Sprott Asset Management LP

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Safe Harbour No More

MARKETS AT A GLANCE

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The US dollar (USD) is the world's "reserve currency". This status is arguably the greatest privilege enjoyed by the US as an economic entity. Most people don't appreciate its significance. As the world's reserve currency, the USD is used by other countries across the globe to back up their own respective paper currencies. In some cases, it's as basic as a country stockpiling US dollars in their central bank vaults. When asked what supports their Pesos, Rubles, or Yen, the powers that be simply point to their pile of US dollars as proof of value. Upon reflection, it's quite obvious how tenuous it is to back up one's currency with a pile of paper issued by another country, but this is exactly how the world of international currency has worked for decades. And it has worked quite well…until now.

Despite falling 36% since 2001 (as measured by the US Dollar Index (DXY)), it is only recently that the US dollar's 'world reserve currency' status has been seriously questioned. The media pundits haven't spent much time discussing this of course, but during the week of September 8th to 11th, the DXY actually fell to new 2009 lows every single day that week. Over the last six months there has also been a substantial increase in anti-US dollar rhetoric from China, Japan, Russia, France, Brazil, and even the United Nations. Reading between the lines, it appears the US dollar hegemony has finally broken, and what happens next will have major consequences for the global economy.

Chart A

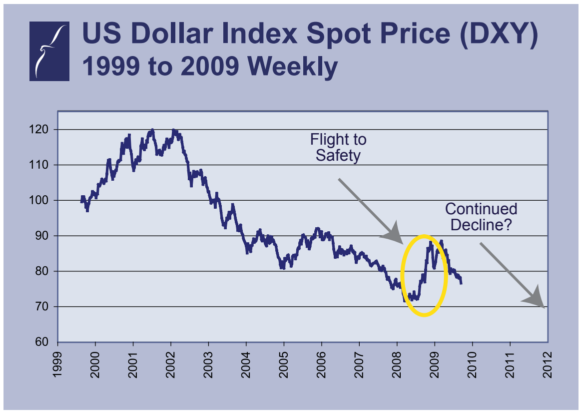

Chart A illustrates the USD's value versus other major world currencies since 2000. You will remember that one year ago, following the collapse of Lehman Brothers, the USD experienced a strong rally as the world flocked to it as a safe haven. Back then, nobody complained about owning US Treasuries – they were the ultimate safe asset for anyone looking to park large amounts of capital. Now that the panic has subsided, however, the international investment community has begun to question that choice. They have watched the US Government abuse its 'world reserve currency' privilege by printing debt and currency by the boatload.

To fully understand the debt predicament currently faced by the United States, it's best to look at the numbers. US Government revenues for the 12 months ended August 31, 2009 were US$2.2 trillion from all sources ($2,157,940,000,000).[1] According to the US Department of the Treasury, the current outstanding debt as of August 31, 2009 is US$11.8 trillion ($11,812,870,150,873.53).[2] To this we must add the unfunded promises that the US Government has made to its citizens. While there are no bonds, bills or notes issued to support these promises, they represent real commitments that will require US dollars to honour them in the future. The National Center for Policy Analysis (NCPA) estimates that the unfunded portion of the US Social Security program totaled $17.5 trillion as of June 2009 ($17,500,000,000,000). The NCPA also estimates that the aggregate unfunded promises for Medicare total a whopping $89.3 trillion ($89,300,000,000,000).[3] Table A summarizes this data (see page 2).

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1 Department of the Treasury Financial Management Service – Monthly Treasury Statement of Receipts and Outlays of the United States Government August 31, 2009. Table No. 1. Summary of Receipts, Outlays, and the Deficit/Surplus of the U.S. Government, Fiscal Years 2008 and 2009, by Month. Retrieved on September 15, 2009 from: http://www.fms.treas.gov/mts/mts0809.pdf

2 Treasury Direct. The Debt to the Penny and Who holds it. Retrieved on September 15, 2009 from: http://www.treasurydirect.gov/NP/BPDLogin?application=np

3 Villarreal, Pamela (June 11, 2009). Social Security and Medicare Projections: 2009. National Center for Policy Analysis (NCPA). Retrieved on September 15, 2009 from: http://www.ncpa.org/pub/ba662

Table A

US Government Financial Summary

	Amount
US Revenue for 12 months ended August 31, 2009	**$2,157,940,000,000**
Obligations[4]	
Total Outstanding US Debt (August 31, 2009)	$11,812,870,150,873
Unfunded Social Security Trust Fund	$17,500,000,000,000
Unfunded Medicare Trust Funds	$89,300,000,000,000
TOTAL Obligations	**$118,612,870,150,873**

According to the US Treasury department, the current weighted annual interest cost of all outstanding US debt (marketable and non-marketable) is 3.36%.[5] Applying 3.36% against $11.8 trillion equals approximately $400 billion. Paying $400 billion in annual interest from revenues of $2.2 trillion seems reasonable, but if we are to then factor in the cost of the US's unfunded obligations, you can begin to understand the problem they now face.

