Financial Crisis
"Round Two" Survival Guide

This bear market is nowhere near over.

Since its March 10 low of 666 in 2009, the S&P 500 rally has been almost unstoppable. Pundits and media commentators alike have taken this to mean that the bear market is over and that stocks should once again be the primary asset class for investors.

None of them knows what they're talking about.

Over the last 30 years, the US has built up record debts on a personal, state, and national level. Consumers thought they were financially stable so long as they could cover the interest payments on their credit cards, states created program after program few if any of which they could afford, and the Federal Government issued $30-50 trillion in debt and liabilities (counting Social Security and Medicare).

This all came to a screeching halt when the housing bubble (arguably the biggest debt bubble in history) imploded in 2007. Since that time, stocks have staged one of their worst years on record (2008), one in five us mortgages has fallen underwater (meaning the mortgage loan is worth more than the home itself), and some trillions in US household wealth has evaporated.

These issues seem to be distinct, but in reality they all stem from a debt problem. And as you know, there is only one legitimate way to deal with a debt problem:

Pay it off.

However, instead of doing this, the Feds (the Federal Reserve, Treasury Dept, etc.) have been producing EVEN MORE DEBT. Here's a brief recap of their moves thus far:

- The Federal Reserve cuts interest rates from 5.25-0.25% (Sept '07-today)
- The Bear Stearns deal/ Fed buys $30 billion in junk mortgages (March '08)
- The Fed opens various lending windows to investment banks (March '08)
- The SEC proposes banning short-selling on financial stocks (July '08)
- The Treasury buys Fannie/Freddie for $400 billion (Sept '08)
- The Fed takes over AIG for $85 billion (Sept '08)
- The Fed doles out $25 billion for the auto makers (Sept '08)
- The Feds' $700 billion Troubled Assets Relief Program (TARP) (Oct '08)

- The Fed buys commercial paper (non-bank debt) from non-financials (Oct '08)
- The Fed offers $540 billion to backstop money market funds (Oct '08)
- The Feds backstops up to $280 billion of Citigroup's liabilities (Oct '08).
- Another $40 billion to AIG (Nov '08)
- The Fed backstops up $140 billion of Bank of America's liabilities (Jan '09)
- Obama's $787 Billion Stimulus (Jan '09)
- The Fed's $300 billion Quantitative Easing Program (Mar '09)
- The Fed buying $1.25 trillion in agency mortgage backed securities (Mar '09-'10)
- The Fed buying $200 billion in agency debt (Mar '09-'10)
- Cash for Clunkers I & II (July-August '09)

And that's a BRIEF recap (I'm sure I left something out).

In a nutshell, The Feds have tried to combat a debt problem by ISSUING MORE DEBT. They're pumping trillions of dollars into the financial system, trying to prop Wall Street and the stock market. They've managed to kick off a rally in stocks… But they HAVE NOT ADDRESSED THE FUNDAMENTAL ISSUES PLAGUING THE FINANCIAL MARKET.

Stocks are headed for another Crash, possibly as bad as the one we saw in October-November 2008. As you know, that Crash wiped out $11 trillion in household wealth in a matter of weeks. There's no telling the damage this Second Round will cause.

The Feds have thrown everything they've got (including the kitchen sink) at the financial crisis… and things are fundamentally no better than they were before: most major banks are insolvent, one in five US mortgages is underwater, and the stock market is being largely propped up by in-house trading from a few key players (Goldman Sachs, UBS, etc).

Make no mistake, we are rapidly headed for ugly times in the financial markets. The time to prepare yourself is NOW! And I've located several investments that will not only protect your portfolio… they'll also help you turn a profit when this "house of cards" we call a market rally comes crashing down.

I've detailed all of them in this report, *The Financial Crisis "Round Two" Survival Guide.*

Two Ways Stocks Pay: Inflation and Dividends

Before we get into the specific investment suggestions, it's important to take a big picture of stocks as an asset class. The common consensus is that stocks return an average of 6% a year (at least going back to 1900).

