

Today's Notes:

- 1. Gold
- 2. The Banks

1. GOLD

The chart below shows just how strong gold has remained. When comparing the performance of gold to almost any other index you can see how well it has performed since the Paulson-induced dollar short covering in mid July. Gold fell a mere 12% while the equity market (the S&P 500) fell 36.12% from 1260.6 to 805.2.



It is worthwhile to examine the Gold / Dollar ratio. If gold is to be considered a store of value it must also serve as a substitute for the dollar. The dollar has strengthened by 21% over the past 7 months from 71.79 to 86.25 (July 15, 2008 thru Jan 20, 2009) based on short covering and massive de-leveraging. I expect there is likely more hedge fund liquidation and dollar short covering in the offing. Nevertheless gold is sending a strong message in holding quite well under the strain of a strengthening dollar.



It was with interest that I received this email from a Morning Note reader in Vancouver.

"I thought I would check in at my local bullion store to see where the gold/silver supply demand was sitting since my last visit in Fall 2008.

1) Gold is available with no min order other than 1oz. Buy it-take it home.....

Spot gold today is \$857

Vendor selling for \$1122 oz (30% premium to spot)

Vendor is buying for \$1068 oz (25% premium to spot).

The vendor is buying and selling gold for a 5% spread. So....better supply, trade more, but vendor is still paying significantly higher than spot to get it.

2) Silver is available only on pre-order min 500 oz (\$10k Canadian), with 6 month delivery.

Spot silver today \$11.16

Vendor selling for...\$19.30 (73% premium to spot)

Vendor is buying for...\$14.70

(32% premium to spot, therefore is buying and selling for a 31% spread. So....no silver supply, lack of trading liquidity and paying huge premium to spot.

In his email he notes that vendors buy their gold (in Vancouver) with a 25% premium. Vendors sell their gold for a 30% premium. Those are the real prices for physical gold today – that which the spot market for physical commands.

Physical silver commands a 32% premium for vendors and a 73% premium for the public. Silver can only be purchased in size and with a very long wait.

Good friend Jim Currie comments that these premia are evidence of the new monetary nature of these metals. I think also they represent the nascent expectation that the US currency will strengthen and then fall – just as the Treasury bond markets must soon begin their demise. If the Treasuries fall dramatically (in price), as predicted by many to be the last great bubble, gold is likely to strengthen significantly. Some suggest that the dollar will continue to strengthen. They reason that the deflationary spiral will continue. But as Chris Tibbs suggests, the US dollar Ponzi scheme must eventually end – in tears – for everyone.

Given this single data point you are probably thinking that this is not a valid conclusion. But call your precious metals dealer anywhere and you will see more realistic market than that given us by the futures market – WHICH ARE SETTLED IN CASH and therefore amenable to manipulation!

Under these circumstances, I think the gold/ silver ratio is far too large. Have a look.



Finally, I want to add some emphasis to the gold story. After all, I have beseeching all Discovery readers to own gold (physical, shares, ETFs or discovery stocks), decrease debt, raise cash and focus on discovery, for the past three years. Here is what Barron's Roundtable participant Felix Zulauf had to say about gold last week. He suggests it will only require 2 to 3 years for gold to double. This means \$1700 per ounce gold in three years. At present gold / silver ratios silver will sell in the \$20 to \$25 per ounce range. If the gold/silver ratio declines to its four year average, silver will sell for \$30 per ounce, a 150% increase from today's spot price. By the way Zulauf was not the only supporter of higher gold on the Roundtable. Very few of the participants rebutted his forecast.

