

Today's Notes:

1. **The Plan**
2. **A New Reserve Currency: China**

1. THE PLAN*Three strikes and you're*

While I was flying to Orlando on Monday Treasury Secretary Timothy Geithner unveiled the second iteration of his plan to save the US (and global) banking system. The markets loved it. They went bid in a frenzy and added 500 plus points to the DOW.

Bill Gross whose company PIMCO is likely one to be asked to invest in these assets, said it would be a good deal for the country and a better deal for investors. He thought that private investors (a select group of institutions) could achieve a 15% return on the investment in toxic assets for little or no risk; such are the sweeteners in this package.

The new Geithner plan harkens back to the Bush Administration's original plan proposed by Secretary Paulson (with a few new bells and whistles) in October 2008. Ah, but October seems like decades ago in the frantic history of "Bailout Nation." The "new" plan is that Treasury and the FDIC will ante up \$500 billion or more (a mere pittance relative to the proposed \$9 trillion budget deficit proposed) and buy up toxic assets. Investors from the private sector will be provided with low interest loans for up to 85% of the amount. Here's how the plan works.

A pool of \$100 million of toxic loans is put up for auction. Bids from private investors are solicited. Hypothetically, suppose the winning bid is \$85 million. The FDIC (taxpayers) will provide 85% financing and the Treasury will invest half the remaining amount, in this case \$7 million. This means 92% financing on favorable terms for some lucky auction bidder. The bidder then ante's up \$7 million and manages the pool of toxic assets. Returns are split equally between Treasury and the private capital. If the pool continues to decline in value the private investor can walk away, thus exposing the government (and the taxpayer) to the total loss.

Here's the catch. There are bids today for these toxic assets. They range on average at \$.30 cents on the dollar. Theoretically this new Save the Banks deal is "sweet." It is as sweet as the government can possibly make it on behalf of the US taxpayer. Theoretically wealth will be transferred to those lucky enough to be allowed to bid on these assets. Downside for the private investment sector is limited and knowable in advance. This is another advantage. However the New York Times wrote in its Editorial yesterday, which I, in turn, have kindly editorialized for you,

"... Investors are currently offering 30 cents on the dollar for certain toxic assets. Banks are unwilling to sell at that price, but that doesn't mean the offer price is too low. It may only indicate their fear that taking such losses might render the banks insolvent. With government (ed: taxpayer) subsidies (ed: direct taxation or inflation) investors will presumably offer a price more to the banks' liking. But that in turn could expose the

government (ed: mom and pop) to big losses. Government loans are huge compared with the amount investors must put up, so even a modest decline in the value of the purchased assets would endanger repayment of the loans.”

Presumably stress tests will be used now to separate good banks from bad banks. We find it very difficult to imagine any serious buy-side institution liking the deal. If bids are already in at 30 cents, even with the leverage imputed by taxpayers, why would an investor bid 80 cents for assets that have some downside potential? Deflation is a terribly difficult tsunami to stop. Clearly the Fed through its Quantitative Easing policy (which begins in earnest today) and the Treasury / FDIC have now applied their “heaviest artillery.”

As the Fed moves forward in purchasing its Treasury securities the yield curve is likely to flatten. This poses its own risk to lending institutions that prosper in a steeper yield curve environment. Yields are falling this AM. The dollar is stronger. Gold is holding but commodities are much weaker. It would appear that the joyous knee jerk from these two programs is beginning to disappear.

Secretary Geithner, speaking this AM, notes that extraordinary action is required and governmental under reaction is dangerous. One wonders why this “extraordinary action” has taken nine months and two administrations as problems have deepened. More to the point, it is now critical to separate failing banks from those that will succeed. This is a time when survival of the fittest must obtain. Yes, some equity holders will lose their investments. Some bondholders will lose their stake. This is in the nature of risky capital markets. There can be no guarantees. Our investment climate, absent a serious recession in the past 20 years, has become inured to a risk free, painless and win/win investment environment. That notion must now be extinguished. Some banks will fail; perhaps some banks must be nationalized. All the intuitions cannot be saved. Violation of Moral Hazard is now a serious detriment to our future as a free capitalist society. This country is not strong enough to insure every failing institution. GE and GM, for example, are both quasi banks with significant exposure to the financial system.

The New York Times editorial sums up my sentiment well, for a change,

“A better way would be to base the rescue on current reality, not assumptions about the future In other banking crises resolution of a system wide problem has sooner or later involved separating solvent banks from insolvent banks. In the end there is no getting around ... wiping out the shareholders and then deciding how the government can best restructure the institutions. The Obama Administration has yet to explain why its approach is better.”

The truth is that this new plan socializes the risk but allocates profits to a few well positioned investors. Oh for the relative health of Canadian Banking system!

2. A SUPER SOVEREIGN RESERVE CURRENCY

Last evening, in response to a question on the role of the dollar post the Great Contraction, President Obama said,

“The dollar is extraordinarily strong right now and the reason the dollar is strong is because investors consider the United States economy to be the strongest in the world.”

Maybe. It is true that the dollar is stronger this AM. But that strength is relative. Gold is still trading above \$900 per ounce; well above its levels of the last decade. The missing point is that the US currency is weaker than the numeraire asset – gold. The dollar is stronger because the rest of the world’s currencies have fallen in a race of competitive devaluations. It is stronger in spite of the current fiscal spending and printing plans from Washington.

However the Chinese and Russians (as well as South Korea and several OPEC countries) are now becoming increasingly vocal over the traditional reserve currency role of the US currency. While that role is not likely to change in the near term, change is most definitely in the wind for the US dollar. The US has beggared the world far too long to sustain the US quality of life. By the way, the Chinese also benefited from this forty year dollar decline (which we have frequently discussed) through the establishment of a dollar peg with the Yuan and an export economy of powerful proportion.

At present with \$2 trillion of reserves or more denominated in US dollars China knows she is exposed to significant dollar risk. There have been four separate warnings from Chinese officials of various levels in the past month. On March 13th China’s Prime Minister Wen Jiabao indicated his concern about the “soaring deficits in the US that could sink the value of the dollar.” Yesterday Zhou Xiaochuan, the Governor of the People’s Bank of China, called for a new monetary system. Citing the ***“inherent vulnerabilities and systemic risks in the existing international Monetary system*** (ed: dollar reserve currency)” China said a new super sovereign system is necessary. Russia has also been vocal on this accord as she has painfully devalued her currency by 40% over the past 6 months.

In 1930, almost 80 years ago John Maynard Keynes suggested a world currency system backed by a basket of commodities. China remarked that we may have missed a great opportunity in not taking his sage advice.

China wants the IMF to intervene here using Special Drawing Rights, based upon the value of the dollar, yen, euro, and pound. Officials at the IMF have also suggested SDRs based upon gold. China now has significant leverage in this matter. That leverage will continue to grow. Hence the proposal and increasing pressure for a “super sovereign” reserve currency that will in Mr. Zhou’s words

“create an international reserve currency – that is disconnected from individual nations and able to remain stable in the long run.”

These are questions that will be addressed and solved once the global financial system is stabilized. Today the concern is on US and global bank solvency, credit availability and renewed consumer borrowing. In any event, the quality of life of the rest of the world must in the future take up the slack as the engine of growth. The QOL in the US must decline , reverting to a new mean.

In the meantime you should be considering Canadian and Aussie dollar denominated assets for your portfolios. Canda's time is coming.

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