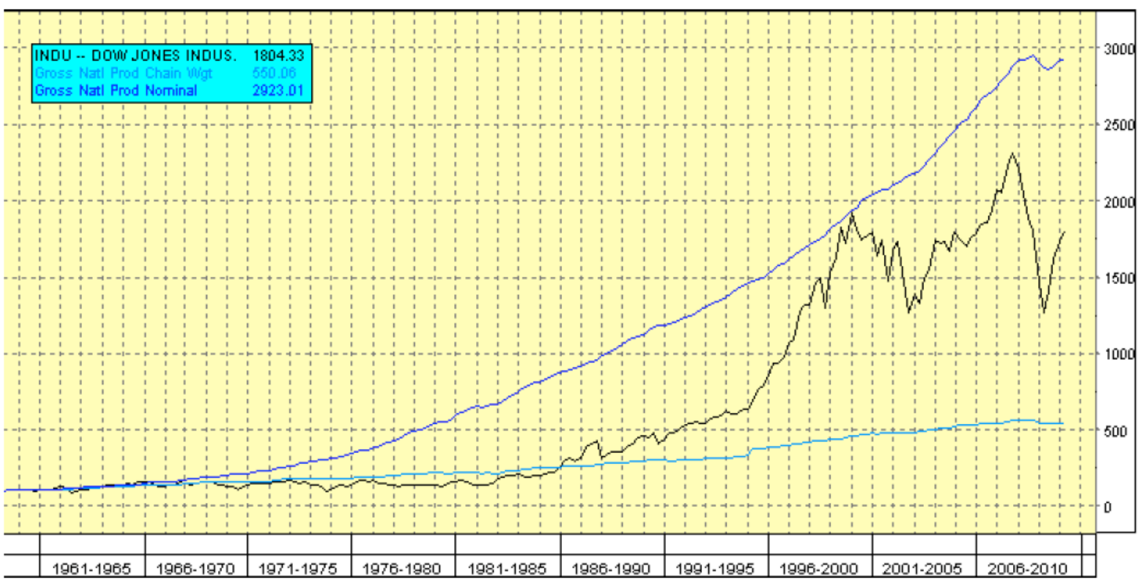
However, a study by the London Business School recently **revealed that when you remove dividends, stocks' gains drop to a mere 1.7% a year (even lower than the return from long-term Treasury bonds over the same period).**

Put another way, dividends account for 70% of the average US stock returns since 1900. When you remove dividends, stocks actually offer LESS reward and MORE risk than bonds. If you'd invested $1 in stocks in 1900, you'd have made $582 with reinvested dividends adjusted for inflation vs. a mere $6 from price appreciation.

So as much as the CNBC crowd (and out serial bubble blowing Fed Chairman Ben Bernanke) would like to believe that the way to make money in stocks is buying low and selling high, the reality is that the vast majority of gains from stocks stem from dividends.

The remaining gains have come largely from inflation.

Bill King, Chief Market Strategist *M. Ramsey King Securities* recently published the following chart comparing REAL GDP (light blue), GDP when you account for inflation (dark blue), and the Dow Jones' performance (black) over the last 30 years. What follows is a clear picture that since the mid-70s MOST of the perceived stock gains have come from inflation.



Which brings us to today. According to official data, the S&P 500 is currently trading at a Price to Earnings (P/E) ratio of 20 and yields 1.7%. In plain terms, stocks are expensive (historic average for P/E is 15) and paying little.

In other words, there is little incentive, other than future inflation expectations, for owning stocks right now.

