

**Today's Notes:**

- 1. The Environment: Strange Ethers**
- 2. Housing Continues its Decline**

**1. THE ENVIRONMENT**

Last week I was a speaker at the Cambridge House Resource Seminar in Vancouver. As always it was a great meeting. There were several thousand people in attendance and they hung on every word of the speakers. It was cold, snowy and rainy the entire time. In fact, due to temperature inversions the fog was so thick for several days that you could not see on the ground. This type of weather is quite unusual in Vancouver at this time of the year. The heaviest snowfall in 18 years is blanketing England this AM shutting down some airports and roadways in London. This leads one to wonder about global warming demonstrating vividly that you cannot forecast the weather.

The equity markets are following cue. They are being offered in Europe and headed down between -2.17% (Britain's FTSE) and -2.51% (Germany's Dax). Equity futures in New York are also lower at this early hour. The S&P 500 index fell 11.37% in January marking another milestone. Most interesting, oil is lower this AM - significantly so. WTI is trading just above the \$40 level (\$40.38) still in contango (seeking storage) and at a discount to Brent crude (\$44.68) – an unusual circumstance. There are strange ethers out there Dear DI.



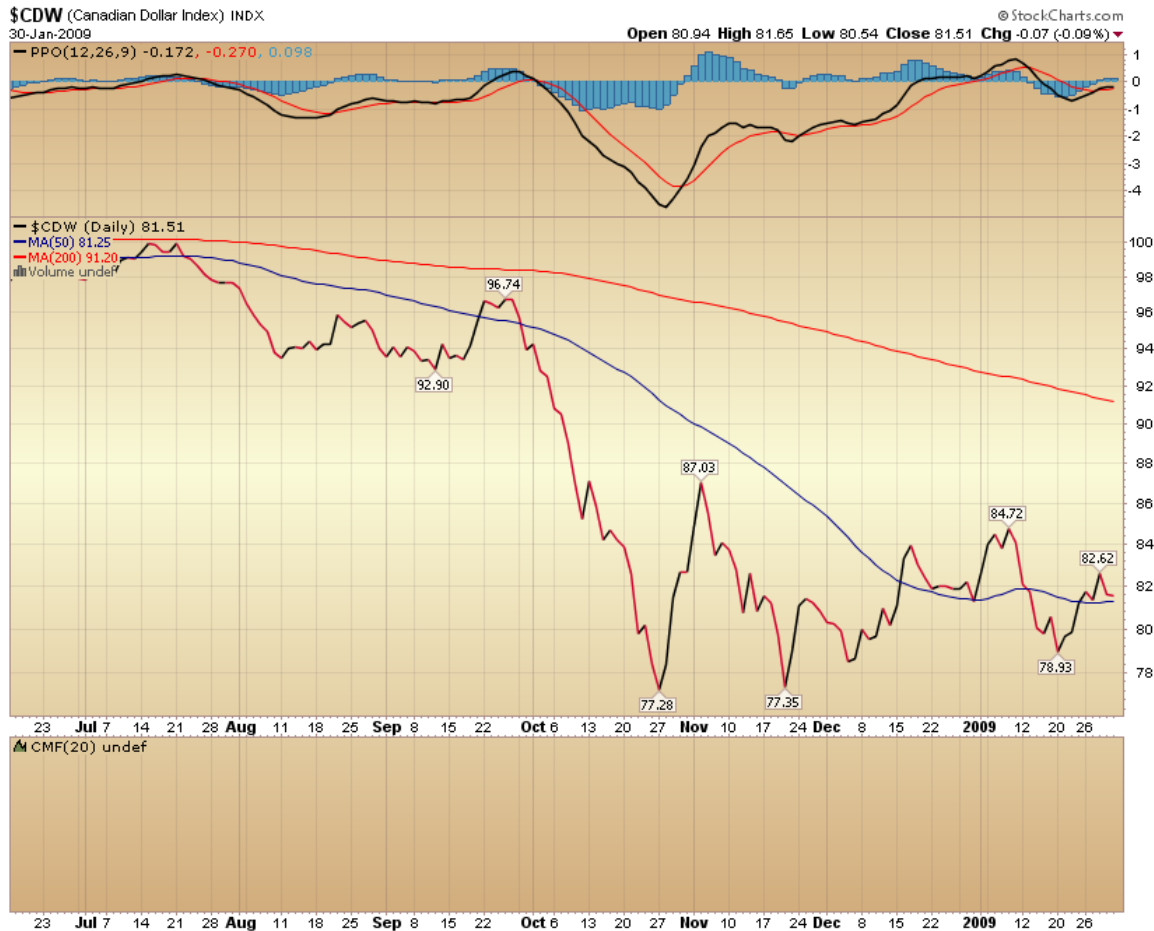
I was prepared to comment, this AM, that a breath of inflation seemed to be returning. After all, gold soared to \$930 before retreating on Friday and Treasury yields seemed to gain a breath of life. The yield on the ten year Treasury note gained 26% from January 15<sup>th</sup> through month end, trading down in price from a yield of 2.2% to 2.84%.

