



The Nightmare Scenario Unfolds: China Abandons the Dollar

We started out this year with one prediction:

Rates on 10-year government bonds have nearly doubled since last year. I expect this trend toward higher rates (lower bond prices) to continue – for a long, long time. This trend – toward higher interest rates in the United States – is the single most important trend in finance. The great bull market in paper money, central banking, and the faith and credit of the United States is over. After all, our leaders have no faith. And we have no credit.

Unfortunately, the problems we face are getting worse at a faster pace. We began the year by shorting bonds. This month, we'll add two stocks to our short positions.

I know most subscribers won't short stocks. I'll do my best in this issue to explain why you must.

U.S. stocks are woefully overpriced, and runaway inflation will drive stock valuations down. If you're not willing to hedge your exposure to the stock market with short positions, then you need to go completely to a cash position hedged with gold. I'll show you how to do that in this issue, too.

First though... let me tell you why I think you ought to be very, very concerned about the future of our global monetary system.

Last week, I was invited to a client meeting in Miami held by the wealth-management firm AllianceBernstein. (I ran into an Alliance member there, too. Thanks for saying hello...) Bernstein's investment research has long been regarded as the best on Wall Street. Why? Bernstein does honest, thorough work because it doesn't engage in investment banking. It's paid to be right, not to sell retail clients down the river to pull off a public stock offering or sell a bond.

In Miami, the firm's head economist spoke about the dynamics of the global currency markets and explained AllianceBernstein's trading strategy. It borrows in four to six currencies with low interest rates and buys four to six currencies with higher interest rates. This diversified approach reduces risk substantially. And it has *historically* produced better average returns than the S&P 500 with less volatility.

The presentation was designed to entice wealthy U.S. investors to open leveraged foreign-exchange

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Editor: Porter Stansberry

trading accounts with AllianceBernstein. And I must say, the presentation was among the most sophisticated I've ever seen. The economist really knew his stuff. But... I was deeply troubled by the presentation.

In my experience, whatever the big brokers are pitching to retail clients, that's the thing most likely to blow up next. I'd never seen a Wall Street firm give a leveraged currency presentation to retail clients before. While this kind of trading can be very profitable, it is extremely risky – especially right now.

For the first time since just after World War I, we have serious sovereign debt problems in all of the major currencies. And for the first time in the history of man... we have a global monetary base that's not anchored to any real asset. In fact, the largest reserve assets of the world's monetary system are obligations of a bankrupt nation (the U.S.) that must print money to afford its own annual deficits.

This is a recipe for disaster.

I believe the entire system of paper money – globally – is coming unglued. The result will be a kind of volatility and disruption to the global economy the world hasn't seen since WWI, when the gold standard ended in 1914.

Ironically... ignorant of these enormous risks... retail investors are running full speed ahead into foreign-exchange trading. Deutsche Bank reports its currency trading platform for retail clients saw a 40% increase in customers during 2009. In the U.S., foreign exchange volume was up

28% last year – almost entirely because of retail trading. I suspect these numbers will continue to grow for a while, but I urge you to avoid this looming disaster. While trading foreign currencies has been a good strategy for a long time... what will happen to those strategies as volatility soars and the large currencies collapse? No one knows.

But one thing I do know for sure: It won't end well for retail investors. Someone has to hold the bag for all of the world's paper money. Who do you think will end up holding the bag? Retail investors or giant institutions like AllianceBernstein?

The World's Paper Currencies Are Falling Apart

Right now, I wouldn't willingly hold my savings in any paper currency in the world. The debts and deficits are far too large, the interest rates too small, and the politicians too crooked (although that almost never changes).

I firmly believe my two-year-old son, Traveler, will be astonished to learn his father once earned, saved, and invested with paper money. By the time he is old enough to know what money is, the entire paper money system will have collapsed. Historians will study the paper-standard period (the global monetary system from 1971-2010) with awe. How, they will wonder, could the entire world fall for such an obvious con?

In Europe, you've got a paper money system that's not backed by anything – not even a political union. As my friend Doug Casey likes to explain: The U.S. dollar's intrinsic value is zero – the dollar is an "I.O.U. nothing." But the euro is a "who owes you nothing?" Nearly all of its members' economies are debt-laden, socialistic shambles.

Consider Italy. Even though it collects 43% of its GDP in taxes(!), the country can't run a balanced budget. Its total debt to GDP is now 103%. The same is true for Greece, Spain, and Portugal. Even the so-called healthy economies, France and Germany, have huge structural problems with enor-

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mous welfare obligations and aging populations.

