

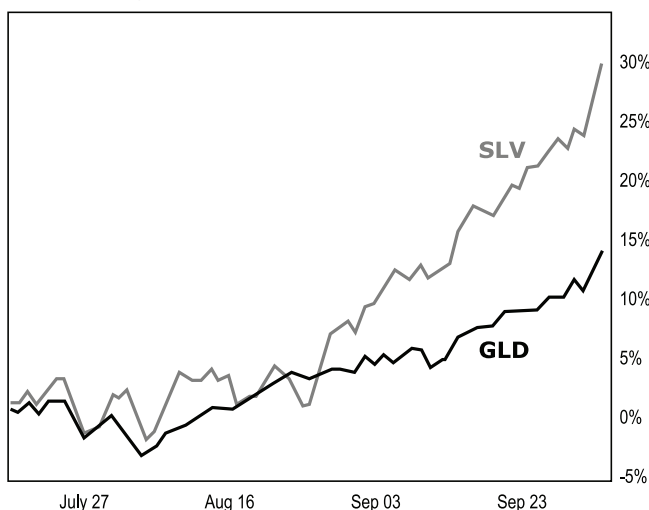


The Power Grid Will Fail within 36 Months

Now, it's really starting to happen...

You might wonder why commodity prices are soaring. In the last year, Moody's base metals index jumped from 1,623 to 2,111 – a 30% increase. The price of silver surged from \$16 an ounce to nearly \$23... a 43% increase. Gold raced from \$1,000 an ounce to nearly \$1,400. Oil jumped from \$65 to \$85 per barrel.

SPDR Gold Trust



As soon as the Federal Reserve restarted the expansion of its balance sheet in late July, commodity prices began to soar, again. Leading the way was silver – a dangerous omen for the future of the world's existing paper monetary system. Silver is now up 30% since the first week of August.

Inside This Issue

- The Dollar's Last Days
- The Lights Are About to Go Out
- Why Coal Prices Will Soar
- Portfolio Review

Editors: Braden Copeland
and Porter Stansberry

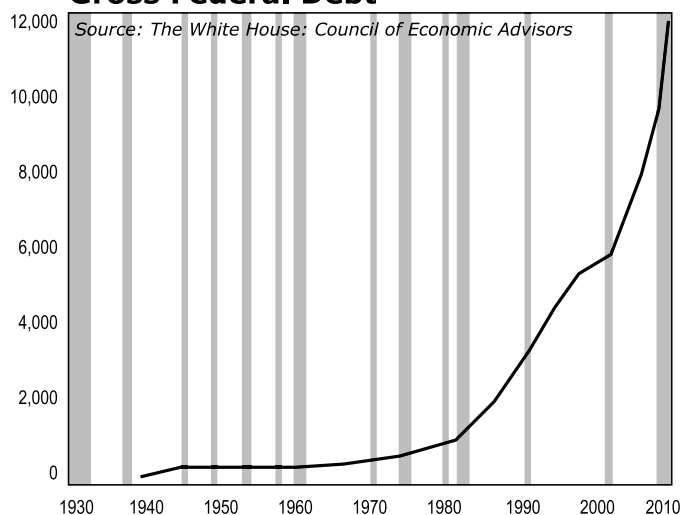
In the past, such moves in the commodities markets indicated a surging U.S. economy. But the U.S. economy isn't growing at all... or is growing by such small amounts economists still debate whether the recession has ended.

There's only one other explanation: Our monetary masters, the central bankers, continue to print money (quantitative easing resumed in late July). To justify this massive inflation, Bernanke and Co. continue to say publicly our main risk is *deflation*. They know too well the root of our problem has nothing to do with a short-

term liquidity crunch – the kind of problem the Fed was designed to help resolve. **The problem now is the solvency of our country.**

Believe us, they know their decision to print away our enormous debts will have catastrophic consequences for both our economy and the world's monetary system. That's why gold is soaring. That's why silver is soaring. That's why other strategic commodities are going to continue to move much higher – something we will explore in detail in this month's letter.

Gross Federal Debt



This chart of gross federal debt helps explain the weakness of the U.S. dollar when compared to sound currencies and precious metals. Growth in government debt has entered a final, runaway period. It is being accompanied with enormous increases to the money supply. The roughly 40-year expansion of public debt in the United States (since we exited from the gold standard in 1971) is unmatched in scope throughout all of history.

As we'll show you, the heart of our country's economy – the power grid itself – is dangerously exposed to a rise in the price of coal. The Fed's actions, the perilous state of our currency on the world's markets, and the rise of China's economy mean the price of coal is certain to rise.

And America's leading power producers absolutely cannot afford a substantial rise in the price of their core fuel source – as we'll show you in great detail.

What will happen? We believe we are a few months away from the failure of the U.S. power grid. The causes will be economic, not technical. But that won't matter to you if your heat doesn't work anymore... or the lights won't come on...

