MORNING NOTES

Monday February 28, 2011

Michael A. Berry, Ph.D.

Today's Notes:

1. The Oil Game

Energy related commodities are the most important of all the commodities we have discussed in the past few years. While food costs, years of oppression and inflation have upset the apple cart in the Middle East, there is now a growing fear of higher energy costs. No matter your thinking on deficits at local, state and federal levels, global energy costs sit at the bottom of the Quality of Life Chain and perpetuate every aspect of lifestyle for better or worse. In short we live on petroleum energy access. Coal makes up 50% of US electricity, 70% in China and oil drives the world's transportation system and will for the next few decades at a minimum.

We are now entering a period of fear once again. It is replacing the Fed's naïve sense of hope that inflation is "well anchored." Till now we have seen an almost magical resurrection of the commodity cycle. Take a look at the Morgan Stanley commodity equity index. These 20 or so securities[i] have made up the entire decline that occurred in the commodity equity sector at the height of the 2008 credit crisis.

In part the CRX and the WTI indices reveal the decoupling and divergence of growth rates between the emerging world and the developed world. We have written recently on the phenomenon of the **Great Convergence** of per capita incomes and divergence of growth rates. The phenomenon is here now. It was formerly known simplistically as a "decoupling of China." But it is much more. Commodity inflation indices reveal fear that the Fed, ECB, economists and politicians now exude at the possibility of a double dip or worse with a weakened and debt laden economy.

The widespread and growing dissension primarily in the countries of North Africa but more generally the entire Middle East places additional focus on oil, its pricing and its accessibility.

On Friday NYT columnist Thomas Freidman wrote that the US should unilaterally impose a $1 per gallon sales tax on gasoline. He reasoned that this is likely to happen anyway with a rising price of oil. This may be true but we question whether such a tax would be spent wisely by Washington or be divvied up in entitlements. That seems to be the 50 year par for the course in American politics.

Daniel H. Yergin the oil historian and chairman of IHS Cambridge Energy Research Associates referring to the price of oil said, ***"We've gone beyond responding to the sort of brutal Technicolor of the crisis in Libya, there's also a strong element of fear of what's next, and what's next after next."***

Bernard Baumohl, chief global economist at the Economic Outlook Group, who had been optimistic about the country's prospects commented on the potential for higher oil prices in vie w of the turbulence in the Middle East,

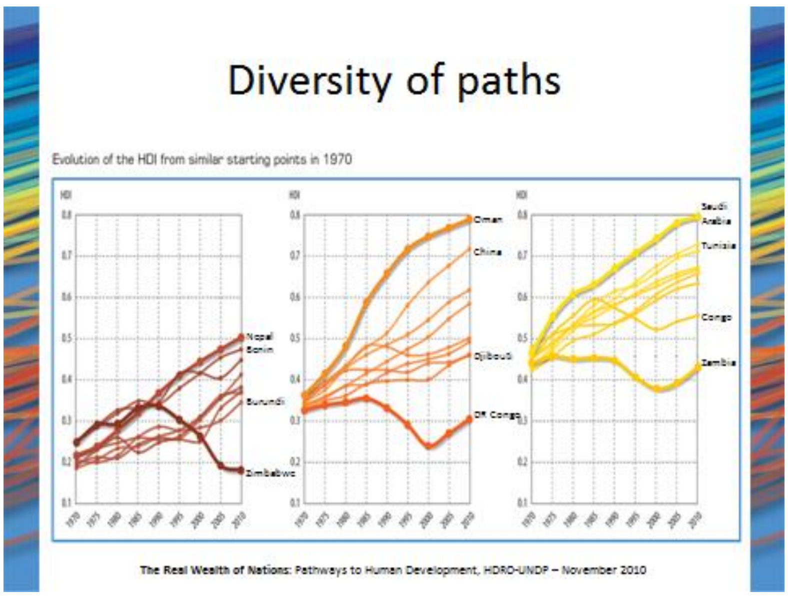
"The irony is that we just barely got ourselves up and off the ground from the devastating financial crisis … The recovery itself is less than two years in, and we haven't yet seen jobs make a decent comeback. Now we're being hit with this new, very ominous event, so the timing couldn't be worse."

