



Europe's Breaking Point

Like dominoes, the highly indebted economies of Europe are going to topple. Greece was first. But plenty more problems are coming. Italy has no way to meet its obligations. Nor do Portugal or Spain. Iceland still has no plan to reimburse Great Britain and The Netherlands for the \$5 billion those governments lent it to cover the collapse of its banking system...

What will the U.S. do when a major European financial institution, like Italy's UniCredit – the predecessor of Kredit-Anstalt – fails? If the resulting contagion causes one of America's major banks to fail, what will the U.S. government do? The answer, my friends, is simple: It will print, print, print, and print. – Stansberry's Investment Advisory, March 2010

We begin this month's issue with a true story.

It's a story the world's governments are praying you won't remember... or even better... you never learned and therefore don't understand.

It's a story about the most powerful country in the world – rulers over a huge, global empire, with the world's most powerful armed forces and possession of the world's reserve currency. It's a story of how that country was reduced to bankruptcy and how it bamboozled its own citizens out of a fortune...

It's a story that should sound troublingly familiar.

In 1917, the British government borrowed 2 billion pounds. That was back when a billion pounds was still a lot of money – roughly equivalent to 462 billion pounds today (or about \$739 billion). Keep in mind... this loan was taken out when Britain's economy was much smaller. The loan equaled to roughly 75% of Britain's GDP at the time. You can imagine this loan as being the equivalent to the U.S. Congress deciding to borrow *another* \$10 trillion this year.

The loan was necessary to finance what was called "The Great War."

Almost 900,000 British troops died fighting in Europe between 1914 and 1918. Another 1.6 million were wounded. And all for... well... no one can exactly remember. Technically, the war began because a young Serbian anarchist shot and killed the Archduke of Austria. Austria then invaded Serbia... and all of the allies and European rivals jumped into the fray.

The sad irony is... The war didn't change anything, outside of moving a few minor territories from the domain of one emperor to another. The truth is, there wasn't anything worth fighting about. The murder of the Archduke was a crime, not a military provocation. And yet... with huge standing armies available to the belligerent nations, the politicians couldn't resist pulling the trigger.

You might recall that the military build-up in Europe at that time was designed to keep the peace through "*a balance of power*." A similar logic was used to justify the giant build-up of America's offensive military capabilities during the Cold War. We called it "*mutually assured destruction*."

Inside This Issue

- How to Bankrupt an Empire
- If We Save Greece... What About Italy?
- How Our Portfolio Has Responded to Crisis
- Two Positions to Take Right Now

Editor: Porter Stansberry

Whatever you call it... when there are millions of young men standing around with powerful weapons and nothing else to do, something's bound to get destroyed.

Europe's first Great War killed 35 million people. And Britain's empire was fatally wounded – even though it had been the “victors.” It would take another war and another 30 years for the British empire to finally die, but the critical damage was done: *The war bankrupted Britain*. Financially, it never really recovered.

The conflict led to the immediate suspension of the gold standard in 1914. No longer could citizens demand bullion from the Bank of England. What followed next was a massive expansion of the public debt and the money supply.

The first War Loan was raised in 1915. It paid 3.5% interest. The second War Loan was raised in 1916. It offered 4.5% interest. And then the third War Loan – the big one – was offered in 1917. It paid 5% interest and raised nearly 1 billion pounds in the month of March. Another 1.1 billion pounds was converted from the earlier War Loans into the new issue at the higher rate. In total, the size of the loan was 2.06 billion pounds.

The huge expansion of credit was, of course, also accompanied by a large expansion in the money supply and a corresponding increase in price inflation. A composite index of commodity prices maintained by the *Economist* magazine shows prices rose from a level of 100 in July 1914 to almost 250 by the end of the war.

By 1917, inflation was accelerating at a pace that threatened Britain's financial stability and thus its ability to wage the war. That prompted the British to issue the massive 1917 War Loan, from which they could retire floating-rate debt, control the increase of the money supply, and slow the rate of inflation. Thus, the British 5% War Loan was the first great refinancing of sovereign debt in the modern age. It was scheduled to come due in 30 years – 1947.

The 1917 War Loan included a few interesting options. First, creditors could opt to receive a 4% annual coupon, *tax-free*, instead of the full 5%. Logically, you would have expected this option to be very popular. But greed seems to trump common sense during any initial public offering. Few creditors chose the tax-free option – only about 2%. Within months after the offering, these tax-free bonds were trading at a large premium to the 5% bonds because income taxes were increased to pay down the war debt...

Finally... to protect the government, the loan could be called from investors for par (100) anytime after 1927. But the

loan was still a huge problem. As Britain returned to the gold standard in the 1920s and the money supply was reduced, the burden of this war debt became progressively harder to manage. Not much of the principal was ever repaid. The interest simply came due every year, year after year... until even these amounts were unmanageable.

In 1931, Britain was forced to abandon the gold standard again. And once again, it was an Austrian assassination. No, it wasn't a duke that was shot this time. It was a bank.

In response to German demands to be reunited economically with Austria in a trade union, France decided to immediately withdraw its capital from Austria's leading bank, Kreditanstalt. The capital call was a deathblow. The bank, which was controlled by the Rothschilds, was absorbing most of Austria's mounting financial problems. Europe's economy was under significant stress because the U.S. launched a global trade war with the Smoot-Hawley tariff of 1930.

The result was a global economic depression and a correspondingly large increase in bad debts. When France demanded its gold back from Kreditanstalt, the deposits couldn't be repaid... in part because of the losses Kreditanstalt had already taken on behalf of Austria's other leading bank.

The failure of Kreditanstalt sparked bank runs in Germany and Britain. To prevent the failure of several major British banks, the Bank of England suspended the right to exchange pounds for gold. The result was a collapse in the value of the pound – from around \$5 to less than \$3.50.