Alas this AM the world seems to be back in its deflationary funk once again. Here we have the US \$ and the Japanese Yen stronger across the board. The Canadian Loonie weaker – good for Ontario – what manufacturing is really left there. The Loonie is trading at US\$.81 as I write. Still, I do not expect the Loonie to weaken much further – perhaps to the US\$.75 range. Ontario is about to become a major world banking center because Canadian banks have been relatively untouched by the dreadful toxic paper glut almost everywhere else in the world. Relatively (everything is relative isn't it?) healthy Canadian banks are likely to begin to buy up banking business in the US – and soon.

We are not certain why the US\$ and Yen are so much stronger this AM. The \$ is once again challenging its peak performance in November when it topped out at .88. Perhaps we are still seeing more debt de-leveraging; perhaps the hedge funds are back at it or perhaps these deflationary ethers have simply spread to the other currencies.



And the Canadian Loonie is weaker still this AM. The northern dollar has fallen 20+% from parity in July to 81.51 cents along with the global retracement in commodities.



And so the world is left to ponder – what next? Will it be a controlled reflation, uncontrolled hyperinflation or, as Gary Shilling so forcefully suggests, a longer deflationary experience. It is clear that we are part way toward a deflationary spiral. Professor Roubini suggests that such a scenario is a three-part exercise consisting of a liquidity trap, deflationary spiral of the economy and finally a debt deflation. Fed Chair Bernanke and now president Obama and his minions Messrs Summers and Treasury Secretary Geithner are determined to reflate, unfreeze the credit cycle, save the banks, save the US homeowner, save the US worker and finally restore the US\$ to its reserve currency status.

The Obama Administration’s fiscal plan in the US calls for over \$1 trillion in spending (including interest). Unfortunately the bill passed by the Pelosi (“We won the election, we wrote the bill”) House is mostly PORK. It cannot have an impact for several years and most definitely cannot create 4 million jobs; that claim is ludicrous. You judge. The Bill contains the following allocations among many:

- 1) \$3 billion for new government cars.
- 2) \$252 billion for income transfer payments. (cash to individuals for doing nothing)
- 3) \$66 billion to education.
- 4) \$150 million to the Smithsonian Institution.
- 5) \$2.4 billion for carbon capture research (how many jobs will that create?)

- 6) \$400 million for global warming research.
- 7) \$50 million for National Endowment for the Arts.
- 8) \$2 billion for child care subsidies.
- 9) \$1 billion for Amtrak.
- 10) \$650 million for digital TV conversion.
- 11) \$30 billion for highways and bridges.
- 12) \$40 billion for a new Electrical grid and airports.

The Senate has yet to approve the legislation. But please consider where the additional trillion dollars will come from. It will either emanate from taxes or it will be printed and monetized. It is very much less likely to come from China or Japan in the form of treasury purchases.

The **bailout mania** of our increasingly panicky US leaders has failed and the rest of the world is very clearly unwilling to subsidize further insanity. The current Deus Ex Machina is the notion of an aggregate “bad bank” for all the toxic paper. This will cost at least \$100 billion. It can be leveraged by a factor of 10 times to make up the necessary \$1 trillion. Nobel Laureate Joseph Stiglitz calls this a “bad idea” and notes it is simply swapping cash for trash. The cash, of course, is yours and mine. In the past we have seen our government create the RFC and RTC and they have worked. But the current status of this banking crisis is much larger and more difficult for a number of reasons. In short no one is certain that a “bad bank” is a good idea. The longer term goal of restoring the US\$ to a sound currency seems quite difficult if not impossible at this point and with these plans in the works.