In Japan, you've got an ongoing, multidecade economic decline with a government sector that's bankrupted the nation while suffocating all private capital. Japan has an enormous debt-to-GDP ratio – 170%. That's second only to Zimbabwe. Imagine historians trying to explain why the world's creditors allowed one of the three major economies in the world to become as debt-laden as the most backward African dictatorship. There's really no way to explain it.

And with the U.S., you have an acute short-term funding crisis that could spark a global run on the dollar at any moment. This is by far the most serious problem because the dollar isn't just another major currency. It is the world's reserve currency, the foundation of the entire system.

Unfortunately, our government's finances have begun to look like a giant banana republic on the eve of devaluation.

The annual funding costs of our national debt are approaching \$4 trillion per year – that's \$1.5 trillion in new annual deficits, plus \$2 trillion-\$3 trillion a year in short-term obligations coming due that need to be refinanced. Foreigners hold roughly half of this debt. Thus, we have about \$2 trillion a year in foreign debt that must be repaid or refinanced each year. This is dangerous because we only have about 25% of the reserves needed to cover our short-term foreign debt. This is clearly a violation of the Greenspan-Guidotti rule. (Please review the November 2009 *PSIA* for more about this obscure, but vital concept.)

It's tough to understand the size of a \$2 trillion annual obligation. It's so large it's meaningless to most people. I could tell you \$2 trillion is 20% of our GDP, but even then, you probably won't understand just how much money this is. So think of it this way...

If you spent \$1 million per day from the time of the founding of Rome – roughly 2,700 years ago – until today, you would have accumulated about \$1 trillion in debt*. Now, double that

amount. And that's the size of our *annual* foreign borrowing obligation.

[* Thanks to Eric Margolis for the trillion-dollar metaphor. See his essay, "Spending America Into Ruin," here: <http://www.lewrockwell.com/margolis/margolis179.html>.]

A Critical Weakness at the Center: The End of America

If our foreign creditors stop funding our debts, we will have a currency crisis.

Not one mainstream economist in 100 thinks this is possible. This doesn't bother me. These same guys told me I was crazy for thinking GM would go bust – the government would never allow it, they said.

You don't have to rely on their naïve opinions or my warnings. Just look at the numbers and ask yourself one simple question: How could our government replace the \$2 trillion we're borrowing from foreigners with domestic savings? It can't. We don't have the money. Our total domestic savings only come to about \$600 billion. If you add together ALL of our domestic savings and currency reserves, you only end up with about half of our annual foreign funding requirement. This puts us completely at the mercy of our foreign creditors.

And here's the bad news: Our foreign creditors have begun abandoning the Treasury market.

Here are three facts you need to memorize. Write them down. Tape them on your refrigerator:

- 1) The U.S. Treasury announced this week China – formerly our largest creditor – sold \$34.2 billion worth of Treasury obligations in December 2009.
- 2) Total foreign holdings of U.S. Treasury obligations fell for the year in 2009. This is a reversal of a 30-year trend.
- 3) Central banks were net buyers of gold for the first time since the end of the Bretton

Woods monetary system in 1971.

This is a shot across the bow to America's empire of debt. It's a wakeup call to everyone who believes, like former Vice President Dick Cheney infamously said, "deficits don't matter."

Deficits don't matter... up until the minute they do. That minute arrives when your creditors won't roll your debt forward. If the Chinese stop buying our bonds, the only way to close America's funding gap is with a massive inflation... And the Chinese have stopped buying our bonds.

We've been papering over the funding gap through Federal Reserve purchases of Treasury bonds and so-called agency securities, which are Treasury-guaranteed obligations of Fannie and Freddie. You can see this for yourself by looking up the results of the weekly U.S. Treasury auction.

You'll see a large buyer called "SOMA," an acronym that stands for "System Open Market Account." That's the Fed's account. For example, at last week's auction of 30-year Treasuries, SOMA accounted for 11% of all purchases, just shy of \$1.8 billion worth. Since Lehman fell in October 2008, the Fed has spent around \$2 trillion on these purchases.

Printing up trillions to finance the government's deficit is dangerous. It leads to inflation and ruins the credit of the government by showing the world we can't legitimately finance our debts. And consider this: U.S. Treasuries and agency securities make up about 60% of the world's banking reserves. When we inflate the U.S. dollar, we inflate the world.

It's not hard to imagine what comes next: soaring hard commodity prices... a big reduction in available credit... sharply higher interest rates... and massive economic disruption. The Chinese know what's coming. They have been buying hard commodities, particularly gold, oil, and copper.

And China isn't the only big seller of U.S. Treasuries. Total foreign holdings of Treasury obligations fell by \$53 billion in December, the

largest monthly reduction ever. What are central bankers buying in lieu of the U.S. dollar? Gold. Central banks were net buyers of gold for the first time since the U.S. abandoned the last vestige of a gold standard (Bretton Woods) in 1971. That's how the dollar standard ends – central banks flee to gold. Gold is the only traditional reserve asset that isn't someone else's liability. It's the ultimate form of savings.

