

Today's Notes:

1. **Canada and Mexico: Neighbours in the Americas**
2. **A Purposeful Stride Down Wall Street**

1. CANADA AND MEXICO

Like bookends, Canada and Mexico adjoin the US geographically and economically. In good times both economies benefit. In poorer economic circumstances both suffer. At least Canada's chief financial officer tells the truth. We have seen very little of that in the US. Washington, perhaps from inexperience, keeps spinning the current recession. For example in order to pass a fiscal spending bill we were told that failing to pass the \$787 billion measure (laced with transfer payments and earmarks) would be a disaster for the country. Few legislators even had time to read the bill in its entirety. The Administration told us that unemployment would be capped at 8% if the Recovery bill was voted into law. Today it seems that the opposite is true. 14.7 million Americans are unemployed – and more shall follow. 16.5% of Americans are underemployed according to the BLS. Yesterday Jim Flaherty, Canada's Finance Minister said,

"We are concerned of course with the reality of rising unemployment. The unemployment rate in the U.S. is well above 9% and is likely to go higher into 2010. We expect some continuing growth in unemployment in Canada as well. [But] the recovery from the recession will happen before a reduction in unemployment."

Mr. Flaherty expects Canada's unemployment rate to increase from 8.4% to 8.7% (by Friday) a 12 year high. Canadian economists expect a blunted recovery in 4Q 2009 or 1Q 2010. The strength of the recovery (real investment or government stimulus?) is an important question.

Unemployment, which usually lags a traditional recovery, is so painful. It is a very powerful catalyst for change. That's why unemployment and weekly-hours-worked statistics are very important. Unemployment may be a lagging indicator but it carries pernicious and long lasting side effects that are behavioral in nature. Unemployment changes consumer behavior. For example BMO recently noted that Canadian delinquencies in credit cards and sales finance purchases increased by 38% and 58% last year. 150,000 Canadian homeowners are having trouble meeting household debt payments. Though Canadians generally avoided the worst of the US housing bubble, unemployment has pushed Canadian mortgage delinquencies higher as well. Derek Holt, the chief economist at Scotia Capital said,

"As bad as the (editor: "Canadian") recession was in the early 1990s, today's bankruptcy picture is shaping up to be worse, even when properly adjusted for population growth over the years".

CIBC predicts a 9% to 9.3% peak unemployment rate for Canada by 2010. Few commentators have focused on the production / capacity gap. How much capacity must be worked off? How much more debt must be liquidated? No one seems to know these numbers and no one seems to be willing to estimate them. This AM once again deleveraging

reigns supreme. The US currency and the Yen are stronger against all fiat cousins. Gold and commodities are falling. These currency fluctuations will reoccur till the excess debt that has been piled up over the past two decades is eliminated.

TODAY The US DOLLAR and YEN MUCH STRONGER, YUAN REMAINS PEGGED, COMMODITIES HEAD LOWER

(Exchange rates displayed are the middle point between bid and ask) [\[details\]](#)

Currency	Chg% X=1\$USD	NY Time	X=1\$USD	X\$USD=1	Gold Price/oz	Gold Chg	Gold Chg%
US Dollar	--	07/06-05:15	--	--	921.70	-10.10 ▼	-1.08%
Australian Dollar	-0.73%	07/06-05:10	1.2638	0.7913	1164.84	-4.19 ▼	-0.36%
Brazilian Real	-0.01%	07/05-17:15	1.9451	0.5141	1792.80	-19.46 ▼	-1.07%
British Pound	-1.31%	07/06-05:14	0.6199	1.6133	571.32	+1.19 ▲	+0.21%
Canadian Dollar	-0.26%	07/06-05:14	1.1638	0.8593	1072.63	-8.96 ▼	-0.83%
Chinese Yuan	-0.04%	07/06-05:13	6.8309	0.1464	6296.04	-66.29 ▼	-1.04%
Euro	-0.25%	07/06-05:15	0.7178	1.3932	661.55	-5.57 ▼	-0.84%
Hong Kong Dollar	+0.12%	07/06-05:15	7.7453	0.1291	7138.84	-86.80 ▼	-1.20%
Indian Rupee	-1.44%	07/06-05:14	48.5050	0.0206	44707.06	+153.04 ▲	+0.34%
Japanese Yen	+0.68%	07/06-05:15	95.3900	0.0105	87920.96	-1569.11 ▼	-1.75%
Mexican Pesos	-0.94%	07/06-05:13	13.3425	0.0749	12297.78	-19.22 ▼	-0.16%
Russian Ruble	-0.61%	07/06-05:10	31.4605	0.0318	28997.14	-138.85 ▼	-0.48%
S.African Rand	-1.10%	07/06-05:15	8.0101	0.1248	7382.86	+0.21 ▲	+0.00%
Swiss Franc	-0.41%	07/06-05:15	1.0911	0.9165	1005.62	-6.83 ▼	-0.67%