The U.S. Dollar's Final Days as the World's Reserve Currency

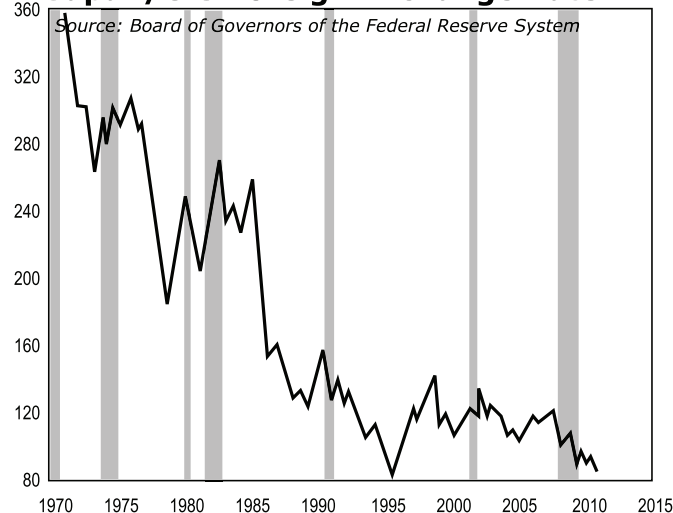
As we wrote in February:

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.

Lest you think these risks are all in our heads...

Last week, Brazil's finance minister, Guido Mantega, said publicly what we've been warning against all year: "We're in the midst of an international currency war, a general weakening of currency."

Japan/U.S Foreign Exchange Rate



The chart above shows the continuous, long term weakening of the U.S. dollar against the Japanese Yen since its tie from gold was broken in 1971. All major foreign currencies would reveal a similar, long-term continuous decline.

What about our predictions about the rising cost of sovereign credit? At first glance, it would appear we are badly wrong. Long-term U.S. bonds are now selling at record-low yields.

On the other hand, the state of Illinois now pays more to borrow than the government of Mexico pays. Mexico is a known default risk. It has historically defaulted on its debts and did so as recently as 1982.

It's at least ironic that the former senator from Illinois – the state with the worst credit in the entire union – is now our president.

U.S. sovereign borrowing costs have not yet spiraled higher because the U.S. government remains (for now) the only sovereign borrower in the world able to legally print the world's reserve currency as repayment. As we've been telling you, that is about to change.

More and more nations and large private institutions are calling for a new currency basket – which would include gold – to replace the U.S. dollar. In February 2010, the head of the International Monetary Fund spoke in favor of such a plan, joining the leaders of Russia, Brazil, China, and dozens of other smaller nations. Last week, The Institute of International Finance (a group of 420 of the world's leading banks) called for a new global currency regime to provide a more stable means of exchange.

For most, this is hard to believe. It will not be long before the U.S. government cannot borrow abroad in U.S. dollars. The moment that happens, our credit rating will plummet. Our borrowing costs will soar. Our currency will collapse. Our standard of living will fall to third-world levels.

Though few are talking about it, our power grid may become one of the greatest victims. Power companies' ability to pass along price increases is restricted thanks to U.S. Federal and Energy Regulatory Commission (FERC) regulations. To overcome this, the largest companies have borrowed heavily, leaving them dangerously exposed to the risk of any expense increases. Their greatest vulnerability is to the cost of their fuel... **coal**.

When the coming inflation hits, coal prices will skyrocket. They will be wiped out – unable to afford the fuel and unable to raise prices fast enough to finance further operations.

The Largest Debtor in the World; The Largest Debtor in History

Most people simply do not understand, measured by total outstanding debts (both public and private), the U.S. ranks next to Iceland and the United Kingdom as one of the most indebted major nations

in the world. It has a total debt (public and private) to GDP ratio of almost 400%. There is no way we can ever repay all of these debts.

The same is true for many developed western nations. In the UK, the total debt to GDP ratio stands at 470%. In Spain, the figure is 340%. France and Italy are at about 300%. Even Switzerland is overloaded with debt at 315%. Meanwhile, most emerging countries remain relatively free of debt, with total debt to GDP ratios less than 150%.

The U.S. is attempting to “paper over” its debts in an effort to stimulate the economy and generate enough inflation to make them affordable. We're trying to use government-led bailouts and massive increases to the money supply to handle our obligations. Most of our major trading partners are attempting to do the same thing, at the same time... which is triggering a worldwide wave of inflation.

Since the beginning of the credit crisis in 2008, the U.S. government has undertaken the largest public stimulus effort in the history of our country.

More than \$10 trillion (about 75% of GDP) in additional public credit was created, almost instantly, via the U.S. Treasury bailouts of AIG, the major commercial banks, Fannie Mae, Freddie Mac, General Motors, Chrysler, and General Electric. Most of these debts will never be repaid, despite claims to the contrary. We estimate the bailouts of Fannie and Freddie alone will cost taxpayers *at least* \$500 billion.

The Federal Reserve has expanded its assets by more than \$1.75 trillion (about 15% of GDP), mainly through the purchase of long-dated “agency” debt (the obligations of Fannie and Freddie) and long-dated Treasury bonds. This has added trillions of dollars to our country's banking reserves. It also lowered the cost of long-term borrowing close to nothing. Unfortunately, this has also lowered the exchange value of the U.S. dollar. The U.S. government is simply creating money to repay its obligations to its sovereign creditors, nearly 50% of which are foreign.

The amount of stimulus has also been record-setting.

At the end of 2007, the gross national (public) debt of the United States totaled \$8.9 trillion –

roughly 70% of GDP. By the end of 2010, it will exceed \$14.5 trillion, an increase of \$5.6 trillion (62%). That amount of debt exceeds the United States' entire annual productive capacity – more than 100% of GDP.

When President George W. Bush took office in 2000, the *entire* national debt was only \$5.2 trillion. Since the beginning of this credit crisis, the U.S. government has borrowed (and spent) an amount of money that exceeds its cumulative borrowing before 2000.

Incredibly, for a nation born out of a desire to free men from the yoke of oppressive governments, this unprecedented surge in government-led economic stimulus has pushed annual government spending to nearly 50% of annual GDP. This is on par with the size of government during World War II.