In the US we now observe sliding house prices, slower than expected growth in GDP and upward pressure on gasoline prices. This is pontetially a lethal combination and if realized could force a toxic combination of higher commodity prices forcing cost push inflation and then a decline into deflation in the developed economies of the world – so dependent for their economic health on cheap oil and gas.

There are programs that can be executed. Allis not lost in this situation. Developing our domestic natural resources starting with shale oil and gas can help to relieve the pressure. A gas to liquids (diesel) development could be in place within a decade according to sources at the DoE. An accelerated program of modular, Gen III+ and Gen IV nuclear build out over the next 20 years also would begin to restore our access to clean and cheaper energy and most important support the eventual electrification of the country. Yes nuclear is expensive but what is the alternative? We can begin to build commodity supply chains (critical metals such as manganese, molybdenum and graphite for example) and the associated intellectual property that they bequeath. These will provide high technology jobs.

In the meantime as supplies of oil and access to them dwindle (such is the currently unrecognized case with 24 metals that we must import 100%) prices will rise and hinder economic growth. While we still spend $660 billion (2012 budget pared down by $70 billion) on defense China now (2009) spends $81.1 billion, a 358% increase over the past decade. Asia is in the midst of an arms race (according the WSJ). Here history is in part repeating itself from the 1930s. The potential belligerents are now China and India and not Japan. This is mostly about access to the natural resources, the materials for energy and infrastructure build out, that any country must develop for sustenance and growth of its per capita quality of life and hence political stability. You only have to look at the turmoil in the Northern Africa to understand the consequences of   a lack of same.

This process has been ongoing since 1970 as depicted in the following chart form the United Nations. The West is only just now realizing that it is in the grip of an unstoppable convergence of per capita incomes. This chart shows the UN's Human Development index and its lower left to upper right moves for almost all countries except perhaps Zimbabwe and Zambia from 1970 forward. This pictorial of human development (HDI) is another representation of the Great Divergence and the critical need for energy and natural resource supply chain development. Heightened resource nationalism is just around the corner..



This will bring agonizing pain and a rebirth of the need to develop our own energy and natural resource dependence as part of our economic vitality. Canada and Canadians will be crucially important in the development of this process with their vast natural resource mentality. Our goal is to make our legislators aware of this process.

In the meantime the commodity cycle is indeed, as Mr. Frank Holmes, proclaims solidly in the grasp of a super cycle. Have fun creating your wealth lifeboat Discovery!

The material herein is for informational purposes only and is not intended to and does not constitute the rendering of investment advice or the solicitation of an offer to buy securities. The foregoing discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (The Act). In particular when used in the preceding discussion the words "plan," confident that, believe, scheduled, expect, or intend to, and similar conditional expressions are intended to identify forward-looking statements subject to the safe harbor created by the ACT. Such statements are subject to certain risks and uncertainties and actual results could differ materially from those expressed in any of the forward looking statements. Such risks and uncertainties include, but are not limited to future events and financial performance of the company which are inherently uncertain and actual events and / or results may differ materially. In addition we may review investments that are not registered in the U.S. We cannot attest to nor certify the correctness of any information in this note. Please consult your financial advisor and perform your own due diligence before considering any companies mentioned in this informational bulletin.

---

[i] Consists of Alcan, Alcoa, Amerada H3ess, Anadarko Petroleum, Apache Corp., Baker Hughes Conoco, International Paper Newmont mining, Phelps Dodge, Placer Dome, Potash Corp Sask., Weyerhaeuser, Schlumberger, Tyson Foods, US Steel, Con Agra, Homestake Mining, Archer Danials Midland.