



The Greatest Danger America Has Ever Faced

On May 11, 1931, the world – at least in financial matters – came to an end.

When you read Henry Paulson's book about the 2008 financial panic and the bankruptcy of Lehman Brothers, you'll see him describing his efforts to prevent a global collapse of the financial system.

What he was afraid of happened on May 11, 1931.

That was the day Oesterreichische Kredit-Anstalt was declared insolvent. Oesterreichische Kredit-Anstalt was the largest bank in Austria. Translated literally its name meant: Imperial Royal Privileged Austrian Credit-Institute for Commerce and Industry. The Rothschild family founded the bank in 1855. It was the leading bank of all of Eastern Europe. The Rothschilds, of course, were also the leading financiers of Europe. They were the king's bankers in every capital city. Thus, Kredit-Anstalt held assets and took in deposits from across Europe, particularly from Germany and England.

The bank was crippled in the crash of 1929.

It had come to the aid of a weaker Austrian bank, Boden-Kredit. A rescue package for Boden-Kredit was assembled by financiers from across the globe, including J.P. Morgan, Schroeder of London and, of course, the Rothschilds of Vienna. The Austrian government further guaranteed Boden's lowest-quality assets.

(If you think this sounds a lot like what happened when America's weakest financial institutions like Countrywide Mortgage, Bear Stearns, and Merrill Lynch failed, you win the Cracker Jack award...)

The bailout of Boden-Kredit worked... for a while.

Had the Smoot-Hawley Tariff of 1930 not split the world's economy in half, Kredit-Anstalt might have had enough time to see Boden-Kredit's loan book repaired. Instead, on June 17, 1930, Smoot-Hawley raised taxes on nearly 20,000 separate imported goods. Around the world, governments responded to the record-high American tariffs by retaliating with matching duties on America's exported goods. As a result, the world's economy collapsed.

In response to the collapse of global trade, Austria sought in early 1931 a free-trade agreement with Germany. This alarmed France, which feared the resurgence of a reunited German economy. So French

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Editor: Porter Stansberry

Who Was Reed Smoot?

It's a reasonable question to wonder how vastly higher tariffs were passed following the 1929 crash. Who could have possibly thought it was a good idea?

The tariff was the brainchild of Reed Smoot, the senior senator from Utah. In addition to his political career, Reed Smoot was one of the 12 Apostles of The Church of Jesus Christ Latter-Day Saints. His father, Abraham Owen Smoot, was a Mormon pioneer, a protégé of Brigham Young, and the second mayor of Salt Lake City. Abraham Smoot had six wives... and 27 children.

In part because of his unusual background and in part because of his leadership role in the church, Reed Smoot faced considerable national resistance to being seated in the senate. Elected in 1902, he wasn't seated until 1907. He won re-election in 1908 and rose in the republican party, becoming the senate finance chairman in 1923. However, immediately following the passage of the disastrous tariff that bore his name, he lost re-election in 1932.

bankers demanded an immediate redemption of all of the short-term loans they had extended to German and Austrian banks.

At the time, the world's international unit of exchange was not printed on paper. International exchange was handled in gold.

And because of the earlier losses associated with Boden-Kredit, Kredit-Anstalt could not meet the French banks' demands for its bullion. Overnight a global banking panic began, as creditors around the world began to think the banking system itself was insolvent. Depositors feared the world's banks couldn't meet legal demands for bullion. They were right.

Even though another rescue was attempted to stem the panic (the Bank of England, the Rothschilds, the Bank of International Settlements, and the Federal Reserve Bank of New York all contributed millions), the entire government of Austria

didn't have enough bullion to meet the demands of Kredit-Anstalt's creditors. The bank failed. And Austria itself went bankrupt because it couldn't meet its obligations to the bank in gold. It was forced to adopt a paper currency.

As the banking panic spread, Germany was forced to abandon gold in order to rescue depositors. And so was England. The rest of the world soon followed, including America, which declared a banking "holiday" in 1933, followed by FDR's seizure of all privately held bullion in the country and the end of the internal gold standard in America. (We held on to the illusion of a gold standard for international obligations until 1971.)

The historians among you are undoubtedly familiar with at least some of these events. Even the tepid student of history probably remembers the name of the Smoot-Hawley tariff. But few... and I would wager perhaps *none* of you, my dear subscribers... know the whole story of Kredit-Anstalt.

The Rest of the Story...

After the collapse of Kredit-Anstalt and after the bankruptcy of Austria, the Rothschilds took what was left of the bank and merged it with another Austrian bank they controlled, the Wiener Bank-Verein. It was renamed Kredit-Anstalt Bankverein.

