

**Today's Notes:**

1. Inflation
2. The Oil Sands
3. Housing

**1. THE NAKED CITY**

*“There are eight million stories in the naked city. This has been one of them.”*

*Naked City (1958): Sandy Dennis, Dustin Hoffman, Jon Voight, Peter Fonda*

Yesterday was a steamy, sultry summer day here on the east coast. I ventured into the naked city to interview executives of an unconventional (Alberta Shale gas) Canadian Gas producer, Stealth Ventures (SLV.V). I'll tell you about that meeting in the future. But what I noticed, because I taxied to the meeting, was the increased expense. The taxi ride, from 11<sup>th</sup> to 44<sup>th</sup> street, where the meeting was scheduled, cost \$10.00. NYC subway fares are scheduled to escalate 13% over the next two years. After the meeting I met with my son and daughter. Both work and live in the “naked city.” My daughter said her breakfast sandwich now cost \$3.50 a \$1.00 (40%) increase over this time last year. Inflation is beginning to show up even if not in the Core CPI numbers. Inflation will impact mom and pop in different ways – directly.

Costco (Costco Wholesale Corp.) has been a favorite of mine, as you may know, for years. I recommended the shares as a Legacy Investment in October 2005 and again in April 2006 in these Notes. I have taken profits twice. The shares have doubled over that timeframe compounding at about 30% annually. When I was a young fellow my father owned an IGA store near London, Ontario. I worked there. It was hard work and the margins were very low. The business model required volume sales. As a result whenever I visited Costco I marveled at the innovation of this new warehouse retailing business model. At Costco labour efficiency, in-house production and economies of scale are the rule. Over the past 5 years every time I have visited Costco here in northern New Jersey, the place has been packed, lines at the automated checkout stations were long and food carts piled high. I often mentioned to Kate how prosperous North Americans seem relative to the rest of the world. It was always, to me, the indicator of the very, very high quality of life that we enjoy.

But it would appear that after years of successful innovation and implementation of its business plan, Costco has hit a speed bump. That speed bump may be reflective of what is happening in the global economy. From **both sides** we are hearing bad news. On the one hand we may have demand destruction which may unload those Costco food baskets of many of the extras for the kids. On the other hand the threat of inflationary expectations is dividing the Fed presidents and FOMC members along fault lines.



Analysts suggested that Costco has been sheltered from the impact of food price inflation by a LIFO 'wafer' on its B/S. It was inevitable that higher costs would hit the firm. 2Q earnings were impacted significantly and the firm missed expectations – for the first time in long time. Costco is a real-time case study that is being repeated in other retailers. The market doesn't like surprises, as you can see, but how much of a surprise was this really. The real issue in this 'story' is which of the two alternatives, deflation or inflation, is the lesser evil. A second question of course is what is the impact of an interest rate change – in either direction? One can never know what might have happened, but the interest rate decreases this time around have not been very effective in staving off the credit crisis we now face. But will future Fed Funds rate increases by the Fed control inflation? Is there real demand in the world or is all this commodity volatility simply speculation by really evil people bent on greed?

Dr. Bernanke is trained and ready to fight deflation. Some of his minions at the Fed are now most anxious to tackle the "unhinging" of inflationary expectations. Seldom have we seen such a division amongst the brain trust at the Federal Reserve. This divisiveness is undermining the confidence in the Fed and its ability to stabilize the capital markets.

One senses that the greater risk, given yesterday's market decline of 282 points and the housing numbers that show continued decline, is the Philadelphia Fed's President Dr. Plosser who advocates raising target rates, in spite of the current market fragility, a necessity. These are difficult and risky decisions and we seem to be nearing the end of the long and tortuous road in Fed policymaking.

I think former Clinton Treasury Secretary Lawrence Summers said it best on June 29 in an FT op-ed article, *“What can we do in this Dangerous Moment?”* He suggested that the housing bill must be passed asap, fiscal stimulus is necessary and addressing the non-monetary (structural) problems of commodity inflation where they exist. This means ceasing the ethanol boondoggle, promoting the use of natural gas and drilling offshore. He suggested that banks must get ahead of the curve in their writedowns. For example, Citigroup has written down \$55 billion but another \$115 billion of potential problem paper still exists. Fourth and perhaps most important Secretary Summers said, *“it must be recognized that in the months ahead there is the real possibility that significant financial institutions will encounter not just liquidity but solvency problems as the economy deteriorates further and further writedowns prove necessary.”*

There may be 8 million stories in the naked city, indeed, but this one is by far the most important.

