

**A Message to The Federal
Reserve Bank of the United
States of America,
May, 2011**

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**Zurich, Switzerland
May 26, 2011**

www.DiscoveryInvesting.com

Reserve Balances with Federal Reserve Banks (WRESBAL)
Source: Board of Governors of the Federal Reserve System



2011-05-18 \$1.547 (Trillion)

Shaded areas indicate US recessions.
2011 research.stlouisfed.org

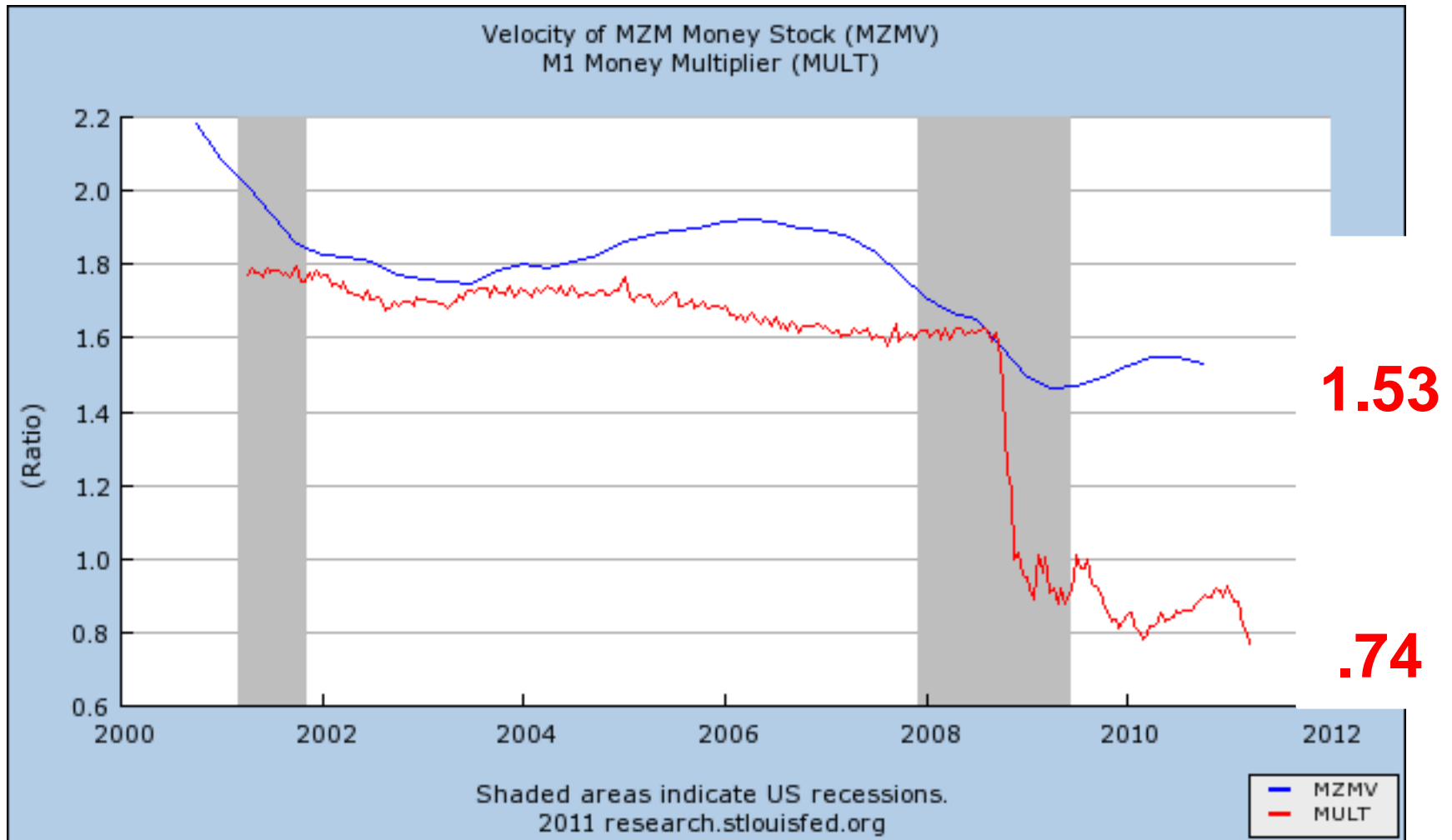
Bank Reserve Balances With the Fed Not the Public

Reserve Balances with Federal Reserve Banks (WRESBAL)
Source: Board of Governors of the Federal Reserve System



Shaded areas indicate US recessions.
2011 research.stlouisfed.org

When The M1 Money Multiplier (-56%) and the Velocity (-29.7%) Decline



US Treasury Yields (Still In Decline)

May 21, 2011

Maturity	Yield	Today's change	1 week ago	1 month ago
1 Month	0.03%	0.00	0.01%	0.03%
3 Month	0.05%	0.00	0.03%	0.06%
6 Month	0.10%	0.00	0.07%	0.11%
2 Year	0.52%	0.00	0.54%	0.66%
5 Year	1.79%	0.00	1.85%	2.11%
10 Year	3.09%	0.00	3.19%	3.39%
30 Year	4.24%	0.00	4.32%	4.47%

Eurozone Yields

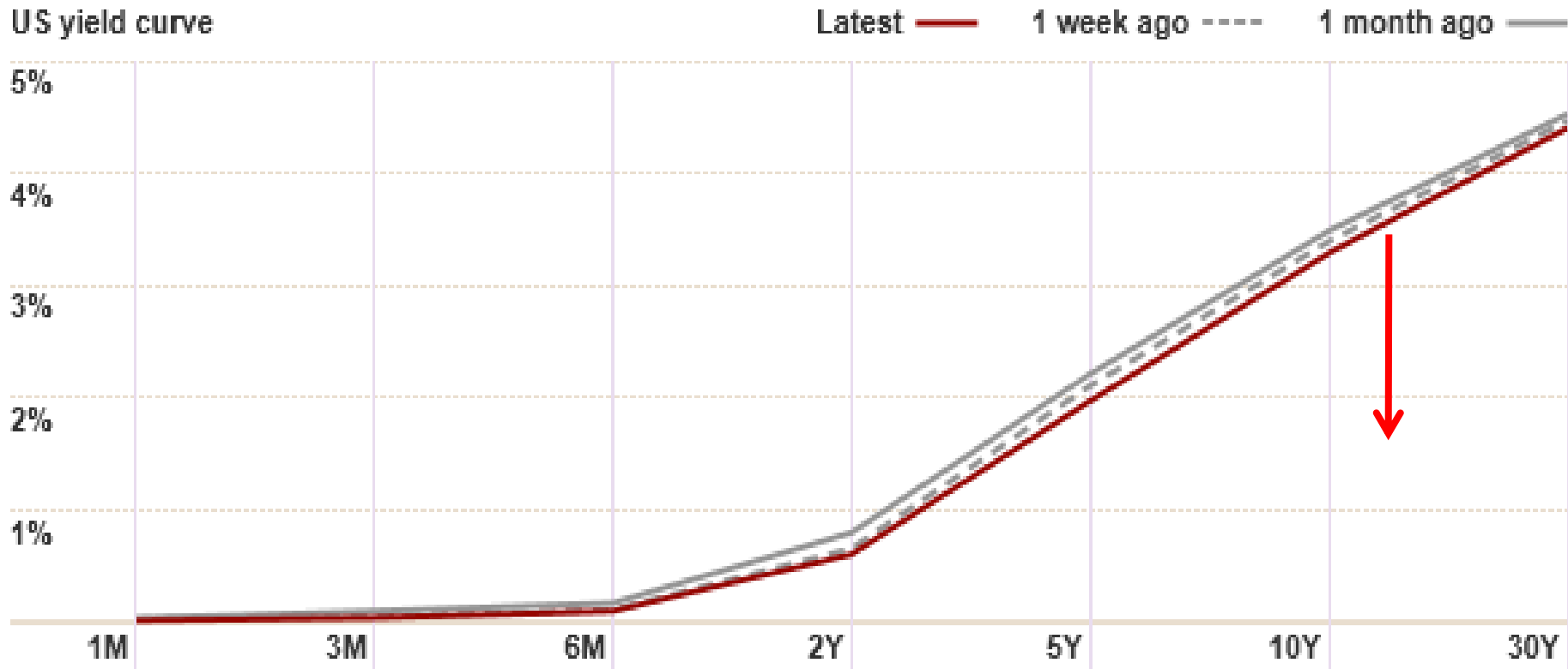
(Tighter - Flattening) May 21, 2011

Maturity	Yield	Today's change	1 week ago	1 month ago
1 Month	0.88%	0.00	0.88%	0.76%
3 Month	0.94%	>-0.01	0.92%	0.82%
6 Month	1.16%	-0.02	1.18%	1.08%
2 Year	1.78%	+0.02	1.78%	1.77%
3 Year	1.92%	>-0.01	1.92%	2.04%
5 Year	2.42%	--	2.44%	2.61%
10 Year	3.07%	--	3.09%	3.27%
15 Year	3.54%	--	3.55%	3.76%
20 Year	3.65%	--	3.66%	3.86%
30 Year	3.61%	<0.01	3.62%	3.80

