



New American Socialism

No one knows what to call it...

That's part of the problem. It's difficult to criticize something that doesn't yet have a proper name.

You can't just call our economic system "socialism." It's not. There's a profit motive and private ownership of nearly all assets. Socialism has neither of these. Besides, far too many people have become far too rich in our system to simply label it "socialism."

If you have ever traveled to an actual socialist country – with a power grid that never works, little public sanitation, petty graft at every turn, and endemic, horrifying poverty – you realize our system and real socialism aren't the same at all.

Our system isn't truly capitalism either, though. The State intervenes in almost every industry, often in a big and expensive way. With government at all levels making up more than 40% of GDP, it's fair to say we live in a State-dominated society.

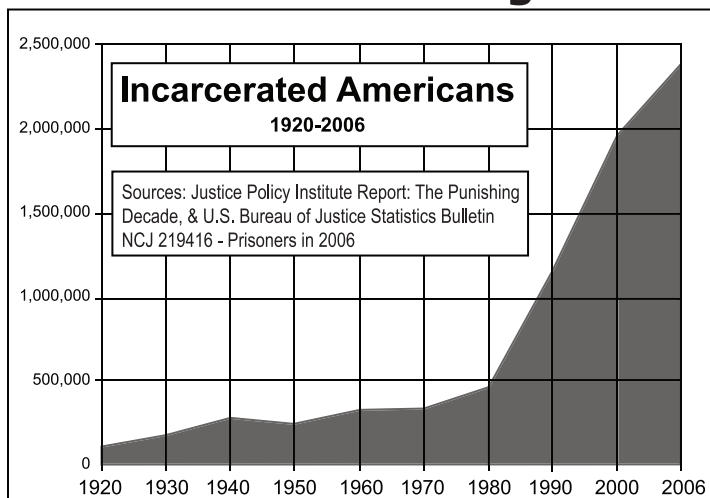
And we share other, disturbing similarities with typical socialist states. Not all of them are economic. The most frightening similarity between the U.S. and classic totalitarian socialist States is the mutual investment in and appreciation of violent coercion. The U.S. has a huge standing army – by far the most powerful in the world. It fights aggressive foreign wars.

And it fights violent domestic wars: U.S. prisons are bulging with a large percentage of the population. *But the overwhelming majority of U.S. prisoners has never committed a violent crime.*

Most of my readers probably aren't familiar with this violent side of America's culture. It's the poor who suffer the most from these aspects of American life. It is their children who are sent to foreign wars. It is their children who get sent to prison.

Likewise, as with all socialist experiments, it is the poor who suffer the worst economic outcomes, too. It is their cash savings that get wiped out by inflation. It is their jobs that disappear when regulations reduce capital investment or government debt crowds out private capital in the markets.

American Gulag?



One hallmark of a totalitarian, socialist government is a large penal system. At its peak prior to World War II, the Soviet Union's "gulag" system incarcerated roughly 800 out of every 100,000 residents. Today, the U.S. incarcerates roughly 743 out of 100,000 residents – a total of 2.3 million inmates. Including people currently on parole, more than 7 million people are in the American criminal justice system – one out of 31 adults. Roughly 70% of this population is "nonwhite," and about 92% is male. Nearly 1 in 11 African American men is either in jail or on parole. Only 7.9% of federal prisoners are violent offenders. The number of drug-related prisoners has increased 12-fold since 1980. The U.S. has the world's largest prison population. Incarceration rates run seven times higher than in similar countries, like Canada, Australia, and the European Union nations.

If the poor knew the first thing about economics, they wouldn't keep voting for socialist politicians and their programs. Alas, they don't even know the basics.

The poor in America, like the poor everywhere, still believe you can rob Peter to pay Paul. They still believe their "leaders" are trying to serve their best interests. It is a sad hoax. What has really happened is clear: Bamboozling the poor has become a way of life for American politicians. And the poor's willingness – even eagerness – to embrace the resulting economic slavery is the linchpin of our system.

But it's not only the poor who have become addicted to the system. Businessmen, like Warren Buffett, embrace it too – despite its limitations and taxes. Buffett calls it the "American System." He says it's the greatest system for creating wealth the world has ever seen.

We're not so sure.

Yes, it certainly makes it easy for big businessmen like Buffett to become wealthy. But those same benefits don't accrue to the society at large. For example... even though the value of America's production has soared over the last 40 years and asset prices have risen considerably, our debts have grown even more.

When you adjust for debt and inflation, you discover America hasn't gotten richer at all. Yes, we have become more affluent. And yes, some individuals have gotten vastly richer. But taken as a whole, when you add back the debts we've racked up, the country hasn't gotten richer at all. Since the end of the gold standard in 1971, real after-tax wages, per capita, stagnated. *On average, we haven't gotten any richer at all in 40 years.*

What happened over the last 40 years?

Why did so many people rush so eagerly into debt? Why did they borrow more and more to buy the same things at ever-higher prices – again, and again, and again? And why do people in America continue to work, day after day, for jobs that offer no opportunity and declining real wages? Most important, how did a few people end up getting so rich from this merry-go-round economic system that never takes us anywhere?

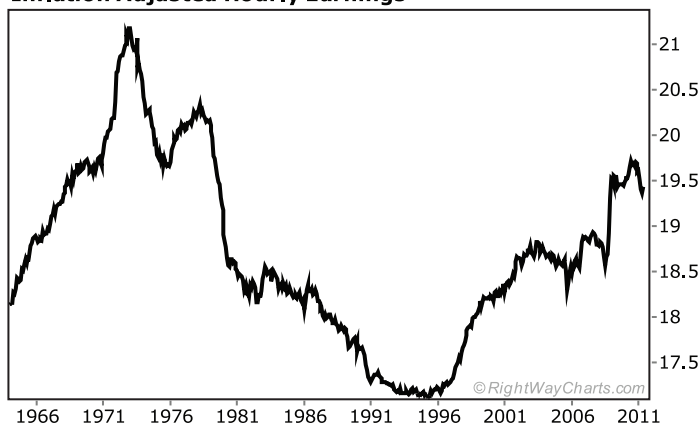
To answer this question, we need only answer one core question: *Who benefits?*

Whose wealth and power increases with inflation? Whose stature in society grows alongside the government? Who profits from increased spending on wars, prisons, and social programs that are doomed to fail? And most of all... who profits from an explosion in debt?