## 2. CANADA’S OIL SANDS

Canada’s Financial Post reported yesterday that 10 Greenpeace activists had blocked a pipe to a waste-water pond operated by Syncrude Canada Limited<sup>1</sup> at the company’s Aurora mine in the Canadian oil sands north of Fort McMurray, Alberta. Apparently 500 ducks died after landing on the pond earlier this year. The Post reports that heavy metals settle in the tailing ponds and that Alberta regulators plan to tighten the rules for the toxic ponds.

In another article Suncor announced yesterday that due to energy inflation its cost of producing a barrel of synthetic crude from the oilsands has topped \$50. At \$100 per barrel SU’s margins are still more than adequate. It does demonstrate that higher commodity prices are likely to stay with us as long as the world is adding new energy users in the BRICS. In other words demand destruction, much argued by those hopeful of lower prices may not prevail.

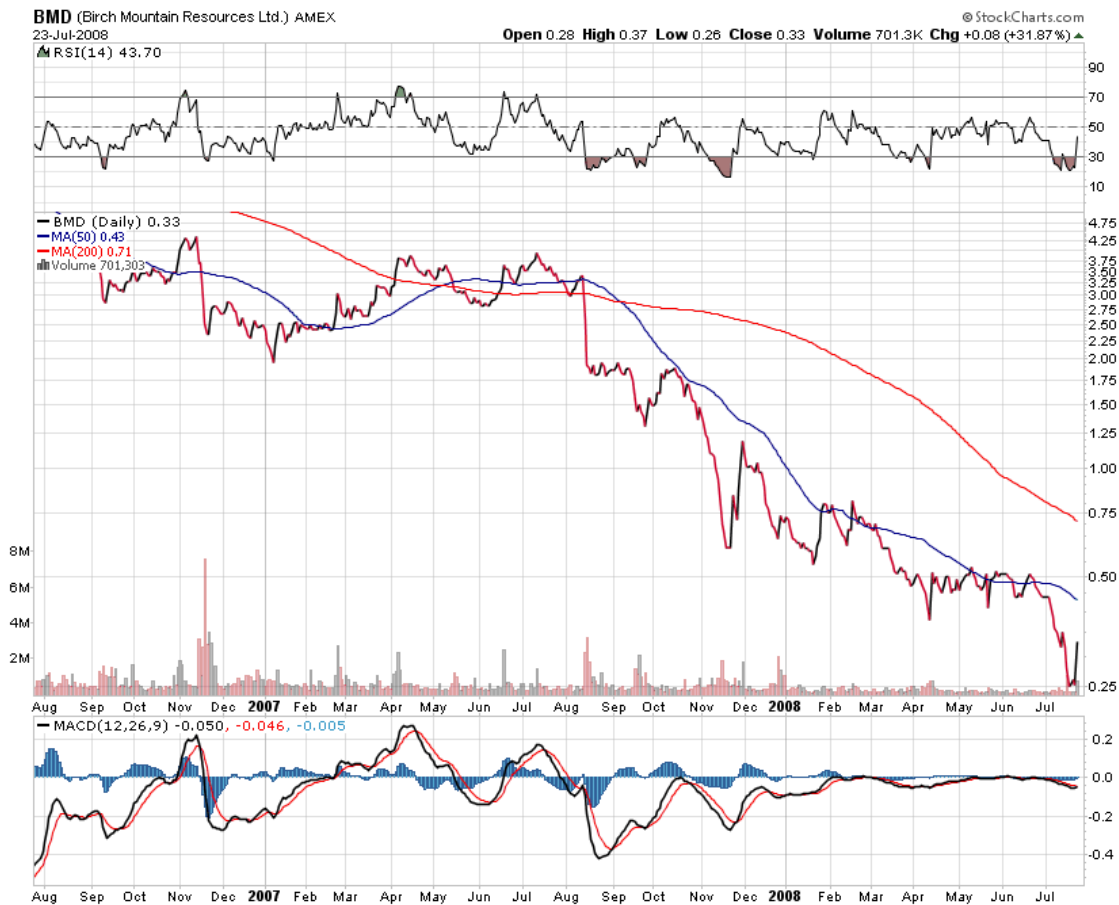
Suncor will also produce 9 million tonnes of petroleum coke (a thermal coal-like substance) by 2012. Suncor’s coke is a by-product of synthetic crude production from the oil sands. Suncor burns 1 million tonnes of coke to power its upgrading operations. The price of coke sells at a discount to coal but it has appreciated by 400% in price along with global coal prices. Here’s the problem. Coke gives off CO<sub>2</sub>, SO<sub>2</sub> and heavy metals such as mercury when burned. But Suncor along with CN Rail (recently bought the Northern Athabasca railway) may plan to ship the coke (and piles of yellow sulphur) by rail first, through Port Rupert BC to Asia. Asia will continue to have a voracious appetite for coal-based energy for decades. Should CO<sub>2</sub> capture technology ever become economic, coke could be used as fuel for the upgrading in the oil sands. In the meantime I think Suncor is still a buy at these levels and have recommended it in June 2006 and August 2007.