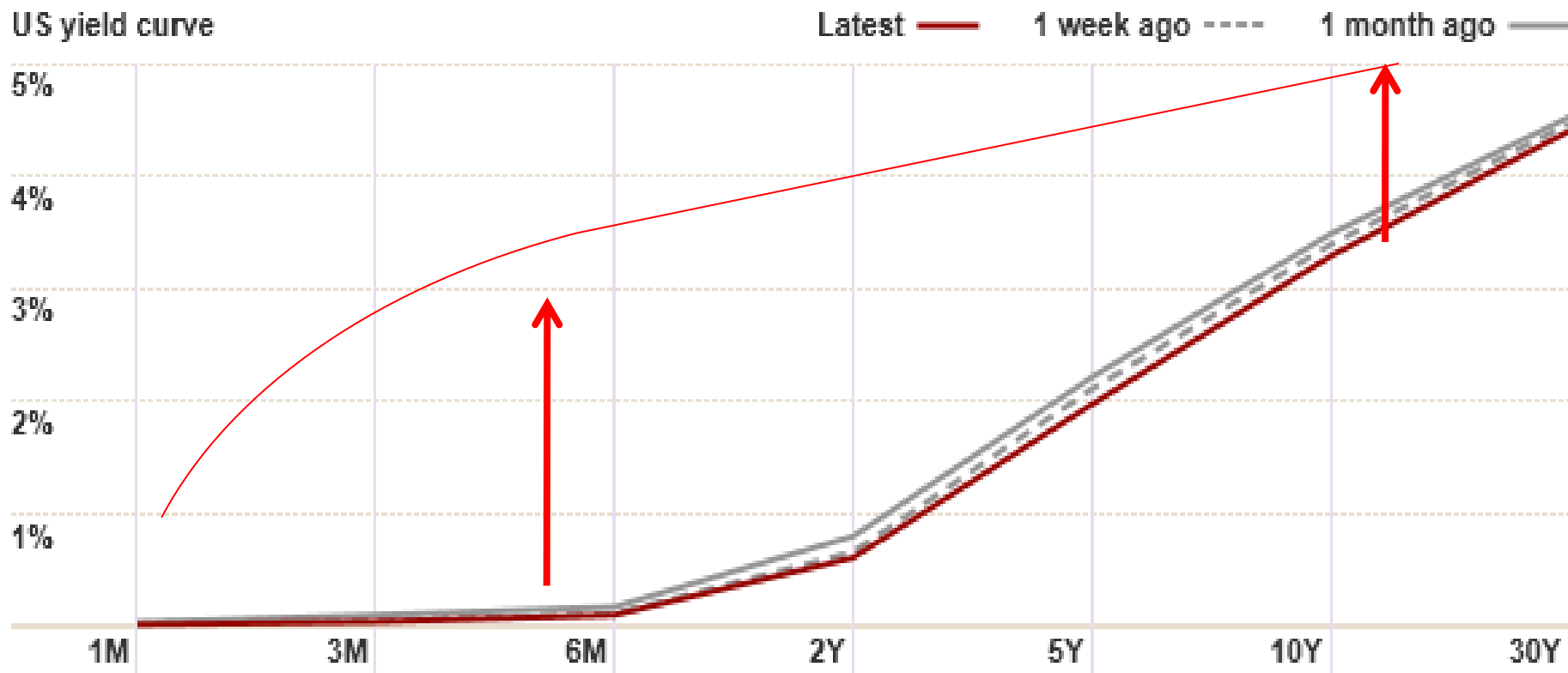
Japanese Yields (Dead) May 21, 2011

Maturity	Yield	Today's change	1 week ago	1 month ago
3 Month	0.11%	0.00	0.11%	0.11%
6 Month	0.12%	0.00	0.12%	0.12%
2 Year	0.18%	0.00	0.18%	0.20%
3 Year	0.24%	0.00	0.25%	0.29%
5 Year	0.43%	0.00	0.42%	0.49%
10 Year	1.13%	0.00	1.12%	1.22%
15 Year	1.60%	0.00	1.58%	1.68%
20 Year	1.92%	0.00	1.90%	2.02%
30 Year	2.04%	0.00	2.01%	2.12%

The United States Treasury Curve: A Steep Non-Normal Yield Curve



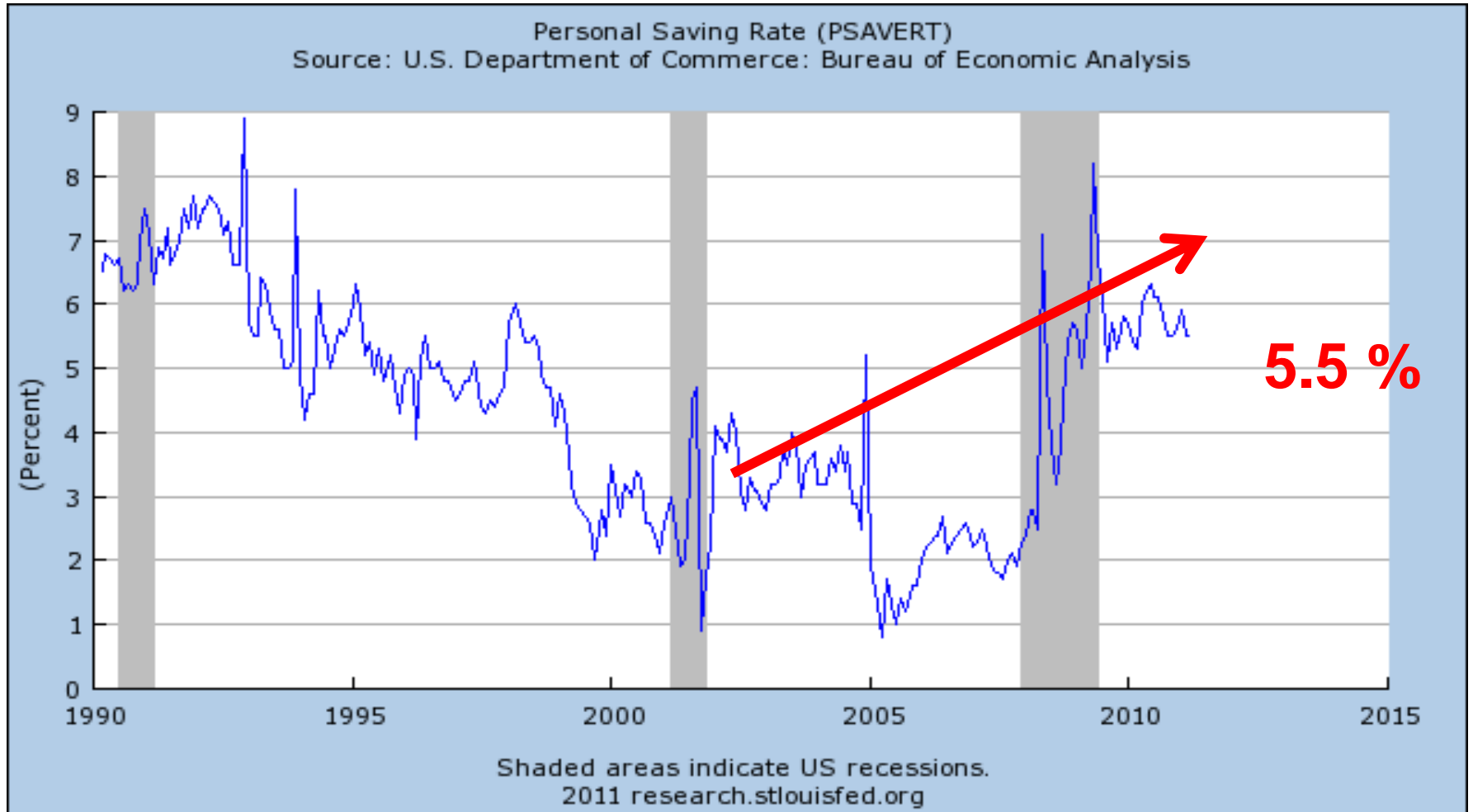
Will Yield's Finally Conform To Reality? Could it be the "D" Word?



US Treasury Yield Implications

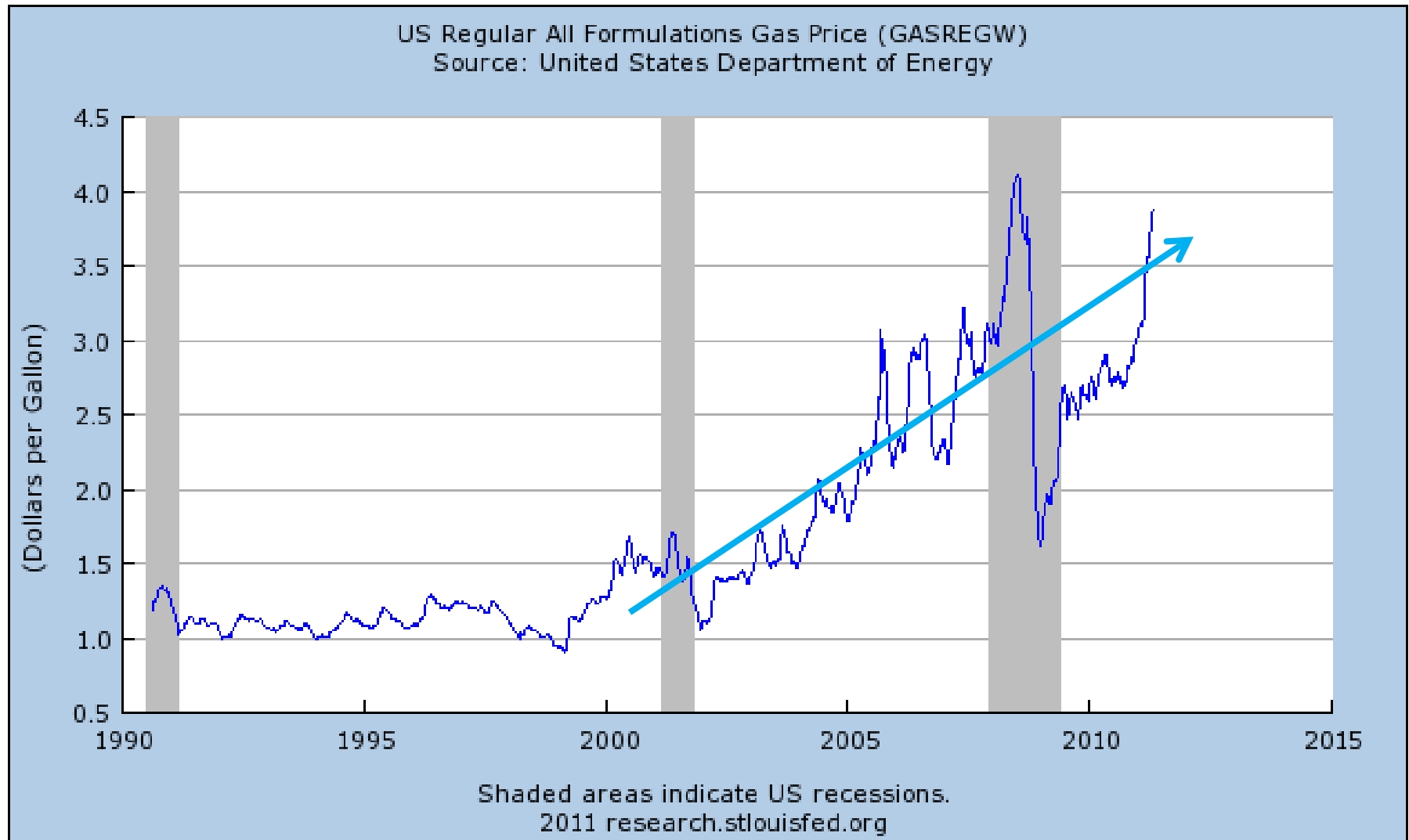
- Treasury yields have fallen for 6 years.
- Major yield declines in '08 / '09 and recovery in '09/ '10.
- No sign of nascent inflation in long rates.
- Evidence that QE I and QE II have focused on short rates.
- Banks have steepest yield curve in decades.
- Banks banking with the Federal Reserve, not the public.
- Does 4.36 % cover Unadjusted CPI?

