

**Today's Notes:****1. Convulsions - II****Convulsions - II**

In spite of the best intentions, the ineffective Keynesian remedies, the entreaties to the contrary, in spite of the rah-rah tenacity of the CNBC talking heads that the Dow Bull is back. World economic growth is slowing – the entire world.

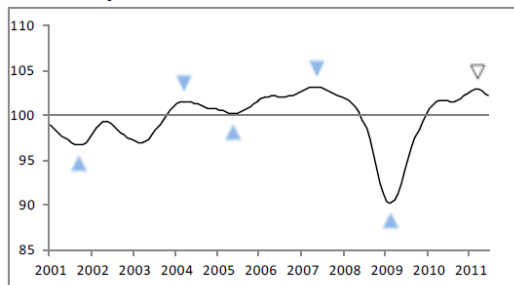
This AM gold soars once more past \$1800 per ounce and Morgan Stanley cuts European growth for next year to ½%. Europe is in trouble – France's Sarkozy and Germany's Merkel exchange platitudes and protest that the Euro will exist forever. But the two leaders cannot implement the European bond fund due to political barriers.

The U.S. is slowing as well; we think political factors are the result. All will be resolved when the debt problem is solved – we just don't know when that will be because debt resolution will require compromise and political will – sadly lacking in Washington and Brussels.

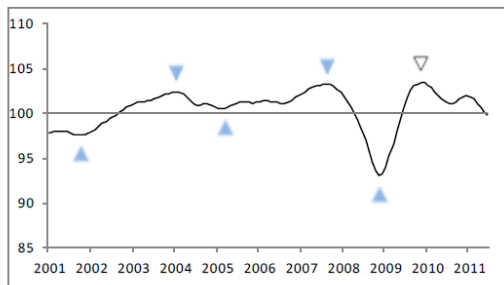
In the meantime despite a stronger dollar and gold price Venezuela wants Canadian, U.S., British and Swiss gold (211 tons) returned – after beginning to nationalize its gold mines. I'll take Canadian gold discovery investments anytime. Canadians have fewer worries – China stands in the wings to buy her oil, potash and nickel.

The OECD sees the slowing world this way also – Many thanks to Tom Drolet for bringing this valuable data base to our attention. I show three areas below but the full data indicates that 20 country leading indicators have peaked or are turning down.

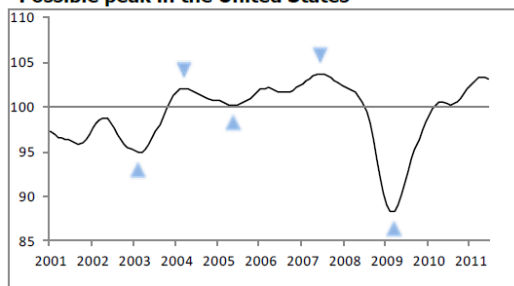
**Possible peak in the OECD area**



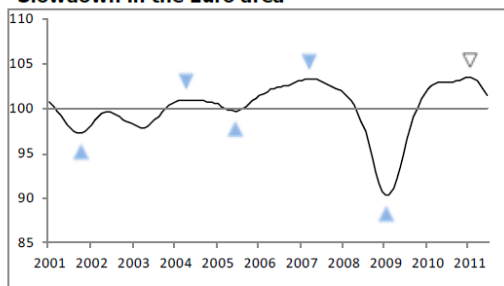
**Slowdown in China**



**Possible peak in the United States**



**Slowdown in the Euro area**



The above graphs show country- and area-specific composite leading indicators (CLIs). Turning points of CLIs tend to precede turning points in economic activity relative to long-term trend by approximately six months. The horizontal line at 100 represents the long-term trend of economic activity. Shaded triangles mark confirmed turning-points of the CLI. Blank triangles mark possible turning-points that may be reversed in the future.

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Please see [http://stats.oecd.org/wbos/default.aspx?datasetcode=MEI\\_CLI](http://stats.oecd.org/wbos/default.aspx?datasetcode=MEI_CLI)

It is not only U. S. economic growth prospects that are anemic. Growth everywhere is either slowing, nonexistent or ephemeral. Without growth employment suffers – without growing employment wealth creation falters and the economic growth will slow. We here at Morning Notes, are close this AM to calling it game – 10 run rule – slaughter rule in Little League parlance.

For four years since July 2007, we have been watching, analyzing, questioning assumptions and writing on the tenacious global struggle between deflation and inflation. It has been said that the Federal Reserve wants inflation, stokes inflation but not inflationary expectations. Deflation seems the worse of the twin evils. Yet despite all the remedies and jokes about helicopter droppings employment and housing lag, real wages fall, consumption stalls. The future seems bleak.

