October 2009

MARKETS AT A GLANCE

SPROTT ASSET MANAGEMENT LP

Surreality Check Part Two...

Dead government walking

By: Eric Sprott & David Franklin

In November 2007 we wrote an article entitled "Surreality Check… Dead Men Walking", in which we discussed the early warning signs of the impending credit crisis and highlighted companies that were looking particularly troubled to us at the time.

We identified General Motors with a book value of negative $74 per share that boasted a market cap of $15 billion. (Ask your friendly neighborhood Chartered Financial Analyst to explain that one to you). Two years later? Following a $50 billion government injection, GM declared bankruptcy on June 1, 2009 and reemerged on July 10, 2009 with new owners consisting of: the US Treasury (60.8%), the Crown in Right of Canada (11.7%), previous GM bondholders (10%) and the UAW Health Care Trust (17.5%). GM stock went to zero.

We identified Fannie Mae, which, at the time, had a market cap of $40 billion and owned/guaranteed $2.7 trillion of mortgages - or about a quarter of all residential mortgages in the United States. Fannie's leverage ratio was a sobering 67:1. Two years later? Fannie Mae and Freddie Mac have both been nationalized. On September 7th, 2008, the US Treasury announced the two mortgage giants were being placed into a conservatorship run by the FHFA and pledged up to $200 billion each to back their crumbling balance sheets.

We highlighted Citigroup as a candidate for collapse under the weight of its subprime portfolio. One year later? $25 billion from the TARP program, a massive US government guarantee on $306 billion in residential and commercial loans and a cash injection of $27 billion into Citigroup for preferred shares. It was a de facto nationalization.

Why the walk down memory lane? The equity market performance in November 2007 masked the underlying problems plaguing the financial system at the time, and it's blindingly apparent that it is doing the same again today. The government has assumed most of the financial system's liabilities in a giant game of 'kick the can'. The calls for a new bull market are coming fast and furious. Market participants are bidding up the stocks of companies that are demonstrably bankrupt, and government balance sheets have ballooned to unforeseen levels. As respected market commentator David Rosenberg recently wrote, "the stock market is divorced from economic reality".[1] It's time for another surreality check, but this time it isn't the publicly traded companies that deserve attention, it's the governments that have saved them. Make no mistake – the dead men are still walking – they're just a lot bigger now than they were two years ago, and they don't generate earnings – they print money and tax their citizens.

1 Rosenberg, David (October 13, 2009). Market Musings & Data Deciphering - Breakfast with Dave

In case you failed to catch it in our previous articles this year, we thought we'd state it outright for our readers this month: the United States Government is on a trajectory to default on their obligations. In its current financial condition, it will not be able to fund its forecasted budget deficits and unfunded Social Security and Medicare promises on top of its current debt obligations. This isn't official yet, and we don't know when the market will react to it, but there is no longer any doubt about the extent of their trajectory. There simply isn't enough taxing power, value creation or outside capital willing to support its egregious spending.

Stating the obvious may be construed by some as fear mongering, 'talking up our book' or worse, but our view is not as severe as you might think. In the Federal Reserve Bank of St. Louis' Review from July/August 2006, Lawrence Kotlikoff stated that "partial-equilibrium analysis strongly suggests that the U.S. government is, indeed, bankrupt, insofar as it will be unable to pay its creditors, who, in this context, are current and future generations to whom it has explicitly or implicitly promised future net payments of various kinds." [2] He went on to suggest that the US should immediately close the Social Security program to reduce future liabilities (could you imagine?), use a voucher system for Medicare to limit costs, and replace personal, corporate, payroll and estate taxes with a single federal sales tax. All this, published in an article from 2006, well before the credit crisis and subsequent meltdown had even begun!

Three years later, the financial condition of the US government is completely untenable. The projected US deficit from 2009 to 2019 is now slated to be almost $9 trillion dollars.[3] How on earth does anyone expect them to raise this capital? As we stated in a previous article, in order to satisfy US capital requirements, all existing investors would have had to increase their US bond purchases by 200% in fiscal 2009. Foreigners, however, only increased their purchases by a mere 28% from September 2008 to July 2009 - far short of what the US government required.[4] The US taxpayer can't cover the difference either. According to recent estimates, tax revenue from all sources would have to increase by 61% in order to balance the 2010 fiscal budget. Given that State government income tax revenues were down 27.5% in the second quarter, the US government will be lucky just to maintain its current level of tax revenue, let alone increase it.[5]