Personal Saving 5.5 % 2011-03-01



Gasoline: The Most Important Energy Source

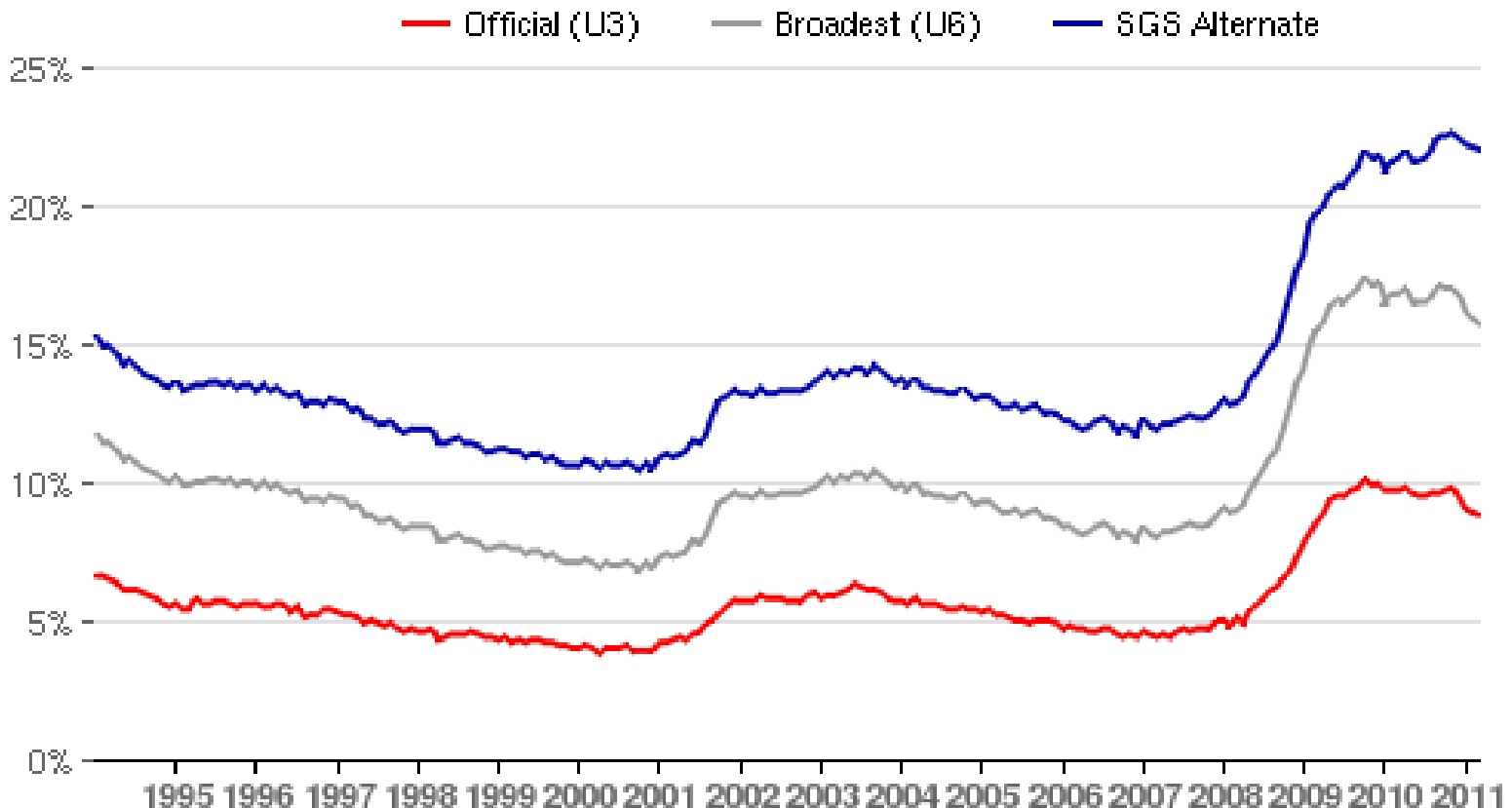
Source May 16, 2011 = \$3.96



Unemployment – Better Certainly, But Sustainable? U3=9%

Unemployment Rate - Official (U-3 & U-6) vs SGS Alternate

Monthly SA. Through Mar. 2011 (SGS, BLS)



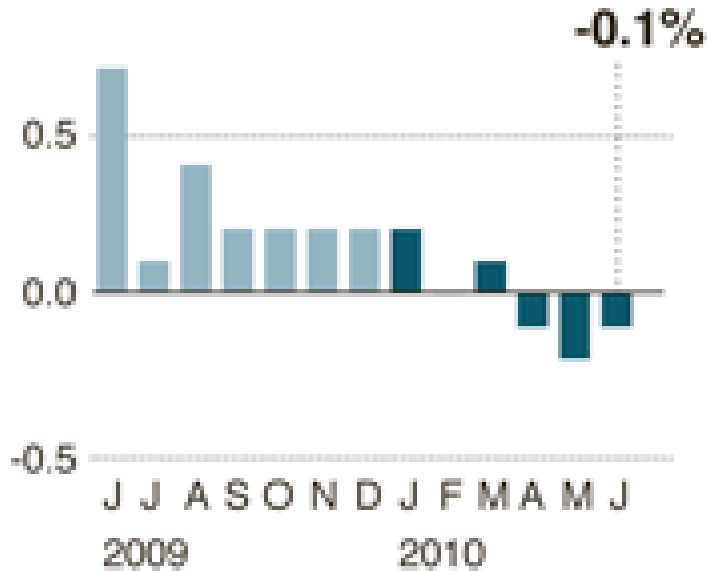
One Year Ago Disinflation

June 15 2010

Changes from the preceding month in the Consumer Price Index for all urban consumers:

Seasonally adjusted

1.0 percent

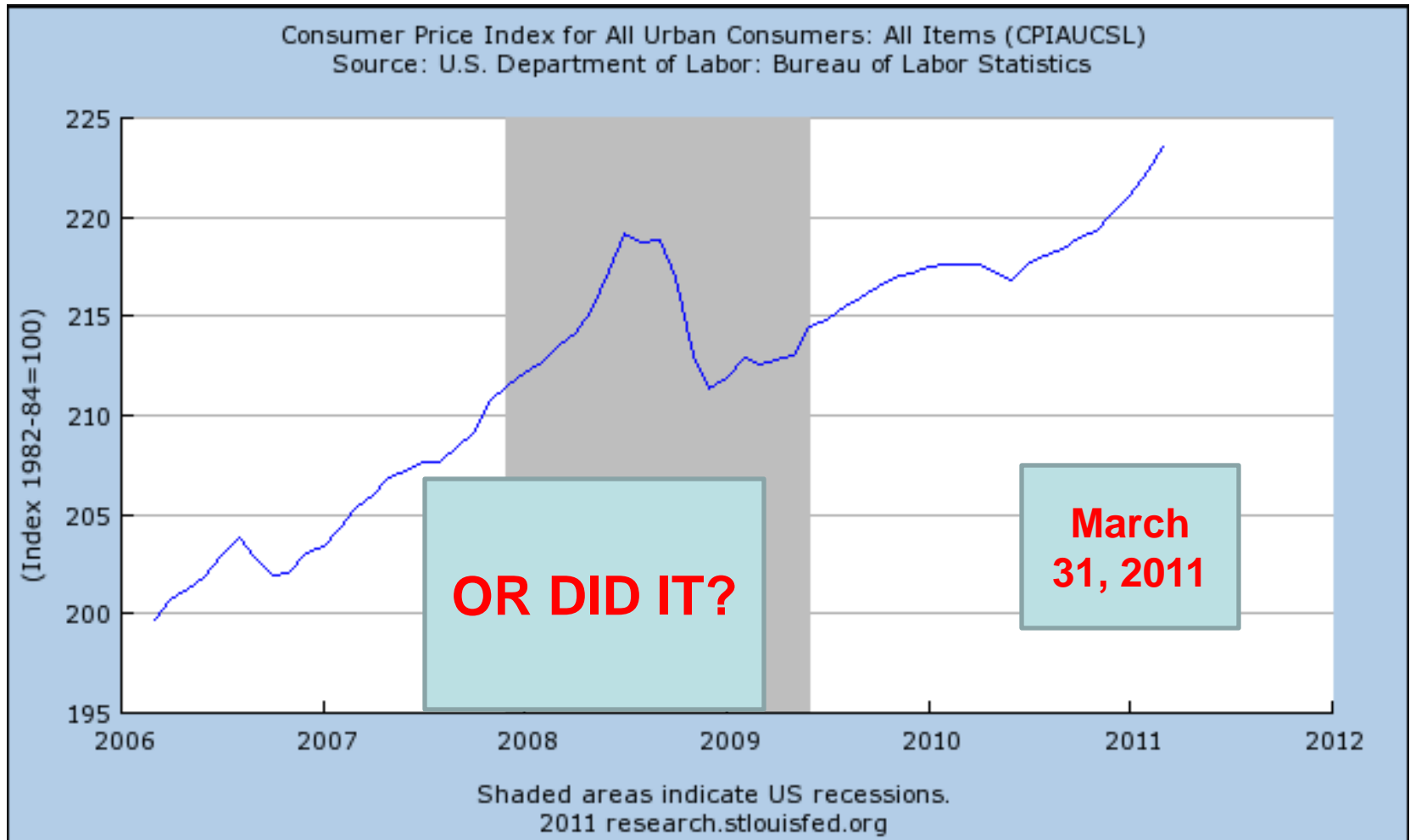


**Prices are falling
the Federal
Reserve calls it
“Disinflation”**

SOURCE: Bureau of Labor Statistics AP

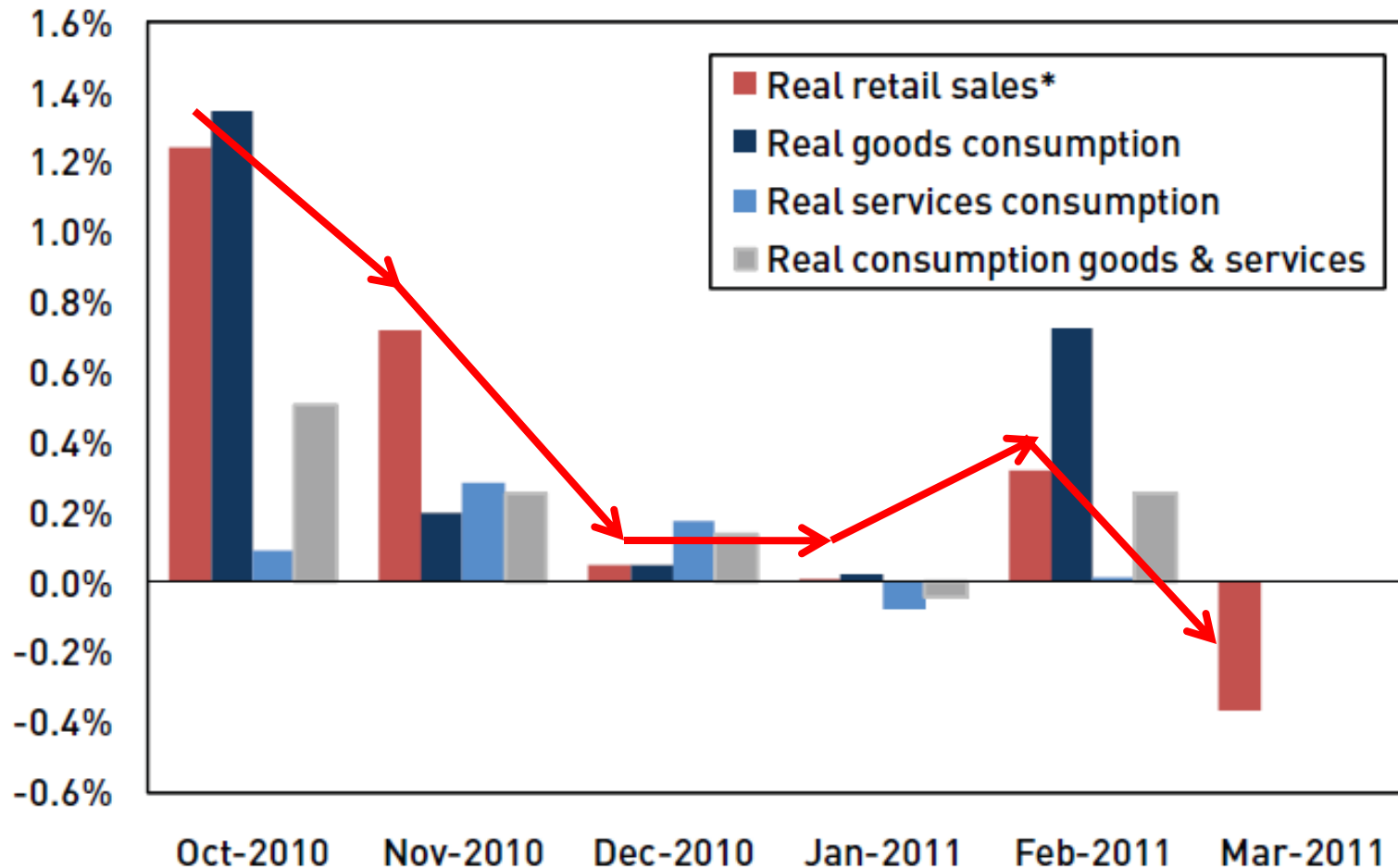
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Inflating the Economy: *The Fed Did What it Said it Would Do*



Retail Sales in March: Down in Real Terms

Service Spending Discipline Tempers Consumption
month-over-month % changes



The Race to the Currency Bottom is Over.

- The Fed signals QE-II's \$600 billion is done?
Is it?
- Emerging countries **MUST** now allow their currencies to appreciate to control inflation.
- They must also raise bank reserves and rates.

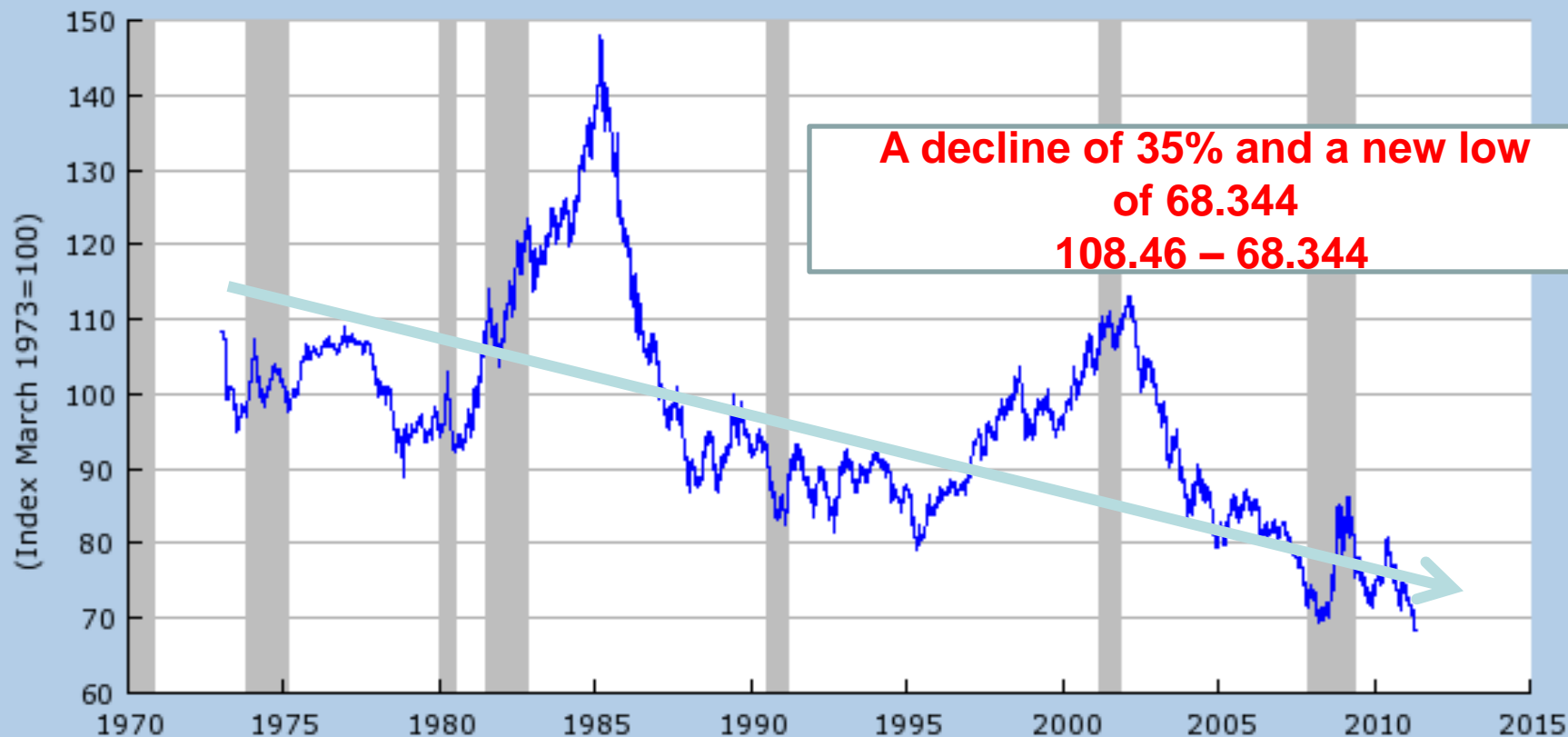
LONG TERM / SIGNIFICANT DECLINE OF THE DOLLAR

The only effective way to Inflate
America's Debt away?

The 30 Year Decline of The Dollar

(April 29 2011)

Trade Weighted Exchange Index: Major Currencies (DTWEXM)
Source: Board of Governors of the Federal Reserve System