Till the excess capacity is worked off and the debt liquidated (or converted to equity) the Canadian economic recovery will be muted. The end for Canada cannot be not in sight till the US housing and banking institutions stabilize. Today there is an increase in excess capacity in the labor market; wage pressures continue to ease; aggregate hours worked continue to fall; and average hourly wages continue to grind lower. **Tightening by the Canadian or American central bankers is most definitely not possible.** The tilt is towards deleveraging, contraction and deflation. Oh, for a little inflation?

Mexico now travels a more difficult path than Canada. Mexico depends on oil revenues for 40% of its GDP. Oil production is now falling in Mexico. She may become an importer of oil within 6 years. Globally the oil addiction is pernicious whether you are addicted as in the US or an exporter as in Mexico's case. Since Mexico exports most of its industrial production to US consumers and since US consumers are on the sidelines from the behavioral shock of wealth destruction, foreclosures and unemployment, Mexico is in trouble. Mexico's unemployment jumped in May to 5.5%, a 13 year high.

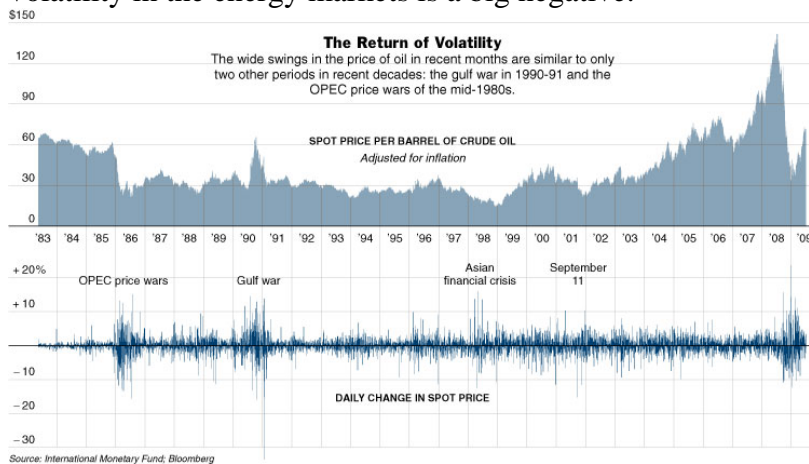
Till the advent of recent global economic woes and the H1N1 swine flu virus (which alone cost the Mexican economy \$2.2 billion), Mexico was the model of emerging economic growth. Now GDP growth in Mexico will shrink by 5.5% in 2009. Exports account for 25% of GDP. In North America economic contraction obtains. Notes Stephen Haber, a senior fellow at the Hoover Institution Stanford University,

“Mexico has not grown like gangbusters in the last decade ... but smart fiscal and monetary policies and a commitment to trade and investment have slowly built a middle class, many of whom will be hit first. They are having a doozy of a recession. They are not going to recover until we do.”

Mexico's incumbent president has his hands full. He is now fighting a war against well organized drug organizations who recruit from the ranks of the unemployed. Remittances are the second-largest source of Mexico's foreign income. Money sent from abroad fell by 19% in April to \$1.78 billion. The fall in remittances has been partially offset by a stronger dollar. In addition to the estimated 10,000 deaths in the War on Drugs, Mexican immigrants unable to find work in the US are returning home and swelling the ranks of the unemployed.

We return to one of our central theses. An economy must have cheap and secure energy to prosper. When an economy prospers, people find the work they want and the overall quality of life improves. The decline in oil prices has impacted both the Mexican and the Canadian economies. In the final analysis they have suffered due to their addiction to the US consumer.

Higher oil prices (commodities in general) are good for Mexico and Canada as net exporters but bad for mom and pop in Kankakee, Illinois. Both Mexico and Canada are resource economies. Silver, gold, uranium, copper, oil, natural gas and many other commodities "back" their economies. This is the ultimate irony. Of course oil prices must increase eventually in spite of the recent oil futures market manipulation on the ICE in London. But volatility in the energy markets is a big negative.



Ultimately the Mexican and Canadian economies will right themselves because of their natural resource largesse, the expectations of inflation and their willingness to support extractive industries. In the meantime, in between time, there will be pain. That pain will last longer than we had hoped. With this pain political and regulatory change is coming. Mexico's will hold its national elections soon.

