



Phase III of the Monetary Crisis

Everyone was just going to riot, just going mad like, chucking things, chucking bottles... It was good fun though... It's the rich people. It's the people that's got businesses. And that's why all of this have happened, 'cause of rich people... It's the British showing the rich people we can do what we want... – Excerpted from a BBC interview with two young, female rioters in North London this week.

Nine months ago, I published a warning to millions of people, around the world.

The same financial problems I've been tracking from bank to bank, from company to company for the last five years have now found their way into the U.S. Treasury. I'll explain how this came to be. What it means is critically important to you and every American... The next phase in this crisis will threaten our very way of life. The savings of millions will be wiped out. This disaster will change your business and your work. It will dramatically affect your savings accounts, investments, and retirement. It will change everything about your normal way of life: where you vacation... where you send you kids or grandkids to school... how and where you shop... the way you protect your family and home...

As you all know, I was warning about the enormous debts we've assumed here in America and other major western democracies. And I was warning about the risks that the U.S. dollar would be downgraded. I believed this could set off a chain of events that would destroy the entire Western financial system. I was worried the collapse would not only prove disastrous for investors... but also for our existing social order.

I'm sure you know people who ridiculed these predictions.

Over the last six months, I've had family, friends, longtime business colleagues, members of the media, and even fellow newsletter writers attack my integrity. They accused me of exaggerating these problems or making these predictions only as a cynical attempt to sell newsletters.

Believe me, I knew saying these things publicly was probably a terrible mistake for my career and company. In the first place, no one would believe me. I wouldn't be surprised to learn that even most of my *own* subscribers believed Treasury Secretary Tim Geithner, when he told the American people there was "no risk" America would ever lose its triple-A rating.

But who's the liar now, Timmy? Me or you?

Inside This Issue

- A global sovereign debt crisis
- Will creditors continue to lend?
- The last, biggest bubble: U.S. Treasuries
- The best short of all – fraud

Editor: Porter Stansberry

I suspect even today most folks remain totally complacent. Despite the downgrade from Standard & Poor's, the soaring price of gold and silver, and the Dow Jones Industrial Average falling roughly 17% in a week... I doubt most people will believe me when I write about the enormity of the financials problems we face.

What's happening is very, very serious. It's not a minor correction in a bull market. Let me put the market's fall in perspective for you.

I asked S&A's analytical researcher, Brett Eversole, to look back at market history and figure out where this week's panic ranks in terms of biggest declines. Over the last 10 trading days, we've seen a panic that's on par with only 16 other events in the stock market since 1928. And most of these events are clustered – '29-'33, '37-'40, and the fall/spring of '08-'09.

There are almost no rare outliers (like October 1987) where the market experienced a decline of this size without any significant economic event associated with it. And do you remember mass riots and violence occurring in the world's wealthiest developed markets back in 1987? Nope.

Many analysts (including some who work for me) are already talking about finding a "bottom" and have begun to recommend various strategies to buy this "dip." *They are making a huge mistake.*

The crisis is merely beginning. We aren't even out of the first inning yet. Let me show you a chart that paints a clearer picture for you about what's really happening in the market.

NYSE Cumulative Advance Decline Index



This chart shows the advance/decline line. It reflects how many stocks went up versus how many

went down on a cumulative basis. When it's rising, most stocks are going up. When it's falling, most stocks are going down. The chart shows you the downtrend is just beginning. And it shows you something else, too...

The advance/decline line exposes the role widely available credit plays in jacking up equity values across the board. Because the advance/decline line only measures the direction of stocks (not the extent of their moves), it shows a clear picture of which way the "wind" is blowing in terms of availability of credit – and that tends to dominate whether the trend is up or down for the market as a whole.

Here's another important thing to remember: All the losses in the market we've seen so far are merely deflating the previous recent efforts of the Federal Reserve to "puff" up the market via its money-printing schemes. *The stock market is still about even with its level from a year ago.*

You should remember in June, I told you the markets were sure to sell off viciously once the Fed stopped its program of buying new Treasury bond issues, so-called quantitative easing. And sure enough, the high-yield market suffered first, then stocks. Here's what I wrote...

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. – Stansberry's Investment Advisory, June 2011.

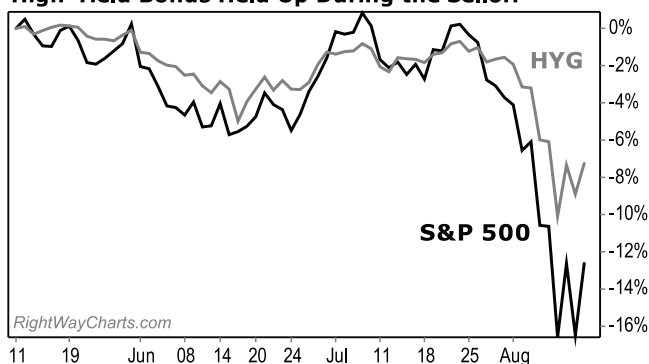
Now, let's review what's happened since then.

