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Does “Backed By Government” Really Mean Anything Anymore?

MARKETS AT A GLANCE

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Is everyone feeling a little richer these days? Chances are, most people would answer this question with an unequivocal “Yes!” After all, the stock markets are up resoundingly over the past three weeks. So much so that proclamations of a “new bull market” are starting to be heard. We’ve turned the corner, or so it is being claimed. All is well with the world once again... or is it? If you were to receive a cheque in the mail for \$1 million, you would probably be pretty happy, right? But what if you found out that everybody received the exact same cheque. Chances are, you would be far less happy, perhaps even discouraged, and for good reason. Your savings have just been plundered.

One has to be very careful with how one interprets asset price signals these days. It could be inflation/currency debasement masquerading as a recovery/bull market. After all, this is the era of **quantitative easing**, a policy measure that has the potential to be highly inflationary. As is well known, the Federal Reserve has been adopting ultra-easy, unconventional monetary policy measures for the past year. Quantitative easing is the next iteration of these unconventional monetary policy measures – one that takes the concept of money printing to the next level. Quantitative easing, in a nutshell, is the policy of taking freshly printed money, created out of thin air, to purchase risky assets, thereby influencing their price. It is targeted money printing whose goal is to take the free market out of the equation. If the free market is deemed not to be valuing risky assets highly enough, then the government will usurp the market’s pricing power by creating more demand than really exists (in economic terms, shifting the demand curve to the right). Note that we include the Federal Reserve as part and parcel of “government”. To believe they have even a modicum of independence is naïveté to the extreme.

During this initial stage of quantitative easing, the Federal Reserve is buying \$1 trillion of US government treasuries and agency debt, up to ten years in maturity. Are these “risky assets”, even though they are “backed by government” and, technically, AAA? The answer is absolutely yes, which is why it is considered unconventional for the Fed to be buying them. The value of government debt over time, in both nominal and real terms, will very much depend on future levels of interest rates and inflation, respectively. This makes treasury bonds far riskier financial assets than, say, 90 day T-bills. True, government bonds aren’t likely to have default risk. After all, any quantity of money could be printed to pay off debts in the domestic currency. Be that as it may, government bonds are far from being *risk-free*. To wit, baby boomers who are relying on government bonds to sustain their standards of living through retirement could be in for tremendous disappointment.

Another way to look at quantitative easing is as a government-induced pyramid scheme. By all accounts, US government bonds are already very expensive. The unwinding of leverage that has been occurring over the past year created enormous demand for the US dollar and US treasuries – demand that was more technical than fundamental in nature. Through quantitative easing, the government is ensuring that an already expensive asset becomes even more expensive. Does this sound familiar, when an

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over-priced asset becomes even more over-priced? That's right, it's called a bubble. In order to save the economy and the financial system the government once again, as is its wont to do, is replacing one bubble with another. It's the same old shtick. One that will end as badly, and likely far worse, than the previous bubbles. We would advise investors not to be the last suckers out of this pyramid scheme. When the government comes knocking, wanting to buy your treasuries at highly favourable prices, then by all means sell it to them post-haste! When the government is buying, you should be selling. Need proof? Just look at what banking shares have done over the past year.

It's also worth noting that, like all bubbles and pyramid schemes, the government-backed bond bubble will require continual and growing inflows in order to be sustained. Can anyone honestly envision a way out of quantitative easing, once started? To quote Winston Churchill, it's a puzzle inside a riddle wrapped in an enigma. Here's the puzzle: the US government will be issuing boatloads of debt over the next few years, stuffing the bond markets with an ever-increasing supply, which somebody will have to buy lest interest rates go higher and derail the stimulus. Enter quantitative easing, but this creates the riddle: will people still want to own US bonds given the deteriorating fiscal situation and the fact that the government is the only willing buyer of them? Which causes the enigma: the Federal Reserve eventually becomes the largest, and perhaps even only, buyer of US government debt, realizing that it can't stop doing so because the termination of the policy would send interest rates to the moon. We would then have the perverse situation where the government would run burgeoning deficits and incur massive debts, financed with ever-increasing debt issuances, which would in turn be bought by the Federal Reserve with neverending quantities of freshly printed money. In effect, government deficits will be financed with printed money. Quite the conundrum, isn't it?