A certain class of people has the power to not only protect itself from these policies but to profit as well. These people have used the last 40 years to produce massive amounts of paper

Wealth Without Income

Inflation Adjusted Hourly Earnings



One of the core features of the New American Socialism is the steady increase in asset prices and debts without a corresponding rise in wages or real wealth. Wages, in real terms, peaked in 1972 – at the same point Nixon moved the U.S. off the gold standard. Since then, our monetary base has exploded along with asset prices, foreign wars, prison populations, government domestic spending, and consumer debt. Wages, on the other hand, have fallen.

wealth. And they are now desperately trying to convert those paper accounts into real wealth, which explains the exploding price of farmland and precious metals.

This explosion of wealth at the top of the "food chain" is the main feature of what I call New American Socialism. It's a system fueled by paper money, the constant expansion of debt, and a kind of corruption that's hard to police because it occurs *within the boundaries of the law.*

Like the European and totalitarian socialism of the last 100 years, New American Socialism harnesses the power of the State to grow and maintain production. Like in traditional socialism, the poor pay the costs of New American Socialism. But unlike socialist systems of the past, this new American version has one critical improvement...

In the New American Socialism, the power of the system produces private profits. In this way, it provides a huge incentive to entrepreneurs and politicians to work together on behalf of the system. This is what keeps the system going. This is what keeps it from collapsing upon itself. And this, unfortunately, is why the imbalances in the world economy will continue to grow until the entire global monetary system itself implodes.

In this month's issue, I detail two investments I want you to make now... These steps take advantage of the corruption inherent in the New American Socialism, and as I'll explain, they will protect your portfolio from the imminent meltdown in credit markets...

How New American Socialism Started

New American Socialism began with the policies of President Franklin Delano Roosevelt. In 1933, FDR seized all the privately held gold in the U.S. and began creating the massive government programs necessary to implement socialism. To give you some idea of how much the federal government grew during FDR's reign, remember federal spending made up 3% of GDP in 1930 – a level that had been fairly consistent for most of America's history. Almost immediately after his election, he tripled federal spending to more than 10% of GDP. And by the time he died in office, federal spending reached 44% of GDP – an all-time high.

As everyone should know by now, the promises of socialism aren't affordable. Robbing Peter to pay Paul is inefficient and kills Peter's incentives. The result is usually economic stagnation, depression, and eventually a crisis that frees people from the government's confiscatory repression. Because America was the only large economy standing after World War II, it took much longer than usual for the problems of socialism to appear in our economy. Also, the government scaled back many of FDR's policies during the post-war boom. In winning the war, we also won a generation of economic spoils.

All this changed in the 1960s. Lyndon Johnson had delusions of government-led grandeur. His ideas of a "Great Society" and "Model Cities," along with an expensive foreign war (Vietnam), were a recipe for massive new debts and an increasing role for government in all aspects of American life.

These policies led to an acute funding problem in 1971 because the debts of socialism couldn't be financed with gold-backed money. It was far too expensive. And so we began a new kind of socialism... the New American Socialism.

What happened in 1971? The size of America's government deficits forced us to abandon gold. After World War II, the U.S. dollar became the world's reserve currency. In exchange for placing the dollar at the center of the world's economy, we made a solemn promise to always exchange the U.S. dollar for gold at \$35 an ounce. Nixon broke that promise, calling our creditors "global speculators" and telling them to go pound sand.

This move away from gold severed the fundamental tie between our economy and our money. Without the link to gold, bank reserves could be created by fiat. And they were. This led to a huge expansion of our money supply and our debts.

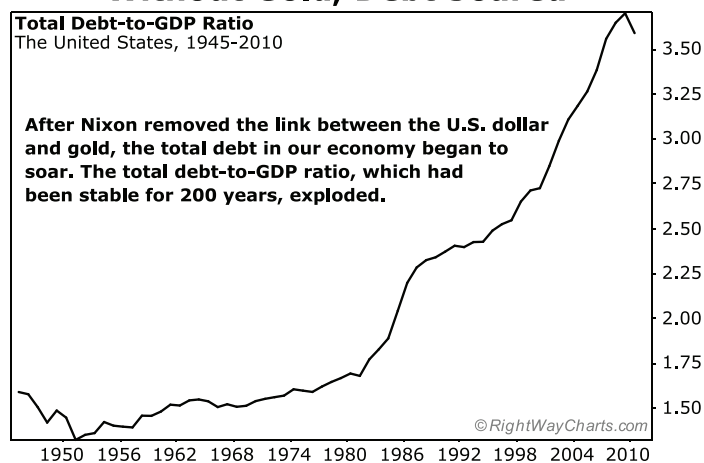
The power to use this debt and to control the creation of new money is the most powerful factor in our economy. The government can now create unlimited amounts of credit to control the U.S. economy. This bestows favored status on certain companies – notably banks. This lies at the core of our economy's structure. It is how fiat money privatizes the benefits

of New American Socialism.

Most Americans simply don't understand our historic tie to gold made it impossible for the banking system to grow beyond clear boundaries. Gold limited the amount of currency in circulation, which, in turn, restricted how much money banks could lend. Under the gold standard, the maximum total debt-to-GDP ratio was limited to around 150%. But as soon as we broke the tie to gold, our total debt-to-GDP ratio began to grow. *It's now close to 400%.*

Without the tie to gold, the amount of economic mischief our government could engineer became practically limitless. No social goal was too absurd... no war too expensive... and no government insurance scheme too patently self-serving not to finance.

Without Gold, Debt Soared



Today, New American Socialism has spread like a cancer throughout our country, afflicting industry after industry. Like a cancer, once it infects an industry, it metastasizes from company to company in that sector. Suddenly, businesses cannot function without massive government aid. These corporate wards of the State weigh down the rest of our economy... making us weaker and less competitive and dragging us further into debt.

Keep in mind, this New American Socialism I'm talking about isn't called socialism at all. It goes by many names. It's been called "*compassionate conservatism*." It's been called "*joint public-private enterprise*." It's been called "*government insurance*."

I've been studying it for many years – finding it in one company after another. I've actually preferred having it in many of the stocks I've recommended over the years because it tends to be good for investors. That's the most insidious thing about New American Socialism: It's a form of socialism that leaves the profit motive in place.

