

## Today's Notes:

## 1. Double Dip

## 1. DOUBLE DIP: THE SURVIVAL STOOL

I have been writing Morning Notes for 7 years now. Every July 1<sup>st</sup> through 4<sup>th</sup> I try to write on the obvious. That is the celebration of Canada Day north of the border and on Independence Day of Canada's southern neighbor. Having been born in Colombia, raised and schooled in Canada and now residing in the U.S., I have a uniquely "pro-America's" view of the world. There is no doubt in my mind that we will resurrect ourselves from the perilous economic shoals on which we have run aground. But it will take time, and cohesive non partisan action.

This week most observers believed we would see equity window dressing for 2<sup>nd</sup> quarter end. By that I mean that we should have seen a stock market rally. But as you know by now equity markets in the U.S. (and I might add around the world) have broken down. Luminaries such as Richard Russell believe we are now beginning a dark journey to much lower equity levels. 9800 on the Dow Industrials and 4400 on the Transports was crucial. Yesterday those market unraveled lower.



Russell calls the current Dow the greatest market top he has ever seen. It appears that the greatest bear market rally we have ever experienced is over.

Unfortunately these markets are not discounting the past; they are discounting the future. Carl Sandburg captured the theme best, "the past is a bucket of ashes." What's done is done. This July 2, 2010 we believe that the tug of war between deflation and Fed-induced inflation is finally settled. Deflation, at least for the present, is in the cards.

The world's bankers are still in frantic deleveraging mode. The St Louis Fed's velocity stat is still well below 1. There is a huge overhang on global growth everywhere from Athens to Washington. China is clearly slowing. We feel that economic growth will be anemic and volatile at best and that a double dip recession in the U.S. is now foreordained. Liberal economists such as MIT's Dr. Paul Krugman take a much more negative view of the situation. Dr. K believes we are slipping in a Depression that will dwarf the Great Depression of the 1930s.

Krugman calls on Washington for more fiscal stimulus. But most are beginning to recognize the failure of the Bush / Obama stimulus packages and with that the failure of Keynesian economics. At present there is a dominant liquidity trap in the U.S. negating and devouring the Keynesian economic solutions.

While equity markets have fallen hard, bond yields are also falling. This is no bubble, it is the beginning of the rationalization of the 70 year debt binge that the west has been living on since the end of WW II. It is to quote PIMCO, the new normal, a painful new normal indeed.

This past week we saw copper prices fall significantly, a harbinger of slower growth worldwide. In addition oil fell significantly though still above \$73 per barrel. Perhaps the most ominous issue is the schism that has developed between the United States and the rest of the G20, particularly Canada and Europe. Almost everywhere we look in the world we see austerity programs in the making. We see tightening of the reins and mouthing of the need to reduce debt and deficit spending. Even the French are reining in expenses at the Elysee palace and raising taxes to 41% on salaries over 69,000 Euros (\$83,000).

Everywhere that is except in the United States where the Obama Administration wants more spending – a failed policy.

But Congress in the US is reluctant to support more spending. Globally there is finally a healthy realization that you cannot borrow and spend your way to prosperity. The Administration in Washington is now hooked on the horns of a dilemma of its own and previous administrations making.

Last July 3 I wrote that unemployment was at 9.5% and sure to move higher. Today U3 unemployment (which we think the BLS has underestimated significantly) is officially at 9.7%. This at a time when the U.S. needs 100,000 new jobs a month to stay even. Two years ago today (July 2, 2008) immediately before the Paulson-led takeover of Fannie and Freddie (for which taxpayers are on the hook for \$1 trillion) oil was \$147 per barrel. At the time Goldman said it would hit \$200. We see that Paulson gambit (July 13, 2008) as the catalyst that starting this great deflation ball rolling.

But today as Canadians and Americans celebrate their respective national holidays in Barrie Ontario, Melfort, Saskatchewan and Kakankee, Illinois (as well as here on Nantucket Island where we are spending a few days) the world faces perhaps its most serious global challenge since the 1930s and the rise of Fascism and Communism.

Deflation, falling prices, is a phenomenon that economists eschew. Once in control of an economy it is devilishly difficult to deal with. **In other words for the most part it must run its course of liquidation and slow growth.**

Debt holders benefit from inflation but suffer in a deflation as the value of a currency appreciates and debt liabilities increase in value.

How long this deflation will obtain? One year? Two years? What are the geopolitical consequences? No one really can say except that there are huge global debt loads and deficits that must be liquidated. Fiscal solutions (government spending) are almost certainly out of the question on this Independence Day. To judge from the \$787 billion shovel ready jobs program of the current Congress this has been a failure as would more such fiat money creation.

The U.S. can “push its face” for a while longer in the global debt markets but the G20 meetings in Toronto not only highlighted the schism in thinking between this U.S. Administration and virtually the rest of the world, but the meetings also very subtly set a course for the ultimate demise of the sole reserve currency status of the U.S. dollar.

One post script is probably in order. We think that following this deflationary experience that will be painful but not fatal, inflation will recur. Besides celebrating this weekend the births of our respective nations sit a while and think about how you might navigate these waters for the next few years. Try to define at least three legs of your personal “Survival Stool.”

Reducing debt and cutting consumption to those items that are necessary for an adequate lifestyle is a personal goal of mine. Raising some cash (20% to 40%) and owning precious metal exposure is another “leg of the survival stool.” I might add that both gold and silver were devastated yesterday but this simply provides a lower entry point. We favor silver at this point and it seems to be rebounding this AM.

The barbell portfolio we have recommended for the past decade as your core portfolio is looking awfully good at present. In the meantime please seek those important discovery companies that will form the backbone of our future recovery – whenever that may be in the cards. They are cheap and getting much cheaper.

All the best for the Holiday Weekend – from Nantucket Mass. We must all be thankful for our many blessings. My granddaughter Lucy is 2 ½ and with me here on Nantucket and I am thankful for all God’s many gifts.

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