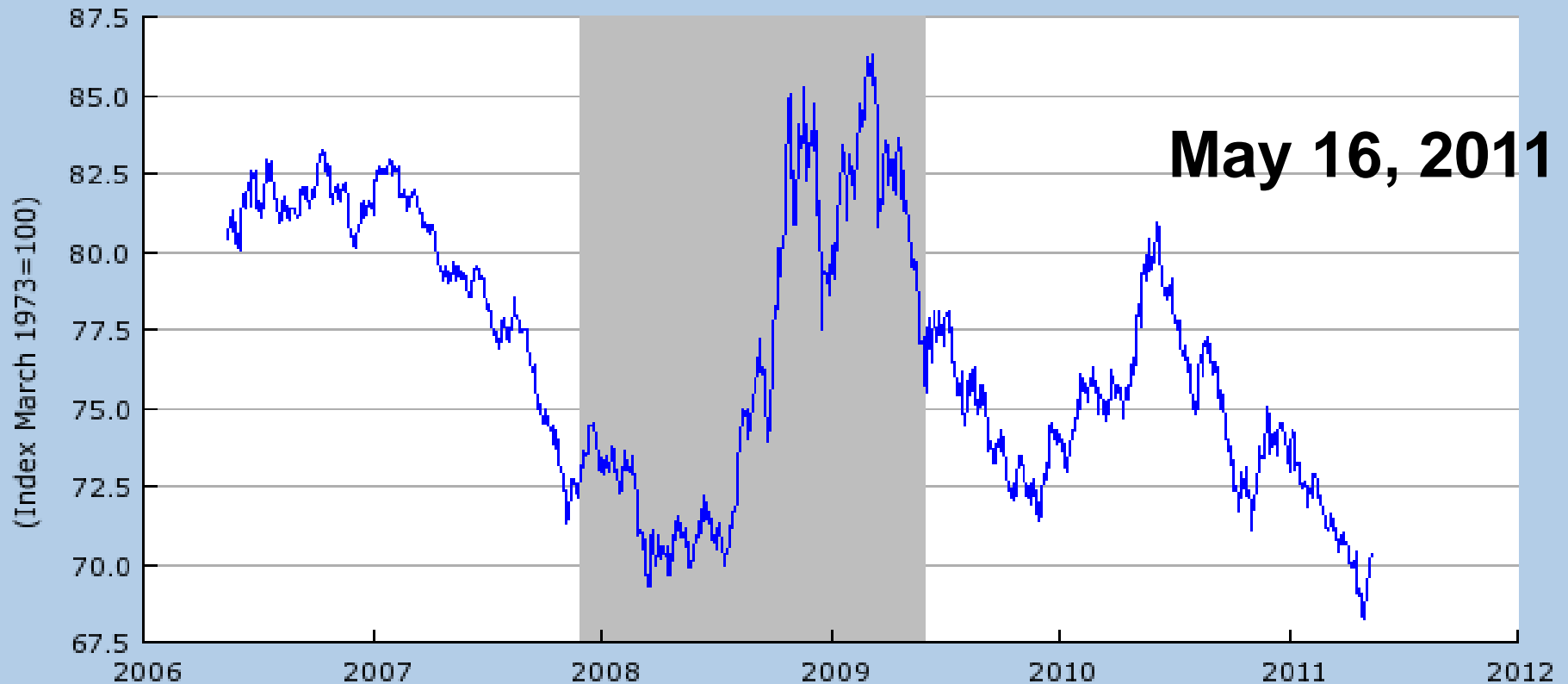


Shaded areas indicate US recessions.
2011 research.stlouisfed.org

Major currency index includes the Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden. http://www.federalreserve.gov/pubs/bulletin/2005/winter05_index.pdf

The Dollar Takes A Rest In Its Journey To The Nether World

Trade Weighted Exchange Index: Major Currencies (DTWEXM)
Source: Board of Governors of the Federal Reserve System



Shaded areas indicate US recessions.
2011 research.stlouisfed.org

“Terminal Velocity”

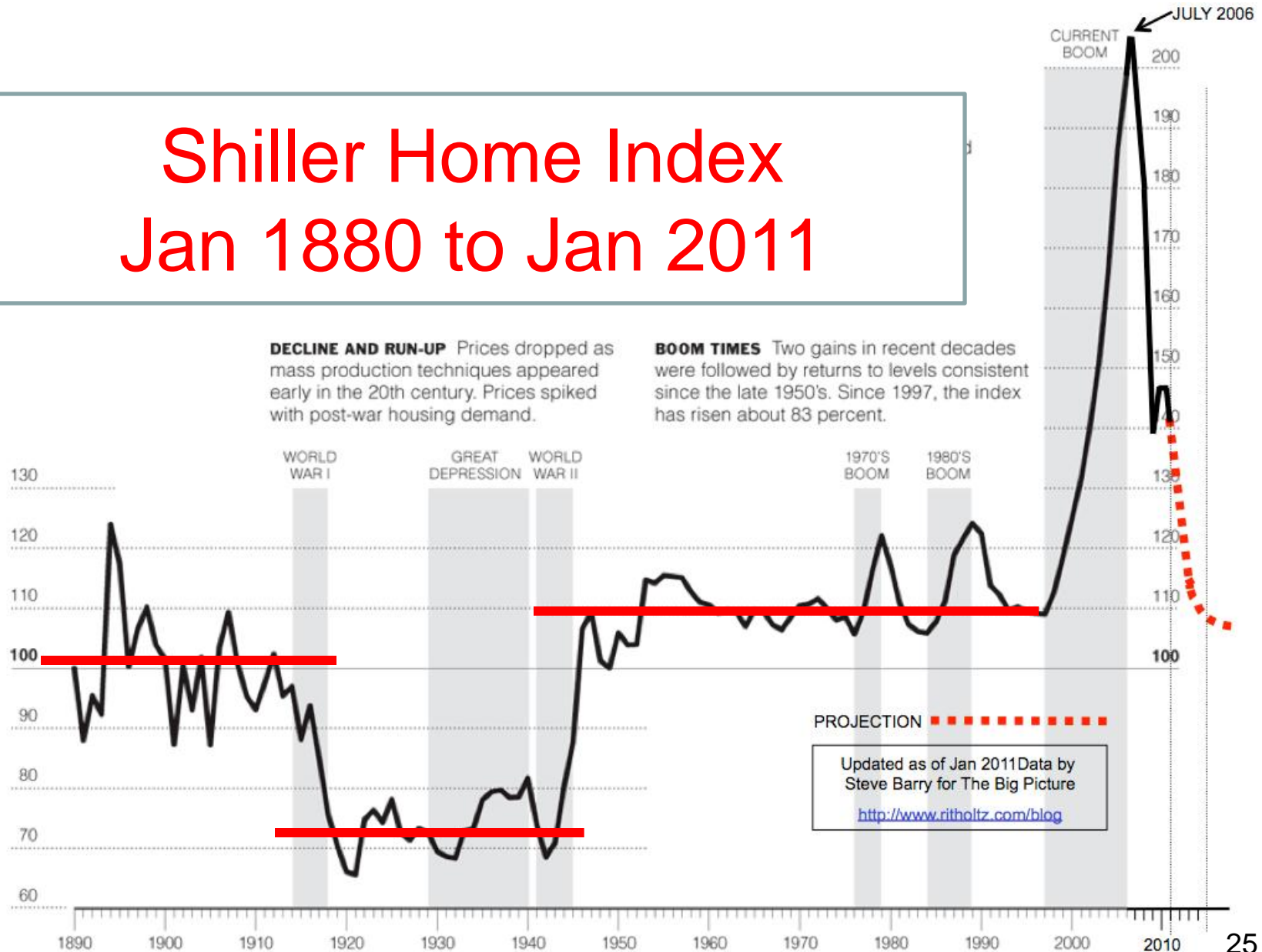
April 15, 2011

- “Two fundamental factors propelled precious and metals. The dollar is approaching terminal velocity and European sovereign default fears are escalating.”
- New US \$ Lows are ahead.

Shiller Home Index Jan 1880 to Jan 2011

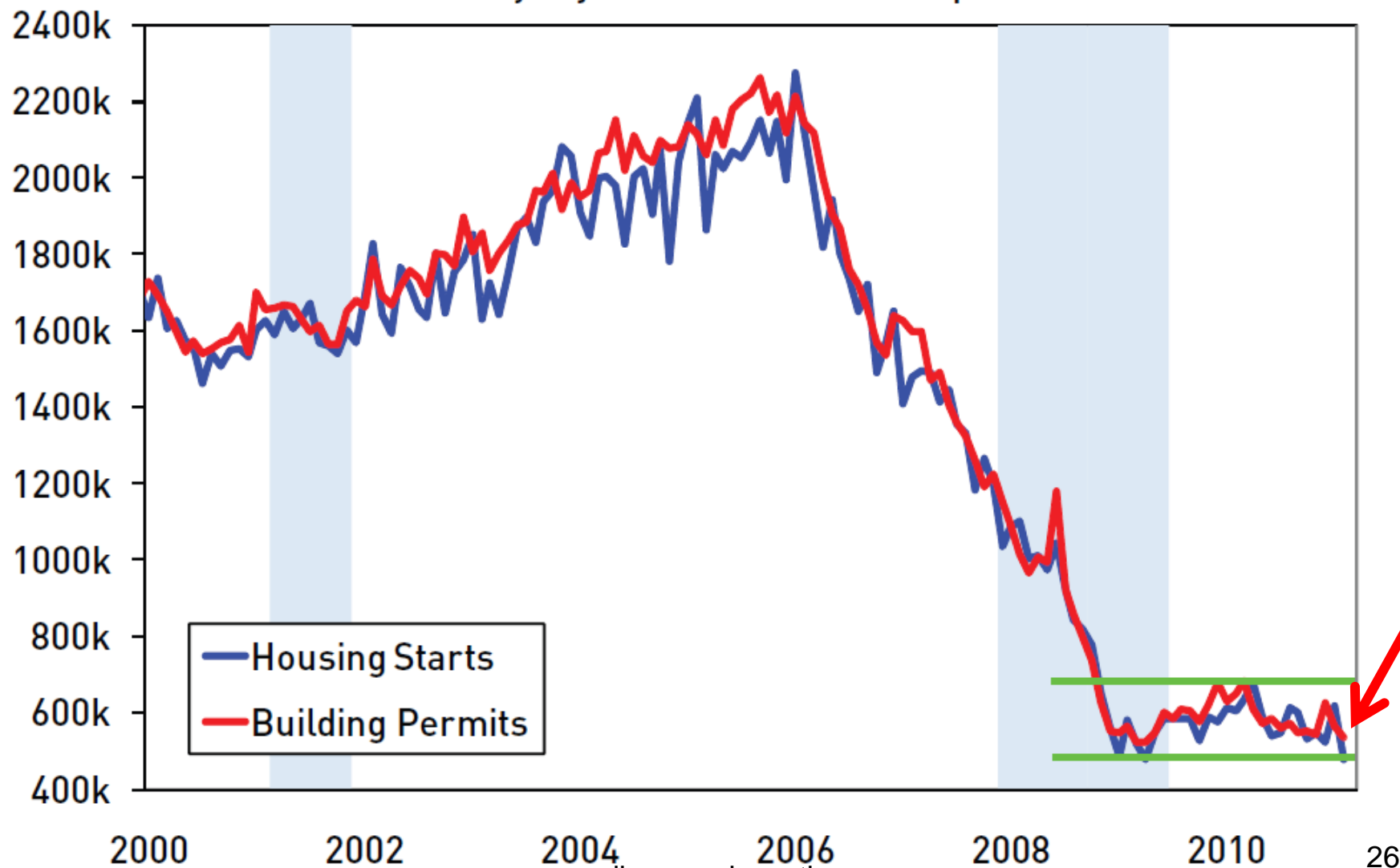
DECLINE AND RUN-UP Prices dropped as mass production techniques appeared early in the 20th century. Prices spiked with post-war housing demand.

BOOM TIMES Two gains in recent decades were followed by returns to levels consistent since the late 1950's. Since 1997, the index has risen about 83 percent.