That's why the New American Socialism has grown decade after decade. That's why it continues to be heavily promoted by

almost every mainstream media outlet and both political parties. It leads to a kind of corruption I believe will be impossible to stop without a full-scale economic collapse.

Two Examples of New American Socialism

Look at the housing sector.

For decades, buying a house in America was a simple, private matter. If you wanted to build or buy a house, you had to save up the money required or find private financing. Private financing was hard to get because banks have trouble foreclosing on real estate loans. Nobody wants to kick a delinquent borrower out of his house. As a result, most banks would only lend half the money required to buy a home. They also demanded their loan be repaid quickly – in no more than five years. That's why, even at market peaks like 1929, mortgages only added up to 22% of the equity in residential homes.

While this made housing difficult to obtain for some people, it also prevented a credit bubble that would sweep housing prices higher. And because prices remained constrained by what the real market (not the debt-fueled market) would bear, housing remained affordable.

In 1900, roughly 50% of Americans owned their own homes. This suggests homeownership was well within the reach of most Americans, especially given the fact that, in many crowded cities, home ownership wasn't practical or desirable. This percentage – roughly 50% – remained constant until the end of World War II when the government began creating more ways for people to borrow money to buy homes.

These efforts went into overdrive when the government mortgage bank FDR created as part of the New Deal was sold to private investors in 1968. Just think about this for a moment... The government is using all its power to make loans available to homebuyers, but the profits from these loans end up with individuals. That's New American Socialism. The risks are socialized; the profits are privatized.

History is nothing if not ironic. In 1999, Franklin Delano Raines – named for the former U.S. president – became the CEO of Fannie Mae, the government mortgage bank. This FDR would blow up the housing bubble and set the stage for a massive monetary crisis.

Raines grew up in politics. He first wrote reports for President Nixon. Then, he worked in the Carter administration. After that, he went to Wall Street and worked as an investment banker for 11 years at Lazard. Then, it was back to D.C. to work for Bill Clinton, who rewarded him with the top job at Fannie Mae. He was hailed as the first black man to head a Fortune 500

For a fascinating history of the U.S. mortgage market, I recommend you read the 1961 report from the National Bureau of Economic Research titled "The Postwar Residential Mortgage Market" by Saul Klarman. It's out of print, but you can find it online at <http://www.nber.org/chapters/c2339.pdf>.

company. Within five years, he'd resign in shame... but not before setting the stage for the largest housing bubble in history.

Most of the crimes Raines committed while at Fannie Mae were paltry, petty graft. He demanded illegal accounting changes that inflated the company's earnings. As a result, he received huge amounts of fraudulent compensation – around \$20 million per year. When his crimes were discovered, he resigned. Later, he agreed to a \$3 million settlement with the government, which was paid by Fannie's insurance company. He also gave up \$1.8 million in stock and options (which were later worth nothing in any case.) If you rob a bank, you go to jail. But if you steal \$50 million-\$100 million from the government's mortgage bank, you keep it all. That's New American Socialism.

Raines was disgraced by his own enormous greed and lack of character. But those crimes are merely an afterthought to the real damage he brought to our economy.

Raines was instrumental in building Fannie's mortgage portfolio to gargantuan proportions. And he was responsible for the company's move into subprime loans.

Rather than lend money to homeowners, Fannie's strategy was to buy mortgages from banks, which allowed banks to lend to more homeowners. Fannie Mae also guaranteed mortgage loans across the industry, which allowed more private capital to become available. The theory was this made housing more affordable. It didn't. It only allowed banks to make risk-free loans, which led to vastly higher home prices, bigger banking profits, and huge profits for Fannie Mae at least temporarily. The downside was the whole system was a charade... a giant con job. Fannie never had the capital required to guarantee the loans it bought and insured. When the bubble inevitably popped, the U.S. taxpayers ended up footing the \$500 billion bill.

How could this have happened? How could the largest mortgage bank in the world be run this way? Thanks to its close connection to the government, Fannie Mae didn't have to submit annual reports to the SEC. It didn't have to meet the same capital guidelines that applied to all of the other banks in the country. It could borrow almost as much as it wanted. It could take almost any amount of risk it decided to take.

Again, how did that happen? How could Congress give

such a huge organization a get-out-of-jail-free card from the U.S. Treasury?

To maintain these incredibly lucrative advantages, Raines established Fannie Mae as the largest lobbying organization in the United States. Fannie went so far as to set up offices in key congressional districts. It began to control the elections of the representatives it needed in Congress. And Raines helped pioneer the “Friends of Mozilo” program (named for Angelo Mozilo, the disgraced former CEO of subprime lender Countrywide Financial)... where key Washington officials got deeply discounted mortgages for their personal properties. Raines reportedly received \$3 million in loans from the program.

This is how New American Socialism works. Fannie Mae used the government to establish a set of extremely valuable benefits in the market for mortgages. It used donations to politicians to protect and extend these advantages. Fannie’s executives rode these advantages until the entire system collapsed. Then, they used the U.S. Treasury to cover all of the losses, while the executives kept millions (or hundreds of millions) in compensation.

And what about the benefits for the rest of us?

We all ended up in debt. Some of us got lucky and made money on housing, but most people got wiped out. The percentage of people who owned their own homes increased from around 50% to more than 65% at the peak. But more often than not, the cheap financing didn’t allow people to buy a house. It allowed them to buy *too much* house – a McMansion. Or it allowed them to buy *too many* houses. So today, America has more empty houses than ever – roughly 10% of the entire housing stock. People ended up with houses they didn’t need and couldn’t afford.

Worse... rather than making housing affordable... the exact opposite occurred. By the peak of Fannie Mae’s power in 2006, housing was the most unaffordable it had ever been in America. It was totally out of reach for the median buyer – unless, of course, that poor buyer was willing to take out an unaffordable mortgage. In that case, he ended up losing his down payment and ruining his credit. And today, even after all of that, he still doesn’t have a house.

It was the only realistic outcome from such a harebrained, socialist experiment in mortgage banking. It was ruinous for the middle class and the poor. And yet, it enriched a tiny, elite group of Americans. It funneled colossal profits to Wall Street, Washington, and certain favored homebuilders. What happened to the homebuilders? They received tens of billions in “tax refunds” covering the five boom years of the housing bubble to make up for the losses they suffered when the bubble burst.

