

**Today's Notes:****1. The Fed Acts****1. THE FED ACTS**

Yesterday the FOMC met and they acted. It was not quite the Quantitative Easing that some expected but it was action. Many observers believed that the FOMC would do nothing but that was not to be the case. Because they are concerned that “unusual uncertainty” obtains in the US and global economies (China seems to be slowing), the Fed mavens decided to act while the Congress fiddles and frets about November’s midterms. The Fed action was not quite Quantitative Easing<sup>1</sup>. Also, the FOMC vote was not unanimous. The golden Greenspan days are long gone and there is, always and everywhere, disagreement and uncertainty about what might happen. Is the economy recovering? Is the economy stalling? There shall be no comfort, no consensus from our central banking solons in Washington. Specifically the FOMC said in part,

*“The pace of recovery in output and employment has slowed in recent months. ... investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Bank lending has continued to contract...”*

In addition the FOMC noted, *“The pace of economic recovery is likely to be more modest in the near term than had been anticipated”*

They warned of a negative surprise in expected growth. Expect one level of growth but realize a lower level. That’s called a cockroach. The theory, as applied to corporate earnings, is that when you see one you see more and they get bigger. That, my dear readers, is what worries the mavens at the most powerful central bank in the world. They are worried – all except Kansas City Fed President Timothy Hoening - about deflation. He believes that the economy is on the slow boat to recovery and that the Fed should not reinvest its mortgage backed portfolio in Treasuries but allow the bloated balance sheet to contract.

Nevertheless the FOMC decided to keep the Fed’s balance sheet constant at \$2.06 trillion. So theoretically it was a neutral decision, neither easing nor tightening but targeting its balance sheet. Lest we forget this could have been the second “kick at the can” for the first QE episode occurred in 2008/2009 when the Fed printed \$1.7 trillion ostensibly to rescue us from the “Greater Depression.”

It’s not just the static money supply, as some have suggested. That doesn’t matter because we believe the US economy is now mired in a long and difficult period of deleveraging (see both the dollar and yen strength this AM). Though no one in Washington admits it, we seem to be in the grasp of a Keynesian liquidity trap with central bankers pushing on a classical Keynesian string.

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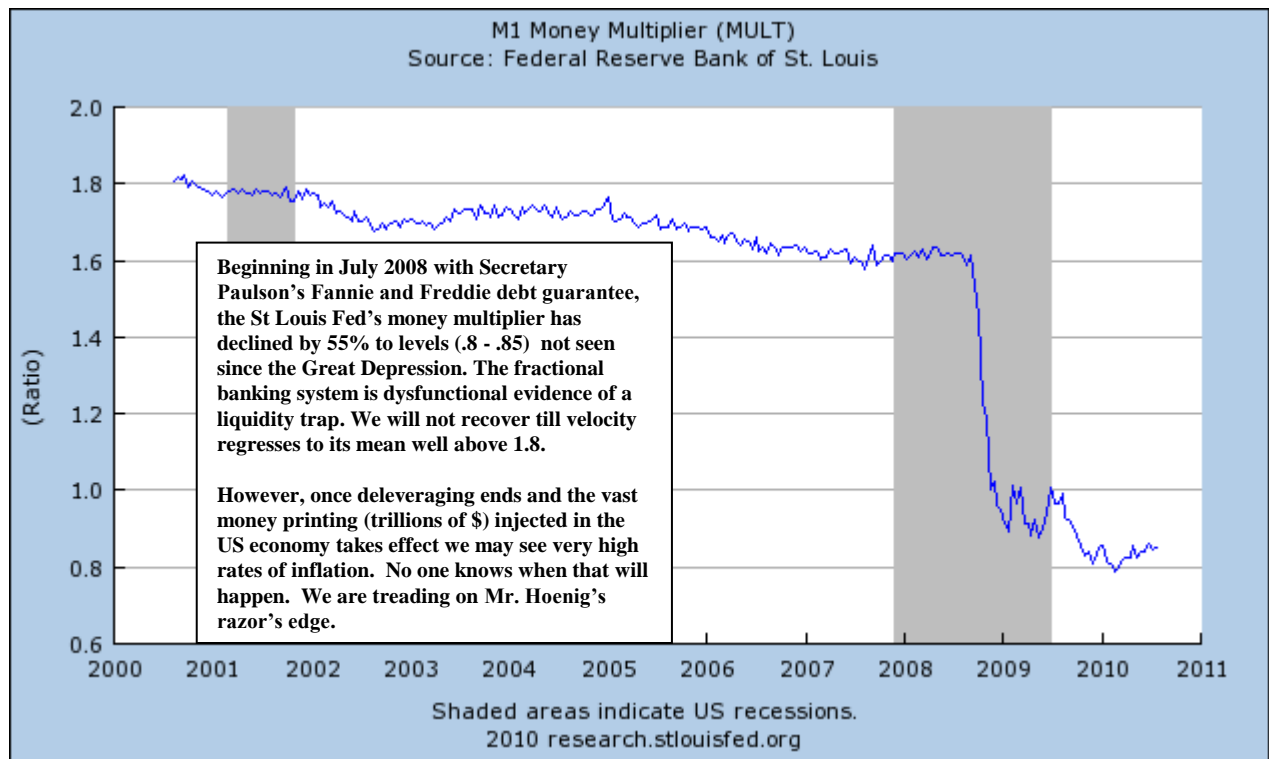
<sup>1</sup> Quantitative Easing is the purchase of Treasuries by the Fed. It is sometimes called printing money but involves the Fed expanding its balance sheet to provide liquidity for the economy.

