

MARKETS AT A GLANCE

SPROTT ASSET MANAGEMENT LP

A Busted Formula

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There's nothing wrong with throwing a little money at a problem to make it go away. There's equally nothing wrong with throwing a little *borrowed* money at a problem to make it disappear, as long as you have the means to pay that borrowed money back.

But what happens if you throw a lot of *borrowed* money at a problem, and the problem *doesn't* go away? If you've ever experienced a situation like that you can probably understand how Europe feels right now. It just unleashed a magnificent \$1 trillion euro bailout and the market responded with a selloff by the end of the week! So what happened? That money was supposed to make the problem go away, after all. And it was a lot of money. Why did the market respond to it with such disdain?

We believe the market's reaction is confirming what we have long suspected: that these bailouts provide next to no long-term value. They don't produce real jobs. They don't improve productivity. They just prolong the precarious leverage game played by the financial sector, and do so at tremendous cost to taxpayers. "Bailout and Stimulate" has been the rallying call for governments and central banks since the beginning of this financial crisis – and it has certainly had its impact over the last two years, but not the type of impact we need to propel real, sustainable growth. There are three recent, glaring examples of this busted "Bailout and Stimulate" formula in action:

Exhibit A: The United States


From the outset of this financial crisis, the US Government and Federal Reserve have spent prolific amounts of money to save its banks and stimulate its economy. According to Neil Barofsky, special investigator general for the Troubled Asset Relief Program, the United States has now spent approximately \$3 trillion on various programs to stem the financial crisis.¹ This figure is expected to be updated again in July.

This \$3 trillion expenditure includes stimulus programs like 'cash for clunkers', the extension of unemployment benefits, infrastructure spending, the "Making Home Affordable" program, as well as the activities of the Federal Reserve. To measure what the fiscal stimulus has actually accomplished we looked to the US Federal budget outlays/receipts to gauge the impact of the stimulus on GDP.

¹ Heflin, Jay (April 20, 2010). Government has spent \$3 trillion (and counting) on financial crisis. *The Hill*. Retrieved on May 27, 2010 from: <http://thehill.com/blogs/on-the-money/banking-financial-institutions/93285-government-has-spent-3-trillion-and-counting-on-financial-crisis>

Table A presents *current dollar* GDP increases year-over-year alongside *current dollar* budget deficits. Comparing the two in current dollars provides a sense of the hard dollar impact that stimulus spending has had on the economy. As the chart illustrates, the net impact of the stimulus contributions and promises made since 2008 have resulted in a combined budget deficit of close to \$2.5 trillion dollars and an incremental net increase in GDP of \$200 billion. A \$200 billion return for a \$2.5 trillion increase in debt represents a terrible return on investment. It implies that the net impact of the stimulus on GDP since 2008 has been a mere 9 cents for every deficit dollar spent. Buying dimes with dollars is bad business, government-funded or not.

Table A

 Stimulus and Deficit Impact on Economy ²				
	2008	2009	Q1 2010	Net Impact
GDP Change³	\$363,800,000,000	(\$185,100,000,000)	\$36,900,000,000	\$215,600,000,000
US Federal Revenue⁴	\$2,464,813,000,000	\$2,044,758,000,000	\$466,119,000,000	
US Outlays	\$3,145,282,000,000	\$3,516,053,000,000	\$795,048,000,000	
Cash Flow Deficit	(\$680,469,000,000)	(\$1,471,295,000,000)	(\$328,929,000,000)	(\$2,480,693,000,000)

Another troubling statistic relates to the cost of job creation for the American Recovery and Reinvestment Act (that's the \$787 billion program designed to produce real jobs in the United States). The White House estimates that it takes approximately \$92,000 of government spending to create one job in the US. The White House justifies this exorbitant amount by stating that at the current employment level, each job in the US economy generates \$105,000 in GDP, thus resulting in good "bang for the (taxpayer) buck".⁵ Spending \$92,000 to generate \$105,000 in GDP seems justifiable on the surface. But further digging reveals that the actual cost to save or create one job in the US was \$117,933 per job from February to December 2009.⁶ That's well over \$92,000, and more than the \$105,000 "return" each job is supposed to provide in GDP. If this metric is correct, it means the US government is actually suffering a negative return from its job stimulus.

To further convolute the issue, one must also consider that the supposed \$105,000 GDP return for each new job doesn't incorporate the fact that the \$92,000 (or \$117,933) spent to create it was BORROWED. Why does this aspect of government expenditure never make it into the analysis? Spending \$92,000 for a \$105,000 pop in GDP represents bad logic when that \$92,000 isn't yours to spend. If we incorporate the interest costs required to borrow the \$92,000, are we really producing value or just digging a deeper hole?

2 We used current-dollar GDP numbers provided by the BEA to determine the marginal impact of deficit spending on GDP. There is no separate data set generated by the BEA, however the number is published in their news releases. It is also worth noting the divergence between reported numbers from the BEA. While the current dollar measurement of GDP decreased by \$185.1 billion or 1.3% on 2009, real GDP was widely reported as increasing by 0.1%. This divergence is due to seasonality adjustments in real GDP and the percentage change reported is a blended increase over the 4 quarters in 2009.