In short, the rich kept all the money they’d made. And the

poor got wiped out. That’s the new socialism model in a nutshell. *Privatize the profits; Socialize the risks.*

Socialism Today in America

Let me offer one more example. This tragedy is still brewing.

For many decades, the government has supported higher education in America. Does the government give money to actual students based on their achievement? Yes... but that’s a small part of the program. Most of the government money spent comes via access to student loans – so-called Title IV funding.

A host of rules apply to these loans, but knowing just a few of them is instructive. The most important rule relates to a college’s total revenue mix. To access Title IV funding, a college cannot receive more than 90% of its revenue from government-related sources. The government is allowing the market to determine whether or not a college is useful and legitimate by requiring it to earn *only* 10% of its revenues from private sources. (Does this sound smart to you? It’s tantamount to requiring only a tiny down payment to buy a house. It’s dangerous because the student – and the college – doesn’t have much skin in the game.)

There’s another important rule. Colleges can lose access to government-backed funds if loans made to previous students experience default rates in excess of 25% for three consecutive years. (Naturally, the rule has a key loophole, which I’ll discuss in a moment.)

These two key rules, which leave the government on the hook for 90% of the risk of the student loans, led to the creation and massive growth of the for-profit education industry. Clever entrepreneurs realized that a traditional college education wasn’t practical for many students who lacked either the cognitive ability to succeed at a traditional college or the desire to acquire a liberal arts education. What many students wanted, could master, and afford were essentially trade schools that taught skills in demand from local employers. For-profit education grew up competing with poorly funded community colleges. And they had a major advantage: huge marketing budgets.

Let me show you what this means in terms of how these for-profit schools spend the Title IV money they receive.

Apollo is the largest company in the for-profit education space. In 2009, Apollo grew its total revenues by \$833 million. Yes, you read that correctly – \$833 million in revenue growth during a severe recession. Its Title IV funding rose by \$1.1 billion. That is, the amount of government-related loans and grants it received increased by more than its total revenue growth. The company became even more dependent on the government.

Where did the money go? Not toward education. In 2009, Apollo increased its spending on faculty and other instructional costs by \$99 million. That is, out of every dollar it got extra from the government it spent roughly 9¢ on actual education.

Instead, a lot of money went to shareholders. Since 2008, Apollo has spent more than \$1 billion buying back its own stock. But most of the money went to its executives. Apollo currently spends almost \$1.5 billion annually on compensation for its administrators and salesmen.

In one way, you can argue for-profit education executives have earned their paychecks. Enrollment is booming, with the public showing a clear preference for the curriculum offered by the for-profit schools. Since 1986, enrollment in the sector has grown sixfold. *The U.S. now has 2,800 for-profit institutions of higher learning.* About 10% of all college students are now enrolled in for-profit schools.

And you can make a good case these firms are providing a valuable service at a reasonable price. Supporters of the industry note that average revenue per student is the lowest at for-profit colleges: \$11,130, while public universities average \$18,922 per student and private not-for-profit colleges received \$37,869 per student.

So are these students (and our society) getting a bargain? Does foisting 90% of the risk on government lead to positive outcomes? No, not really. Instead, much like Fannie Mae did to housing, these government guarantees create huge incentives for selling college to students who can't afford it. It also makes college more expensive and less affordable.

The most recent examination of student-loan repayment shows for-profit education students have much higher default rates. In 2008, the national default rate on student loans was 7%. The default rate for private not-for-profit schools (the most expensive) was 4%. The default rate for public not-for-profit school loans was 6%. The default rate for private for-profit schools was 11.6%. U.S. Secretary of Education Arne Duncan said of the numbers:

The data tells us that students attending for-profit schools are the most likely to default... Far too many for-profit schools are saddling students with debt that they cannot afford in exchange for degrees and certificates they cannot use.

When you look at the default figures in aggregate, the problem jumps out at you. Students at for-profit schools represent 26% of the borrower population. They make up 43% of all defaults.

When I saw that number, the first thing that occurred to me was... "Wait a minute... I thought schools get kicked out of the program if default rates reach 25% for three consecutive years? How can for-profit schools represent so much of the default rate

when they make up so few of the students borrowing?"

The answer is – *borrowers who default after the first two years of repayment aren't counted.*

What?!!?

That's right. To count as a default you have to stop repaying your student loans in the first two years after graduation. The repayments required during this time frame are extremely low – much like the teaser rate on a subprime mortgage. The real extent of the problem can't be understood until you see the actual default rate on all loans. After all, the real default rate isn't the percentage of students who default in the first two years. It's the percentage of borrowers who never repay their debts. What is the real number? Well, we don't know. *The Department of Education won't make that data public.*

What we do know is the companies themselves write off between 50% and 60% of the private loans they make to their students.

The companies use these private loans to make sure they stay within the 90% rule that governs access to the government's backing. That's tantamount to the many second mortgages that were made on the side to homebuyers, so they could afford their down payments. And not surprisingly, when folks buy a home using 100% borrowed money or when they get a college degree using 100% borrowed money, they frequently won't (or can't) pay the loan back.

I have no objection to a private lender who decides to lend to poor credit risks – even for things like an expensive home or degree. But let that lender bear the risk. Don't pass those risks to me via government protection.

Obviously, with 50% to 60% of these loans defaulting, the only real profit in the system comes from the government's protection. And the scary part is the amount of government money flooding into these schools is soaring.

Historically, little government money was available to these schools – only \$2 billion to \$4 billion a year. But then... with the right kind of legal corruption... the floodgates opened.

Sally Stroup was the head lobbyist for Apollo. In 2002, she became the assistant secretary of the Department of Education under President Bush. Guess what happened next?

Stroup gutted the rules that governed which students these schools could recruit. Government funding for for-profit college education is now more than \$20 billion a year. And at current growth rates, within 10 years 40% of all government-backed college funding will go to for-profit education.

Call it socialism. Call it New Socialism. Call it *compassion-*

ate conservatism. It doesn't matter what you call it, the rules of the game are clear: *The government takes all of the risk while investors and executives keep all of the profits.*

This industry is selling a product its customers cannot afford. This industry overwhelmingly targets women and minorities – people who are often up against a wall financially. This industry games the rules of the government and spends a fortune on lobbying – more than \$12 million in the last year. This industry would literally not exist without government-guarantees standing behind 90% of its revenues. And Wall Street experts estimate this industry will rack up around \$250 billion in credit losses over the next decade – an amount of money that exceeds the losses from Fannie Mae and Freddie Mac so far.

All of these risks will eventually cost the U.S. Treasury billions, as these students will never be able to repay these debts. While these students have no financial skin in the game (many borrow 100% of their tuition), they face enormous consequences down the road from this scheme... Student loans are notoriously difficult to discharge, and many borrowers will be crippled financially by the obligations they cannot afford.

The facts of this situation are incontrovertible and well known – even inside the current president's administration. And yet... and yet... even when all of these facts were studied and reviewed... what did the president do?

Critics had demanded so-called “gainful employment” regulations that would limit how much a student could borrow to an amount of money he would likely be able to repay based on the current employment and income track record of other alumni. Obviously, such sensible regulation was never likely to be implemented by Washington... especially not by a minority president when the funding in question goes overwhelmingly to poor, minority students.

Instead, in early June, Obama's administration promulgated a new set of rules that were supposed to address the abuses and the risks of the government's 90%-funding rules for for-profit education.

The new rules actually loosen the funding requirements – substantially. Colleges will be eligible for federal support as long as at least 35% of their students are repaying their loans over the first three years. Now, up to 65% of the students can default. And what about limiting loan amounts to ability to repay? Loan amounts may not exceed 30% of anticipated discretionary income. How will students pay for food, housing, transportation, insurance, etc. if they're spending 30% of their incomes on student loans?

Rather than tightening the standards, the new rules actually loosen the standards. They also go further in guaranteeing continued federal support. Under the new rules, no schools will lose funding until 2015 at the soonest, to give them time to adapt to

the new “standards,” which were trumpeted as a major reform.

Only in Washington D.C.

The Investment Challenge

I have a question for you, dear subscriber. It's a complicated one though... so bear with me.

The for-profit education “business” is one of the most obvious frauds ever foisted on the American people. The industry has been structured to take advantage of the least sophisticated members of society. It promises benefits the students on average are unlikely to achieve: a better job and a better life. Instead, they are saddled with unpayable debts and enjoy no corresponding increase in wages.

Assuming the government should not do anything to protect the students from this fraud, shouldn't the risks of perpetrating this fraud be left with the companies themselves? Let Apollo guarantee these loans. Let it take the risk that these debts will never be repaid.

But that's not how the New American Socialism works. What happens is, all of the profits of this scam go to the executives and the shareholders. The risk – 90% of it – goes to the government.

Socialism always destroys the poor because it robs them of social mobility and makes it impossible to protect themselves from the predations of the powerful. Historically, its damage has been limited because eventually socialism so disrupts an economy that even the rich and the powerful suffer. That's what's so dangerous about this New American Socialism. It doesn't subject the rich to any depravation at all. It does just the opposite. The New American Socialism retains the profit motive for the rich and the well connected. In this new model, only the poor suffer. The rich are always protected.

It's capitalism for the rich, without any risks. And socialism for the poor, without any rights.

My question to you is, what's the future of our country? Our leaders are now so corrupted by New American Socialism they can't even stop the for-profit education scheme I describe above. The facts, by the way, aren't even in dispute. This is the obvious stuff – the stuff no one can really dispute. If our leaders let this industry rack up \$250 billion in bad debts over the next decade, how can we expect them to do anything to stop our massive annual deficits and our runaway federal debt? If the administration can't stop the for-profit education industry from getting its hands into the U.S. Treasury, whom will it stop? Nobody.

The entire system is so corrupt investors must begin to view U.S. government bonds and our currency with great suspicion.

As investors, the hard question is, how should we handle companies and sectors caught up in the forces of New American Socialism? Should we buy shares of Apollo (Nasdaq: APOL)? They're cheap, trading at about 3.5 times cash earnings, and the U.S. Treasury has essentially guaranteed its future revenues. That's certainly attractive. My bet is the stock doubles over the next year.

But... are you willing to make a profit on a business that couldn't survive without government protection, whose products probably aren't saleable in a real market? How mercenary are you? It's a difficult question.

Despite my misgivings about the business model, given the government's recent decision to continue providing loans to Apollo students it's probably a good stock to own. The only real question is: Do I want to be buying stocks – any stocks – right now? For me, the answer is no.

The problem is, the system itself is unstable and unsustainable. We can't know when or how, it will break down. But we know it can't last long. Why not?

Consider the big problem brewing in U.S. pension funds. If pension funds can't meet their obligations, the federal Pension Benefits Guarantee Corporation (PBGC) must, by law, assume the obligations.

I would like to nominate the PBGC as the most Orwellian of all government agency names. You see, the PBGC is not a corporation at all. It is a federal agency. And it doesn't really guarantee anything. It's just another phony insurance scheme, where the disbursements were supposedly going to be funded by premiums paid for by private industry. But in fact, according to research conducted by The New York Federal Reserve, the PBGC is already underfunded by at least \$30 billion.

I believe even that large sum is probably optimistic.

U.S. pension funds currently control roughly \$15 trillion in assets. That's, by far, the largest pot of institutional money in the U.S. (or the world). It's bigger than mutual funds. It's bigger than insurance companies. It's much, much bigger than hedge funds or private-equity funds.

And here's the big problem... Almost all pension funds assume an 8% annualized return over the long term. The actual performance for the last decade has been much worse – basically flat. If you change the assumptions behind pension fund accounting to adjust for a world of low interest rates and smaller average returns – say to a 5% annualized return – suddenly, pension funds are not underfunded by 20% on average, they're underfunded by 40% on average, according to the research done by my friend Mebane Faber at Cambria Capital. That implies future unfunded pension obligations of \$3 trillion to \$5 trillion.

I believe the health of our pension funds reflects the real health of our economy. When the largest pots of institutional money can't meet their obligations, your economy is suffering a dramatic and *dynamic* problem.

The problem is New American Socialism. It's that government spending (and government power) has so warped our economy that little gets done without a government racket/protection scheme in place. Quite simply, our country has bought into the idea that it's OK to rob Peter to pay Paul, as long as the profits in the transaction go towards certain well-connected corporations, lobbyists, and congressmen.

The New American Socialism is perfect for a society that's organized by special interest groups and believes its economic power is eternal. After all, the entire structure is fueled by debt that individuals inside the system believe someone else will have to repay. The New American Socialism is founded on an institutionalized belief, across our country, that Vice President Dick Cheney had it right: *Deficits don't matter*. As a result, debt continues to grow faster than it can even be accurately counted.

Sooner or later, these debts will bankrupt all of us. The only question is when. Maybe sooner than anyone realizes. There's about to be a major crisis in the high-yield sector of the credit markets.

In fact, it has already begun.

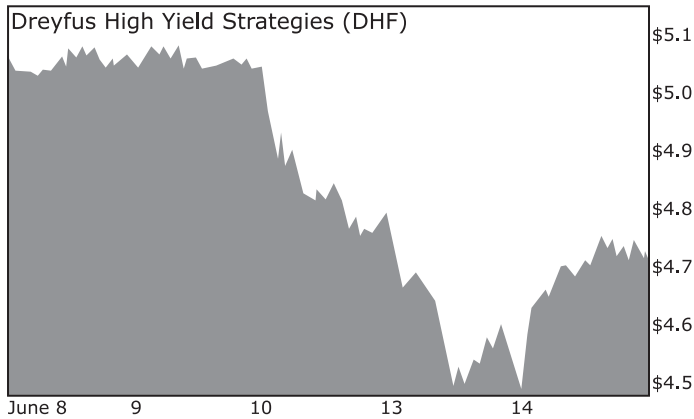
Another Crisis in Credit

Last week, at the annual New York meeting of the private wealth club I founded, Atlas 400, one of our members stood up. He is a senior executive at a major Wall Street bank. He is in charge of the bank's high-yield, fixed-income desk. He is one of the world's leading dealers of high-yield bonds. He told our group he wouldn't buy anything in the space, and at some point in the next few months, he predicted the market would endure a complete wipeout. He said the market began to turn last week, and deals were getting harder and harder to price.

The market is blaming the "back up" in high-yield bonds on the Federal Reserve, which has been selling some of the assets it took over in its bailout of AIG. It has dumped roughly \$30 billion of these so-called Maiden Lane II securities onto the market over the last month. (These are mostly lower-quality mortgage securities.) This influx created a big increase in the spread between high-quality debt and high-yield debt. You can see the impact on the market in the following chart of the Dreyfus High Yield Strategies closed-end mutual fund, which is simply an investment fund of high-yield bonds:

The Fed selling \$2 billion-\$3 billion per week of Maiden

High Yield Bonds Tumble...

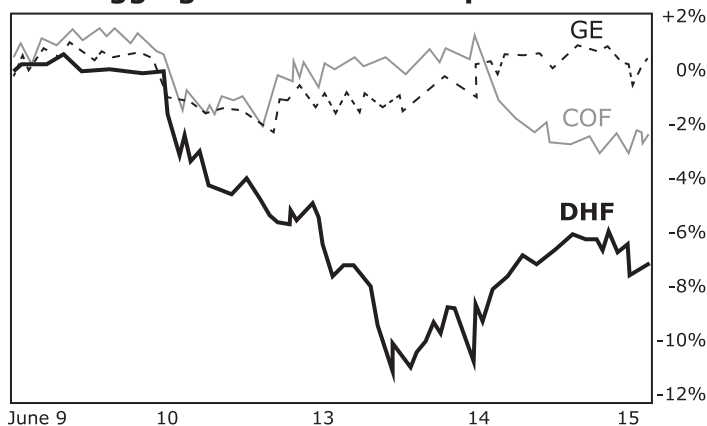


Lane II was enough to make the credit market tank last week. Imagine what will happen on June 30, when the Fed ends its \$600 billion quantitative easing program. The Fed has been printing money and buying roughly \$85 billion worth of Treasury bonds per month. That gives the credit market a huge boost. The capital that otherwise would have filled the U.S. Treasury coffers has instead been available to buy higher-yielding debt.

When quantitative easing stops, the high-yield market will continue to fall – forcing credit spreads wider. This will make low-quality bonds harder to sell, reduce the amount of credit available to the U.S. economy, and cause a pull back in the markets. You can think about it this way... adding just \$2 billion a week to supply caused the credit market to catch a cold. Imagine what will happen when \$20 billion a week is withdrawn from demand.

To anticipate this looming event, I'd like us to return to some of our favorite short positions from the previous crisis period – Capital One Financial (NYSE: COF) and General Electric (NYSE: GE). Both of these companies rely on the credit markets. You can see that by looking at a short-term chart of their stocks as compared to the movement in Dreyfus High Yield fund:

Dragging Down GE and Capital One



Capital One owns a large portfolio of unsecured credit-card debt. Additionally, as cardholders continue to increase their balances, Capital One must securitize these obligations. If credit spreads widen, Capital One will make less money going forward as investors will pay lower prices for its loan securities and investors may well begin to doubt the value of its assets.

Capital One's business is huge and has been performing well lately, thanks to fat margins made possible by low funding costs – aka the Fed's near-zero interest rate policy. The company holds \$124 billion of credit-card debt, funded via \$109 billion of low cost deposits. It makes more than 7% currently on the spread between what it earns from the credit card receivables and what it pays for the deposits.

My bet is that Capital One's funding costs will increase and the value of its credit-card receivables will decline because of increased financial stress related to a slowing economy.

We made a similar prediction in 2008, and we were right. In the recession of 2009, Capital One's charge-off rate reached 10%. Currently, its allowance for loan losses is near 4%.

However, selling Capital One short is risky. If credit spreads don't continue to widen and if the company's charge-off rate doesn't increase, the Fed's zero-percent interest policy will continue to make this a profitable business.

So while I recommend taking this short position ahead of the end of QE2 on June 30, I advise you to use a 15% stop loss initially on the position. This will protect us against getting the timing wrong on this short. Also, I would remind you to use a sensible position size on this position. No more than 4% of your portfolio. This short sell recommendation, as with most of my short sell recommendations, is a *hedge*. Our expected return on these kinds of positions is breakeven, on average. Shorting stocks in the market protects us in the event of a widespread downward move in the market.

As you know, we haven't shorted many stocks, despite being fundamentally bearish since February 2010. It is difficult to make money shorting stocks when the Federal Reserve has a printing press that's spitting out the world's reserve currency. I am returning to a more active shorting position because I believe the end of QE2 will reveal the financial world more accurately... as the tide goes out, more financial institutions will be revealed as being far weaker than is commonly believed.

Nowhere else is that more true than with General Electric.

The numbers on this company – America's leading company – are simply astounding. Even though GE has paid down \$80 billion in debt over the last two years, it still owes its creditors more than \$600 billion. This is an amazing figure. It is

more money than Greece owes its foreign creditors. It's more money than Portugal owes. It's larger than the entire external debt of Brazil... and Turkey... and Mexico. It's five times as much money as notorious Iceland owes.

Defenders of GE will surely explain that this \$600 billion figure is something of an exaggeration because the company holds so many safe assets – it has \$468 billion in investments and cash. The problem is, many of these investments are credit-card receivables and dicey mortgages in Eastern Europe.

Why is one of America's largest and most important corporations heavily invested in credit cards and Eastern European mortgages? New American Socialism. Investing in risky, high-yield financial instruments allows the company to maximize its credit rating and its political connections to produce the largest possible profits. But this business model is incredibly risky. In fact, GE would have gone bankrupt in 2008 without the aid of the U.S. government, which has guaranteed all of the company's debts through 2012 – *for free*.

And... what did the politicians decide to do about GE in the wake of the financial crisis? Nothing.

In spring 2010, the government began efforts to reform the banking sector, hoping to prevent a repeat of the 2008 crisis. The bill, ironically, is known as Dodd-Frank – ironic because Sen. Dodd and congressman Frank were the two primary recipients of Fannie Mae's lobbying efforts over many years. And Dodd was a beneficiary of the notorious "Friends of Mozilo" loan scheme.

Part of the reform – known as the Volcker Rule – forbids large financial firms from owning hedge funds and increases regulations on their derivative trading. But these rules only apply to companies "predominantly engaged" in financial services, defined as companies where 85% of annual revenues or consolidated assets come from financial activities. At GE, 83% of its assets are finance-related.

In other words, one of the largest financial companies in the world is not governed by the Volker rule. The financial reform act didn't reform GE, whose potential bankruptcy would have dwarfed the losses at AIG, Bear Stearns, and Lehman Brothers.

Only in America.

If you've followed my work on GE over the last few years, you know my argument against the company. It grew its balance sheet by enormous proportions, increasing it roughly \$200 billion, during the credit bubble of 2003-2008. To pay back its huge debt load, it is selling assets. That's the good news.

The bad news is, selling its best assets (like half of NBC

Universal) increases the size of its distressed assets as a percentage of its total assets. So while total debts are down, I would argue the real leverage in the portfolio is up. GE has fewer high-quality assets to support the debt. And you can see this by looking at cash flows.

In 2008, with \$797 billion of assets, GE produced \$48 billion in cash from operations – a cash return on assets of 6%. In 2009, with an asset base of \$781 billion, the company produced \$24 billion in cash. A cash return on assets of only 3%. And in 2010, with an asset base of \$751 billion, the company produced cash from operations of \$36 billion, a cash return on assets of 4.7%.

My point is, even though GE has recovered somewhat from the recession of 2009, its return on assets has not rebounded to pre-crisis levels – not even close.

And consider this...

In 2010, with cash from operations at \$36 billion, GE decided to repay \$49 billion in debt. That's good. It funded this debt reduction by cashing in investments that produced \$42 billion in cash. That's fine, too – except these huge profits are not repeatable. In any case, GE produced a total of roughly \$68 billion in free cash flow in 2010. It chose to spend almost \$50 billion of that in debt repayment, leaving roughly \$18 billion. Then it paid a \$5 billion dividend and spent \$4 billion on share buybacks.

Why would a company that's so far in the hole spend almost \$10 billion on capital distributions to shareholders? Right now, if GE put 100% of its cash from operations into debt repayment every year and its earnings stayed at 2010 levels, it would take 16 years to pay off its debts. It would take at least a decade to pay down its debts to a more manageable level. No question, if GE were being managed prudently, that's what it would do.

GE holds about \$40 billion in tangible equity. I believe its European mortgage losses are likely to be at least this large over the next five years, which means, at some point soon, GE could be going to the market for new equity. If that happens, the company's share price will probably fall in half.

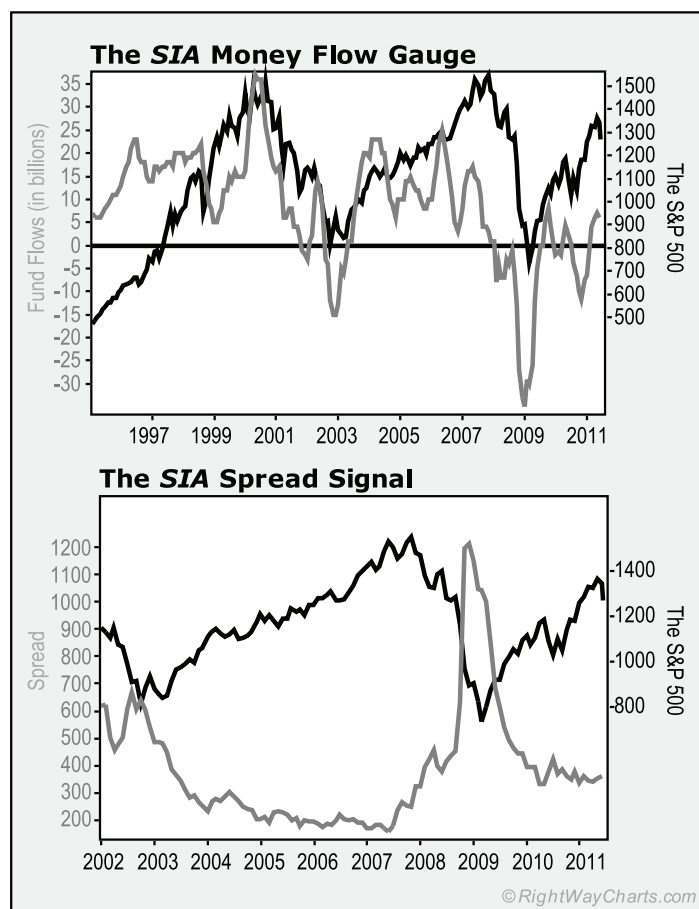
Why run the company this way? Because the managers know GE is too big to fail. They're not running the company as though they actually own it. They're simply running it to maximize their own compensation. If it fails, it fails. The stockholders will get wiped out and the government will bail out the creditors. In the meantime, GE's managers are trying to get rich. They want to keep the company as leveraged as possible. They don't want to repay debts. They want to maximize the company's ability to borrow.