These economic problems made paying the 5% War Loan almost impossible. As a result of the depression and the collapse of the British pound, by 1932, the interest on the 5% War Loan was consuming 40% of all income taxes. A key part of the problem was that obligations of the British government were still due in gold. The government had to find another way to finance this debt – preferably in sterling, which it could print. It couldn't simply default, as British banks were major holders of the paper and they were poorly capitalized because of the Great Depression losses. There had to be another way...

In 1932, to recapitalize its banks, the Bank of England began injecting large amounts of liquidity into the banking system, via purchases of government bonds. As a result, bond prices soared and interest rates fell sharply, from 5% in February 1932 to 2% in June 1932. (This move should sound familiar to anyone watching the U.S. Treasury market. The Fed's “quantitative easing” has pushed interest rates from 4% to less than 2% on U.S. 10-year bonds.)

There was only one exception to the huge rally in the

British bond market – the 5% War Loan bonds. These bond prices didn't go up at all because the British government had the right to call them back from investors at par. Because of that clause, their market price didn't exceed par (100). So even though these bonds paid a superior coupon... to speculators, the issue was less attractive than other bonds because price appreciation was impossible.

In June 1932, Neville Chamberlain (who was head of the British Treasury at the time) decided to take advantage of the bond market rally to get the government out of the 5% War Loan. He proposed to exchange the entire 5% War Loan into a new, sterling-based perpetual issue, bearing interest at a lower (though still market-beating 3.5%). These new 3.5% bonds would not be limited to trading at par, which meant their market price was sure to soar well above their issue price. And to further sweeten the offer, the new issue couldn't be called back from investors until 1952. This meant the holder would be entitled to an above-market rate of interest for an even longer period, which greatly would increase the bonds' potential value.

And remember... this new issue included no gold clause and, at the time, Britain had left the gold standard. But who in his right mind was worried about inflation during a Great Depression?

The British government used all its power to convince the banks, who were the major holders, to exchange their 5% War Loan for the new 3.5% bonds... except for one holdout, Midland Bank.

Midland's chairman, Reginald McKenna, had headed the British Treasury during World War I. He knew very well the terms of the original bond. Likewise, he understood the government barely had the means to pay it. He steadfastly refused to exchange the bonds, claiming responsibility to his banks' shareholders. In the end, the Bank of England secretly agreed to buy almost all of Midland's bonds at the real market price so that the government could claim that all of the major banks had converted *voluntarily*. Thus, there was no default.

Given the apparent advantages of the new issue – a longer call date, a market-beating rate of interest, and the ability to trade well above par – most of the public holding the 5% War Loan was readily bamboozled into the exchange. In fact, most of the crowd was wild to exchange their rights to collect interest in gold for the likelihood of earning a small – but immediate – capital gain. The 5% War Bonds they were exchanging could only be redeemed at par – and thus rarely traded at a premium – while the new 3.5% bonds could be readily sold at a premium. In fact, mounted police had to be called out to

maintain order when the crowds lined up to exchange their old certificates.

Not everyone was fooled. Only 92% of the 5% War Loan bonds were exchanged. John Train, who tells the story in his excellent book *Famous Financial Fiascos*, quotes Lord Keynes, who described the exchange as “a bit of a bluff, which a fortunate conjunction of circumstances are enabling us to put one over on ourselves.”

What happened next? In the 10 years following the conversion, inflation reduced the purchasing power of the pound by 34%. In the next 10 years, the purchasing power of the pound fell by another 38%. Interest rates on bonds moved from around 2% to well over 10%, destroying the market value of these bonds. Investors ended up losing roughly 99% of their savings.

And the final irony? The bond has no fixed maturity date. In all likelihood, it will never actually be repaid, even in devalued pounds.

America's position in the world today is not too different from Britain's before World War II. Yes, we are the world's foremost military power. And yes, we control the world's reserve currency. But despite all this power, we can't afford to pay our debts in sound money. Instead, we've used our printing press to manipulate the bond market into giving us a lower yield on our government's debt, increasing the money supply (stoking inflation), and essentially defaulting on our obligations.

This will have long-lasting ramifications on our standard of living and our standing in the world. Most Americans don't understand these facts. Instead, we – like the British in the 1930s – remain greedily willing to trade in the bonds of a bankrupt government for a small capital gain earned in a soon-to-be worthless currency.

And of course, we're not the only government in this position.

Trillions of dollars in sovereign debt around the world can no longer be financed. Nor can these debts simply be defaulted on, as doing so would destroy the world's banking system and leave depositors with nothing.

That's how we know... sooner or later... there will be a massive, global attempt to refinance these debts. The offer will sound good – much like the offer Britain made to its creditors in 1932. Much will be promised in an attempt to bamboozle you out of your savings. Interest rates prior to the offer will be driven lower and lower, forcing you to reach for better yields. The offer will probably sound enticing to most investors.

But remember this: *Anyone who is foolish enough to trust governments over gold will be wiped out.*

Why They Can't Let Greece Default

Greece is now within days of an outright default on its sovereign debt.

That, at least, is the current conviction of the credit default market. It currently gives Greece a 91% chance at default within five years. But the formula for determining this pricing is a little conservative and little liquidity remains in the market. Greece is as good as gone.

We've long considered this outcome a certainty. No, we do not have access to the privy counsels of Europe's leaders. But we consider ourselves to be relatively facile with math. And the math of trying to bail out the Greeks never made any sense...

As we pointed out repeatedly in these pages, the Greek government owes close to \$500 billion – far in excess of 100% of GDP. It is already collecting taxes equal to 40% of GDP, yet it continues to run large annual deficits (more than \$30 billion annually). The government cannot increase revenues, because its economy is shrinking. In the first quarter, Greece's GDP declined by 8.1%. In the second quarter, GDP fell by 7.3%.

Greece cannot refinance its obligations because interest rates on its debts have soared. The current market yield on Greek two-year bonds is a euro-record 55%. And the government cannot make further spending cuts – government salaries were already cut by 20% – because of the real threat of social unrest.