The chart on the following page shows the roughly 15% decline in the high-yield corporate bond exchange-traded fund (HYG). You can see how it was followed by the S&P 500 index of large-cap U.S. stocks. Clearly, bonds and stocks began to decline at almost the *exact* same time as the Fed halted its securities-buying program.

Why did this happen? What's so important

about the Fed's quantitative easing?

High-Yield Bonds Held Up During the Selloff



Will Our Mountain of Debt Lead to Default... or Hyperinflation?

The world must refinance a truly *stupendous* amount of debt over the next 24 months.

I would estimate the U.S. government's financing needs alone equal something close to \$7 trillion, or 50% of GDP. In Europe, the 90 largest banks must finance 5.4 trillion euro in debt over the next 24 months – 45% of GDP. That's not counting *any* of the European sovereign debt that must be refinanced over the next two years, which I estimate will add another \$1.5 trillion-\$2 trillion euros to the credit required.

The U.S. downgrade last month means no sovereign borrower is immune from a downgrade. Finding a way to refinance all these debts won't be nearly as cheap as everyone assumed only 30 days ago. It certainly seems plausible that increased financing costs will cause the world's largest economies to slow, which will exacerbate the challenge of refinancing these enormous debts.

And that assumes the markets are functioning. It doesn't take into account what might happen in the face of a large quantitative easing program, which could technically avoid default only by massively devaluing the world's leading paper currencies.

Howard Marks is one of the world's top hedge-fund managers. He runs a large fund called Oak Tree Capital. Here's how he describes the current situation. It's accurate... and remarkable... for a reason I'll explain below...

Credit has been available to governments

deemed creditworthy without limit and without concern for the fact that:

- * *Countries were constantly spending more than they were taking in.*
- * *Their deficits were growing non-stop relative to GDP.*
- * *Their national debts likewise were expanding relative to GDP.*
- * *In other words, repayment of principal was absolutely unimaginable.*

One of the most striking aspects of debt in the modern era is that little if any attention is paid to repayment of principal. No one pays off their debt. They merely roll it over... and add to it.

Thus credit ratings are highly deficient (shocker!) in a way that few people talk about. What ratings describe isn't the borrower's ability to repay principal, but its ability to make interest payments and refinance principal. But the assessment of their ability to roll their debt – likewise – isn't based on an ability to repay, but rather to refinance again.

So ultimately, the security of capital providers stems not from the borrower, but from the continued willingness of other capital providers to roll debts in the future. (It was their occasional refusal in 2007-08 that caused the worst moments of the financial crisis.)

With no one asking how debt could be repaid, nations were allowed for decades to increase their deficits and debt non-stop relative to their GDP. And then, in the first quarter of 2010, the little boy stepped out from the crowd, took note of the emperor's non-existent new clothes, and said "Hey, wait a minute: Greece will never be able to repay even the debt it has, forgetting that it takes on more all the time. Its economy is non-competitive and stagnant, and tax compliance is non-existent. They shouldn't be able to borrow."

That's all it took. Greece was denied further credit. And then people took a look around

peripheral Europe and saw more of the same. Today, although the situation is nowhere as dire, they're also looking at the U.S. and some of its states. – Howard Marks' letter to clients, July 21, 2011

The most important idea in his letter is that creditworthiness no longer reflects the borrower's ability to *repay* his debts. It has become a judgment about creditor's willingness to *continue lending*.

It's vital you understand this concept. It suggests *the entire purpose of the world's credit markets has become corrupted*. The game isn't to figure out how to make a safe loan. The credit market is speculating who will default *first*.

That's a huge problem because creditors tend to act together. Once one of them begins to balk, the others think twice, too. The result will be an avalanche of defaults on a mountain of debt... and the collapse of the entire paper currency system.

For the last 40 years, any analyst who questioned the ability of triple-A-rated sovereign nations (or banks guaranteed by sovereign nations) to refinance their debts was regarded as a fool or a crank. That's part of the reason the Western world has come to depend on debt in a way that's unsustainable. And it's the reason so many people viewed my warnings as either naïve or deliberately deceptive.

But all ego aside, I'm not Howard Marks. When investors of his reputation, who control as much capital as he does, begin doubting the ability of the West's leading sovereign borrowers to refinance, it is a *remarkable* event.

This is a sea change in the way the world's financial markets work. This is a harbinger of tremendous problems. These issues will not be solved quickly. And there will be much suffering. The crisis is only just beginning.

To give you some tangible evidence of what's about to happen in the world's sovereign debt markets, take a close look at the U.S. 30-year Treasury bond auction results from yesterday.

