



For Whom the Bell Tolls

The world's most influential investor gives the U.S. Treasury the ultimate warning

Who is the world's most influential investor?

Most people would say Warren Buffett. He is a living legend – probably the most successful investor in history. He is the CEO, chairman, and the largest shareholder of Berkshire Hathaway, which controls more than \$60 billion of publicly traded stocks and holds total assets of around \$370 billion.

Buffett is famously bullish on America. He says in his most recent letter to shareholders:

Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America. Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential – a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War – remains alive and effective. We are not natively smarter than we were when our country was founded nor do we work harder. But look around you and see a world beyond the dreams of any colonial citizen. Now, as in 1776, 1861, 1932, and 1941, America's best days lie ahead.

You may be surprised to learn that we agree... almost completely... with Warren Buffett.

We have no doubt America's best days lie ahead of us. We are confident 20 years from now America's economy (and the technology that enables its growth) will be virtually unrecognizable to an investor from 2011.

Over the long term, our standard of living will undoubtedly improve.

We part ways with Buffett only on one point: We don't believe the "American system" remains alive and effective. In almost every critical way, the system of incentives, responsibilities, and freedoms that powered America's ascendancy have been corrupted, regulated, or simply destroyed.

What Happened to the 'American System'

The American Revolution delivered to the world a huge nation, virtually free from the burdens and tyranny of government, with a sound currency, little debt, and a population dedicated to avoiding foreign wars. These principles translated into huge financial advantages, making us the wealthiest nation in the world by about 1850. We stuck to these principles, with a few notable exceptions, until about 40 years ago.

Inside This Issue

- What's Behind the 40 Year "Debt Explosion" in the U.S.
- QEII Ends in June. Will Global Markets Crash?
- Our 3 Best Market Indicators
- How to Hedge Your Portfolio with Gold and Cash

Editors: Braden Copeland
and Porter Stansberry

No doubt, in its historic form, the “American system” works. But does it still exist?

Buffett was born on August 30, 1930. In that year, the federal government’s total budget was less than 3% of GDP. Today, total government spending exceeds 40% of GDP. America no longer has any significant advantages in regards to the size of our government. We have at least as big of a domestic government burden as any other major economy. And thanks to our military spending, a much bigger burden in total.

Our military now stations troops permanently in more than 150 countries. Almost 400,000 of our 1.5 million active duty personnel are serving outside the United States. Our founding fathers feared having any standing army. Today, we keep a standing army in harm’s way – spending as much on our military as the rest of the world combined. Whether you agree with these decisions or not, there’s no arguing the point that this kind of foreign policy is radically different than America’s historic position.

Finally... the most important change to the “American System” came when Nixon took us off the gold standard in 1971.

Why the Gold Standard Matters

The banking system of the United States was backed by gold for more than 200 years. During certain emergencies – like the Civil War and the Great Depression – gold backing was suspended. But eventually... the dollar was always returned to its foundation in gold.

Gold has always been a key part of the “American system.” It assured creditors their debts would be repaid in currency that was literally as “good as gold.” Besides serving as a yardstick for creditors and debtors, gold reserves have also *limited* the amount of credit available in our economy. This is its real function – something most observers (including Warren Buffett) don’t fully grasp.

Basing our money on gold limited the amount of new credit banks could create to the size of its reserves. And this limited the amount of money that could be created inside the system, holding inflation in check. The gold standard prevented massive credit bubbles from forming because credit creation was linked to the size of the economy via gold reserves. Growth in reserves could only be achieved by increases in production or through trade.

The gold standard’s powers shouldn’t be exaggerated. A gold-backed monetary system doesn’t prevent bankers from making bad loans. It won’t stop investors from paying too much for lousy investments. And it doesn’t work to prevent bubbles when debts outside the banking system are created

without limit, as occurred with the various trust companies prior to the Great Depression. The gold standard only works to the extent that it’s enforced, just like any other standard.

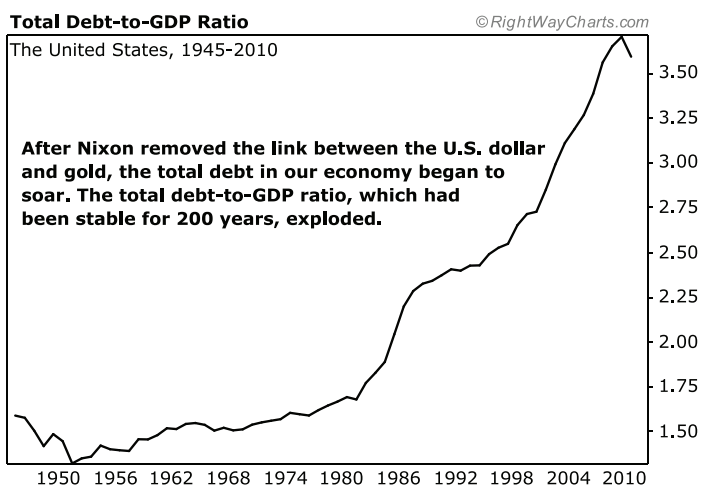
Historically, it was used wisely. That’s why the ratio of debt (both public and private) to GDP had been remarkably stable at around 1.6 times GDP though most of U.S. history. The size of our gold reserves limited our debt burdens. And reserves could only grow in correlation with the overall economy. Bankers couldn’t build up onerous amounts of debt.

That all changed in August 1971. Rather than cut the government’s spending and raise interest rates to slow demands from our trading partners for bullion, President Nixon took us off the gold standard. From that point, our creditors had no legal claim to our gold reserves. And the banking system had nothing but the Federal Reserve to limit the creation of additional credit and money.