Updated as of Jan 2011 Data by Steve Barry for The Big Picture
<http://www.ritholtz.com/blog>

Trapped: "Starts Must Rebound in March or something BIGGER is going



US Housing Tsunami

- #1** 28.4% of all single-family mortgaged homes are now underwater.
- #2** The average home price is 8 % lower than last year. It continues to fall 1% a month.
- #3** Home prices have fallen 33% from the peak of the housing bubble.
- #4** During Q1 of 2011 home values declined at the fastest rate since late 2008.
- #5** 55% of all single-family homes in Atlanta and 68% in Phoenix have negative equity.
- #6** U.S. home values have fallen 6.3 trillion dollars since the housing crisis first began.

U.S. Housing, Cont'd

- #7** In February 2011, housing starts experienced their largest decline in 27 years.
- #8** New home sales are down 80% from the peak in July 2005.
- #9** Historically, the percentage of residential mortgages in foreclosure has hovered between 1% and 1.5%. Today, it is 4.5 %.
- #10** Foreclosure filings are projected to increase by 20 % in 2011 (Realty-Trac).
- #11** 25% of all mortgages in Miami-Dade County are "in serious distress headed for either foreclosure or short sale".

Housing Cont'd

#12 in 2009 the average homeowner being foreclosed upon had not made a mortgage payment in 11 months. Today, the average homeowner being foreclosed upon has not made a mortgage payment in 17 months.

#13 Sales of foreclosed homes now represent an all-time record 23.7% of the market.

#14 4.5 million home loans are either in foreclosure or are 90 days delinquent.

#15 According to the MBA, 8 million Americans are at least one month behind on their mortgage payments.

#16 In September 2008, 33 % of Americans knew someone who had been foreclosed upon or who was facing foreclosure. Today that has risen to 48 %.

- **#17** During the first quarter of 2011, less new homes were sold in the U.S. than in any three month period [ever recorded](#).
- **#18** According to a recent census report, 13% of all homes in the United States [are currently sitting empty](#).
- **#19** In 1996, 89 % of Americans believed that it was better to own a home than to rent one. Today that number has fallen [to 63 %](#).
- **#20** The United States has been in a "housing recession" for [57 months](#).

- Sadly, the truth is that our "authorities" really do not know what they are doing. The following is what Fed Chairman Ben Bernanke had to say about the housing market [back in 2006](#)....
- *"Housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise."*

Tax Increases (Strong Headwinds)

Certainly Going Up – 70% Top Rate???

May 28, 2011

Wall Street Journal

A 62% Top Tax Rate Millionaire Surtax

- Senate Dems Consider a 3% surtax in incomes above \$1 million May 28 2011
- Cancellation of Bush era Tax Cuts.

Take a “Tax” Hike!

- “If enacted this could leave the U.S. with a combined federal and state top tax rate on earnings of 62% ... more than double the highest federal marginal rate of 28% in 1989.
- Welcome back to the 1970s. Just what we need to recover!

Today's Math (May 2011)

- Tax Receipts ~\$2.2 trillion
- Total Federal Expenditures ~\$3.7 trillion
- Entitlement Spending ~\$2 trillion

Tax Math (Increasing Rates)

- Top Rate 35%
- Proposed increase /deduction phase out 41.5%
- Millionaire Surtax (3%) **44.5%**

Payroll Taxes Add In

- Medicare Hike 2.5% 1993 Tax
- New Total Federal Tax Rate **47%**

Obama Care 2010

Earners over \$200,000 (Couples \$250,000)

- Congress snuck in an extra 0.9% Medicare surtax on "high-income earners" for Obama Care

47.9%

Obama Admin Proposes to Eliminate \$106k Income Ceiling on SS Tax (May 2011)

- Subjecting all wage and salary income to Social Security taxes would add roughly 10.1 % to the top tax rate.
- This takes the grand total tax rate on each additional dollar earned in America to about **58%.**

The program was originally designed to operate as an insurance system, with each individual's payment tied to the benefits paid out at retirement.

State Taxes

- Add additional 4% (average)
- New Jersey, New York 8.97%

62% to 67%

Investment Taxation.

- Capital Gains tax rate to 23.8% from 15%
- Dividend rate to 45% from 15%

Average Tax Rate Globally in 2011

~30%

- Average Tax rate around the world is ~30%

Deficits and Debt

Total Public US Debt (05/04/11) (Ceiling \$14.3 trillion)

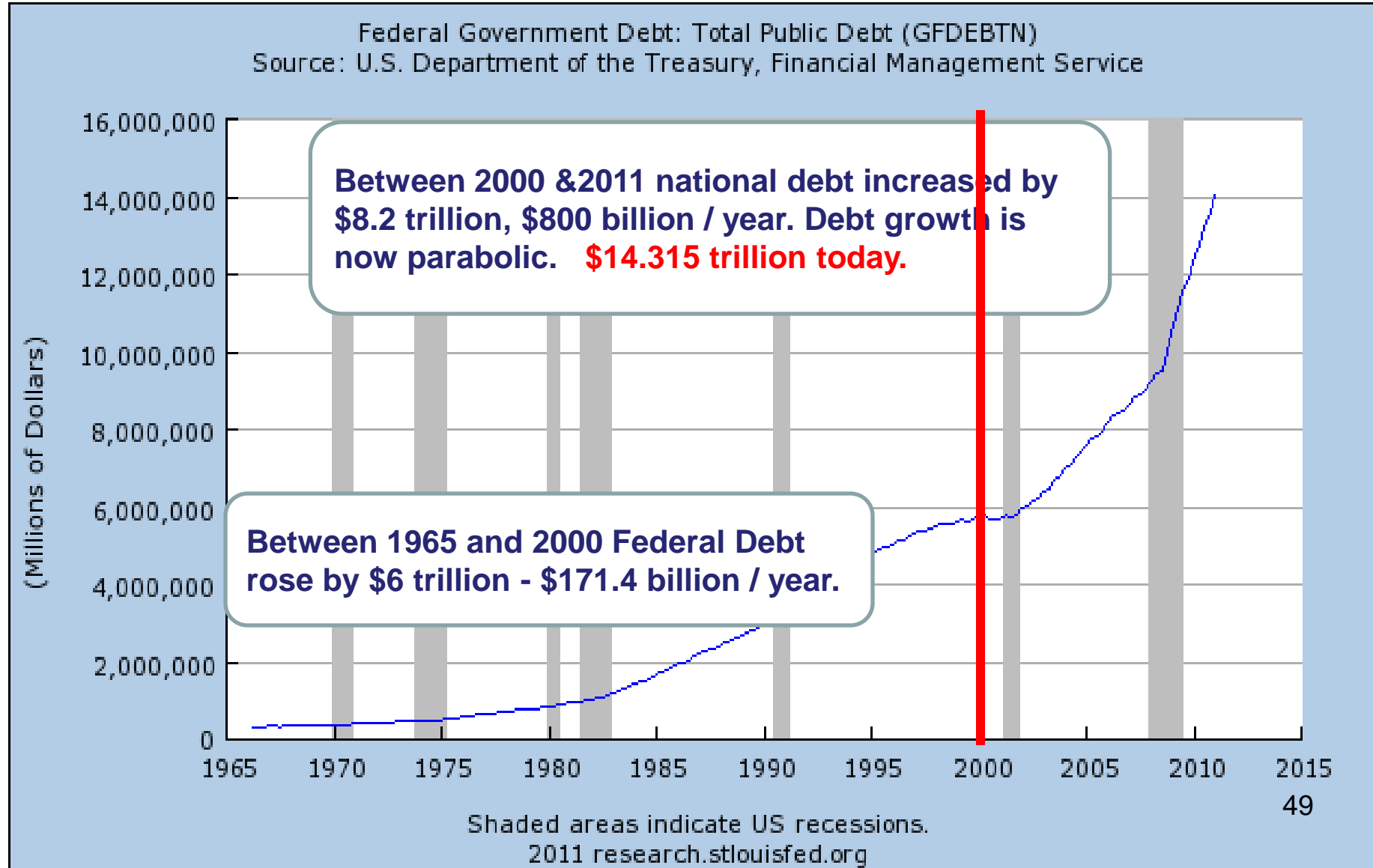
Debt Held by the Public	Intragovernmental Holdings	Total Public Debt Outstanding
9,698,384,234,058	4,635,429,256,577	14,333,813,490,635

<http://www.treasurydirect.gov/NP/BPDLogin?application=np>

The Sustainability Conundrum: Catch 22

2010-12-31

\$1.4025215



Serious Headwinds to US Growth

- Taxes
- Entitlement Reform
- Energy Legislation
- Restructuring of the Financial System
- The Deflation / Inflation Long Cycle

The STATES: Profligate Spending At an 80 year End

"The days of Alice in Wonderland budgeting in Trenton end."

Governor Chris Christie

Railing Against Third Rails: Public Enemy Number 3?

- “Benefits in San Diego are undeniably sweet—firefighters and police can retire at age 50 after 20 years of service A firefighter who retires after working 25 years collects a pension equal to 3/4 of his salary.”
- Public Pension plan laws must be reorganized.

The Top 10 Underfunded State and City Pension Plans:

California's pension plan has a \$92.7 billion shortfall only a 30% deficit – not even in the top ten underfunded state plans .

Top 10 State Plans = \$105 billion.

Top 10 City Plans = \$29.2 billion.

