

# MARKETS AT A GLANCE

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## It's Déjà Voodoo Economics... All Over Again

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If you're of a certain age, chances are you remember exactly where you were when JFK was assassinated. Similarly, if you're from Canada or the United States and have an even remote interest in hockey, it's highly likely that you remember exactly where you were when 'Sid the Kid' scored the winning overtime goal in the Olympic gold medal game. These were both "significant events", albeit for different reasons. We wonder, however, if any of you recall where you were on September 18th, 2008? Do you remember that day? We can't seem to recall it either, which is strange, because it was one of the most important days of the decade. October 7, 2008 is another day that should stick out in our memories, but we're sure you don't remember that day either – and we're in the same boat. How is it, then, that we can't recall where we were or what we were doing on the two days the entire financial system almost collapsed?!? It boggles our mind. These dates should have been emphasized in every "review of the decade" written at the end of 2009, but we've been hard pressed to find them mentioned in any mainstream publication. This is troubling to us, and makes us wonder if people are even aware of the incredible events that took place on those fateful days only eighteen months ago.

The financial industry often prides itself on the hindsight principle. We may not predict the future with great accuracy, but when things fall apart we're very quick to explain why and how it happened with authoritative aplomb. "Hindsight is 20/20", as they say. But is it really? Despite our seemingly thorough analysis of past failures, the financial industry seems to have an uncanny ability to make the same mistakes over and over again. Perhaps this is due to the fact that we don't properly review events passed. Our obsession with predicting future results impels them away into oblivion. The fact remains that a cursory look back on the last decade reveals an apparent cycle of asset bubbles that all grew and burst before our eyes, with little effort made to actually address the underlying causes that made them possible. We have written at length about the next asset bubble now forming in government debt and currency. Looking back on the last decade from 2000 to 2009, are there any lessons that can provide some guidance for the next decade? And are there any lessons that can be gleaned from September 18th and October 7th, 2008, when we almost lost the entire financial system? We certainly hope there are.

The seeds of the financial mess we are currently experiencing began in the mid-to-late nineties. As we approached year 2000, the widespread belief developed that new technology would rewrite economic rules. The euphoric years between 1995 and 2000 blew the first asset bubble of the 21st century in the technology-heavy NASDAQ Index. Alan Greenspan first uttered his now famous

“irrational exuberance” warning in December 1996 when describing stock valuations at the time.<sup>1</sup> It wasn’t until mid-1999, however, that the U.S. Federal Reserve actually increased interest rates in an attempt to quell the overheated stock market. The Fed actually raised rates six times between June 1999 and January 2000 in an attempt to cool an already overheated economy. The dot-com euphoria burst on March 10, 2000, when the NASDAQ peaked at 5,132, representing more than double its value from only a year before. We were watching the bubble closely at the time, and wrote on March 9th 2000, “In the next few months, if not weeks, we anticipate that the Nasdaq will capitulate to market liquidity. Valuations are screaming at us! Excessive speculation is running rampant! DON’T BE A PART OF IT!!!” It was a timely recommendation.

In many ways, the NASDAQ bubble was somewhat conventional in that it was born out of over-enthusiasm for the prospects of new technology. The fact that the Federal Reserve actually tried to cool the bubble down, however feebly, in the years before its peak, is really what differentiates it from the bubbles that followed. The NASDAQ collapse is well understood now, ‘in hindsight’. This collapse compelled Alan Greenspan and the Federal Reserve to embark on the largest rate cuts in US history in an effort to soften its impact. The inability to face the economic pain of the market crash ultimately set the stage for the second bubble of the decade, this time in housing. The key point to emphasize here is that the Federal Reserve lowered interest rates *thirteen times* between January 3, 2001 and June 25, 2003 in order to cushion the economy. These rate cuts allowed for increasingly easy access to credit on a worldwide scale. It didn’t take long for the second bubble to develop, and it wasn’t hard to see the warning signs. Even The Economist magazine noticed, stating on June 16, 2005, that “the worldwide rise in house prices is the biggest bubble in history.”<sup>2</sup> Home prices rose at an annualized rate of more than 11% from 2000 to the peak on July 31, 2006 - more than doubling in that time period.<sup>3</sup> The financial sector became the US economy’s central economic driver, generating up to 41% of all corporate profits and making it the fastest growing sector of the economy.<sup>4</sup> In July 2005, Greenspan described certain real estate markets as “frothy” and recommended that the Federal Reserve rein in lending standards.<sup>5</sup> We wrote in response at the time that “(Alan Greenspan) should be careful what he wishes for... it may come true. It’s like throwing stones in glass houses. It may all end with the Federal Reserve having to bail out the financial system, as it did with the savings and loan crisis a decade ago.” We now know what transpired in the years to follow – we’ve all lived through it, and it ended with the biggest bailout in financial history.