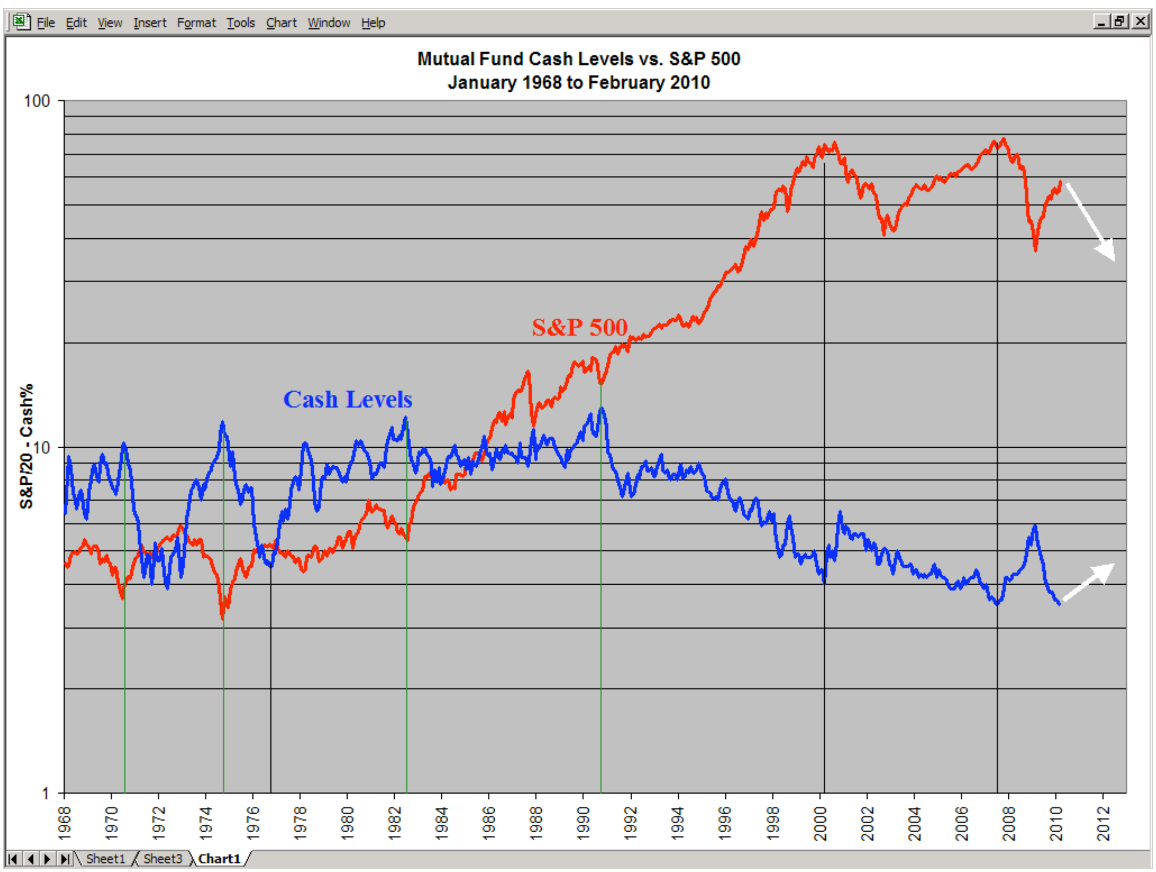
With this in mind, now is the time to be pruning your "long" holdings. We've had a spectacular run in stocks since the March 2009 low and the likelihood of this continuing much longer is relatively slim.

Running Out of Buyers

By most historic metrics, the market is showing signs of a significant top. Here are just a few key metrics:

1) Investor sentiment is back to super bullish autumn 2007 levels.
2) Insider selling to buying ratios are back to autumn 2007 levels (insiders are selling the farm).
3) Money market fund assets are at 2007 levels (indicating that investors have gone "all in" with stocks).
4) Mutual fund cash levels are at a historic low.

This final point is key. Mutual funds are the "big boys" of the investment world. If they have become fully invested in the market, this means there are few buyers left to push stocks higher. This is evident in the fact that every time mutual fund cash levels dropped, stocks collapsed soon after (see chart below).



http://home.comcast.net/~RoyAshworth/Mutual_Fund_Cash_Levels/Mutual_Fund_Cash_Levels.htm

In plain terms, the odds are high that a Top is forming in stocks. With that in mind, if your portfolio is heavily invested in stocks, now is a time to be taking some profits. If you can, consider moving a sizable chunk into cash.

The market is extremely tired and the systemic risks underlying the Financial Crisis are in no way resolved. With investor complacency (as measured by the VIX) back to pre-Crash levels, the Fed withdrawing several of its more significant market props, and low participation coming from the larger institutions, this market is ripe for a serious correction.

I'm not saying this will immediately happen. But at some point there will be a new round to the Financial Crisis. When that happens, we WILL have another Crash. Indeed, it is quite possible that stocks are making a VERY significant top, so being heavily invested in stocks going forward doesn't make much sense. Take some money off the table. If you need a place to put it, I suggest physical cash or Gold/ Silver bullion.