Who else is buying gold? Elite hedge-fund managers. Just after I wrote my November issue, George Soros began buying massive amounts of gold. He bought more than \$600 million worth of the gold ETF (GLD), becoming its fourth-largest owner. Gold is now Soros' single largest investment position. Probably no one else in the world has more experience trading successfully around bankrupt governments. **If Soros is buying that much gold, it means he knows the U.S. dollar is going to collapse.**

These trends are troubling. They prove America doesn't have an unlimited capacity to fund its deficit spending. We can't simply get away with printing our way out of debt because our trading partners and our creditors have at least one option: gold.

I've been warning about the probability (not the possibility) of this "doomsday" scenario, where the U.S. dollar collapses and loses its status as the world's reserve currency for several years. I call this scenario "The End of America" because without the privilege of controlling the world's reserve currency, our standard of living will crumble. I've seen currency collapses firsthand in places like Argentina. The middle class is wiped out because it can no longer afford its debts. People lose their assets in the midst of soaring inflation. It's horrible.

Turning Good Credit to Bad

I know that for most of you this outcome is simply unthinkable. That could never happen here...

Never is a long time. You must remember the

goal of all currency and credit manipulation is to create credit where none actually exists. If you study the history of John Law – the original promoter of paper money in the West – or any other credit bubble, you discover they were all paper-shuffling schemes designed to give bad credit the appearance of good credit.

John Law, an 18th century Scottish economist, turned a horrible credit risk (the bankrupt government of France) into the most desired financial asset in the world, simply with promotion.

Law launched the first paper money bank in France – The Royal Bank. Its notes were legal tender and could be used to pay taxes since the French crown owned the bank. Using the bank's "capital" – which was nothing more than paper claims on a bankrupt country – Law bought the Mississippi Company, which held a monopoly on trade with France's colonies. Of course, this was all a show – the crown owned the bank, and it already owned Mississippi. No title had changed hands. But it wasn't hard to convince people Mississippi was worth more than the rest of France combined.

To raise real capital, Law began exchanging publicly held French debt for notes in the Mississippi monopoly. He kept increasing the dividends paid and adding new monopoly companies to the bank's portfolio – all of which drove investors to distraction. The price of the bank's shares soared from 500 livres in 1719 to more than 18,000 livres by 1720. But the entire scheme collapsed in 1721 when investors came to their senses and realized they had been buying the assets of a bankrupt nation the entire time.

Now... think for a moment about the subprime crisis. The financiers engineered a way to turn subprime mortgage credits into securities that resembled triple-A-rated bonds. In reality, it was all just paper shuffling. Most of the "buyers" of subprime real estate didn't put any money down. Nor did a large percentage of these "buyers" have any real capacity to meet these obligations. Nevertheless, investors came to believe these sub-

prime loans were as good as the highest-rated corporate and sovereign debt.

What happened? By improving the appearance of the credit, the investment banks and the mortgage brokers lowered their borrowing costs and expanded the amount of credit they could obtain on subprime real estate. Lending boomed. Housing prices soared.

Unfortunately, as with John Law's bank notes, none of this actually improved the creditworthiness of subprime loans. The prosperity manufactured by paper shuffling didn't last. It never does. Sooner or later, the reality of the poor credit is always exposed. The newly created "wealth" disappears. Credit disappears (because no credit was due). Interest rates soar. Asset prices collapsed. A bust follows the boom.

The same thing happened in the emerging markets in the early 1990s. The Asian "Tigers" decided to peg their currencies to the U.S. dollar. Almost overnight, weak currencies, like the Indonesian rupiah, were considered nearly as reliable as the U.S. dollar, merely because the central bank of Indonesia promised to support the currency. In the early 1990s, Indonesian interest rates plunged. Available credit soared. Asset prices soared. The finance minister was hailed as a national hero – he'd created an enormous amount of prosperity almost instantly.

But of course, the Indonesian rupiah wasn't as reliable as the dollar. Holders realized the Indonesian central bank couldn't meet its promise to hold the rupiah exchange rate to a fixed dollar value. The exchange rate fell from around 2,400 rupiah to the dollar in July 1997 to less than 14,000 rupiah to the dollar by mid-1998. Inflation soared to 60% annually, and interest rates went to more than 80%.

Financial history is unanimous on this point: Sooner or later, the real quality of the borrower is revealed.