And contrary to the mainstream media's rhetoric, government bailouts and handouts haven't been limited to big business. Today, more than 40 million people are receiving food stamps at an annual cost approaching \$6 billion.

The government now directly controls almost half of all production. It is no longer an exaggeration to describe America as a socialist country...

If you've been to socialist countries before, you know one of the main differences between socialist states and free markets is the widespread availability of cheap, reliable electricity.

Get ready... The lights in America are about to go out.

Why Efforts to 'Paper Over' the Debt Will Fail

For these enormous debts to be managed and brought under control, our economy must grow rapidly. The only way out of the hole we've dug would be large and lasting changes to our economy's global competitiveness. In short, we have to work a lot harder and a lot smarter.

We're talking about real, noninflationary growth. Growth not caused by a huge increase in debts. Growth caused by actual increases in production, productive capacity, and productivity.

One of the best ways to measure real increases to production – as opposed to the various government statistics, which have all kinds of "adjustments" made to them – is to look at real wages. If the U.S. experienced substantial increases to its productive capacity, real wages would rise.

Since the U.S. abandoned the gold standard in 1971, real wages have declined. "Wait," you might argue. "Didn't household incomes increase through about 1998, reaching \$51,295 in constant 2005 dollars?" Yes, these increases resulted from the addition of second household incomes: Wives' wages didn't amount to much until the mid-1970s.

Since 1998 the real median household income in the United States has fallen. By 2009, the median household income was \$50,303, according to the U.S. census – lower than it was 10 years earlier. That's the first 10-year period in United States history that household income has declined.

In a normal, free market economy, production leads to consumption. In America, we've done something different for the last 40 years. Instead of increasing production, we borrowed to finance our consumption. It's all in the numbers. *Increases to debt (public and private) have supplanted real wages and economic growth for four decades.*

That's why government efforts to stimulate more consumption via more borrowed money won't work.

Programs like "cash for clunkers," tax incentives for buying a home, "shovel-ready" public works projects, or another round of rebate checks won't work. They are all just Band-Aids. They will not stimulate *real production*. They will only add debt to our national balance sheet. The things the government is doing will only make the situation *worse*.

What should the government do instead? We propose asking someone with far more experience than Barack Obama, John Stewart, or Newt Gingrich. We'd seek a real economist, not some Ivory Tower theorist with foolish ideas like Princeton's Alan Blinder. (Blinder dreamed up Cash for Clunkers, claiming it would stimulate the economy, improve the environment and reduce income inequality "all at the same time." That U.S. politicians didn't dismiss his idea out of hand shows their poor state of economic

literacy. That they enacted the program at all explains why this country is so close to falling apart.)

Who would we advocate consulting with the government? John Stuart Mill, the legendary 19th century philosopher, economist, and civil servant. Sure, he's been dead for nearly 200 years. But dead men tell no lies. Says Mill about the correct path to national wealth:

What a country wants to make it richer is never consumption, but production... the legislator has to look solely to two points: that no obstacle shall exist to prevent those who have the means of production from employing those means as they find most for their interest; and that those who have not at present the means of producing to the extent of their desire to consume shall have every facility afforded their acquiring the means, that becoming producers, they may be enabled to consume.

Mill was explaining one of the true, core ideas of classical economics – the idea that consumption and production are part of the same economic act. Production and consumption are the two sides of every exchange. A transaction cannot be consummated until something is produced. Nor can a profit be earned until production is consumed.

Thus humans fulfill their needs and desires only through production and consumption. This is the heart of any economy and the source of all wealth... Yet most of today's politicians don't understand they are the same thing, always moving towards equilibrium.

Government policies meant to stimulate consumption will always fail if they make no corresponding effort to reduce barriers to production – such as reductions to the regulatory burden, reductions to taxes on capital and income, etc. Knowingly or unknowingly nearly all of today's politicians – both Democrat and Republican – have bought into the great conceit of socialism, the lie that you can have lasting increases to consumption without a corresponding increase to production.

How then should we stimulate production? Arthur Laffer has done some of the best modern work on understanding the role increases in production play in stimulating the economy as a whole – and

consumption in particular. Laffer says countries suffer major economic declines for only four major reasons: monetary instability, high or rising taxes, high or rising tariffs, and excessive regulation, particularly wage and price controls.

We can narrow this down to two items because tariffs are a form of taxation and wage and price controls are (normally) a government response to monetary instability.

Unfortunately, as long as OBAMA! is in power, our government will do nothing to reverse either of these trends... already hard at work destroying our economy. You've seen what's happening to the world's monetary regime: a full-scale currency war is underway with the Federal Reserve leading continuous rounds of quantitative easing – a.k.a. devaluing the dollar. Commodities prices are soaring one day and crashing the next. The same holds for the exchange value of the dollar versus other currencies. Speculators are thriving... The economy is dying.

As for taxes, OBAMA! has promised to allow the Bush tax cuts to expire, which will raise capital gains taxes as high as 39%, allowing the estate tax to return at an increased rate of 55%, and resulting in combined state and federal income tax rates of more than 50% for residents in two of the largest states – New York and California.

These taxes will greatly reduce the incentive to invest in new businesses or to grow existing business – especially the severe tax on capital gains. Whether you think “rich” investors ought to pay these taxes and the “rich” ought to pay estate taxes doesn't matter to the economy as a whole. Taxes, at these rates, will decimate production – there's simply no doubt about it. With such tax increases, all efforts to simultaneously stimulate consumption will fail. Thus, while the rich might end up poorer... the poor will end up with even bigger problems, like soaring unemployment and the collapsing value of whatever wages they earn.

