

Today's Notes:

1. THE STRONG DOLLAR

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Last week the US currency was under tremendous pressure. As I wrote last Tuesday, this break with the dollar has been psychological. Without doubt the break has been a global. Thursday evening Larry Summers (National Economic Council) and Federal Reserve Chairman Benjamin Bernanke hit the speaking circuit to stem the decline of the Greenback. The message from Washington is always the same – the US stands for a strong dollar; in spite of the rhetoric the reality has been different for more than 30 years.

Dr. Summers rejected Paul McCulley's (PIMCO) "New Normal" hypothesis of slow economic growth. Summers sees a vibrant and growing American economy in our future. He also suggested that devaluing the currency was not the way out of the current situation. Referring to today's central banking practice of currency intervention, as a failed strategy he rejected, "*the idea that nations can devalue their way to prosperity.*" Referring to Secretary Geithner's views regarding the US dollar he said, "*Our commitment to a strong dollar (is) based on strong fundamentals.*"

By Friday afternoon the Administration's efforts appeared effective. The week long dollar decline was arrested. We may never know how close we came to a dollar meltdown or perhaps even a run on the Greenback. Yet the staying power of the Administration's currency entreaties remains to be seen. We shall watch the US dollar with much interest in the next few weeks and months. Sustainable dollar strength can emanate fundamentally only from higher Fed Funds interest rates. Even Dr. Bernanke and the most ardent hawks on the FOMC are not prepared to advocate an interest rate increase given the fragile US real estate and credit markets.

On the other hand Australia's Reserve Bank did just that, reflecting its geographic closeness to China's expected demand. This action is not likely to be repeated by other countries till there are clear signs of a global economic recovery. In fact it is much more likely that other countries will intervene to strengthen the dollar and thus weaken the relative value of their own currencies. In previous Notes I have referred to this phenomenon as the "currency race to the bottom." Thus the dollar should not decline much further unless there is a behavioral run on the dollar – a sort of dollar bubble.

There is certainly nothing new about currency interventions, by the way. In March 2007 Japanese financial authorities working with other OECD officials worried over the decline of the dollar. The trade weighted value of the dollar fell as low as .71. There were meetings held on interventions and many believe Japan did intervene to support the US currency. All was for naught however because by July 15 then treasury Secretary Paulson gave the Chinese a "guarantee" on Fannie and Freddie debt which sent the US dollar soaring .

The following graph shows the decade-long decline of the US currency versus its northern Neighbor, the Canadian Loonie. The decline has been as relentless as it has relative to the Euro, the Yen and the Swiss Franc. Pressured by the exploding US budget deficit we expect to see more downward pressure on the dollar. Thus the potential exists for a currency race to the bottom. After all, one sure way to handle mountainous debts is to inflate them away. I presume the indebted US economy needs inflation, particularly now, more than most others.



The price dynamics of gold and the hard commodities will answer this question in due course. In any event investors must – I stress must - acquire a core holding in the commodity sector and particularly in gold and silver. This might be established in Exchange Traded Funds (ETFs), large cap commodity equities (such as Freeport McMoRan, Goldcorp) or directly in physical ownership of the metals.

In Friday’s action gold and silver fell if only slightly. It would seem that the messages by Messrs Summers, Geithner and Bernanke rang hollow. Since October 1 gold has risen by 5% and silver by 8.3%. In the past 3 months, gold has risen 13.37%. The gold to silver ratio fell another 4% in favor of silver.



It is also clear that it is not the US, but her trading partners who must deal with the inevitable question of fiat currency policy and specifically the relative strength of their currencies.

The US in turn must deal with her budget deficit. The Obama Administration does not seem to realize this. Citizens around the world have complained about the American consumer's proclivity to consume and their debt addiction as the current credit crisis evolved. But the rest of the world benefited for years. By 2006 the US consumer comprised 20% of world GDP.

Unfortunately Washington decided to solve the current problems by prolonging the debt binge –this time using the printing press. This will support another bubble in some asset market. Bond's perhaps? All this is a recipe for a weaker currency and much stronger gold price in dollars. The side effects that follow the use of the printing press, particularly for a "reserve currency" and inevitable its monetization is global and can be harsh. Anyone remember Weimar Germany and hyperinflation?

The current confluence of world events is most ironic. Just at the time the rest of the world is emerging with 3 billion souls learning about and yearning for a higher quality of life, the current world currency order has broken. Currency realignments are indeed in order. More important currency stability is required. With the world's energy systems about to change dramatically, US health care changes of a trillion dollar magnitude and tough new regulations on the capital, commodity and credit markets something has to give. Alas it will be the dollar that gives in the longer run. No country can spend forever while financed through debt creation. Eventually the global currency markets will force a restraint on US spending. In the meantime the cycle of asset bubbles shall continue. Please protect yourself.

The precious metals markets, in their long term wisdom, have been foretelling this outcome for years. We have not listened. Examine the following table of the total returns of gold bullion in 13 different currencies courtesy of Kitco. These are holding period total returns stated in percent. It is obvious that gold has been a stellar performer in almost all holding periods for most currencies. In US dollars gold provided a total return of 226 % over the past ten years and 148 % over the past 5. This equates to compound annual returns of 12.54% and 20.0 % respectively. Does anyone know an investment compounding 20% each year on average for the past 5 years and 12.54% for the past 10 years?

	30 Days	60 Days	6 Months	1 Year	5 Years	10 Years
US	5.27	5.82	17.51	23.41	148.85	226.00
Australia	0.62	1.79	-4.84	-12.4	101.91	133.72
Britain	10.61	15.48	10.14	32.84	182.41	240.69
Brazil	1.34	4.68	-5.63	-7.03	53.06	191.97
Canada	1.86	4.98	0.44	9.66	106.77	129.28
China	5.21	10.77	17.34	23.24	104.93	168.43
Euro	4.09	6.44	6.63	12.33	109.00	138.09
India	1.16	7.78	9.92	18.69	152.87	248.92
Japan	3.04	3.77	5.45	11.91	104.44	174.58
Mexico	4.55	13.15	19.01	26.01	193.80	361.99
Russia	1.02	1.96	4.57	39.48	153.53	273.53
South Africa	3.02	1.78	-3.07	-3.44	182.10	293.51
Swiss	4.58	5.18	6.97	11.84	105.17	128.56

Holding periods total returns (percent) for gold in 13 currencies

In most longer term holding periods gold provided significant returns. Equally interesting, gold's returns in British Pounds, Russian Rubles, Mexican Pesos, Indian Rupees, and South African Rand were extremely high. The dollar strengthened against these currencies in the last decade. Finally it is noteworthy that during the last 30 and 60 days gold returns have been positive in all 13 country currencies.

But silver has been an even better performer. The last ten years have seen silver rise from a low point of \$4.02 per ounce to its current level of \$17.70, a 340.3% total return. Silver outperformed gold by more than 100%.

On Friday I attended a presentation by commodity guru Jim Rogers. Long term he is very bullish on China, the commodity cycle and believes that silver is severely undervalued. Mr. Rogers also thinks water and food are commodities of interest. We'll save a write-up on those commodities for another day. In the meantime please have a look at Silver Wheaton and Endeavour Silver. Both have significant leverage to silver and we think they are undervalued. As always please perform your own due diligence.



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