You can see what happened next in the charts below...

David Stockman, the director of the White House Office of Management and Budget under Ronald Reagan, explained why credit exploded last month at Jim Grant’s conference in London:

American lawmakers have been freed of the classical monetary constraints. There is no monetary squeeze, and there is no reserve asset drain. The Fed always supplies enough reserves to the banking system to fund any and all private credit demand at rates which are invariably low.



Freed from any requirement to acquire new reserves through industry or trade, the size of our banking system exploded. By 1990, the total debt-to-GDP ratio in the U.S. had grown substantially to 2.6 times GDP. It reached 3.6 times by 2007 – even before the financial crisis. **Today, total debt in the United States stands at \$56 trillion – 3.8 times GDP.**

That's \$180,000 in debt for every man, woman, and child in the United States. That's nearly \$700,000 in debt per family in the United States. The interest on these debts is more than \$3.5 trillion per year. To give you some idea how much money we're spending on interest alone... just consider the total budget of the U.S. federal government is also \$3.5 trillion. Again, \$3.5 trillion just covers the interest!

These debts are completely unaffordable. How many families in America do you know that can afford to finance and repay \$700,000 in debt? Not many... Certainly not the "average" family.

Default or Inflate?

This debt crisis leaves us in a difficult position. Should we default on our debts (many of which are owned by foreign investors) and risk a collapse of our economy? Or should we simply print more money to pay for these debts, and risk a massive inflation?

So far it seems clear our political leaders are choosing inflation. That's why the Federal Reserve is printing trillions of dollars – aka, "quantitative easing." It's buying around 70% of all new debt issued by the U.S. Treasury. This is greatly expanding our monetary base, in hopes the resulting inflation will make it easier to repay our debts.

In our view, this is complete madness. What's the point of paying our debts if the resulting inflation impoverishes the entire country? That's clearly what's happening.

America is in the early stages of a massive debt crisis and currency collapse.

We created this economic tragedy over the last 40 years by abandoning the "*American system*" Buffett references. We have abandoned, willingly, our core economic advantages. Our leaders, including Buffett, convinced us these things didn't really matter... and we could succeed without them.

They will be proven wrong.

You can see for yourself what's going to happen. The dollar is crashing. Against other major currencies, it has lost 35% of its value in the last 10 years. Against a standardized basket of commodities, it is down 50%. To bail out our banks and profligate housing speculators, we are burning the family furniture. As the currency crumbles, the value of every asset in America declines. As the currency crumbles, so does our standard of living. And we are increasingly at the mercy of our foreign creditors.

And for what? We've gone three generations into debt for mortgages on houses we don't need. We spent almost \$100 billion to save a car company whose products no one wants. We

spent perhaps hundreds of billions of dollars to bail out a handful of Wall Street firms – the same companies whose financial products got us into so much debt in the first place. Then in our spare time, we became the proud overlords of Iraq and Afghanistan, where \$1 trillion and thousands of destroyed lives gets you... nothing.

Inflation will soar. The bond market will get wiped out. Our standard of living will plummet.

Just imagine what the historians will write about the "American Empire" in 100 years...

Ten years ago, America sat on a pinnacle of power almost unimaginable even 50 years ago. We controlled the world's reserve currency. And it was just paper. We had no military rival. We invented the computer and built the Internet. Our military, our corporate brands, and our banks dominated the world economy like no other empire in history...

And then we went broke.

How could that have happened? It is as if our success and power convinced us we could break the laws of economics with complete impunity – while breaking all history's blood rules, too.

Down payments? Who needs those? Everyone *deserves* a home. Home prices never fall. Besides, we'll just get AIG to insure those bonds. What could go wrong?

Afghanistan? The Graveyard of Empires? We can handle it.

What about a civil war-prone country (Iraq) with Stone Age infrastructure, three rival indigenous tribes, and a unifying, religious-based hatred of Americans? Why not? Let's invade. We'll get the British to help. They had such success last time...

And why bother managing all these government employees? Let's let them set their own wages and benefits. What could go wrong?

Health care? Of course we can afford it. Let's toss in Viagra and other prescription drugs, too. That'll get us some votes.

Taxes? Nobody wants those. We'll cut 'em. How will we pay for all this? The rich will pay. Oh... that doesn't work? Well, we'll just keep borrowing from the Chinese. Have you seen what interest rates they'll accept? What a bunch of fools... Besides, everyone knows *deficits don't matter*.

And so it went... for nearly 10 years.

You couldn't have written a piece of fiction with a more absurd twist. It doesn't make any sense. But that's exactly

what's happened. Like Charlie Sheen on a bender, we've jumped head first into more bad ideas over the last decade than perhaps any other country in modern times. And now we've come to the logical conclusion... The day of financial reckoning is here for the global paper currency system.

Why the World's Most Influential Investor Sold All his Treasury Bonds

"Never send to know for whom the bell tolls; it tolls for thee," John Donne wrote in his "17th Meditation."

We know Donne wasn't talking about the bond market. But the quote comes to mind this week. We can't recall seeing such a stark example of someone "ringing a bell" at the top of a market before. *The world's most influential investor has sold every last U.S. Treasury bond in his fund.* And because the U.S. Treasury market is the largest securities market in the world, we think this move "tolls" for every investor in every market in the world.

We started this issue with a trick question – who's the world's most influential investor? You'd expect us to talk about Warren Buffett. But it's not him. Buffett is a day trader compared to Bill Gross.