Now, consider the euro. Prior to the creation of the euro, a crisis like the current one in Greece

would have sent interest rates on the debt of other shaky economies rocketing. Italian sovereign debt would have been 500 to 700 basis points (or more) higher than similar German government debt. In other words, if German bonds were paying investors 5%, Italian bonds would pay investors 10% or 12%. The higher cost of credit for Italy would make up for the higher risk of devaluation. Italy, quite simply, isn't a good credit risk. It's subprime sovereign debt.

But with the euro in place, Italy's debts are considered almost equal to Germany's. The market believes the euro currency union imposes better economic management on Italy and implies a German guarantee if anything goes seriously wrong. Poof... as though by magic... a poor credit (Italy) turns into a great credit – at least on paper.

What happened to Italy after the introduction of the euro? Italy borrowed more and more money every year, taking advantage of the low cost and availability of credit. Asset prices in Italy soared as this debt produced an investment led boom.

What will happen next? You should already know. Sooner or later the poor quality of the credit will be exposed. Italy's lenders will take huge losses. Asset prices in Italy will collapse. Interest rates will soar. The same will happen across the euro zone. And the euro will be exposed for what it really is – just another paper money scheme. No different than John Law's bank or Bear Stearns' subprime CDOs.

But what about the U.S.? When will the real quality of U.S. credit become apparent to our creditors? How long will our paper currency scheme last?

Drowning in Debt

I believe the problems of Japan and the euro will hasten the demise of the U.S. dollar. Investors are beginning to look at the real credit quality of all sovereign borrowers – even the U.S. Sooner or later, they're going to ask themselves: How will America ever repay these debts? How can it even

afford the interest on these obligations? And what are the ramifications for the world's paper currency system if the U.S. defaults?

The answers, my friends, aren't pleasant. Credit will disappear. Interest rates will skyrocket. Asset prices will collapse, while our currency plummets in exchange value – meaning the prices of hard commodities will soar. I'd expect the average American to lose 50% to 75% of his purchasing power in the first year after the devaluation of the U.S. dollar, if not more.

I know this will happen. It is not a question of if, only when.

I believe we're approaching this end game faster than anyone realizes. For the last year, the Federal Reserve has been buying stupendous amounts of long-term credits – both mortgages and Treasury bonds. Specifically, the Fed announced it would buy \$1.75 trillion (that's not a typo) of mortgages and Treasuries between March 2009 and March 2010. This is an attempt to fool the world into believing our credit markets are safe and long-term U.S. dollar interest rates won't suddenly rise.

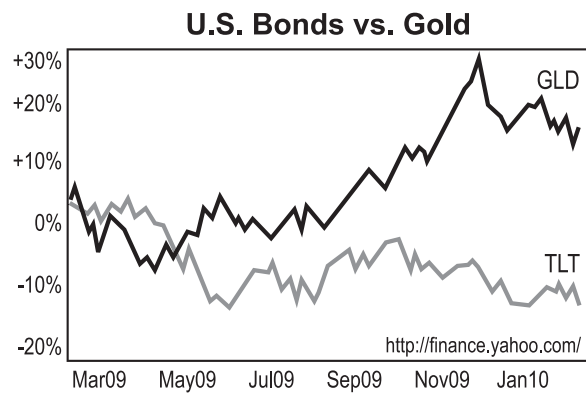
Imagine what would have happened in our economy last year if the Fed hadn't printed \$1.75 trillion to throw at long-term interest rates and the federal government hadn't run a \$2 trillion budget deficit. Last year, we borrowed or printed nearly \$4 trillion and injected it into the U.S. economy – that's roughly 40% of GDP!

Even with all of this stimulus, the economy is barely growing. Meanwhile, the creditworthiness of our government, central bank, homeowners, corporations, and consumers continues to fall. Here's the best way I can show you what I mean.

The Barclays iShares 20+ Year Treasury ETF (TLT) tracks the value of the U.S. government long-bond market. This is the primary market the Fed was trying to support over the last year. Gold, on the other hand, is the best market-based judge of the soundness of the U.S. dollar and our creditors. The SPDR Gold Shares ETF (GLD) is an

accurate proxy for the price of gold.

Look what happened to U.S. bonds (TLT) and gold (GLD) over the past year. This occurred even as the Fed was massively intervening in the credit markets.



The value of the U.S. long-bond market fell by more than 10% despite the government support. And the value of gold increased by more than 10% as investors fled the dollar. It's interesting the relative moves were nearly identical. There's no free lunch. For every penny the government prints or borrows and uses to manipulate long-term interest rates, that same penny is being taken out of the value of the U.S. dollar, as is revealed in the price of gold.

You will see lots of debates about what the coming currency crisis means. But if you can understand this chart, you will grasp what's happening and how to protect yourself. It's simple: The value of the dollar is collapsing as the uncreditworthiness of the United States becomes evident. That means the price of hard assets – like gold – will keep rising and the value of our government's long-term obligations will fall.

