

**Today's Notes:**

1. **The Great Disruption?**
2. **Fiscal Spending or Financial Reconstruction**

**1. THE GREAT DISRUPTION?**

Thomas Friedman, New York Times contributor and acclaimed author, is at it again. Following his “flat earth” theory the fine New York Times columnist now believes this crisis is “The Great Disruption.” Prepare for another Friedman tome of the same title.

The recent set of expanding crises around the globe has curtailed the notion that the earth is flat. Protectionism is spreading as quickly as daffodils in May. Competitive currency devaluations are the norm. Global trade, the keystone of a “flat earth” economy, has virtually ceased. It's every country for itself in the **NEW** global jungle.

China seeks to secure commodities. Why? Because she knows that she will need them. Chinese navy vessels surrounded a US Navy ship in international waters yesterday – a few days after Secretary of State Clinton requested that China buy our T-bonds. Venezuela curries oil-favor with her South American “allies” while Latvia and Romania beg, in vain, for financial deliverance from Germany. Russia cozies with Hungary; China signs a free trade agreement with Peru while the US Congress blocks an agreement with Colombia. The world is certainly no longer “flat” as Friedman proposed. It is becoming entangled, compartmentalized and vastly more complicated. The race for new consumers and access to commodities is on. New barriers are being erected. Washington has not yet recognized this new aspect of global geopolitics.

How will our leaders function in a world that is increasingly compartmentalized, more uncooperative and unsynchronized? Will we develop our own natural resources? Or will we continue to debase our “reserve” currency to export inflation and buy resources from others? This latter approach is a failed US domestic policy of the postwar period. US energy dependence and addiction have resulted. Perhaps Mr. Friedman is correct in that the status quo of post WW II US policy is now disrupted forever. One issue is quite clear. The North American lifestyle, supported by cowboy capitalism and unrestrained by government, has met its Minsky Moment. That occurred on July 13<sup>th</sup> 2008. But just as the now debunked notion that the world is flat and globalization is the new norm, the Friedman proposal of a “Great Disruption”, one that will lead to a green world buoyed by cheap alternative energy, devoid of nasty carbon-based sources, replete with universal health care, free of pollution and a conservator of water, air and natural resources is a gigantic stretch.

Where will the iron ore for bridges, copper for intelligent electrical networks, zinc and tantalum for shovel ready projects, rare earth metals and lithium for new “green” batteries, molybdenum for light weight autos and uranium for green energy come from? China is expeditiously securing natural resources. She has no intention of falling into the Malthusian trap of potential resource depletion with its threat to her social stability. Other countries are following suit. Higher quality of life for its population is the foremost concern and that

concern must be addressed internally. The old models of massive trade imbalances are no sufficient to support the well-being of China's population. How will we rebuild US infrastructure without the natural resources which Mr. Friedman claims are being rapaciously depleted? In short he is now selling the fear of "Peak Resources" as Thomas Malthus did in the 19<sup>th</sup> century. Is this another guilt trip from the New York Times and the Left? This latest philosophy from Mr. Friedman should sell a lot of books.

Mr. Friedman lives in a fool's paradise as do most of those that believe we are guilty of global warming. To them global warming is a primary casus belli – one which, when solved, will readjust and recalibrate our lives. Readers love these guilt trips though they are of no practical use in eventual solutions.

In his op-ed of March 8, 2009 Mr. Friedman invokes the "animal spirits" of markets and a power no less than Mother Nature as castigating us,

*"Let's today step out of the normal boundaries of analysis of our economic crisis and ask a radical question: What if the crisis of 2008 represents something much more fundamental than a deep recession? What if it's telling us that the whole growth model we created over the last 50 years is simply unsustainable economically and ecologically and that 2008 was when we hit the wall — when Mother Nature and the market both said: "No more."*

So here we are tilting at windmills (no pun intended) once again, pretending that clean, cheap energy is within our near-term reach and all will be made possible because of this "Great Disruption." This is a perfect setup for the expansion of the state's control and all those wonderful intrusions of government does on our guilty souls.

## **2. SOLUTIONS: FISCAL SPENDING OR ...**

Chris Low, of FTN Financial, reports that neither the Asians nor the Europeans are likely to respond positively to Obama economic spokesman Larry Summers' request for a coordinated spending response around the world. Europe cannot make a decision because the Germans and French could never agree on this. This perhaps is the central weakness of the European Union as forecast by Milton Friedman decades ago.

On Monday we averred that this request from Washington to our allies worried us. The Summers' request implies the US is now out of bullets in its efforts to stem the ongoing disintegration of the economy. It was not only about sharing the load, as some have suggested. His request also signaled that the Great Contraction is global and therefore requires a global effort.

