A Publication of Newsmax and Moneynews

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Financial Braintrust Alliance Dossier

Vol. 1, No. 2 / December 2012

Opportunities at the Edge of the Fiscal Cliff

By Andrew Packer

The Force is strong with George Lucas — or at least his business sense is.

The creator of the wildly successful *Star Wars* movies famously declined his director's salary when the 1977 film went over budget. Instead, he kept merchandising rights and made millions off of action figures, lunchboxes, books, video games, a special effects studio, and innumerable other goodies in the decades since via his firm Lucasfilm.

At the end of October, Lucas signed a deal to sell his company to a bigger and even more powerful empire: Disney. It's a great fit. Both companies are entertainment powerhouses. Much like Disney's Pixar and Marvel acquisitions, it'll add powerful franchises to the company, which besides a well-known mouse, also includes ESPN and the ABC network.

> "What's happening? Owners and founders of companies want out. There's just too much uncertainty, centering around the fiscal cliff."

The deal is for a whopping $4.05 billion in cash and stock — which goes entirely to Lucas. In turn, Lucas will donate most of it to his charity, which focuses on providing and improving educational opportunities for children around the world.

But what's more interesting is the reason *why* the filmmaker is cashing out now. The likely answer is simple: the higher tax rates set to kick in at the start of 2013.

"I'm Altering the Tax Deal"

In essence, starting Jan. 1, Uncle Sam will repeat one of Darth Vader's menacing lines in *The Empire Strikes Back*, "I am altering the deal. Pray I don't alter it any further."

Right now, Lucas will only have to pay a 15 percent long-term capital gains tax from the sale. Next year, as things stand, that jumps to a minimum of 23.8 percent. That includes an increase from 15 percent to 20 percent on the income tax side, and a 3.8 percent charge to pay for Obamacare.

But this isn't just a one-time way for billionaires like Lucas to save millions of dollars in taxes. We all face higher taxes come January. Lucas is just getting out ahead of the looming fiscal cliff.

He's not alone. I've talked with some of the folks that I used to work with in private equity. Deals are being made. Not at the record frenzy of 2006 or 2007, where leverage played a role in juicing the markets, but it's happening. Why? Owners and founders of companies want out. There's just too much uncertainty, and it all centers around the fiscal cliff.

Cliff Diving

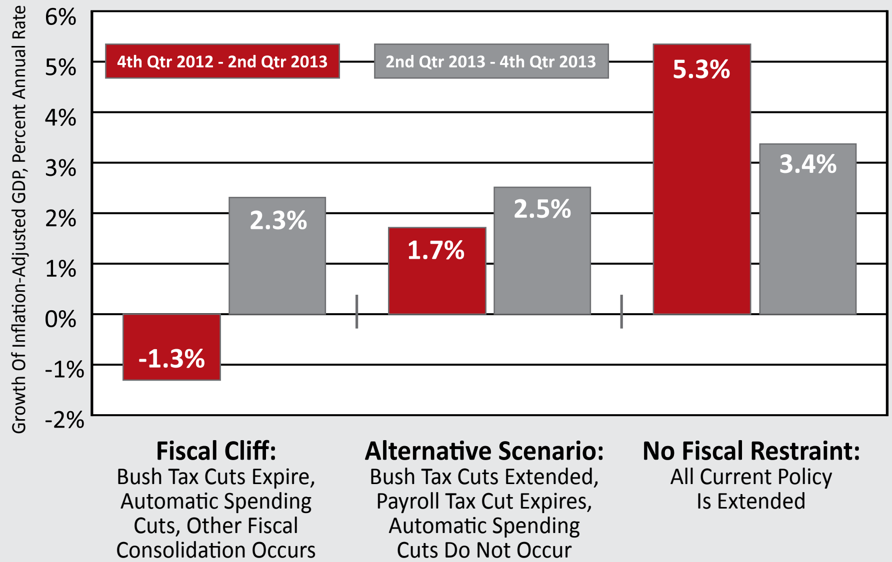
While taxpayers will be hit with bigger bills starting Jan. 1, 2013, the government will be tightening the belt with a 10 percent cut in spending. "Right now there's a mandate for a 9.4 percent cut across all government programs," said Belpointe Asset Management Chief Strategist David Nelson in an exclusive call with the Braintrust Alliance.

