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Surreality Check... Dead Men Walking

MARKETS AT A GLANCE

Eric Sprott
Sasha Solunac

Although it is our job to understand markets, we must confess that we are having a difficult time understanding the behaviour of the stock markets over the past few months. This isn't necessarily a bad thing. After all, if we are proven to be ultimately correct in our assessment that the markets are behaving irrationally, then we and our investors should do quite nicely in the end. But in the short run it can nonetheless be frustrating to watch illogic take hold when, for anyone who is able to connect the dots, the financial markets are currently in as bad a shape as they've *ever* been. Ever? Yes, ever. Or at least, worse than most of us have experienced in our lifetimes – and many of us have been around long enough to have experienced some pretty nasty markets. Yes, we are alarmists, and we believe justifiably so. After all, it only stands to reason that things can get pretty ugly after the party that was arguably the biggest global credit bubble in history comes to an end. There is now a lot of trash lying strewn about in the dance hall. Trash that until recently was considered to be highly valuable and in great demand, but that is now worthless toxic paper that needs to be cleaned up and thrown into the trash bin.

Make no mistake. The credit markets are clearly and unambiguously saying that the game is over. The music has stopped playing and anybody who is still dancing will undoubtedly slip on the trash and fall flat on their face. There is nary a safe place to hide in the credit markets as all paper that symbolizes debt and leverage is getting trashed. Save for 'risk-free' government debt, almost all bonds are taking it on the chin as the perceived risk of default has exploded at all levels – not least of all for the reason that supposed credit insurance and default swaps and guarantees aren't likely to be worth the paper they're written on. Furthermore, the housing market, the chief beneficiary of the credit bubble, is still crashing in the US as mortgage lending has dried up. How bad is it? In an investment conference last week, the CEO of Wells Fargo went as far as to say that the US housing market is in the worst shape it's been since the **Great Depression** of the 1930's. Anecdotally, in Florida some houses are being sold for **half** the price they were during the peak of the housing bubble two years ago. For banks and mortgage lenders, that's scary stuff that is sending shock waves throughout the financial system. Yet stock markets have yet to clue in... it's *surreal*.

While government treasury bonds have increased in price as flight to safety has once again taken hold and the prospect of further rate cuts drives yields down, the same is not true for other debt instruments. Recently making headlines: the municipal bond markets, traditionally viewed as safe tax-free investments, are experiencing rising yields and falling prices in spite of falling treasury bond yields. Muni bond issuances are being pulled due to the market's perception of higher risk of default.¹ In particular the financial health of the various guarantors of these bonds is being put into question (more on this later). Private equity and their leveraged deals are now long dead. Problems at money market funds are once again making headlines.² And banks are once again reticent to lend to each other, and for good reason, as evidenced by the rising spreads on interbank lending rates. LIBOR is once again soaring to distress-signaling levels, and the US two-year swap spread is the highest its been since 1989.

It has become clear that the desired liquidity injections being generously applied by central banks are losing their effect. Since the Fed began cutting rates again, the cost of borrowing for *everything except government bonds* is now higher. Both the US Federal Reserve and the Bank

Sprott Asset Management

Royal Bank Plaza
South Tower
200 Bay Street
Suite 2700, P.O. Box 27
Toronto, Ontario
M5J 2J1

T: 416 943 6707
F: 416 362 4928
Toll Free: 888 362 7172

www.sprott.com

¹ "Credit Pressure Filters Down To Muni Market", Wall Street Journal, November 16, 2007.

² "More Money-Market Funds Hit Trouble", Wall Street Journal, November 16, 2007.

of Canada were in money printing mode again last week, but is anybody else getting a case of *déjà vu*? When the subprime crisis first reared its head in February, the printing presses of the world's central banks went to work and for the time being seemed to quell the market panic. But then the crisis re-emerged in August only in expanded form as the contagion spread beyond subprime. The printing presses went to work again and the hit seemed to temporarily relieve the markets. Now here we are in November and it's *déjà vu* all over again. Credit and leverage is like a drug addiction. In each case a larger and larger dose is needed, and in each case the effects of euphoria don't last as long as they did before. And just like a drug addiction, *it doesn't get solved by giving the patient more morphine*. Analogously, the problem that was created in the financial system by too much paper can't be solved by printing even more paper. Such a simple solution would defy logic. The imbalances won't go away. We believe the crisis will continue to resurface again and again regardless of what steps are taken to paper it over.

Yet, if one were to believe the stock markets, one would hardly think that we are arguably in the midst of one of the worst financial crises the credit markets have ever seen. According to the stock markets everything is ok. Perhaps not great, but certainly not bad, and definitely ok. In spite of volatility, both the Dow and the S&P remain firmly up for the year. What financial crisis? There's a surreal haze shrouding the equity markets into a false sense of optimism. We think it's high time to slice through this haze with a surreality check.

