

Today's Notes:

- 1. The CFTC: Regulation of Energy Futures Markets**
- 2. Home Prices**

1. THE CFTC

The Commodities Future trading Commission (CFTC) has a new leader. He is Gary Gensler. Mr. Gensler said yesterday that he would consider halting rampant speculation in the energy markets. This would be accomplished, for the most part; by changing (reducing) the position limits on trades in the futures contracts. Let's be very clear about one aspect of the futures markets. They are vital to the price discovery process. We must all remember that while futures contracts can be used for speculation (price discovery) they are at least as valuable for hedging risk. I have no doubt about these facts. By the same token, the rules that govern these markets have been abused time and time again and no one in Washington has paid the least bit of attention. They are not products of the common man but inure to institutional investors for the most part. Here I separate option contracts (Calls and Puts) from futures contracts. While both types of financial contracts are leveraged investment vehicles (there is a margin requirement or debt assumption associated with these contracts), option contracts are quite different and much safer, by design. Both are "derivative" instruments. This means that their values are based on an underlying asset or spot market. In the case of oil futures, the spot price of a barrel of oil.

The history of futures markets goes back thousands of years. Aristotle mentioned the idea in early writings. In this country they were valuable to farmers who could hedge their production and deliver the physical entity when the crops were finally harvested.

However something happened in early 1970s. Futures contracts on financial assets were introduced in Chicago on the Chicago Mercantile Exchange. In addition the provision for cash settling these contracts became de rigeur. This means that instead of producing a commodity (such as corn, oil or wheat) and delivering upon maturation or extraction of the commodity, the futures buyer or seller could simply write a check. To me this is the Achilles heel of the futures market. Others disagree; they believe that cash settlement is the essential ingredient to make the futures markets liquid. In the interim, the institutions have had a field day dominating these markets, as you might expect.

There have been stark warnings that this structure could be destabilizing as well as a powerful price discovery and risk management facility. By the fall of 1987 a new institutional product called Portfolio Insurance was all the rage. The idea was that a fund could protect its equity portfolio by selling stock index futures contract to get to a magical number called Delta. This process was continually revised and became known as dynamic hedging. It was supposed to be cheap.

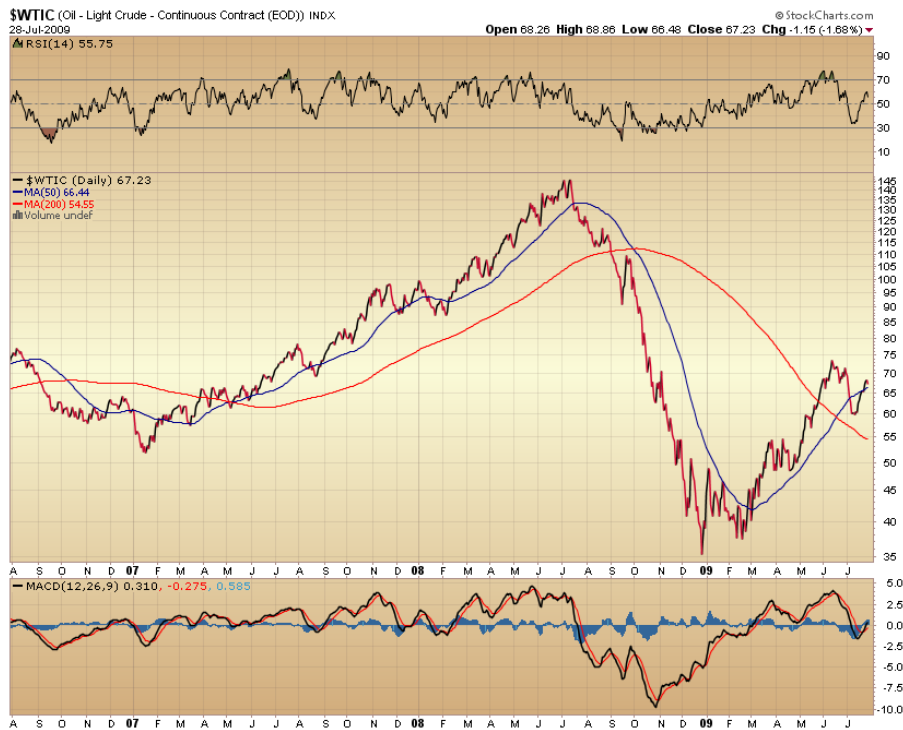
By late October the equity markets worldwide could no longer bear the burden of institutions selling more and more cash settled stock index futures contracts. The markets crashed, falling by 23% on October 23 1987- almost twenty years ago. The

lesson – when everyone moves to one side of the boat, the boat is likely to tip. When the dust cleared from this 1987 episode only about 65% of stocks actually were insured. It was vastly more expensive than advertised.