Not only is there a government cut, it's apparently going to happen across the board with the usual competence one can expect from the government. "Consider the military. If the Navy has 10 aircraft carriers, the most logical thing to do would be to cut one carrier. Instead, the spending cuts of the fiscal cliff will make for a 10 percent cut across the board. Rather than have one carrier out of commission, we'll have 10 carriers dangerously underfunded."

Indeed, the numbers look mixed. As it stands, the Bush-era tax cuts will expire and automatic spending cuts will kick in at the end of the year. Between now and the first half of 2013, we could see two quarters of negative growth, which the Congressional Budget Office estimates at negative 1.3 percent. In short, we'd voluntarily slip into a recession.

Congress Could Kill The Economy If They Go Over The "Fiscal Cliff"

Deep Cuts and Higher Tax Rates in Current Law Will Hurt GDP Growth in 2013



While government spending will take a hit, the real effect of the fiscal cliff will be higher tax rates hitting the private sector. Keep in mind economic growth has still been anemic in the private sector since the end of the financial crisis.

SOURCE: CBO, TalkingPointsMemo.com
Note: Fiscal Scenarios Include Other Policies Not Listed Here

The CBO estimates if the government extends the Bush tax cuts (they already did it once), but allows the payroll tax cut to expire and automatic spending cuts don't kick in, we'll slog on with a 1.7 percent growth (compared to the most recent estimate for the third quarter of 2012, 2 percent).

Finally, if everything is extended, we could see growth taking off over the next six months at a whopping 5.3 percent, which then would drop to 3.4 percent in the second quarter through the fourth quarter of 2013.

Andrew Packer has been an avid investor since childhood. Starting with bullion and collectible coins, he expanded into stocks as a teenager. He has since added options, real estate, and bonds to his personal portfolio. His investment approach is based on value, growth at a reasonable price, special situations, and any other opportunities presented by the market. After earning a BA in economics, Andrew honed his analytical skills while working at various companies, including real estate research and private equity firms. Andrew has written investment services on small-cap value investing, shorting, and contributed big-cap value investments to a monthly publication.

Note all the measures that constitute falling off the cliff: higher tax rates and lower government spending. Basically, everything that's being measured about the cliff so far is on the government spending side. That overlooks the bulk of the economy, the private sector, which is already taking measures or delaying investment decisions as a result of this uncertainty.

"We're looking the wrong way through the telescope. We've already tumbled into a fiscal abyss," warned James Dale Davidson, investment author and founder and former head of the National Taxpayers Union, on the Alliance call. With the private sector jittery and full of business owners looking to sell out, it's easy to see the argument that we've already started falling off the cliff.

But what we're seeing right now is a tumble down a small hill in the form of reduced economic potential. We can thank the uncertainty in the private sector for that. The full effect of this fiscal cliff will have a much steeper slope when government spending combines with a tax hike on the private sector. And every day we get a little closer to that drop-off.

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The Dossier Online

Highlights this month on the FBA website:

• **Braintrust Expert Call:** On Friday, Dec. 7, we will host our monthly Braintrust call, in which financial experts from around the globe call in and debate the latest economic issues and stock picks. The audio will be available for listening on www.fbtalliance.com, in the afternoon, with the written transcript to follow on Dec. 10.

• **Exclusive Articles:** Check back to the "Home" screen on www.fbtalliance.com daily for new blog posts and video interviews from our experts.

• **Educational Video Series:** Interested in charting and technical analysis? Sean Hyman, editor of the Ultimate Wealth Report, has created a three-part series to explain the ins and outs of chart reading when it comes to stock picks, which will be released in full by Nov. 21. Find them in the "Library" tab, under "Video."