The bottom line is that while at least \$4 trillion has now been allocated to (thrown at?) the problem there is very little to show in terms of restoring the stability of the economy. The bailouts and President Obama’s “Buy American” folly have infuriated our Canadian, European and Asian partners. Based upon the speeches by the Russians and Chinese at Davos they are less willing to lend a hand.

On the whole, the resolution of the deflation / reflation dynamic is very much in doubt at this stage. As central banks around the world race to zero interest rates and encourage a competitive devaluation of their currencies, as protectionism raises its powerful head, as a Keynesian liquidity trap becomes more evident and global economic growth contracts, deflation is in the air. Given the present circumstances and the plans in place, the US is headed directly for a new socialism with a lower standard of living, perhaps the only way out of the problem short of social insurrection or worse.

Yet we are beginning to see some transactions in the commodity world. Chinalco this AM looks like it will transact with RTZ. It may up its ownership stake to 11%. RTZ is attempting to reduce its debt load of \$39 billion and needs to raise capital. The French oil company Total made a bid for the oil sands assets of UTS last week. At least some executives in the rest of the world believe in recovery. But for now demand destruction proceeds apace and has overwhelmed supply destruction in the commodity space. Seems like a good time to buy assets.

## 2. HOUSING

The sub-prime crisis and housing bubble have been one cause of the current problems. There is much to say this AM re the US housing numbers. Basically they are alarming. The Case Shiller housing price data came to the markets last Tuesday while we were in Vancouver, Canada. There is no good news here. From the top of the market (July 2006) through the end of November the average 10-city house price has fallen 25% in the US.

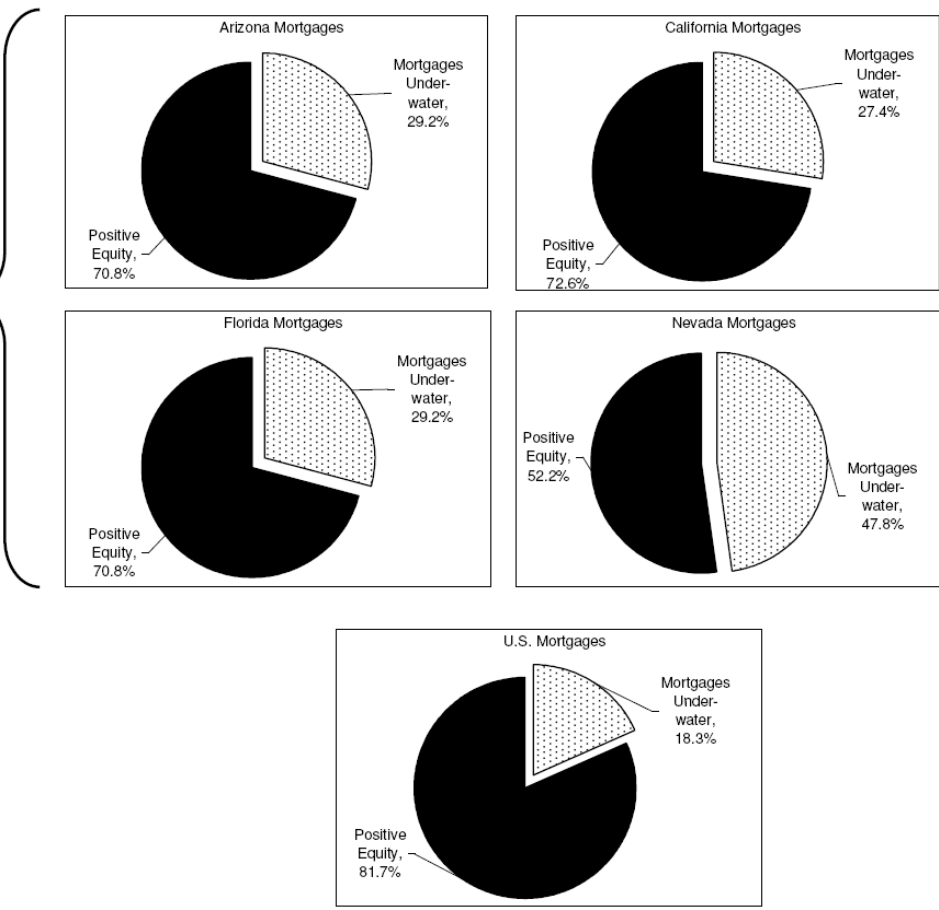
The following chart tells the story. We also saw an independent estimate of further declines in December and they are in the double digit range. In short there appears, in many markets, to be another 15% house price decline in store.

