

Today's Notes:

1. Where We Are
2. What To Do?

1. WHERE WE ARE

Or perhaps we should title this Morning Note, "Where Are We?" Here's a single data point of interest reported this AM. Over the U.S. Memorial Day weekend the theater box office was down 15% year on year. Is this a one-off datum or does it represent the new reality of disposable consumer spending in the US?

We are also in the midst of increased volatility and downward pressure on the U.S. equity markets. This A.M., in particular, European bourses are declining by 2% + and the Dow futures by 119 points as I write. The world's capital markets may now be suggesting that we are headed for an economic downturn. We are inclined to believe this is the case.

There are two primary catalysts for investors. First, the situation in Europe is careening from bad to worse. Second, there is news from China that growth may be slowing. In Europe, despite the \$140 billion Greek rescue package arranged at the insistence of France and the opposition of the German public, the European banking system is poised to meet a "second wave" of debt crisis. Private debt has been pushed to the sovereign level almost everywhere. It has nowhere to go from there. It must be paid down, restructured, defaulted or inflated away. It cannot be pushed indefinitely into the future in the hope that economic growth will magically reappear. In the case of Greece a painful and potentially violent deflation awaits. She has no currency to debase. Other members of the EU are worried about a resulting banking contagion.

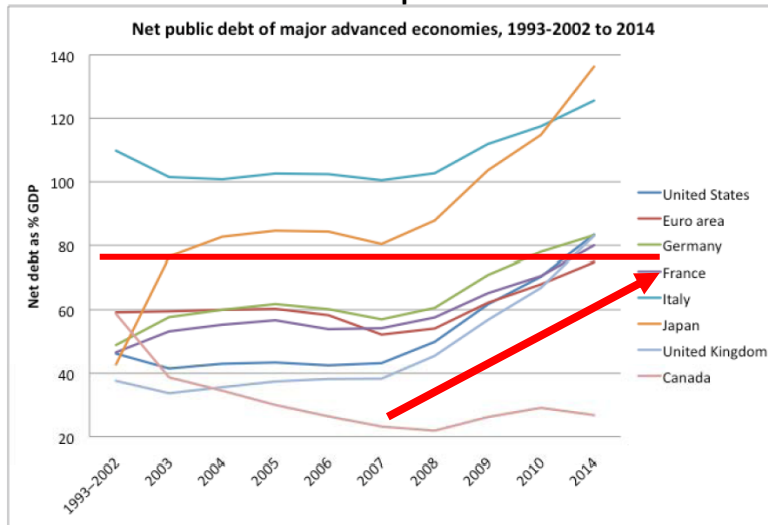
The European Central Bank (ECB) warned on Monday that euro zone banks face up to 195 billion euros (US\$234 billion) in a "second wave" of potential loan losses over the next 18 months due to the financial crisis in the Med countries. The bank has increased purchases of eurozone government bonds, so-called quantitative easing.

All this is reminiscent of the terrifying banking crisis the U.S. from 2007 to 2009. That event was interrupted by Washington pushing money out the door to the banks and onto the taxpayer's plate. The US crisis ended with a leaked internal memo from CitiBank on March 5, 2008 that indicated they would survive. The resulting bear market rally in U.S. equities that ensued lasted two years. It has ended.

Meanwhile China warned that the global economy remained vulnerable to sovereign debt risks perhaps a result of its own spending predicament. Spain "assured" investors it would reform its rigid labor market even if employers and trade unions cannot agree after its credit rating was cut. Debt problems in Spain, Portugal and Italy are next for Europe's banks and the US dollar swap market. The UK and the US are waiting in "too-big-to-fail" debt /GDP purgatory. But who is big enough to take on their sovereign risks?

The ECB said eurozone banks would make provisions for losses of 90 billion euros, and 105 billion in 2011, on top of 238 billion euros written down 2009 bad debts (total ~\$US 520 billion).

Recently Harvard Professor Niall Ferguson painted an ominous historical portrait of the global debt problem and today's possible solutions¹. He outlines the scenarios for sovereign debt (as well as private debt) ratios. A likely scenario, now that much has been tried, is deflation in the immediate future followed by significant inflation or perhaps even a hyperinflation. One look at Professor's Ferguson's chart on runaway western, lifestyle-induced debt ratios helps to place the problem in perspective. A debt to GDP level of eighty (80%) percent is generally considered unsustainable². You can see where major advanced economies are headed.



