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"The European Time Bomb is Ticking..."

"...and accelerating! Market indicators are now predicting that Greece will default on its debt. When it does, the European banking system implodes—and US banks get sucked down too.

"Meanwhile in the US, a certain major bank might collapse on its own anyway, and the Federal Reserve's 'Operation Twist' has a devious goal that nobody wants to talk about. America is in a no-win situation, but we as investors can still flourish despite it all. Read on for more!"

James DiGeorgia, Editor

Europe teeters on the brink of implosion, but gold and silver go *down* instead of up. US equity markets plunge, but the dollar gets *stronger* instead of weaker. America gets a credit rating downgrade, but Treasury rates hit new *lows* instead of highs.

Lately it seems that we're living in Never-Never Land. But there is a secret logic behind the market's apparent madness.

Last month, I explained how the growing debt crisis in Europe could be the dominant financial event in 2011/2012. This month, the timetable for financial implosion is shortening rapidly, as...

Greece Nears Default

According to market indicators, a Greek sovereign-debt default is all but inevitable.

First, the Greeks are going to run out of money by the end of the month. They were scheduled to get another tranche of bailout money, but that's in jeopardy. Northern Europeans (especially Finland) are demanding Greek national assets as collateral. And the deal requires 90 percent of existing bondholders to agree to a debt swap—but participation is much lower so far.

Having said that, I doubt the collapse will happen this month. (That's good—it gives us more time to prepare.) When the collapse occurs, it will probably be a surprise. The out-of-money deadline this month is too obvious, and too much of a clear and present danger. So I expect European officials to pull a rabbit out of a hat somehow—maybe by the time you read this. There will be a short-term stunt to get through the autumn (including the bank recapitalization that French and German leaders are proposing now), and then an attempt at a long-term solution.

(A growing possibility is a debt swap to longer maturities, like the one Uruguay did eight years ago.)

But Europe can't avoid the inevitable forever. According to Credit Market Analysis Ltd., which tracks the credit-swaps market, swaps on Greek bonds are now priced as if there's a 95 percent chance (!) of default. This is as close to "inevitable" as the markets can get.

This is also clear from more public statistics, like interest rates. Yields on 2-year Greek notes have blasted up above 50 percent. Apparently, investors have little confidence that they'll get their principal back, never mind the interest.

There have been many ideas and proposals for bailouts and so on. But these are the equivalent of slapping Band-Aids on an arterial hemorrhage. They might delay the day of reckoning, but they can't prevent it.

To avoid disaster, Europe needs to replace Greek debt with 'Eurobonds' backed up by the stronger economies on the continent. But the stronger economies want nothing to do with this idea.

Specifically, German Chancellor Angela Merkel has refused to be "blackmailed" into supporting Greece. And without Germany, the Eurobond plan is dead on arrival.

A managing partner at Hayman Capital captured the opinion of many when he told *Reuters* that "Greece has to default." But once it does, the dominoes start falling, and nothing can stop them. Then we'll see the fallout that I discussed in last month's issue.

This grim prediction comes from the top levels of the United States government itself.

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US Treasury Secretary warns: Greek default means "cascading default," "bank runs," and "catastrophic risk" of global meltdown!

Timothy Geithner recently spoke to the delegates to the IMF/World Bank meeting in Washington. When a top government official uses phrases like those above—when he is compelled to warn publicly of "catastrophic risk" and "bank runs," when just the warnings alone could cause markets to crash—you know we're in serious trouble.

Just since I published last month's *GEA*, the danger has grown substantially. It's now known that some of Europe's largest institutions are hopelessly entangled in the mess, including France's Crédit Agricole and Société Générale. With $3.6 trillion in assets between them, they are the largest banks in the world.

There are disturbing parallels here to the Great Depression. Fed Chairman Bernanke has said that he believes the "most critical" trigger of the Depression was the May 1931 failure of Creditanstalt, one of Europe's largest banks at the time. Until then, the downturn was severe but still ordinary in nature. But Creditanstalt's failure spread to other banks and then caused wave after wave of financial crises around the world, crippling Western economies for almost a decade.

There's a key difference between then and now. Today, global economies are far more tightly interconnected. If a full-blown credit and liquidity crisis strikes Europe, the contagion will spread like wildfire all around the world.