In the real world, there is only one good way that government spending can be financed, and that is through taxes. If spending exceeds tax revenue, then the difference will need to be borrowed. But borrowed money is simply future taxes. Either way, government spending and taxes go hand in hand. Pay for it now, or pay for it later, the piper will someday have to be paid. If the pipers are foreigners, then they will demand returns that will take an increasing proportion of future tax revenues. In our opinion, with the recent colossal deterioration in fiscal prudence, we are moving dangerously away from any semblance of this undeniable reality. With baby boomers now starting to retire, we are beyond any reasonable expectation that today's deficits (at least \$2 trillion this year, plus another \$10 trillion, using optimistic assumptions, over the next decade) and unfunded social security and medicare liabilities (somewhere between \$45 trillion and \$90 trillion in present value, depending on assumptions) could ever be passed on to future generations. The buck stops here... literally and figuratively. We are quickly approaching a scenario, if we haven't passed it already, where the US government has no hope of honouring its obligations... at least, not with anything that is worth a pittance.

For the above reasons, and many others, people shouldn't be taking much comfort in the phrase "backed by government". For what does this phrase really mean, other than a transfer of wealth within the context of an ever shrinking pie, thanks to the government's increased role in finance and economics. Unfortunately, we are moving ever further away from Adam Smith's invisible, yet virtuous, hand. The list of things backed by government grows by the day. Bank deposits. Money market funds. Commercial paper. AIG. Fannie and Freddie. GM and Chrysler. Even corporate bonds. Nonbank institutions, like GE Capital, can now issue debt backed by FDIC, i.e.

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the government. With quantitative easing, the government is even trying to guarantee the yield curve. In the near future, quantitative easing may even be used to buy mortgages and stocks.

Unfortunately, the emperor has no clothes. Government guarantees are worthless. They are merely guarantees to print more money. Ironically, the more the government guarantees, the more worthless that guarantee becomes. To purport that “backed by government” has any value is one of the biggest con jobs of all time.

Let’s take the Federal Deposit Insurance Corporation, or FDIC, as an example. Do you believe there is a fund supporting your bank deposit? There is no fund. Only printed money supports it. It’s just another government-backed institution. FDIC, as an independent corporation, is completely and utterly bankrupt. In fact, they haven’t even been collecting premiums from the banks for the past 10 years. There is nothing backing FDIC except yet another government guarantee to print money.

From the point of view of the investor who believes his money in the bank is safe because it is “backed by government”, we would posit that this trust is misplaced. It is our opinion that, during this era of quantitative easing and other wanton money printing measures, never have bank deposits been **less** safe. The perception of safety is just an illusion. Bank deposits, and government bonds even more so, are almost certain to lose purchasing power with each passing year, especially with interest rates where they are now. There is a way that governments can guarantee that nothing will lose money. It’s called inflation. But this is true only in nominal terms. In real terms, nothing destroys wealth, specifically paper wealth, like inflation. This is the Achilles Heel of the phrase “backed by government”. For the one thing they cannot guarantee is what you will be able to buy with your backed-by-government paper. Sure, they can legislate price controls. But history shows that this would only lead to chronic shortages and black markets.

In our opinion, the only way that people can protect themselves against the money printing binges the world is currently experimenting with, is by investing in tangible assets. In this regard, the only truly AAA asset is gold. As the saying goes, all roads lead to Rome. Week after week, no matter what we look at, all the evidence and all the signposts point to the same conclusion: own gold. Government guarantees can only redistribute wealth at best, destroy it at worst, but never can they create it or guarantee the real value of paper financial assets. When the government wants to buy your financial assets we would suggest that you sell to them, with a thank you, and use the proceeds to buy real tangible assets. In our opinion, this is the only way to guarantee the preservation of your wealth.

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