Here's how the *Financial Times* described the results of the auction...

The most extreme move is in yields on 30-year Treasuries, which are rising by the most

since the early 1980s, a rise of more than 27 basis points to yields of 3.75 per cent. That followed an auction with the poorest demand in nearly three years, as investors balked at buying risky, long-term notes that yielded just a bit more than inflation, and dealers were left with inventory to sell.

I am well aware our short recommendation of U.S. Treasuries is not yet profitable. But soon, the Treasury market will be overwhelmed with new supply and a paucity of buyers. The current panic in stocks won't last forever. Sooner or later, they will get cheap enough to buy safely. But Treasuries? What's the intrinsic value of the paper promises of a bankrupt government? Nothing.

Without the direct buying of both the U.S. and European central banks, global sovereign credit will collapse – we'll see a global run on banks and sovereign debts.

I believe it has already begun.

The America You Knew Is Dead

Think about it this way.

If you take a bunch of zeroes off the numbers of the U.S. government's financial situation, it looks more like a family budget.

There's income of \$22,000. That's a low-wage, entry-level job in most small U.S. cities. But this entry-level earner has been spending like an executive year after year for 40 years or more – \$36,000 per year in spending. The result has left him with debts that total \$140,000.

The world's financial markets have stopped trying to estimate a reasonable amount of interest for him to pay because any reasonable amount would push him into default. All the markets are doing now is trying to guess how the game will end and when.

As long as this poor guy can keep flipping credit card accounts month after month, he can keep his interest expenses manageable. But... as soon as someone begins charging him a real rate of interest, he's finished. A typical 18% credit card rate on his balance would total more than 100% of his income.

Likewise, as soon as our creditors demand a real-

istic interest payment, we're finished. Thus, all the analysis about when the Treasury market will finally crack is just guesswork. We can't know exactly when. But we do know how – painfully and with soaring interest expenses.

The gap between what our government has promised to give people and what we can realistically afford to pay is so large – and our access to additional real credit is so tenuous – I am concerned about what will happen next. We can't continue to finance these deficits. We can't risk the inflation that will result from printing the money we need.

Just stop spending? Is it that easy?

John Haywood writes for *Human Events*. He makes a connection between the looting in London, where the government is desperately trying to cut its budget to avoid a default and the ultimate outcome of all socialist policies.

The London riots have been marked by widespread looting. Some of those looters are common criminals taking advantage of the chaos, but many would indignantly insist they are "entitled" to everything they're taking, because "the system" has failed them. There are only two ways to justify government dependency, after all: you can either tell people they're helpless and cannot survive without the maternal protection of government, or convince them the free market is filled with predators that only a paternal government can repel.

The paternal approach is a much easier sell, because it doesn't require the populace to think badly of itself. Unfortunately, it raises the pressure level of anger and resentment in society, until there is a detonation. We can get off this road, before American cities burn like London, but it is the deadliest fantasy to imagine we can change where the road leads.

I have concerns about John's approach. Perhaps that's because I spend most of my time in Baltimore and Miami, two cities with large populations of people who depend on the government. I cannot imagine what would happen in either city if, say, food stamps were cut in half or Medicare spending was curtailed by even 25%. (Medicare fraud seems to be a way of

life in Miami's ghettos.)

But I can tell you this with absolute certainty: If you don't think America's cities are going to burn with flash mobs and violence just as they've done in Greece, Spain, Ireland, and England, you're the one who's naïve.

Germany Will Leave the European Union Within the Year

As for who will default first, America or Europe... my vote remains with Europe.

Europe's problem is particularly acute. The European Central Bank appears unwilling (so far) to engage in the massive amounts of money creation that might stabilize the markets. That's why our short sells of the Royal Bank of Scotland (RBS) and Deutsche Bank (DB) have been so profitable, so quickly (up 12.5% and 16.3%, respectively) in just a month. Investors simply aren't sure what the central bank would do if there were a run on these banks.

The problem is, Germany finds itself holding the bag for essentially all the credit problems. Its central bank is currently holding more than \$300 billion in IOUs from peripheral European central banks – obligations that are probably worth less than \$100 billion. It's unclear whether Germany will continue to finance these bad debts. And Germany's leaders are loath to consider any substantial effort to monetize the debts through inflation because of German history.

In the last few days, French banks have come under great pressure. The latest rumor sweeping through the markets has Germany abandoning the euro with a few other northern European countries, while France would join the other peripheral nations in a much weaker currency that would experience a radical devaluation.

So while the stalemate in Washington grabbed all the headlines recently, I'm certain the European stalemate bears much more responsibility for the market's turmoil lately. It's ironic, too. The worst damage of the Great Depression happened when France unilaterally withdrew all its capital from Austria in 1931, sparking the failure of UniCredit's predecessor bank, Kredit-Anstalt.