The Eurozone itself could fracture literally overnight. As a strategist at Société Générale in London wrote, "The contagion impact of a default will be severe, because next in the firing line will be Italy, Spain and it will take in the whole of the European banking sector too… This trio are already under intense pressure, but it will get much worse."

How "much worse" could it get? Worse than we might imagine…

European official warns: Crisis could bring war

Jasek Rostowski, the Finance Minister of Poland, recently told the European Parliament in Strasbourg: "Europe is in danger… If the Eurozone breaks up, the European Union will not be able to survive."

He warned that unrest could be severe enough to cause armed conflicts. This agrees with a recent report from financial giant UBS, which wrote: "monetary union breakup is not something that can be treated as a casual issue of exchange rate policy… It is also worth observing that almost no modern fiat currency monetary unions have broken up without some form of authoritarian or military government, or civil war."

Such a drastic outcome is unlikely (or so we hope). But what is almost certain is that if Europe's credit markets seize up, then banks will start to fold—including American institutions.

SNL Financial recently reported that US banks don't have much direct exposure to faltering sovereign debt in Europe—but they have tremendous exposure to European banks which do:

- $370 billion to German banks
- $375 billion to UK banks
- $276 billion to French banks
- And $143 billion to other European countries.

This is part of the reason why…

Oil Stocks and the *GEA* Portfolio

With the mounting crisis in Europe, I haven't had room in the last few monthly issues to discuss the oil market.

I do however talk about oil in the regular email *Updates*. If you follow these, you know that we'll probably start a *GEA 3* portfolio soon, to take advantage of current market conditions.

I'll say more about oil in future issues. For now, I just wanted to note that along with high potential in gold, we're also positioned for great returns in oil going forward.

The US is in a no-win situation

If a financial crisis engulfs the Eurozone, we get engulfed too.

What happens if Europe (somehow) avoids a full-blown financial shock? Then we go back to 'business as usual.'

But that's bad too.

The 'flight to safety' out of the Eurozone is the only thing propping up US Treasuries today.

After all, investors didn't stampede into the dollar because it's a good currency. It's just not as terrible as its competitors.

If the euro survives as a strong currency, then the markets will wake up and remember that:

- The US is running a $1.5 trillion deficit per year…
- Despite all the hot air blowing out of Washington, the deficit is getting worse instead of better…

- Washington is refusing to address its problems, hoping instead that we'll be distracted by "debt super-committees" and other forms of smoke and mirrors…
- America is on the precipice of falling back into recession…
- And the US just had its credit rating downgraded.

If the euro survives the debt crisis, then the 'flight to safety' is over. The greenback goes down.

And not even the Fed can stop it, regardless of how 'creative' its plans might get.

The Truth About Bernanke's "Operation Twist"

The Federal Reserve just announced yet another plan to pull the economy out of its tailspin.

This time, the Fed won't be dropping interest rates to zero, or printing truckloads of money. (Both moves would be pointless. Rates are already below zero in real terms, and the Fed has already printed a couple of *trillion* dollars in funny money without the desired effect.)

As I've warned many times, the Fed is out of bullets now.

So Bernanke is getting creative. His latest stunt is something that pundits are calling the "Twist."

The Fed has decided to sell short-term Treasuries while simultaneously buying longer-term Treasuries. Among other things, this will flatten the yield curve and drive down long-term rates.

Supposedly, the Fed is trying to staunch the bleeding in the housing sector. The usual way to do this is to drive mortgage rates down.

But if Bernanke is trying to rescue real

United Nations says Iran is working on nukes

The UN's nuclear agency said it is "increasingly concerned" about the "extensive and comprehensive" information it has uncovered about Iran's development of nuclear weapons.

All along, Tehran has denied that its ongoing uranium enrichment program would be used to make weapons. It claims that the uranium will only be fuel for electricity generation.

But the UN notes that:

- Iran already has enough highly enriched uranium to make six nuclear weapons.
- Iran has consistently stymied UN efforts to monitor their nuclear program, and has consistently failed to cooperate with international inspectors.
- Many nations have given the UN "extensive and comprehensive... and credible" intelligence that the Iranians have designed nuclear warheads, to be mounted on missiles.
- Iran recently started enriching uranium at a new location—an underground bunker that's more protected from air attack.
- Iran is stepping up its efforts to convert low-enrichment uranium into weapons-grade material, even though this is unnecessary if its only purpose is electrical generation.