*“My one recommendation for the longer term is **physical** gold. Consider the basic set-up: World economies are so weak that we are seeing government stimulation of historic proportions. At first this is deflationary, but it will become inflationary. Gold is the only currency that won't get devalued. It will be revalued.*

If the Fed's liabilities had to be covered in gold, it would sell for more than \$6,000 an ounce. We aren't going back to the gold standard, but the markets won't trust the central banks anymore. Gold is in a very slow bull market. The year-end price has been higher each year since 2001. The gold market could have a shakeout in the next six months, and the price could fall back to \$700 an ounce or below from today's \$850. But two years from now it will be a lot higher. It is one of the few commodities that held up during the forced liquidation of almost everything else. We have talked about the risk of currency devaluation. If you were a citizen of Iceland and your currency went down by 50%, consider how gold performed in your currency. Gold functions as a protection against your central bank doing stupid things

*You don't own it (gold) in a leveraged way. It was helped by the forced liquidation of other things. There was some forced liquidation of Comex futures contracts, but ... **there was a massive move into physical gold**. Gold will stay in a bull market. It can't be manipulated like a currency.*

You can sell it, but unlike a currency, you can't make it out of thin air. You have to dig hard to get it out of the ground, and there is a limited quantity available.

Gross: *How many years will it take for gold to double?*

Two, but don't blame me if it takes three. If you're a little more adventurous, you can buy gold stocks, but put the core of your holding in physical gold. Gold-mining stocks have underperformed physical gold for more than a year, due to rising production costs. Production costs should decline slightly because of lower energy prices

One final comment is in order. I think you should be buying gold, silver, uranium and natural gas as the top of my list of discovery commodities today. I like Quaterra Resources for its silver and uranium resources, Bravo Gold for its new “Eskay –like” gold discovery in BC and Houston Lake Mining for its continued discoveries in north-western Ontario and its Canadian presence.

2. THE BANKS

I am very troubled this AM. I watched the banks fall on their swords yesterday. It was not only US banks that declined, but also British and European banks. Obviously the RBS debacle in Britain has cast a pall over the entire global banking system. This dynamic – outlasting now three rescue attempts, commencing last July - is now beginning to “smell” increasingly depressionary.

I wouldn't make too much of the fact that yesterday we inaugurated our 44th president and the banks fell en masse by 20% plus. They were due. And it was not only the banks. GE was downgraded and their dividend is now in question. Nevertheless, the banks are in need of either common equity infusions (no one wants to invest, you see) or they are in need of nationalization.

There have been a number of rescue attempts. In spite of Paulson / Bernanke jawboning, planned TARP purchases of toxic assets, “ring-fencing” of Citigroup and Bank America's toxic assets, injections of billions of \$s of capital directly into the banks and now the plan to design a “bad asset” bank, the markets are acting as if this game is over. The TED spread is still too high (even though it has fallen) and the VIX is on the rise. The shell of market fear is increasing.



A picture of Bank America (see below) after it unfortunately took on both Countrywide and Merrill Lynch is instructive. It is so amazing the Government, bankers and investors all missed the size and impact of this economic contraction. It will be called the Great Global Contraction. Given the pain just beginning to be felt in Britain and Euro land (President Sarkozy is injecting Euros into the French banks this AM) this banking demise cannot probably be remedied in any one country.

It looks like we may be headed for an equity holder wipeout through bank nationalization. This will likely have to be global in nature. In the early 1990s Sweden went through such a contained banking system failure – also based upon housing collapse. I have written about this experience in past MNs. The country nationalized the banks and eventually sold them back to investors. The resulting banking collapse required 6 years of slow economic growth and rebuilding of the Swedish banking system. Regarding this experience the New York Times suggests,

“Standing shoulder-to-shoulder with the opposition center-left, Mr. Bildt’s conservative government announced that the Swedish state would guarantee all bank deposits and creditors of the nation’s 114 banks. Sweden formed a new agency to supervise institutions that needed recapitalization, and another that sold off the assets, mainly real estate, that the banks held as collateral.

Sweden told its banks to write down their losses promptly before coming to the state for recapitalization. Facing its own problem later in the decade, Japan made the mistake of dragging this process out, delaying a solution for years.”

This may be the direction in which we are heading.



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