From here the bank would go through a long series of permutations...

The bank was nationalized after WWII. It became the main commercial bank of Austria. Then, it merged with another state-owned bank, making it the Bank of Austria Kreditanstalt. That bank merged with German-Bavaria's HVB in 2000. And then, finally, in 2005, the Bank of Austria Kreditanstalt merged with Italy's UniCredit.

Don't worry about the details... The important concept for you to understand is, roughly 75 years after its collapse set off the banking crisis that ended the gold standard and destroyed the world's financial system, Kredit-Anstalt (now known as UniCredit) is once again the largest bank in Eastern Europe.

I believe it will soon fail again, setting off another global banking crisis that will signal the end of the U.S. dollar standard.

The bank is already in trouble.

In 2008, the bank's shares crashed because investors realized it was one of the largest owners in Europe of subprime mortgage-backed securities. Even today the amount of the bank's losses in subprime are unknown because it changed its accounting standards to avoid marking certain assets to market, reportedly to avoid taking a \$2 billion loss. Like many other large banks around the world, it was forced to raise capital on onerous terms.

Surprisingly, the government that came to its aid in late 2008 wasn't the U.S., Germany, Austria, or even Italy – it was Libya... That's right. Muammar al-Gaddafi is apparently a poor student of economic history. He invested more than \$1 billion in the company in exchange for a measly 3.6% stake.

But the bank's subprime losses were only the beginning.

One of UniCredit's largest subsidiaries was an elite private bank – Bank Medici. On January 4, 2009, the *New York Times* revealed the bank had invested a large portion of its assets with Bernard Madoff. The total losses reportedly total more than \$2 billion.

Only days later, UniCredit was forced to raise \$4 billion euros from public investors at a 29% discount to its previous share price, pushing the company's share price down to less than two euros. Essentially all of its shareholder equity was wiped out. Today its core, Tier 1 capital ratios are still among the lowest in Europe, at less than 8%.

The bank... like its predecessor Kredit-Anstalt... is hanging on, having been left deeply wounded by the initial crisis. Will it survive?

I don't think it's possible.

Today, UniCredit is the largest creditor to Eastern Europe. It owns, for example, Bank Pekao, Poland's largest lender. It generates about half of its profit from Ukraine, Hungary, Romania, and

Slovakia. JPMorgan estimates loans to Eastern Europe will generate roughly \$40 billion of losses by the end of 2010.

And who will bail out UniCredit's depositors if it fails?

The Italian government? It can't. It is already struggling with enormous deficits and a debt-to-GDP ratio more than 100%. The rules of the European Monetary Union won't allow Italy's government to add that much more debt to its balance sheet.

So what will happen? Let me show you.

This Is a Global Monetary Crisis... And It Is Far From Over

I believe the crisis that began with subprime mortgages in 2008 will continue to spread until the world's sovereign credits collapse and the global system of paper money fails.

I don't make this prediction lightly. But let me show you the numbers. Then, I'll ask you two simple questions. You can decide for yourself if I'm likely to be right... or if I'm just another newsletter writer who has gone off his rocker.

First things first...

When the Great Depression happened, the world's financial system was based on gold – at least in principle. The fact is, the world's central banks had inflated their economies with so much money they couldn't possibly meet demands for bullion. Once people lost confidence in the system, it collapsed. Far too much credit had been piled into far too few productive assets.

Today though, there's no bullion to demand. So how can the system collapse?

Instead of using bullion, banks around the world use sovereign debt as bank reserves and the monetary base. The money is good – unless the sovereign goes bust. The problem is, once again, central banks allowed so much leverage into their banking systems there's simply no way any sovereign nation can afford the potential liability of a run on the

banking system. Today, too much debt has been piled onto too few taxpayers.

As an extreme example, take Iceland. By 2008, the country had external debts in excess of 50 billion euros, roughly 80% of which were foreign banking deposits. In 2007, Iceland's GDP was only 8.5 billion euros – a debt-to-GDP ratio of 488%. How was the government of Iceland supposed to guarantee the depositors of Iceland's banks? Think about it this way, Iceland's banks had more than half a million foreign depositors – that's more people than live in Iceland itself. The losses to foreign bank depositors come to more than 160,000 euros per resident of Iceland.

Now, obviously, Iceland's sovereign credit isn't the basis of the entire global banking system. At the base of the system lies the U.S. dollar. About 62% of the world's central bank reserves are U.S. dollars. I expect one sovereign collapse after another will put more and more pressure on the U.S. dollar. And before this crisis reaches its natural bottom, you will see the U.S. dollar destroyed as the world's reserve currency.