If You MUST Stay Long, Shift to Quality

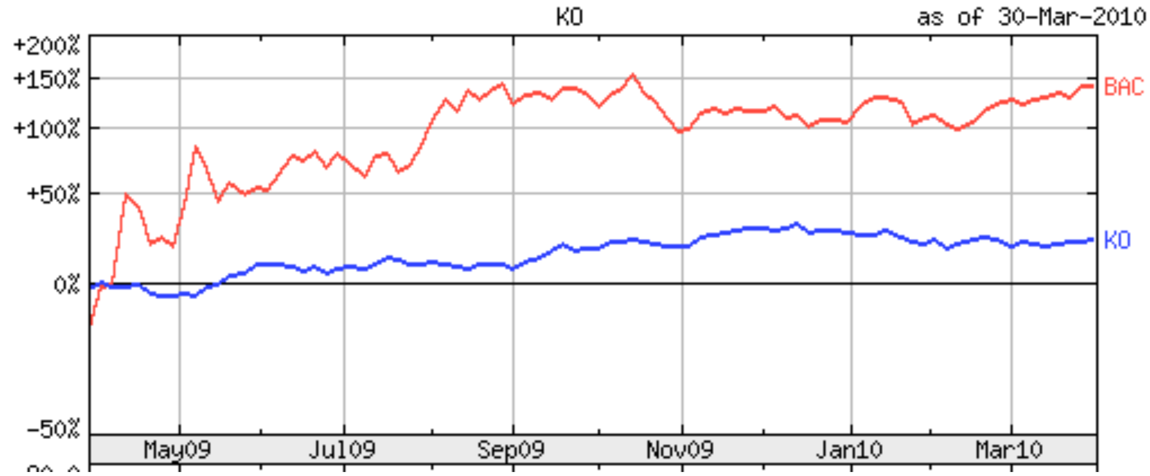
If you DO have to stay invested in stocks, now is the time to be shifting out of junk into quality. The market rally from March 2009 has largely been lead by junk companies (financials, retailers, etc). Meanwhile, quality has lagged dramatically.

As an example, let's compare the performance of Coke (KO) to Bank of America (BAC).

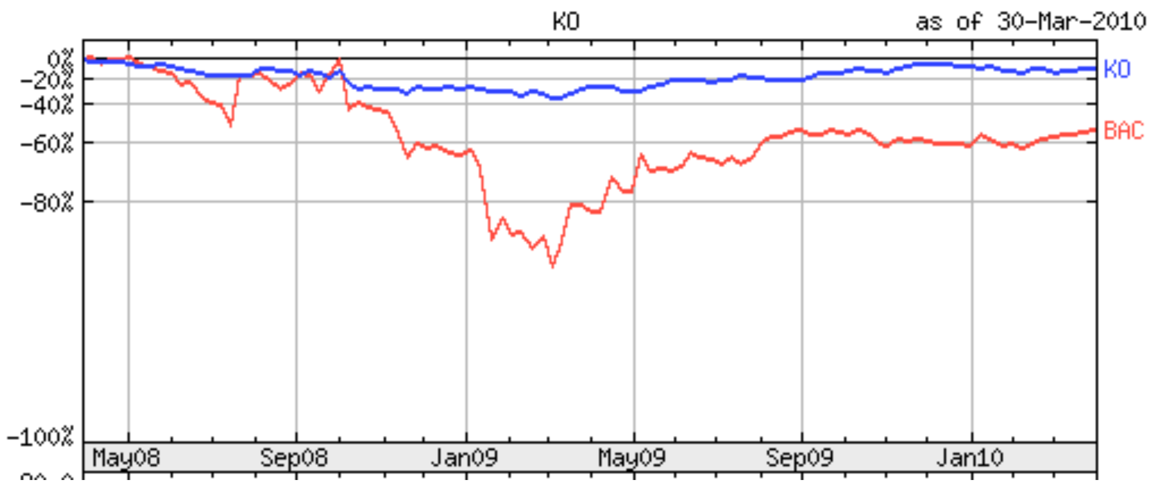
KO is one of the best, most profitable brands in the world. The competitive moat around this business is extraordinary and it remains one of the most easily recognized franchises on the planet. You can drink six glasses of Coke a day and still enjoy it the next day. That quality is almost nowhere to be found in any other food/ beverage on the planet: even chocolate would get old after six bars a day.