3 Bureau of Economic Analysis (March 26, 2010) Gross Domestic Product: Fourth Quarter 2009 (Third Estimate) and Corporate Profits, 4th quarter 2009. Retrieved on May 25, 2010 from: http://www.bea.gov/newsreleases/national/gdp/2010/gdp4q09_3rd.htm.

4 Financial Management Service, A Bureau of the United States Department of the Treasury. Monthly Receipts, Outlays, and Deficit or Surplus, Fiscal Years 1981-2010. Retrieved on May 25, 2010 from: <http://www.fms.treas.gov/mts/index.html>. We adjusted the cash flows to a calendar year period to match GDP reporting.

5 Executive Office of the President Council of Economic Advisers. (May 2009) Estimates of Job Creation from the American Recovery and Reinvestment Act of 2009. *Council of Economic Advisers*. Retrieved on May 27, 2010 from: <http://www.whitehouse.gov/administration/eop/cea/estimate-of-job-creation/>

6 McPheters, Lee (February 3, 2010) What Is the Cost per Stimulus Job? *Knowledge @ W.P. Carey*. Retrieved on May 27, 2009 from: <http://knowledge.wpcarey.asu.edu/article.cfm?articleid=1857>

Numerical discrepancies aside, the fact remains that GDP is a terrible metric to measure the return of a job program. GDP is technically the value of all finished goods and services produced in an economy. From a business perspective, GDP is akin to revenue, which isn't an asset, and is different from 'earnings' or 'profits'. Businesses don't hire additional workers for their marginal increase to 'revenue' – they hire to increase their marginal 'profit'. The White House approach to job stimulus will maximize spending, not profit. Rather than maximize spending, why not maximize actual employment by finding a way to produce a job for less than \$92,000? Surely some of the fifteen million unemployed workers in the US would appreciate some help in that area.⁷

Exhibit B: The Latest Bailout Failure in Europe

In a show of force designed to impress the world markets, the European Union pieced together an unprecedented loan fund worth almost €1 trillion euros. The fund's capital was made available to rescue euro zone countries in financial trouble. The European Central Bank announced it was ready to buy euro zone government and private bonds "to ensure depth and liquidity." The US Federal Reserve, the Bank of Canada, the Bank of England, the European Central Bank and the Swiss National Bank announced that temporary US dollar swap facilities would be opened to provide liquidity. Never have so many organizations coordinated and contributed so much to a single bailout effort!

So what was the ultimate effect of this shock and awe campaign? After enjoying a short-lived obligatory rally, the market for stocks, bonds, and the euro (in terms of USD) traded lower by the end of the week. Gold, a barometer of fear, appreciated almost 6% in euro terms over that same week.

Which brings us to the crux of the problem...

Exhibit C: Over-Levered Banks

Banks are at the epicenter of this financial crisis. The reason? Leverage. We outlined our measurement of bank leverage in our article *Don't bank on the Banks* in November 2009. As equity investors we worry about the impact a change in assets will have on a banks' tangible common equity. Readers will note that the German financial regulator recently banned naked credit-default swaps of euro-area government bonds and banned naked short selling in ten German banks and insurers. It shouldn't surprise you to learn that, according to their most recent filings, German banks are some of the most levered in the world. Table B shows the leverage calculation for each of the four largest banking institutions in Germany as of March 2010.

Table B

German Bank Leverage			
INSTITUTION	TANGIBLE ASSETS (BILLIONS) ⁸	TANGIBLE COMMON EQUITY (BILLIONS) ⁸	LEVERAGE RATIO
DEUTSCHE BANK AG	€1,658	€27.4	60:1
COMMERZBANK AG	€842	€6.8	124:1
DEUTSCHE POSTBANK AG	€237	€3.0	77:1
LANDESBANK BERLIN AG	€143	€1.9	75:1

Source: Bloomberg, Sprott Asset Management LP

⁷ Bureau of Labor Statistics, U.S. Department of Labor. (May 7, 2010) The Employment Situation-April 2010. Retrieved on May 27, 2010 from: <http://www.bls.gov/news.release/pdf/empst.pdf>

⁸ Reported figures for each institution as of Q1 ended March 2010

Commerzbank has the highest leverage of the German banks at 124:1. This means that if their assets drop in value by a mere 0.8%, their tangible shareholders equity is effectively wiped out. How many asset classes do you think have dropped by 0.8% since Commerzbank's last filing in March? We would guess almost all of them have (except gold of course). Hence the recent ban on naked short selling of German bank shares. They're too vulnerable to handle the market's wrath.

The German banks are not alone. Most large banks around the globe are operating with too much leverage. The governments can keep the "Bailout and Stimulate" game going, but it won't amount to much in the long-term unless the leverage issue is wrung out of the banking system. Until that happens, bailing out the banks is akin to pouring money down a bottomless pit.

The key point to remember with bailouts and stimulus is that it's ultimately your money that the government is spending – and your children's money. The numbers strongly suggest that your money isn't being spent wisely. We need real jobs and real growth, not bigger, more leveraged banks. The market isn't oblivious – it can see what's happening. Gold's recent strength in lieu of seemingly 'deflationary' economic data confirms the market's doubts over government intervention in the financial system.

Needless to say, we remain bearish.



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