It's like we're driving a car towards a huge cliff and the fall will surely kill us all... The driver's arguing that if he speeds up enough, the car will fly to the other side... And the passengers are screaming, “Stop!”... because there *isn't* another side. There's only a cliff.

That cliff, as you'll see, is the price of coal.

Why the Power Grid Is at Risk

Since the credit crisis began in 2008, Porter has been warning about the growing *certainty* of a currency crisis. More recently, we've also been looking for the ideal vehicle to demonstrate why inflationary monetary policies simply don't work.

We've found the perfect test case in the two major power companies that operate the biggest coal fired power plants in the United States.

These businesses – American Electric Power (NYSE: AEP) and Southern Co. (NYSE: SO) – are the main coal-fired power producers in the United States. Porter first warned you about American Electric Power in the April 2009 issue: "I believe [AEP] will go bankrupt in the next two or three years because it has been using the same kind of Ponzi financing that bankrupted General Motors."

Originally, Porter's rationale was based on his analysis of the fragile state of the company's operating model: It simply doesn't earn enough money to pay its dividend, but it continues to borrow money – more and more every year – to finance it.

We initiated our short position (in April 2009) just as the stock market began its huge upward move from March 2009. Not surprisingly, given our poor timing, we were stopped out at a loss. Nevertheless, AEP's operating results have continued to deteriorate.

In 2009, AEP once again produced a huge loss on a cash basis. After earning \$2.4 billion in cash from operations, it spent \$2.8 billion on capital investments/plant maintenance. While these expenses aren't on the company's income statement, they are not really investments in the normal sense of the word. Without these expenditures, the company's fleet of power plants would fall apart. We view these expenses as regular, ongoing costs. Judged on this basis, AEP didn't make the \$1.3 billion it reported to Wall Street. It actually lost roughly \$400 million.

And even though it has lost money on a cash basis every year since 2006, AEP continued to increase its dividend payments, from \$663 million to \$761 million. How could the company possibly afford to increase its dividend payments in a year

when it lost hundreds of millions of dollars? That's the most amazing part. After borrowing more than \$10 billion since 2005, it decided not to borrow the money. Instead, it sold stock.

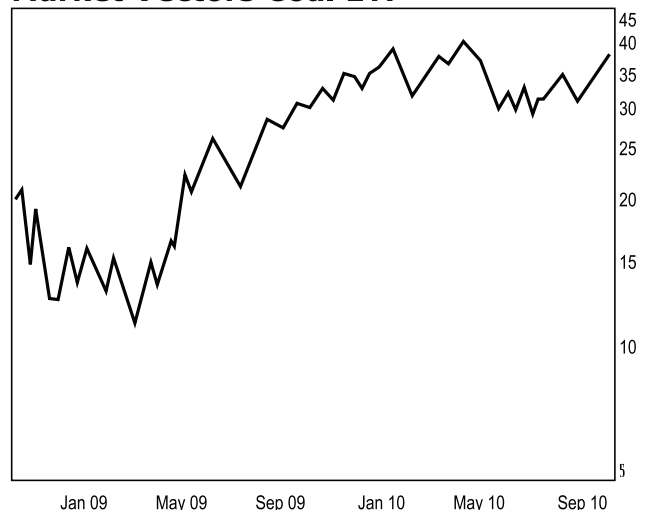
That's right... to finance its dividend this year, AEP actually sold shares. I'd love to talk to shareholders about this decision. (Who in his right mind would want to pay taxes on dividend income at the same time the company is selling \$1.7 billion in new shares?) Why would any investor tolerate a business that simply sells stock to finance its dividend? We have a name for that kind of finance: *Ponzi*.

But... this company isn't simply another poorly run tech firm or crooked investment fund, it is the major supplier of baseline power to the Midwest.

If this company has to constantly raise capital simply to stay in business and meet its dividend, what would happen to its share price, its dividend, and its credit rating if, suddenly, its largest single expense were to double (or more) in price? With a business model that's already drowning in debt and share issuances, how would AEP weather a generational currency storm and a global battle for coal?

And what about the other coal-fired power companies? Coal is still the source for roughly half of the electricity produced in the United States. Can any of the coal-fired power companies stand a big increase to the price of coal?

Market Vectors Coal ETF



You can follow the price of coal now on the stock market, via the Market Vectors Coal ETF (KOL). Since the bottom in the spring of 2009, coal has gone up about 300%.

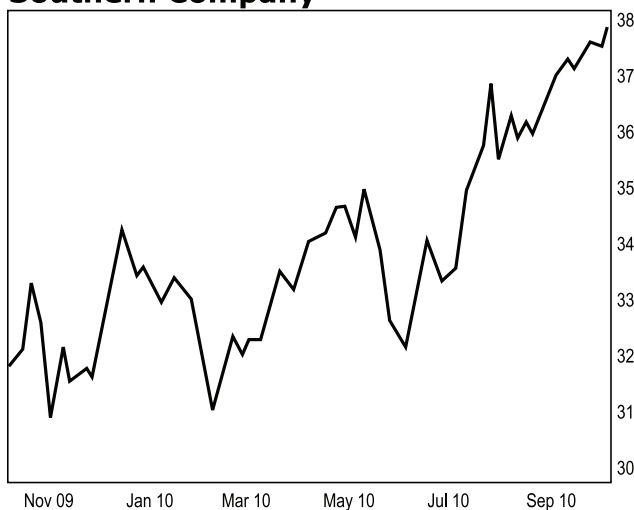
You won't be surprised to learn the answer is no. This is a serious problem. It is far more important than a simple securities trade. If we're right about these companies, the United States faces major black-outs, simply because the coal-powered operators won't be able to afford the coal. Because their businesses are financially insolvent, they wouldn't be able to borrow the money to pay for it.