**Birch Mountain management announced that they are putting themselves up for sale.** RBC will handle the sale. There are rumors that several companies may be

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<sup>1</sup> Syncrude is a joint venture owned by Canadian Oil sand Trust, Conoco Phillips, Nexen, Imperial Oil, petro Canada, Nippon Oil Corp, Mocal Energy Ltd. and Murphy Oil Corp.

interested in buying the limestone assets of the company. It has been a long hard fall for shareholders, including myself, in this company. At its peak the shares sold for \$9. They recently bottomed at \$.25. I suspect most of the problem was that oil sands producers were just not ready for the array of limestone based products that the firm could offer. The management team did execute on the building of the quarry. They recently announced two significant contracts. One important contract is for reagent grade limestone to purify the Suncor's power plant in a trial. This is very high margin material. The second was for the South haul road. Both these contracts were expected much more quickly and, for a number of reasons, were delayed.



I visited the oil sands 7 times over the past 4 years, I met with North American, LaFarge, Suncor, Syncrude, the Fort McKay supporters and many others. I suppose, in the final analysis, Birch Mountain was the tail that did not wag the dog. In other words the capital expenditures in the recent development of the oil sands were directed at building basic production capacity such as upgraders – just my opinion. I believe that Birch management is determined to sell the company. I think the company's creditors will allow a reasonable sale process. The question then is, what is Birch Mountain worth? I have my opinion but I can say the assets are certainly worth more than \$.32 cents, where it trades today.

If you have read this Note carefully you will realize that tailings pond security and purification, flue gas desulphurization, cement and infrastructure build out are becoming critical in Fort McMurray. For example, high grade limestone is the perfect solution for capture of the sulphur dioxide and heavy metals from burning coke as a fuel in upgrading. These environmental pressures and the global energy build out will increase the value of Birch's limestone assets. Someone is likely to buy a very valuable asset. That value is to be realized in the future.

### 3. HOUSING

I am sorry to report this AM that foreclosures have more than doubled over this period last year (up 121% in Q2). Home foreclosures have increased 14% since the first quarter of 2008. One of every 43 homes in Nevada and 1 of 65 homes in California are in foreclosure. **These are troubling numbers for the banks and the economy.** Citigroup still has \$115 billion in questionable real estate "paper." I am especially sorry because so many families are torn from their homes. With this new data, Realty-Trac estimated, this AM, that in 2008 2.8 million foreclosures will occur. They also suggest that housing prices have another 15% downside in the next 12 months. This is not surprising but it is imperative that our legislators move quickly on the Fannie / Freddie legislation and that these GSE's become more (and not less) active participants in the housing market. I suppose we are seeing one of the worst aspects of a democracy – the snail's pace of reform. The Senate is now holding up the Fannie / Freddie rescue bill. It's just the way things work in Washington. To those who say let them fail – nonsense.

It is becoming apparent that the "Kudlow Equity Euphoria" of the recent days may have been premature. Yesterday's Dow fell almost 300 points. The markets look teary this AM and gold is slightly higher while the dollar is trading lower in pre market activity. Along with the foreclosure data and housing deflation, near recession unemployment and a commodity pullback we are carefully watching for signs of real deflationary contraction – as I am certain Dr. Bernanke is as well.

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*consultant to Piedmont Mining (250,000 options), Valcent Products (300,000 options), Global Green Solutions (400,000 options) and War Eagle Mining. He owns shares in Goldcorp, Golden Predator, Senesco Technologies, Birch Mountain Resources, DataMeg, Immtech International, Horseshoe Gold, Midway Gold, Derek Oil and Gas, Terraco Gold, Stealth Ventures, Kenrich-Eskay Gold, US Silver, Galway Resources, Neuralstem, Oil Sands Quest, Enhanced Oil Resources, Piedmont Mining, MegaWest Energy, Valcent Products, CGX Energy, MacMillan Gold and Quaterra Resources. He has been awarded 250,000 options on Terraco Gold exercisable at C\$.50 for 5 years, for services as a consultant. He has also been retained as an advisor by Dejour Enterprises (200,000 options plus retainer of \$2,500 per month), Grande Portage (210,000 options, \$5,000 per month retainer and Galway Resources (200,000 options and \$5,000 per month). In his role as advisor he has been awarded 75,000 options from Polymet which strike at C\$2.76. We cannot attest to nor certify the correctness of any information in this note. Please consult your financial advisor and perform your own due diligence before considering any companies mentioned in this informational bulletin.*