Bill Gross personally manages \$250 billion in bonds. That's about four times bigger than Buffett's equity portfolio. His firm, Pacific Investment Management (PIMCO) manages more than \$1 trillion in bonds, about three times more assets than Buffett's Berkshire Hathaway.

On Wednesday, PIMCO confirmed an incredible market rumor: *Gross sold all his funds' holdings of U.S. Treasury debt.* As recently as February, Gross held 12% of his fund's holdings in U.S. Treasury bonds.

Gross has been outspoken about the risks to interest rates rising after the Fed ends the second round of quantitative easing in June 2011.

When QE2 ends in June, then \$1.5 trillion worth of check-writing per year basically disappears. Because of that, investors are already anticipating the event and heading for the exits.

Gross is so concerned about the bond market crashing (interest rates rising), his fund will begin buying equity-like investments later this year, including preferred stock.

I hope you'll think carefully about what this means.

The world's biggest (and best) bond market investor has sold *all* his Treasury bonds. He is getting out of the dollar, buying emerging-market bonds. And he is so concerned about the fallout from the Fed's quantitative easing, he's begun buy-

ing certain stocks, too.

If you haven't yet begun to shift your assets out of the dollar, this is probably your last wake-up call.

Why This Crisis Is Good News

No doubt, we're in the midst of a serious financial crisis.

Yet at the beginning of this letter, we agreed with Buffett that the long-term future of America is bright. How can we be optimistic about the long run, given our fears about the immediate future?

We think this crisis will finally remind people about the virtues of the American system Buffett remembers. Imagine how bad things will have to get before people stop believing the lies they've been told for 50 years? That's how bad things are going to get. We hope people will finally wake up and demand a return to those sound, uniquely American principles – a limited government, personal responsibility, sound money, and a humble foreign policy. When that happens, our prosperity will return, almost overnight.

Perhaps this seems naïve and overly optimistic. That's OK. We're comfortable being doubted, mocked, lampooned, and shouted down. Over the last three years, we've been warning repeatedly about the troubles arriving today. At first, most people dismissed our warnings... or just laughed at us. But we knew folks would eventually come around... The problems were too big to ignore.

Finally... the world's most influential investors seem to agree with us. It's not just Bill Gross. The world's best real estate investor, Sam Zell, told CNBC last week:

My single biggest financial concern is the loss of the dollar as the reserve currency. I can't imagine anything more disastrous to our country. I'm hoping against hope that ain't gonna happen, but you're already seeing things in the markets that are suggesting that confidence in the dollar is waning. I think you could see a 25 percent reduction in the standard of living in this country if the U.S. dollar was no longer the world's reserve currency. That's how valuable it is.

You could have taken these words right out of one of our essays at almost any point between 2007 and today. And there will come a time soon, when the bond market has crashed... when the dollar has been wildly inflated... when food stamps don't work... when the banks are closed... when there is panic in the streets...

We will tell you it's time to buy stocks again. We will tell you it's time to buy bonds again. We will tell you America is

finally on the right path. You will think we've lost our minds.

Yes, that day will come. But... it's not here yet. Not even close.

What To Do Now

So... what happens now? What does any of this have to do with your investments? How can you make some money as the world blows up?

The crisis has reached the point where what's coming is obvious to knowledgeable and objective investors. That means it's time to "batten down the hatches" on our recommended portfolio...

The stock market is setting up for a big correction. It's time to be incredibly cautious with your investments.

We think our old friend Doug Casey said it best in his recent newsletter. Nothing is cheap enough to buy anymore – and the reason why is the bigger problem:

I've been looking for bargains, all over the world and in every type of market... absolutely nothing – anywhere – is cheap at the moment. You may ask, how that can possibly be? It's almost metaphysically impossible for "everything" to be expensive, if for no other reason than that it raises the question: "Relative to what?" Nonetheless, we're in a genuine economic and financial twilight zone, where nothing is cheap and everything is high risk... The reason for this anomaly is worldwide [money printing] on a completely unprecedented scale and by practically every government. So much money has been created in the past couple of years that it's flowed into every sector of every market – stocks, bonds, commodities and property. Even money itself is actually overpriced...

In this issue, we'll give you something far more valuable than just another stock pick. We'll show you our three secrets for timing the markets accurately. Each month, you'll be able to use these indicators to know when it's time to buy again.

We know... all of the financial textbooks say you can't time the markets. Every time we explain how easy it is to time the markets (by shifting your asset allocation into or out of the stock market), we get hundreds of angry letters from financial planners accusing us of being charlatans, etc. Most of the modern financial industry – index funds, financial planners, buy-and-hold publishers, etc. – is based on the idea that you can't time the markets. The industry has spent millions of dollars on research to prove the markets are "efficient" and trading in and out of them is a waste of time.

We doubt if a more valuable lie has ever been sold. Think about how much money is made off charging investors 1% of their assets simply for holding them? Don't take your money out, they say, because you can't time the market. It's just bull.

The truth is, anyone who has even the most rudimentary understanding of how to value stocks and bonds can time the markets profitably. We'll prove it in this month's letter.

First, our three indicators...