Now, decades later, the same bank finds itself at

the center of the crisis, although this time, it will be Germany's turn to withhold credit and thereby force a global financial restructuring.

I believe Germany will leave the euro before the end of this year, triggering a massive devaluation in all the euro's remaining members. What will happen to the dollar – or any other paper currency – after that?

What Happens Next

I still see this crisis the same way I did back in December 2008.

The developed world carries far too much debt. These debts can no longer be financed with sound money on realistic terms – the numbers simply don't work, as I've demonstrated time and time again in these pages. Thus, our leaders are left with no choice but to default through a massive inflation of the money supply.

This risk isn't in the market yet – though yesterday's action in Treasury bonds is certainly a harbinger. **Don't forget: The real catastrophe hasn't even begun.**

The biggest bubble in the world today is the U.S. Treasury market, not the stock market. This crisis won't be over until the U.S. has either defaulted or inflated its way out of these debts.

That's going to take years. And it's going to lead to massive social unrest. Nobody will believe me. But look at what's happening in England. Do you think that won't happen here when the 45 million Americans on food stamps can't buy dinner because inflation has driven food prices up 400% in 12 months? It will happen here.

But the next major step in this crisis is for the Fed to announce, in partnership with other major central banks, a huge campaign to buy European sovereign debt and bank debt. If UniCredit fails, Italy will fail. If Italy fails, the euro will collapse. If the euro collapses, the entire Western financial system will fall – GE, for example, would be left insolvent, along with dozens of other major international financial companies.

The world's central bankers and governments can't allow that to happen in an uncontrolled way. So they will print, print, print when Germany leaves the euro.

That's why it's time to buy silver again. That's why it's not too late to own gold... And that's why we'll soon buy lots of the new oil and gas deposits in the U.S. But not yet... It's far too early. This crisis has to get a lot worse before the real panic sets in.

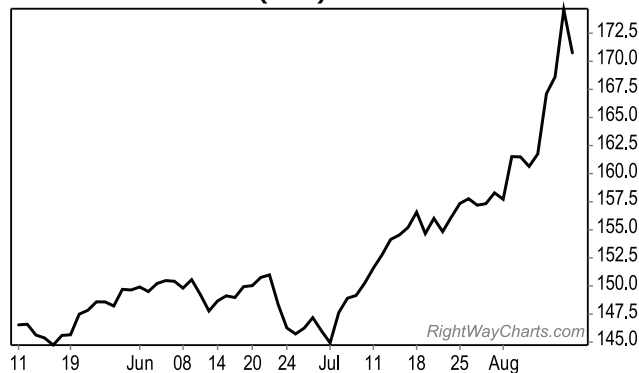
So what should we do for now? First, we're going to count our blessings that we thoroughly hedged our portfolio. We'll watch our short positions in **Pulte (NYSE: PHM)**, **General Electric (NYSE: GE)**, **Royal Bank of Scotland (NYSE: RBS)**, **Deutsche Bank (NYSE: DB)**, and **Capital One (NYSE: COF)**. Once you've seen a capital gain of 50% (once the shares have declined by 50%), cover your position. We're almost there on Pulte and RBS. I'm sure we'll get there on Deutsche Bank, Capital One, and GE before this crisis is over.

But we don't want to leave these shorts on beyond a 50% capital gain, because after that point, our risk-to-reward ratio begins to decrease (stocks can't go lower than zero). We also don't want a bunch of shorts out when the central banks finally act because their actions will drive investors out of bonds and back into stocks in the short term.

This is a dangerous time in the world's financial markets. As I've said almost every month since February 2010, these markets aren't safe for most investors. If you're not able (or willing) to hedge your portfolio by shorting stocks and holding gold and silver bullion, my best idea is for you to be 50% long gold (GLD) and 50% long short-term Treasury bills (SHY). That's still my best advice for most readers.

If you've followed that advice, all the turmoil over the last month has not hurt your portfolio at all – and you've earned roughly 7.5% in 30 days. There's

SPDR Gold Trust ETF (GLD)



nothing better than making a lot of money while everyone else panics.

This month, we continue to build our bullet-proof portfolio by adding a new silver trade and shorting a business we believe is completely fraudulent.

Here's How to Get Back into Silver... Safely

We are bullish on silver.

That's not because of its supply-and-demand characteristics... And it's not because we believe JPMorgan has been manipulating the price of silver, preventing it from going higher. (That may be true – I don't know. But if it is, silver investors should be grateful. They've gotten the opportunity to buy more silver for less.)

So why are we so bullish on silver? History.

No other investment asset loves a monetary crisis like silver does. I would urge (even beg) all subscribers who haven't read the May 2006 issue of this newsletter to do so immediately. It explains in great detail the reasons why silver prices tend to soar during a monetary crisis. It also explains the three phases of a monetary crisis. Back then, I explained why we were on the cusp of entering the second phase of a monetary crisis, which I defined this way...