Greece is now down to less than \$10 billion in foreign reserves. It's truly only a matter of days before Greece defaults.

Bloomberg quotes Gary Jenkins, a major bond dealer in London, to sum up the situation...

There's a growing realization among politicians that they're throwing good money after bad. They've finally woken up to the fact that they're not going to get this money back.

And yet... if the euro is to survive, the damage from the Greek default must not be allowed to pass through to Europe's banks. If the actual losses from Greek bonds are transmitted through Europe's banking system, several of Europe's biggest banks will fail. This will trigger a general collapse of the banking system and all of the sovereign debt markets in Europe.

You can see the regulators attempts to contain the losses taken from the banks if you watched last month's events

closely. A compromise was reached between Europe's big banks and their regulators to limit the impact of declines to Greek debt. Rather than forcing the banks to mark the Greek paper on the books at the market's price (down 50% or so), they were allowed to mark the paper as being down only 21%.

Almost all of Europe's banks took this option – except the Royal Bank of Scotland, which marked its Greek paper down to the market price and took a \$1.2 billion loss. As you know, we were short the stock – which collapsed 50% in a month – in part because it took such a large loss.

The interesting point to understand is that the Royal Bank of Scotland isn't the largest holder of Greek paper. France's BNP and Belgium's Dexia (whose CEO just resigned this week) share that title... They only took 21% "haircuts," leaving these two major banks with losses of 550 million euros and 338 million euros, respectively.

The credit default market operates under the assumption that holders of Greek debt would recover 40% of their investments in the event of a default – losses of 60%. In the event of a Greek default then, most of Europe's big banks would see losses nearly 200% larger than the write-downs they took in August. Total losses would exceed \$100 billion. The follow-on effects – like depositors withdrawing funds and the wholesale lenders pulling credit lines – would leave the entire system insolvent.

You should know, I'm not the only worried analyst.

Josef Ackermann knows more about Europe's banks than almost anyone else in the world. He's the CEO of Europe's leading bank – Deutsche Bank. At a conference in Germany this week, Ackermann told a group of leading bankers, "It is an open secret that numerous European banks would not survive having to revalue sovereign debt held on the banking book at market levels..."

This is a particularly bad situation. Europe's banks are far more leveraged and more exposed to sovereign debt than U.S. banks. How they got that way is particularly ironic...

When the euro was being formed about a decade ago, banking regulators wanted to encourage the development of sovereign debt markets and tighter economic integration across Europe. To encourage banks to buy sovereign debt, they adjusted the banking reserve requirements so that European sovereign debt literally didn't count on measures of risk-based assets. The banks didn't have to set aside any capital to reserve against potential losses in sovereign debt. That meant they could leverage up to extreme levels by purchasing sovereign debt. And that's exactly what they did.

I was able to obtain a copy of Goldman Sachs' recent

“State of the Markets” report, which it sent to its hedge-fund clients. It contains a detailed study of how Europe’s banks ended up owning so much European sovereign debt. From January 1, 1999 – when the euro was launched – until the peak of the 2000s credit bubble, total European sovereign debt on the balance sheets of Europe’s banks rose from around 2 trillion euros to more than 3.3 trillion euros – an increase of over 50% in about seven years.

Europe’s banks also heavily invested in other highly rated securities – like the triple-A-rated mortgage securities from American investment banks that contained highly dubious collateral, like subprime mortgages. Again, European banking rules allow much higher amounts of leverage to be used when investing in these supposedly “safe” triple-A-rated assets.

The combination of regulations favoring sovereign debt and triple-A-rated assets was a disaster. Regulators completely ignored the huge increase in leverage that resulted from the risk-based capital rules.

When you look at risk-based measures of assets, there’s been no change in leverage at Europe’s banks over the last decade. On this “risk-adjusted” basis, Europe’s banks have roughly \$8 trillion in deposits and \$8 trillion in investments – the same ratio of deposits and assets they had back in 2000. But in fact, Europe’s banks hold \$18 trillion in investments and are now trading at 28 times total assets to equity. With that amount of leverage, a 3.5% decline in your asset base will wipe out 100% of your equity. That’s a Bear Stearns/Lehman/Fannie margin of error. It makes no sense.

Worst of all, much of the funding for Europe’s banks comes from U.S. money-market funds and the interbank market. Only about 54% of their capital comes from their customers. A large amount of their capital – 33% – comes from sources that would transmit the crisis to America. The wholesale credit market in Europe comes from U.S. money-market funds. Europe’s interbank market touches major U.S. money center banks.

How will American creditors respond to the crisis? By the end of 2012, Europe’s banks will have to refinance more than \$8 trillion in wholesale funding, mostly from U.S.-based money market funds.

What if the crisis in Greece spills over into European banks? Will these lenders be willing to lend into a crisis, where there’s so little equity remaining in the books and so little political confidence in the European Central Bank?

My bet is no.

Finally... as my longtime subscribers understand, even if the Greek debt problem is contained by a European bailout

fund, Italy is still in question. Italy’s near-term debt maturities dwarf Greece’s. Italy must refinance \$192 billion euro this year, followed by \$168 billion euro next year and then another \$100 billion in 2013 – all while running a 3.9% of GDP annual deficit. Told by the International Monetary Fund to immediately balance its budget, the Italian political process seems paralyzed. When asked last month by the *New York Times* how Italy would finally balance its books, Mario Baldassarri, an M.I.T.-trained economist and the chairman of Italy’s Senate Finance Committee said, “Not even the Lord Almighty knows.”

This is from the world’s third-largest sovereign borrower. Italy’s public debt is 1.7 trillion euro – seven times larger than Greece’s public debt. The steep economic declines that doomed Greece to certain bankruptcy haven’t hit Italy yet. But we are certain they will as credit becomes harder to get in Italy. The fact is, Italy has been in a recession almost since the day it joined the euro. Its economy has grown by a total of 0.54% over the last 10 years. What has grown the whole time? Government debt, which now exceeds 120% of GDP. Nobody ever repays debts of this magnitude in sound money – and the Italians will certainly be no exception.