Indicator No. 1 – The SIA Money Flow Gauge

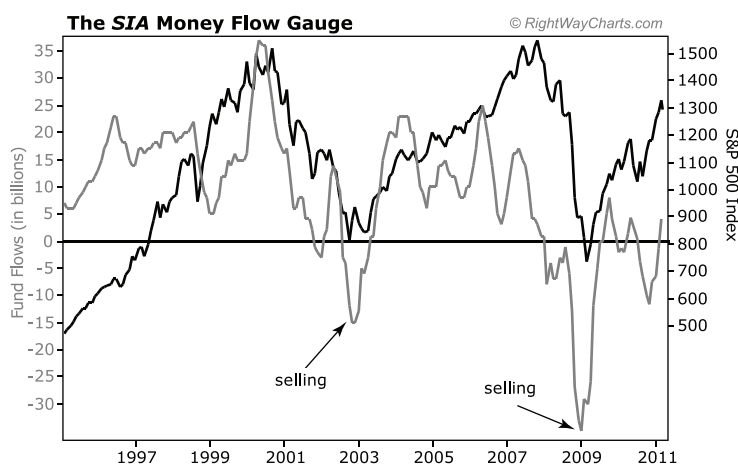
If you follow finance long enough you'll hear about mutual-fund "flows."

You'll see something about cash flowing into mutual funds for the month, comparing the flow with historical levels. "Flow" represents the money retail investors are piling into 401(k)s and allocating with a "style box" system into mutual funds. It's also the money they're investing in mutual funds through IRAs. Most of the time, these investors are buying. *What's interesting is what happens when they start selling.*

At some point when the market is crashing, they finally begin to give up. They sell, exhausted by the losses in their brokerage accounts. Periods of extreme selling lead to market bottoms.

You may have heard the old Warren Buffett adage: "Be fearful when others are greedy, and greedy when others are fearful." That's how it happens. That's when you prepare to buy.

Look at this chart of the SIA Money Flow Gauge.



The thin line on the gauge shows new monthly, U.S.-based investment flows into domestic and international stock mutual funds since 1995. (It's a six-month moving average of

flows provided by the Investment Company Institute.) The thick line shows the performance of the S&P 500 Index.

We use the Money Flow Gauge to identify extreme selling periods, like we saw in 2002 and 2009 (marked on the chart). These are times to buy.

In both cases, the S&P 500 surged higher as mutual-fund outflows decreased and inflows returned. This new buying pushed stock prices higher. Buying confirmed by rising prices begets more buying. Stocks rallied. That's how the indicator works. We use it to look for periods of extreme fear.

So what does all of this tell us about today?

The S&P has been marching higher the past few months. After retail investors sold during 2010, they are buying again.

However, all is not well. The S&P 500 has been slipping over the last few weeks. Retail investors are not returning to the market with the same conviction they have in the past. They have not yet begun to sell either. We know they must – probably in record amounts – before this crisis ends.

Thus, we sit at an important crossroads...

It seems the world's largest, developed economies will continue to be plagued by serious financial problems. Turmoil in the Middle East and Northern Africa is leading to even higher oil and commodity prices. As a result, money available for other goods and services is decreasing. The European debt situation has not gone away either. Countries there – including Spain and Italy – remain on the verge of bankruptcy. You are well aware of the economic trouble facing the U.S.

We are unlikely to be aggressive buyers of stocks until after the world's largest, developed economies have begun to resolve their debt crisis. This may take a decade... or longer.

On the other hand, emerging markets are growing. China's GDP is increasing by nearly 10% annually. India's is climbing by more than 8%. The average annual GDP growth of the next eight largest economies in Asia is greater than 6%. With 600 million rising middle class in China and India alone, the demand that's coming for strategic commodities is almost unfathomable. That's why we continue to be bullish on energy, sound money (gold and silver), and agriculture.

But our bullishness is tempered by the fact that these investment trends are obvious and these commodities have become expensive. We will have much better opportunities in the future as the global financial crisis continues to worsen.

Indicator No. 2 – The *SIA* Spread Signal

What's the best way, overall, to measure the opportunity

in the world's global markets?

Almost all individual investors rely on standard stock market measures of value – like price-to-book ratio, price-to-earnings ratio, or dividend yield. Not us.

The total value of the bond market in the United States is \$36 trillion. Last year, about \$1 trillion of these bonds traded each day.

The U.S. stock market is less than half the size of the U.S. bond market. Its total value is a little less than \$17 trillion. The average dollar value of stocks traded each day last year was less than \$150 billion, just 15% of the bond market's volume.

Even more important, *the bond market includes almost no retail investors*. The minimum investment for a single bond is often \$10,000 and can be as much as \$100,000. It takes institutional-sized pockets to deal in them. Single transactions regularly run into the tens of millions of dollars.

As a result, the majority of bonds trade among experts and insiders who work through special designated dealers. They are professionals working for insurance companies, pension funds, and other multibillion-dollar institutional funds. In the bond market, there are almost no amateurs.

As a result, we find the bond market to be a much better source of information and insight. You can think of it this way.... Who would you rather take a stock tip from – your average day trader, who's trading a \$10,000 account leveraged to \$20,000... or the bond desk at Goldman Sachs, which trades tens of billions of dollars in bonds each week?

And... inside the bond market, whose expertise do we find particularly valuable to track? The emerging-market traders. That's where the best opportunities are... and where you'll find the smartest investors. We specifically track bond buyers *trading emerging market corporate industrial bonds*.

We follow the pricing they establish, buying and selling the bonds of more than 400 different emerging-market industrial companies. (For an explanation of how this pricing – the spread – works, and why it is important, please see the sidebar on p.7.)

Companies on our watch list include everything from Korea Expressway in South Korea to Gol Finance, the holding company for a Brazilian airline.

We use a basket of industrial-oriented companies because their bonds are widely traded, their businesses are well understood, and their numbers are typically clear and easy to compare with similar businesses. Countries on our list include: China, India, South Korea, Brazil, Russia, Malaysia,

Indonesia, Chile, and Argentina... Jamaica, Hong Kong, Mexico, Kazakhstan, Pakistan, Ukraine, and Singapore.