So what’s the point, you ask? *In hindsight*, it’s very safe to argue that the Fed probably *shouldn’t* have lowered rates thirteen times between January 3, 2001 and June 25, 2003. It proved to be an extremely damaging policy. Artificially low rates created a lending mania of enormous proportions which dragged consumers along for a debt-fueled buying orgy. In our January 2008 commentary, aptly entitled “Welcome to the 2008 Meltdown”, we opined that “There are meltdowns occurring everywhere: commercial real estate... car loans... credit cards. It was all a massive Ponzi scheme sustained by overleverage. Because this has been one of the most egregious bubbles ever, its impact is likely to linger longer than anyone expects. This is more than just a market failure. It’s a systemic meltdown.” And it was. But the meltdown happened so fast that it never seemed to burn into our collective memory. Everyone remembers that we went into a severe recession in late 2008, but do they know the details of what actually transpired? A quick review is needed to appreciate how close we really came to a full shutdown.

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1 The Federal Reserve Board. Remarks by Chairman Alan Greenspan (December 5, 1996). The Challenge of Central Banking in a Democratic Society. Retrieved on March 10, 2009 from: <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>

2 The Economist. (July 16, 2005) In Come the Waves. Retrieved from: [http://www.economist.com/opinion/displaystory.cfm?story\\_id=4079027](http://www.economist.com/opinion/displaystory.cfm?story_id=4079027).

3 Bloomberg. S&P/Case –Shiller Composite – 20 Home Price Index Not Seasonally Adjusted

4 Johnson, Simon (May 2009) The Quiet Coup. The Atlantic. Retrieved on March 10, 2010 from: <http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/>

5 Andrews, Edmund (May 21, 2005) Greenspan is Concerned About ‘Froth’ in Housing. The New York Times. Retrieved on March 10, 2010 from: [http://www.nytimes.com/2005/05/21/business/21fed.html?\\_r=2&oref=slogin](http://www.nytimes.com/2005/05/21/business/21fed.html?_r=2&oref=slogin)

It was the Lehman Brothers bankruptcy on Sept. 15th that set everything in motion. Most market participants will remember that date - Bank of America bought Merrill Lynch the very same day, so it was certainly memorable. What many people fail to appreciate, however, is the mayhem that took place during the following days in the US money markets. The day after Lehman's collapse, the Reserve Fund, one of the oldest and most high profile US money market funds, began to hemorrhage money as investors redeemed in panic. Large institutional investors soon began pulling money out of other major US money market funds fearing heavy losses from Lehman Brothers debt. Almost \$173 billion was pulled from such funds over the next two days, threatening to collapse the entire US financial system.<sup>6</sup> Two weeks later, on Sept. 29th, investors sent the Dow Jones plummeting 778 points, representing the largest single-day loss in the history of the index. In hindsight, it was somewhat of a delayed response, because the real damage had by then been averted by the Treasury's blanket guarantees on all money market funds.