BAC on the other hand has swallowed Countrywide Financial AND Merrill Lynch's garbage assets. It is effectively insolvent based on its derivative exposure alone (the company has derivatives equal to 3,000% of assets). BAC's balance sheet is like an open sewer and without serious government intervention the company would not even exist right now.

And yet, BAC's stock has risen nearly 200% since the March '09 lows… while KO is up less than 50%.



This relationship works to the downside as well. What I mean is that when stocks come unhinged, Quality (Coke) then outperforms Garbage (Bank of America) hands down.



So, if you HAVE to remain invested in stocks to the long side for whatever reason, now is the time to be moving into high quality companies. This means finding companies with low debt, lots of cash, strong results (KO actually GREW revenues in 2008), and significant competitive advantages.

Also, and this is critical, look for companies with strong balance sheets: companies that will still EXIST if there's another Crisis. Depression or no, people will still drink soda, alcohol, smoke cigarettes, and need medicine. I've compiled a list of companies you should consider if you need to remain involved in stocks going forward:

Company	**Symbol**	**Sector**	**Price/ Cash Flow**	**Dividend Yield**
Coke	KO	Soft Drinks	15	3.2%

Budweiser	BUD	Alcohol	14	N/A
J&J	JNJ	Medicine	10	3.02%
Wal-Mart	WMT	General Retail	8	2.16%
Exxon Mobil	XOM	Oil	11	2.51%

You'll note that most of these companies pay decent dividends (compared to the S&P 500's 1.7%). This is critical going forward. With stocks overvalued, you want to make sure you're at least getting paid for remaining involved in the market.

However, there is an added bonus to owning Quality stocks right now. Because this market rally has largely been dominated by Garbage stocks, Quality companies like Coke have not yet risen to extreme valuations. Thus, you can still buy them at relatively cheap levels (less than 15 times cash flow). So, in a sense, they are a good investment based on pricing as well.

I want to stress that these investments are only if you HAVE to stay in stocks for some reason. If there is another collapse these companies will fall like everything else. However, they will likely fall less than the rest of the market (see the chart comparing Coke and the S&P 500 below).

source: Yahoo Finance

So while I do not expect these positions to make a lot of money now (these are not short-term trades), they should shelter you from losing too much money should another Crash hit. Indeed, if the market DOES collapse and these companies fall 10-15% across the board (while the market falls 30%+) I would consider these investments even MORE attractive than they are today.

Let me explain.

Volatility can either hurt you or be your friend. Most people would sell a position if it fell 20-30%. This is wise if you're investing based on momentum. However, if you're investing based on value, then doing this is completely antithetical to attaining high returns.

Consider Coke. Let's say tomorrow Coke collapsed from $55 to $25 per share. Most investors would panic and sell. I, on the other hand, would be buying greedily. Why? Because Coke's business has a fundamental value. Even during a Financial Crisis and Depression, people will continue to drink soda.

So the opportunity to buy Coke at $25 a share (which would be 7-8 times cash flow) would be truly an extraordinary opportunity. Indeed, from an income perspective alone, the opportunity here would be fantastic.

Consider that in 2009, Coke paid out $1.76 in dividends. With shares at $55, this means a dividend yield of 3.2% (roughly three times what you'd get by leaving your money in a savings account).

However, if Coke shares fell to $25, that $1.76 suddenly becomes a 7% yield ($1.75/ $25.00). That's a heck of a return from an income perspective. **Even if globally the world entered a sharp Depression and Coke's income fell by 30%, pulling its payouts down to $1.23, you're still looking at a 5% yield.**

Indeed, companies like Coke offer the potential of REAL value should their share prices drop. Their fundamentals almost ALWAYS outperform investor sentiment. What I mean by this is that should there be another Collapse, Coke's share price will almost certainly fall MORE from its current levels than Coke's cash payouts or income will from theirs.

During 2008, Coke shares fell 30% or so. However, Coke actually INCREASED its dividend that year. Anyone who bought Coke in October 2008, now collects a 4% yield on their shares (four times what he or she would get from a bank account).

This is why companies like Coke remain so strong during times of Crisis. With the FDIC broke and most US banks insolvent, investors desperately need a place to park cash that will still EXIST in a few years. Companies like Coke are a reasonable alternative to a savings account in the sense that you're paid a higher yield for your deposit (now 3%, but 5% or higher if Coke shares plunge).