Unfortunately, I believe this trend will explode soon, when our creditors suddenly decide the costs of holding their dollar obligations vastly outweigh the benefits. You won't want to be holding dollar-denominated assets on that day – especially not expensive stocks.

You see... it's not only the government whose

credit has declined. In 1980, 32 U.S. corporations had triple-A credit ratings. By 2005, only eight retained a triple-A rating: AIG, ADP, Berkshire Hathaway, ExxonMobil, General Electric, J&J, Pfizer, and UPS.

Today, only four are left: ADP, J&J, Microsoft, and ExxonMobil.

That's an 87.5% reduction in top-quality credit. And while credit quality has declined in corporate America, total debt loads have soared. This is a serious problem. At the very least, I expect equity valuations to fall significantly as interest rates rise. Right now, the S&P 500 is trading at about 25 times earnings. I think we'll see this multiple fall in half and stay depressed for a long time. That would send stocks down, on average, by 50%.

The consequences of a currency crisis are so horrible I often sit and think to myself... I must have this all wrong. Things can't possibly be this bad. But then I look at all of the numbers again. I've spent my entire career following the numbers and reaching my conclusions based on the numbers alone. They've never led me astray. They've given me the confidence to reach correct conclusions literally unthinkable to other analysts.

Given the hard choice between a reality that's hard to accept and a delusion that's impossible to trust, I'll pick the reality. I hope you do the same.

The fact is... our country is bankrupt. It is only a matter of time before investors abandon our currency. It is only a matter of time before credit becomes vastly more expensive and our dollar is worth much, much less. While some people will benefit from this disruption, the economic chaos these changes will bring will destroy much, much more.

So... what should you do with your savings?

The safest thing to do right now is to split your savings between short-term Treasuries and gold. That's the equivalent of a "cash" position, as the gold will hedge your dollar exposure and the

short-term Treasuries will mitigate the volatility of gold. You can do this through exchange-traded funds (ETFs). The Barclay's iShares 1-3 Year Treasury ETF is an easy way to own short-term Treasuries. The symbol is SHY. And GLD is the most liquid gold ETF.

I personally hold my gold in bullion coins and recommend you do the same. It's better and safer than the ETF. But for lots of people, the ETF is simply more convenient. As for safety, considering Soros bought more than \$600 million of it, you've got to assume it's pretty safe.

But understand, this totally safe approach will not generate much income. SHY is paying a 1.6% annual coupon, and GLD pays nothing at all. You'll be earning less than 1% on your assets – but they will be safe.

On the other hand, if you need to generate income or you want to see your money grow at any reasonable rate, you're going to have to take some risk and speculate. There's simply no other option when you're faced with our current macro-economic outlook.

Why Now Is the Time to Sell Stocks Short

The safest trades I can find right now are actually selling stocks short.

Most people think shorting stocks is risky. But right now, the bigger risk is buying stocks. Think about our strategy this way... During a boom, as more credit becomes available, asset prices inevitably rise. Capital becomes easier to get. Companies find it easier to grow. Customers find it easier to buy. During a period of collapsing credit, the exact opposite occurs.

So if it makes sense to own equities during a credit boom, doesn't it make sense to sell equities during a bust? I think so. I'm going to do my best to protect your wealth by finding the companies most likely to fall in price over the next year or two. Even if I'm completely wrong about the com-

ing collapse of the global paper currency system, we could still do well shorting these stocks.

To sell stocks short, you need to know the three basic approaches. First, you look for frauds. The problem is, frauds don't happen all that often, and they're hard to discover. Unless we get a specific tip from an insider or unless we happen to stumble across something egregious in an SEC filing, we probably won't find opportunities here. (If you have any direct knowledge of fraud at a public company, please contact us: feedback@stansberryresearch.com.)

The second approach is to pick out overly indebted firms, like General Electric. These are probably my favorite situations in all of finance. There's something reassuring about shorting a company that cannot afford its debt. It's like playing chess when you've got your opponent locked up. The game might be four or five moves from checkmate, but you can see it coming and you know your opponent has no way out.

But this month, we're not going to write about frauds or bankrupt companies. Instead, we're focusing on the last category of stocks you should sell short – companies whose business model has disappeared because of technological innovation.

I don't care if you were the best buggy-whip maker in the world, once Henry Ford started selling cars people could afford, your fate was sealed.

Shorting stocks whose business is disappearing because of technological innovation is surprisingly hard. Lots of these buggy-whip stocks have good balance sheets and talented managers. It usually takes longer for these companies to roll over than you expect. But they can be spectacular long-term trades and give you plenty of protection against bear markets. I shorted Kodak in 1998 when I bought my first digital camera. It went almost straight down for the next 10 years and was a fantastic hedge against my exposure to tech stocks during the bear market of 2001-2002.