As we discussed in last month’s issue, the original purpose of credit analysis was to determine the borrower’s ability to repay. But in this era of gigantic sovereign debts, ratings have become based on a country’s ability to get additional financing. That leaves countries (like Greece, Italy, France, and even the U.S.) at risk of a sudden financial collapse.

Two years ago, interest rates on Greek debt were essentially the same as those of any other European country. What changed? Nothing... except the market’s willingness to extend credit. The rates on Greece’s two-year bonds (55%) and the credit default prices (91% probability of default) indicate that Greece has come to the end of the road.

I can’t tell you when this will happen to Italy. But I can tell you... with 100% certainty... it will. And when it does, it will happen faster than anyone expects. All the facts are there. You can see for yourself.

The only option to prevent a true global banking collapse is for the European Union to undertake an immense recapitalization of both its banking system and sovereign debts. I doubt this can happen as long as Germany remains in the euro... but it’s not impossible, given the risks to Germany’s banks.

What will happen? I wish I knew. But here’s what I see clearly. The U.S. can’t maintain its deficit spending without more and more quantitative easing. Foreign creditors have begun to abandon the Treasury market. And there’s no way domestic savings can finance more than about \$600 billion a year in additional debt. More quantitative easing in the world’s

reserve currency is *extremely* inflationary.

The world's largest economic area – the euro zone – is in the midst of a serious sovereign debt and banking crisis. I believe these problems will, eventually, be tackled by the equivalent of a massive devaluation. The size of the euro float will expand dramatically in support of a huge euro-bond issue to restructure Europe's sovereign debts and prevent a full-scale European banking panic. This, too, is massively inflationary... And I can't imagine how it's avoided.

As a newsletter that's primarily focused on equity recommendations, this situation leaves us in a quandary. We've long been expecting a crisis in Europe – just read our newsletters from 2010. And since February 2010, we've been expecting a serious bear market in stock prices. We got our first real correction in August, thanks to Europe's problems. And luckily, we were able to capitalize, thanks to our fairly large short book. We took 50% gains on shorts in Pulte and Royal Bank of Scotland. And we're up substantially on our short of Deutsche Bank.

As far as our long positions go... on average, we've broken even with the stocks we recommended since February 2010... But we took on risk for no gain. The main reason for our poor performance was simply timing. We got completely hosed on our Eagle Ford recommendations, both of which we had to sell for a loss, even though we were entirely right about the future value of both of the stocks we recommended. We simply bought them at exactly the wrong time, just a few weeks before a big market swoon in July 2010 that stopped us out of these excellent companies. A few months later, our exact prediction came true: **Petrohawk (NYSE: HK)** was bought out for a large premium. And shares of **SM Energy (NYSE: SM)** soared because of increased production in the Eagle Ford.

Man, is that frustrating!

On the other hand, we did a truly great job by getting out of our financial stocks in May and selling almost everything else in our portfolio, except for companies highly leveraged to inflation – energy stocks, agricultural stocks, and precious metals stocks.

And fortunately, our short recommendations have done *extremely* well – up 18% on average, with an average holding period of far less than a year. The only losing position we have in our short book is our short recommendation of U.S. Treasury bonds. We have now lost money trying to short the U.S. Treasury on every attempt. We pledge not to attempt that particular short again for at least one year.

From a portfolio strategy standpoint, the simple thing for us to do is keep doing what's been working – which is selling stocks short. So that's what we're going to do this month.

But we do so with some trepidation...

The world's financial authorities can't afford to let the European situation get out of control. It was on the verge of going that way in August. I suspect things will get worse from here before they get better. But I also think that when the monetary authorities decide to solve these problems by creating a lot more money and credit, short sellers are going to get hurt. It's crucial that you close your positions when you're up 50% on our short sells. It's also important to remember that if you're going to short stocks, you ought to offset them with a collection of super-high-quality dividend-paying stocks, too.

And above all, make sure you're holding gold and silver. Your precious metals allocation should make up *at a minimum* 15% of your portfolio. If you've been in silver and gold for a while, chances are your allocation is now far more substantial. That's OK. Up to 50% of your portfolio is fine with me. But if you're more than 50% in silver and gold, I'd consider rebalancing toward high-quality equities offering yields greater than 5%. Wait for days when the market falls out of bed to add these positions. Your goal should be to end up 12 months from now with no more than 50% in silver and gold and about 25% of your portfolio in high-quality stocks – like the kind in my “no-risk” portfolio or the kind Dan Ferris has labeled as “World Dominators” in the portfolio of his *Extreme Value* advisory. If the market is still doing poorly, you can continue to hedge your equities with short sell recommendations from these pages.

With that proviso, let's look at what we're going to add to the portfolio this month...

PULTE II

My favorite short sell setup is a company with a vastly overleveraged balance sheet.

Take GE, for example. It has borrowed more than \$600 billion. That's a larger debt than most sovereign countries. And GE doesn't have the power to tax – at least not yet, despite all that CEO Jeffrey Immelt has done to cozy up with OBAMA!

GE's return on assets is now about 1.5%. That's far too little profitability to continue to finance its balance sheet. I don't believe GE's funding costs will stay that low. Once again, the only thing that keeps this company from going bankrupt is the willingness of its creditors to extend loans. Some day soon, they will change their minds.