Of course, because Coke is a stock, you can lose 10-15% or more if shares drop and you sell. In a Crisis, plain old cash will outperform just about anything. This is why I've suggested moving money to cash, if you can. It's also why I suggested buying Coke and the other companies listed above only IF you HAVE to be in stocks right now.

Catastrophe Insurance: Trades For When the Collapse Hits

Now is also the time to be taking out some "Catastrophe Insurance" by compiling a list of trades to make once stocks begin to collapse. Let me be clear, **these are not trades that you'll make right now… these are trades you'll make WHEN stocks collapse.**

Personally, I favor UltraShort ETFs.

If you're unfamiliar with UltraShort ETFs, these are invetsments that return 2X the inverse of a particular ETF. Let's take an example, the UltraShort Financials ETF (SKF).

SKF returns 2X the inverse of the Financials ETF (IYF). So if IYF falls 5%, SKF rises 10%. If IYF falls 10%, SKF rises 20%. In this sense, SKF is a great "hedge" or means of playing Financial stocks to the downside.

However, there's an added bonus to UltraShort ETFs like SKF: these investments ALSO trade based on demand from the marketplace. So if stocks collapse say 30%, you might actually see gains GREATER than 60% (2X the inverse) due to investors piling in as they seek to profit from the collapse.

Consider SKF's performance in 2008, for example. In 2008, financial stocks (as measured by the Financials ETF: IYF), fell roughly 50%.

However, if you'd bought SKF once the Crisis really took hold (late September), you could have made MORE than 100% in two month's time:

This is what makes the UltraShort ETFs so handy when a Crisis hits: because they truly skyrocket as investors stampede like elephants into safety.

However, I MUST STRESS that these are not investments to "buy and hold". Instead, these are short-term trades you should make ONLY once stocks have begun to truly collapse. Simply add them to your "on deck" trades to make once the next Crisis hits.

You're probably asking yourself, "*how can I distinguish between an ordinary correction and a REAL Crisis?*"

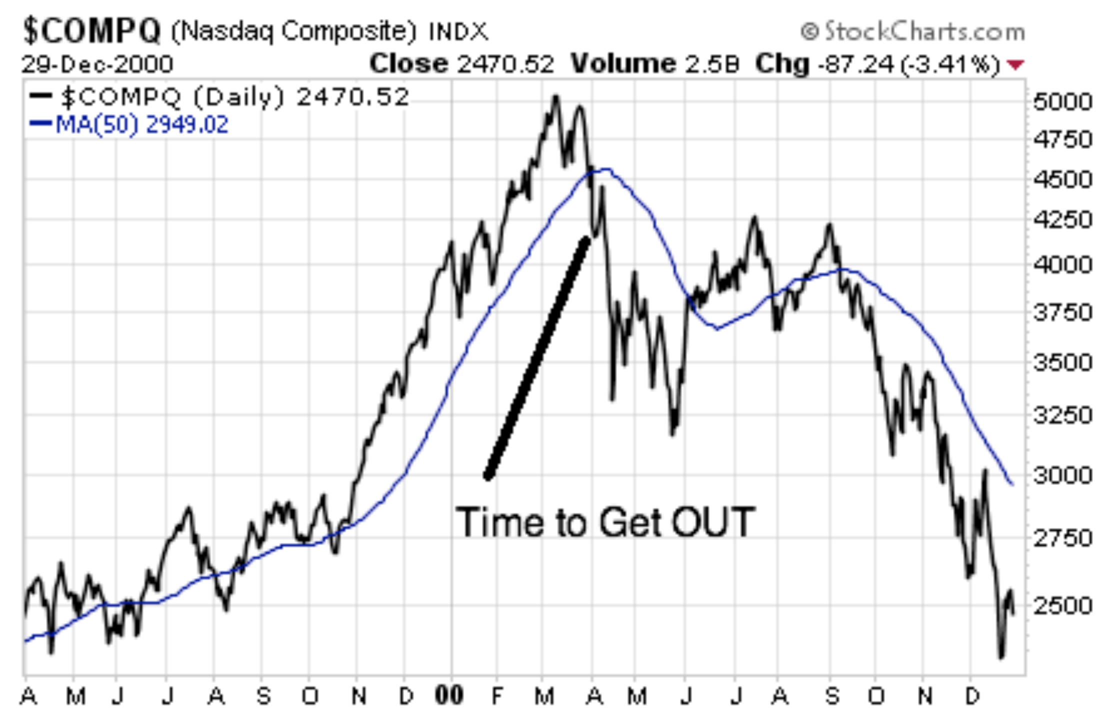
Let's see what history shows us.