The International Atomic Energy Agency notes that it cannot "conclude that all nuclear material in Iran is in peaceful activities."

So what took them so long? Iran's intentions (and actions) have been obvious for *years*.

Iran's nutjob President Mahmoud Ahmadinejad has announced that once he has nukes, he'll wipe Israel off the map. It's no wonder that Israel bought dozens of powerful bunker-buster bombs from the US.

Unless the Iranian leaders are somehow overthrown and replaced with sane people, then sometime soon, the Israelis will be forced to attack Iran and take out its nuclear program. That's a potential flashpoint for a broader war in the Middle East.

Oil and gold will go berserk. If you follow our *GEA* approach, you'll do very well.

Portfolio Update

In Update #1178, we opened a new position on Continental Resources (symbol CLR). We sold short the October $45 puts (CLR111022P45).

In Update #1182, we took profits on our CLR puts. We had sold for $2.25, and we bought back at $1.10. We netted a quick profit of $115 per contract.

In Update #1183, we issued roll-up instructions for subscribers who sold short puts on Whiting Petroleum (WLL) and Occidental Petroleum (OXY). On WLL, we rolled up the Sep. $50 puts (WLL110917P50) to the Oct. $50 puts (WLL111022P50). On OXY, we rolled up the Sep. $90 puts (OXY110917P90) to the Nov. $90 puts (OXY111119P90).

In Update #1184, we gave an update on the Compton Petroleum recapitalization. There was a 200 to 1 share reversal on August 10. See the Update for details.

In Update #1185, we noted that in September, we collected $720 in total profits and premiums from options.

In Update #1187, we issued hedge instructions for subscribers who own Energy Exploration and Production ETF (XOP), Devon Energy (DVN), and Apache Corp. (APA). On XOP, we sold the Oct. $58 calls (XOP111022C58). On DVN, we sold the Nov. $75 calls (DVN111119C75). On APA, we sold the Nov. $110 calls (APA111119C110).

In Update #1188, we recommended adding to our position on Sandridge Energy (SD). We sold the Dec. $6.00 puts (SD111217P6).

In Update #1191, we issued instructions for subscribers who own Apache Corp. (APA), EOG Resources (EOG), and Devon Energy (DVN). These were designed to reduce our holdings, in anticipation of our upcoming *GEA 3* portfolio. On APA, we rolled down our Nov. $110 calls (APA1111119C110) to the Nov. $80 calls (APA111119C80). On EOG, we sold the Nov. $75 calls at the market. On DVN, we rolled down our Nov. $75 calls (DVN111119C75) to the Nov. $55 calls (DVN111119C55).

In Update #1193, we issued instructions for subscribers who own Energy Exploration and Production ETF (XOP) and Pengrowth Energy Corp. (PGH). On XOP, we rolled down our Oct. $58 calls (XOP111022C58) to the Nov. $48 calls (XOP111119C48). On PGH, we sold to open the Nov. $9 calls (PGH111119C9).

In Update #1196, we issued instructions for subscribers who hedged Anadarko Petroleum (APC), Apache Corp. (APA), and Energy Exploration and Production ETF (XOP). On APC, we rolled down the Oct. $72.5 calls (APC111022C72.5) to the Nov. $60 calls (APC111119C60). On APA, we rolled down our Nov. $80 calls (APA1111119C80) to the Nov. $75 calls (APA111119C75). On XOP, we rolled down our Nov. $48 calls (XOP111119C48) to the Nov. $37 calls (XOP111119C37).

estate, he's trying to catch a falling knife. Housing isn't cratering because of high mortgage rates. (Mortgages are already cheaper than dirt.)

No, the housing market is collapsing because it was inflated up to insane levels, and then the bubble burst. Lowering rates further will do nothing to help US real estate prices.

What this *will* do is inflict severe collateral damage. Bernanke wants to flatten the yield curve. But a steep yield curve is exactly how banks make money! (They borrow at low short-term rates and lend at higher long-term rates.)

Flattening the curve is yet another blow to the already reeling US banking sector. In trying to help real estate (an effort doomed to failure), Bernanke might just take down a major bank or two.

But Bernanke isn't stupid, so…

Why is he risking this disaster?