Here's another way to view what a terrible company GE has become. Its total enterprise value is \$550 billion. (Enterprise value equals market cap plus debt minus cash.) That is a gigantic amount of capital. But guess how much money

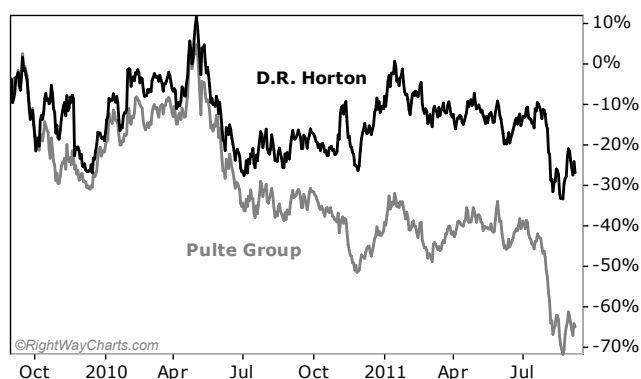
in income for its owners (aka dividends) that pile of assets generates? Less than \$5 billion. Less than 1%. Investors would get 100% more income if they owned Treasury bonds, whose yields have been decimated by the Federal Reserve's quantitative easing.

If anyone can explain to me why investors would ever consider owning GE or how the company will avoid bankruptcy, I'd love to hear the argument... because I can't even imagine answers to those questions.

Lately, we've been focused on overleveraged financials and homebuilders. Both of these industries are plagued by the same basic problems – bad debts related to assets that were hugely inflated during the credit bubble of 1999-2006. We're going to stick with them this month by adding **D.R. Horton (NYSE: DHI)** back into our short book. We first recommended shorting D.R. Horton back in December 2008. Here's what we said then...

*Out of all of the homebuilders, the first one to go bankrupt will most likely be **D.R. Horton (NYSE: DHI)**. The company faces a huge series of debt maturities over the next nine years: \$550 million in 2009, \$360 million in 2010, \$400 million in 2011, \$300 million in 2012 and 2013, \$500 million in 2014, \$300 million in 2015, \$400 million in 2016, and \$800 million in 2017... Technically, it can't even make a top-line profit – it spends more to build a house than it earns selling it. It's lost roughly \$500 million just building and selling homes in the last year – and that's not including any of its operating costs. Throw those in, and you're looking at losses of more than \$1.25 billion – before interest expenses... Unfortunately, the company still owes nearly \$5 billion. The more assets it sells, the closer it comes to defaulting on a revolving debt covenant, which would set in motion the immediate repayment of most of its debts...*

What happened? Well, as you can see for yourself, the stock didn't continue to fall, despite its poor operating results or the risks it faced of violating its debt covenants.



What did we get wrong? Congress decided to bail out the homebuilders by allowing them to write off their losses in 2008 against the profits they'd paid taxes on over the previous five years. The U.S. Treasury sent D.R. Horton \$1.3 billion over 2009 and 2010 in tax "refunds."

Next to the Cash for Clunkers program, this might be the single worse use of tax dollars I've seen during this recession. The problem in the housing market is that far too many houses were built, leaving more houses vacant than at any other time in American history. Millions more homes are still in foreclosure. We don't need more homebuilding right now. We need less. So what does Congress do? It sends billions and billions of dollars to the homebuilding companies.

This capital allowed D.R. Horton to get out of its revolving loan commitments and free itself from the risk of a catastrophic debt-covenant default. It has continued to sell assets and pay down its debt load, repaying more than \$2 billion in loans over the last three years. Assets have fallen by a similar amount, \$1.7 billion.

The company is shrinking and has done a good job of managing its huge debt load – thanks to a billion-dollar handout from Congress. Long-term debt is now down to \$2 billion. Total debt amounts to a little more than \$3 billion. And the obligations *appear* covered by the \$3.5 billion worth of land and houses the company still owns. But there's still a fatal problem here...

As I explained in my December 2010 short recommendation of Pulte, the largest homebuilder in America... these large national homebuilders...

... specialize in cheap houses and bad locations... what could go wrong? Well... if you sell these poorly constructed homes in bad locations to tens of thousands of people who can't actually afford to pay for them, you've got a giant problem on your hands. No one wants to live in a neighborhood plagued by mortgage fraud, empty homes, and deteriorating common areas. That's exactly what's happened to many of PulteGroup's communities.

D.R. Horton is experiencing exactly the same problems. It's having a hard time selling homes at a profit, despite lowering prices substantially.

You can see this in a few different ways when you look at the company's results. Despite gutting the overhead from \$200 million per quarter all the way down to \$113 million, the company still didn't earn a profit on a cash-flow basis in the last quarter. Cash flow has fallen precipitously from \$700 million in 2010 (as it sold off inventory) to negative \$124 mil-

lion in the last two quarters. Likewise, inventories are growing again for the first time since the downturn began.

And when you dig into the quarterly details, you get a clear picture of the housing holocaust. Homebuilding revenues fell 29% year over year in the most recent quarter. The number of homes closed fell 33%. Home sale margins declined. And inventories rose to 11,400 compared to 10,500 a year ago.

I don't expect D.R. Horton to quickly go bankrupt, as I did back in late 2008. But this company will not survive the downturn. It still owns too much land and owes too much money. Far too many houses are for sale in America. And too many of D.R. Horton's communities have become impaired. You'll see a continuing decline here, quarter after quarter. And if I'm right about the coming European crisis, you might see another shock to the availability of mortgage credit. If mortgage rates rise, D.R. Horton will collapse.

As far as big milestones to watch for, the company owes creditors \$786 million in 2014. I don't expect that debt will be repaid. Nor do I think the company will be able to refinance it, as its collateral continues to fall in price.

The chart on p.7, which compares the shares of D.R. Horton to the shares of Pulte, tells the story of an industry that's caught in a huge secular decline. It may be 20 years before the housing market's supply-and-demand dynamics become attractive again for homebuilders. Neither of these two companies will survive that long. We've already booked our 50% gains on shorting Pulte. D.R. Horton will not be far behind. These two companies have nearly identical products and business models and serve the same markets.

Sell short D.R. Horton (NYSE: DHI). Use a 25% trailing stop loss.