Source: IMF

History is about to repeat itself in spite of an extensive financial infrastructureⁱ assembled over the decades since the Great Depression. Basically the “buck” stops right here and now. Professor Ferguson lists six government debt reduction remedies. They are:

- 1 A higher growth rate of GDP
- 2 A lower interest rate on the public debt
- 3 A bailout, meaning either a current transfer payment or a capital transfer from abroad
- 4 Fiscal pain, meaning an increase in taxes and/or a cut in public spending
- 5 Increased recourse to seigniorage (revenues from monetary issuance) by the central bank
- 6 Default, including every form of non-compliance with the original terms of the debt contract, including repudiation, standstill, moratorium, restructuring, rescheduling of interest or principal repayment etc.

Source: Buiter (2010)

¹ *Niarchos Lecture*, Peterson Institute, Washington, D.C. May 13, 2010.

² See Rogoff and Reinhart, *This Time It's Different*.

But his research, spanning 300 years, predicts the following. The first three alternatives are almost never exercised because they are either impossible (likely slower GDP growth, interest rates already near zero, bailout already attempted) or they are political anathema.

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After World War II the U.S. grew its GDP and inflated away its enormous debt acquired during the war, about equally. Today, the growth solution to the debt problem in the U.S. is an unlikely solution. Dr. Doom, Nouriel Roubini of NYU suggests,

“In contrast, some emerging markets risk overheating and are showing symptoms of a potential asset bubble. Labor market conditions will remain very weak in some advanced economies ... Savings will have to rise faster than consumption for the coming years. That is why growth will remain anemic.”

Therefore in the immediate future we will likely experience another economic downturn. Gold (stronger by \$12), oil (weaker by \$1.75) and the dollar (stronger by 1.5%) are signaling that possibility today. Growth in corporate earnings cannot be extraordinary in these circumstances. However earnings are the least of central bankers' worries this AM. For at some point in the future, a point I am unable to predict, the gloves will come off and very high rates of inflation will be the final solution. In spite of a stronger dollar, this AM, we also see a stronger gold price (\$1225) and weaker copper, oil and silver prices. Your future is being signaled.

The equity market has been signaling this future for weeks now. On Friday May 21st the plunge protection team muscled the market higher in the last half hour of the trading day. This has happened several times in recent weeks and yet the Dow remains under pressure with significant volatility while forming the right shoulder of a bearish head and shoulders technical formation.

2. WHAT TO DO?

If you believe the global economic scenario that seems to be unfolding, you need to own precious metals and raise some cash (move some assets to the short end of the Treasury yield curve). At some point in the future there will be inflation and you will have a chance to exchange your cash for much cheaper assets. This is famous barbell portfolio that I have written about so often during the past decade. Gold is being sought today as a protective store of value. Whether the central bankers and the establishment like it or not the smart money in the world is moving to gold and silver and has been for some time. Gold is moving higher this AM while growth oriented commodities are under pressure. The dollar carry trade seems to be reversed this AM. The U.S. currency is stronger across the board.

But I do remain committed to Discovery Investing. In the new future you must review the ten point factor model and focus on three issues. I'll discuss those in a moment.

However first I am becoming more interested in food production, water resources and cancer and infectious disease biotechnologies. Specifically companies such as Senesco and Neuralstem seem to be making significant progress in their target areas. In the natural resource area, oil will continue to be the core energy commodity for two to three decades. World class discoveries in these areas should be sought out. The US will move toward total electrification and the infrastructure (grid, battery technology, nuclear technology, road system) will be rebuilt. Energy metals will become more important. These are the rare earth elements as well as lithium, vanadium, molybdenum, uranium, phosphates and copper.

The key to discovery investing success will be using the factor model and focusing on companies with three strengths:

- 1) World class asset potential.
- 2) Experienced management track record.
- 3) Balance sheet strength to sustain the company for 18 months to 2 years.

In the energy sector, I am still a strong supporter of Oil Sands Quest, CGX Energy and MegaWest. Oil will continue to be a critical energy source for decades as we transition to an energy space that will be electric. Most energy researchers believe that it will be the year 2040 before we can make a significant break with fossil based fuels.

Two weeks ago the New York Times published an article I thought I would never see in that publication. They concluded that the Canadian oil sands were now strategic to the United States. With the Gulf disaster ongoing and Canada the largest oil supplier to the US (1.9 million barrels per day). The Times claims that 1 million barrels of Canadian imports are from the Alberta's oil sands. That is why I am very bullish on Alberta's oil sands and also the energy resources of Saskatchewan. These are great discovery investing locales. The Chinese realize this also and they are making inroads into the resource wealth of Canada. I would suggest looking north to Canadian discovery opportunities as well as positioning in the world class domestic U.S. and Mexican opportunities.

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ⁱ (IMF, BIS, Glass Stiegel, Federal Reserve, ECB, etc.)