

Today's Notes:

1. When the Music Stops
2. Access to the DiS (Be Sure to take Advantage of MN 2 below)!

1. When the Music Stops

What will you do when the music stops? The year of 2011 was mostly a dreadful experience for investors in junior mining stocks. The average discovery stock declined 40 percent. One look at the TSXV index tells the entire story. The market reached its top of 2,439.83 in early March and then declined precipitously for 7 months. It bottomed on Monday, October 3.



Stocks on the TSXV (Canadian Venture Exchange) declined 47 percent. Some shares declined by more. The Toronto Stock index declined 25 percent. While the mining stocks, particularly the juniors, met stiff headwinds between March and October, in the US the S&P 500 reacted violently to the Standard and Poor's debt downgrade in early August. The US index declined 22% in a week in August. Since then the US index has regained almost all the value it had attained in May (1,363). At its peak the SP500 attained 1,363 and it fell to 1,099 by early October. It now trades at 1,316, only a few points below its top.

In fact January was the best beginning of the year month for US stocks in this new millennium. The S&P appreciated 4.4 percent.

The German DAX index fell 33% between May and September. It is still 14% below its May 2011 top. Is there a lesson here? Well, yes. It might be that US equity markets, perhaps all US markets, including the US dollar, are considered safer at present. We do know that last week the Fed (I present at the Federal Reserve's FFIEC in March and again in September) announced that short interest rates would not be raised till at least late 2014. There is most definitely a sniff of deflation-fear in the air in Washington. The Fed's rationale is that economic growth will be sub normal throughout this period in the US. The folks at PIMCO opine that one or two more rounds of quantitative easing must yet occur. We are unsure about that, inflating the money supply has not worked so far – why more now? De-leveraging, so necessary worldwide, seems to proceed far too slowly and growth in the US economy is inhibited by the overhang. Just yesterday the Case Shiller housing number for November was announced – Not good news.

Their U.S. 20-city index 20-city housing index fell compared with a year ago, as the housing market continues to be weak. The one –month decline was 1.3%, the 1 year decline was 3.7 percent and since the market peak almost 33% nationwide. This means that the country's uncovered leverage has increased - mortgage debt under water. Hyman Minsky would understand the impact of this. This is the unwinding of asset values. He called these "Ponzi Units" because they were financed on future asset value increases. These are serious headwinds here even as the current administration in Washington is proposing to relieve more than 1 million under water mortgages of their full obligation.

Who will lose in a 50 percent reduction in mortgage debt?

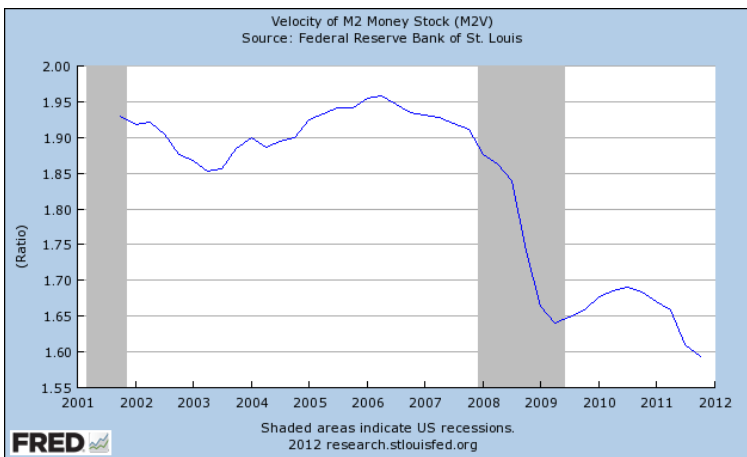
While the official inflation indications are muted no one feels that way. Real income has not risen now for a decade. Prices of consumer goods surely have risen. The chart below shows the stagnant CPI-adjusted household income figures from the US government (1988 to 2009). As you can see income has not risen during the past decade and in fact has risen very little in the past two decades (average 4 percent for 50th percentile).

Percentile	2009	2006	2003	2000	1997	1994	1991	1988
20th	<b>\$20,453</b>	\$21,314	\$20,974	<b>\$22,320</b>	\$20,520	\$19,215	\$19,338	\$19,830
50th	<b>\$49,777</b>	\$51,278	\$50,519	<b>\$52,301</b>	\$49,309	\$46,175	\$46,269	\$47,433
80th	<b>\$100,000</b>	\$103,226	\$101,307	<b>\$101,884</b>	\$95,273	\$89,936	\$87,173	\$88,146
95th	<b>\$180,001</b>	\$185,119	\$179,740	<b>\$180,879</b>	\$168,626	\$157,172	\$148,055	\$149,207

