

Today's Notes:

- 1. The General: Has No Clothes**
- 2. Deficit: Capitulation**

1. THE GENERAL HAS NO CLOTHES

"I cannot conceive of one because for years I thought what was good for our country was good for General Motors, and vice versa. Our company is too big. It goes with the welfare of the country."

Chares Wilson CEO of GM 1953

The General (General Motors) is dead. Long live the General. This company had been number 1 for 77 years. Our family was always a General Motors family. I remember with great fondness the 1957 Chevy. It was one hot car. In 1976 I remember the famous 427 engine in the Impala. In later years I drove Oldsmobiles. I loved the cars. Anyone remember the 442? As of 6 AM Chevrolet Saturn (a GM affiliate) filed for bankruptcy in New York. The following chart shows a 91% decline in the share value of the stock effectively wiping out the equity holders of GM. Shareholders must include (or have included) a great many pension funds and endowments. This AM Bloomberg carried the story of a couple with six children who had invested \$700,000 in GM corporate bonds because they thought they were safe, would see their children through college and ensure their retirement. This is the human aspect of this self-induced disaster that has befallen the General. By the 1970s the handwriting, in the form of Japanese carmakers, was "on the wall."



Later this morning the General (GM) a 100 year old company will file for bankruptcy. The US government will own 60% (\$20 billion loan), Canada's government 12% (\$9 billion loan) shareholders will get nothing. The bondholders (many retirees who believed in the General) will get between 10% and 15% of the new equity. How is it in our society that secured bondholders have been pushed aside? Irrespective of the human toll, the bond markets are going to be much more expensive in the future because of this government trump card. The United Auto Workers (Union Benefit Trust) will receive the remainder of the equity stake. Taxpayers on both sides of the border will have paid in about \$50 billion, the price for 8 to 10 nuclear plants that could alleviate our energy dependency.

There are many reasons this has happened. Blame can be spread widely. But perhaps most important is the fact that while the world changed around it, GM management, unions and ultimately the shareholders and bondholders did not. For the past 6 years I have written in the Morning Notes that the US automotive industry (as well as the Airline and Pharmaceutical industries) had grown tepid and resistant to change. We admonished that \$5 to \$10 gasoline was coming and we could see no reason why automotive companies could not produce a safe and comfortable 50 mile per gallon car. More than anything else technology and common sense passed the General's management by as they chose to build SUV's, Escalante's and Suburbans. By the way they had a lot of help from the American populace.

We ALL ignored the reality. The fallout will be significant. Thousands of employees will lose their jobs, between 10 and 13 GM manufacturing plants will close impacting local tax authorities, and downstream the parts industry will be devastated.

Now American and Canadian taxpayers will ante up another \$40 billion (debtor in possession financing) to help the General through its bankruptcy process. This will be directed in part by the president's new Car Czar and his expert team of Summers, Chu, Geithner and Browner. President Obama has already mandated new mileage and "green" emission standards that are unrealistic in timeframe. We are an ignorant and uniformed electorate. We had better become studious and involved very soon.

I refer to a Morning Note I wrote on November 2 2005. It is not because I am clairvoyant or full of hubris. I am neither. I simply want to suggest that this eventuality was obvious for the past 4 years. In fact it was obvious for the past decade that, **"The General Has No Clothes."**

On November 2, 2005 I had presented to the FFIEC (the Federal Reserve) in Washington DC. In my presentation I suggested that General Motors faced ultimate bankruptcy. It was as clear then as it is in reality today. At that time the shares were trading at \$27. Here's what I said on Wednesday, November 2, 2005,

"Last week I was presenting a seminar to a group of executives in Washington, DC. I analyzed the General Motors situation thoroughly, I thought. I noted that there was a significant chance, given slowing auto demand, pension under funding and legacy health care funding problems, that GM could seek bankruptcy protection. I was surprised to see several of the executives shaking their heads derisively at me.

Unfortunately I could not engage them. They would not comment. It was apparent however that many people still have not awakened to the reality of the US economy.

As you can see, GM is clearly a stock to be sold on strength. It now seems possible that the company could eventually seek Chapter 11 protection, in my opinion. Yesterday GM and Ford announced poor sales results. Both companies reported a 26% decline in car sales in October compared with October 2004. Ford has taken the unusual step of suspending production in 8 of its North American plants. It is a large sales decline to be sure – but the decline of both companies is even more significant.”