In the August issue, starting on page 6, I predicted that the US government was launching a program of "financial repression" in a

US Banks Might Topple Even Without European Problems

What do you think of a banking system which has:

- A major bank with $421.7 billion tied up in mortgages… even as foreclosure rates are skyrocketing, real estate prices are plunging, and more homeowners go underwater every month?
- A major bank with $52.5 trillion in high-risk derivatives… which works out to more than 36 times its total assets, and over 340 times bigger than its risk-based capital?
- A major bank with a share price that plunged 29% in just five weeks, and is down more than 50 percent from its highs earlier this year? (More than $83 billion in shareholder value has been wiped out.)
- And a major bank that is being sued for $57.5 billion for mortgage fraud by the federal government?

So what do you think about the US banking system… especially when I tell you that all those problems are <u>just from the largest bank alone</u> (Bank of America)?

You might have heard of the recent outrage among BofA customers, when executives announced that it will start charging monthly fees for debit cards. What you might not have known is that they had no choice—with all the problems plaguing BofA and other US banks, bank executives are desperate for revenue.

The debit card fees were triggered by a regulatory change at the Federal Reserve. Card swipe fees are now restricted to 24 cents per transaction, down from the current average of 44 cents.

The Fed admits that banks' swipe fee revenues will be slashed by about 40 percent. Many banks are barely solvent today, with billions of dollars in bad mortgages and foreclosed real estate on their books. Now the Fed has pulled the rug out from underneath.

Bank of America is the most troubled bank, but it's not the only one that's struggling. That's why other banks (Citigroup, Wells Fargo, and more) are already following Bank of America's lead on this.

And as if that weren't enough…

(continued on the next page)

desperate attempt to avoid a complete meltdown of the dollar.

Under normal circumstances, a nation with debt levels as high as the US would eventually have to destroy the value of its own currency. At $14.3 trillion, our debt is far too high to be repaid by taxing US citizens and businesses. The only way to shed the debt would be to print a mountain of money to devalue the dollar. This would be done on purpose, to devalue the purchasing power represented by the debt. Then it would be possible to pay it down.

But, as I explained in the August issue, we are not living under normal circumstances. I believe the government is launching a 'financial repression' program to pull itself back from the financial brink without a massive hyperinflation of the dollar.

Financial repression is an economics term, referring to a deliberate transfer of debt burdens from a national government down to state governments, businesses, and private citizens. With this technique, Washington can avoid the consequences of its gross financial mismanagement by inflicting agony on everybody else. You and I will receive lower incomes, pay more taxes, lose more purchasing power to inflation, and so on. But the fat cats in Congress will have saved their political backsides, because few if any people outside of Washington will have any clue where all the pain came from.

You might remember that in the August issue, I listed the five necessary parts of a financial repression program. One of them (restricting capital movements abroad) is already being implemented. Now Bernanke's "Twist" will start to fulfill another, by forcing down long-term interest rates.

This allows the government to borrow at below-market rates. In fact, the Fed's announcement drove rates down to multi-decade lows—at a time when Congress is piling up over $1 trillion in new debt *per year*.

In essence, the Fed has announced that the US debt market is no longer a free market. Long-term interest rates will now be set by the Federal Reserve.

Who benefits from this? Obviously, the federal government does. Washington can continue to borrow mountains of money at ridiculously low rates.

Who gets hurt by this? Basically, everybody outside of Washington. Many private interest rates in the US are based on Treasury rates.

First, this is a heavy blow to retirees in the US. Lower long-term rates will pull down other forms of fixed-income investments, which are the foundation of retirement plans.

Second, pension plans will be wounded as well, for the same reasons.

Third, business earnings will suffer. Consumer spending could fall steeply over the long term. As fixed-income investments fall, retirees receive less money to spend. Those nearing retirement will also be forced to cut current spending, and will contribute more to their struggling retirement accounts instead.

And if business earnings go down, so do their stock prices. This puts investors and retirees in an even tighter financial bind, which reduces spending further… and downward the spiral goes.

And I haven't even mentioned state and local governments, many of which are already groaning under falling tax revenues as housing prices have plummeted. Artificially low interest rates will torpedo the fixed-income earnings that many states and municipalities rely upon as the foundation of their portfolios.

You see the point. Washington is making <u>its</u> financial problems <u>our</u> financial problems, while avoiding the responsibility, the consequences, and (most of all) the <u>blame</u> for its actions.