The economic paradigm also seems to have changed, fiscal and monetary philosophies and the tools therein are not working. The Austrian approach is painful but we may be headed that way.

If the 1.15 million dispirited workers, no longer in the job hunt, were included in the recent government U3 statistics, the unemployment rate would be 10.2% - this after a fiscal stimulus of a trillion or more and a monetary QE boost of \$1.7 trillion<sup>2</sup>. Even the FOMC suggested yesterday that, *“employers remain reluctant to add to payrolls.”*

The signs are quite convincing and that is what the Federal Reserve is signaling.

One look at the St Louis Fed’s money multiplier coupled with the static money supply reinforces our concerns and rationalizes the Fed actions from yesterday.



The US equity market has taken note this AM. The futures (Dow) are trading down significantly (-162 points. 1.5%) as I write. The following chart of the Dow shows a very ominous triple top. Richard Russell recently called this the “Mother of all Market Tops.”

<sup>2</sup> *“Over the past three months,” he said, “1,155,000 unemployed people dropped out of the active labor force and were not counted as unemployed. Even ignoring population growth, if these unemployed had not dropped out of the labor force, simple arithmetic shows that the official unemployment rate would have risen from 9.9 percent in April to 10.2 percent in July, rather than — as it has — fallen to 9.5 percent.”*

The Horror Show, Bob Herbert, New York Times August 9, 2010



Gold, which had declined significantly overnight on the stronger dollar deleveraging, has increased this AM (~\$1209). The Fed's new position on targeting its balance sheet size may seem to be neutral but it presages its significant concern of deflation. In that respect it is not neutral. The psychological impact is real. The Fed has done the Congress and the Administration a favor, if not mom and pop and Wall Street. While Congress diddles over how to spend to get re-elected it is apparent that the Fed believes that New York Times columnist Paul Krugman's fiscal spending solutions have failed.

Nevertheless we would not be surprised to see gold and silver decline. Please remember that gold has not been the friend of any central banker anywhere since 1971 and the Great Nixonian Decoupling. If so you must be a buyer of gold and silver on weakness. Within a few years the US dollar is toast. Protect yourself. Yes liquidity is paramount now. The barbell portfolio today of cash and gold exposure plus cheap discovery companies is our preferred portfolio allocation.

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