Over the next few months, I plan to add four

to six short recommendations to the portfolio, while trimming some of our exposure on the “long” side. This will hopefully allow us to continue to produce positive returns in the face of a severe crisis.

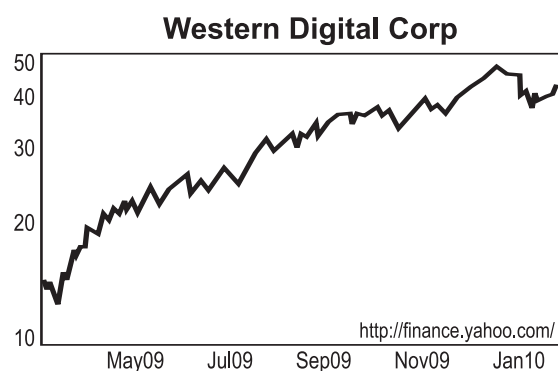
\$18 Billion of Obsolete Equity

In the spring of 2003, I predicted a massive boom in demand for hard drives, as data of all kinds found their way onto digital disks.

I knew new kinds of media – like YouTube and Gmail.com – would produce more digital content than had ever been created before. And I knew as more and more people adopted broadband Internet connections, they’d inevitably need much larger hard drives to save their data.

I studied all of the hard-drive makers and recommended the shares of **Western Digital (NYSE: WDC)**, the leading maker of consumer hard drives. It was trading for less than \$10 at the time. I wrote: “If I’m right and there is a new storage boom beginning, Western Digital running to a new high share price (\$50) will only be the beginning. There’s a lot of upside here over the next three to five years.”

I was exactly right about the boom in digital storage. And I was mostly right about Western Digital. It didn’t quite make it to \$50, but it came close.



In 2003, I predicted demand for digital storage would boom over the next five years and Western Digital's stock would reach \$50 per share...

But for Western Digital, the boom is over. Consumers don’t need its product anymore. Users are already adopting two new kinds of storage technology that completely eliminate the need for Western Digital’s hard drives.

Just to be clear, I don’t think demand for digital storage has slowed. In fact, it’s increasing at about the same rate as bandwidth usage. According to various sources (Level 3, Cisco, government statistics), traffic on the Internet is growing at roughly 50% a year. And since all of those bits of information being passed around the Internet have to be stored somewhere, demand for storage is growing at approximately the same rate.

For a long time, this growth propelled Western Digital’s earnings because most consumers stored their data on their home computers (which used Western Digital hard drives). In the fiscal year after my 2003 recommendation, Western Digital saw revenues of \$3 billion and earnings of 74¢ per share. By 2008, Western Digital revenues totaled more than \$8 billion, and earnings per share hit nearly \$4. In only four years, Western Digital grew its revenues by 166% and its earnings per share by 429%. Its share price rose from around \$10 to nearly \$50. That’s a boom.

So why would I recommend shorting a digital-storage maker in the face of escalating rates of bandwidth growth? Two reasons. First, most of the digital storage fueling the Internet growth today is being installed at the corporate level. For example, Microsoft’s new cloud computing service, SkyDrive, allows users to keep up to 25 gigabytes (GB) of data on their servers for free. That’s roughly 2.5 million e-mails. Or a pickup truck filled with books. Or about 12,000 digital photos. For most users, this is enough storage – for free.

Likewise, Gmail has greatly expanded the amount of free storage it offers. When Google launched the e-mail service, it offered 1 gigabyte of storage. Today, it offers 7.4 gigabytes and the amount continually increases.

Similarly, dozens of small businesses, like

Carbonite, allow users to back up all of their files for around \$50 per year. These services are easier to use than an extra hard drive because they don't require any expertise – you just sign up and everything is backed up automatically.

Even worse for Western Digital is the increasing efficiency of solid-state storage devices – what's commonly known as “flash” media storage. Remember when the iPod first came out in 2003? It was about as big as a cigarette box and could hold maybe 2,000 songs. Its storage system was a tiny hard drive. A few years later, Apple introduced much smaller iPods. They held fewer songs, but they were much lighter and much more energy efficient. They didn't have a hard drive at all, just a flash memory card – a semiconductor designed for memory.

Today's latest iPod – the iPod nano – isn't much bigger than a credit card. It has 16 GB of storage on a flash media card. It can store 4,000 songs or 16 hours of video – twice the capacity of the original iPod without using a hard drive.