Then again, though lesser publicized, the Government of China through CitiGroup invited me to testify before the CSRC (China’s version of the American SEC) in Shanghai and Beijing in 1995. While Chinese government bond futures markets were in very early stages of development at that time, it seems that a group of speculators had cornered the bond market using their futures contracts. At the time we recommended new position limits, margin requirements and of course advised on the dangers of cash settlement. China promptly closed its bond futures market and only recently (a few years ago) reopened the futures markets.

I am sure there are many more examples of the power of the futures markets. Let me say again that properly regulated the futures markets are a necessity in a modern economy. They allow efficient risk management and price discovery. Nevertheless these markets are known for their power over spot markets. They are the “tail that wags the dog.”

Today we have the new head of the CFTC, Gary Gensler, threatening to impose new regulations on the oil futures markets. The issue is, of course, the recent volatility of the oil spot market. Unless you have been living in a cave you will know that oil spot markets have run from \$40 per barrel in 2004 to a high of \$147 and subsequent decline to \$35 per barrel in 2008. This is called volatility. The Obama Administration throws the blame to Wall Street. There is indeed plenty of blame to go around. There will be regulation of these oil futures markets in the US. I think it will take the form of restrictions on institutions that can use these markets and through position limit changes. **There will be limits placed on speculative trading for certain institutional investors.**



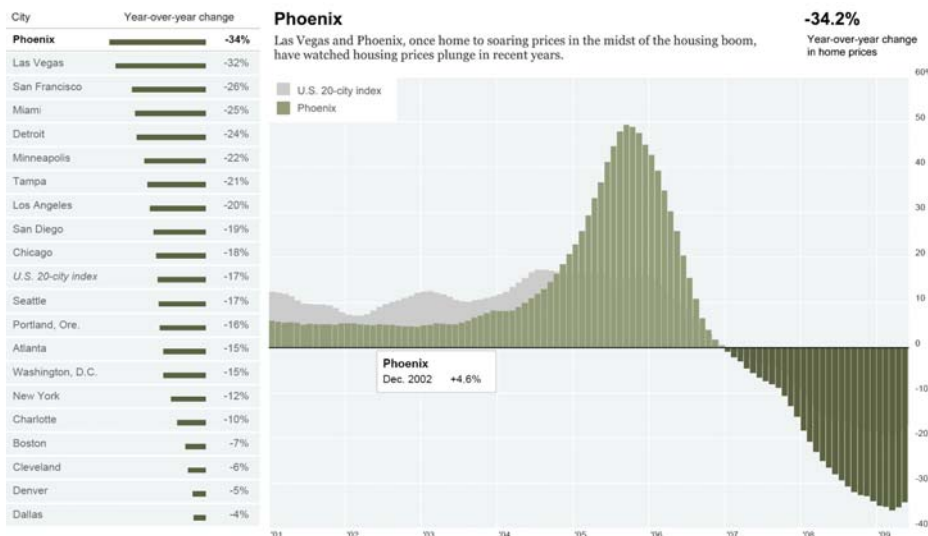
This is a picture of volatility in the global oil futures market. **Is this a result of unbridled speculation using cash-settled futures or is the futures market telling us that Peak Oil is approaching?**

The fallout? What about regulation of global futures markets? Will business simply move off shore? What about over-the-counter futures contracts? These are non-exchange traded contracts (remember Credit Default Swaps?). Will these regulations limit liquidity in the energy markets while smoothing volatility?

Finally this issue relates to any number of futures markets that are the “tails that wag ...” Take silver for example. Very few doubt that speculation in the silver futures markets have led to keeping a lid on spot silver. Ted Butler has been a relentless champion of the cause. Will Mr. Gensler also focus on silver and gold futures markets and implement the same position limit and margin requirement changes there as well. Regulating oil markets is politically attractive today as a result of the focus on global warming and cap and trade. We must all remember that oil prices are headed higher eventually irrespective of regulation – it is simply a matter of time till fossil fuels become relatively scarce. If holding energy prices down is the intention of new regulations, they will surely fail.