Phase II happens as the government begins to take actions to halt rising prices through force. The government will not cut its own spending, which is the primary driver of inflation... It will not begin to address the unsustainable nature of entitlement spending, or the current value of its long-tail obligations...

Instead of addressing the genuine causes of inflation in the United States, the government will begin to tax, regulate, and even imprison what it labels the culprits. These efforts will only exacerbate and accelerate the rise in prices.... Once Phase II begins, more and more people have tangible evidence that something has gone badly wrong with the economy. They begin to hoard. Rich people hoard gold and silver.

Since I wrote those words, the annual government deficit has soared from less than \$500 billion to more than \$1.5 trillion annually. The U.S. government continues to foster a soak-the-rich, tax-and-regulate regime, in which a dozen or more states have enacted steeply progressive “millionaire” taxes. Obama has personally lobbied the American people for more taxes on the “rich” – all of which have been used to justify more government spending and ever-larger government deficits.

Meanwhile, the inflation and the joblessness these policies cause have led to a return to “misery index” conditions in the United States and more social unrest. I wish I could tell you the worst was over and our leaders will soon come to their senses and return our country to sound economic policies. But that will not happen.

Instead, the political dynamic in our country – where criminals run wild on the streets (and in the halls of Congress) while the government continues to print money to pay its debts – will soon lead to what I call a “Phase III” monetary crisis.

In a Phase III crisis, people flee from the currency at all costs. Civil society falls apart. Cash savings are destroyed and other forms of savings that depend on a stable currency – like insurance policies – are wiped out, too. Worst of all, the monetary crisis makes it impossible for people to save or invest in America. Our standard of living and our stature in the world collapse.

That's what's going to happen. I can't tell you exactly when. But the sure way to know how bad things are getting is to watch the Treasury markets. As long as the world continues to buy our bonds, we're safe. But a moment will arrive – and it won't be long – when investors simply refuse to own our government's debt at almost any price. If you don't take steps right now to protect yourself, you will be wiped out when that moment arrives.

The best thing you can do about it is to own silver and gold. Owning silver and gold gives you real money that the politicians can't devalue and will have a hard time trying to confiscate – especially if you store it overseas. Given the big move up in gold recently, I currently recommend silver over gold.

And if you're going to buy silver, you must

understand the silver ratio...

The market for silver has two distinct phases. First are the times when silver trades alongside gold as money.

During these periods, there's vast global demand for silver. When gold was the world's reserve currency and silver was also used as money, silver prices averaged around 1/16 the price of gold.

On the other hand, during periods where silver was "demonetized" – when it was not commonly used as money – this ratio to gold would become completely unpegged. In 1991, for example, an ounce of silver traded for only 1/100 the price of an ounce of gold.

When I first began to perceive we were in the early stages of a huge monetary crisis, I recommended readers add silver bullion to their portfolios, as a hedge against the risk of hyperinflation. Back then, silver was trading at around \$14. Gold was trading for around \$675. Thus, the silver ratio stood at around 50. That is, silver was trading at 1/50 the price of gold.

Today, gold is trading around \$1,800. Silver is trading around \$40. Investors who took my advice and began to stockpile precious metals have done very well. Silver is now up about 185%. Gold is up 166%. Considering that housing has probably fallen in half and stocks are down about 30%, precious metals have been a great hedge.

But here's the really interesting part. Today, the silver ratio is 45. That's not much lower than it was back in 2006. But the risks of a massive inflation have grown dramatically.

I believe silver is, by far, the better buy of the two precious metals today.

Silver should be trading at a ratio of 20-25. That would put silver's price somewhere around \$72-\$90 – not around \$40.

There are two strategies I recommend for all silver buyers.

First, I recommend holding 10%-20% of your portfolio in gold and silver bullion. I've been saying this for years and years and years. You hold these posi-

tions as insurance against catastrophe. Now that a monetary catastrophe appears likely, it's going to cost you a lot to buy that insurance. Sorry about that... I wish you'd bought it sooner and gotten a better price, but I still think you ought to own it.

If you want to buy gold or silver bullion, I recommend calling my friends at Asset Strategies International (800-831-0007). That's where I buy my bullion. I've known owners Michael and Rich Checkan for more than a decade. They don't pay me a penny to recommend them in my pages. I simply find them honest and reasonable, and I know they've treated my subscribers fairly for years. Just to be completely clear – I don't care where you buy your bullion. Shop around. Get a good price. But if you've never bought bullion before, go with Michael or Rich Checkan. You can trust them.

The other way to own silver is simply in your portfolio through an exchange-traded fund. Just like the SPDR Gold Trust (NYSE: GLD) allows you to buy gold through your stock portfolio, **iShares Silver Trust (NYSE: SLV)** lets you invest in silver through the stock market. SLV is a closed-end fund that holds silver bullion and silver futures. We've held it from time to time in these pages.

The downside of trying to hold silver in your portfolio is that it's extremely volatile. Given the big move up we've seen in gold and the big move down in banks over the last month, right now might turn out to be a lousy time to buy silver.

And man, when I tell you it's volatile, I mean it... A 10% weekly move (up or down) in silver isn't unusual. Watching that kind of action go against you every day for a week or two will force most folks out of the metal at a big loss. So... here's what we're going to do. We're going to buy silver again – but we're also going to sell call options against our position to generate immediate income.

Right now, if you buy SLV at \$38 or so, you can sell a **January 2012 call option with a \$40 strike price** against your position for \$3.70 per contract (prices as of Thursday night). Options trade in contracts of 100 shares. So to make this trade, you'll have to buy 100 shares of SLV for every options contract you sell. One hundred shares of SLV should cost around \$3,800. Then, selling the calls will give you

\$370 of income up front.

As you can see, the income you'll receive by selling your call is equal to about 9.7% of your purchase price. On an annualized basis, you will earn more than 20% by making this trade. If silver goes up to more than \$40 an ounce and the option you've sold is exercised by the buyer, you will sell 100 shares of SLV for \$40. You'll make about \$200 in capital gains, and you'll keep the \$370 of call option premium you were already paid.

You'll have made roughly \$570 on a \$3,800 position... a return of 15%. And you'll have made those gains in less than five months. Doing two of these trades each year would make you more than 30% annually. That's hard to beat.

So I recommend you...

Buy the iShares Silver Trust (NYSE: SLV) for \$38, and

Sell, to open, the SLV January 40 calls (SLV120121C00040000) for \$3.70.

If silver doesn't go up by January – if instead it goes down – you can continue to sell call options against your position, earning income to offset your temporary losses.

Given the high volatility in the market right now, I recommend cashing in on the turmoil by selling covered calls on silver. Experienced options traders will undoubtedly pick their own forward month and strike price (the price at which you are willing to buy the stock). For the purposes of our newsletter portfolio, we'll go with the \$40 strike and the January expiration. We'll record the first premium we receive (\$3.70) as a discount to the acquisition price of SLV (\$38) and all subsequent covered call income (if any is received) as dividend income.

If you've never traded an option before, this trade is a good place to start. Don't be afraid to call your broker and try it. (Check with your broker to make sure your account is set up to trade options.) That's the only real way to learn. If you don't try it, a year from now, you'll still be the same investor you are today. If you're doing fine without options, great. But if you're not getting the results you really want, I recommend you give it a try.

Shorting a Fraud

I want to add one more position to the portfolio this month.

Given the market's huge move, I wouldn't ordinarily put on short positions right now. I won't be surprised to see a big rally here, given how far and how fast stocks have fallen.

But I'm pretty sure this stock won't rally – ever.

The company is called **Education Management Corp. (Nasdaq: EDMC)**... EDMC is currently trading for \$17-\$18. The company sells post-secondary education – mostly to people who can't afford it. The government helps out with student loans, a large percentage of which end up in default. We discussed this problem and companies in this sector in my June 2011 issue "New American Socialism." I won't rehash all the details here as most of you have already seen my work on the topic. But it isn't hard to understand why "earning" an online degree or a piece of paper from such illustrious institutions as Argosy University may not be worth what EDMC charges.

When it comes to short selling stocks, I'm only interested in three types of opportunities. My favorite short sell situation is a balance sheet that's overwhelmed with debt. These situations – like my famous short recommendations on GM, Fannie, and Freddie – are almost foolproof. These corporations simply cannot afford to pay back their debts. Believe it or not, selling these stocks short is far safer than buying most stocks. There's truly only one possible outcome: default.

The second type of situation is obsolescence. Most of the time, you'll find these setups in technology. A great example is my 1998 short sell of Kodak – back when the stock traded for more than \$80. After buying a digital camera, I never bought a roll of film again. I figured more and more people would have the same experience. And I was right.

But the best short sell setup is fraud. When you can find the rare company that's actively engaged in a large-scale fraud, you're almost sure to make a killing. I believe we have that opportunity with EDMC.

EDMC is selling bogus education to bogus stu-

dents and living off the institutional laziness and stupidity of the federal government to pay for it. While you could make essentially the same argument against the entire for-profit educational sector, EDMC seems a special case. Its own employees are its accusers.

My friend Whitney Tilson recently pointed out to me that the Department of Justice has joined a lawsuit against the company (along with four other states) that alleges false statements by the company to qualify for Pell program grants totaling \$11 billion. That's a lot of fraud.

Additionally, the lawsuit alleges the company structured its compensation program for recruiters based on the number of new students enrolled, which, if true, would have made the company ineligible for Pell grant monies. The lawsuit originated from two employees who filed against the company.