We use emerging markets because we've found they're the best indicators of value across the world's markets. When these bonds become attractive, you'll almost always find great value around the world. When these bonds become expensive, you likely find little opportunity anywhere else either.

And there's a secret to using emerging-market bonds to time the world's markets.

You value emerging-market bonds by comparing their yields to U.S. Treasury bonds of a similar duration – i.e., yields of five-year emerging-market bonds compared to yields of five-year U.S. Treasury bonds. Thus, the price of these bonds is frequently expressed only as a “spread” – meaning the difference in yields between emerging makers and the U.S. Treasury.

You don't really need to know all that... But you do need to know what matters is the trend in these spreads. They tend to trend strongly – either narrowing (becoming more expensive) or widening (becoming cheaper.)

Markets around the world tend to be bullish when the spread is trending lower. You'll want to buy stocks during these periods.

Markets around the world will be bearish when emerging-market bond spreads increase. You'll want to hold or even sell some stocks – especially the lower-quality names – during these periods.

That's it. Following the trend of the spread of emerging-market corporate bonds over the last decade – one of the toughest in market history – not only made you money, it also kept you from losing it.

Take a look at the chart on p.8. The thick black line is a plot of the monthly closes of the S&P 500 Index back to December 2001. The thin line is a plot of the average spread for a basket of emerging market industrial corporate bonds.

Back in 2002, after widening for several months, emerging-market bond spreads began to narrow significantly (Point A). It was a signal to buy stocks. For the next several years the trend continued. The bond buyers were predicting a continuing bull market. Stock investors made a lot of money.

In 2007, the spread suddenly spiked higher (Point B). Bond buyers were beginning to see more risk. It was time to

Understanding the 'Spread'

Bond pricing depends on risk. The interest rate paid to holders reflects this risk. The riskier the bond, the higher the interest rate should be. That means the bond buyer must thoroughly research the borrower and its business before he buys. That's the only way he can know how much interest he should receive. He must determine a fair “risk premium.”

That risk premium is the difference between the interest rate paid on the bonds he will buy and what he deems the comparable risk-free interest rate (where he could invest the money with no risk). In the bond world, they call this difference a “spread.” (Today, bond buyers still use U.S. Treasuries to establish the risk-free rate... though we know this is eventually going to change.)

The riskier the investment, the wider the spread. For example, South Korean steel making giant POSCO, on its bond due in August 2016, is paying 1.94% more in interest than the U.S. Treasury due in 2016. The spread is said to be “194 basis points,” or bps.

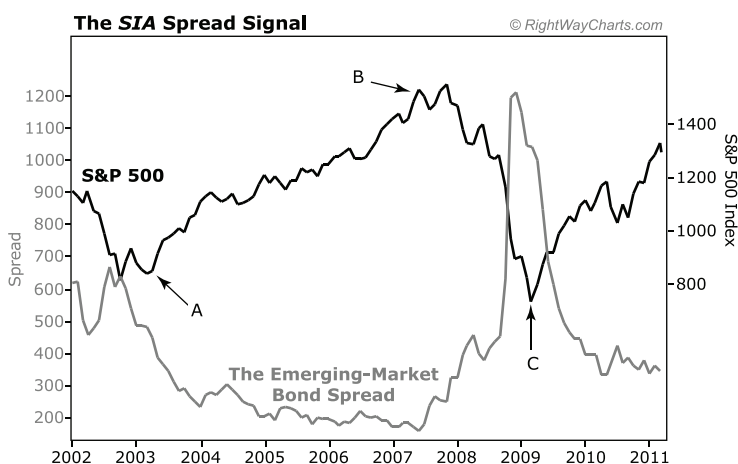
On the other hand, the spread on obscure South Korea-based Hynix Semiconductor's bond due near the same time is 514 bps. The Hynix bond buyer is demanding to be paid 3.2% more in interest than the POSCO bond buyer. The risk is greater.

Spreads move as risks change. The ultra-smart and experienced bond buyers make sure of it...

The spread widens when risk increases. If war breaks out in South Korea and a Hynix bond owner wants to sell his bonds, he will have to ensure the buyer earns more interest for owning it. And the spread narrows when risk decreases. A healthy, growing economy often leads to tighter spreads.

The other thing that can drive spreads is the movement of the “risk-free” interest rate. If it were to move higher without the rate on the corporate bond also moving higher, the spread would close. It usually doesn't work this way. When the risk-free rate moves higher or lower, corporate bond rates also move higher or lower. That's why, when it comes to bonds, the spread is the important number.

Again, a widening spread means more risk, a narrowing spread means less risk.



get out of stocks. You might recall our February 2007 issue – “A Tech Stock Anomaly – An Honest Software Company” – where we warned the market was making a top. (We explained this indicator then, too.)

Finally, as the stock market recovered in the beginning of 2009, the bond buyers were already tipping their hand. The spread moved sharply downward, indicating they saw less risk (Point C). Stock investors caught the bottom almost on the nose. They’ve been riding the surge through today.

What is the signal telling us today?

So far, it has been trending lower over the last several months, telling us it’s OK to be in the market. During the last several weeks, however, events have not been favorable for global economies. Spreads have begun to widen. The move hasn’t been significant enough to trigger a new bear market, but we think it’s a strong possibility over the next four to six weeks.

Also suggesting caution is...

Indicator No. 3 – The SIA Black List

Another way to measure risk in the markets is by measuring investor greed. As Buffett says, “Be fearful when others are greedy; be greedy when others are fearful.”

But how do you know when other investors are being greedy? How do you know when other investors are fearful?