The bottom line is that there is serious cause for concern here – and don't be fooled into thinking this crisis will fix itself when (and if) the economy recovers. Just how bad is it? Below we outline the obligations of the US Federal Government from 2004 to 2009. We present two sets of numbers, as government accounting can vary widely depending upon the source. In column A, we outline the Total US government Obligations, using actuarial reports from the Social Security Administration and the Medicare Trustees Reports. In column B we identify Total Federal obligations according to GAAP accounting provided by Shadow Government Statistics, calculated on a US fiscal year end basis with estimates for 2009. The differences in the absolute amount of total obligations ($114.7 trillion vs. $74.6 trillion in 2009) are a function of timing, the calculation timeline for Social Security and Medicare, and other obligations included under GAAP rules. Either way we choose to calculate it, the total number is preposterously large. From 2004 to 2009, US unfunded obligations increased by an average of almost 50% over this six year period under both calculation methods, while US government revenue increased by only 12%.[6] No company or government can increase its liabilities by more than four times the rate of its revenue and stay solvent for an extended period of time.

2 Kotlikoff, Lawrence (2006) Is the United States Bankrupt? Federal Reserve Bank of St. Louis Review JULY/AUGUST 2006. Retrieved on October 20, 2009 from: http://research.stlouisfed.org/publications/review/06/07/Kotlikoff.pdf
3 Congressional Budget Office.The Budget and Economic Outlook: An Update (August 2009). Retrieved on October 20, 2009 from: http://www.cbo.gov/
4 Department of the Treasury. Treasury International Capital System. Major Foreign Holders of Treasury Securities (July 2009). Retrieved on October 20, 2009 from: http://www.treas.gov/tic/mfh.txt
5 Hart, Jerry and Selway, William (October 15, 2009). State Revenue Falls Most Since 1963 on Incomes, Sales (Update2). Retrieved on October 20, 2009 from: http://www.bloomberg.com/apps/news?pid=20601015&sid=aFbiGWsXmkyU
6 US government revenue for fiscal 2004 was $1,880,279 million and for fiscal 2009 was $2,104,613 million. Historical revenue retrieved on October 20, 2009 from http://www.gpoaccess.gov/USbudget/fy09/pdf/hist.pdf Revenue for 2009 was downloaded from http://www.fms.treas.gov/mts/mts0909.pdf

And as the numbers imply, the hole that the US government is digging is getting deeper by the minute. On a GAAP basis, US government unfunded obligations increased by more than $9 trillion from last year alone! That represents ten years of projected deficits added in a mere twelve months. How can this be happening? The numbers are surreal, and we must ask ourselves how much longer the world will continue to support this spending frenzy.

The Federal Deposit Insurance Corp. is another major problem for the US. The FDIC's Deposit Insurance Fund, which had $10.4 billion at the end of June, has spent so much covering bank failures over the last three months that it is now completely out of money. This means there is no capital set aside to insure the $4.8 trillion of deposits and $320 billion worth of FDIC-guaranteed debt that US banks and other financial companies have issued. The real shocker that we discovered some time ago is that the FDIC 'funds' were never even held in a segregated bank account – the fees collected from the banks are accounted for as a part of the government's general revenues that go towards military spending, bailouts, interest costs and other government programs. The FDIC 'fund' merely consisted of IOU's from the general revenues accounts. And now that the Deposit Insurance Fund balance as of September 30, 2009 is negative the FDIC wants the institutions to prepay their assessments for all of 2010, 2011 and 2012.[13] In effect, the FDIC wants to borrow money from the banks it provides insurance for. Does this not strike you as surreal? Why would anyone have any confidence in anything the FDIC guarantees?

Chart A

Comparison of US Government Obligations

Valuation Date[7]	Social Security Unfunded Obligations[8]	Medicare Trust Funds A,B,D Unfunded Obligations[9]	TOTAL Unfunded Obligations	US Debt[10]	COLUMN A Total US Government Obligations	COLUMN B Total Federal Obligations (GAAP) from Shadow Government Statistics[11]
2009	$15.1	$88.9	$104.0	$10.7	$114.7	$74.6[12]
2008	$13.6	$85.6	$99.2	$9.2	$108.4	$65.5
2007	$13.6	$74.3	$87.9	$8.6	$96.5	$59.8
2006	$13.4	$70.5	$83.9	$8.1	$92.0	$58.2
2005	$11.1	$68.1	$79.2	$7.6	$86.8	$53.3
2004	$10.4	$61.6	$72.0	$7.0	$79.0	$49.5

