

Today's Notes:

1. Headwinds: Unemployment, Foreclosures and Commercial Real Estate. Deficit and Taxes

1. HEADWINDS

I call it a definitional recovery. To my knowledge no one else has coined the term. It is definitional because the economic recovery we shall see (I have maintained in the 4th quarter of 2009) will be a result of the \$787 billion fiscal program beginning to exert its effect. Please remember that the Bush / Pelosi Congress spent another \$250 billion in 2008 that buoyed first quarter 2009 GDP slightly. Alas all fiscal spending, even if directed at initiating real growth (rather than Congressional earmarks), is temporary.

In order for a **REAL** economic recovery we must have incentives for the private sector to invest. Given the new stigma associated with risk-taking and speculation, (and the government's dalliance with too big to fail dogma) mom and pop the ultimate progenitors of real investment in the economy, are saving. The saving rate is now approaching 8% - from 0% in 2007. That means that 70% of the \$14 trillion US economy (approx. US \$10 trillion) is on the sidelines. We can argue about the beginning or the end of the current economic recession but it is the depth of the recession and quality of the recovery that matter. In his weekly radio and Internet address on Saturday President Obama said,

"It will take many more months to fully dig ourselves out of a recession -- a recession that we've now learned was even deeper than anyone thought ... and when we receive our monthly job report next week, it is likely to show that we are continuing to lose far too many jobs in this country. As far as I'm concerned, we will not have a recovery as long as we keep losing jobs."

Even president Obama believes that while US GDP may grow, jobs are going to be scarce for a long time. To these unemployed it feels more like a depression even as Washington sees a definitional recovery in GDP.

But there are significant headwinds buffeting this recovery.

- 1) On Sunday (August 2, 2009) Treasury Secretary Geithner refused to rule out a tax increase to 95% of Americans when questioned by George Stephanopoulos on the Obama Administration's pledge for no taxes on 95% of US incomes. He said

"We're going to have to do what's necessary ... We have to bring these deficits down very dramatically, and that's going to require some very hard choices."

"We will not get this economy back on track, recovery will be not strong and sustained, unless we convince the American people that we are going to have the will to bring these deficits down once recovery is firmly established."

National Economic Advisor Larry Summers agreed. My take - Taxes on the middle class will increase even if spending plans are delayed. Anyone remember what happened after President Bush '41 uttered the infamous "no new taxes?" Will there be a national sales tax? Such a tax would significantly retard the recovery.

- 2) Unemployment may indeed be a lagging indicator but if you are unemployed or under-employed and unable to put food on the table, this still will feel like a depression. Today 9.6% of the American population is unemployed and 16.8% is underemployed – most since the great Depression. Unemployment is increasing each month. Michigan’s unemployment rate is 15.2%, Rhode Island’s 12.4%, Oregon’s 12.2%, South Carolina’s 12.1%, Nevada’s 12.0% and California 11.6%.

In the past month (June 2009) the following states exhibited the largest increases in unemployment rates:

Employment	May-09	Jun-09	Loss	%
Kansas	1,355,900	1,336,500	19,400	1.43%
New Mexico	826,000	819,000	7,000	0.85%
Michigan	3,877,100	3,845,800	31,300	0.81%
Ohio	5,133,200	5,100,200	33,000	0.64%
Virginia	3,677,600	3,654,800	22,800	0.62%
Utah	1,214,700	1,207,900	6,800	0.56%
Colorado	2,261,800	2,249,300	12,500	0.55%
California	14,351,500	14,285,000	66,500	0.46%
Tennessee	2,662,200	2,649,900	12,300	0.46%
Oregon	1,634,400	1,627,200	7,200	0.44%
Texas	10,399,300	10,358,700	40,600	0.39%
Georgia	3,918,700	3,904,500	14,200	0.36%
New York	8,605,200	8,582,200	23,000	0.27%
Minnesota	2,655,800	2,649,100	6,700	0.25%
Newly Unemployed in these states in June			303,300	

As you can see there is a stiff unemployment headwind on this recovery. Most expect this headwind to increase.

- 3) Unemployment benefits are quickly running out. The NYT (8/01/09) reports that in 24 states benefits now extend to 79 weeks (33 weeks typical in a cyclical recession). \$24 billion of the \$787 billion fiscal stimulus was allocated to these transfer payments. In many other states the benefits (approx \$300 per week) extend from 44 to 76 weeks. Without further unemployment extensions ½ million

will drop off the dole by September 30 and 1.5 million will lose their benefits by year end. Congressman McDermott (D Wash) wants to pass legislation to increase benefits for states with unemployment levels above 9% (see list above). This effort alone will cost another \$40 to \$70 billion.

- 4) While residential housing prices may finally be bottoming, commercial real estate is tottering. In my dealings with Federal Reserve, FDIC and OCC banking regulators there is a very strong sense that commercial real estate declines have yet to be fully felt on the banking system. Moody's estimates that commercial real estate prices fell 7.6% in May. They have now fallen from their October 2007 peak by 35%. Distressed sales are beginning to ramp up. \$29 billions of CMBS (3.5% of total) have become delinquent YOY. Total commercial bank exposure could reach 12% or \$300 billion affecting many smaller banks. Commercial real estate prices in Hong Kong, Singapore and Europe have also fallen precipitously. Rents in Hong Kong are 20% lower in the first quarter. Rents in Moscow have fallen 63% in 12 months through June. The commercial real estate decline is global. Europe's banks have significant exposure to this sector.



Viewed through the lens of these headwinds the “recovery” will be difficult for the US and the global economy. There is some good news. For the present the banking system seems secure even as other shoes continue to drop and smaller banks are now feeling the bite of deepest and longest recession we have experienced since the great depression. The idea that so much wealth has been extinguished and so much debt created, dramatically changes the balance of power in the world. The Chinese are quite right to continue to be concerned with the future trajectory of the US dollar – whether or not we like it in the West.

Now the real puzzle is Congress. How on earth can our lawmakers expect to:

- 1) Tax energy use by 30% (when both China and India have publically said they will not participate in cap and trade).
- 2) Implement universal public health care with an increasing cost curve and a \$1.6 trillion bill.

- 3) Run the war in Afghanistan (1 trillion \$s?).
- 4) Create good jobs for those unemployed while increasing taxes on the middle class.
- 5) Increase our natural resource dependence on Russia, China and the emerging world.
- 6) Convince China and the rest of the world to finance this bouillabaisse of spending profligacy and bailouts by participating in our debt markets.

Can the dollar remain strong over the next decade as we work our way slowly out of this self-induced miasma? I do not believe it possible. I am not entirely certain that China and the BRICS will be able to lead us out either. It will be a long, slow economic road back. You must ponder these issues and decide upon appropriate investment and wealth preservation strategies. If you agree you must contact your representatives and make your concerns known – that’s real democracy not socialism.

Recovery – yes. The initial credit crisis is past. Common sense – no.

Now the specter of a lingering economic malaise brought on, in part, by Washington’s failure to recognize failure and pay the piper. There is no free lunch.

The 2008/2009 strength of the US currency was a brief respite for Canadians in Ontario and Quebec. As Toronto’s Globe and Mail pointed out yesterday some parts of the Canadian economy will be impacted and some will benefit. Nevertheless the trajectory of the US \$, even in this “recovery,” must be lower particularly as de leveraging ends. The commodity currencies will benefit. Industries in Ontario and Quebec are unlikely to be happy. Holders of American dollars are also unlikely to cheer. Unfortunately it is the only way out if Washington’s grandiose taxation and spending plans are to be realized.



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