Let's start with General Motors. In spite of recent beatings, the markets continue to believe that this stock is worth \$27 per share, or a market cap of \$15 billion. Yet after the latest write-down in the third quarter, the book value of GM now stands at an eye-popping *minus* \$74 per share. This means that GM will need to pay off \$74 in net liabilities per share before they can even begin to have positive equity. It also means GM will have to earn \$100 per share (present value no less) before they can justify their stock price. Compounding the issue, the prospects for the North American auto industry are looking rather grim on a go forward basis. Still not convinced? As overshadowed as GM's assets are by its liabilities, its assets are overstated because on the asset side GM still has 50% of GMAC. GMAC is GM's financial services arm, which happens to own Residential Capital, or ResCap. ResCap was one of the big players in the US subprime mortgage market and almost two thirds of its \$60 billion loan book is subprime loans.

Another example is Fannie Mae. Fannie Mae is a Government Sponsored Enterprise (GSE) that is in the business of selling mortgage guarantees to mortgage issuers. These mortgages are then sold into the credit markets as mortgage-backed securities with Fannie Mae as the guarantor, i.e. the absorber of credit risk in case of delinquency or default. In many cases Fannie is even required to purchase delinquent loans from lenders. Needless to say, delinquent loans are not only ballooning in frequency but are also in many cases well above current market values of the underlying houses backing the mortgages and, in Fannie's own words, the situation seems to be getting worse.

Fannie Mae's book of business has expanded exponentially during the housing bubble at double-digit annual rates, doubling in size since 2001. They now own or guarantee \$2.7 trillion of mortgages, roughly a quarter of all US residential mortgages. At least \$100 billion of these mortgages are in the subprime/alt-A category, and much of the rest is also at risk of impairment due to the weakening housing market. How much equity is backing up these mortgage assets and guarantees? A relatively paltry \$40 billion. Which means that if only 1.5% of Fannie's assets end up overvalued then their equity is gone. Is Fannie Mae's balance sheet in a position to withstand the worst housing market since the Great Depression?

Although Fannie has attempted to divert some of the risk to other mortgage insurers, we believe these insurers are in no better position to honour mortgage guarantees than is Fannie. MGIC, the largest mortgage guarantor, has insurance coverage on \$200 billion of mortgages backed by equity that has a market value of \$1.6 billion, or 125:1. PMI Group, another large mortgage insurer, has guarantees on \$120 billion of mortgages backed by equity that has a current market value of \$1 billion, or 120:1. Others are in an even more precarious position. ACA Capital, the company we mentioned a few articles ago that is owned by investment banks and insurers over

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\$60 billion of Credit Default Obligations, or CDO's, has a market cap that is now \$50 million. That equates to leverage that is greater than 1000:1

It should go without saying that being in the business of insuring any type of default risk is not a good business to be in right now, especially when what is backing up the guarantees is a tiny sliver of equity. We suspect that many, if not most, of these guarantors will fade into surrealism themselves before the credit crisis has fully played itself out, with dire ramifications to those who rely on them to save their overleveraged balance sheets. This just in: Freddie Mac, another GSE in a similar business to Fannie Mae, just announced a third quarter loss and the likelihood of needing to raise capital in order to conform with statutory capital guidelines. Good luck raising equity in this market! The stock is down 30% as we speak. Perhaps the market is finally starting to wake up from its blissful surreal dream state, albeit belatedly.

But the big mess will come from the big banks. To varying degrees, all the major banks are knee deep in subprime and other toxic assets on their balance sheets. Level 3 assets for many of the main financial players are now in the order of 200% of equity. As we mentioned in our last article, "The Financial System Is A Farce", Level 3 assets are the ones that are "marked-to-myth" and are based on management's best guesstimates. Although new accounting rules are likely to result in \$100 billion of write-downs at the major banks (for now), when all is said and done it is estimated that \$250 to \$500 billion of losses could be incurred.³ To put this in perspective, Citigroup, the largest bank in the US, currently has a market cap of \$150 billion. Furthermore, if one were to use the ABX Index as an indication of what subprime debt is being valued at in the markets (20 cents on the dollar or less for anything below A, and 68 cents on the dollar for some of this year's AAA), then we believe many banks and investment banks would be shown to be severely undercapitalized. But of course, the liquidation of these assets in any quantity is impossible. Like a hot potato, nobody wants it. That's why the super SIV solution is dead in the water. Ultimately there can only be a market solution, regardless of how painful and ruthless it may be.

Some would argue that the sheer size of the GSE's, the major banks, and most of the investment banks make them too big to fail. The government would likely have no choice but to bail them out. Perhaps so. But what will the value of the stocks be in that scenario? Probably a lot lower than they are now. But maybe not. After all, when central banks print money it is the banks that are first beneath the helicopters. Once again one must question the logic of trying to solve a problem created by too much easy money by throwing at it even more easy money. It's a nonstarter – a cure that is worse than the disease. The already badly bruised dollar would become a pariah currency.

So what's keeping stock markets up? Although the credit markets are saying that leverage is now anathema, everybody is still stuck knee deep in it. In a world where the value of debt is being put into question, what does that say about the value of equities, which are at the very bottom of the financial pecking order? The stock markets need a surreality check. Connect the dots and the evidence is overwhelming that the equity of many companies is at risk of being wiped out. They are dead men walking. Like all dead men walking, their only hope is to wait for a government reprieve... a stay of execution... or in this case, a Fed bailout.

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M5J 2J1

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www.sprott.com

³ "Banks Face \$100 Billion of Write-downs on Level 3 Rule", Bloomberg, November 7, 2007.

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