Let me show you our concerns, starting with Southern Co., the bigger of the two – currently a \$31 billion corporation by stock market value.

Since 2006, Southern Co. hasn't produced any free cash flow. That is, after you account for its capital spending, the business isn't actually generating any real income. The losses have been big, too... and they're growing... It started with a \$238 million loss in 2006. That has grown to a \$1.5 billion loss in 2009.

These losses haven't resulted in any reduction to the company's spending on its cash dividend, which has increased from \$1.1 billion to \$1.4 billion over the same period. Southern Co. has financed these dividends and much of its annual capital spending with new debt – a total of more than \$12 billion since 2006 alone. This debt has saddled the company with an annual interest obligation of almost \$1 billion.

Southern Company



So far investors seem oblivious to the risks in Southern Co.'s poor results over the last four years. We believe they're simply chasing the company's rich dividend, which has been supported with billions in new debts. What will investors do to the stock if the dividend is cut?

Losses over the last four years have erased an entire decade of earnings. Over the last 10 years,

Southern Co. hasn't earned a single penny in cash. Yes, it earned \$29 billion selling electricity. It *spent* \$30 billion more on its plant and equipment simply to stay in business. On top of that, it paid \$11.5 billion in dividends. It financed all of it with \$12 billion in debt.

Now, the company finds itself with a \$4 billion-a-year capital expense budget and roughly \$1 billion annual interest payments. In other words, the interest expense has increased its annual breakeven point by 25%. Southern Co. needs to earn \$5 billion just to breakeven in 2010.

It has never earned that much in its entire operating history.

As you can see, the situation is plenty bad *without* any increase to coal prices. But...

If we're right about the situation in coal, Southern Co. is most likely looking at a major decline in its operating cash flows. That puts the company in serious jeopardy with its creditors far faster than anyone on Wall Street wants you to know.

How important is the price of coal to Southern Co.? Roughly 60% of the company's fuel comes from coal. In total, the company spends \$6 billion a year on fuel. It is the company's largest expense by a wide margin. We estimate roughly half of this expense is coal purchases. How? While the company doesn't disclose what it spends on coal, it does disclose its cost basis in terms of kilowatt-hours produced.

Electricity production from coal costs 3.70¢ per kilowatt-hour in 2009. That's up enormously from two years ago (2007) when it cost 2.61¢ per kilowatt-hour. In fact, coal price increases and natural gas price declines have caused Southern Co.'s overhead costs to merge. Natural gas power cost the company 7.58¢ per kilowatt-hour in 2008, but only 4.58¢ per kilowatt-hour in 2009. That's only 23% more than coal. Given that roughly 60% of the company's production comes from coal, it's a safe bet that at least half of its fuel costs are from coal, too.

Now, imagine the company's cost to acquire coal doubles over the next year. That would add \$3 billion in expenses. That increase alone would completely wipe out the company's cash from operations. It would leave it in need of roughly \$7 billion in new equity or debt... without good prospects for earning

the money back in the short term, as regulators would never allow the company to double its retail power prices.

After four years of financing losses and dividend increases with lots of new debt, Southern Co.'s balance sheet doesn't have much flexibility left. And it's going to need that flexibility because of a huge change emerging in the global market for coal...

Why Coal Prices Will Soar

According to Bill Gross, who manages the world's largest pile of fixed-income assets at PIMCO, the Federal Reserve is going to resume large-scale quantitative easing at the rate of \$100 billion per month. News of this plan has been leaking out for the last two months following an important speech Bernanke gave at Jackson Hole this summer when he said, essentially, that we needed a lot more inflation.

If the Fed does resume quantitative easing at the \$100 billion per month range, it would be buying the equivalent of all of the new debt that's being issued by the U.S. Treasury – all of it. This represents an increase of roughly 30% to the money supply in the first year. That's an extraordinary amount of new cash.

The first round of quantitative easing (from March 2009 to March 2010) triggered a 300% increase in the price of coal. While I don't expect prices to move quite so far, quite so fast the second time, I'm fairly certain coal prices will move higher on the back of the Fed's money printing. How much? I'd say at least 50% over the next year.

But that's not the real problem... China is.

Trade and capital flows are transferring most of the inflation the Fed is creating to the Chinese economy. U.S. politicians continue to stimulate *consumption* in the U.S., while most of the production to meet this demand comes from China. We borrow and spend. They produce and profit. Hopefully, you understand simply printing more money and buying government bonds won't change this dynamic – It simply results in still more money being sent to China.

What will China do with the flood of capital? Lots of things. But one thing it will certainly do is *build more coal-fired power plants*. Coal-fired plants

produce 80% of the electricity in China and demand for electricity is growing roughly 9% a year. It's hard to comprehend how fast demand for coal is growing in China, but consider these facts...

China is now the world's second-largest consumer of electricity, after the United States. A decade ago, China's installed generation base was only 315 gigawatts. Today, it's 900 gigawatts – and 78% of its production is still coal-based.