The best way to judge extreme investor sentiment (greed and fear) is by looking for outrageous equity valuations. When several huge companies are selling for unbelievably high prices, it’s a sign investors have become far too greedy.

We define a “huge” company as a stock with more than \$10 billion in market cap. And we define an “outrageous

price” as more than 10 times sales. We prefer to use a multiple of sales rather than earnings because earnings are a product of the income statement, which modern accounting has warped to the point of obscenity. Investors should disregard all reported “earnings.” Sales, on the other hand, is a measure of cash transactions... and is much harder to fake.

Historically, paying one year’s worth of sales (1x sales) for a good business is a fair price. Paying 10 times usually doesn’t make sense. And the bigger the company, the less sense it makes... because as companies get bigger, their growth rates inevitably decline.

Paying 10 times sales for a company with a market cap in excess of \$10 billion makes no sense, whatsoever.

Thus, the SIA Black List is the list of companies with shares trading for 10 times sales that have market caps in excess of \$10 billion.

(**Note:** We don’t count every company in this list. We exclude certain businesses you would normally value solely based on assets. For example, a gold-mining company with 50 years of proven reserves isn’t normally valued by its current sales: It’s valued based on its reserves. We concede this is a judgment call, especially today when so many commodity-related companies have found their way onto our Black List.)

How do we use our black list as an indicator?

We track the total number of companies that fit the “10 and 10” criteria each month. That is... how many companies around the world have both \$10 billion-plus in market cap and are trading at 10 times sales or more?

When the market is attractive or near a bottom, you’ll typically find almost no companies on this list. At the bottom in October 2002, for example, only three stocks made the list. And at the bottom in March 2009, it was a list of one.

On the other hand, when the number of stocks on the 10-and-10 list rises to more than a dozen, investors have begun to lose their minds. They’re paying way, way too much for popular stocks. It’s proof we’re near a market top.

At the last stock market peak (October 2007), we found 14 stocks on our list.

Today, 13 companies crowd our Black List – a big warning sign. Too many investors have become greedy. They’re paying way too much for certain stocks. We may well be approaching a market top. There is cause for caution.

This is also a good list to consult when you’re searching

for stocks to sell short.

Looking back at the list we had at the October 2007 peak, any one of those 14 companies proved to be an excellent candidate for shorting. A year later, they were *all* lower. The average fall was 45%.

Why Shorting Stocks Is Critical

Longtime subscribers will hopefully recall our issue from February 2010 – “The Nightmare Scenario Unfolds: China Abandons the Dollar.” (We encourage new subscribers to spend a little time reading our back issues through December 2008. You’ll discover we weren’t always bearish... even though we’ve been warning about the End of America for quite a while.)

The February 2010 issue describes a top forming in the stock market. It focuses on the lack of obvious value in equities and the growing likelihood of a major sovereign debt crisis in the world’s largest economies...

Investors are beginning to look at the real credit quality of all sovereign borrowers – even the U.S. Sooner or later, they’re going 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?

We took the opportunity to sell five long-held positions for substantial gains. We rarely sell stocks “out of the blue” this way, but we wanted to hedge the portfolio against what would be a serious crisis.

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... I don’t want to own stocks that don’t pay substantial dividends or won’t benefit from the coming inflation... 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 told subscribers if they were unwilling or unable to short stocks, they should go completely to 50% cash and 50% gold.

SIA Black List

<u>COMPANY</u>	<u>SYMBOL</u>	<u>MARKET CAP</u>	<u>PRICE-TO-SALES</u>
Tencent Holdings	TCTZF	\$53 Billion	21.3
Baidu	BIDU	\$42 Billion	34.8
Vmware	VMW	\$35 Billion	11.9
Tullow Oil	TUWOY	\$21 Billion	20.5
American Tower	AMT	\$21 Billion	10.5
Public Storage	PSA	\$20 Billion	11.5
Salesforce.com	CRM	\$17 Billion	10.0
Silver Wheaton	SLW	\$16 Billion	36.4
Power Assets	HGKGY	\$14 Billion	10.7
ARM Holdings	ARMH	\$13 Billion	19.0
Continental Resources	CLR	\$11 Billion	11.4
China Merchants Holdings	CMHHY	\$11 Billion	21.5
Cairn Energy	CRNCY	\$10 Billion	20.3
Total:	13		

We still think that’s good advice.

Cash, by the way, doesn’t necessarily mean U.S. dollars. It means any form of an extremely liquid and safe short-duration instrument. As a proxy, we recommended the **Barclay’s 1-3 year U.S. Treasury Bond ETF (NYSE: SHY)**. This may seem odd given our fears about an imminent devaluation of the U.S. dollar, but that’s why we also recommended the matching 50% allocation to gold.

If you’re not going to short stocks, you should take a “neutral,” liquid position. That’s what a 50% gold/50% cash portfolio will do for you. It will allow you to wait out this crisis without losing money to inflation or devaluation, because the gold will hedge your exposure to the U.S. dollar and the cash will provide some protection against the volatility of a soaring gold market.

We know this advice will sound pretty radical for new subscribers used to Wall Street’s “buy-and-hold” mantra. We strongly suggest you disabuse yourself of the notion that the only way to make money is to always be invested in stocks. It just ain’t so.

For example, even though stocks performed well last year, if you followed our advice to go cash and gold, you would have seen a double-digit gain in your portfolio. Gold is up about 30% since last February. Assuming a 50% allocation, your total return would have been around 15%. That’s essentially the same return as the S&P 500. But you could have gotten it without having any exposure whatsoever.

er to the stock market.