Most investors don't have a clue about this. They're being misled by stupid talking heads in the media, who never saw a printing

(continued from previous page)

With many US banks struggling to survive, Uncle Sam has apparently decided to knock them out once and for all.

The Federal Housing Finance Authority just sued 17 financial firms (including Bank of America, Citigroup, JP Morgan Chase, and others) for selling poor-quality mortgages to Fannie Mae and Freddie Mac.

The total price tag: a staggering $196 billion.

Bank of America is on the hook for $57.5 billion, thanks to its previous purchases of Countrywide Financial and Merrill Lynch. JP Morgan Chase was second-highest at $33 billion.

The government claims that the mortgages it bought were based on documents containing "misstatements and omissions of material facts concerning the quality of the underlying mortgage loans, the creditworthiness of the borrowers, and the practices used to originate such loans."

That's true—but it's also irrelevant. The US government *required* these banks to issue these 'liar loans'. The banks made the loans because Fannie and Freddie (i.e., the US government) insisted on criminally stupid loan standards.

By 2007, at the height of the bubble, the Department of Housing and Urban Development required that 55% of purchased mortgages needed to be "affordable," with at least 25% made to low-income home buyers.

Fannie and Freddie dominated the mortgage aftermarket. So the banks had little choice but to comply with the government's wishes and issue lots of questionable loans. Now the government is suing them for doing so.

Here's what I want to know. Once the government's lawsuit drives the first major bank into bankruptcy, what happens then?

Will Washington bail it out?

press they didn't like. Each time Washington announces another bailout or so-called stimulus plan, the pundits clap and cheer.

But here's something they all forget…

The Fed can't print wealth. It can't print jobs. It can't print a sound banking system.

All it can do is print paper money.

And so that's what it will do. Once the 'financial repression' foundation is in place, I expect the printing presses to be cranked up again.

The worst binge will probably be in early 2013. Politicians are most willing to stage severe financial interventions right after an election. That way, by the time the next election rolls around, voters have had time to forget what Washington did since the last one.

Then again, it might happen much sooner. The current Administration might decide that a huge dose of economic 'juice' in early 2012 might get it re-elected. There's no way to tell what will happen.

Gold Demand Still Raging

The World Gold Council reports that during the second quarter, even as gold prices were at record highs, Indian and Chinese demand grew 38% and 25% respectively year-on-year.

Central banks also continue to buy the metal, vacuuming 69.4 metric tons off the market in just the second quarter alone.

The report noted that demand's "growth is likely to continue, due to increasing levels of economic prosperity, high levels of inflation and forthcoming key gold purchasing festivals." Other factors driving gold demand skyward are the European debt crisis and America's financial woes.

Rare coins continue to be especially hot. Sotheby's, the large auction firm, has had its best year ever. In the first half of 2011 alone, they've sold over $3 billion worth of collectibles.

Therefore, you shouldn't let down your guard. Even though official rates of inflation are low right now, you shouldn't reduce your allocation of gold and other counter-dollar assets. Once the presses start running, the dollar could plunge (and gold soar) very quickly.

But that might sound like strange advice, especially since…

Gold got hammered last month

The yellow metal got pounded in September. It fell over $100 in a single day (and 11 percent overall). Silver took it on the chin too, falling by over 25 percent.

Why did this happen?

Actually there were several reasons. None of them are surprising—and none of them are reasons to worry.

First, every market goes up and down. Precious metals have been driving up relentlessly all year. It was time for them to take a breather.

Next, some investors (including a few large ones) are taking profits. After a great run like gold has had this year, no doubt these profits were substantial.

Also, as equities have plunged, speculators have been hit with margin calls. To raise cash for these, they're selling their profitable positions, including gold.

Plus, margin requirements for gold futures have gone up, which means trading volume has gone down.

Lastly, as the Eurozone flirts with collapse, investors are fleeing to the dollar. As a counter-dollar asset, gold is getting pressured down.

Add these reasons up, and a temporary lull in precious metal prices was inevitable.

But the overall bull remains. That makes this pullback a great buying opportunity.

Someday, the gold bull will be over. But not yet. We see gold's continuing strength in the fundamentals, and we see it in the technicals. So I'm looking forward to a long run of profits ahead of us. The growing crisis in Europe, combined with the current lull in gold prices, makes this an excellent time to add to your positions.