**The Debt Bomb:** When I was a professor at the University of Virginia in the 1980s the established academic dogma stipulated that there is an optimal capital structure for a company, Miller and Modigliani be damned. The idea was that a tax shield on a company's debt creates value by reducing the weighted average cost of capital up to a certain level of debt. Once past that level of debt which is industry or company specific, the risk of bankruptcy will rise and with it the cost of debt and the cost of capital. The theory is intuitive and appealing and appears to be borne out empirically in the real world.

Almost every family understands this reasoning about borrowing and taking on debt. For a Canadian or American family the gold standard has been the banker. Historically no family has been able to borrow more than it can reasonably pay back – a central tenet of commercial and personal banking. Most Americans and Canadians have assumed debt on homes and cars and paid them down over time.

However the last three administrations in the US (Clinton, Bush and now Obama) pushed very hard on deregulation of the financial industry (Glass Steagall) and strove to make mortgage debt available to everyone, everywhere to stimulate home ownership under the rubric that every American ought to own a home. Fannie Mae and Freddie Mac – now wards of the government with hands out recently for more taxpayer dollars. Freddie Mac requested \$1.5 billion and Fannie Mae requested \$5.1 billion this past week. Fannie who financed many mortgages lost \$2.9 billion in the quarter. Fannie and Freddie jointly have drawn down about \$170 billion in taxpayer aid from the Treasury. Today the extensive leverage has morphed up from mom-and-pop's mortgage to sit menacingly at the taxpayer level as Fannie and Freddie plead for another round of Treasury drawdowns. Everyone in charge hopes that somehow economic growth will re-emerge and take care of the massive debt overhang. We do not see that eventuality likely.

So debt has been shifted up from the household level to the country level. That's right I said country not company. Therein lays a horrific problem that, not treated, properly metastasizes.

It occurs to us that the overwhelming weight of debt, borrowing at every level of society – particularly government but also mom and pop – has snuffed out the oxygen of this economic cycle. In the past 71 years the federal government has increased the debt ceiling 86 times to a mere \$16 trillion. Because of this leveraging (partly a result of the reserve currency status of the US dollar) the dollar is now in question.

It would also seem that government has been wary of dealing with the leverage situation. We harken back to a quote by Bernice Cohen (**The Edge of Chaos**) whose prophetic book from 1997 should be read by everyone including the Solons in Washington and every concerned citizen.

***“Again, the debt deflation takes a predictable form. The massive inflation of the boom is followed by the crisis of the crash and demands for cash become overwhelming. This triggers the liquidation: a massive selloff in financial and other assets to convert everything as quickly as possible into cash. This phase follows hard on the heels of the crash crisis because, the matter how inadequate, borrowers and lenders must agree on the reckoning. Every debt must be settled. Loans will either be repaid and the Borrower suffers, or the borrower will default and the lender bears the loss. In the***

*scramble to repay debt, property, commodities, precious metals, antiques, art objects all will be sold, even at rock-bottom prices to eliminate debt.*

*New in-words take center stage; restructuring and refinancing. In Chaos theory, this phrase is termed self-organization. It represents scattered islands of order emerging within the chaos of the collapse. At this stage, thousands of careworn speculators and investors now develop a new revulsion; they become debt averse. As confidence in the credit system reaches an all-time low the recession tightens its grip, accompanied by a drop in interest rates and commodity prices. As this grueling phase unfolds the wily investors, who sold out in good time, may slowly begin to reinvest their hoarded cash piles. Base building phases on charts mirror this recuperation process. With the glacial slowness, confidence returns and depression lifts.*

*No matter how harrowing the crisis and liquidation, the onset of the deep depression actually marks the dawning of a new credit cycle and the turning point for new up wave. This usually requires months of painful base-building. The economy shows intermittent signs of revival amongst the gloom. Prices of shares or a national index begin to form a floor base level. The human urge to rebuild takes hold.”*

Are we facing Cohen’s vision of the future? I do not know but there is a growing likelihood that given the evident failure of the world’s central bankers that such a scenario may unfold.

In fact many believe that a second Great Contraction is underway. Harvard’s Professor Kenneth Rogoff (see *The Second Great Contraction*, Toronto Globe and Mail, Aug 3 2011) asks:

*“Why is everyone still referring to this as the great recession?”*

Rogoff believes this is not a typical recession with a cyclical springboard. The real problem he notes is that *“the economy is badly overleveraged.”* He suggests a more accurate term for our coming double dip “recession” is *“the Second Great Contraction”* a phenomenon that occurs he says only once every 70 to 80 years.