Not many people take my view seriously – yet. That doesn't bother me at all. Like I said, it all boils down to two questions. Any reasonably bright high school freshman should be able to answer these questions. And they point to one inescapable conclusion: The final collapse of the U.S. dollar is already well underway...

Why the Dollar Will Be Abandoned

Henry Paulson believed he could forestall the crisis in 2008 by substituting the Federal Reserve's balance sheet and the U.S. Treasury's balance sheet for our entire private banking sector. In the parlance

of Texas hold'em poker, it was an all-in move.

In total, the U.S. has doled out around \$10 trillion in TARP money, security purchases, and debt guarantees. Keep in mind, total U.S. GDP is roughly \$14 trillion. Paulson and Bernanke provided roughly 71% of GDP in additional money and credit to the banking system, almost overnight. By virtue of favorable accounting treatments, almost none of this was accounted for as U.S. government expenditures. Such a large amount of new money and credit is impossible to even describe – and it's hardly being counted right now.

People who think the problem is contained have no idea how many nonperforming assets are still on the books. Banks around the world have yet to truly mark their assets to market. Mortgage defaults continue to increase – especially in the U.S.

According to Lender Processing Services, the nation's leading provider of mortgage-processing and settlement services, more than 13% of all mortgages are either not current or in foreclosure. That's more than 7 million loans. And it's not just subprime. In fact, *prime* loans deteriorated at a faster pace than subprime loans over the last quarter. And the worst-performing prime loans have jumbo balances: principal amounts of more than \$417,000.

In February, RealtyTrac, which maintains a nationwide database of foreclosed, auctioned, and bank-owned homes, reported the number of foreclosures increased 6% over February 2009. While that's a slower annual rate of growth in foreclosures, the types of loans now defaulting – jumbo prime loans – will cause banks serious losses. And that's not to mention the looming disaster in commercial real estate mortgages, which make up the lion's share of assets at regional and local banks.

Instead of doing anything to actually solve these problems, our leaders are arguing about launching a new enormous entitlement program (health care) that will require huge tax increases. It's clear they have no understanding of the magnitude of the crisis we face. Instead of cutting taxes and cutting the size of government by a large amount, they've papered over our banking system losses with make-believe

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money – phony insurance schemes that are actually insolvent.

Take the FDIC. The U.S. currently has more than 700 insolvent banks that need to be rescued. Total assets at these banks exceed \$400 billion. But right now, the FDIC's deposit insurance fund has a negative balance of \$20 billion. Currently, the reserve ratio at the FDIC – that's the amount of money the FDIC has to protect creditors divided by the total amount of insured deposits – is *negative* 0.39%. By law, the FDIC is required to keep a minimum reserve ratio of 1.15%. At some point this year, the Federal Reserve will approve a line of credit to the FDIC of at least \$500 billion. Mark my words: *This will happen*. And none of this money will ever appear on any congressional appropriations bill. It will be created out of thin air.

Look at Fannie Mae or Freddie Mac. As any longtime subscriber knows, these firms are totally insolvent and rely on the government for all of their funding. Last year, these two firms made up 87% of the entire mortgage market for single-family homes. Without the direct support of the federal government, it would probably be impossible to get a 30-year fixed mortgage – the mainstay of the mortgage market – at any price.

And what does this support cost? To date, the U.S. Treasury has invested nearly \$100 billion into senior preferred shares of Fannie and Freddie, which are worth precisely zero. I've previously estimated the U.S. will end up spending around \$500 billion to cover the losses on mortgages Fannie and Freddie owned or guaranteed as of the end of 2008.

The other big government housing agency – the FHA – will experience losses of a similar magnitude. The FHA insures mortgages for subprime-rated borrowers, most of whom have made only a 3.5% down payment. As Fannie and Freddie tightened lending standards in 2009, the FHA did its best to make up for the loss of liquidity.

Currently, the FHA insures roughly \$800 billion in mortgages – a 42% increase over 2008.

When you start adding up the likely future losses – all of which will end up on the balance sheet of

the Federal Reserve or the U.S. Treasury – and then you begin to consider our record-setting current fiscal deficits and our soaring total debt load, you must begin to wonder: Can the system hold together?

Democracies Are Horrible Credit Risks

As a democracy, we (and every other major industrial nation) are unlikely to approve policies that require us to pay back our government's debts. We are even more unlikely to approve policies that require us to pay back our banking system's debts. And we are most unlikely to pay back *foreign* banking system debts.

