Sprott Asset Management LP

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Beyond the Stimulus

MARKETS AT A GLANCE

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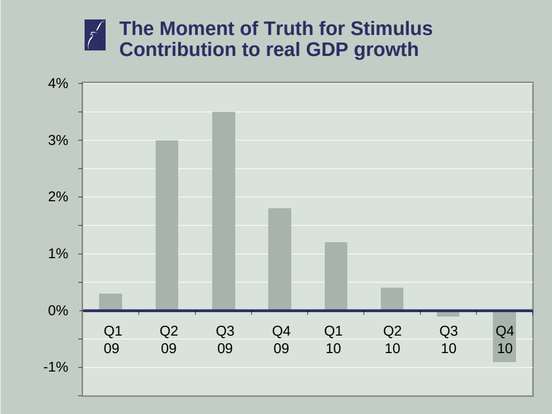
Are you stimulated yet? We hope you are, because we've just witnessed the largest economic stimulus in the history of the world. Never before have so many government dollars been thrown at the economy to prevent a depression. When added together, the combined financial, monetary and fiscal stimuli in the US are more than the cost of the two World Wars and "The New Deal" combined.[1]

Stimulus spending worldwide has taken the form of a combination of tax cuts, transfer payments (free money) and infrastructure investments on roads, schools, railroads etc. In the US, the financial and stimulus contributions have been especially impressive in scale. According to CNN's bailout tracker, the various US government departments have committed to stimuli worth $11 trillion dollars and have issued cheques totaling $2.8 trillion dollars thus far in 2009.[2] Neil Barofsky, the Special Investigator General for the TARP program, has estimated that the total cost to the US taxpayer could be as high as $23 trillion.[3] The vast majority of this stimulus has been directed at the financial sector - a complete waste of money in our opinion, supporting a segment of the economy that never deserved to be bailed out. Nonetheless, the US taxpayer has spent massive sums, committed to promises worth even more and may ultimately owe debt in the double-digit trillions when all is said and done. Nice of them to spend so generously, wouldn't you say?

Although the stimulus has been fantastic for the stock market, it has generated very little benefit for "Main Street". To make matters worse, the effects of the stimulus packages have already started to wear off. To explain why, we must mention the American Recovery and Reinvestment Act of 2009 (ARRA), which was specifically directed at stimulating the real economy as opposed to "saving Wall Street". ARRA calls for a total spend of $787 billion, which breaks down into $287B in tax breaks, $192B in direct aid and $308B in discretionary spending. According to Christina Romer, a White House economic advisor, 70% of this stimulus will be spent by the end of September 2010.

CHART A



Source: Moody's Economy.com, Sprott Asset Management LP

What impact will this stimulus have on the economy? Chart A presents results from Moody's that is representative of several private forecasts that we have reviewed.[4] The chart

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[1] Inflation adjusted in 2008 dollars; the cost of World War I is $312 billion, World War II is $3.6 trillion, "The New Deal" which was legislation to aid the US during the Depression is $500 billion. These and other costs can be found at: http://www.ritholtz.com/blog/2008/11/big-bailouts-bigger-bucks/

[2] CNNMoney.com's bailout tracker. Retrieved on August 16, 2009 from: http://money.cnn.com/news/storysupplement/economy/bailouttracker

[3] Kopecki, Dawn and Dodge, Catherine (July 20, 2009). U.S. Rescue May Reach $23.7 Trillion, Barofsky Says. Retrieved on August 16, 2009 from: http://www.bloomberg.com/apps/news?pid=20601087&sid=aY0tX8UysIaM

[4] Zandi, Mark (June 22, 2009). U.S. Fiscal Stimulus Revisited. Retrieved on August 16, 2009 from: http://www.economy.com/dismal/article_free.asp?cid=116000&src=economy-hp-dismal-article

illustrates the ARRA's impact on real GDP by quarter, and reveals that right now, in Q3 2009, the US is experiencing the maximum impact of the Obama stimulus package. That's right - this is as good as it gets. The majority of the Act consists of tax cuts and transfer payments to citizens, the impact of which was felt within the first two quarters of being received.[5] By the end of September 2009 this stimulus will have worn off, and along with it will vanish the greatest marginal impact of the entire stimulus package itself. According to economic forecasters like Moody's, by 2010 the net impact of the stimulus package to real GDP will be barely over 1%.

This is not good news for "Main Street", especially considering the dramatic increase in unemployment that we've witnessed recently. If the effects of stimulus wear off as quickly as they were injected, we could be in for a very difficult Fall (no pun intended). To make matters worse, this scenario is not limited to the US alone - it could potentially impact any of the other large economic powers who have instituted their own massive stimulus packages, most notably China, resulting in a simultaneous global economic decline that would make 2008 look pleasant in comparison.

China deserves special mention here, because on a percentage of GDP basis, they are far and away the greatest stimulator of all. While the US has made significant commitments, their $2.8 trillion capital deployment to date only represents a mere 20% of their 2008 GDP. Chinese government spending (combined with Chinese bank lending), on the other hand, is completely unprecedented in the history of banking, and far outweighs the US stimulus in scale and scope.

The Chinese have deployed 4 trillion yuan in stimulus spending through to 2010.[6] In concert with this stimulus, the Chinese central bank has scrapped its national lending quotas in order to jump start their economic engine. In the first half of 2009, