

**Today's Notes:**

1. **The Importance of the Individual**
2. **Banks**

## **1. THE IMPORTANCE OF THE INDIVIDUAL**

On February 11, 1979 Milton Friedman took 2 ½ minutes to explain the critical importance of the individual and choice in the free enterprise system to a doubting Phil Donohue. I wonder what Dr. Friedman would say 30 years later about our current predicament and the role government is assuming in our lives? The individual's freedom and ability to choose and take risks to create value are, of course, all important life elements and a cornerstone of our country. Individual ability to choose and take risk is being suppressed. It is increasingly evident that it is the government that is defining risk and the taking of risk. The sanctity of Moral Hazard has now been repeatedly breached by both recent administrations<sup>1</sup>. We must guard these life elements jealously. Please take time to ponder the Friedman interview.

Unfortunately in the current partisan atmosphere in Washington the role of the individual and that of individual risk taking is being suppressed. When the President of the United States uses the "Bully Pulpit" to criticize institutions for not "playing ball" (Chrysler debt holders) and forces a CEO to resign (GM's Wagoner), when a Treasury Secretary and Chairman of the President's Economic Council team up to run an auto company (General Motors), and when no institution is too large to fail (the other side of individual risk taking) something is seriously amiss.

Under the guise of saving the economy, there is a not so stealthy encroachment on the rights of the individual. No one is noticing. This is not, "Change We Can Believe In." It is "change we must be wary of." Where is Milton Friedman when we really need him? Think carefully about the following interview which was conducted 30 years ago. Another read of Friedman's "Free to Choose" is in order for all. We pray that Washington will not stray too far. Thanks to Chris for reminding us of this interview.

**PD:**

*When you see around the globe the mal distribution of wealth, the desperate plight of millions Of people in underdeveloped countries. When you see so few haves and so many have-nots. When you see the greed and the concentration of power. Did you ever have a moment of doubt about capitalism? And whether greed is a good idea to run on?*

**MF:**

Well first of all tell me, is there some society you know that doesn't run on greed? You think Russia doesn't run on greed? You think China doesn't run on greed?

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<sup>1</sup> Moral hazard arises because an individual or institution does not take the full consequences and responsibilities of its doings, and therefore has a tendency to act less carefully than it alternately would, leaving another party to hold some responsibility for the consequences of those actions. Perhaps the world's institutions pre-2008 took on far too much risk because they believed they would be rescued. The 1998 government rescue of Long Term Capital set an unfortunate precedent. **This is the route our government (both Bush and Obama) has chosen today.**

What is greed? Of course none of us are greedy.  
It's only the other fella that's greedy.

The world runs on individuals pursuing their separate interests.  
The greatest achievements of civilization have not come from government bureaus.

Einstein didn't construct his theory under order from a bureaucrat. Henry Ford didn't revolutionize the automobile industry that way.

In the only cases in which the masses have escaped from the kind of grinding poverty that you are talking about, the only cases in recorded history are where they have had capitalism and largely free trade. If you want to know where the masses are worst off, it's exactly in the kind of societies that depart from that.

So that the record of history is absolutely crystal clear, there is no alternative way, so far discovered, of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system

*PD: Seems to reward not virtue as much as the ability to manipulate the system.*

MF:

And what does reward virtue? You think the Communist commissar rewards virtue? You think a Hitler rewards virtue?

Do you think, excuse me if you'll pardon me, American presidents reward virtue? Do they choose their appointees on the basis of the virtue of the people appointed or on the basis of political clout?

Is it really true that political self interest is nobler somehow than economic self interest?

You know I think you are taking a lot of things for granted. And just tell me where in the world you find these angels that are going to organize society for us? Well, I don't even trust you to do that.

## **2. BANKS**

Last Friday we were treated to the results of the stress tests by the Treasury. These had been widely leaked so there were no surprises. For once the Geithner crew at Treasury has done a good job of setting and meeting expectations. Another Geithner gaff (remember the infamous quip that the China had a good idea with a new currency standard on February 10th?) and his career in Washington would have been materially shortened. The bank news on Friday was well received by the market. The bear market equity rally continued unabated making it the largest equity rally in such a short timeframe since 1934. As the following chart demonstrates the combination of Wall Street (very much alive and under the thumb of highly placed ex Goldman executives) and a new and intrusive government in Washington have injected a positive psychology into the markets. Perhaps mom and pop were ready to feel good after such a long string of negativity. This new psychology has propelled the market. We all needed the respite.

