

**Today's Notes:**

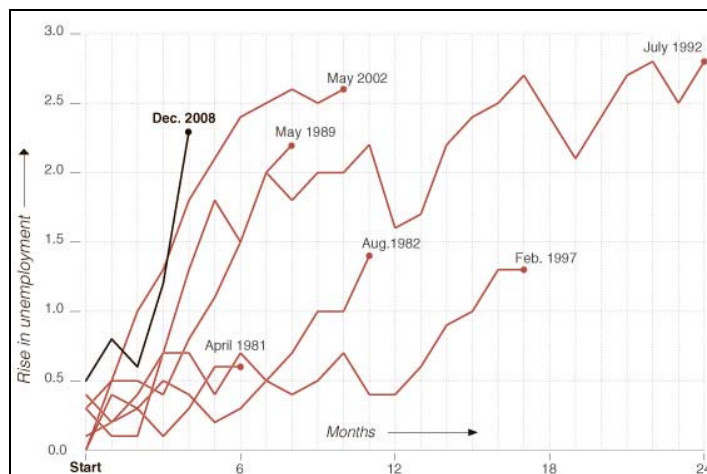
- 1. Home Alone**
- 2. Island in the Sun**

## **1. HOME ALONE**

Two years ago Kate and I decided to sell our home in Charlottesville, Virginia. This was a difficult decision. Charlottesville (actually Crozet located at the base of the Blue Ridge Mountains 15 miles west of Charlottesville) is a delightful locale. People are friendly and our home turned 100 years old during our stay. In June 2007 we sold our Crozet brownstone. As it turned out it was a fortuitous decision. At present we own a condominium in northern New Jersey within easy access of New York City. For the past three years I have been suggesting that you raise cash and dash your debt level. By selling our fine old homestead in Virginia – we accomplished that goal. It was clear from July 2006 that the housing bubble and the banking system were at risk. What was not clear, at that time, was the potential global extent of the collapse. This has led me to define “The Great Contraction” as opposed to the Great Depression.

This AM, I note (Thanks to Graeme Irvine) that real estate in Northern New Jersey, where we live, is now feeling the sting of the Great Contraction. The New York Times reported that housing prices in Northern New Jersey have fallen 11.7% in the past year. Sales in 2008 fell 18% from 2007 and 39% from peak sales in July 2005. This is not surprising, of course. It is just that New York City and the tri-state area has traditionally been immune to housing declines. Indeed even in this contraction New York has fared quite well. Now, job insecurity and deepening deflationary “spirits” seem to dominate the real estate market.

Not only have many New York banks requested TARP monies (and therefore employee incomes will be strictly limited) but New York City is now suffering under the most devastating, quickest employment decline in the past 3 decades years.



Source: New York Times

**NYC employment decline most likely will breach the record unemployment levels of May 2002 and July 1992 in half the time.**

Now with Wall Street falling on its petard and the last of the big bonuses in the bank, the Gen Y banking community is treading most carefully. There are humungous IO, ARM and fixed mortgages that need servicing. These were predicated on the continuance of big bonus checks. Washington shall have something to say about that. The New York Times in revealing Short Hills, New Jersey travails notes;

***“Of course, Wall Street is not supplying as many well-heeled buyers these days. It is still too early to judge the extent of the impact on the Short Hills real estate market, analysts say. So far, median home prices have fallen about 15 % since the boom times of three or four years ago, according to Mr. Paoella. But Ms. Bigos, who has been selling real estate in Short Hills for 24 years (following in her mother’s footsteps), conceded that the last quarter of 2008 was “by far the worst” that she had ever seen.”***

For those that are cashed up, the bottom of the housing market in Northern New Jersey will provide an opportunity when that market bottoms in 2010 / 2011. But more important, much more important, the decline of the bridge and tunnel crowd signals that the US housing crisis is now in full bloom.