• **Analysis of Key Data:** Top economic forecaster Joel Naroff breaks down what investors need to know whenever key new data is released. Watch the "Home" page on the site for his regular updates.

It's Always Darkest Before the Dawn

All the estimates of the effects of the fiscal cliff jump right to the final "big" number that measures the growth of the economy: gross domestic product (GDP).

It makes sense. It's an easy calculation to follow. Simply, GDP equals private consumption (the private sector), plus investment, plus government spending, plus net exports (exports minus imports). Or, in short, GDP= C + I + G + (X-M).

It's a pretty simple equation. The hard part is getting accurate numbers for all the components.

So we can see that GDP will take a hit from the fiscal cliff as the value of G declines automatically. We can also reason that higher tax rates will reduce the amount of C and I as consumers have less money to spend and save. Ironically, our trade balance is so hugely imbalanced that a recession in the U.S. could actually improve our (X-M) number, which has been negative for some time.

But for the bulk of the post-war era, government has run deficits. The G number has been larger than it would have been with a balanced budget. More recently, the trillion-dollar-plus deficits of the past five years have really given total GDP a huge boost.

There's a reason why the original economist who developed the GDP equation, Simon Kuznets, warned Congress in 1934 that it shouldn't be used to measure welfare. Yet, it is anyway.

So, while many have been lamenting the fiscal cliff, my views are a bit more optimistic. I think it's ultimately *good* we're getting off the cliff. I don't think we should have climbed up here in the first place.

Cliff? More Like "Between a Rock and a Hard Place"

For starters, we should have curbed the growth of government spending ages ago. Had we done so, we wouldn't have trillions of dollars in debt dragging economic growth down today. We wouldn't have to make the painful choice between higher taxes or lower government spending. We would've been on healthier economic ground.

Furthermore, the private sector of the economy would be larger. Since the end of World War II, the government has historically collected about 25 percent of GDP in taxes. But the percentage of GDP attributed to government spending has averaged in the mid to high 30 percent range, with more recent years reaching near 40 percent.

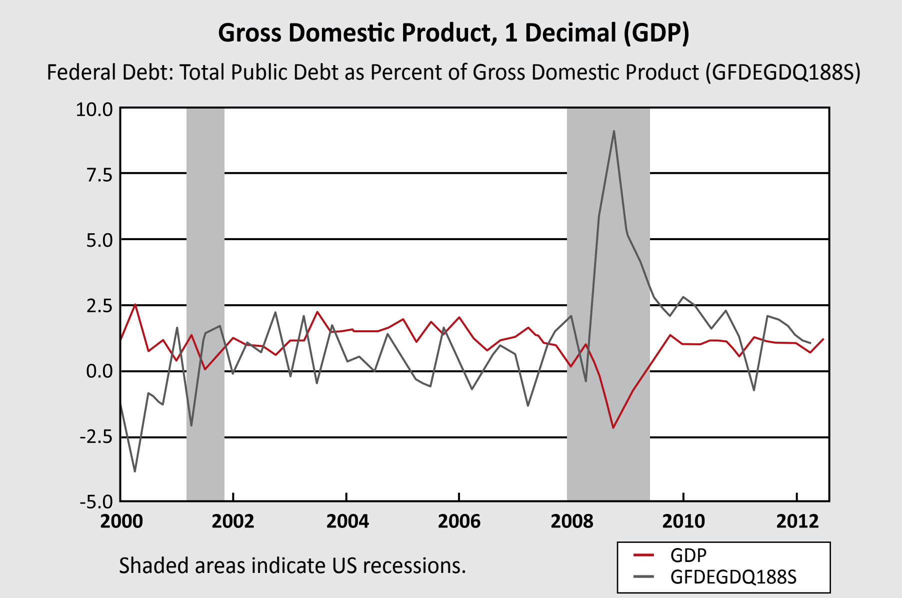
Politically, tackling spending has been nearly impossible. It's always made more sense for politicians to promise their constituents all sorts of pet projects. In terms of Uncle Sam's bottom line, it's not even pocket change, it's pocket lint. A few million here, a few there, and you're *still* not even talking about real money.