On a very positive note, fundamentals seem to be bottoming – not getting worse. But this is only the end of the beginning. Economic growth is still in the doldrums – everywhere in the world including China. China's real growth (minus fiscal spending which is temporary) is between 0% and 2% according to Stratfor. Make no mistake the US consumer cannot quickly be replaced. The US consumer makes up 17% to 20% of global GDP. A severely chastened Mom and Pop are now saving, returning to work and trying to reduce their burdensome debt load. By the summer of 2008, each US house hold held \$1.30 of debt for every \$1 of income. Household income in the US has shrunk faster than the snow that fell

on Saskatoon on Friday last. The race is on to reduce household debt to a sustainable level. US savings rates no longer negative and are now 4% and piercing a 10 year high point.



If there are indeed Green Shoots out there they have been fully discounted by the equity markets. The SP500 index has risen 36% since the leaking of Citibank's internal profit memo on March 7<sup>th</sup>. We think the move is largely a boost in investor psychology. Fundamentals are still not that good.

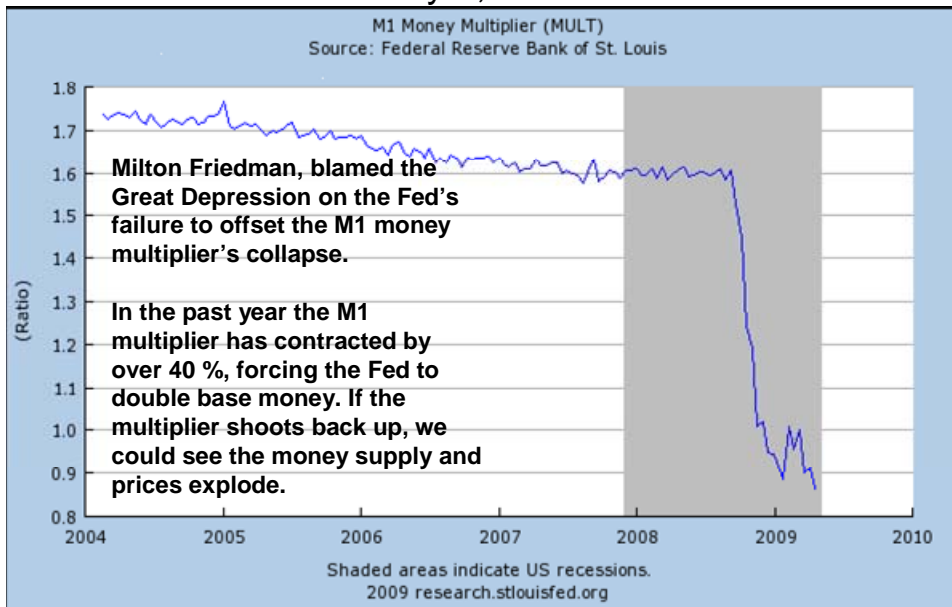
According to the Administration, 10 of 19 banks need to raise \$75 billion in capital to be considered safe. No single bank failed the tests. The “strength” of tests used to calculate the recapitalization requirements were not readily disclosed or understood. The banks argued vehemently to reduce the initial capital requirements imposed and in several cases the amounts were reduced.

If housing prices do not bottom soon, or if the upcoming schedule of Interest Only and option ARM mortgage resets through 2011 has impacts foreclosures, the banks shall see many more assets turn toxic. One hopes that the stress tests have considered that possibility.

Finally one look at the amount of heavy artillery (TARP, TALF, quantitative easing, reduction in interest rates, etc.) that has been thrown at all these problems is instructive. There have been no fewer, in my opinion than 9 attempts to save the banks. They have been piecemeal; no single attempt has had the desired impact to date. The most successful effort was the leaking of the Citigroup internal profit memo immediately following the bottom of the general market on March 7<sup>th</sup>. Even with a substantially expanded money base the money multiplier has fallen to Depression levels.

# Declines by 40%

May 8, 2009



We have yet to determine how effective and widespread the auction of toxic assets (PPIP) will become. For the past 8 weeks a sense of renewal has been spawned in the capital markets. Spring brings with it renewal. The strength of this rally is a sign of just how devastating the Great Contraction has been. At the very least the capital markets now must take a breather. At worst, I think they must retest the March 7th bottom before they signal victory in the global deleveraging and asset price contraction. Please remember that no asset grows to the sky nor does it fall immediately into the abyss. Psychology has most definitely turned but the fundamentals still face serious headwinds and foretell a long recovery period. Psychology is also ephemeral and can be fleeting. One very positive note, clearly a Green Shoot, is that the banking system itself will not now disintegrate. One wonders, though, if its self-healing properties might not have offered a quicker path to health. Please see the chart below – banks values are still 60% down from their values pre recession levels.

## Milestones in the Credit Crisis:



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