An important piece of Discovery Investing is discovering new trends. There appears to be a new trend in the global auto industry. ... However, I wrote this article to ask each of you to perform a thorough analysis of your various investment plans. Do you know what mutual funds you own? Do those funds own US automakers, pharmaceutical and airline stocks. You almost surely have more exposure than you think. What you don't know will hurt you.

One aspect of today's bankruptcy is critical. This is a global event. It ushers in the changing of the guard globally. Politically, economically and from a capital markets regulatory perspective all has changed significantly. It is now more likely to be a confrontational situation with the government confronting corporate bondholders from time to time. Investments that were not supposed to be speculative (corporate bonds in GM) are now very speculative and have been made so by the solons in Washington and Ottawa. “Too Big to Fail” is the modus except for shareholders and bondholders. The ethics of Moral Hazard has been thrown down in a most ungracious manner. Some risk takers have been rewarded and others thrown to the wolves – like the family who invested \$700,000 in GM bonds. This is wrong and immoral.

Today my platform of Discovery Investing is even more important.

There has been a 180 degree shift in risk profile from what was previously considered “safe” to what was considered very risky. Yes, Incubator and Mature Discovery stocks have risk. But the trend to new discoveries in alternative energy, health care, transportation and infrastructure lies ahead. Commodities must also return to prominence as the quality of life cycle resumes – world wide. Yes you may lose on 6 or 7 out of every 10 Discovery investments. However, if you diversify prudently, continue to perform due diligence; if you are a **hands on investor** in the discovery space – I am convinced that you will be successful beyond your wildest dreams. The moral of this story is that there is no completely “safe” investment anywhere in the world today.

I feel empathy for the GM workers, institutional investors, suppliers and most of all for mom and pop who trusted that the 100 year legacy of the US auto industry was a “safe” bet.

2. DEFICITS

Unfortunately not much has changed for the better here either. Defects (Budgetary and current account) keep piling up and have been piling up for the past 5 years. The CBO suggest that the debt to GDP ratio will reach 100% within 5 years and that will make the debt payments, even in the \$13 trillion US economy, unsustainable. Professor John Taylor at Stanford suggests (*Can Exploding Debt Threaten America?*, FT May 26, 2009) there are two choices for the government. First they can raise taxes. Professor Taylor thinks that with a CBO forecasted \$1.2 trillion (\$1,200,000,000,000) deficit, taxes which now amount to \$2 trillion, would have to increase by 60% to balance the budget. Of course such an increase would also be unsustainable, both economically and politically. Such taxation is unlikely, but possible. Already a value added tax (VAT) is being bandied about the halls of Congress. We have spoken about the carbon cap and trade (tax) and of course the new mining law if passed will extract between 4% and 8% gross royalties (25% of all profits) form the US mining industry. Lots of new taxes are on the way. On the other hand the government could devalue the US dollar to inflate away this tremendous debt load.

Currency	Chg% X=1\$USD	NY Time	X= 1\$USD	X\$USD =1	Gold Price/oz	Gold Chg	Gold Chg%
US Dollar	--	06/01-08:00	--	--	983.70	+4.10	+0.42%
Australian Dollar	+0.88%	06/01-07:50	1.2371	0.8083	1217.06	-5.58	-0.46%
Brazilian Real	-0.01%	06/01-00:01	1.9671	0.5084	1935.23	+8.36	+0.43%
British Pound	+1.08%	06/01-07:59	0.6111	1.6365	601.15	-4.00	-0.66%
Canadian Dollar	+0.61%	06/01-07:59	1.0842	0.9224	1066.59	-1.91	-0.18%
Chinese Yuan	+0.03%	06/01-05:37	6.8219	0.1466	6706.61	+22.11	+0.33%
Euro	+0.30%	06/01-08:00	0.7041	1.4204	692.57	+0.83	+0.12%
Hong Kong Dollar	+0.01%	06/01-07:59	7.7560	0.1289	7630.30	+32.04	+0.42%
Indian Rupee	+0.33%	06/01-07:34	46.9625	0.0213	46201.71	+42.96	+0.09%
Japanese Yen	+0.38%	06/01-07:59	94.9600	0.0105	93412.15	+36.68	+0.04%
Mexican Pesos	+0.45%	06/01-08:00	13.0710	0.0765	12861.86	-0.28	0.00%
Russian Ruble	+0.50%	06/01-07:50	30.6338	0.0326	30137.48	-21.17	-0.07%
S.African Rand	-0.45%	06/01-08:00	7.9750	0.1254	7847.40	+70.36	+0.90%
Swiss Franc	+0.07%	06/01-08:00	1.0661	0.9380	1048.67	+3.64	+0.35%