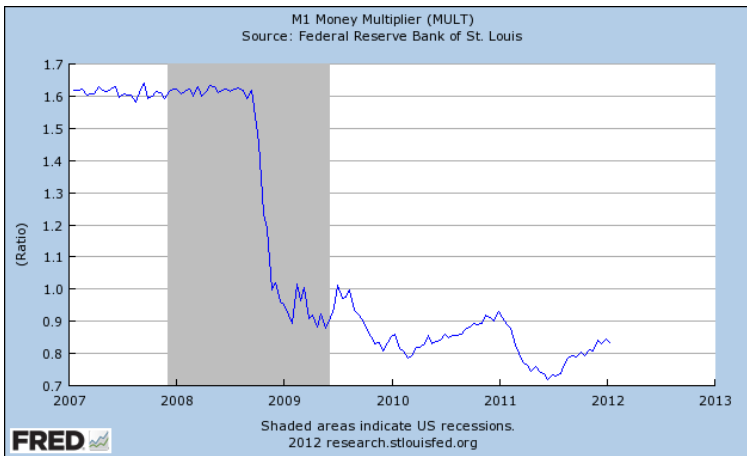
It is well known that even as the official unemployment rate has declined to 8.5% those with new jobs are earning, on average, 25% less in their new jobs. So is this then the face of the “new normal” for the next three or more years?

And why, last Wednesday, did the Fed announce it would hold short interest rates at low levels for another 3 years. Is this the beginning of Japan-style stagnation? Well, examine the St Louis Fed’s velocity of money or their money multiplier. They are both still signaling a giant stall for the US economy, a banking system in stasis and a lack of consumer demand. The Multiplier is shown through January 11, 2012 while the St Louis Fed’s M2 Velocity is calculated through Q3 2011 (Velocity gives an indication of the number of turns of the money supply relative to the GDP).

In either case it is evident that the money supply is not being put to work effectively. We think the US banking system is still vulnerable tied as it is to Europe’s woes.



The Velocity of money in the U.S. continues to collapse indicating that the money supply is turning over ever more slowly.



For the past 42 months the M1 money multiplier has sent one message, **each printed dollar generates less than \$1 in the economy.**

Interest rates still continue their volatile nose dive. Take a look at the 5 and 10 year treasuries. Under the influence of the Fed’s admonitions they sell near all-time lows. How can retirees and new boomers survive in the US fixed income market?

As you can see the 5 year Treasury yield is .71% - historically quite low and just the way the Fed seems to want it. The Ten year sells for a measly 1.83%.

Date	1 mo	3 mo	6 mo	1 yr	2 yr	3 yr	5 yr	7 yr	10 yr	20 yr	30 yr
01/03/12	0.01	0.02	0.06	0.12	0.27	0.40	0.89	1.41	1.97	2.67	2.98
01/04/12	0.01	0.02	0.06	0.12	0.25	0.40	0.89	1.43	2.00	2.71	3.03
01/05/12	0.01	0.02	0.07	0.11	0.27	0.40	0.88	1.43	2.02	2.74	3.06
01/06/12	0.02	0.02	0.05	0.12	0.25	0.40	0.86	1.40	1.98	2.70	3.02
01/09/12	0.01	0.01	0.05	0.11	0.26	0.38	0.85	1.39	1.98	2.70	3.02
01/10/12	0.01	0.02	0.05	0.11	0.24	0.37	0.86	1.41	2.00	2.71	3.04
01/11/12	0.01	0.02	0.05	0.11	0.24	0.34	0.82	1.34	1.93	2.63	2.96
01/12/12	0.02	0.03	0.06	0.11	0.22	0.35	0.84	1.37	1.94	2.65	2.97
01/13/12	0.02	0.03	0.06	0.10	0.24	0.34	0.80	1.32	1.89	2.59	2.91
01/17/12	0.02	0.03	0.06	0.11	0.21	0.33	0.79	1.31	1.87	2.57	2.89
01/18/12	0.02	0.03	0.07	0.11	0.24	0.35	0.82	1.34	1.92	2.63	2.96
01/19/12	0.04	0.05	0.07	0.11	0.26	0.36	0.87	1.43	2.01	2.72	3.05
01/20/12	0.03	0.05	0.07	0.11	0.26	0.38	0.91	1.47	2.05	2.78	3.10
01/23/12	0.03	0.04	0.07	0.12	0.26	0.39	0.93	1.51	2.09	2.82	3.15
01/24/12	0.02	0.04	0.07	0.12	0.24	0.39	0.92	1.49	2.08	2.82	3.15
01/25/12	0.03	0.04	0.07	0.12	0.22	0.34	0.81	1.40	2.01	2.78	3.13
01/26/12	0.04	0.05	0.08	0.12	0.22	0.31	0.77	1.34	1.96	2.74	3.10
01/27/12	0.05	0.06	0.08	0.12	0.22	0.32	0.75	1.31	1.93	2.71	3.07
01/30/12	0.05	0.05	0.08	0.12	0.22	0.31	0.73	1.27	1.87	2.64	2.99
01/31/12	0.04	0.06	0.08	0.13	0.22	0.30	0.71	1.24	1.83	2.59	2.94

Tuesday Jan 31, 2012

However take a look at the Fed's table for **real rates**.