Solid-state media devices will soon power all consumer storage (digital storage of less than about 500 GB). The trend started with the iPod, and it's spreading to laptops – a key market for hard-drive makers because now more laptops sell each year than desktop computers. Today, both Apple and Dell offer laptops with solid-state memory (flash memory) as an upgrade. I know because I bought one about two months ago.

There are lots of reasons to prefer solid-state memory devices over hard drives. The most important reason is durability. Hard drives have moving parts: a spinning magnetic disk and a moving read/write head. The system is basically a miniature turntable. Hard drives are engineered to last about three years. When your computer breaks, nine times out of 10, the hard drive failed.

Solid-state memory systems, on the other hand, have no moving parts. They eventually burn out, but they're engineered to last 15 years. They also require much less energy, which increases bat-

tery life on laptops and reduces heat. Solid-state memory is also much faster – you don't have to wait for the hard drive to boot up to begin working for example. (If you want to see a demonstration of the differences between hard-drive storage technology and solid-state memory, see this Intel-produced video: <http://communities.intel.com/docs/DOC-2998;jsessionid=4CC79A4B5FE7B0208E03A0CBB6AF31B>.)

Hard drives have been the leading type of consumer digital storage because they were much cheaper than solid-state devices. But solid-state memory systems are based on microchip technologies, and their productivity advances at the pace of Moore's Law – you can get about twice as much storage for the same price every 18 months.

These leaps forward in efficiency have finally overtaken hard drives at the consumer level. And the competition from solid-state devices will continue to get much more intense.

Guess who makes the highest-quality solid-state memory devices? Intel.

You do not want to compete against Intel. Nobody can survive competing against Intel. Think about it... Intel already makes nearly all of the microprocessors used in personal computers. It can optimize its memory cards for use with its processors. Hard drives won't be able to compete on price or performance for consumer-level storage needs.

The game is already over. Western Digital just doesn't know it yet. But the numbers don't lie. Last year was the first year since 2003 that Western Digital's revenues and earnings per share fell. Revenues were down 7.5%. Earnings per share fell 45%. Despite rising demand for digital storage, Western Digital's revenues and earnings fell. They did because solid-state competition is stealing disk storage market share.

Over the next 18 months, Western Digital will see its sales fall by more than 25% and its earnings disappear. Within the next three to four

years, the entire market for consumer hard drives will completely disappear. Solid-state memory will take over the entire market for consumer-level digital storage.

This is such a sure bet that it makes sense to short the entire consumer hard-drive sector. And that's very easy to do because there's only one other major manufacturer.

The other dominant hard-drive maker is **Seagate Technology (Nasdaq: STX)**. It has suffered the same sudden revenue decline beginning last year – only its numbers are worse. Sales fell by 22%. And earnings completely collapsed – the company lost more than \$3 billion for the year.

Both companies – Western Digital and Seagate – make essentially the same products. They split the market almost 50/50. Seagate is slightly larger. But Seagate has \$2 billion in debt. Western Digital only holds \$400 million in debt. They are both valued by the stock market for more than \$9 billion. Seagate will most likely never turn an annual profit again. Western Digital won't be profitable after the end of this year. The future value of both of these firms is zero. They're buggy-whip makers.

I recommend you sell both Western Digital (NYSE: WDC) and Seagate Technology (Nasdaq: STX) short. Use a 25% trailing stop loss. Be prepared to cover your short position after the shares have fallen 50% each.

Portfolio Review

In light of the concerns I have about the dollar, I believe it's time to be extremely cautious with our portfolio positions. I don't want to own stocks that don't pay substantial dividends or won't benefit from the coming inflation. That means we need to sell several long held deep value stocks: **Nokia (NYSE: NOK)**, **Valhi (NYSE: VHI)**, and **Chunghwa Telecom (NYSE: CHT)**. While these stocks are still cheap, they simply don't provide enough of an ongoing dividend to

give us the margin of safety we need right now.

Likewise, I think it's time to sell some of the assets we picked up at absurdly low prices during the market panic last spring. High-yield bonds are no longer providing enough of a cushion in terms of higher yields, so we will sell **HYG**. And we're selling our real estate fund, **C&S REIT Income (NYSE: RNP)**. We earned nice gains on both positions, but it's time to move on. Higher interest rates will hurt both of these positions.

I've also increased the risk ratings on virtually all our positions. It will be difficult for stocks to maintain their current prices in the face of an extreme disruption to the global economy and soaring interest rates. Now is definitely the time to have a hedged portfolio.

We now have six positions rated buy and six positions rated sell short. We're hedged.

