

Today's Notes:

1. The East Asia Co Prosperity Sphere: The Next Asia
2. The Reversal of the Dollar Carry Trade

1. THE EAST ASIA CO-PROSPERITY SPHERE

Sixty eight years ago today at 6 AM six Japanese aircraft carriers, the Akagi, Kaga, Soryu, Hiryu, Shokaku and Zuikaku launched 197 attack planes. These included 51 Val dive bombers, 58 Mitsubishi Zero fighters and 89 Kate torpedo bombers that launched to attack the United States of America in the Hawaiian Islands. In an unfortunate circumstance Japan had not yet declared war in advance of the attack. It sank or damaged 18 US capital ships and killed ~2,500 soldiers, sailors, marines, airmen and civilians¹. This precipitous action brought the United States into World War II. Canada and Britain were already engaged in Europe but within 8 hours of this attack on Pearl Harbor Japan attacked Hong Kong. Two battalions of Canadian soldiers from the Royal Rifles of Quebec and the Winnipeg Grenadiers who were sent to defend the Crown colony were decimated. By December 25th the Canadians were either killed or captured. Hong Kong had surrendered. Those Canadian soldiers captured spent 44 horrific months in Japanese prison and forced labour camps.

This war was to encompass the globe. Killing technology was rapidly perfected ending in development and delivery of a nuclear bomb and the beginning of the nuclear age. Estimates are that ~ 61 million died from all causes in WW II.

In an historic twist of irony the attack on Pearl Harbor was the catalyst that was to propel the United States into the position of the world's greatest power, which it has remained since. Japan's desire to build and control a "*Greater East Asia Co-Prosperity Sphere*," the goal of its declaration of war on the British Commonwealth and the United States, ended the Great Depression and allowed a massive US scientific, manufacturing and infrastructure base to develop with as much debt issuance as we now have in the United States. This debt buildup from 1941 to 1950 saved the world from totalitarianism and created trillions of \$s in value.

As is evident from her declaration of war (which I include below in its entirety) highlighted by me to indicate Japan's life and death requirement for commodities which had been embargoed by the West; steel, oil and iron ore upon which Japan's existence was critical.

By the grace of Heaven, Emperor of Japan [Emperor Shōwa], seated on the throne occupied by the same dynasty from time immemorial, enjoin upon ye, Our loyal and brave subjects:

We hereby declare War on the United States of America and the British Empire. The men and officers of Our Army and Navy shall do their utmost in prosecuting the war. Our public servants of various departments shall perform faithfully and diligently their respective duties; the entire nation with a united will shall mobilize their total strength so that nothing will miscarry in the attainment of Our war aims.

¹ Eight battleships, three cruisers, three destroyers and four auxiliary vessels were sunk or damaged during the attack of Pearl Harbor

To insure the stability of East Asia and to contribute to world peace is the far-sighted policy which was formulated by Our Great Illustrious Imperial Grandsire [Emperor Meiji] and Our Great Imperial Sire succeeding Him [Emperor Taishō], and which We lay constantly to heart. To cultivate friendship among nations and to enjoy prosperity in common with all nations, has always been the guiding principle of Our Empire's foreign policy. It has been truly unavoidable and far from Our wishes that Our Empire has been brought to cross swords with America and Britain. More than four years have passed since [China](#), failing to comprehend the true intentions of Our Empire, and recklessly courting trouble, disturbed the peace of East Asia and compelled Our Empire to take up arms. Although there has been reestablished the National Government of China, with which Japan had effected neighborly intercourse and cooperation, the regime which has survived in Chungking, relying upon American and British protection, still continues its fratricidal opposition. Eager for the realization of their inordinate ambition to dominate the Orient, both America and Britain, giving support to the Chungking regime, have aggravated the disturbances in East Asia. Moreover these two Powers, inducing other countries to follow suit, increased military preparations on all sides of Our Empire to challenge Us. **They have obstructed by every means Our peaceful commerce and finally resorted to a direct severance of economic relations, menacing gravely the existence of Our Empire.** Patiently have We waited and long have We endured, in the hope that Our government might retrieve the situation in peace. But Our adversaries, showing not the least spirit of conciliation, have unduly delayed a settlement; **and in the meantime they have intensified the economic and political pressure to compel thereby Our Empire to submission. This trend of affairs would, if left unchecked, not only nullify Our Empire's efforts of many years for the sake of the stabilization of East Asia, but also endanger the very existence of Our nation.** The situation being such as it is, Our Empire, for its existence and self-defense has no other recourse but to appeal to arms and to crush every obstacle in its path.

The hallowed spirits of Our Imperial Ancestors guarding Us from above, We rely upon the loyalty and courage of Our subjects in Our confident expectation that the task bequeathed by Our forefathers will be carried forward and that the sources of evil will be speedily eradicated and an enduring peace immutably established in East Asia, preserving thereby the glory of Our Empire.