DATE	5 YR	7 YR	10 YR	20 YR	30 YR
01/03/12	-0.77	-0.43	-0.04	0.55	0.81
01/04/12	-0.82	-0.48	-0.08	0.54	0.79
01/05/12	-0.86	-0.51	-0.10	0.51	0.76
01/06/12	-0.85	-0.51	-0.11	0.49	0.73
01/09/12	-0.88	-0.53	-0.13	0.47	0.72

01/10/12	-0.84	-0.48	-0.08	0.51	0.75
01/11/12	-0.85	-0.51	-0.10	0.50	0.71
01/12/12	-0.85	-0.50	-0.10	0.50	0.74
01/13/12	-0.89	-0.54	-0.14	0.46	0.71
01/17/12	-0.91	-0.57	-0.17	0.43	0.68
01/18/12	-0.91	-0.56	-0.15	0.47	0.72
01/19/12	-0.88	-0.48	0.00	0.56	0.76
01/20/12	-0.85	-0.47	0.01	0.60	0.80
01/23/12	-0.84	-0.46	0.02	0.66	0.84
01/24/12	-0.89	-0.50	-0.01	0.62	0.82
01/25/12	-1.02	-0.62	-0.12	0.53	0.76
01/26/12	-1.09	-0.68	-0.16	0.51	0.74
01/27/12	-1.13	-0.71	-0.18	0.49	0.73
01/30/12	-1.14	-0.74	-0.24	0.42	0.68
01/31/12	-1.17	-0.77	-0.28	0.37	0.61

Tuesday Jan 31, 2012, 4:12 PM

As you can see the 5,7 and 10 year treasury bonds all sport negative real rates of return, and increasingly so. The 30 year bond yields .61% on a CPI-adjusted basis. I reiterate, how can retirees and boomers possibly survive with this bond market?

The commodities fared better in 2011 than any equity index. Gold and silver especially seemed to hold their own quite well. They are performing well this day – gold’s next challenge shall be the \$1800 mark.

So where are we now?

We think that at some point, perhaps this year, perhaps next, “the music will stop.” One catalyst for this outcome may be Europe’s continuing troubles. We do not think the EU will survive in its present form. Any banking turmoil in Europe will impact Canada and the US.

China is another 2012/2013 wild card. The question there is whether it will experience a hard or soft landing. Difficult to call indeed, but China certainly contributes to global economic risk today. Our friend Gordon Chang, writing in Forbes.com, indicates that China is now buying as much gold as possible.

We keep hearing that the Greek Sovereign debt problem is solved. In August there was great angst over a 50% haircut for Greek sovereign debt holders. Now it looks like interest rate resets will price the Greek debt at a 70% discount. We hear, this AM, that a warrant will be attached to the new paper

(replacing the original debt) that will pay off as the European economy recovers. Will these warrants end in the money?

More to the point, what about all the Credit Default Swaps (CDS) purchased for American banks to protect against sovereign defaults? These are insurance contracts bought and paid for to hedge risk of a 70% haircut on Greek debt. Would the ISDA trigger a default? We think the American banks may own 90% of this insurance exposure.

Finally we need to see if the rest of the world can decouple. Chris Berry's view, see Morning Note from last Friday, is that the second tier countries can come to the developed world's rescue. These are called the Timbi's (Turkey, Indonesia, Mexico, Brazil and India). The demographics are better here and growth rates Ok. Quality of Lifestyle cycles are exploding. But in the short run, the 2012 /2013 timeframe, we are wary.

So what to do? First and foremost, we reiterate and reemphasize, you should own gold or silver in kind and keep an allocation in your possession. We believe these metals will appreciate significantly going forward due to the catalysts listed above. We think that the European Central Bank and the Fed will be forced to try again to inflate, to increase the money supply.

The U.S. dollar has not been a store of value while gold has continued to be so, particularly over the past decade. Second we think this is a good time to review your discovery holdings using the Discovery Investing 10 point grid.