We believe that there is more at stake. It is not only US leadership in redressing the wrongs of the past that is at stake; it is also the breakdown of coordinated action around the globe – the failure to agree in such a time of economic peril. The truth is that no one really knows how to properly address the problems. This is evident from the piecemeal rescue attempts of both the Bush and Obama Administrations and our zealous and pious Congress (Barney Frank, for Example) wasting efforts while seeking irrelevant aspects of the crisis such as revealing bonus data at Merrill Lynch? It is strictly politics as usual, related to the many invocations of the Politics of Fear from the White House.

There are, however, some very important lessons. Keynesian and Monetarist economics have failed us. There are many reasons for this failure, spread over 5 different presidents and 38 years of our history. Richard Nixon set this playing field in motion by removing the stability of gold from the currency equation in April 1971. Jimmy Carter's administration initiated this housing debacle with the infamous Community Reinvestment Act of 1978. Ronald Reagan ran the budget deficits to great extents during his tenure. Bill Clinton unhooked Glass Steagall which allowed Wall Street to party. Under Mr. Clinton the rescue of Long Term Capital Management set a "moral hazard" precedent for all who followed. Also under Mr. Clinton, Fannie and Freddie, and CEO Franklin Raines were allowed to grow to such huge proportions that virtually guaranteed their nationalization. Mr. Raines took \$90 million in salary and gave us cooked books. Under Mr. Bush, Alan Greenspan was given free reign with monetary policy for 6 years and the rest is history. Dot-Com and Housing bubbles were allowed to grow to unsustainable proportions.

Currency de-stabilizations are ubiquitous and devaluations are now a tool in an attempt to minimize consequences of the global asset bust. Russia has devalued her ruble 35% from 23 to the US\$ to 35 rubles. China has allowed some but not much appreciation of the Yuan. Canada's currency has been whipsawed in such a short time that her commodity-based economy has been severely impacted. In Eastern Europe currency devaluations have spread much pain and fostered social unrest. Japan was the most vocal opponent of a weaker US dollar in March 2008 and led the OECD in buying the US\$ in July – which set off the calamity (the markets Minsky Moment) that has now grown full bloom. Recently Japan was forced to intervene to manipulate her currency lower. Her trade has fallen off a cliff.

Whether we like it or not, mom and pop in both Kankakee and, to a lesser extent, Floral, Saskatchewan have lived off a strategy of inflation and "beggaring" their neighbours. Have a look at the 200 year value of the US\$. I think you get the point. Everyone in Washington and Ottawa talks about a strong dollar but when it comes to the reality of increasing quality of life .....



**Is this how the US has lived relative to the rest of the world? In the twentieth century the real value of the US currency has fallen from \$1.20 to \$0.06 (2008) according to Professor Jeremy Siegel.**

**The dollar has been a poor store of value but a very good exporter of inflation. With fiscal spending will the dollar fall further? Can the US inflate its now massive debt load away in the future? Gartman is right – own things that hurt when they fall on your feet.**

Once the banks are healthy and solvent, lending once again (5 years?), the world must address this innate currency instability and eliminate the chaos emanating from it. What will that system look like? Sorry, I do not know. Most economists believe that a gold standard, which worked through 1971, till the French started calling gold back from Washington in return for greenbacks, worked well. History tells us that wars almost always get in the way of a Gold Standard. But experts, like my friend Dennis Gartman, frequently talk of desiring “things that hurt when they fall on your feet.” Why? It is because those “things” tend to maintain value over time. Could a basket of globally priced commodities serve the purpose of a gold standard? Probably not, it is too simple for today’s economists. But commodities are widespread and global. Further, there are many different varieties so commodity price volatility could be diversified to a systematic level.

We believe that the crisis will ultimately end. But it will not end without pain and it will not end in the short run even if the banking solutions work. But even in the short run there are significant problems with the Keynesian approach. I include an email from a reader of Monday’s MNs. I think it is instructive.

***“So now Larry Summers is asking the rest of the world (at least the G20) to begin spending seriously? This is the same rest of the world which has, over many years, built its economic structure around relative export dependence and reliance upon U.S. consumer demand (directly or indirectly)? Where is the demand going to come from? Bridges to nowhere? Japan has already spent more than 10 years doing that, has a shrinking labor force and growing retiree base pinching its pennies and a government debt to GDP which shames Italy in scale.***

***Larry’s position exemplifies the performance to date of this administration: in a leadership position, now looked to with hope both domestically and by our international partners, but which seems incapable of providing the confidence required to pull the economy out of its increasingly self-sustaining downward spin. How do you stop an old-fashioned “run on the bank”? Exhibit confidence, lots of it! Hand out cookies and coffee (or tea) to those waiting in line to withdraw their savings. Be pleasant as you close accounts. Make sure you count out the cash very visibly to those later in line. Have a line of armored trucks standing outside the bank (purportedly) full of cash. Do it right, with lots of smiles and encouragement and you will soon see folks getting back in line to reopen their accounts and apologize for succumbing to the panic.***

***This administration prefers to use this panic to support a political agenda/program and offer only statements that yes, it is catastrophic and will likely stay that way for some while longer....***

***We think this shall continue, particularly in light of the overriding request for fiscal spending.”***

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