Because there is little hope of paying for their unfunded liabilities through current tax revenues, the Social Security and Medicare promises will undoubtedly require new bond issues. You probably don't need a calculator to realize that the US can never cover the debt costs on $118 trillion. Even if the US Government were to spend 100% of their tax revenues on debt payments, the absolute maximum they could rationally borrow today couldn't exceed $64.2 trillion ($2.157 trillion ÷ 3.36%). What is glaringly obvious is that the United States' penchant for increasing its 'promises to spend' is directly threatening the future viability of the USD. While US politicians brazenly approve future spending promises they forget the real costs those promises imply – and there is no feasible way we can see those promises being paid for under foreseeable economic conditions.

Knowing what we've discussed above, you may wonder why the world continues to buy US debt at all. Normally when countries have attempted to brazenly overspend, their currency (or their government debt) has met the wrath of the 'bond vigilantes' – rogue traders in international bond and currency markets who impose market discipline on sitting governments. The most famous example of this was George Soros, who 'broke the Bank of England' in 1992 when it refused to allow the British Pound to devalue. The fact remains that every other country that has attempted to spend as much as the United States has been severely punished for doing so. Take Poland for example. Last week, the Polish government suffered a devastating blow as a bond offering failed and ended their attempts to double their budget deficit. Analysts were recommending that investors sell Polish bonds "across the curve", meaning virtually all of them. Doubling a government deficit seems relatively tame in this current orgy of G20 government spending, and yet Poland was punished for attempting to do so. Citing Poland's recent experience, it is worth questioning then how the United States is still able to issue bonds under such a crushing debt load with no plans to rein in spending. In our opinion, the answer is obvious: they have done so through the Federal Reserve's program of Quantitative Easing, which is just a fancy term for money printing.

The Chinese Government, which is by far the largest foreign investor in US Government debt, is fully aware of the current situation. As early as February 2009, Luo Ping, a Director-General at the China Banking Regulatory Commission, was quoted as saying, "We hate you guys. Once you start issuing $1 trillion-$2 trillion…we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do."[6] This month, Cheng Siwei, a Chinese official said, "If they keep printing money to buy bonds it will

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4 Richard Fisher, President and CEO of the Federal Reserve Bank of Dallas, is on record stating that unfunded liabilities from Medicare and Social Security totaled $99.2 trillion as of May 2008. The NCPA data above is the most recent estimate available. Fisher's speech can be retrieved at: http://www.dallasfed.org/news/speeches/fisher/2008/fs080528.cfm

5 Treasury Direct. August Statement of Average Interest Rates. Retrieved on September 15, 2009 from: http://www.treasurydirect.gov/govt/rates/pd/avg/2009/2009_08.htm

6 Sender, Henny (February 11, 2009). China to stick with US Bonds. Financial Times. Retrieved on September 15, 2009 from: http://www.ft.com/cms/s/0/ba857be6-f88f-11dd-aae8-000077b07658.html?nclick_c&nclick_check=1

lead to inflation, and after a year or two the dollar will fall hard. Most of our foreign reserves are in US bonds and this is very difficult to change, so we will diversify incremental reserves into euros, yen, and other currencies."[7] Recently, China has even gone so far as to promote the purchase of gold and silver to its citizens.[8] Silver bullion is now being advertised on Chinese television as a prudent investment for the general public.[9] Chinese banks have even planned to sell gold and silver bullion bars in four different sizes. This represents a fundamental change in Chinese policy where the distribution of gold and silver was once strictly controlled.

So how will this US debt crisis ultimately resolve itself? Let's consider the options. It would appear from our analysis that the spending 'promises' are the crux of the problem now facing the US Government. If there isn't enough new capital in the current environment to fund new Treasury bill issues (as we argued in "The Solution... is the Problem"), then there certainly isn't enough capital to pay for the US's unfunded future obligations. The choices, therefore, are bleak:

1. Default on Medicare promises. (Unlikely given the current debate in Washington to expand medical coverage.)

2. Default on Social Security promises. (Unlikely given the increasing average age of the voting public.)

3. Put forward a credible plan to balance the budget. (Unlikely given the most recent budget projections.)

4. Default on outstanding debt. (Unthinkable)

None of these options are feasible for the US Government. So they realistically only have one option left – to print their way out of their debt crisis.

We keep coming back to the numbers for the US debt, and they don't add up. Even Alan Greenspan, former Chairman of the Federal Reserve, believes that the rising budget deficits in the United States are "unsustainable". Because the US Government is printing dollars to fund their liabilities, it is highly unlikely that we will ever see a failed bond auction similar to that of Poland. The far more likely outcome, therefore, will be a US dollar crisis. It is for this reason that we have positioned our hedge funds and mutual funds so heavily in precious metals. At the end of the day, when the world finally realizes what the US has done to the world reserve currency, international investors will shift into an asset that no government can print. In our opinion the US dollar's status as a 'port' in the financial storm has officially come to an end.

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8 Williams, Lawrence. (September 3, 2009). China pushes silver and gold investment to the masses. Mineweb. Retrieved on September 15, 2009 from: http://www.mineweb.com/mineweb/view/mineweb/en/page33?oid=88452&sn=Detail
9 China encourages Silver Bullion for investment. http://www.youtube.com/watch?v=PqFpl31UwPI
10 Matthews, Steve and Minshi, Millie (September 9, 2009). Greenspan Sees 'Fairly Pronounced Recovery' in U.S. (Update2). Bloomberg. Retrieved on September 15, 2009 from: http://www.bloomberg.com/apps/news?pid=20601068&sid=aFBopI.OOyKM

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