7 We used January 1 valuation date for Social Security Medicare and US Debt Outstanding. GAAP estimates are provided by Shadow Government Stats using fiscal year end.
8 Social Security Administration, Office of the Chief Actuary (August 2009) UNFUNDED OBLIGATION AND TRANSITION COST FOR THE OASDI PROGRAM by Alice Wade, Jason Schultz and Steve Goss. Open group unfunded obligation for the infinite future projection period beginning at valuation date. Retrieved from: http://www.ssa.gov/OACT/NOTES/ran1/
9 U.S. Department of Health & Human Services. Centers for Medicare and Medicaid Services. Taken from Medicare Trustees Report for each year. All figures through the infinite horizon. Retrieved on October 20, 2009 from: http://www.cms.hhs.gov/ReportsTrustFunds/
10 Treasury Direct. The Debt to the Penny and Who holds it. Calculated for January 1st in each year. Retrieved on October19, 2009 from: http://www.treasurydirect.gov/NP/
11 Shadow Government Statistics (October 9, 2009). No. 250 General Outlook and Trade Data Update. Retrieved on October 20, 2009 from: http://www.shadowstats.com/
12 Estimate from SGS
13 Federal Deposit Insurance Corporation (September 28, 2009) Special Assessment, Restoration Plan and Proposal for Maintining Fund Liquidity. Retrieved on October 20, 2009 from http://www.fdic.gov/news/board/Sept29no1.pdf

We do not mean to pick on the United States alone. The proclivity to overspend has spread to most governments throughout the developed world. According to recent estimates, the countries that make up the G20 will face a combined budget deficit of 10.2% of GDP in 2009, the biggest since World War II. The US leads this ‘rogues gallery’ of government spending on a percentage of GDP basis at 13.5%, followed closely by Britain and Japan at 11.6% and 10.3%, respectively. If governments choose to continue down this path, it must be questioned where all their funding will come from, not to mention the impact it will have on their respective currencies.

Hemingway wrote that a man goes broke “slowly, then all at once”. We believe the same sentiment can be applied to governments. If fiscal abuses continue unabated, confidence eventually erodes until investors just stop lending. It happened famously to Lehman in September 2008, and it is happening now to the US government. The Q2 Flow of Funds Report published by the Federal Reserve revealed that the Federal Reserve purchased as much as half of the newly issued treasuries in the second quarter.[14] This means that the Federal Reserve isn’t merely supporting the market for US treasuries… it is the market for US treasuries. Printing new dollars to support an almost $9 trillion dollar budget deficit that stretches out over the next ten years puts the US on the road to ruin, and the major governments of the world have noticed and are taking action.

How could they not after all? Most of these countries have historically supported their own currencies by stockpiling an average of 63% of their foreign currency holdings in US dollars. Recently, however, it was revealed that the US dollar now makes up only 37% of new foreign reserve holdings.[15] There is also little doubt that the USD is now a hot topic in central bank circles. A recent article in Britain’s “Independent” revealed secret meetings held between the Arab states, China, Russia, Japan and France to replace US dollar transactions for oil with transactions made in a basket of major currencies - including the euro, the yen and the Chinese yuan. Officials in several of the participating countries denied the talks or any knowledge of them, but that didn’t stop the US dollar from selling off when the story broke.[16] We interpret these actions by foreign governments to be evidence of this erosion of confidence. We don’t know when this will translate into a failed auction for US debt, a currency crisis or other significant event, but the signs that the world is losing economic confidence in the US government are becoming more pronounced every week.

So what can be done to avert catastrophe? As Will Rogers’ once said, “if you find yourself in a hole, the first thing to do is stop digging”. Put simply, the US government must reduce its spending. It is the only effective way to directly address its unfunded obligation issues. Closing Social Security to new entrants and using vouchers to reduce the cost of Medicare, as recommended by Kotlikoff, are economically valid options that should be considered. Unfortunately, neither Congress nor the President have shown a willingness to heed Will’s advice thus far.

We believe the US government’s current trajectory presents one of the greatest macro-economic risks at play today. The Federal Reserve and the US government have assumed the toxic financial trash that brought the banking system to its knees a year ago. By monetizing debt to support their budget deficit and ‘save the system’, both entities have chosen to walk a well worn path traveled by so many governments before them. Like dead men walking, the US government is merely biding its time until the moment of truth. Unlike Fannie Mae, General Motors or Citigroup, however, there is no one left to grant a reprieve.

---

14 FEDERAL RESERVE statistical release z.1 Flow of Funds Accounts of the United States Flows and Outstandings Second Quarter 2009. Retrieved on October 20, 2009 from: http://www.federalreserve.gov/releases/z1/Current/z1.pdf

15 Xie, Ye and Worrachate, Anchalee (October 13, 2009) Central Banks leaving greenback in the lurch. Retrieved on October 20, 2009 from: http://www.smh.com.au/business/central-banks-leaving-greenback-in-the-lurch-20091012-gu2i.html

16 Fisk, Robert (October 6, 2009) The demise of the dollar. Retrieved on October 20, 2009 from: http://www.independent.co.uk/news/business/news/the-demise-of-the-dollar-1798175.html

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

T: 416 943 6707
F: 416 943 6497
Toll Free: 888 362 7172

www.sprott.com