You might recall from my June article about the for-profit education sector that many of the companies have ties to the Republican party. EDMC is no exception. The company's current chairman and former CEO is former Maine Gov. John McKernan... who is also the husband of current Republican Sen. Olympia Snowe. The amount of political corruption in this industry speaks to the integrity of its educational products.

There's no doubt in my mind these companies all pay recruiters to round up students in violation of the various rules and regulations regarding Pell grants. There's no doubt in my mind *most* of the education they offer either isn't really useful or is vastly over-priced – or both. And there's no doubt in my mind that better and cheaper educational opportunities abound in the United States.

In short, I think EDMC was probably engaged in a big fraud. Given the size of the fraud and the political nature of this case, I don't think the prosecutors are going to settle. They're going to send a message to the industry. I'd be surprised if EDMC exists as a public company by the time this lawsuit reaches its conclusion.

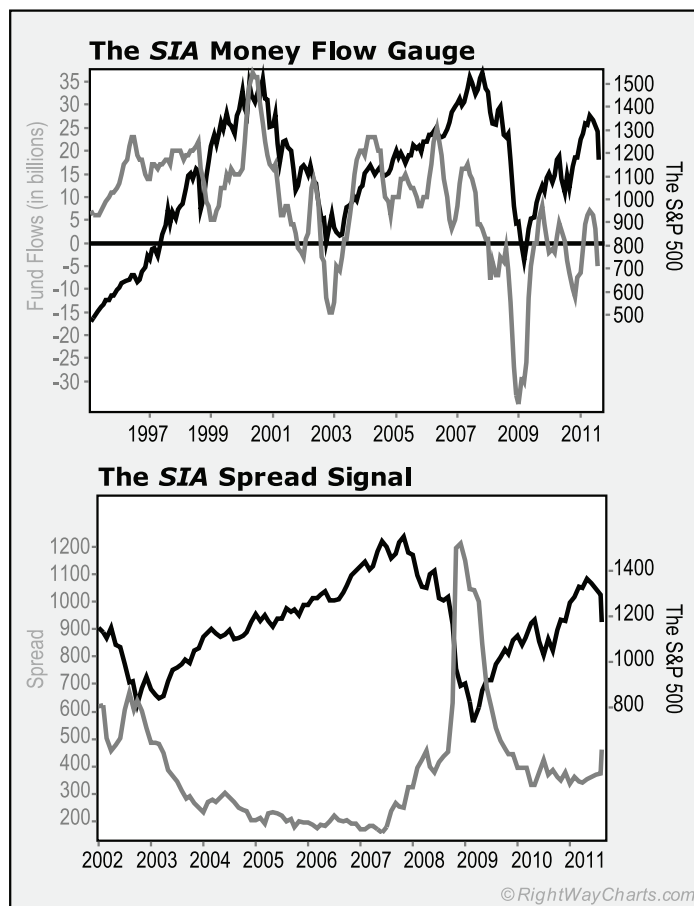
Sell shares of EDMC short. Use a 25% trailing stop loss.

SIA Indicators

We told you last month our indicators were warning that a long bear market was approaching. Interest rate spreads continue to narrow, which means credit is becoming harder and harder to get, in most markets around the world. That's extremely bearish for equity valuations, especially for companies that are highly leveraged.

On the other hand, our Black List of stocks (table on p.11) that are trading for insanely high prices (more than \$10 billion in market cap and more than 10x sales) has been decimated by the falls in stock prices we've seen so far. The list has fallen to less than 10 companies for the first time since we began publishing it on a monthly basis. That suggests that most of the "froth" has come out of the equity markets. At this level, this indicator is mildly bullish.

In regards to mutual-fund money flows, they have turned negative, which is actually very bullish for the stock market. The question now is when will these flows reverse? My bet continues to be that we'll



THE SIA Black List

<u>Ticker</u>	<u>Short Name</u>	<u>Market Cap</u>	<u>P/S</u>	<u>P/E</u>	<u>Total Return YTD</u>
BIDU	BAIDU INC-SP ADR	48,693,710,848	29.70	64.03	48.80
VMW	VMWARE INC-CL A	37,183,131,648	11.07	68.88	-0.83
PSA	PUBLIC STORAGE	19,782,490,112	11.05	38.05	12.95
IVN	IVANHOE MINES	13,765,229,568	138.88		-12.70
SLW	SILVER WHEATON	12,248,760,320	21.01	27.25	-10.93
AVB	AVALONBAY COMMUN	11,209,400,320	11.48	92.31	13.20
ELD	ELDORADO GOLD	10,428,229,632	11.57	46.09	-1.22

see larger redemptions and worse money flows for the next several months at least, so I'm simply not willing to follow my indicator here, yet.

