Sprott Asset Management

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The Phony Express

MARKETS AT A GLANCE

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If an unsuspecting investor didn't know any better, he would be inclined to believe that a new trend has taken hold in the financial markets during the months of July and August. The "winning trade" now seems to be to go long financials and short commodities. Although this trade certainly would have made money over the short time period just mentioned, we would continue to posit that this trade is wrong over the longer term. Investors are having the wool pulled over their eyes courtesy of the Phony Express – outside forces that are trying to orchestrate the markets to instill a false sense of optimism. Although the evidence may be circumstantial, the motive and the means are quite clear. As the old saying goes, if it walks like a duck and quacks like a duck, then it is a duck.

Call us conspiracy theorists if you will, but we cannot help but see the visible hand of government in the machinations of this latest phony market rally. There is certainly nothing in the fundamentals that has changed over these two months to indicate that the malaise in the financial sector is nearing an end. Quite the contrary, the financials are as sick as ever and things are only getting worse. To claim that the financials have bottomed is, we believe, to ignore the obvious. In a recent note to clients, Richard Bernstein, chief investment strategist of Merrill Lynch, wrote that the credit crisis is "broad, deep, and global" and "far from over" for financial companies. He further wrote: "Investors are ***significantly underestimating*** [our emphasis] both the scope and the extent of the credit bubble and the consequences of its subsequent deflation" and that "the problems are not confined to large institutions that are overexposed to U.S. subprime loans." He further opined that stocks are unlikely to rebound soon, adding: "We are skeptical that trying to bottom-fish will prove profitable."[1]

We would agree wholeheartedly with this opinion and believe that those who are buying into this rally are likely to be greatly disappointed down the road. Surprisingly, we still hear the financial crisis being referred to as a *subprime crisis* when, in fact, subprime is now the least of the financial system's worries going forward. The shoe has yet to drop in other areas of the credit markets such as credit default swaps, home equity loans, prime loans, auto loans, consumer credit cards, and commercial real estate. The losses in these areas have for the most part only just begun. All continue to worsen as the credit crisis deepens, and will only be exacerbated by the certitude of economic weakness yet to materialize (but will) in the finance-heavy US economy (that is, if one is to believe the official data which claims that the US isn't in recession just yet). The potential losses in these areas are all being "significantly underestimated", especially if one were to believe in the current market rally in financials.

We've already written many articles over the past year about CDO's, SIV's, MBS's, ABCP's, GSE's, L3's, and other acronyms that are currently ailing the financial industry. We can add to this list HEW's (Home Equity Withdrawals) as an example of losses yet to come. One of the largest areas of loan growth during the housing and credit bubble has been in home equity loans and second mortgages. According to a report by Fitch[2], home equity loans account for over 10% of gross loans at seventeen of the largest banks in the US. There are over $1.3 trillion of outstanding home equity loans and lines. Some banks have over 200% of their equity exposed to this one area (not to mention all the other areas) that succumbed to reckless lending practices during the credit bubble. According to data we've seen, nearly one in three people who bought

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[1] "Credit Crisis Still 'Far From Over', Merrill Says", Bloomberg, August 13, 2008
[2] "US Home Equity Woes: Banks Grapple with Higher Losses", Fitch Ratings, March 14, 2008

homes since 2003 are now in a negative equity position. Not good for the prospects of recovery for home equity loans! Adding insult to injury, the carnage in US housing prices continues. According to Commerce Department data, as of July new home prices are down 6.4% since April and the latest Case-Shiller Home Price Index shows a 16% decline year-over-year in existing home prices as of June. Thus far, since its peak in July 2006, this index is down 19%, with the trough yet in sight. What does this tell us about the risks of substantial losses yet to be realized on banking balance sheets, merely from once-innocuous home equity loans? They could be enormous.