Today, China consumes *three times* more coal than the U.S. – more than three billion tons. But China only has about half of the U.S.'s coal reserves. And that means, China must import a lot of coal. At current growth rates, China would exhaust its current reserves in only 16 years. Obviously that's not going to happen – more mines will be dug, etc. But just as obviously, it will take a long time to build the mines and lay the railroad infrastructure required. In the meantime, China will need a lot of coal.

Current market surveys show China will import 150 million tons of coal this year. That's only 5% of China's total coal demand, but it represents 15% of the total U.S. demand. Right now, almost all of this coal comes from Australia, where China takes up about 60% of the export supply of coal.

And here's the crucial fact: China's coal imports *doubled* in the last year.

We know total power production in China is scheduled to double over the next eight years. It's building a new coal-fired plant nearly every week. The United States has built only 12 new coal-fired power plants since 1990. Assuming China's coal imports double again (and they will), Chinese demand will exhaust Australia's export capacity. And when China's import demand doubles again after that (to 600 million tons per year), it will exhaust the world's total export supply.

China's not the only problem... don't forget about India.

Its installed power base exceeds 600 gigawatts and demand is growing at about the same pace as in China. India also relies on coal for most of its power (70%). It burns 500 metric tons of coal a year currently, mostly from domestic sources. But Vinay Kumar Singh, the CEO of India's Northern

Coalfields, says the country will need to import at least 250 million tons of coal a year by 2020. India's imports of coal from South Africa rose 74% last year.

It's no exaggeration to say China and India's demand for electricity are the future of global power. Already China's coal production represents more than twice the amount of energy produced from all of Saudi Arabia's oilfields.

What's fueling all of this demand for coal-fired power plants? Huge urban populations in China and India. Consider these figures. In America, the baby boomers – the 50 million Americans born in the years after War World II – produced the demand for vast amounts of new infrastructure in America.

There are 300 million newly urban Chinese people. And 300 million newly urban Indians. That's 600 million people moving out of the Stone Age and into the modern world – a group 12 times bigger than the baby boomers. While it's true these people will want to buy lots of things – from Cokes to Buicks – the thing they need most is electricity.

Americans don't yet realize the Fed's attempts to paper over our debts come with serious consequences. As our money loses its purchasing power, costs will rise – especially power costs. Undoubtedly, our politicians will blame "speculators" for the soaring price of coal. But the truth is, the paper that will push prices higher came from the Federal Reserve, not from any hedge fund.

Whether we realize it or not, we compete with other nations around the world for resources. Historically our currency – as the world's reserve currency – has given us an enormous advantage. Coal, for example, is priced in dollars. But we stand on the verge of losing that advantage... and the consequences will be drastic. We will face higher prices for coal, among other sources of energy.

At the moment, the two leading coal power producers in the United States are being managed as though they can afford huge debt burdens... as if they don't even have to earn the dividends they pay. This is the beginning of a financial tragedy because as the dollar is devalued, the cost of coal will soar. ***These firms don't have any flexibility left on their balance sheets to manage these suddenly rising expenses.***

While I don't think it's time to short these stocks yet... that moment is coming. When it arrives, it will prove devastating, not only to the shareholders but to the entire power grid, which could easily fail if these companies are unable to operate.

We'll continue to monitor this situation, and we'll do our best to increase awareness of this problem, even if that means losing an attractive opportunity to sell short. We'd much prefer to have a safe and sound power grid than another trading profit.

On the other hand... we have a simple way to profit from the rise in coal prices...

How to Invest in Coal

Here's all you need to know about why you should invest in coal:

Chinese coal usage would *triple* if China started using as much electricity as the U.S.

That would increase global demand for thermal coal (the kind that fuels power plants) by 5 billion tons a year. *If the Chinese close the China-U.S. power gap by just 20%, global thermal coal demand would increase by as much as the U.S. uses in a single year.*

Unbelievable? The Chinese are so aware of the need, they are digging mines recklessly enough that lives are lost almost daily. China also continues to import. In the first quarter of 2010, China imported nearly 50 million tons of coal... and is on track to import 200 million tons this year. Its coal appetite is growing. The only question is, how fast?

Demand for metallurgical coal (used in steel production) is climbing, too. The Australian Bureau of Agricultural and Resource Economics (ABARE) revised its 2010 and 2011 global demand forecasts higher at the end of September (Australia is the world's largest met coal exporter). In June, the bureau forecast a 10% increase from 2009 levels. Based on shipments during the summer, the September revision was to 241 million tons, a 14% jump. For 2011, the bureau bumped the number from a 7% to an 8% increase over the revised 2010 forecast.

Barring a second global recession, rising thermal and met coal demand is undeniable...

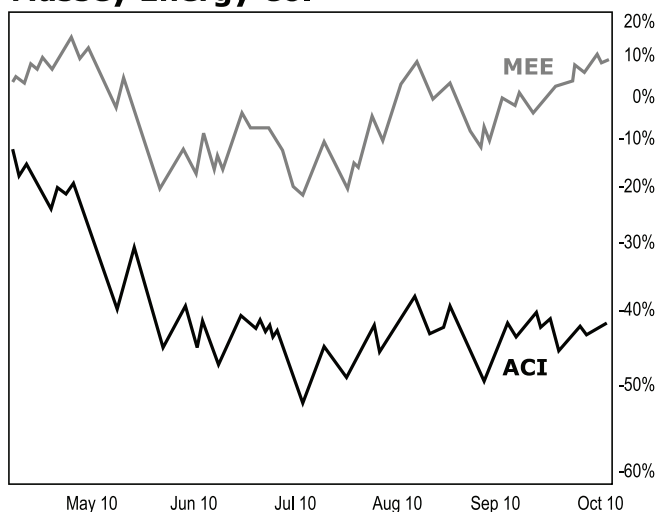
With demand increasing, supply is a growing concern. The Russian and Indonesian governments have put limits on coal exports to ensure reserves can satisfy their own growth. The Chinese are already making inroads into South Africa. They're also working on supply commitments from Russia for 2011.