If you recall from 2008, stocks didn't go straight down. Instead they dropped, bounced, and then began the serious collapse. Looking back at that time, the 50-DMA served as a useful metric for gauging that a serious decline was about to begin:

As you can see stocks rolled over and broke below their 50-DMA in late 2007. After that, the 50-DMA acted as strong resistance. Indeed, there was only one bounce above this level, which lasted roughly a month and a half. The real trouble began in the summer of 2008, and investors were given a decent warning when the S&P 500 collapsed and then bounced to test the 50-DMA and failed to break it.

Similar warnings appeared before the 1987 Crash:

The Tech Bubble:



And the 2008 Crash:

Thus, this tells us that the 50-DMA is a strong metric for gauging when real trouble hits stocks again. **On that note, the trigger you should be looking for in terms of when the next Crash will hit will be a decisive break BELOW the 50-DMA followed by a strong bounce that FAILS to break above it again.**

With that in mind, here are some trades to put "on deck" for when the next round of the Crisis hits.

Trade #1: Short the Russell 2000

The Russell 2000 is perhaps the junkiest index in the US. Many of the companies that comprise this index don't even MAKE money and most likely should have never been taken public in the first place. This is the "risk" index, the index of companies that are garbage. For that reason, the Russell 2000 will collapse most when stocks truly begin rolling over.

The below chart compares the Russell 2000's performance against that of the Dow Jones Industrial Average during the 2008 Crash. As you can see, the Russell dropped significantly more:

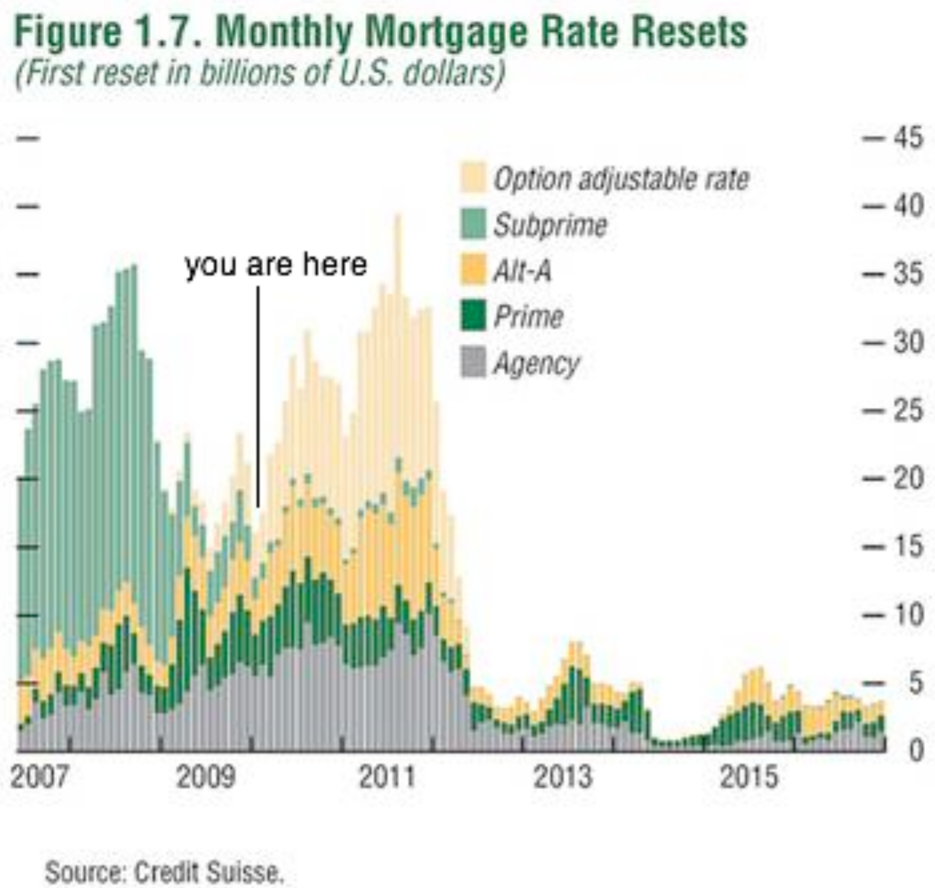
For this reason, I suggest buying the UltraShort Russell 2000 ETF (TWM) when the market begins its next real collapse.