My Favorite Obsolete Short

The other short positions I love are companies with obsolete technology or products. While these trades aren't as certain as companies with too much debt, they are often better trades because they're less volatile and tend to unfold over a long period of time. Let me explain what I mean by showing you a classic example from the past...

In 1998, I recommended shorting shares of Kodak. At the time, the stock was trading around \$70-\$80. I'd just bought my first digital camera. I was already using online photo albums and digital software to share pictures. I knew I'd never buy another roll of film again. And I figured that soon, nobody else would either. In fact, Kodak's revenues peaked in 1996. They've mostly been declining ever since.

But the decline has taken a long, long time.

Look at these numbers. They show Kodak's revenue per share since 2001, when the company's decline was already well underway. As you can see, revenues per share have fallen steadily... But they remained in double digits through 2007.

Kodak's revenue per share 2001-2011				
Year	Q1	Q2	Q3	Q4
2001	10.26	12.36	11.36	11.54
2002	9.29	11.44	11.49	11.82
2003	9.22	11.37	11.75	12.72
2004	10.19	12.09	11.77	13.11
2005	9.87	12.84	12.37	14.61
2006	7.98	9.36	9.04	10.81
2007	7.24	8.58	8.80	11.23
2008	7.26	8.62	8.50	9.06
2009	5.51	6.58	6.64	9.63
2010	7.13	5.79	6.55	7.18
2011	4.92	5.52		

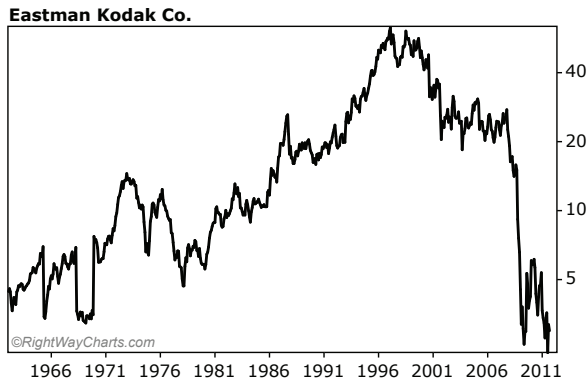
Likewise, you see the same kind of tenacity in the slow decline of gross margins. Yes, margins have been decimated. But it took a lot longer than anyone thought it would to reach single digits. Cost-cutting can keep companies in business a long, long time... as long as their balance sheets are strong.

Kodak's Gross Margin 2001-2011				
Year	Q1	Q2	Q3	Q4
2001	35.87	37.29	34.31	30.61
2002	31.78	37.59	38.48	35.05
2003	30.31	33.58	33.50	31.63
2004	27.64	31.78	31.95	26.15
2005	24.40	28.16	25.95	23.04
2006	20.46	21.39	25.09	23.82
2007	20.58	26.09	26.73	24.69
2008	20.26	23.58	27.48	20.43
2009	13.13	18.97	20.38	34.35
2010	41.43	19.49	27.08	19.05
2011	9.46	14.21		

So... what's the point of all of this? Well, here's the fascinating thing. Despite management's best efforts to control costs and slow the decline of falling revenues, it was nearly impossible to make a real profit for shareholders. Too much of the cash flow went toward paying off Kodak's debt. Cash flow finally turned negative in 2009. It continues to get worse. We're in the final stages now.

But consider how long it took...

Now... look at the chart. After 1998, when was a good time to short this stock? Almost any time.



Nothing management did to preserve cash flows, manage the balance sheet, or salvage revenues really helped. Ironically, one of the things management did was buy back shares. I hope you understand why that was insane. But in corporate America... you see people do stupid things like that all the time. That's why I've become more and more a fan of selling stocks short. I'm especially eager to short situations like this, where there's simply no chance the company will succeed.

I identify these companies in two ways.

First, I always ask myself if it's likely that my son Traveler, who is now 4, will ever use this product or service. Will my son buy a roll of film in his life? No way. Digital technology has rendered all types of chemical film completely useless.

The second thing I do – and I got this idea from legendary investor Warren Buffett – is I always ask myself, “Would a well-financed entrepreneur attempt to create these businesses or industries if they didn't already exist?” For example, if you had \$1 billion to invest, would you try to build a global newspaper franchise? Would you buy up timber forests and paper pulp factories and printing presses... and hire thousands of unionized employees? Wouldn't you just hire 50 or 100 smart folks and build a website?

I first recommended shorting shares of Gannett – the publisher of *USA Today* in September 2008. (Incidentally... the lead story in the September 2008 issue is one of the most interesting stories I've written about. It's worth reading, even if you have no interest in shorting Gannett.)

You can see for yourself that we got the timing right on that one. The stock absolutely collapsed in the bear market of late 2008 and early 2009. We booked a 50% gain on the short. I recommended shorting it again in March 2010. There's no point in going back over the entire thesis with you



here. You can read the back issues to get the full story – nothing has changed. Here's the basic idea...

As publishers ourselves, we have some insight into what's happening to newspapers. New distribution technologies (mostly the Internet) make content you'd typically look for in a newspaper – stuff like a local weather forecast, movie listings, sports scores, etc. – available for free. And with free wireless networks (WiFi) becoming almost ubiquitous in most cities, most people can get this information automatically sent to their computers or even their cell phones. You have no reason to buy a newspaper for your commute when you can see the latest headlines on your cell phone, listen to news over satellite radio, or download an interview by your favorite journalist to your iPod...