When demand exceeded supply between 2006 and 2008, the blended price for thermal and met coal grades spiked from an average of \$62 to nearly \$119 per ton for U.S. coal. The coal price in Europe jumped from \$64 to \$148. In Japan, the price raced from \$63 to \$123. Those who can afford to protect themselves are doing what they can to build inventories and lock up supply.

With the coal price inflation coming, now is the time to be invested in a coal miner. America is the Saudi Arabia of coal... and we're about to see a global coal boom unlike anything the world has ever witnessed. We want to buy the best American coal producer.

Take a look at this chart of the last six months for Massey Energy (NYSE: MEE) and Arch Coal (NYSE: ACI) – two of America's biggest coal miners. Based on the price action of the two stocks, which would you choose?

Massey Energy Co.



The obvious choice is Massey, the gray line, right?

You may recognize the name Massey Energy. It is the largest coal miner in the Central Appalachian region of the United States. The company mines both thermal and met coal. It sells coal worldwide.

Massey is also the company that had the April 5 mining tragedy at the Upper Big Branch (UBB) mine in West Virginia. Twenty-nine miners died. Production at the UBB mine ceased. The stock took a beating. It has not recovered. The mine remains closed.

Investors concerned with Massey's ability to replace lost production, potential liability, and regulatory fallout from the April disaster have sold. Yet the damage is not permanent. Massey will get its affairs in order and return to profitability with the rising price of coal. Investors will start buying Massey stock.

Will they be overpaying? Based on the chart, that seems impossible. It's not. *Massey stock still isn't cheap.*

Over the last five years, shares have traded for an average of 8.4 times trailing 12-month operating cash flow. Today, Massey trades for 10 times its trailing 12-month operating cash flow of \$320 million.

Let's assume operating cash flow increases by 25% over the next 12 months to \$400 million. Using the same 10 times multiple works out to a \$39 stock price. This is a 25% gain from the \$31 where shares are today, *using an already inflated multiple.*

The prospects for **Arch Coal** are far better. How can that be, if (1) the business fundamentals are the same, (2) the Massey tragedy has been digested by the market, and (3) Arch's stock price is already rallying?

We'll approach it the same way we did with Massey. Arch's average operating cash flow multiple over the last five years is 10.9 (Other miners', Walter Energy and Peabody Energy, averages have been 11 and 23, respectively. Arch's number is reasonable.). Right now, the multiple is 8.9. Arch remains a good value relative to its historical price and cheaper than Massey – hard to believe looking at the chart.

To project how high Arch might go, we look at two factors: operating cash flow growth *and* something called "multiple expansion"...

Again, we will assume operating cash flow grows by 25%. This increases operating cash flow to \$602 million from \$482 million for the next 12 months. Using just the 8.9 multiple gives us a \$33 stock price – a 25% gain from the \$26.50 where shares are today.

Factoring in multiple expansion carries the potential even higher...

Using the historical average, 10.9, on \$602 million converts to a market cap of \$6.5 billion. At this level, shares would be trading for \$40, *a gain of more than 50% from today.*

In front of the imminent wave of coal demand, which stock do you want to buy? The one that's an average buy and may struggle to climb 25%? Or the one that's cheap and looking at a 50% gain?

Action to take: Buy Arch Coal (NYSE: ACI) up to \$28. Use a 25% trailing stop loss.

If the lights do go off, at least you'll own a lot of coal.

Portfolio Review

Wal-Mart (NYSE: WMT) appears to be reading our script. We recommended shares last month. We explained how, investing in Wal-Mart, you are making an emerging market and international investment with the world's largest global retailing giant that few realize is still growing.

Two weeks after our issue, Wal-Mart exploded. The company announced plans to acquire the South African-based retailer, Massmart, which runs 290 stores in 13 countries. Wal-Mart would pay \$4.6 billion – *in cash*. It would be Wal-Mart's first move into Africa.

Recall that Wal-Mart had fewer than 500 stores in Mexico in 2000. Less than 10 years later, the company has more than 1,500. Mexico is a country of 100 million people. There are 1 *billion* Africans. Wal-Mart surges on...

If you aren't benefiting from international exposure and growth owning Wal-Mart shares yet, buy some before you miss out.

Other buys in the portfolio are computer-chip titan **Intel (Nasdaq: INTC)**, health care colossus **Johnson & Johnson (NYSE: JNJ)**, and the nuclear power heavyweight **Exelon (NYSE: EXC)**. If you don't own shares of any of these, get a toehold (at the very least).

Given this month's coal story, **Calpine (NYSE: CPN)** deserves highlighting. Bear in mind Calpine provides power generated exclusively from burning natural gas. Natural gas is plentiful in the U.S. More reserves are proven each day.