In particular Factor 7 (Financial Soundness and Sustainability) will be critical this year and next<sup>ii</sup>. Review every one of your discovery holdings, word-scoring this factor and rating it "very important" perhaps even "mandatory." Then view your company's new DiS ranking. If the ranking has fallen and, more important if the Crowd Score has fallen, you need to re-think this investment position. I think you should also re-score the Ownership and Control factor and the Investment Sentiment factor. These could become more importance in the 2012 /2013 timeframe. By the same token the Contrarian (valuation) factor, perhaps, should receive a lower word-score or a lower level of "importance."

Here are a few Mature discovery companies that we think have more sustainability. They are Revett Minerals (cash flowing from its Troy mine), Midway Gold and Hecla. Incubator companies that are of interest to us include Challenger Deep, Sandspring, Terraco Gold, Northern Graphite and Senesco Technologies.

If you have an interest in the Discovery Investing Software please sign up as on the system. We require only that you remain an independent thinker and score your companies as frequently as possible / necessary. Your scores will remain anonymous and you will enjoy the experience.

You will be happy to have reviewed your portfolio using the DiS software (all US and Canadian stocks are available) when the music stops as we think it will sometime in the next two years. In the meantime if Brussels and Washington continue easing as we think they must equities in general might surge ahead. But at some point, easing strategies will cease being effective and that is when the music will stop.

Please see MN two for access to the Discovery Investing Scoreboard.

## 2. Access to the Discovery Investing Scoreboard

### **MN Subscribers: Discovery Investing Scoreboard is now available free of charge!**

I want to alert all of my subscribers to a new investment tool called the Discovery Investing Scoreboard (DIS) ([www.discoveryboard.com](http://www.discoveryboard.com)), which has been mentioned in recent MNs. The DIS platform has particular application to the junior mining, biotech and high-tech sectors, where the traditional investment analysis metrics such as P/E ratios or cash flows are often simply non-existent. It allows you to evaluate any publicly listed US or Canadian company based on a set of forward-looking factors that cover the primary types of information gained from conferences such as Cambridge House.

DIS uses some sophisticated computational intelligence technology to account for the inherent imprecision in this type of evaluation and to allow for the variable importance of different factors and the requirement that some of them may be considered mandatory for a company to obtain a good score. However, all this is implemented within a user-friendly interface that only asks for word inputs from the user. Another unique feature of DIS is the computation of a crowd score that reflects the consensus of all users about a given company.

All company scores computed within DIS are relative to the same 0-10 scale, which allows them to be compared directly from one company to another. There is no comparable tool that enables this kind of investment analysis. Rather than having to combine all of the relevant information on a given company in your head, and even worse, having to compare all of this information across multiple companies, you can now enter your evaluations into the DIS system on a rational basis and see the overall company scores that result, as well as get a picture of the range of uncertainties about your scores. You can then rank and compare your own company scores against the crowd scores to make investment decisions.

We have made the system available on a free basis. On the home page you can select among several tutorial videos under the “Learn” menu (I recommend you view at least the first two videos listed to get started). There’s also a short user guide available at the top of the Learn menu. Click on “Become a Member,” to go to the Registration page, where you can sign up for free. There are additional tutorial popups and videos that can be accessed from the blue question mark circles on both the scoring page and the results display page. I think you’ll find DIS to be a great tool and easy to use.

An important point to note in using the system: the most reliable crowd scores arise from having users independently score a company, without collaborating on their evaluations. So please use your own judgment in scoring rather than consulting with others about it.

Please use this system as you wish but maintain your independence of thinking. When in doubt you can use a crowd score for a factor till you research that aspect of the company. Your scores will be anonymous except to you. Two great books to read on this topic are: “The Wisdom of Crowds” Surowiecki 2004 and “Thinking Fast, Thinking Slow” Kahneman 2010. Let me know how it goes.

*The material herein is for informational purposes only and is not intended to and does not constitute the rendering of investment advice or the solicitation of an offer to buy securities. The foregoing discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (The Act). In particular when used in the preceding discussion the words “plan,” confident that,*

*believe, scheduled, expect, or intend to, and similar conditional expressions are intended to identify forward-looking statements subject to the safe harbor created by the ACT. Such statements are subject to certain risks and uncertainties and actual results could differ materially from those expressed in any of the forward looking statements. Such risks and uncertainties include, but are not limited to future events and financial performance of the company which are inherently uncertain and actual events and / or results may differ materially. In addition we may review investments that are not registered in the U.S. We own shares in Senesco Technologies, Revett Minerals and Northern Graphite. 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.*

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<sup>i</sup> International Swaps and Derivatives Association

<sup>ii</sup> Please see our DiS You Tube videos for a short description of each of the Discovery Factors.

<http://www.youtube.com/playlist?list=PLB3B02A07A161C48D>