In witness whereof, we have hereunto set our hand and caused the Grand Seal of the Empire to be affixed at the Imperial Palace, Tokyo, this seventh day of the 12th month of the 15th year of Shōwa, corresponding to the 2,652nd year from the accession to the throne of Emperor Jimmu.

In an effort to discourage Japanese militarism, Western powers including Australia, the United States, Britain, and the Dutch government in exile, which controlled the petroleum-rich Netherlands East Indies, stopped selling iron ore, steel and oil to Japan, denying it the raw materials needed to continue its activities in China and French Indochina. In Japan, the government and nationalists viewed these embargos as acts of aggression; imported oil made up about 80% of domestic consumption, without which Japan's economy, let alone its military, would grind to a halt.

Faced with a choice between economic collapse and withdrawal from its recent conquests (with its attendant loss of face), the Japanese Imperial General Headquarters began planning for a war with the western powers in April or May 1941. This planning culminated in the attack on Pearl Harbor 68 years ago today – just about now.

We have now read an excellent book by Stephen Roach: *The Next Asia: Opportunities and Challenges for a New Globalization*.

Here's what Morgan Stanley's Roach said about "The Next Asia."

"Asia in the past 30 years has done an extraordinary job- especially China, but increasingly, the rest of the region – in lifting standards of living well beyond anything we've seen in the annals of economic development."

This is of course the key for survival of any country. The ability to raise the well being, lifestyle or quality of life for its citizens is key to survival. The situation in Asia is much different today than it was 68 years ago. Today China has accumulated massive foreign exchange reserves and is buying commodities essential for the **Next Asia** which is identical in intent and purpose to Japan's declaration of the East Asian Co-Prosperity Sphere.

The difference is that so many more commodities and discoveries are necessary today. Rare earth elements, tungsten, molybdenum, lithium, phosphates, oil, gas, coal, uranium, nuclear

technology, CCS technology, genetic technology, food technology and on and on, are all necessary for the Next Asia just as oil and iron ore were necessary for Japan's survival in 1940. Today China is in a position to control these elements as she builds her infrastructure to improve the lifestyle of her citizens. The metro system in Beijing, with its 17 million inhabitants, will increase in reach from 125 miles today to an ultra modern 350 miles by 2015. Each year two new subway lines come on stream increasing the lifestyle and productivity of the residents of Beijing.

On January 17 the I will present a keynote address in Vancouver titled, "The Rise and Fall of the US Dollar." The US economy will not, of course, waste away under these Asian pressures. Yet given the new intrusion of Western government,

- 1) the imposition of moral hazard on our financial and industrial institutions by Too Big To Fail bailouts,
- 2) new governmental oversight and "Czars" of all sorts with extended powers and
- 3) excessive debt issuance necessary from all the myriad spending programs which can only be financed by higher taxes,

the quality of life (if we go forward with current plans) in the US will fall as it will increase geometrically in the "Next Asia."

Watching the reaction of copper prices over the next year will be especially interesting. I believe that they will probably be a precursor of the expectations that Asia can shift its focus from an export-driven model to one more evenly consumer-based. This will happen in due course. The real issue is how long will this shift take.

We must all realize that the fate of a country is often intertwined in the geopolitics of war. 68 years ago today was a prime and tragic example of such an eventuality. No government wants its citizens to live a more modest lifestyle. But that is surely in the future for the West if we move forward under the present governmental plans. Japan failed in her attempt to resurrect Asia – China will not.

2. REVERSING THE DOLLAR CARRY TRADE

Here we go again. If you have been a reader of Morning Notes for the past couple of years the following table of exchange rates is déjà vu. There is a rush to buy the dollar this AM and it is soaring. Why the rush? Because the global investment community has borrowed in US dollars at essentially zero interest rates and invested elsewhere – the infamous carry trade. I suspect there was a carry trade in biblical times though I cannot find the data to prove my point. The carry trade is the simplest of trades. It is to borrow in the low overnight interest rate country and invest in the high yielding country. We often see these trades go bust because, of course, the end result is an asset bubble of some sort. The Yen carry trade of the past two decades is perhaps the most well known example. Please examine the following currency table from Kitco this AM. Sure enough, the US currency is stronger against all its fiat cousins except, unfortunately, the Japanese Yen. Poor old Japan – she never got over the bubble of the 40,000 Nikkei equity index in 1989 or for that matter her dastardly attack on Pearl Harbor 68 years ago today.

But don't worry about the Chinese currency. Both the Yuan and the Hong Kong dollar remain faithfully pegged to the US. This must be causing some raised eyebrows in export-oriented Beijing. We shall watch this Yuan dollar cross with great interest in the next few days and weeks. As China's currency appreciates with the dollar Europeans are cheering, Americans still grumbling about managed exchange rates and Canadian industrialists in Toronto and Quebec City much happier.