Quantitative Easing Pushed the Market Higher... But What Will Hold It Up When the Fed Stops Buying?

Shortly after we published our February 2010 letter, the European sovereign debt crisis began. Stock markets began to fall around the world. Our timing was almost perfect.

To protect our portfolio, we picked six stocks to short in 2010. We earned an average profit on these positions last year of more than 17%. We picked wisely, making money on four out of six recommendations. And keep in mind... we are still in the Barnes and Noble short from last year, which may end up becoming even more profitable for us this year.

Still, our returns would have been much higher if "QE2" hadn't come around. In August of last year, central banks in the United States and Europe began a second round of massive monetary expansion, driving asset prices higher in almost every category. This massive monetary expansion is why the stock market has performed so well. The last two years have seen the second biggest rally in history – better even than the rebound in stocks following the market's bottom during the Great Depression.

The monetary authorities are doing everything in their power to propel the stock market higher. This hurt our returns last year, as we were hedging our portfolio with short recommendations. They can't do this forever. Imagine what will happen to stock prices when the central banks stop printing...

We think you'll see a huge correction in stock prices, with the most inflated stocks falling more than 40%. If we're right about that, you'll be glad you took our advice and hedged your portfolio with short recommendations.

So once again... our advice is to either hedge your portfolio with our short sell recommendations, or get out of the stock market (go to 50% gold and 50% cash). During periods like this,

your goal as an investor is to maintain what you've got. We'll tell you when it's finally time to load up and make huge profits, like we did in late 2008 and throughout 2009.

Now... if you've never shorted stocks before and are afraid to try, start with a single share. Just short one share. Watch what happens. As you learn how to short successfully, you'll discover no difference at all between shorting stocks and buying them: They are two sides of the same coin. To set up your account for shorting, you'll probably have to call your broker and tell them what you want to do. Don't be afraid to make the call. Assuming you've got enough capital to fund a margin account, you will be approved. It's really easy.

This month, we hope you'll practice so you'll be ready for the short recommendation we'll have for you next month. You can be almost certain it will be from the *SIA* Black List.

Portfolio Review

First, a bit about trailing stops. Stops – or rules about when to sell – are not something mainstream financial advisors often cover (perhaps because it is not in their interest for you to want to sell). Yet the concept is extremely important. To be a successful investor, you must not only take gains, you must also exit losing positions to protect your capital. You can only do this if you have a rule when to sell.

Our typical recommendation includes putting a 25% trailing stop on a new position. This means you sell any time a stock closes 25% below its highest close since entering the position. Or in the case of a short, if it closes 25% above its lowest close. (With certain stocks we use an absolute stop. We make it clear in the issue when we do.)

<u>Symbol</u>	<u>Current</u>	<u>Trailing Stop</u>	<u>Symbol</u>	<u>Current</u>	<u>Trailing Stop</u>
WMT	\$52.65	\$42.51	EGLE	\$3.99	\$4.00
INTC	\$20.79	\$16.11	CPN	\$14.99	\$11.59
SIVB	\$53.55	\$42.47	SJT	\$24.55	\$18.99
PSEC	\$11.92	\$8.34	SLV	\$34.36	\$26.45
NLY	\$17.80	\$9.06	COP	\$75.18	\$55.74
HSY	\$53.63	\$36.43	GDx	\$56.83	\$47.34
JNJ	\$59.61	\$39.83	CRM (short)	\$127.20	\$159.00
EXC	\$42.96	\$22.49	TLT (short)	\$92.08	\$110.24
BP	\$45.66	\$36.42	AGO (short)	\$14.17	\$17.28
TIE	\$17.25	\$15.45	PHM (short)	\$7.09	\$8.18
MON	\$67.09	\$56.76	BKS (short)	\$12.04	\$20.00
ACI	\$32.15	\$26.79			

The recent volatility in the markets and the fact a major correction likely lies ahead makes this an excellent time to review your trailing stops. If a position of yours closes below your trailing stop, sell the next day.

On p. 10 is a table of the trailing stops and the Thursday closes for the model portfolio. Keep in mind, depending on when you bought, your trailing stop could be different.

If we could assign you homework for this month, it would be this: Learn more about trailing stops and how much to invest in a stock by reading these two great tutorial articles written by our colleague Steve Sjuggerud in our free e-letter, *DailyWealth*:

- Don't Lose Money: The Most Important Law of Lasting Wealth
<http://www.dailywealth.com/1041/Don-t-Lose-Money-The-Most-Important-Law-of-Lasting-Wealth>
- How Much To Invest In Any Single Investment
<http://www.dailywealth.com/1042/How-Much-To-Invest-In-Any-Single-Investment>

What you learn in them will make you a much more disciplined and better investor.

We were stopped out of **Eagle Bulk Shipping (Nasdaq: EGLE)** this month. Shares closed at \$3.99 on March 10 as the broad market sold off. This was below the \$4 absolute stop (not a trailing stop) on our original recommendation. If you have not already, **sell shares of EGLE**. We're booking a 15% loss on the position in the model portfolio.

Since we recommended shares of **Titanium Metals (NYSE: TIE)** two months ago, the price action has been volatile. After surging from less than \$18 to more than \$20, our titanium supplier's stock again trades for less than \$18.

The sell-off came with the surge in oil prices. Many investors are concerned this will slow new aircraft purchases, which would hurt TIE since the majority of its sales come from aviation. This is a near-term concern. Long term, new aircraft will still be needed. They will also need to be lighter, so they burn less of the expensive fuel. This is bullish for TIE stock since titanium is used to make planes lighter.