Good investing,



Porter Stansberry
February 19, 2010

Porter Stansberry's Model Portfolio

Prices as of February 18, 2010

<u>"No-Risk"</u>	<u>Symbol</u>	<u>Ref. Date</u>	<u>Ref. Price</u>	<u>Recent</u>	<u>Div.</u>	<u>Description</u>	<u>Action</u>	<u>P/L</u>	<u>RISK</u>
Hershey	HSY	Dec-07	\$40.55	\$38.83	\$2.38	Chocolate empire	Buy	2%	2
Annaly	NLY	Nov-08	\$13.64	\$17.63	\$3.04	Gov. port. repair	Hold	52%	3
Exelon	EXC	Oct-02	\$21.47	\$44.46	\$12.05	Nuclear power	Hold	163%	4
Verizon	VZ	Feb-06	\$31.54	\$29.15	\$8.42	Blue-chip telecom	Hold	19%	4
Nokia*	NOK	Jul-04	\$14.65	\$13.44	\$2.75	Profitable telecom	SELL	10%	5
Valhi	VHI	Mar-05	\$16.11	\$18.41	\$19.62	Simmon's holding co.	SELL	136%	5
Chunghwa Telecom	CHT	Aug-07	\$13.91	\$18.81	\$2.40	Taiwan's Verizon	SELL	21%	5
<u>The "Next Boom"</u>									
Financial ETF	XLF	Aug-09	\$14.33	\$14.38	\$0.10	Fed manipulation	Buy	0%	2
Freeport-McMoRan	FCS	Nov-09	\$85.33	\$76.60	\$0.15	Inflation hedge	Buy	-10%	3
Silver	SLV	Oct-09	\$17.48	\$15.88		Money crisis	Buy	-9%	3
ConocoPhillips	COP	Apr-09	\$42.36	\$48.87	\$1.94	Cheap oil	Buy	20%	3
San Juan Basin	SJT	Jan-10	\$18.34	\$21.92	\$0.14	Safe natural gas play	Hold	20%	3
Gold Miners ETF	GDX	Dec-08	\$28.02	\$45.06	\$0.11	End of America	Buy	61%	4
Visa	V	Jun-09	\$66.50	\$86.96	\$0.36	Global money	Hold	31%	4
High Yield Bonds	HYG	May 09	\$76.66	\$86.19	\$4.17	Yield spread	SELL	20%	5
C&S REIT Income	RNP	May-09	\$6.31	\$10.58	\$0.60	REIT spread	SELL	77%	5
<u>Forever</u>									
Johnson & Johnson	JNJ	Jul-06	\$60.52	\$64.04	\$6.10	Blue-chip health	Hold	16%	4
<u>Victims</u>									
iShares US Bond	TLT	Jan-09	\$114.30	\$88.97	\$3.01	End of America	Sell Short	20%	5
Am. Electric Power	AEP	Apr-09	\$30.53	\$33.52	\$1.23	King of coal	Sell Short	-14%	5
First Solar	FSLR	Jul-09	\$144.00	\$126.29		Expensive solar	Sell Short	12%	5
General Electric	GE	Nov-09	\$16.02	\$16.24	\$0.10	Overleveraged	Sell Short	-4%	5
Western Digital	WDC	Feb-10	NEW	\$43.40		Obsolete tech	Sell Short	NEW	5
Seagate Technology	STX	Feb-10	NEW	\$20.73		Obsolete tech	Sell Short	NEW	5
Current PSIA Average	31.1%								
S&P 500 2009	21.0%								

* We sold covered calls on these stocks, adding the call premiums to the dividends.

Please note: our investment philosophy limits risk through the use of stop losses and trailing stop losses. Unless otherwise noted below, all "Next Boom" recommendations use a 25% TRAILING STOP LOSS; "No-Risk" recommendations use a 25% STOP LOSS; and all "Forever" recommendations carry no stop loss. NEVER ENTER YOUR STOPS INTO THE MARKET. KEEP SUCH INFORMATION PRIVATE.

How to use a trailing stop: A stop loss is a predetermined price at which you will sell a stock in case it declines. A "trailing stop" is a stop loss that "trails" a stock as it rises. For example, let's say you set a 25% trailing stop on a stock you purchase for \$10. If the stock rises to \$20, you would move your trailing stop to \$15 (\$5 is 25% of \$20, \$20 - \$5 is \$15). Only use closing prices, and never enter your stop into the market. For more information, see our frequently asked questions at www.stansberryresearch.com/secure/faq.asp.

PSIA's Model Portfolio does not represent any actual investment result. Our reference price represents only the price of our recommended securities at the time we wrote the recommendation. Our sell or "stopped out" price represents the closing price at the time a reasonable reader would have had the opportunity to sell - typically the day after such a recommendation is given.

Our risk label is based mainly on current share price and the nature of the business.

1 = the lowest possible risk. 10 = the highest possible risk.

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