Currency	Chg% X=1\$USD	NY Time	X= 1\$USD	X\$USD =1	Gold Price/oz	Gold Chg	Gold Chg%
US Dollar	--	12/07-07:10	--	--	1140.70	-20.70 ▼	-1.78%
Australian Dollar	-0.90%	12/07-07:00	1.1018	0.9076	1256.77	-11.37 ▼	-0.90%
Brazilian Real	-0.65%	12/07-07:09	1.7383	0.5753	1982.82	-22.92 ▼	-1.14%
British Pound	-0.92%	12/07-07:09	0.6122	1.6336	698.28	-6.17 ▼	-0.88%
Canadian Dollar	-0.35%	12/07-07:09	1.0618	0.9418	1211.14	-17.68 ▼	-1.44%
Chinese Yuan	-0.04%	12/07-04:44	6.8250	0.1465	7785.28	-137.91 ▼	-1.74%
Euro	-0.30%	12/07-07:09	0.6755	1.4805	770.49	-11.60 ▼	-1.48%
Hong Kong Dollar	-0.01%	12/07-07:09	7.7551	0.1289	8846.24	-159.83 ▼	-1.77%
Indian Rupee	-0.73%	12/07-07:05	46.5100	0.0215	53053.96	-573.69 ▼	-1.07%
Japanese Yen	+0.55%	12/07-07:09	90.0350	0.0111	102702.92	-2444.42 ▼	-2.32%
Mexican Pesos	-0.38%	12/07-07:10	12.7203	0.0786	14509.99	-207.85 ▼	-1.41%
Russian Ruble	-0.79%	12/07-07:01	29.7740	0.0336	33963.20	-343.63 ▼	-1.00%
S.African Rand	-1.15%	12/07-07:09	7.5088	0.1332	8565.29	-56.66 ▼	-0.66%
Swiss Franc	-0.48%	12/07-07:09	1.0219	0.9786	1165.62	-15.52 ▼	-1.31%

Now examine the following graph of the US dollar over the past three years. The infamous Sunday July 13, 2008 speech by Treasury Secretary Paulson initiated a (similar?) reversal in the decline of the dollar and a meltdown of the global financial community. As the dollar strengthened for 7 months between July 2008 and March 2009 the world teetered on the brink. Only the fabricated and leaked positive earnings announcement by CitiGroup CEO (former hedge fund manager) Vikram Pandit turned the dollar lower and equity markets higher in March 2009. Those trends have remained in motion since March. Kuwait sold its \$3 billion investment in Citibank to pocket a quick profit of \$1 billion this AM.

Now the real question is how much more deleveraging as been initiated by this government news that ONLY 10,000 jobs were lost last month – even though 98,000 Americans simply quit looking for a job. We do not expect the reversal of this carry trade to be significant. We do not expect to see changes like those spawned by Secretary Paulson's Fannie and Freddie China guarantee in July 2008. We freely admit we do not know the size of the dollar carry trade or the bubbles that it has likely spawned. But there should be less impact from this reversal. This means that the dollar will move higher for a while and gold and commodities will fall as they are sold to repay short dollar positions. We do not expect to see a waterfall but hopefully some realignment of currencies can take place. Could this be an opportunity for China to make some changes to her dollar peg? Probably not – that will be gradual indeed.



As for gold, we think the gold price was ahead of itself. When Hu Xiaolian, a vice-governor at the People's Bank of China opined on November 22 about a gold bubble the end was clearly in sight for this run.

“We must keep in mind the long-term effects when considering what to use as our reserves. We must watch out for bubbles forming on certain assets, and be careful in those areas.”

China is in the process of unloading its \$2 trillion foreign exchange surplus of US dollars. Let's face it the Chinese are shrewd traders. They are spending on natural resources that they know they will need for Stephen Roach's "Next Asia." They will be back into the gold and commodities markets when gold finds its bottom. The same holds for copper and steel and all the other commodities so critical for the development of a higher quality of life in China. Without providing its citizens a higher quality of life – so evident in the West – the game is over for those who now control China's command economy. Gold is trading off \$27 this AM as we write this note. We would **not** expect gold to fall below the range \$1060 to \$960 in this correction. Keep your powder dry and raise some cash if you have garnered profits as you should have this year in the metals.

Many of you have written to ask me to write more frequently on my Discovery companies. The reason is that, as my friend Graham Irvine would say in is excellent

LondonIrvinereport.com, “*we are in uncharted territory.*” We must be very careful in the short run. Longer term, the next 3 to 5 years, the global QOL cycle will perpetuate significant discovery opportunities in a wide spectrum of industries. Therefore we are focusing on contrarian plays in the Discovery Space, trading with little downside.



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