The fact remains that on Thursday, September 18th, the US financial system almost completely collapsed. The details of that day remain frustratingly murky. The imminence of complete disorder seemed to scare Congress into action, but we can only piece the story together through random anecdotes that have been partially revealed through subsequent interviews. In what has been dubbed 'the Kanjorski meme', Congressman Paul Kanjorski recounts a meeting that was held between Ben Bernanke, Henry Paulson and certain members of Congress where the conception of the "Troubled Asset Relief Program" (TARP) supposedly took place. To stem the flow of money out of US-based money market funds, Paulson had to provide an almost instant guarantee on all money market funds held within the US. Kanjorski recounts, "If they had not done that, their estimation was that by 2pm that afternoon (September 18th), \$5.5 trillion would have been drawn out of the money market system of the United States, [which] would have collapsed the entire economy of the United States, and within 24 hours the world economy would have collapsed. We talked at that time about what would happen if that happened. It would have been the end of our economic system and our political system as we know it."<sup>7</sup> Further details of these meetings have been provided by Senator James Inhofe, who recounted that Paulson had warned of martial law and civil unrest if the TARP bill failed.<sup>8</sup> It is interesting to note that while Henry Paulson mentions several meetings that took place on September 19th in his book, the discussion of 'imminent financial collapse' and 'martial law' was noticeably absent.

The official record of the events of September 18th, 2008 comes from a research report issued by the Joint Economic Committee. The reports states, "On Thursday September 18, 2008, institutional money managers sought to redeem another \$500 billion, but Secretary Paulson intervened directly with these managers to dissuade them from demanding redemptions. Nevertheless, investors still redeemed another \$105 billion. If the federal government were not to act decisively to check this incipient panic, the results for the entire U.S. economy would be disastrous."<sup>9</sup> Between the official record and the statements by members of congress and the senate, we can piece together an almost system-wide collapse that was potentially hours away.

The second fateful date to remember was October 7, 2008, when the UK almost collapsed. Bank of England Governor, Mervyn King, describes the situation: "Two of our major banks which had had difficulty in obtaining funding could raise money only for one week then only for one day, and then on that Monday and Tuesday it was not possible even for those two banks really to be confident they could get to the end of the day."<sup>10</sup> This was the justification given for the Bank of England to provide secret

6 Henriques, Diana (September 19, 2008) Treasury to Guarantee Money Market Funds. The New York Times. Retrieved on March 10, 2010 from: <http://www.nytimes.com/2008/09/20/business/20moneys.html?em>

7 Kanjorski, Paul (January 28, 2009) Kanjorski: We came so close to complete financial collapse. Pocono Record. Retrieved on March 10, 2010 from: <http://www.poconorecord.com/apps/pbcs.dll/article?AID=/20090128/NEWS04/901280302>

8 CNN iReport (November 20, 2008). Paulson Was Behind Bailout Martial Law Threat. Retrieved on March 10, 2010 from: <http://www.ireport.com/docs/DOC-150837>

9 United States Congress, Joint Economic Committee Research Report #110-25 (September 2008) Financial Meltdown and Policy Response. Retrieved on March 10, 2010 from: <http://www.house.gov/jec/Research%20Reports/2008/rr110-25.pdf>

10 BBC (September 24, 2009) Mervyn King and other key players reveal true extent of financial crisis one year on. Retrieved on March 10, 2010 from: [http://www.bbc.co.uk/pressoffice/pressreleases/stories/2009/09\\_september/24/money.shtml](http://www.bbc.co.uk/pressoffice/pressreleases/stories/2009/09_september/24/money.shtml)

loans of £61.6 billion to The Royal Bank of Scotland and HBOS to maintain solvency.<sup>11</sup> Amazingly, news of these loans was never revealed until November 24, 2009, more than one year later. Recalling that fateful day, David Soanes, Managing Director of UBS Bank, and part of the group assembled to assist with the UK government's crisis response, stated, "We only really knew by probably about seven o'clock at night (October 7, 2008), that we, that everyone was going to get through to the next day."<sup>12</sup> These revelations raise new questions about the true scope of bailouts undertaken by the major governments at the time. Lord Myners, the UK Financial Services Secretary, alluded to similar covert banking operations conducted by the European Central Bank and the US Federal Reserve.<sup>13</sup> We have no idea what he is referring to, but we would certainly be interested to learn more.