The **UltraShort Russell 2000 ETF (TWM)** returns 2X the inverse of the Russell 2000. So if the Russell 2000 falls 5%, TWM returns 10%. If the Russell 2000 falls 10%, TWM returns 20%. It's a terrific means of playing the collapse in small cap stocks.

Again, wait for stocks to enter a free fall before opening this trade.

Trade #2: Short Financials

By now you know that the current Crisis has centered on the financial sector, specifically the banks. The *Protect Your Savings* report details the issues extensively. However, as further proof, the below chart shows that US banks are about to get slammed with another round of mortgage defaults from the residential housing sector (I'm not even going to bother including the commercial real estate market which is a multi-billion time bomb in of itself).



Suffice to say, Financials have a lot of issues coming their way in the future. For that reason, when the next Round of the Crisis hits, I suggest buying the **UltraShort Financials ETF (SKF).**

SKF returns 2X the inverse of the Financials ETF (IYF). So if the IYF falls 5%, SKF returns 10%. If the IYF falls 10%, SKF returns 20%. It's a terrific means of playing the collapse in financials stocks.

Again, wait for stocks to enter a free fall before opening this trade.

Trade #3: Short the Retail ETF

The US consumer accounts for 70% of US GDP. Real unemployment is currently close to 17%. Food Stamp usage is around a record 38 million. Tax receipts for 2010 so far are LOWER than 2009's levels (didn't everyone think the entire world was ending back then?).

And yet, retail stocks are back to their 2007 highs:

As you can see, retail stocks in general are up nearly 200% during the worst recession in decades. It's simply staggering. For that reason, I suggest **Shorting the Retail ETF (XRT)** when stocks start to collapse.

XRT gives broad exposure to the retail sector. Its top holdings are:

Company	**% of Assets**
Casey General Stores	1.9%
Gamestop	1.9%
Jos A Bank Clothiers	1.8%
Netflix	1.8%
Tractor Supply	1.7%
Annetaylor Stores	1.7%
Limited Brands	1.7%
Childrens PI Retail Stores	1.7%
Best Buy	1.6%
Abercrombie and Fitch	1.6%

Shorting this ETF gives you the opportunity to short retail across the board. However, if you're more inclined to short specific companies, I'd focus on apparel and clothing retailers like Gap (GPS), Limited Brands (LTD), Nordstrom (JWN), and the like.

As with the other trades, only enter these shorts when the market begins to enter a free fall.

Trade #4: Short the Emerging Markets

Emerging markets have leaded the US on this latest rally: they bottomed back in November 2008, while US stocks continued to plunge until March 2009. That's not the only "leading" emerging markets have done. While the S&P 500 is up some 60% from its March lows, China, Brazil and their kind have all more than DOUBLED from the November 2008 lows.

This relationship will reverse in the next Crisis.

During times of Crisis, the "flight to safety" involves institutional investors dumping their foreign shares to load up on Treasuries or other perceived "safe havens." Consequently, emerging markets are hit hardest when the markets collapse.

For that reason, when the next collapse begins I suggest shorting emerging markets via any number of inverse Ultrashort ETFs. The most popular ones are:

1) **The UltraShort Emerging markets ETF (EEV)**
2) **The UltraShort China ETF (FXP)**
3) **The UltraShort Brazil ETF (BZQ)**

All three of these return 2X the inverse of an underlying index: the MSCI Emerging Markets ETF, the FTSE/ Xinhua 25 ETF, and the Brazil ETF, respectively. As such, they represent a great way to pocket major gains when the emerging markets collapse along with the rest of the financial world during the next Crisis.

As with the other trades, only enter these shorts when the market begins to enter a free fall.

Conclusion

This concludes the our report. If you found this interesting you might want to consider delving into our other FREE reports. All of them are available for downloading. Simply click here.

Good Investing!

Graham Summers
Chief Market Strategist
Phoenix Capital Research