According to Stanford's Dr. Taylor this would require 50% depreciation (also called competitive devaluation) of the US currency with respect to its OECD cousins. Our view is that both these measures will be utilized to some extent. You can see this in the foreign exchange market action this AM. The dollar is weaker this AM against almost all its fiat cousins. At the same time gold is stronger in dollars as are almost all commodities. The commodity move must be considered a weakening dollar effect and not a commodity bull market at this point in the cycle. Gold is weaker in Aussie dollars, Canadian dollars, British Pounds and Russian Rubles.



After a wild ride for almost 9 months **the US currency is headed down**. We expect a recovery but also expect to see much lower levels. The Canadian dollar is very much to our liking. I am sure the powers that be in Ontario do not feel quite the same elation.

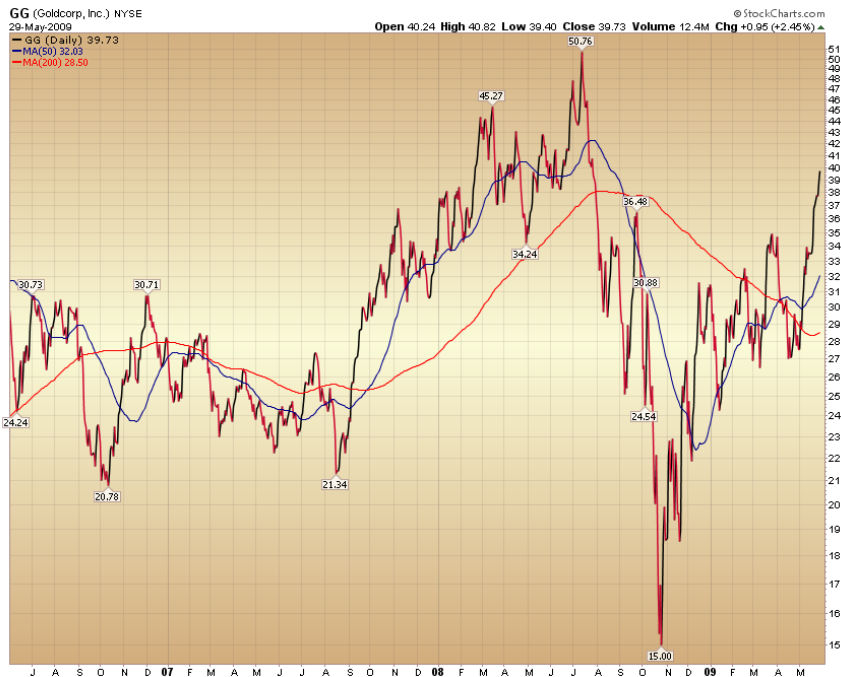
Between July 15th 2008 and March 7th 2009 everyone desperately needed US dollars. As you can see that has changed and the \$ is now falling off a cliff. Is this move in anticipation of the great inflating away of debt that the Obama administration must have in view of its tendency to fund green energy, socialized health care, banks, Wall Street and now the auto industry. We think so. We still must observe much higher gold prices before we concede that the deflationary pressures have subsided.

But deficits must be financed. Secretary Geithner is in Beijing this AM calling for a new relationship between Washington and Beijing. There will indeed be a very new relationship. Stay tuned. You must have a reasonable allocation to gold and silver in your discovery portfolio. I think Goldcorp (GG) is an example of a very cheap gold / silver legacy discovery investment. Please have a look.

On September 15, 2004 I wrote,

“Everyone has heard about the twin deficits that have allowed US citizens to maintain a high quality of life (at the expense of the rest of the world). Continued and unrelenting deficit spending MATTERS. It may not matter today or next month but at some point these monsters (the Federal Deficit and current account balance) will awaken. The dollar must fall, the Renminbi must eventually appreciate and gold will move higher. Keynesian deficit spending was never meant to be a way of life. It was supposed to iron out cycles. The outcome is for-ordained. Tighten your belts and prepare – now.”

For long time Discovery readers I hope you have heeded these words. The point of capitulation is close.



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