What is a Trillion Dollars

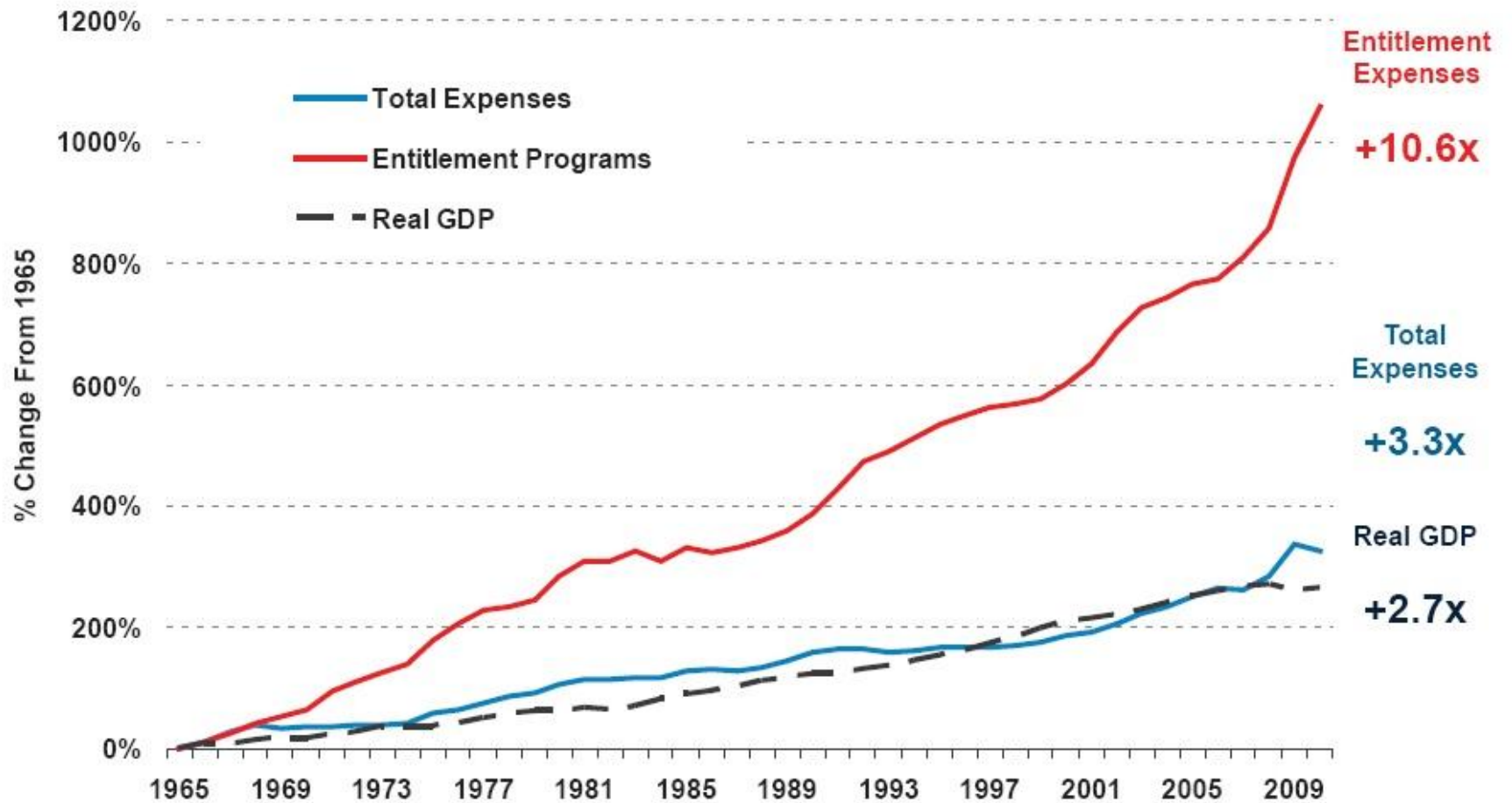
- Take \$1 million dollars and multiply it by 1 million. $(1,000,000 * 1,000,000)$ or 10^{12}
- US public and private debt (not including state debts and underfunding) is \$14.33 trillion.
- Each US family of four is indebted to rest of world \$13,000.

The US Entitlement Conundrum

- The US Federal Budget will be \$3.7 trillion in 2011
- Government receipts are \$2.2 trillion
- 185 Entitlements Programs cost ~ \$2 trillion – growing at 15% each year.

Debt Level: Entitlement Spending Increased **11x** (1965 to 2010), While Real GDP Grew **3x**

USA Real Federal Expenses, Entitlement Spending, Real GDP % Change, 1965 – 2010



Note: Data adjusted for inflation. Source: White House Office of Management and Budget.

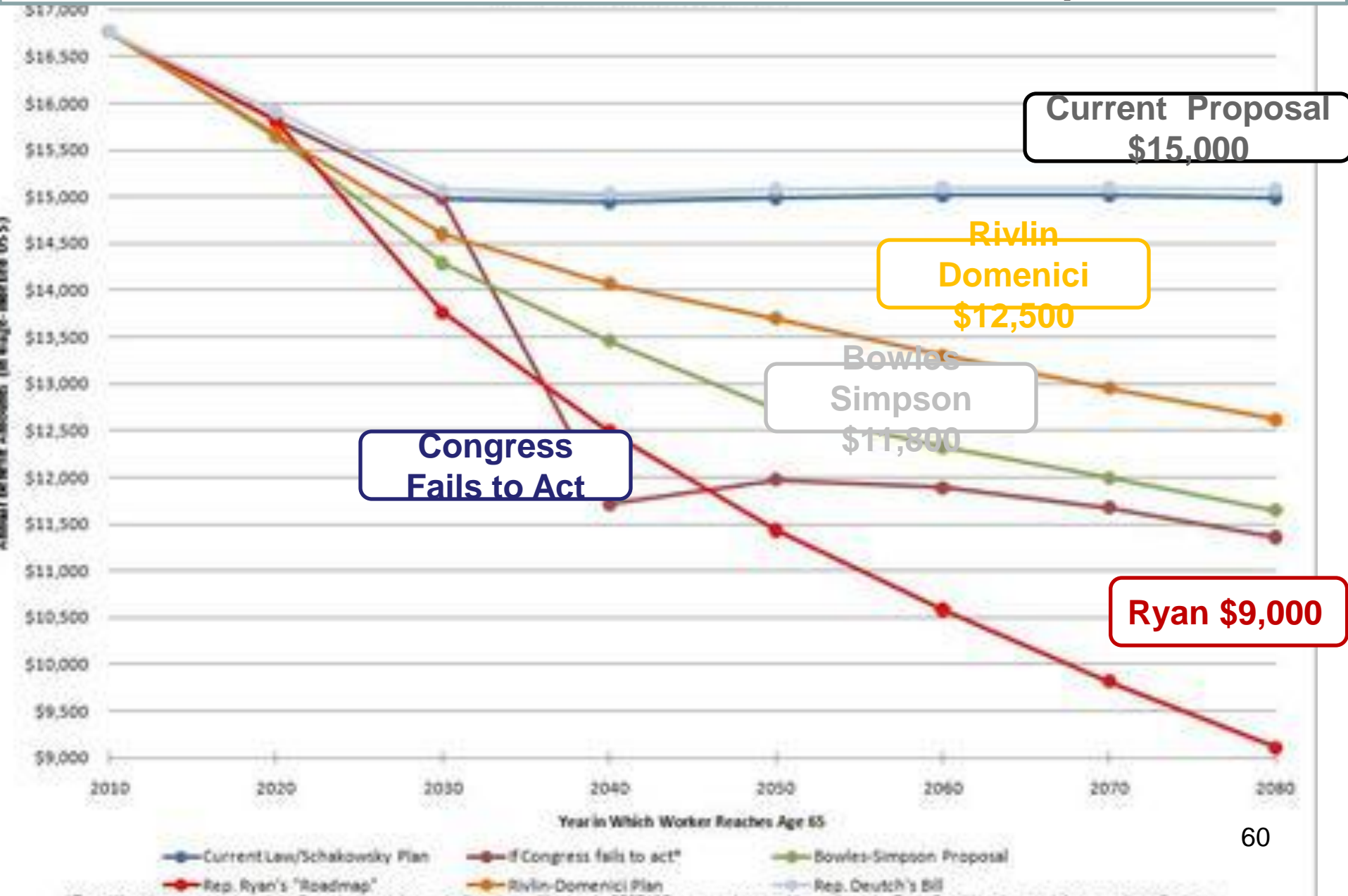
Tax Hike Required (Kotlikoff)

“Roughly speaking, we require an immediate and permanent doubling of our personal-income, corporate and federal taxes as well as the payroll levy set down in the Federal Insurance Contribution Act.”

The US Fiscal Gap: Kotlikoff

- The US has a fiscal gap—the present value of all its future spending (including debt its service) less all future taxes **of \$202 trillion** — 14 times GDP.
- Greece has a fiscal gap of about 11 times GDP.
- To close the US fiscal gap requires raising all federal taxes, immediately and permanently by 66%.

Annual Social Security Benefits for Medium Earner (\$43,084) Under Current Law and Recent Reform Proposals



Unfunded Liabilities: Something Has to Give

Medicare is facing unfunded liabilities of \$50 to \$100 trillion depending on the accounting measure used, making future benefit cuts both inevitable and desirable.

Unsustainability of The Current US Economy

There are 185 federal government means-tested 2010 welfare programs cost ~ \$700 billion, up 1/3 since 2008.

Total welfare spending for 2010 reached ~ \$900 billion, up 24% since 2008.

Total annual welfare spending will grow to ~ \$1 trillion by 2013.

In 2010 the IMF said Canada's entire GDP was \$1.33 trillion.

Over 10 years from 2009 to 2018, federal and state welfare spending will total \$10.3 trillion.

Unsustainability of The Current US Economy

Spending for Social Security and Medicare in 2010:

Social Security was \$721.5 billion.

Medicare totaled \$457 billion. A total of \$1.179 trillion.

Federal welfare spending amounts to \$1.879 trillion.

The total federal budget for 2010 was \$3.720 trillion.

Therefore Entitlement spending is ~ 50% of the budget.

~50% of US Citizens and Permanent Residents pay 2.3% of the federal income taxes.

Ultimate End of All Entitlement Economies

The US and European welfare states are imploding, like the Soviet state did, because the immutable laws of mathematics tell us that many countries are insolvent.

At some point, the US must try to hyper-inflate or cut entitlement spending or it will default and be forced to restructure its debt

Tis' why Bill Gross is out of Treasuries and long gold.

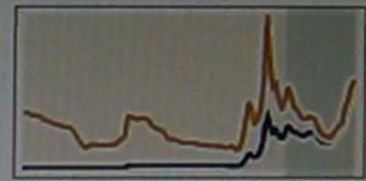
Four Difficult Choices For Congress, The Fed and the Obama Administration

- 1. Increase Taxes – VAT?
- 2. Decrease Entitlement Spending ?
- 3. Increase productivity ?
- 4. Inflate out – whither the dollar?