But where politicians get jumbled up around election time is on taxes. Americans are an odd bunch: When it comes down to it, we want big-government programs. But we want small government taxes. So, really, in the guise of giving people what they want, we've gotten it. And the price is an ever-increasing tab — $16 trillion of debt and over $100 trillion (and counting) in unfunded liabilities for Social Security and Medicare.

In that respect, cutting back government spending is a good thing. Actual government cutbacks, which we could see in the "worst case" scenario, are *real* cutbacks.

In Washington, when politicians speak of cutbacks, they tend to mean reducing the future growth rates of government programs. It's another way of having your cake and eating it too. You can get elected to Congress, and fulfill your campaign promise to cut spending by, say, reducing the future growth rate of a government program from 12 percent to 6 percent per year and calling that a cut.

The naysayers say that reducing government spending will hurt the economy. In a way, they're right. GDP will drop, because government spending is a part of GDP. But, government spending can only come from one of two ways — from taxing the productive wealth of the private sector, or going into debt. On the tax side, rising tax rates are an absolute necessity one way or another at our current spending. They're also necessary if government spending were to be cut in half.



Ironically, an uptick in federal government debt — which occurs when the economy tanks and the government embarks on massive stimulus programs — tends to lead to a decline in GDP, because government spending can only come at the expense of the private sector.

SOURCE: 2012 research.stlouisfed.org

Right now, over 16 percent of tax revenues are just covering the interest on our national debt.

Remember, that debt is selling at a historically low rate. Investors who lend to the federal government get only 1.726 percent for 10 years. With official government inflation rates running about 2 percent per year, loaning money to Uncle Sam is a guaranteed loss in real terms.

Of course, you'll get your money back. In fact, the 14th amendment of the U.S. Constitution, passed after the Civil War, states "[t]he validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."

But our finances say we *should* question that. Right now, it's hard for anyone who's looked at the numbers to understand how that debt can possibly be repaid… and the situation is only getting worse.

The fact that a country with a constitutional provision to *always* repay its debts has lost its AAA credit rating doesn't bode well for the world. If the U.S. isn't an AAA creditor, *then nobody else is either.*

Still, there's time for the government to fix things. Facing our problems head-on now is a fantastic opportunity, but if not, inflation looms. As chartered market technician Michael Carr noted on the monthly call, "The Federal Reserve is pushing on a string — and if clichés are running the economy at this point, inflation is inevitable."

Imagine what a huge bout of inflation could do. That debt could suddenly be repaid in nominal terms. Yes, the payment would be in dollars that had significantly reduced purchasing power. It would be the swindle of a lifetime, perhaps even the greatest in history.

I don't like the idea of higher taxes. Neither do most Americans. I *really* don't like the idea of taxation via inflation, which is *also* a tax, but one that also wreaks havoc on the economy in the process. So a rise in tax rates may finally force the electorate and Congress to rethink its future spending priorities.

Thus, the fiscal cliff is an opportunity for Americans to come together and decide what kind of government we really want — how big or small, and what programs to emphasize.

That's why we'll have some kind of long-term solution. We may even see a short-term solution emerge within the coming weeks as a lame-duck Congress sits down to salvage their legacy. Many political insiders agree. The basic reasoning is that, when it comes down to it, no politician will want to take responsibility for falling off the cliff — so either way, in the coming months we can expect at least a short-term Band-Aid.

That means the private sector's move to combat the uncertainty over the fiscal cliff is creating some investment opportunities today — while fear still reigns and prices remain depressed.

Opportunities at History's Crossroads

With the fiscal cliff in mind, our Financial Braintrust Alliance members noted three excellent opportunities. First, guest speaker David Nelson recommended Microsoft (MSFT). The global software firm stands to benefit from the launch of its latest product, Windows 8.