The other 90% of banking assets aren't faring much better. With the sole exception of government bonds, they are all dropping in value. Even investment grade corporate bonds now have spreads greater than 300 basis points over treasuries – a multi-decade high. The worst among these are the bonds of the banks themselves, which trade at a 378 basis point spread over treasuries.[3] Things are far from well in the financial world. There is nary an area of the banking system showing even a modicum of health. So why the rally? Although ultimate quantification remains a grey area, one need only scratch the surface to come up with $2 trillion of potential losses that have yet to be taken in the banking system, on top of the relatively tame $500 billion that has so far been written off mostly in subprime. The final tally has yet to be known, but when all is said and done the losses are sure to be mind-blowing. The markets, at least for now, appear to be ignoring this uncomfortable fact.

It is little wonder, therefore, that attempts to recapitalize the banking system have encountered tremendous difficulty and have come at onerous cost. In the marketplace recent preferred share offerings of even the largest banks are yielding 9-12%. These are exorbitant costs for preferred capital, which normally trades at a better yield than bonds. Furthermore, as we discussed in our article from two months ago[4], many equity offerings are being done with a 'full-ratchet provision' attached, with potentially limitless dilution of existing shareholders going forward. As losses mount, so will the equity offerings, and so will the death spiral dilution. The increasing likelihood that Fannie and Freddie are going to require a massive government bailout, to the obvious detriment of shareholders, also leaves us scratching our heads about the logic of this rally.

Given all of the above, the latest market rally in the financial sector looks and smells like a fake out. We believe there are forces in the market that want to cover up the damage in the financial system in order to restore a modicum of confidence so vital to its survival. Why did the SEC suspend the shorting of certain bank shares on July 15? The obvious intent was to drum up the markets. Why did the Fed call Credit Suisse when rumours began circulating that they were pulling a credit line from Lehman Brothers?[5] Should the Fed be involved in the business decisions of foreign banks, urging them to maintain ties that are potentially to their detriment? Once again, the intent was to drum up the markets by maintaining a sense of optimism. We'd go so far as to say that the nefarious undertakings of the Plunge Protection Team itself are having a hand in this rally in financial shares. Perhaps just long enough so that more capital can be raised by the financial sector. Ironically, if financial companies were to take advantage of this rally to raise more much-needed capital, it would stop the rally in its tracks and likely throw it into reverse as further demands are made on the equity markets and further dilution of existing shareholders ensues. But whether or not one believes in market manipulation (and we believe an investor would be naïve not to), at the very least one can conclude that the rally in financials has weak legs that won't stand the test of time. With or without manipulation, the markets cannot ignore the obvious for long.

The other half of the "phony express" trade has been the drubbing of commodities. The thrashing has been so severe that some are even being led to believe that it's the death knell of the bull market in commodities. Nothing could be further from the truth! Once again, it has all the characteristics of a phony. The market action in the price of gold has been particularly

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[3] "Corporate Bonds Feel Pain As Spreads Climb Back Up", Wall Street Journal, August 22, 2008, p. C1
[4] "Lack of Transparency = Shareholders Get Ratcheted", Markets At A Glance, June 2008
[5] "Fed Acted on Lehman Rumor", Wall Street Journal, August 21, 2008, p. C1

difficult to fathom from a logical standpoint. After hitting almost $1,000 per ounce in mid-July, the price of gold is now in the low $800's. This is the phoniest market of all. It's the phoniest of the phonies.

As we like to say, gold is **the canary in a coalmine**. It can smell the noxious fumes long before anybody else can. (In this case, the noxious fumes are emanating from the toxic assets of the financial system.) As any good banker worth his salt knows, in order to pull off an even remotely believable rally in financial stocks it's necessary to commensurately pummel the price of gold. This, indeed, has been successful – at least in the paper market for gold where opportunities for manipulation are ripe. But the physical market for gold tells an altogether different story. In the real world, gold is unequivocally in shortage. The US mint has stopped selling American Eagle one-ounce gold coins for the first time since production began 20 years ago, claiming that supplies have been "wiped out" as a result of a buying spree in gold coins.[6] So far this year they have sold 311,000 ounces of the gold coins, 50% more than they sold in all of 2007. Kitco, a major bullion dealer, recently issued a press release warning that they are experiencing delays in gold deliveries due to "unprecedented demand". Does this sound like an environment where the price of gold should be plunging? Most definitely not – except under the ruse that is the rigged paper-based gold market.