Unlike coal, natural gas isn't leaving our borders. Export makes little economic sense. Its price isn't going to skyrocket because of growth in Asia. Coal's is. The cost of power is going up, but Calpine's fuel costs aren't. Calpine's profits will soar. *Buy Calpine while it's cheap – even at a 10% discount from where we first recommended it.*

We're closing our short position on the indebted bank-dressed-up-like-an-industrial stock **General Electric (NYSE: GE)**. The coming inflation will make GE's current debts easier to repay. While we wouldn't recommend buying the stock, we're no longer sure it can't refinance in 2012. We want to close the position for now and reconsider it after 2012. **Buy, to cover, GE.** We're booking a 10.1% loss on the short in the model portfolio.

The recent rally whipsawed us out of our **Brunswick (NYSE: BC)** short. After plummeting from \$15 to less than \$13, shares reversed to touch \$16, closing above our trailing stop. We ended up with a 6.7% loss on the trade. **Buy, to cover, Brunswick.**

Finally, we never opened the short position on **Advanced Micro Devices (NYSE: AMD)**. We have now removed it from consideration. As we mentioned in our September 29 update e-mail, reports are circulating that Oracle may be interested in acquiring the company. If true, AMD could surge much higher. The result would be painful if we're short. Caution is advised. We're letting this one go.

Good investing,



Porter Stansberry and Braden Copeland
October 8, 2010

P.S. In our August issue, we recommended another way to play Asian commodity demand – **Eagle Bulk Shipping (Nasdaq: EGLE)**. At the time, shares traded for less than \$5. We recommended buying them up to \$5. With the Asian commodity demand story continuing to grow, thanks to quantitative easing, **we're moving our buy-up-to price to \$5.25.** We think you'll make 100% here – or more – in the next year. Maybe even enough to keep pace with inflation...

Investment Advisory Model Portfolio

Prices as of October 7, 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>Return*</u>	<u>RISK</u>
Wal-Mart	WMT	9/9/10	\$51.91	\$54.36		Global blue-chip	Buy	4.7%	1
Annaly	NLY	11/6/08	\$13.64	\$17.70	\$5.05	Gov. port. repair	Buy below \$17.50	66.8%	1
Johnson & Johnson	JNJ	7/6/06	\$60.52	\$63.22	\$7.67	Blue-chip health	Buy	17.1%	1
Exelon	EXC	10/9/02	\$21.47	\$42.92	\$13.10	Nuclear power	Buy	160.9%	1
Intel	INTC	7/16/10	\$21.51	\$19.40	\$0.16	Blue-chip tech	Buy	-9.1%	2
Weyerhaeuser	WY	7/16/10	—	\$15.94		Timber REIT	Buy below \$13.53	—	2
Prospect Capital	PSEC	6/24/10	\$10.03	\$9.84	\$0.40	Warrant banker	Buy below \$10.08	2.1%	2
Hershey	HSY	12/6/07	\$40.55	\$47.88	\$3.34	Chocolate empire	Hold (Long)	26.3%	2
SVB Financial^^	SIVB	6/29/10	\$41.42	\$43.78		Warrant banker	Buy below \$42.50	5.7%	3
<u>The "Next Boom"</u>									
Arch Coal	ACI	10/8/10	NEW	\$26.00		Coming coal boom	Buy below \$28	NEW	2
Calpine	CPN	5/13/10	\$13.93	\$12.69		Nat gas power	Buy below \$15	-8.9%	2
ConocoPhillips	COP	4/2/09	\$41.45	\$59.71	\$3.04	Cheap oil	Hold (Long)	51.4%	2
Eagle Bulk Shipping	EGLE	8/12/10	\$4.72	\$5.32		Super-cheap ships	Buy below \$5.25	12.7%	3
San Juan Basin	SJT	1/7/10	\$18.34	\$24.68	\$1.33	Safe natural gas play	Hold (Long)	41.8%	4
Silver	SLV	10/13/09	\$17.48	\$22.02		Money crisis	Hold (Long)	26.0%	4
Gold Miners ETF	GDX	12/11/08	\$28.02	\$56.58	\$0.11	End of America	Hold (Long)	102.3%	5
<u>Victims</u>									
Brunswick^	BC	8/12/10	\$15.01	\$16.01		Sinking boat maker	Stopped Out	-6.7%	5
Adv. Micro Devices	AMD	7/15/10	—	\$6.87		Intel's punching bag	Removed 9.29/10	—	5
iShares Italy ETF	EWI	6/10/10	\$15.79	\$17.27		Europe crumbles	Short	-9.4%	5
Barnes & Noble	BKS	5/13/10	\$20.01	\$16.61	\$0.50	Obsolete bookstores	Hold (Short)	14.5%	5
Gannett	GCI	3/11/10	\$16.29	\$12.59	\$0.08	Obsolete newspaper	Hold (Short)	22.2%	5
Western Digital	WDC	2/18/10	\$43.40	\$28.35		Obsolete tech	Hold (Short)	34.7%	5
General Electric	GE	11/19/09	\$15.76	\$17.05	\$0.42	Overleveraged	Buy to Cover	-10.8%	5
Current Portfolio Avg: 27.2%									
* This is the return since reference date, including dividends. ^ Recent price and gain reflect stop-out date. ^^ See "Special Reports" section of the website for further information. Investment Advisory's Model Portfolio does not represent any actual investment result. Our reference price represents the price of our recommended securities at the time we wrote the recommendation. Our sell 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. Please note: Our investment philosophy requires limiting risk through the use of trailing stop losses. Unless otherwise noted, all recommendations use a 25% TRAILING 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. Our risk label is based on current share price and one-year business outlook. 1 = the lowest possible risk. 10 = the highest possible risk.									

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