2. HOME PRICES BOTTOMING?

Finally, a breath of pure oxygen. Yesterday in spite of other data that were negative the Case Shiller May housing price numbers came to the market. There were refreshing. I have oft written that the residential and commercial real estate markets must bottom before the banks and the economy are “out of the woods.” It seems that yesterday we received that news. I have chosen Phoenix since the Valley of the Sun was hardest hit amongst all the “sand” cities. It does seem that we have hit a bottom and we shall wait with baited breath for the June number sin one month. Now we must also countenance the commercial real estate market which is headed south quickly. Nevertheless this recession is bottoming (though recovery will still be painful), the banking crisis is for the present on hold and the worst may be over for residential real estate.



There are still head winds, to be sure. In the new phase of this recovery we shall have significant de-leveraging to contend with. You can see it again this AM in the currency markets. Here the US\$ is stronger against all comers (even the yen) and the Loonie is significantly weaker by .41%. Commodities (Gold off +\$20 in 2 trading sessions) have

taken it on the chin. This is to be expected in the ongoing global de-levering and capacity contraction that we must endure. The real question in my mind is this tug of war between deflationary and inflationary forces. Further down the road I expect that the fed will be either too early or too late draining the system of liquidity.

Currency	Chg% X=1\$USD	NY Time	X= 1\$USD	X\$USD =1	Gold Price/oz	Gold Chg	Gold Chg%
<u>US Dollar</u>	--	07/29-09:25	--	--	933.70	-3.30 ▼	-0.35%
<u>Australian Dollar</u>	-0.92%	07/29-09:20	1.2201	0.8196	1139.16	+6.37 ▲	+0.56%
<u>Brazilian Real</u>	-0.32%	07/29-09:23	1.8827	0.5312	1757.88	-0.59 ▼	-0.03%
<u>British Pound</u>	+0.01%	07/29-09:24	0.6083	1.6439	567.97	-2.05 ▼	-0.36%
<u>Canadian Dollar</u>	-0.41%	07/29-09:25	1.0849	0.9218	1012.92	+0.54 ▲	+0.05%
<u>Chinese Yuan</u>	+0.13%	07/29-06:06	6.8266	0.1465	6374.00	-30.59 ▼	-0.48%
<u>Euro</u>	-0.53%	07/29-09:25	0.7090	1.4105	661.95	+1.17 ▲	+0.18%
<u>Hong Kong Dollar</u>	-0.11%	07/29-09:24	7.7547	0.1290	7240.56	-17.25 ▼	-0.24%
<u>Indian Rupee</u>	-0.10%	07/29-08:14	48.2750	0.0207	45074.37	-112.46 ▼	-0.25%
<u>Japanese Yen</u>	-0.16%	07/29-09:25	94.7050	0.0106	88426.06	-167.29 ▼	-0.19%
<u>Mexican Pesos</u>	-0.26%	07/29-09:25	13.2412	0.0755	12363.31	-12.12 ▼	-0.10%
<u>Russian Ruble</u>	-1.27%	07/29-09:20	31.4805	0.0318	29393.34	+265.76 ▲	+0.91%
<u>S.African Rand</u>	-0.27%	07/29-09:25	7.8865	0.1268	7363.63	-5.88 ▼	-0.08%
<u>Swiss Franc</u>	-0.54%	07/29-09:25	1.0809	0.9252	1009.19	+1.87 ▲	+0.19%

The material herein is for informational purposes only and is not intended to and does not constitute the rendering of investment advice or the solicitation of an offer to buy securities. The foregoing discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (The Act). In particular when used in the preceding discussion the words "plan," confident that, believe, scheduled, expect, or intend to, and similar conditional expressions are intended to identify forward-looking statements subject to the safe harbor created by the ACT. Such statements are subject to certain risks and uncertainties and actual results could differ materially from those expressed in any of the forward looking statements. Such risks and uncertainties include, but are not limited to future events and financial performance of the company which are inherently uncertain and actual events and / or results may differ materially. In addition Dr. Berry may review investments that are not registered in the U.S. He has been awarded 100,000 options of Derek Oil and Gas exercisable at C\$.47. He is a consultant to Valcent Products (300,000 options). He owns shares in Goldcorp, Golden Predator, Senesco Technologies, DataMeg, Horseshoe Gold, Midway Gold, Derek Oil and Gas, Terraco Gold, Kenrich-Eskay Gold, US Silver, Neuralstem, Piedmont Mining, MegaWest Energy, Valcent Products, CGX Energy and Quaterra Resources. He has been awarded 250,000 options on Terraco Gold exercisable at C\$.50 for 5 years, for services as a consultant. We cannot attest to nor certify the correctness of any information in this note. Please consult your financial advisor and perform your own due diligence before considering any companies mentioned in this informational bulletin.