As evidence, look at the rioting in Greece. Here the government can't even convince its own people to merely pay for their social welfare programs. Iceland recently put forth a measure to repay its foreign bank depositors over a 15-year period. It was voted down by more than 90% of the public. It is still unclear how Iceland will settle its bankers' foreign obligations.

I know you think Iceland must be a horrendous aberration. But consider these numbers: *In the United States, overall debt-to-GDP stands at nearly 400%*. That's right now, today. This only figures in a fraction of the trillions that have been guaranteed to the banking and housing sectors. That's the highest ratio on record, and it's not far from Iceland's peak debt-to-GDP ratio (488%). To give you some perspective on how out of control our debt problem has become, just consider that over the last 10 years, our total debts have risen by nearly \$30 trillion while our GDP has grown by less than \$5 trillion.

Keep in mind, all of these obligations are on the books right now. I'm not even going to mention the \$40 trillion in future obligations our government has pledged to Social Security and Medicare recipients. Social Security will begin requiring a government bailout in 2017, according to the latest numbers.

But the biggest risk to the U.S. government's balance sheet isn't the soaring costs of these transfer payments or the wars in Afghanistan and Iraq, or even the enormous losses in our banking system. **The biggest risk is a loss of confidence in the dollar.**

If our creditors begin to demand higher interest payments from us, we are in big, big trouble. Roughly half of our total government debt is owed to foreign creditors. Right now, the U.S. is paying less than 2.5% in interest on the \$10 trillion in public debt that's outstanding. That comes to roughly \$200 billion – or 1.4% of GDP.

What happens if our creditors decide the dollar isn't as stable as it looks? What happens if our government decides it has to bail out foreign governments and banking systems simply to prevent the crisis from spreading or the world's economy from shutting down?

If that occurs, it seems fairly likely our creditors will rightfully fear a massive increase in the dollars in circulation and will demand higher rates of interest on dollar-denominated debts.

Assuming our debts grow as projected (and they will surely grow faster than we expect), our government should owe roughly \$15 trillion by the end of OBAMA's first term. If you assume only reasonable rates of interest – say 6% – the government will have to spend \$250 billion per year on interest. That's about 14% of all income tax receipts. And that's just for interest. But what if there's evidence of a massive inflation and rates go to Iceland-like territory – like 15%. Then we'd have to come up with \$2.2 trillion a year *just in interest payments*. That's essentially 100% of all government revenues.

Another way to think about this is to realize income taxes (personal and corporate) and estate taxes make up more than 80% of all of the government's revenue. This burden is highly skewed to land on remarkably few people, thanks to high marginal rates. Whether you think this is appropriate in America (where the Constitution grants us all the right to be treated equally under the law) doesn't really matter at the moment.

What does matter is, thanks to highly “progressive” income taxes, roughly 50 million people pay the lion's share of our government's revenue. So when we're talking about what our government owes, we're really talking about what the government can coerce out of these 50 million people.

Sooner or later, it's going to occur to our creditors that when you divide up \$1.5 trillion in annual deficits by only 50 million people, you're talking about adding \$30,000 in debt each year to these folks. On average, these people earn a little more than \$300,000 per year. And when you look at a total deficit of \$15 trillion, you have to wonder how likely it is we will ever repay it, even if our interest costs never spiral higher.

The Two Key Questions

So now... about those two questions I want to ask...

Here's question number one.

What are the chances the American people decide to vastly curtail the qualifying age of the government's main transfer programs (Social Security/Medicare) to 75 and opt for a flat rate of income tax (say 20%) for the entire population with no deductions?

Those are the kinds of radical changes we'd have to see to prevent a collapse of the U.S. government's sovereign credit rating over the next five years. I assign a 0% chance either political party could accomplish this kind of fiscal reform. And in fact, I'm sure neither political party will ever even attempt it.

Now... here's the second key question.

What are the chances the U.S. government (either the Treasury or the Federal Reserve) winds up bailing out at least one other major sovereign debtor in the next five years?

According to the International Monetary Fund, the 20 largest industrialized nations (collectively known as the G20) should see total government debt to GDP rise to more than 100% in the next three years. Annual fiscal deficits for these countries are now close to 10% of GDP annually and will most likely continue to rise – not including the cost of any future banking system bailouts.