Next, Michael Carr suggested the best opportunity was in an investment that offered inflation protection and should rise along with global economic growth — oil. The best vehicle here is the United States Oil Fund (USO).

Finally, James Davidson advised the Alliance to look at a small cap he serves as chairman and CEO of, Zinco do Brasil/TurkPower Corporation (TRKP), which is a small exploratory company with zinc mines that may also benefit from strong global demand for rare earth metals.

Among these opportunities, I think Microsoft offers the best opportunity. The Alliance weighed in heavily and agreed with an investment in Microsoft. Here's why.

A Tale of Two Companies

In order to understand the investment opportunity in Microsoft, it helps to compare it to another big-name tech company, which for now I'll call Company X.

You'd know Company X right away. Ten years ago, it was a small stock left on Wall Street's curb. Today, it's one of the most widely held stocks known. The company's founder and CEO has had a tumultuous relationship with the media, who seem to both adore and revile his wild success.

The industry Company X is in is rapidly changing, but they have the bulk of their market locked down. When one of their hot new products is launched, consumers line up around the block to buy it. In the past, some consumers have even tried to get their latest products autographed.

Profit margins at Company X are fat. The company both generates and receives plenty of lawsuits, including a few that may indicate trouble with regulators with regard to antitrust laws.

Company X is on a tear — the market value of the company is over $500 billion dollars, and some believe that it'll soon be a $1 trillion company. Indeed, it's almost an *embarrassment* to compare Company X to Microsoft, which today is sort of a utility along with other tech-boom "has-beens" like Intel and Cisco.

Microsoft is launching Windows 8, a new operating system that has the look and feel of Apple. It's not the first time in the company's history that the company has been accused of taking a bite out of their main competitor that way.

The stock market doesn't particularly care for Microsoft, which trades at about nine times forward earnings (compared to the overall market's 16). The 3.1 percent dividend yield suggests a company with ample cash flow today, but that its heyday of growth was a long time ago. And while still a respectably large company with a $248 billion market cap, it pales in comparison to the bright future offered by Company X.

Company X Revealed

From what I've shown you about Company X, if you guessed Apple, you're… well, incorrect. Ditto with Google. Company X is *also* Microsoft… as it was at the peak of the tech bubble in 1999. At its peak, Mr. Softie (Wall Street slang for the company) traded at over 70 times earnings and had a peak market cap of $619 billion dollars.

So today, shares of the company are 60 percent lower than at their bubble peak. But what's better is that the company is wildly more profitable today than it was when it just sold operating systems.

At the market peak for Mr. Softie 12 years ago, there was no video game division with the Xbox. There was no way to profit from the merging between computers and cell phones — there just wasn't the technology.

That brings us to today with its latest tech offerings. The biggest new product is Windows 8. As someone who's used Windows software personally and professionally since the days of DOS, upgrading to a newer version is either a big hit or a big miss. Typically, it alternates; as the company learns the lessons it needs to when it launches a dud. Windows 7 was a dud.

I went down to my local Best Buy to take the new software for a spin. Windows 8 definitely looks like it could be a hit. A bit of a departure from prior versions of Windows, it's designed more with touch-screen products in mind (such as cell phones and tablets). It's sleek and fast — usually the kind of description you'd give to Apple software. And, unlike some of its predecessors, the software has some huge security upgrades. In short, Windows 8 shows that lumbering Microsoft can catch up to (and even in some areas exceed) the kind of user-friendly interface that's more often associated with Apple.

Fundamentally, the company is in great shape. Today, about 21.7 percent of Microsoft's share price is net cash on the balance sheet. The company has over $66 billion in cash and only $12 billion in debt. The debt is relatively new, but given today's low interest rates, it's a cheap time for them to borrow. As I mentioned before, other metrics place the company's valuation at a solid discount to the overall market.

There's another reason to like Microsoft here: the markets don't like tech companies right now. Yes, when the market hates companies, it does so for a reason. Google and Apple recently reported lower profit margins and the market sent them tanking.