US Housing Prices		
Percentage Gain January 2000 to July 2006		
Percentage Decline July 15, 2006 to December 1, 2008		
127% Phoenix <b>-42.6%</b>		
174% Los Angeles <b>-35.8%</b>	178% Miami <b>-39.6%</b>	
149% San Diego <b>-37.9%</b>	138% Tampa <b>-32.4%</b>	28% Charlotte <b>-7.6%</b>
118% San Francisco <b>-38.1%</b>	35% Atlanta <b>-14.6%</b>	134% Las Vegas <b>-41.2%</b>
40% Denver <b>-9.0%</b>	68% Chicago <b>-16.1%</b>	115% New York <b>-13.4%</b>
50% Washington DC <b>-28.1%</b>	78% Boston <b>-15.0%</b>	23% Cleveland <b>-13.0%</b>
	23% Detroit <b>-34.3%</b>	25% Dallas <b>-6.4%</b>
	71% Minneapolis <b>-22.1%</b>	80% Seattle <b>-13.6%</b>

While Phoenix leads the pack with an average house price decline of 42.6%, even Charlotte, the last remaining city with housing appreciation before the November numbers, has now declined 7.6% from peak in July 2006. Joining the list of cities with acceleration declines is Chicago, Boston, Dallas and Cleveland. It is decidedly not a “pretty picture” and it is not yet finished.

Last week Oppenheimer’s Meredith Whitney reported these statistics regarding negative equity in the US housing market at the end of November. Nevada, for example has 48% of its home under water” The statistics are quite amazing and indicate the severity and continuance of the housing crisis in the US. Furthermore they support the thesis that asset values continue to be destroyed and a nascent deflationary spiral is in effect. Perhaps more interesting is the national picture with almost 19% of US homes with negative equity. Ms Whitney also notes that at least another 5% of homes with market prices relative to mortgages that are on the verge of going “under water.”

States with greatest home price declines (AZ, CA, FL, and NV) have a 49%+ higher frequency of negative equity mortgages vs. national average



Sources: First American Corelogic and Oppenheimer & Co. Inc.

We note that billions of \$ in Interest Only and Option ARM (adjustable Rate mortgages) will come due in 2009 through 2012. Resets on these loans will increase average payments by 60% to 80%. So unless growth kicks in and unemployment decreases (instead of increasing as it is now – U6 is 13.5%) the housing debacle is longer and certainly deeper. Canadians should not feel this pain directly though house prices in Toronto have declined by 10% over last year. And still the Leafs cannot win a Stanley Cup.

What do these statistics mean? The following chart provides an example. Assume a typical house was selling for \$150,000 in January 2000. What is it worth today and when will it hit bottom? The following chart provides some clues. Normally we would expect average (long run) price appreciation of about 2% to 3% per year. If houses were to appreciate at 2% or 3% per year over the past 9 years, a \$150,000 home in January 2000 should be worth between \$180,000 and 195,000.

A cursory examination of the current values in various cities based on the Case Shiller data shows that homes are still significantly overvalued in 14 of the 20 cities. These numbers imply another leg down of approximately 15% without considering the potential for house prices, as in Detroit and Cleveland, to overshoot on the downside. What this all means is that the US and European banks will have more toxic paper to deal with going forward. That “bad bank” will need to be a “Big Bad Bank.”

\$340,900 Phoenix  
**\$197,000**

\$411,000 Los Angeles  
**\$263,040**

\$373,500 San Diego  
**\$231,943**

\$327,000 San Francisco  
**\$222,033**

\$210,000 Denver  
**\$191,100**

225,000 Washington DC  
**\$162,000**

\$417,000 Miami  
**\$254,370**

\$357,000 Tampa  
**\$241,332**

\$202,050 Atlanta  
**\$172,935**

252,000 Chicago  
**213,900**

\$267,000 Boston  
**\$226,950**

\$184,500 Detroit  
**\$121,267**

\$256,500 Minneapolis  
**\$200,070**

## US Housing Dynamics

(\$150,000 January 2000)

Value July 2006

Value December 1, 2008

\$192,000 Charlotte  
**\$177,408**

\$351,000 Las Vegas  
**\$206,388**

\$322,500 New York  
**\$212,850**

\$184,500 Cleveland  
**\$160,515**

\$187,500 Dallas  
**\$175,500**

\$270,000 Seattle  
**\$233,280**

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