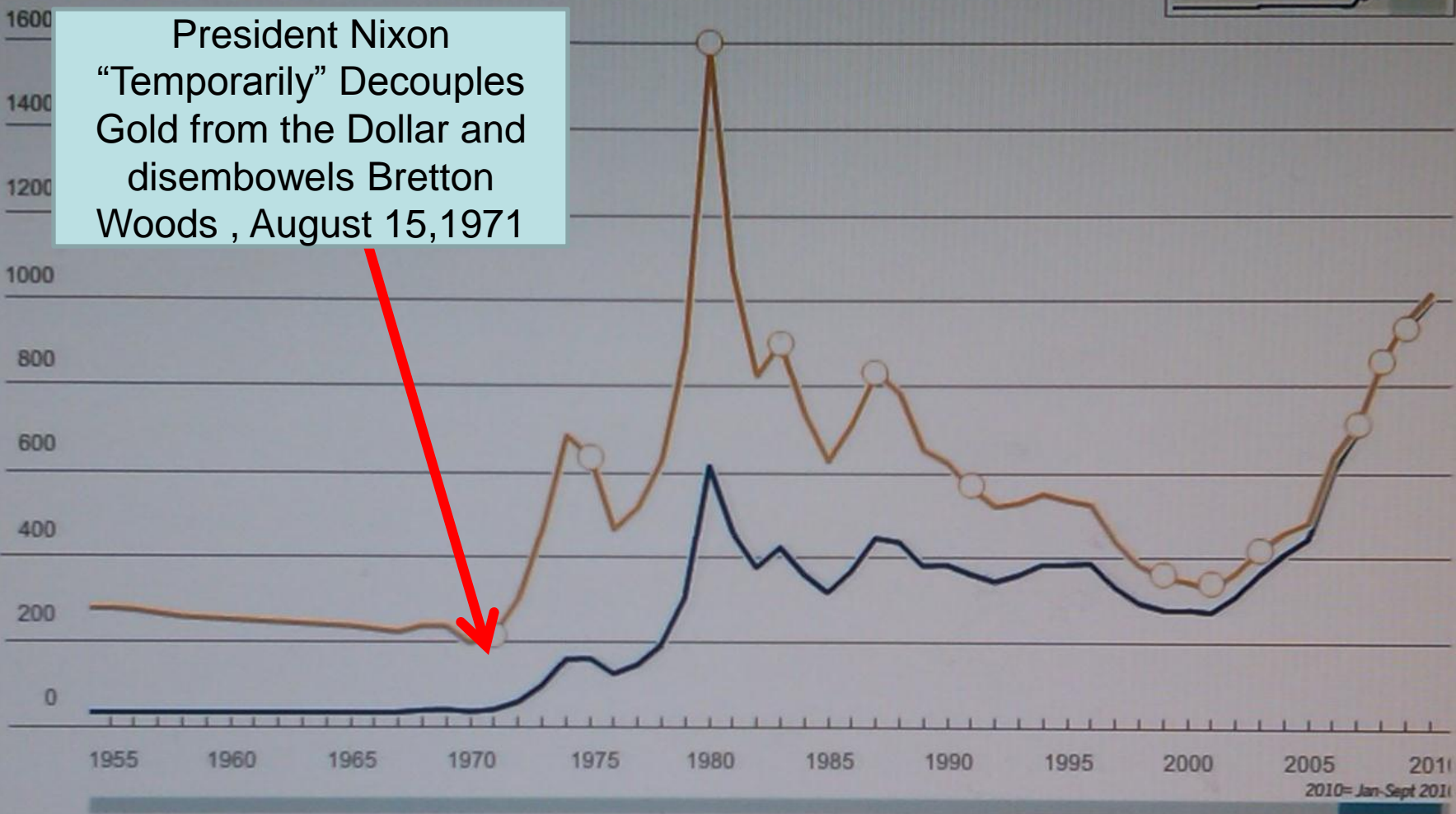
The gold price since 1900

Annual average prices (\$ per troy oz)

— Real (in 2009 prices, deflated by US CPI)
— Nominal



President Nixon
"Temporarily" Decouples
Gold from the Dollar and
disembowels Bretton
Woods , August 15, 1971



Drag the slider along the timeline, roll over and click the circles for further information

Source: Thomson Reuters Datastream

Gold price

Against oil price and commodities index (rebased)



Does oil lead gold? Is oil the progenitor of high QOL?

Or, has gold assumed the role of the world's preferred store of value?

Is gold morphing to money if not currency?

Source: Thomson Reuters Datastream

The Exodus of Intellectual Property

- The growing Structural breakdown in labor markets (wages, employment) in the West
- Labor's diminishing pricing power.
- IP and supply chains moved offshore.
- Credit and entitlement borrowing has filled the Lifestyles vacuum

Going Critical

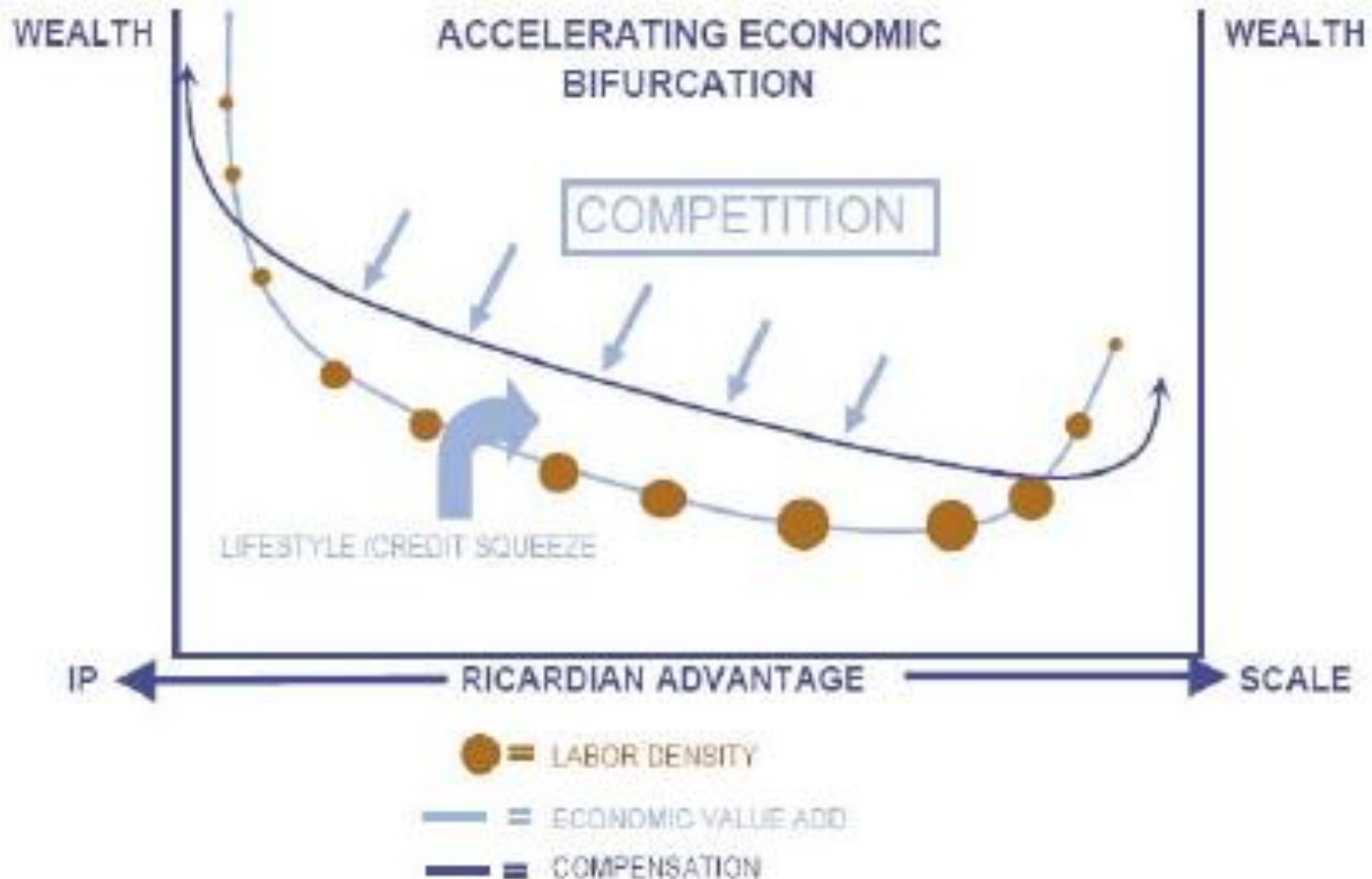
(Be Careful What You Wish For)

- Hence, emergence of the class of “Critical Metals.”
- US labor disemboweled AND IP development and high value job creation is now offshore.
- Globalization, the macro philosophy of the 1980s, is evident with QOL transformational impact.

As Technology Supplants Labor



IP Moves From EU and America to Emergica



When the Credit Induced Lifestyle Must End

For the past twenty years, the global economy has been rapidly bifurcating between Intellectual Property (IP) and Scale.

Commonly known as the global labor arbitrage, Ricardo's theory of comparative advantage has been playing out in dramatic fashion.

As IP has followed Moore's law, innovative competition has pushed most workers EVA below their compensation costs.

This, in conjunction with rising benefit and regulatory expense, has kept wage growth anemic and job insecurity high. Thus, credit has been the necessary lifeblood to keep most workers lifestyles moving higher.

CRITMET Case Studies

- Talison Lithium
- American Manganese
- Northern Graphite
- Challenger Deep

Store of Value Names of Interest

- Carlisle Goldfields
- Midway Gold
- Terraco Gold

Haunted by 'Specter of Unavailability,' Experts Huddle Over Critical Materials

- *Science* , Vol. 330 no. 6011 p. 1598
- *December 17, 2010*

Why Discovery Investing Will Endure as a Wealth Creating Discipline

“The specter of mineral unavailability” due to geopolitical risks or market imbalances haunts other elements as well.

Most of the world’s **lithium**, a key component in batteries for consumer electronics and electric vehicles, is mined in Bolivia.

Dr. Roderick Eggert,
Mineral Resources Economist,
Colorado School of Mines.

Why Discovery Investing Will Endure

Congo and Zambia are the main sources of **cobalt**, used in high-strength alloys and as an industrial catalyst. **Indium and tellurium**, ingredients of photovoltaic cells and flat panel displays, are byproducts of, respectively, zinc and copper processing.

Because availability of **indium and tellurium** depends on demand for copper and zinc, supplies of the two won't necessarily increase with increasing prices.