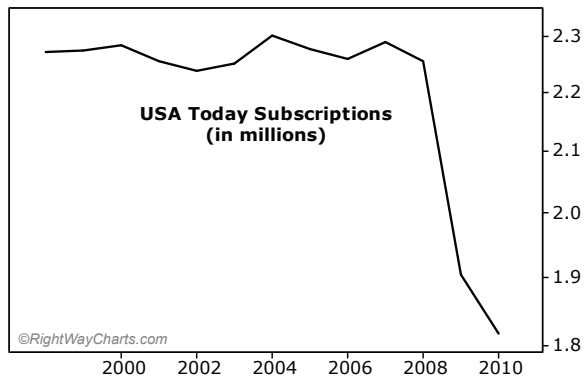
Meanwhile, newspapers make the majority of their revenue selling space ads, not subscriptions. Moving their content to online formats (which are smaller) destroys their business model because websites don't offer nearly enough ad space. The Internet also makes it easy for advertisers to judge whether buying space ads in newspapers is worth the expense – and most of the time it's not. Online advertising can be accurately tracked, which makes life hell for ad salesmen. Potential buyers no longer have any question about how many people looked at a specific ad – and how many bought because of it. – Stansberry Investment Advisory, September 2008

First, Gannett has a lot of debt – more than \$2 billion in long-term debt, plus another \$1 billion or so in pension and health care obligations for retired employees. That's always great news for a short seller. Total debt is in excess of \$4 billion.

Second, it controls a huge number of products (newspapers), all of which are in a sustained secular decline. The latest numbers show publishing circulation revenues fell another 3% for the first six months of 2011. Ad revenue fell more – by 6%.

And take a look at what's happened to its subscriber rolls...

The USA Today Subscription Base Is Down 21%



The last nail in this company's coffin is the wild expansion binge it went on during the boom. It bought up dozens of small "community" publications. Gannett paid absurd amounts of money for these rags, which were almost immediately rendered worthless by the Internet.

When you look on the balance sheet, you see the legacy of these purchases in the "goodwill" segment. Gannett holds \$2.8 billion worth of goodwill on its balance sheet. That's the excess amount of money they paid to acquire those publications in the early-to-mid 2000s. Sooner or later, these assets will be written off. They're not producing much, if anything, in the way of earnings.

On the other hand, the company is still producing a lot of cash flow. But it has virtually stopped paying dividends in an effort to preserve capital, extend operations, and repay debt. (At least, they stopped buying back stock in 2008...)

As for what I expect to see happen now... The circulation and revenue declines will continue, with ad revenues falling even faster than most people expect. Cash flow will dry up within a year or two at most, leaving the company struggling to pay its debts. Value investors and other vultures who try to pick up the shares on the cheap will end up disappointed as legacy obligations to employees and big asset write-downs destroy what value remains.

Sell short shares of Gannett (NYSE: GCI). Use a 25% trailing stop loss.

SIA's Indicators: First Signs of a Bottom

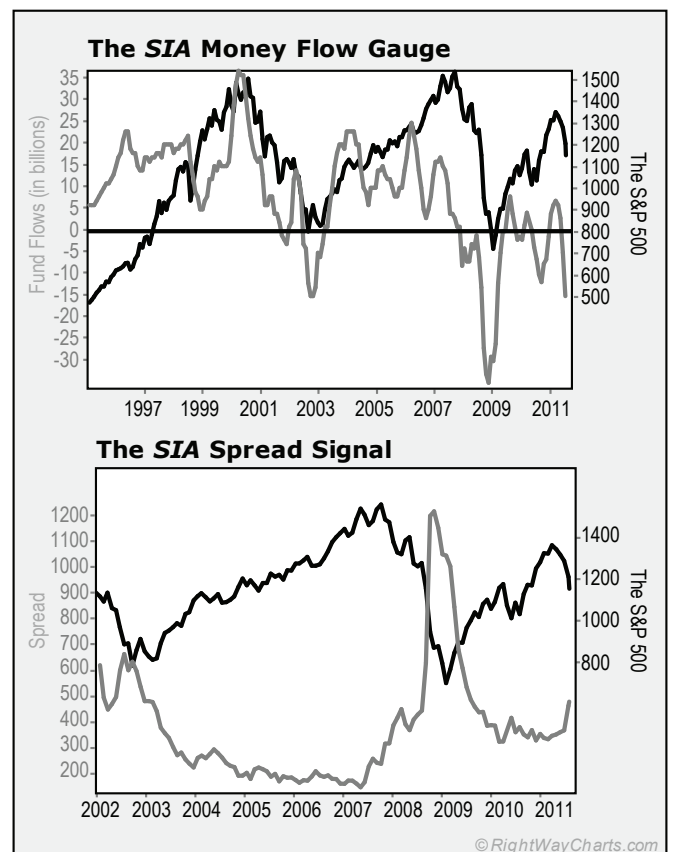
We use three simple gauges to determine our broad position in the market cycle.

First, we look at what's called the "risk spread" in the bond market. This index shows us the average spread between the interest rates being paid by high-yield borrowers (junk bonds) versus U.S. Treasuries. The spread is displayed in the grey line on the chart. The S&P 500 Index is displayed in the black line. This is a contrarian indicator – that is, as the indicator goes up, stocks go down, and vice versa.

What you should see is that the lower the spread, the higher stock prices tend to go, because the spread is a gauge of the availability of credit. When credit is easy, the spread between junk and Treasury bonds is small. Optimism and greed are widespread in the market.

When the spread widens, fear returns and stocks fall. When the spread is extremely wide, fear dominates and stocks will trade at extremely depressed prices. We try to avoid buying stocks when there's too much greed in the market (when spreads are tight) so we have plenty of cash to deploy when fear is rampant (when spreads are wide) and stocks are cheap. Or as Buffett has famously explained: We try to be fearful when others are greedy, and we try to be greedy when others are fearful.

Right now, as you can see, fear has just begun to return to the markets. We don't think the spreads are wide enough yet to begin loading into stocks... But it's the first sign of a bottom buying opportunity being created.