We cannot hope to save the banks without the ability to keep mom and pop, yes, even Joe and Sally Investment Banker, in their homes however “underwater” they may ultimately become. If we cannot solve the nationwide housing problem then the Obama Administration will have no choice than to nationalize the banking system in whole or in part.

As I have written in the past, Sweden nationalized a much, much smaller banking system in 1992. It took 6 years to privatize that banking system and great courage in identifying and extinguishing toxic assets. It does not seem at present that either the former Bush Administration or the current one understands this reality.

## **2. ISLAND IN THE SUN**

***Oh Island in the sun  
Built to me by my father’s hand  
All my days I will sing in praise  
Of your forest waters, your shining sands.***

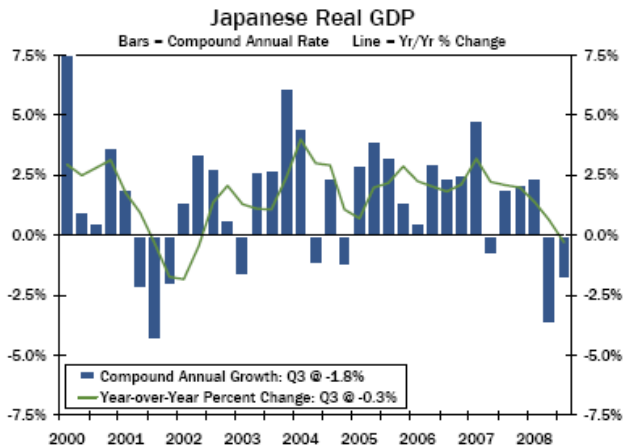
Harry Belafonte, Irving Burgess

Japan’s economy contracted by 12.7% (annualized) in the fourth quarter of 2008. These numbers are particularly concerning because Japan is the world’s second largest economy and an export driven economy at that. Last week I wrote on the banking system mistakes that Japan had corrected in 2002 and that revived its economy by 2005. But a funny thing happened on this blue planet post July 2006. There began, at fist barely noticeable, then with increasing acceleration, a race to the bottom. This race was evident in interest rates and in currencies.

Unfortunately Japan (and the US) had lived on something called a “Carry Trade” for years. With ultra low interest rates compared to the rest of the world, and easy credit availability, the world went crazy borrowing Yen, US dollars and Swiss Francs to invest elsewhere. For example Poles took out mortgages in Swiss francs to benefit from the lower interest rates in Switzerland.

The carry trade and the reverse carry trade promised lower financing costs - and they delivered.

But then came the sunny days of mid July (July 13<sup>th</sup> and 22<sup>nd</sup> to be exact) last year. Mr. Paulson's speech to mollify the Chinese concern on Fannie and Freddie debt exposure changed the world forever. Beginning on or about July 15<sup>th</sup> a massive yen and US dollar short covering began. This initiated a very strong feedback loop in which asset prices of all types were impacted negatively. As dollars and yen were purchased in an accelerating short covering, the values of these currencies soared relative to their fiat cousins. But to purchase dollars investors had to sell commodities and other assets.



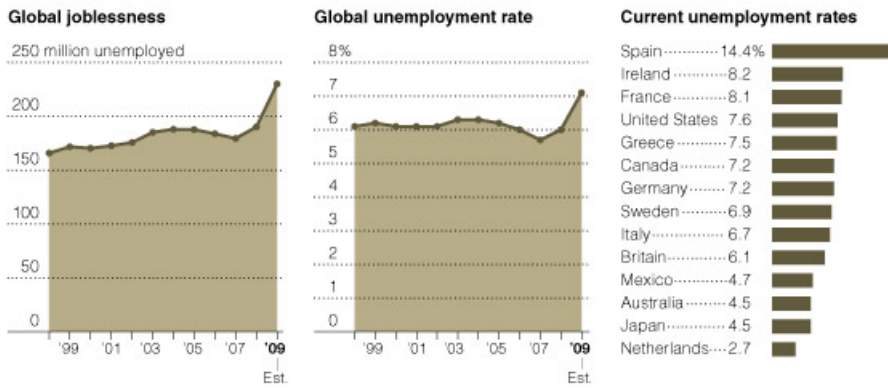
Margin clerks joined the party to force the liquidation further. The rest is history. As asset values fell (commodities, housing, equity shares, etc.) the debt underlying these assets became toxic. Housing values fell further and faster – sub prime, ALT-A and finally prime mortgage debt was infected by this feedback loop. That loop exists to this day. Securities underlying mortgage debt also became toxic, not only in the US but globally. I have come to call this phenomenon “The Great Contraction.”