He claims today’s malaise is something “completely different” than the Great Recession. We are fighting the wrong economic war with ineffective weapons. What we need is moderate Inflation. But demand-based inflation has not been forthcoming. Real wages are falling, banks have stopped lending and home prices are still declining. And interest rates, unbelievable, a Ten Year yield of 2.047% this AM.

## US benchmark yields

Maturity	Yield	Today's change	1 week ago	1 month ago
1 Month	0.01%	>-0.01	0.01%	0.00%
3 Month	0.01%	0.00	0.02%	0.01%
6 Month	0.05%	0.00	0.07%	0.05%
2 Year	0.19%	>-0.01	0.18%	0.36%
5 Year	0.88%	-0.03	1.00%	1.43%
10 Year	2.12%	-0.05	2.33%	2.91%
30 Year	3.52%	-0.05	3.49%	4.29%

### Deal With the Debt!

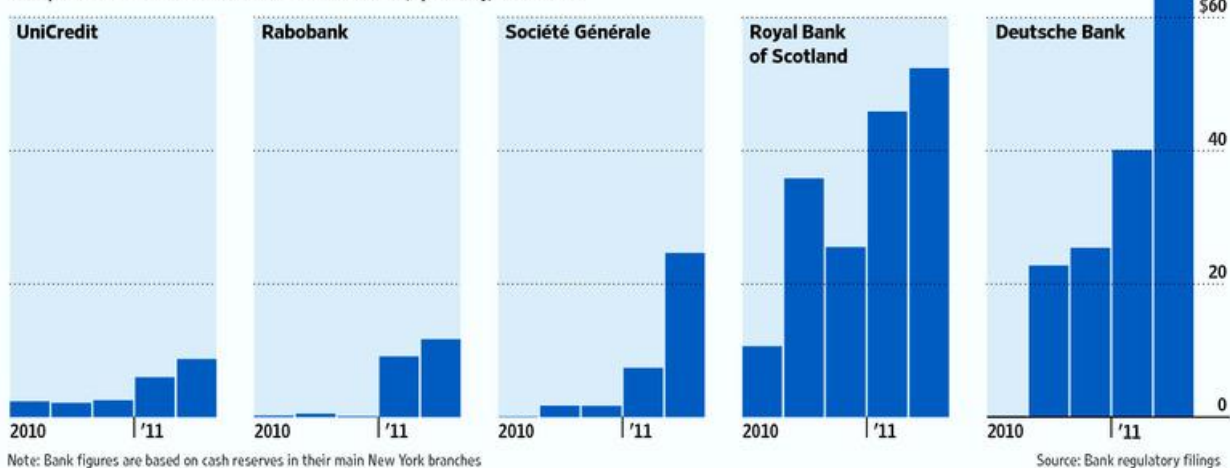
Dealing directly with bad debt, as Cohen suggests above, and implementing bouts of 4% to 6% inflation may be the only effective tools left. Resolution will be months at best, years if we keep pushing the debt ball down the road.

### The Federal Reserve Worries:

Unfortunately the globalization process has linked most of the world. This AM the Wall Street Journal notes another problem. European banks hold U.S. dollars – lots of U.S. dollars. The fed is worried and domestic banks are under pressure this AM.

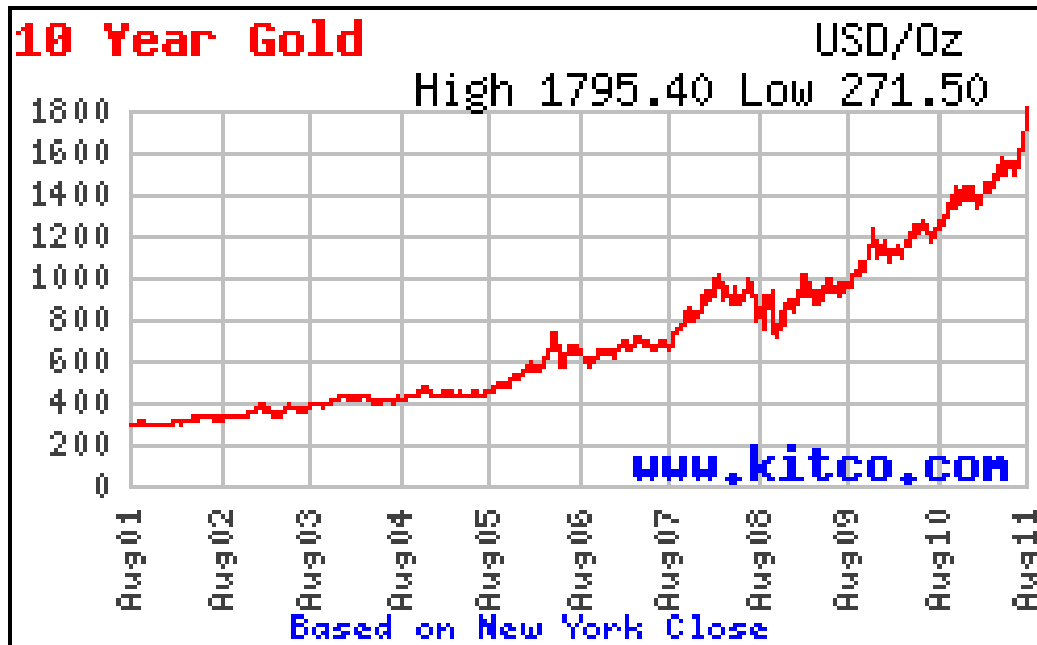
#### Dash for Dollars | European banks have stockpiled billions of dollars in the U.S.