Yet, it's also helpful to remember that the market has a love/hate relationship with stocks. When Microsoft was Company X at the height of the tech bubble, Apple stock was a washed-up company. Yet today Apple's the hottest stock on Wall Street — and a completely reinvented company. Markets love a winning turnaround story.

Portfolio Update

This month we add Microsoft to the Core Portfolio, marking our first foray into the technology space, at $29 or lower per share.

In the extended portfolio, we're adding the ETF United States Oil Fund (USO) at or under $32 per share. The investment, however, comes with some caveats that I want to mention. We already have a few energy-related investments in our portfolio. These include Exxon Mobil (XOM), Petrobras (PBR), and Legacy Reserves (LGCY) in the Extended Portfolio. Unlike USO, which is a pure play on the changing price of oil as a commodity, these companies are in the business of exploring,

PICK AT A GLANCE

MICROSOFT (MSFT)

PRICE: $29.50 (as of Nov. 5)

52-WEEK RANGE: $24.30-$32.95

INDUSTRY: Tech

P/E RATIO: 15.93

DIVIDEND YIELD: 3.10%

PROFILE: Microsoft develops, licenses and supports software products and services, while designing and selling hardware worldwide. Products include the Windows operating system, Microsoft Office and the Xbox 360 gaming platform.

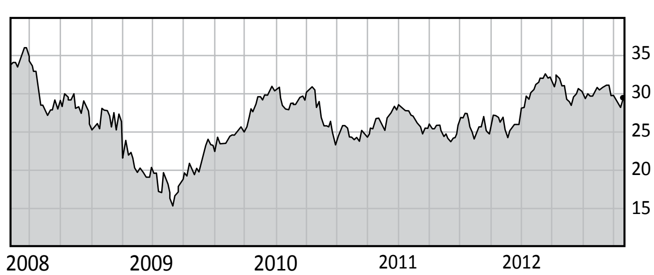
POSITIVES

- The new Windows 8 is thus far proving to be a significant upgrade to previous Windows versions, and works well across multiple devices.
- The company's financial situation is solid; it delivers plenty of cash and a strong dividend among tech players.

RISKS

- Windows 8 doesn't get the market traction it needs in the marketplace, leading to some negativity on the stock.
- CEO Steve Ballmer has proven to be a bit ham-handed in his role; a change in leadership at some point would likely prove a net positive for the stock price.

MSFT 5-Year Chart



refining, producing, and shipping oil. In that sense, these companies carry the risk that any other business has — their performance may not strictly change with the price of oil. Be aware that U.S. Oil won't pay a dividend and may prove volatile.

As for Davidson's pick, Zinco do Brasil/TurkPower (TRKP), we are not officially adding it to the Extended Portfolio, being that it would be too much of a conflict of interest to do so. If you do look into it further, just note that it's extremely speculative. If you invest, invest only small amounts, and be prepared to lose the entire stake.

CORE PORTFOLIO

RECOMMENDATION	Ticker	Exchange	Entry Date	Entry Price	Recent Price	Dividend Yield	Div. Paid Since Entry	Total Return	Buy at or Under	Stop Loss
Bank of America	BAC	NYSE	6/12/2012	$7.28	$9.94	0.55%	$0.01	36.65%	$8.00	$5.82
Rio Tinto	RIO	NYSE	7/13/2012	$46.26	$51.21	3.54%	$0.73	12.47%	$51.00	$37.01
iShares MSCI Italy Index	EWI	NYSE	8/13/2012	$11.19	$12.48	3.74%	$0.00	11.53%	$12.00	$8.95
Newmont Mining	NEM	NYSE	9/14/2012	$56.96	$48.50	2.46%	$0.00	-14.85%	$63.00	$45.57
Market Vectors Coal ETF	KOL	NYSE	10/19/2012	$25.56	$25.87	N/A	$0.00	1.21%	$28.00	$20.45