Like dominoes, the highly indebted economies of Europe are going to topple. Greece was first. But plenty more problems are coming. Italy has no way to

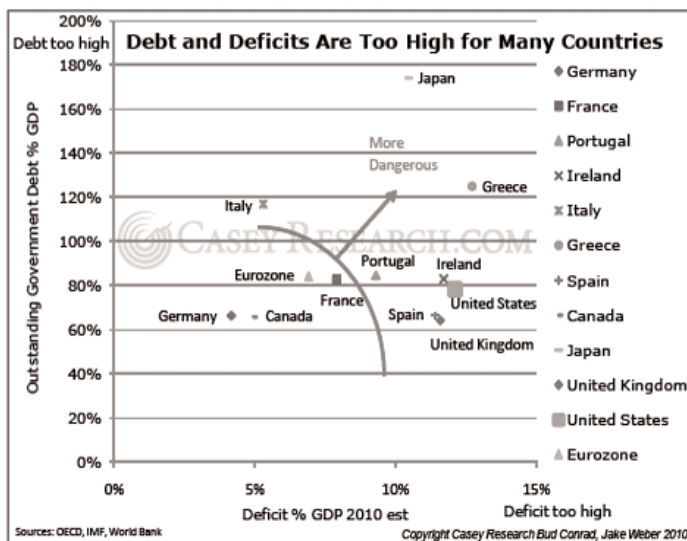
meet its obligations. Nor do Portugal or Spain. Iceland still has no plan to reimburse Great Britain and The Netherlands for the \$5 billion those governments lent it to cover the collapse of its banking system.

Events over the past two weeks in Greece should give you plenty of warning governments all over the world have too much debt.

What will the U.S. do when a major European financial institution, like Italy's UniCredit – the predecessor of Kredit-Anstalt – fails? If the resulting contagion causes one of America's major banks to fail, what will the U.S. government do?

The answer, my friends, is simple: It will print, print, print, and print. Here's the important fact to remember...

The United States is the only government in the world that can actually afford to underwrite the world's banking system. That's not because we have any real savings, it's only because we control the world's reserve currency. It's a paper standard, which means we can always print more of it.



The current standard of money and banking – the U.S.-dollar paper standard – will end in a massive inflation over the next five years because the U.S. Federal Reserve will lose all its credibility as it tries to help finance U.S. government deficit spending while containing massive losses in the global

banking system. Our creditors will demand much higher rates of interest, while also fleeing to gold, silver, and oil as reserve assets.

The world economy will slow dramatically – even as inflation soars – because the global banking system will suffer through a long contraction.

Credit tends to pile up because it feels so much better to spend money than it does to pay back a debt. Monetary systems throughout history have always crashed when too much debt was piled into too few productive assets. Sooner or later, the horse of productivity simply can't pull the bogey of compounding interest. That's why debt is so dangerous to equityholders, homeowners, and governments.

Now, the moment has arrived for the entire system of paper money and sovereign credit to collapse.

The world's governments simply cannot possibly afford the debt they've compiled or live up to the size of the transfer payments they've promised. Add onto these debts the expense of guaranteeing the global banking system against the huge losses it's facing, and you have all of the pressure you need for a total collapse.

OK, OK... The Sky Is Falling... So What Do I Do?

If I'm right about the extent of the problems the world's sovereign debtors face, the world will experience a vastly slowing economy. Even though I expect the U.S. dollar to fall in value relative to hard commodities – like gold and oil – I think it will be difficult for the U.S. equity market to sustain its current high price.

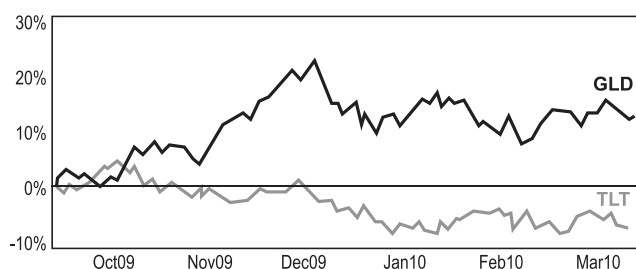
Stocks are trading at big multiples to earnings. High-quality names and low-quality names are just too expensive right now to be bought safely. Volatility in the market has almost disappeared: Stocks have gone nowhere but up for nearly a year. Isn't that a sign I must be wrong about all of these financial problems?

Not at all. The huge run-up in equities we've

seen over the last year is merely proof our central bank is still powerful. The stock market rebound that's lifted shares in the United States started the same week the Federal Reserve began its \$2 trillion program of "quantitative easing" – which simply means printing up money and buying debts with it.

The Fed's program is scheduled to end this month. That's when we'll have our first real test of the true appetite for risk. **I bet we see a big correction in the stock market at exactly the same time.**

Let's review our strategy for this year...