The SIA Blacklist					
Ticker	Short Name	Market Cap	P/S	P/E	Total Return YTD
BIDU	Baidu Inc	49,964,539,904	30.23	65.16	48.86
VMW	Vmware Inc	37,276,028,928	11.08	68.96	0.89
PSA	Public Storage	21,282,609,152	11.87	40.86	21.28
AVB	AvalonBay Communities	12,537,719,808	12.20	98.03	20.83
ALXN	Alexion Pharmaceuticals	11,042,280,448	16.69	92.78	47.61

Next, we pay close attention to money flows. This is simply a measure of how much capital is buying stocks, measured by weekly flows into (or out of) equity mutual funds. Again, the indicator is the grey line, and the S&P 500 is the black line. This is a correlated indicator. As money flows into stocks, they go up. Likewise, when money flows out of stocks, they go down. What we want to do is look to buy stocks when other are selling them at panic rates. We saw this opportunity in 2002. We saw this opportunity again in late 2008. And... I'd wager... we're seeing another such opportunity develop right now.

There's one other indicator I use. And... for some reason... it tends to create the most confusion. I like to see how many stocks around the world are trading for stupidly expensive prices. Please understand, I'm not attempting to analyze these companies. I'm not saying they should be sold short. I'm not saying they are going out of business... I'm only saying that their extremely high prices make it very unlikely that investors buying these stocks today will see good long-term results.

For me, the definition of a "stupid" price is a company with a market cap of more than \$10 billion (a huge company) that trades for more than 10 times annual sales. As every businessman knows, as you get bigger, maintaining annual grow rates gets harder and harder. In my experience, very, very few companies bigger than \$10 billion in market cap can justify such a high share price (10x sales). I'm not saying it's impossible... just rare.

So when I see a dozen or more stocks around the world trading at these kinds of prices, I can tell there's far too much "froth" – far too much greed, far too many inexperienced investors bidding up prices to "stupid" levels. When my "Black List" of overpriced stocks gets longer than 10 or 12 names, I get concerned – not about the individual names, but about the overall level of the market as a whole.

When I began to publish my Black List a few months ago (March 2011), 13 names appeared on the list. Since then, the

S&P 500 is down 8%. Five of the stocks on the list have fallen by double-digit percentages. Today, only five stocks remain on the blacklist. My bet is that by the time we reach the actual market bottom, there will be zero names (or maybe one) left.

The key to understanding this indicator is simply to realize it's not about the names on the list, it's about the number of companies on the list. Subscribers were confused how **Silver Wheaton (NYSE: SLW)** could be on the Black List and also in our recommended portfolio. Analyzing resource companies by their current revenues can be misleading, as the market tends to value these stocks by the size of their reserves.

As a result, we don't include most resource stocks in our Black List... But Silver Wheaton, as a royalty company (not a miner), is a stock that doesn't fit neatly into these categories. The point is, any stock's inclusion in our Black List doesn't necessarily mean we would short it. It just means its share price is trading at a level that will require substantial amounts of future growth to justify.

Good investing,



Porter Stansberry
September 9, 2011

Stansberry's Investment Advisory Model Portfolio

Prices as of September 8, 2011

	Symbol	Ref. Date	Ref. Price	Recent Price	Dividends	Description	Action	Return*	Risk
"No Risk"									
Wal-Mart	WMT	09/09/10	\$51.91	\$52.21	\$1.40	World Dominator	Hold	3.3%	5
Johnson & Johnson	JNJ	07/06/06	\$60.52	\$64.95	\$9.89	World Dominator	Hold	23.7%	5
Exelon	EXC	10/09/02	\$21.47	\$42.94	\$15.20	Nuclear power	Hold	170.8%	5
Hershey	HSY	11/06/08	\$40.55	\$57.88	\$4.70	World Dominator	Hold	54.3%	5
The "Next Boom"									
ConocoPhillips	COP	04/02/09	\$41.45	\$65.88	\$5.57	Cheap oil	Hold	72.4%	5
Calpine	CPN	05/13/10	\$13.93	\$14.41		Nat gas power	Hold	3.4%	5
BP	BP	02/11/11	\$45.93	\$37.08	\$0.84	Cheap oil	Hold	-17.4%	5
Silver Wheaton	SLW	12/01/10	\$37.90	\$40.70	\$0.06	Silver secret	Buy	7.5%	5
Monsanto	MON	11/18/10	\$59.63	\$67.36	\$0.84	Soaring food	Hold	14.4%	5
San Juan Basin	SJT	01/07/10	\$18.34	\$23.16	\$2.59	Cheap energy	Hold	40.4%	5
Dominion Resources	D	07/18/11	\$48.00	\$48.15	\$0.49	Export LNG	Buy	1.3%	3
Silver^	SLV	08/11/11	\$34.10	\$41.22		Inflation Hedge	Buy	20.9%	5
Victims									
ProShares UltraShort Euro	EUO	05/13/11	\$17.55	\$18.02		Debt crisis	Buy	2.7%	5
iShares US Bond Fund**	TLT	02/11/11	\$88.19	\$110.31	\$2.41	Debt crisis	Buy to Cover	-27.8%	5
Pulte Group**	PHM	01/06/11	\$8.23	\$3.91		Real estate crisis	Buy to Cover	52.5%	5
General Electric	GE	06/15/11	\$18.55	\$15.59	\$0.15	Debt crisis	Sell short	15.1%	5
Capital One	COF	06/15/11	\$48.00	\$43.10	\$0.05	Debt crisis	Sell short	10.1%	5
R. Bank of Scotland**	RBS	07/18/11	\$14.35	\$6.81		Debt crisis	Buy to Cover	52.5%	5
Deutsche Bank	DB	07/18/11	\$50.78	\$34.11		Debt crisis	Sell short	32.8%	5
Education Management	EDMC	8/11/11	\$17.74	\$15.85		Fraud	Sell short	10.7%	5
Gannett	GCI	9/8/2011	NEW	\$9.87		Obsolete	Sell short	NEW	5
D.R. Horton	DHI	9/8/2011	NEW	\$9.80		Obsolete	Sell short	NEW	5
* This is the return since reference date, including dividends. ^ Price adjusted by profits from selling January 40 calls ** Prices when Trailing Stops or 50% gains were hit 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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