But... for those of you who aren't as bearish as I am on the future of the world's monetary system, our indicators have gone from extremely bearish last month to mildly bullish overall.

Portfolio Review

Well... I did warn you that buying **Cheniere Energy (AMEX: LNG)** was risky. And I did recommend pairing with **Dominion Resources (NYSE: D)**. If you did so, you might still be in Cheniere, but for the purposes of our model portfolio we were stopped out last month. I was impressed to see the shares of Dominion hold up to the selling pressure last month. That bodes well for this position, long term.

Using trailing stop losses will sometimes result in a loss on a position that might have turned into a gain if we'd hung on to the stock. That's why lots of people decide not to use them. On the other hand, using trailing stop losses (where you close out a position if it moves more than 25% against you) all the time makes it nearly impossible to suffer a catastrophic loss. In our experience, the most important factor determining overall portfolio results is avoiding catastrophic losses. If you're able to limit losses to 25% of capital on positions that make up no more than 5% of your portfolio, you're only going to lose 1% of your portfolio on any one position – and that's assuming the stock you're buying goes straight down from the moment you buy it.

Based on my years of working with individual

investors, the hardest part of our strategy seems to be sticking with position sizes and following stop-loss discipline.

We could be *exactly right* about the future of liquefied natural gas exports. And we could be right that Cheniere is in the forefront of this business. It could make billions exporting cheap American shale gas. And the stock could go to \$40 or \$50, maybe even \$100. All of those things might still happen. If they do, we'll participate via our position in Dominion. But... if those things don't pan out perfectly, Cheniere will probably go to zero. And that's a risk I refuse to take with our model portfolio.

We're moving most of our short-sell recommendations to holds, simply because the market has already moved so strongly in our favor. We continue to rate almost all the long positions in our portfolio as holds too, because we think it's far too soon to begin buying stocks.

We hope you'll bear with us through this difficult period. We'd much prefer to be bullish... But we have to write what we believe. And what we believe remains based in the reality of the numbers we see... not in our wishes as citizens or publishers.

Good investing,



Porter Stansberry
August 12, 2011

Stansberry's Investment Advisory Model Portfolio

Prices as of August 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	\$49.73	\$1.40	World dominator	Hold	-1.5%	5
Johnson & Johnson	JNJ	7/6/06	\$60.52	\$63.44	\$9.32	World dominator	Hold	20.2%	5
Exelon	EXC	10/9/02	\$21.47	\$41.08	\$15.20	Nuclear power	Hold	162.1%	5
Hershey	HSY	12/6/07	\$40.55	\$55.79	\$4.35	World dominator	Hold	48.3%	5
<u>The "Next Boom"</u>									
ConocoPhillips	COP	4/2/09	\$41.45	\$65.52	\$5.57	Cheap oil	Hold	71.5%	5
Calpine	CPN	5/13/10	\$13.93	\$14.10		Nat gas power	Hold	1.2%	5
BP	BP	2/11/11	\$45.93	\$39.70	\$0.84	Cheap oil	Hold	-11.7%	5
Silver Wheaton	SLW	12/1/10	\$37.90	\$37.05	\$0.06	Silver secret	Buy	-2.1%	5
Monsanto	MON	11/18/10	\$59.63	\$69.21	\$0.84	Soaring food	Hold	17.5%	5
San Juan Basin	SJT	1/7/10	\$18.34	\$24.29	\$2.47	Cheap energy	Hold	45.9%	5
Cheniere Energy	LNG	7/19/11	\$9.57	\$7.55		Export LNG	SELL	-21.1%	5
Dominion Resources	D	7/19/11	\$48.00	\$48.00		Export LNG	Buy	0.1%	3
Silver	SLV	8/11/11	NEW	\$37.80		Inflation Hedge	Buy	NEW	5
<u>Victims</u>									
ProShares UltraShort Euro	EUO	5/13/11	\$17.55	\$17.24		Debt crisis	Buy	1.8%	5
iShares US Bond Fund	TLT	2/11/11	\$88.19	\$103.52	\$2.09	Debt crisis	Sell short	-19.8%	5
Pulte Group	PHM	1/16/11	\$8.23	\$4.44		Real estate crisis	Hold	46.1%	5
General Electric	GE	6/15/11	\$18.55	\$15.68	\$0.15	Debt crisis	Sell short	14.7%	5
Capital One Financial	COF	6/15/11	\$48.00	\$44.14	\$0.05	Debt crisis	Sell short	7.9%	5
R. Bank of Scotland	RBS	7/19/11	\$14.35	\$12.56		Debt crisis	Hold	12.5%	5
Deutsche Bank	DB	7/19/11	\$50.78	\$42.51		Debt crisis	Hold	16.3%	5
Education Mgmt.	EDMC	8/11/11	NEW	\$17.74		Fraud	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.

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