First, our primary trade is a wager that gold (GLD) continues to outperform U.S. long-dated Treasuries (TLT) – which you can see in the chart above. Over the last six months, we've seen gold outperform long-dated U.S. Treasuries by roughly 15%. I expect this trend to continue and accelerate over the next six months as the Fed stops supporting the U.S. Treasury market.

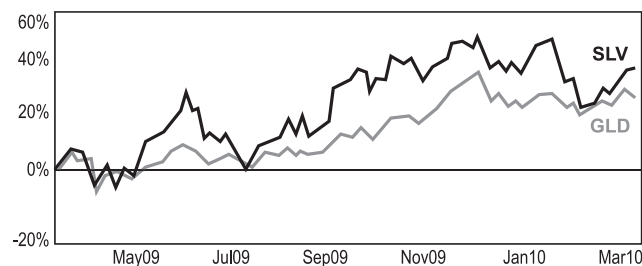
Second, we have committed to building a large number of short-sell positions in equities, focusing on companies that are frauds, overly indebted, or obsolete. We're going to continue with that strategy this month by returning to one of our most successful short sells of 2008 – a company that's both highly indebted and obsolete.

Third, we've greatly trimmed our recommended portfolio. We're sticking only with stocks whose earnings we believe can greatly increase during an inflationary period and/or have a large and safe dividend stream to protect us against a long bear market.

What most people don't understand about a period of increasing inflation is that even though

growth in the money supply will increase earnings, matching increases to interest rates force equity valuations lower. And in the race between valuations and earnings, valuation almost always wins. It's hard to make money in stocks (on the long side) if the market's overall earnings multiple falls in half. If stocks go from trading at 20 times earnings to trading at 10 times earnings (which is what I expect will happen), your stocks will have to double their earnings for you to merely break even, outside of what you're paid in dividends.

So if you haven't done it yet, now is the time to carefully pare down your holdings. Keep only good dividend-paying stocks or firms with great leverage to inflation. And in all cases, keep an eye on your trailing stop losses. You will want to sell on the way down so that you'll have plenty of capital when we hit the next panic.



Before I move into this month's new equity recommendation, I want to introduce you to one more key metric we'll be following more closely, given our concerns about the world's monetary system. As paper systems fail around the world, they will have to be replaced with something else. As I mentioned, the U.S. dollar makes up 62% of the world's central bank reserves. As these banks move to unload the U.S. dollar, they're not going to buy any other kind of sovereign debt. They're going to buy gold. And once supplies of gold get tight, they're going to buy silver.

If I'm right about my predictions, over the next five years, the price of silver is going to soar. And you should see a return to a more classic gold-to-silver ratio of around 1:16. With gold around \$1,100 today, that would give you a silver price target of nearly \$70. Today, silver is around \$17.

So... in addition to watching the relative value of U.S. long bonds and the price of gold, I suggest you also keep an eye on silver prices and the gold-to-silver ratio. As you can see in the chart on page 8, even though the last year has been great for gold investors (with gold up more than 20%), it has been even better for silver investors. I expect this trend will continue for at least the next few years. If you haven't bought any silver yet, my advice is to wait until you've seen silver underperform gold for a while, then buy a bit of silver. Don't buy too much at once because silver is extremely volatile. Just add to your position over time. Don't get greedy.

The Most Obsolete Industry in America

Given the uncertainties in the global economy and the expensive valuations in the stock market, when it comes to equities, I recommend you either buy almost nothing or, even better, add to your short positions.

I know some subscribers simply won't sell a stock short, no matter what. I think that's simply foolish and naïve. The great global credit bubble was a boon to equity valuations and stock prices for the last 30 years. It seems reasonable to expect that the collapse of this sovereign debt bubble will take at least a few years to unwind. And during this period, you're far more likely to make money selling horrible businesses than you are to make money buying good businesses. You can either adjust your strategy... or suffer the consequences.

Rather than simply repeat all of my earlier analysis, let me refer you to my October 2008 newsletter, where I first recommended **selling short the shares of Gannett (NYSE: GCI)**. You'll find a full analysis of the company – which hasn't changed much, except its subscriber base has continued to shrink... And its debts haven't. (You can find the writeup on the *PSIA* page of S&A's website: www.stansberryresearch.com. Click on my letter's name, and select "Monthly Issues.")

Back then – nearly two years ago – the stock was trading for a little more than \$17. After falling down to \$2, it has bounced nearly all the way back.

Gannett is a rare treasure for the short seller: It's the leading business in an undeniably obsolete business, it holds a tremendous amount of debt, and on its balance sheet you will find an array of worthless assets purchased at all-time high prices. In short, there's no way this business can succeed and there are dozens of ways it can fail.