Investment in resource discovery potential will be value creating in the long run. We hope the aforementioned changes will be positive and value creating, not destructive overreactions that will challenge our freedoms. In Washington economic protectionism is increasing as it did in the 1930s. We must not fall into that trap. Canadian, American and Mexican lawmakers must get together and address these issues in a constructive manner. That is the only route out of this economic malaise that will otherwise be our companion for the next few years. Feedback loops between Mexico / Canada and the US are at work as well. The long delayed free trade pact with Colombia should be ratified by Congress. This would be a signal to our neighbours in the Americas that we must row the economic boat in the same direction. Any other US policy will draw out and worsen the current economic dilemma.

2. A PURPOSEFUL STRIDE

Many years ago my mentor at the University of Virginia, Professor Robert Vandell published (with Robert Parrino, V&P) an article titled “*A Purposeful Stride Down Wall Street.*” This was an obvious takeoff on Burton Malkiel’s (Princeton) famous best seller “*A Random walk Down Wall Street.*” Both the Malkiel book and the V&P article (published in *The Journal of Portfolio Management*, Winter 1986) relate to the question of the value of active versus passive investing.

Malkiel’s view is that investors cannot beat the market over time. This is one of the central tenets underlying the Efficient Market Hypothesis. He suggests that the best investment strategy is one of indexing to the market. Malkiel recently wrote in the Wall Street Journal that an indexer would have earned 9.2% over the past three decades. He opines that very few active investors can boast those returns today. V&P on the other hand challenge this approach. Their research showed that active investors can outperform the market for the following reasons:

- 1) The capital markets are less than perfectly efficient.
- 2) A highly disciplined approach can capitalize on opportunities.
- 3) Style diversification is essential, no one discipline works all the time.
- 4) With more skill, risks cancel out more quickly.

I make the case for an active approach to Discovery Investing based in part on the V&P research. Most observers, yes even academics, now believe in light of recent events, that the capital markets are less than efficient in setting prices. Yale’s Professor Shiller has defined “animal spirits” that stalk the equity markets and drive prices to extremes. One look at the price movement of a company such as Freeport McMoran tells the story of animal spirits. The shares fell in a very short time from \$124 to \$17 and then staged an amazing recovery. Animal Spirits? Indeed!



If professor Malkiel is correct in assuming that you cannot forecast equity prices, what about discoveries? Obviously discoveries are also difficult to predict. However, we think

they are much easier to foretell than share prices. The reason is that there is little impact of animal spirits in the drilling of an ore body or the testing of a new cancer therapy. Either you have it or you do not. We also think that a highly disciplined approach to discovery analysis (V&P's point 2) can minimize errors. That is why I developed the Ten Point Grid carefully over the past 6 years. Using the Grid will increase your expertise and minimize errors in the discovery identification progress. V&P's point 4 is relevant here. Experience and discipline will most definitely reduce your error rate. Adequate diversification will reduce much discovery risk as well. Understanding management strengths and "world class" discovery potential is imperative. Finally style diversification is essential. Discovery investing can provide that for your portfolio. This is V&P's point 3. World class discoveries will almost always create value even when they might be ignored by the markets (inefficiencies) for a while. So we suggest that it imperative to have a reasonable allocation to discovery and within that a sound diversification.

Discovery investing can be tailored very naturally to your risk and industry imperatives. Within the discipline there are Incubator stocks (high risk / high reward – sometimes called "penny dreadfuls" pre discovery), Mature discovery stocks – those that have made initial discoveries that perhaps the market has not yet recognized, and finally Legacy discovery names such as Freeport McMoran, Apple Computers, Research in Motion or Teva Pharmaceuticals. A natural space for diversification exists within the Discovery Space.

Perhaps a more important aspect of discovery investing is that there is a natural platform for research, learning and the teaching of others. Much technology is changing in our lives. This makes the Discovery Space unlimited in size and choice. It is obvious we critically require new technology in computation, data security, health care as well as the more traditional resource discovery – if we are to continue to improve the quality of our lives. Try cheap and secure energy supplies for the next 30 years. The alternative energy space also presents such an opportunity.

Finally, Discovery Investing is, in many ways, a socially responsible investing strategy. Why is this? What does an effective treatment for cancer or a cure for ALS mean for society? Such investments are worthy of our consideration for the societal benefits. What would an agricultural technology that reduces water and fertilizer usage for wheat or soybeans mean for society? What would a safer, much cheaper nuclear reactor technology, one that does not produce radioactive by-products mean? The answer is obvious and this rationale alone is a good reason to consider making Discovery Investing as a responsible part of your overall wealth creation portfolio. Later this week I will identify potential companies that fit into all these categories – and more. In the meantime have a great day.

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