Furthermore, we believe the latest inflationary data is also very bullish for the price of gold. The July Producer Price Index in the US blew away expectations, rising 1.2% in the month, the highest monthly increase in 27 years. Year-over-year, the PPI is up 9.8%. Even the highly rigged CPI (Consumer Price Index) is up 5.6% over last year. In many emerging economies, consumer inflation is running well into the double digits. This is hardly a tamed inflationary environment, and should be highly bullish for gold. Those who claim that a recession will put a lid on prices have obviously never heard of stagflation. After all it's a fiat currency world we live in, not a gold standard. Inflation is anywhere and everywhere a monetary phenomenon. The highly topical, and in our view imminent, government bailout of Fannie and Freddie should be screamingly bullish for gold. This will come at an enormous cost that will have to be paid for either by doubling the Treasury's debt or cranking up the Fed's printing presses. Either way, it will not bode well for the financial markets and should be, once again, gold positive and financials negative. The price of gold should be skyrocketing… but it isn't, courtesy of the Phony Express who want to turn the canary into roadkill.

This just in: Gold Fields, a major gold producer, claimed in a press conference last week that its mines could not be replaced anywhere in the world at current gold prices of $820 per ounce. The CEO of Gold Fields said: "If you tried to build these mines today, you would need a $2000/oz gold price and higher to justify the investment." If this isn't gold bullish, we don't know what is. Indeed, we continue to believe that gold is woefully underpriced from both the demand (for physical delivery) and supply (replacement cost) fundamental standpoints.

We believe the market action in the price of oil is also not above suspicion. The run up in the price of oil in the first half of the year was nothing short of phenomenal. A pullback of some sort was inevitable and certainly not unexpected. However, we find it suspect that the price of oil (and gold) should fall just as tensions in Georgia escalated into an all-out war, resulting in the shutting of a major oil pipeline and fuelling (pardon the pun) renewed tensions between East and West. Make no mistake, what is occurring in the Caucuses not only has worrisome geopolitical ramifications, but also obvious and significant ramifications for the energy markets, not least of all because Russia is currently the world's largest producer of oil with undeniably increasing geopolitical clout. That the price of oil (and gold) should behave the way they did as these events unfolded defied logic.

Be that as it may, those who are fearful that the so-called bubble is bursting in the energy sector should take solace in the fact that the insiders of oil and gas companies are buying their

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[6] "The Eagle Has Been Grounded", Wall Street Journal, August 21, 2008, p. C1

stocks… and in droves.[7] This is far from the behaviour one would expect in the midst of a bursting bubble. When the NASDAQ bubble of 2000 burst there was insider selling galore. When the housing bubble burst in 2007 the insiders of homebuilders rampaged for the exits. Not so for the energy sector. Although the Phony Express wants you to believe that the commodity bubble is bursting, reality seems to say otherwise. Perhaps it's because it wasn't a bubble in the first place.

We believe the bizarre action in the markets during July and August does not portend of a new trend. In our opinion, oil, gold, and other real assets shall remain in a bull market and the faux-rally in financials will die the death of a thousand cuts. We believe the *visible hand* (and not so visible hand) are everywhere trying to phony up the markets. Apparently there is too much at stake to let the free markets decide. But logic, and history, dictates that decide they ultimately will.

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[7] "Oil, Gas Insiders Bet Energy-Stock Bull Is Primed to Resume Run", Wall Street Journal, August 20, 2008, p. C3