Let us begin our update on Gannett with something that warms the heart of any short seller: a debt burden that cannot be repaid and is unlikely to be refinanced at any reasonable rate of interest.

Specifically, as of its last SEC filing, Gannett had a little more than \$3 billion in long-term debt. (Just to be clear, this amount does not include any of the company's nearly \$500 million worth of unfunded pension liabilities...) Thanks to an additional \$500 million it borrowed in October 2009, Gannett says it can meet all of its maturities through March 2012 – but this assumes its losses don't grow materially larger in 2011. Guessing when the default occurs is not our primary objective. It is enough to simply know a default will inevitably occur. And this we know for certain...

We know Gannett will fail because its core business is the *USAToday* newspaper. Its average circulation declined 16% last year to around 1.9 million readers. Its circulation has been in decline for several years and will never recover because most people



under the age of 30 will not buy a newspaper.

Gannett also owns another 83 U.S. daily papers and 650 nondaily publications in the United States. The problem is, thanks to the Internet and its offshoot – wireless networks – more and more people get their news digitally... and for free. These digital pages can't deliver the same amounts of ad revenue per page as newspapers once did. And because digital ads can be easily tracked (like coupons), the pricing of such ad space is much more competitive. Additionally, there are *millions* of competitors in online news, including a blogger who specializes in every imaginable niche and will offer his content to all viewers for free.

These issues hurt Gannett in a nasty way because its main paper, the *USAToday*, was the first national daily publication. Gannett has invested billions in the ability to print and distribute newspapers around the country – an asset base that, thanks to e-mail, the Internet, and cell phones – is now worthless.

Adding to Gannett's woes was a huge acquisition spree it conducted in the early 2000s that saw it buying free local dailies and paying outrageous sums for the titles. All in all the company still holds \$3.4 billion on "intangible assets" on its balance sheet. This is primarily the goodwill value of those earlier acquisitions, most of which will be written off over the next two to three years as losses mount. These assets constitute 48% of Gannett's entire asset base.

So... how is the newspaper business doing since we last checked in with Gannett? In a word, horribly. Publishing revenues at Gannett fell to \$4.4 billion in 2009, down 23% from 2008. That's the top line – revenues. The company's other businesses are miniscule in comparison. Digital (the company's website) generated \$586 million – thanks to its purchase of CareerBuilder. But on a *pro forma* basis, the segment saw revenues fall 15%. Broadcast revenues were \$631 million, down 18%.

And while Gannett likes to trumpet its digital activities, the plain fact is, the company's revenue base is \$5 billion worth of old media (newspapers,

TV networks) and only \$600 million worth of new media – websites. That's 88% old media and 12% new media. It is extremely unlikely the company's digital efforts will ever yield big enough profits to finance its existing debt load.

But I can't fault the management team's effort. In 2009, it cut operating costs by 64% – a truly amazing feat. How did Gannett do it? Well, it fired a bunch of people. But the main reduction in expense came because it spent 34% less on newsprint... thanks to circulation declines. Too bad such declines won't help them repay their debts.

The company's net income accounting is worthless to consider because it includes all kinds of special charges and restructuring expenses, etc. So I recommend looking at the basics. How much cash is this business producing? After capital expenses, Gannett produced \$1.2 billion in 2007. In 2008, that figure slipped to \$835 million – a decline of 30%. In 2009, Gannett produced \$799 million of free cash, an annual decline of about 5%. The company was able to staunch the decline by cutting thousands of employees and because it didn't have to buy as much newsprint. It will be difficult (if not impossible) to continue expense reductions of this magnitude, thus I expect free cash flow to fall by at least 20% this year, to around \$650 million.

That might seem pretty good, if you were merely looking at the company's market cap. The total value of all of the outstanding shares is only \$3.8 billion. The problem is, once you begin to account for debt repayment almost all of this cash flow disappears. Over the last three years, for example, Gannett produced \$2.8 billion in free cash. But it spent \$2.1 billion paying back debt.

The question before us is, in the race between Gannett's declining cash flows and its debt maturities, what will be left for shareholders? Our answer: Nothing.

Whether we're right about the outcome of the world's debt crisis or not, one thing we can be certain about: My 2-year-old son will never read a newspaper. That's bad news for the shareholders of

Gannett. **Hedge your existing equity portfolio by selling short the shares of Gannett (NYSE: GCI). Use a 25% trailing stop loss.**

Final Notes

I know one of the main questions I'll be asked about this particular letter is: *What would you do about it, Porter? If you were in the government, how would you handle this crisis?*

Just to be clear, I don't want that job. I only ask for the government to leave me alone. But if Congress called me and said we'll do whatever you tell us to, just get us out of this jam, then there's a pretty easy way to solve our problems.