It is “Great” because it now impacts Russia, China, Eastern Europe and even the European Union. I suspect the re-election of President Chavez, ostensibly for life, in Venezuela is part and parcel of this ongoing global dynamic. Most important, global growth, so dependent on credit and securitization is now stalling. The “D” word is being whispered. President Obama's economic advisor Larry Summers suggested on Sunday that 10% unemployment is not out of the realm of possibility due to policy lags.

On Saturday the FT published the following measure of current global unemployment. This was about the same time that the G-7 finance ministers were dithering in Rome. As you can see Spain leads the pack with 14%+ unemployment. These numbers are almost surely likely to deteriorate over the next year. In the US U-6 unemployment is now rocketing through 13.9%.

## Bleak Employment Outlook

By the end of 2009, job losses from the current global recession could reach 50 million, according to the International Labor Organization.



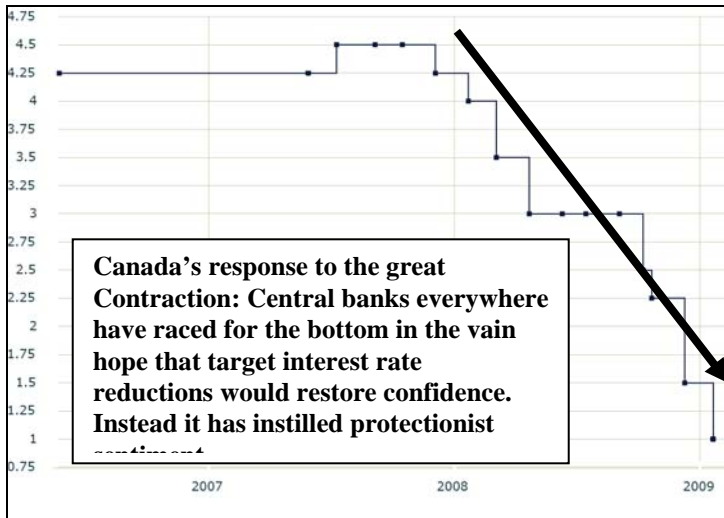
Sources: International Labor Organization; Organization for Economic Cooperation and Development

THE NEW YORK TIMES

For example, the banks in Austria are teetering on the edge of the Great Contraction. They need at least \$300 billion of recapitalization. The Austrians lent to the Eastern Europeans in a capricious lending spree that was never to end. The European Union's stability is now at stake. The banks in England are in worse shape. Central banks around the world have reduced rates to near zero levels. Such monetary policy has not worked. Even Russia, protected by its oil largesse, has suffered.



In the US few have heard from Fed Chairman Bernanke recently. We appear to be in a classic Keynesian liquidity trap. So now the world (G-7 meeting) wants to spend our way out. But in the 1970s such spending did not work. Instead it led to stagflation.



It is clear that there is no island in the sun on this blue planet today. There is no sunny place that is inviolate. It is also clear that a large part of what our fathers and mothers have built is about to be destroyed – liquidated in the frenzy of toxic waste.

There is no easy way out for Japan and she must now feel the cruel winter. But her travail will end. There is light at the end of this long tunnel. China and India are in the market for commodity exposure. This is just the right timing for their acquisition processes. Keep your powder dry, except for gold exposure and mature discovery opportunities with near term cash flow or M&A potential.

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*role as advisor he has been awarded 75,000 options from Polymet which strike at C\$2.76. 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.*