That's how New American Socialism works. We're not building a better tomorrow. We're building a better today.

I'm willing to bet it doesn't work out like most people expect. Instead, I think the folks running GE are going to get what they deserve... and sooner than they realize. I recommend shorting shares of General Electric (NYSE: GE). Use a 25% trailing stop.

SIA Indicator

As you can see in the charts below, our indicators remain neutral, with a somewhat bearish bias. Specifically, only eight companies now make our "black list." The small correction



we've seen in stock prices since about mid-March has taken some of the froth off of the equity market – but not all of it.

Our money-flow gauge shows that we're a long way from a buying opportunity, as mutual funds continue to buy stocks.

Please pay attention to the *SIA* Spread Signal Chart this month and for the next several issues, as I expect this is where the "action" will be. I think we are going to see spreads continue to move higher, which will produce a correction in the stock market. If the Fed doesn't produce another round of quantitative easing, this could lead to a new credit crisis. The fact is, the U.S. economy is far too indebted. And the ongoing sovereign crisis means that, sooner or later, we'll face another credit crisis.

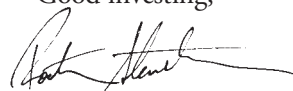
Portfolio Review

This month, we're making a lot of adjustments – moving the portfolio into a better bear-market position.

As I wrote in an e-mail last week, we want to lighten up some of our commodity-related positions. Sell **Titanium Metals** (NYSE: TIE) and **Arch Coal** (NYSE: ACI) now, if you haven't done so already.

Likewise, we recommend selling **Posco** (NYSE: PKX), the Korean steel giant, which briefly traded for less than our \$100 recommended buy limit late last week. We have also moved our entire long portfolio to a "hold." In general, we do not want to buy stocks in the face of the next round of the credit crisis.

Good investing,


Porter Stansberry
June 16, 2011

THE *SIA* Black List: Down to 8

<u>TICKER</u>	<u>SHORT NAME</u>	<u>MARKET CAP</u>	<u>PRICE-TO-SALES</u>
BIDU US Equity	BAIDU INC-SP ADR	43,499,347,968	31.12
VMW US Equity	VMWARE INC-CL A	39,813,808,128	12.79
PSA US Equity	PUBLIC STORAGE	20,033,110,016	11.34
CRM US Equity	SALESFORCE.COM	18,829,019,136	10.37
IVN CN Equity	IVANHOE MINES	14,946,920,448	161.03
AVB US Equity	AVALONBAY COMMUN	11,583,410,176	12.32
SLW CN Equity	SILVER WHEATON	10,745,690,112	22.04
YNDX US Equity	YANDEX NV-A	10,151,419,904	21.57

Stansberry's Investment Advisory Model Portfolio

Prices as of June 15, 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	\$52.32	\$1.03	World dominator	Hold	2.8%	5
Johnson & Johnson	JNJ	7/6/06	\$60.52	\$66.16	\$9.32	World dominator	Hold	24.7%	5
Exelon	EXC	10/9/02	\$21.47	\$41.09	\$14.67	Nuclear power	Hold	159.7%	5
Hershey	HSY	12/6/07	\$40.55	\$54.72	\$4.35	World dominator	Hold	45.7%	5
<u>The "Next Boom"</u>									
POSCO	PKX	4/7/11	\$112.55	\$97.46		Asian steel	SELL	-13.4%	7
ConocoPhillips	COP	4/2/09	\$41.45	\$70.57	\$4.91	Cheap oil	Hold	82.1%	5
Calpine	CPN	5/13/10	\$13.93	\$15.24		Nat gas power	Hold	9.4%	5
BP	BP	2/11/11	\$45.93	\$41.95	\$0.42	Cheap oil	Hold	-7.8%	5
Titanium Metals	TIE	1/14/11	\$18.40	\$16.53	\$0.08	New steel	SELL	-9.7%	7
Silver Wheaton	SLW	12/1/10	\$37.90	\$31.05	\$0.03	Silver secret	Hold	-18.0%	5
Monsanto	MON	11/18/10	\$59.63	\$67.57	\$0.56	Soaring food	Hold	14.3%	5
Arch Coal	ACI	10/8/10	\$26.00	\$25.10	\$0.31	Coal boom	SELL	-2.3%	7
San Juan Basin	SJT	1/7/10	\$18.34	\$23.79	\$2.22	Cheap energy	Hold	41.8%	5
<u>Victims</u>									
ProShares UltraShort Euro	EUO	5/13/11	\$17.55	\$17.59		Debt crisis	Buy	0.2%	5
iShares US Bond Fund	TLT	2/11/11	\$88.19	\$96.92	\$1.44	Debt crisis	Sell short	-11.5%	5
Pulte Group	PHM	1/16/11	\$8.23	\$7.00		Real estate crisis	Sell short	15.0%	5
General Electric	GE	6/15/11	NEW	\$18.24		Debt crisis	Sell short	NEW	5
Capital One Financial	COF	6/15/11	NEW	\$47.87		Debt crisis	Sell short	NEW	5

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

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.

Corrections Regarding Last Month's Portfolio Page

There were two unfortunate mistakes in last month's portfolio update. First, we announced we hit a trailing stop loss on Silver Wheaton when, in fact, we had not. We alerted everyone about the mistake immediately via an e-mail update. Unfortunately, another mistake was subsequently discovered. Our Pulte short hit a trailing stop loss at \$8.24 in late April, which we simply missed because it barely closed above our stop. We hope you, like us, missed the stop and that you continue to hold the position short. We have decided to leave Pulte in our portfolio. That's sure to give our critics a lot of ammunition. So we'll admit upfront it's cheating. It is also true that our long-standing advice has been to sell the stock short above \$8. If you did close the short, feel free to sell Pulte short again whenever it trades for more than \$8. From now on, we'll place a hard \$10 stop loss on the position. We will only sell if shares trade for more than \$10. Fundamentally, we remain more convinced than ever that the stock will ultimately fall to zero. We've taken concrete steps to ensure these mistakes don't happen again.

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