The first thing you have to do is get the economy moving forward again. The only way to do it is to reduce the marginal tax rate as much as possible. I'd recommend a 12% flat tax for everyone, with no deductions. This rate has been tried before in several different economies (New Zealand, Ireland, Russia) and it seems to produce the most amount of revenue with the least amount of economic disruption. Politicians resist lowering taxes on the rich or broadening the tax base (they're socialists, really), but that's the only way to both stimulate the economy and raise revenues.

Next, I'd get rid of every possible impediment to business investment – including permanent elimination of all government subsidies (which simply keep bad businesses around, preventing more efficient businesses from succeeding), regulations, capital gains taxes, etc. I'd do everything I could to clear the decks for new investment in America. Likewise, I'd get the government completely out of the business of providing insurance of any kind – for banks, retirement, the mortgage market, etc. The government is a horrible capital allocator. Americans will have to learn to take care of themselves again. (I know they'll be just fine.)

Next, I'd instruct the Federal Reserve to set up a return to the gold standard over the next 30 years. It will take us that long to repay our debts, but it's worth it. As soon as the market sees we're serious

about paying off our debts, our interest rates will fall and investors will return to our currency.

Finally, I'd insist on amendments to the U.S. Constitution to protect citizens from confiscatory rates of income tax, from ever being subject to a central bank again, and from government deficit spending.

It is immoral to use the power of government to take 40%-50% of a man's legal earnings. Likewise, it is repugnant to the most basic instincts of fairness that any bank would be allowed to inflate away the value of someone's private savings. And finally, only the most disgusting of human beings would place debts upon his children.

Today, our government does all of these things – with gusto. Unless it is reformed, it will not exist in its current form for long. Bankrupt governments don't last.

Regards,



Porter Stansberry
March 12, 2010

Porter Stansberry's Model Portfolio

Prices as of March 11, 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	\$41.68	\$2.70	Chocolate empire	Buy	9%	1
Exelon	EXC	Oct-02	\$21.47	\$44.93	\$12.05	Nuclear power	Hold	165%	3
Verizon	VZ	Feb-06	\$31.54	\$29.84	\$8.42	Blue-chip telecom	Hold	21%	3
Annaly	NLY	Nov-08	\$13.64	\$18.12	\$3.04	Gov. port. repair	Hold	55%	5
<u>The “Next Boom”</u>									
Financial ETF	XLF	Aug-09	\$14.33	\$15.60	\$0.10	Fed manipulation	Buy	10%	2
Freeport-McMoRan	FCS	Nov-09	\$85.33	\$80.50	\$0.15	Inflation hedge	Buy	-5%	3
Silver	SLV	Oct-09	\$17.48	\$16.81		Money crisis	Buy	-4%	3
ConocoPhillips	COP	Apr-09	\$42.36	\$51.30	\$2.44	Cheap oil	Buy	27%	3
Visa	V	Jun-09	\$66.50	\$92.74	\$0.36	Global money	Buy	40%	3
San Juan Basin	SJT	Jan-10	\$18.34	\$22.17	\$0.28	Safe natural gas play	Hold	22%	4
Gold Miners ETF	GDX	Dec-08	\$28.02	\$45.32	\$0.11	End of America	Hold	62%	5
<u>Forever</u>									
Johnson & Johnson	JNJ	Jul-06	\$60.52	\$64.22	\$6.59	Blue-chip health	Buy	17%	2
<u>Victims</u>									
iShares US Bond	TLT	Jan-09	\$114.30	\$89.92	\$3.32	End of America	Sell Short	18%	5
Am. Electric Power	AEP	Apr-09	\$30.53	\$34.22	\$1.23	King of coal	Sell Short	-16%	5
First Solar	FSLR	Jul-09	\$144.00	\$113.69		Expensive solar	Hold	21%	5
General Electric	GE	Nov-09	\$15.76	\$16.48	\$0.20	Overleveraged	Sell Short	-6%	5
Western Digital	WDC	Feb-10	\$43.40	\$38.86		Obsolete tech	Sell Short	10%	5
Seagate Technology	STX	Feb-10	\$20.73	\$19.23		Obsolete tech	Sell Short	7%	5
Gannett	GCI	Mar-10	NEW	\$16.29		Obsolete newspaper	Sell Short	NEW	5
Current PSIA Average	25.5%								
S&P 500 2010	2.7%								
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