This type of activity by the leaders of our financial system certainly helps to explain why those two dates are not more ingrained in our collective memory – strong efforts were obviously made to hide their severity. The fact that these details were left out of Henry Paulson's memoirs strikes us as astounding. It also seems incredible that the best we can do to understand those fateful days is to cobble together comments made after the fact. It serves to be reminded that the events of September and October 2008 had previously been considered unthinkable, and we must never forget that the 'unthinkable' can happen again. A complete banking collapse would not be pleasant – and it's certainly not an experience we would ever wish upon ourselves, but it must be remembered that WE ALMOST WENT THERE.

So where does this leave us for the decade ahead? In bad fiscal shape. It seems as if we're just making the same mistakes over again, and on a far larger scale. We have passed the debt obligations of the financial system onto the governments. We have liquefied the system beyond any rational explanation, more than doubling the monetary base since the collapse of Lehman Brothers. Social Security, which was in balance in year 2000, is now underfunded by \$15 trillion dollars. Total unfunded obligations of the US Government are now \$104 trillion. If we add the \$6 trillion of outstanding Fannie Mae and Freddie Mac debt and the \$12 trillion of outstanding national debt, we arrive at a total US government debt obligation of \$122 trillion. It's a truly preposterous amount of money that will never be paid off in today's dollars. As we wrote in our October 2009 article entitled "Dead Government Walking", the US Government is on a trajectory to default on their obligations, and the same can realistically be said for the UK and Japan. The answer put forward by the US, UK and Japanese governments? Quantitative Easing and 0% interest rates. Have they learned nothing from the past decade?!

As our readers know, the flagship funds at Spratt have been managed with the view that we entered a long-term secular bear market in year 2000. We have never detracted from this view, and it remains in place today. We will not be bears forever, because the cycle will eventually reverse, but a new secular bull market will not, and cannot, emerge until the world solves its debt problems. Our overarching macro view is strongly influenced by the Kondratieff Cycles. The 'winter season' began in the year 2000 and continues to this day. We have watched this cycle unfold, and have noted the Kondratieff Theory's eerie ability to predict the debt defaults and banking collapses that we witnessed over the past two years. Our analysis suggests that we are only half way through this Kondratieff winter, with another approximate ten years remaining. They will undoubtedly be an interesting ten years, and it should come as no surprise to our readers that gold is considered the ultimate asset class to own during the 'winter cycle'. It has certainly served us well up to now.

A review of the last decade would not be complete without our predictions for the next ten years. Rather than bore you with prognostications, we would like to leave you with some titles we are considering for future editions of *Markets at a Glance*.

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11 Conway, Edmund and Monaghan, Angela (November 24, 2009) Bank of England tells of secret £62bn loan to save RBS and HBOS. Telegraph. Retrieved on March 10, 2010 from: <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6646923/Bank-of-England-tells-of-secret-62bn-loan-to-save-RBS-and-HBOS.html>

12 BBC (September 24, 2009) Mervyn King and other key players reveal true extent of financial crisis one year on. Retrieved on March 10, 2010 from: [http://www.bbc.co.uk/pressoffice/pressreleases/stories/2009/09\\_september/24/money.shtml](http://www.bbc.co.uk/pressoffice/pressreleases/stories/2009/09_september/24/money.shtml)

13 BBC (November 25, 2009) Alistair Darling defends secret loans to RBS and HBOS. Retrieved on March 10, 2010 from: <http://news.bbc.co.uk/2/hi/business/8378087.stm>



Titles for  
future MAAGS  
— Eric

"Another  
Financial  
Bailout?"

"The Sub  
Sovereign  
Debt Crisis"

China Boom  
to Bust  
to Kaboom

Fannie Mae  
and  
Freddie Mac  
R.I.P

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Nortelization  
of the  
Gold Sector

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Come out,  
wherever  
you are....  
The Continued  
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"Black  
Ops  
Bankers"

The Silver  
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Economics  
1936 to 2010

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Government  
Walking Part 2,  
3, 4, 5, 6.....

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