European banks' cash reserves in their U.S. units, quarterly, in billions

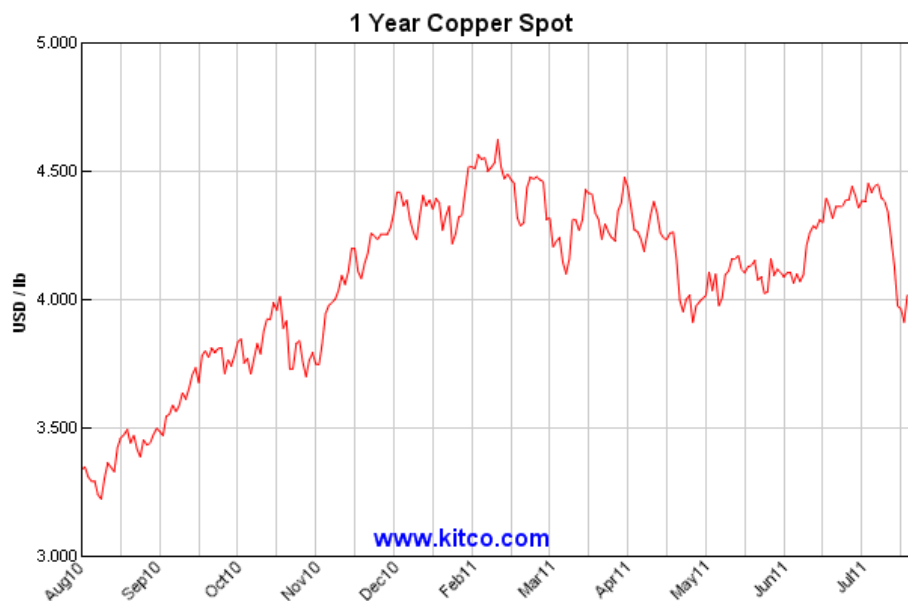


Meanwhile copper seems to be holding around \$4 despite a good correction. Frankly we would very much like to see gold consolidate around \$1700 for a few months but that

seems unlikely as events accelerate round the world. - China still buys at this level. Gold is beginning to look exponential after 10 years of steady increases.



**Discovery Investing:** Discovery Investing, even in times of slowing growth, is going to be the place to be. The DI Ten Point grid and our new software system (Due in January) will be more important. Share prices may indeed slide but even more expert judging of management, world class resource potential and balance sheet will yield value creation.



Some quick Notes (more to follow):

American Manganese (AMY TSXV) notes this AM it will begin testing through Kemetco its pilot plant for production of EMM. Everyone says no about this stock but we like it very much and we own the shares.

Northern Graphite (NGC TSXV) continues to define the graphene structure of its graphite flake deposit at Bisset Lake between Ottawa and North Bay. We expect a bankable feasibility study in the future. This is a great turnaround story (not unlike Revett Minerals) with top management is Greg Bowes. Management, management, management. We hope to visit the site this Fall.

Carlisle Goldfields (CGJ TSXV) has another site visit this AM. My visit to Lynn lake allowed me estimate that there is significant gold discovery potential and open pittable mining potential 2 to 4 grams. Once again under Bruce Reid and Carl McGill CGJ is a most interesting turnaround story.

Grande Portage (GPG TSXV) and Quaterra Resources (QMM AMEX) continue to drill Juneau's HG property with previously announced very high grade gold results that management termed – “extremely impressive.”

Please be prepared psychologically but do not panic. The world will need even more discoveries and we plan to be there when those discoveries are made.

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