coming. Some changes are clearly necessary. Some changes will be beneficial. Many changes will be hastily considered and bring with them the risk of government intrusion and restriction of liberty.

Citigroup announced an \$8.2 billion loss this AM. It is ironic that in September Citigroup bid for Wachovia and lost, fortunately. Bank America won Merrill Lynch - unfortunately. Evidently, Citi wrote off everything that was questionable including \$5.3 billion in derivative securities. Before today Citi had already written down \$67 billion in bad assets. Citi will now split into two units. **This is the third cash infusion into Citigroup by the government in 4 months.** \$20 billion was injected in October, \$25 billion in November and now \$20 billion in January. Government lifelines are becoming a self fulfilling prophecy.

Bank of America, the lucky acquirer of Countrywide and Merrill Lynch (on September 15<sup>th</sup>), also announced a loss of \$15.6 billion in its Merrill Lynch unit and \$2.4 billion itself. This forced Uncle Sam to step in and inject another \$20 billion of capital as well as guarantee \$118 billion of the bank's (BOA) lending portfolio. The Treasury, FDIC and Fed all participated in this lifeline guarantee. The government now owns 6% of Bank of America.

There are three points here:

1. Even though the equity futures market like these write downs and the B of A government lifeline, we witnessed this same play in November. Dr. Bernanke was accurate on Tuesday - the banking system remains unstable and at risk.
2. How much more money must be printed by government and injected into the banking system before we finally and irrevocably nationalize the US banks in this country? FDIC Chairwoman Bair says this is unlikely – I have my doubts that she is correct.
3. Mr. Obama will spend \$150 to \$160 million (4 times more than his predecessor) on his inauguration celebration. Guess who some of the largest contributors were to his inauguration celebration? There are billions of dollars to be given away in DC. There are billions in taxes to be collected. How will this Broadway play finally end?

This AM our representatives in Washington have crafted an \$825 billion fiscal spending rescue package. \$275 billion of that package will extend tax breaks to Americans. The Battle of the TARP has evidently been won by the incoming president. In a characteristically political statement, that lacked all humility, Mr. Obama remarked.

*“I know this wasn’t an easy vote because of the frustration so many of us share about how the first half of this plan was implemented .... Now my pledge is to change the way this plan is implemented and keep faith with the American taxpayer.”*

Again we hear the word “change” from the incoming Chief Executive. Yet, given the ongoing instability and fragility in the banking system it cannot be clear to anyone what “change” makes sense regarding the TARP allocations. Mr. Obama should give thanks that the Paulson Treasury and Democratic Congress pushed hard for the TARP last year.

I suspect that Mr. Obama will never have more public and Congressional support than he has at present. This is because the **Great Unknown** lies directly in front with an unknown, incoming President. In examining the chart below, note that **“only”** \$90 billion is actually allocated to infrastructure development. Please note that \$48 billion is allocated to **“OTHERS.”** Sorry for my pessimism but this appears to be another spending boondoggle for the lucky few who can curry favor with those dispensing the dollars. They are lining up as I write.

And so we have in the past few days added another \$1.175 trillion to the amazing all in total of over \$8 trillion for rescuing all of us from our debt-induced greed and the calamity that had its birth way back in the 1978 Carter days with the Community Reinvestment Act. The calamity extended for over 30 years till the bubble finally burst. Just to write it out that is \$1,175,000,000,000.00. Even this large amount is not really fathomable and it is not going to be enough. Several commentators wrote back in the sunnier days of April 2008 that the government ought to buy all the mortgages in the US. Perhaps that is exactly what should have happened.

So this is the first cut at how the money will likely be spent. Have a good look at the plan. Can anyone see how this will create 2 to 4 million jobs in the next three years? If so educate me. No one in Washington understands if this program is adequate or if these specific allocations will do the trick – for trick it shall be.

## Divvying Up \$825 Billion

The economic recovery package, outlined by the House Democrats, allocates about \$275 billion for tax cuts and \$550 billion in new spending. Major components of the bill:

### **\$275 billion** TAX CUTS FOR INDIVIDUALS AND BUSINESSES

Includes a tax cut of \$500 for individuals and \$1,000 for couples by reducing payroll tax withholdings and a proposal that would allow businesses to cut taxes by writing off current losses against profits earned in the past five years, instead of the usual two years.

### **\$119 billion** AID TO STATES FOR HEALTH CARE AND OTHER ESSENTIALS

- \$87 billion to temporarily increase aid to states for Medicaid costs.
- \$25 billion for high priority needs like public safety and other critical services, which may include education.
- \$7 billion for law enforcement and to help needy families.

### **\$117 billion** EDUCATION

- \$41 billion to local school districts for schools serving impoverished and disabled students and for construction needs.
- \$39 billion to local school districts, public colleges and universities.
- \$15 billion to states for meeting key performance measures.
- \$22 billion for higher education; includes increasing the Pell grant.

### **\$106 billion** AID FOR UNEMPLOYED AND THE NEEDY

- \$43 billion to extend jobless benefits and provide training services.
- \$39 billion to help those who lost their job to keep their group health benefits under the COBRA law and provide short-term options to be covered by Medicaid.
- \$20 billion to increase the food stamp benefit by over 13 percent.
- \$4 billion to increase Social Security benefit payments for low-income disabled and elderly people.

### **\$90 billion** INFRASTRUCTURE

- \$30 billion for highway and bridge construction.
- \$31 billion to repair federal buildings and other public infrastructure and make them more energy efficient.
- \$19 billion for water and environmental projects.
- \$10 billion for public transit and rail systems.

### **\$54 billion** ENERGY INVESTMENTS

- \$32 billion for smarter electricity grid and renewable technology.
- \$22 billion to repair public housing, make federal infrastructure more energy efficient and provide aid to low-income people to weatherize their homes.

### **\$16 billion** INVESTMENTS IN SCIENCE AND TECHNOLOGY

- \$10 billion for scientific research and facilities.
- \$6 billion to expand broadband Internet service to rural areas.

**\$48 billion** OTHERS (may include small-scale investments in categories above)

## 2. STRATEGY

How does one go forward in this environment? First let me say that Discovery Investing is, by no means, dead. But it is delayed. In fact where other investing strategies (growth or value) may founder in the next few months, it is clear that we are likely to need many new discoveries in several areas. Discoveries in biotech, high tech and infrastructure are all critical. Discoveries in energy conservation and efficient generation and delivery are also critical.

I want to reiterate that maintenance of our particular standard of living (AKA Quality of Life) requires cheap energy. That goal is now compromised by the wrong-headed notion of human global warming. Energy supplies, whether in photovoltaic, wind, nuclear or carbon-capped coal generation will become vastly more expensive. This will hurt the US economy. More than that, we become more dependent on OPEC every day that financing of discovery companies comes off line – and believe me it is coming offline quickly.

So I recommend the following strategy. In the commodity sector deflation now holds sway. But I am convinced that deflation will last for the duration of the year and not much beyond. Then at some point in mid to late 2010 we shall see inflation rear its head. So much supply in zinc, nickel, uranium, oil et. al. will have come off line that discovery companies that remain, with world class discovery prospects, top notch management and reasonable balance sheets, will go bid.

So you have a hiatus. In the meantime, I would tend to short Treasuries and own the gold shares. Goldcorp for example is an incredibly cheap stock at these levels. Nor would I be afraid to own the likes of BHP, RTZ or Freeport Mac – now. In addition I am still very positive on the biotech sector. It is a matter of attracting investment in this very tough time.

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