* Denotes recommendation not yet purchased

As of close November 6, 2012

EXTENDED PORTFOLIO

RECOMMENDATION	Ticker	Exchange	Entry Date	Entry Price	Recent Price	Dividend Yield	Div. Paid Since Entry	Total Return	Buy at or Under	Stop Loss
iShares U.S. Pref Stock Ind	PFF	NYSE	6/12/2012	$37.75	$39.98	6.07%	$0.83	8.28%	$41.00	$30.20
Annaly Mortgage	NLY	NYSE	6/12/2012	$16.63	$15.32	13.05%	$1.05	-1.66%	$17.00	$13.30
SPDR Gold Shares ETF	GLD	NYSE	6/12/2012	$155.36	$166.30	0.00%	$0.00	7.04%	$170.00	$124.29
Petrobras	PBR	NYSE	7/13/2012	$19.58	$21.97	0.69%	$0.00	12.21%	$21.00	$15.66
Exxon Mobil	XOM	NYSE	8/13/2012	$88.14	$91.61	2.59%	$0.00	3.94%	$90.00	$70.51
Legacy Reserves	LGCY	NASDAQ	8/13/2012	$26.65	$27.24	8.37%	$0.56	4.41%	$27.00	$21.32
FX Capital Management	FXCM	NYSE	8/13/2012	$9.65	$8.96	2.49%	$0.06	-6.57%	$9.75	$7.72
iShares Barclay TIPS Bond	TIP	NYSE	9/14/2012	$121.82	$121.86	2.06%	$0.00	0.03%	$124.00	$97.46
SPDR Financial Select	XLF	NYSE	10/19/2012	$16.25	$16.15	1.62%	$0.00	-0.62%	$16.50	$13.00
Vodafone	VOD	NASDAQ	10/19/2012	$28.00	$27.08	4.06%	$0.00	-3.29%	$28.00	$22.40

* Denotes recommendation not yet purchased.

As of close November 6, 2012

The "Total Return" column includes all reinvested dividends at concurrent recommended buy prices. Returns calculated based on a purchase of $1,000 of the security on the listed entry date and price. The "Dividend Yield" column reflects the yield investors receive assuming they bought at the entry price and followed all subsequent recommendations.

SOLD POSITIONS

RECOMMENDATION	Ticker	Portfolio	Entry Date	Entry Price	Total Return	Exit Date	Sell Price			
Hellenic Telecom	HLTOY	Extended	7/13/2012	$1.49	61.07%	10/19/2012	$2.40			
B.P. Prudhoe Bay Royalty	BPT	Extended	7/13/2012	$116.92	-24.14%	10/19/2012	$86.88			

* Denotes recommendation not yet purchased

As of close November 6, 2012

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Closing Thoughts

When it comes to political bickering, it seems like things have never been worse. Some members of the Alliance liken it to the Cold War-era policy of Mutually Assured Destruction. The notion is simple: If one side has to suffer, so does everyone.

It's a good metaphor. Government cannot create, it can only destroy. Any appearance of creation comes from appropriation from the private sector. The notion that some bureaucrat in Washington, D.C., knows how to better allocate your money than you do seems absurd to me.

But I think there's a more apt metaphor.

As investors, it makes far more sense to think of politicians as children playing ball in the street. Call me cynical, but when I hear finger-pointing and other raucous comments from politicians, I'm reminded of the signs around my neighborhood that say "Slow Children at Play."

So don't get mad — get rich. In investing, that's simply done by avoiding potential political risks and investing where the opportunities lie.

Andrew Packer

Actions to Take Now

Action No. 1: Buy Microsoft (MSFT) at or under $29 per share for the Core Portfolio. While an American company, it's a global behemoth in the high-margin software sector. Technology stocks are a different breed than they used to be back in the heyday of the tech bubble. Now, they're more utility-like in nature, but offer solid dividend yields and better profit margins than commodity-dependent electrical utilities.

Action No. 2: For investors who participate in the Extended portfolio, add shares of U.S. Oil (USO) at or under $32, but bear in mind the caveats I've mentioned in this issue.

To subscribe to this newsletter, please go to
www.moneynews.com/offer