

**Today's Notes:**

**1. THE CRISIS: PANIC ATTACK**

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Some time ago I wrote that the current economic crisis was over. Many readers wrote widely excoriating my statement. I was, of course, referring to the immediate nature of the banking crisis which, between September 2008 and March 2009, looked very much like a global banking melt down. You may recall that several large institutions in the insurance, and commercial and investment banking industry simply vanished. Even Ken Lewis the CEO of Bank of America has fallen casualty to the Merrill Lynch shotgun marriage hastily arranged by Fed Chairman Bernanke and then Treasury Secretary Paulson. There really was a great deal of panic and the TV pundits really played it up. While credit markets seized our infamous Ted Spread zoomed to stratospheric heights. Hundreds of billions of dollars poured forth from our Treasury and the Federal Reserve in the form of mortgage purchases, loans to banks and virtually every give away scheme deemed possible. There is no doubt that at some point in November 2008 we were perilously close to Armageddon. I think the key day was November 21<sup>st</sup> – a day I was presenting at the Federal Reserve in Washington.

During those days we became inured to a wide variety of acronyms and new lifeboats; TARP, TALF, FSP, CARS, PPIP, ARRA 2009, ESA (2008) and QE, just to mention a few<sup>1</sup>.

The impact of this flurry of new programs was lost on most people including quite possibly those who originated them. The interaction of these programs seemed muted until recently. These “solutions” were invented on the fly as the system disintegrated. The overall Paulson / Bernanke goal was to throw more than enough liquidity at the markets to stabilize the system – even if the government was forced to become the liquidity provider of last resort. In many cases they are still the liquidity provider today. In hindsight it is little wonder that a measure of credit market stabilization was achieved.

Many economists believe that such a powerful set of government stimuli will induce inflation. Nobel Laureate Gary Becker suggests that the authorities (The Federal Reserve and Treasury) will never be able to arrest the pent up demand that these knee jerk responses will create.

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<sup>1</sup> Troubled Asset Relief Program (\$700 billion), Term Asset-Backed Loan Facility (\$1 trillion), Financial Stabilization Plan, Consumer Assistance to Recycle and Save (\$3 billion), American Recovery and Reinvestment Act 2009 (\$787 billion), Public Private Investment Program (\$40 Billion), Economic Stimulus Act of 2008 (\$152 billion), Quantitative Easing (?).

One of the major problems with most legislation is that everyone wants short term results. Indeed with the banking system on the edge of the abyss in the fall of 2008, we needed short term results. Nevertheless there is a long delay factor in the impact of these strategies. We contend that around the globe governments have thrown the “kitchen sink” at the continually evolving problems. There were so many new financial innovations from Washington that economists seemed to become confused on their impact and began to disagree on basic issues.

The inflation / deflation tug of war is one such issue upon which two separate groups of economists and policy makers disagree and are now fixated. The split extends into the FOMC where sides have been taken. My friend economist Gary Shilling makes a very strong case for deflation in his recent and always insightful “Insight” publication. Gary sees excess capacity everywhere and falling demand and prices given the proclivity of the new consumer to save. One has to look no further than the commercial real estate market here in New York to realize that rents are falling.

This AM the Reserve Bank of Australia raised its cash rate from 3% to 3.25%. This has sent a message of hope around the world. They intend to fight inflation that they see coming. No one, and I mean no one, in the US has the inner strength to advocate an overnight Fed Funds rate increase. Nevertheless the Aussies are betting that rescue plans are having their desired affect. On the other hand, just yesterday Michael Geoghegan the CEO of HSBC said,

***“I’m not as convinced we’re through the worst as others are. The reality is that profits will be quite reduced.”***

He is convinced that a second downturn is coming.

Of equal interest is the disparity in the world’s fiat currencies. At the center of this debate are too old foes. They are the US dollar (representing, I suppose, all fiat currencies) and gold. We saw significant dollar strength following July 2008 as dollars everywhere were sought in flight to safety and to reverse the dollar carry leverage trade.

Today however there appears to be a very new and powerful force at work. Take a quick look at the price movement of the US currency in the past 7 months.



As you can see the US dollar has been under pressure. We think the dollar will eventually test the lows of April 2008.

It seems that the collective psychology of the market has reached its tipping point. China, Russia, Japan, the Middle East Countries and even France are rumored to be looking at alternatives to the dollar for commodity trade. While I do not believe in the imminent demise of the dollar in the short run, the psychology of the dollar market has definitely soured. Gold, its nemesis, is soaring as we speak.

Let's examine the issue from a different perspective. How does the US escape its current debt trap? We have suggested that eventually it will be absolutely necessary for the US to inflate its way out of the trap. This may be the case as we see the current dollar weakness and strength in all other currencies. However this dollar weakness, we think, will be temporary. China is not likely to suffer a weaker dollar for too long without some recompense.

But there are still significant economic headwinds around the world despite the Australian optimism. In the US, commercial real estate loans have yet to unwind. Sheila Bair head of the FDIC is suggesting many more bank failures will occur between through the end of 2010. She may now force the banking system to pay FDIC insurance premiums in advance. This would severely impact the lending ability of the banking system. Most observers see at least another \$200 billion or more of bank failures in the future. The FDIC has about \$10 billion remaining in its insurance fund.

Last Friday's employment report was very disappointing, a big setback. U-6 unemployment (unemployment plus underemployment) is running perilously close to 18%. It appears that

the government's Birth / Death adjustment (employment for small firms) overstated US employment significantly in the past year.

The loan status of the Austrian banks vis a vis their lending to Eastern European countries like Hungary and the state of Latvia's economy threaten a further meltdown. We shall hear of these issues in due course. We shall also hear more from China. We have yet to determine whether the China story is evolving into another bubble or a real consumer economy in China is underway. We fear the former scenario shall unfold.

**Gold?** A picture tells a thousand words. Gold has touched a new nominal high of \$1035 per ounce (futures) this AM. Now this price move is not about inflation – yet. We are not necessarily inflating out of the debacle. **It is instead the very beginnings of a global move to diversify away from the dollar.** It is all about gold's role as the ultimate currency haven. Inflation may or may not come later – but it is not here at present. Gold is going much higher – you must own a core position.



The real winner is silver. A quick look at the gold / silver ratio tells the story of the outperformance in silver quite convincingly. Goldcorp, Silver Wheaton, Endeavour Silver Terraco Gold and Revett Minerals seem to be good opportunities in the silver space.



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