What's also bullish for TIE is the new round of buying from Chief Executive Officer Harold Simmons. He bought another \$3.4 million worth of TIE stock on March 8, paying \$17.87 per share. Now, Simmons has bought nearly \$60 million worth of stock since late last year – all for around \$17. While the ride for TIE shares may continue to be volatile, it is a good sign the guy who is closer to the compa-

ny than anyone continues to see long-term value at the price where we've gotten in.

On the short side, keep an eye on **Barnes and Noble (NYSE: BKS)**. When selling short, always exit your position once you reach a 50% profit. After that, you enter the area of diminishing returns. Remember, the maximum profit on any short is 100%. For the model portfolio, the 50% gain number on BKS is \$10 per share. If the stock closes at less than \$10, we will buy to cover the next day.

If you are not short **Pulte Group (NYSE: PHM)** already, this is a great stock to short. The housing market continues to suffer. Pulte has another problem, too. During the third quarter the company had to expense \$272 million – 25% of its revenue – for warranty repairs in their new construction. The company said new claims are coming in with greater frequency.

Of course they are... Customers who bought the homes aren't about to pay out of pocket for the repairs. They're already strapped and likely in a house that isn't worth what they paid for it. Further, they probably know as well as anyone Pulte may not be around long. They'd better get as much money as they can... quick. Pulte is in serious trouble. Again, **get short PHM**.

Finally, the rush to "safety" over the last month in the face of the turmoil in the Middle East has temporarily pushed U.S. Treasury rates lower. This has created an even better shorting opportunity for U.S. debt. **Sell Short iShares Barclays 20+ Year Treasury Bond Fund (NYSE: TLT)**. This is an investment that will gain with rising interest rates.

We have gotten some questions about "going long," i.e. buying the ProShares UltraShort 20+ Year Treasury (NYSE: TBT) instead of shorting TLT. This fund will move higher as interest rates move higher. However, this exchange-traded fund is what is known as a "leveraged ETF." Leveraged ETFs are designed to move some multiple of what they track. Over the long term, though, they have been proven not to work very well. Sometimes they even go the wrong direction. That is why we are not officially recommending TBT. Thank you for the questions about it.

Good investing,



Porter Stansberry and Braden Copeland
March 11, 2011

Stansberry's Investment Advisory Model Portfolio

Prices as of March 11, 2011

<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	\$52.65	\$0.67	Global blue-chip	Buy	2.71%	1
Annaly	NLY	11/6/08	\$13.64	\$17.80	\$5.69	Gov. port. repair	Buy below \$15.25	72.21%	1
Johnson & Johnson	JNJ	7/6/06	\$60.52	\$59.61	\$8.75	Blue-chip health	Buy	12.95%	1
Exelon	EXC	10/9/02	\$21.47	\$42.96	\$14.15	Nuclear power	Buy	165.98%	1
Hershey	HSY	12/6/07	\$40.55	\$53.63	\$4.01	Chocolate empire	Hold (Long)	42.14%	2
Intel	INTC	7/16/10	\$21.51	\$20.79	\$0.50	Blue-chip tech	Buy	-1.04%	2
Prospect Capital	PSEC	6/24/10	\$10.03	\$11.92	\$0.91	Warrant banker	Buy below \$10.08	27.88%	2
SVB Financial^^	SIVB	6/29/10	\$41.42	\$53.55		Warrant banker	Buy below \$42.50	29.29%	3
<u>The "Next Boom"</u>									
Calpine	CPN	5/13/10	\$13.93	\$14.99		Nat gas power	Buy below \$15	7.61%	2
ConocoPhillips	COP	4/2/09	\$41.45	\$75.18	\$4.25	Cheap oil	Hold (Long)	91.63%	2
BP	BP	2/11/11	\$45.93	\$45.66		BIG oil	Buy below \$50	-0.59%	3
Titanium Metals	TIE	1/14/11	\$18.40	\$17.25		Surging aircraft orders	Buy below \$20	-6.25%	3
Monsanto	MON	11/18/10	\$59.63	\$67.09	\$0.28	Exploding food prices	Buy below \$65	12.98%	3
Arch Coal	ACI	10/8/10	\$26.00	\$32.15	\$0.20	Coming coal boom	Buy below \$33	24.42%	3
Eagle Bulk Shipping	EGLE	8/12/10	\$4.72	\$3.99		Super-cheap ships	STOPPED OUT	-15.47%	3
San Juan Basin	SJT	1/7/10	\$18.34	\$24.55	\$1.90	Safe natural gas play	Hold (Long)	44.25%	4
Silver	SLV	10/13/09	\$17.48	\$34.36		Money crisis	Hold (Long)	96.57%	4
Gold Miners ETF	GDX	12/11/08	\$28.02	\$56.83	\$0.51	End of America	Hold (Long)	104.65%	5
<u>Victims</u>									
iShares US Bond Fund	TLT	2/11/11	\$88.19	\$92.07	\$0.30	Runaway inflation	Short	-4.74%	5
Assured Guaranty	AGO	1/14/11	\$19.00	\$14.17	\$0.05	Muni bond implosion	Short above \$18	25.18%	5
Pulte Group	PHM	1/16/10	\$8.23	\$7.09		Buckling homebuilder	Short above \$8	13.85%	5
Barnes & Noble	BKS	5/13/10	\$20.01	\$12.04	\$0.75	Obsolete bookstores	Hold (Short)	36.08%	5

Current Portfolio Avg: 35.56%

* This is the return since reference date, including dividends.

^^ See "Special Reports" section of the website for further information.

Stansberry's 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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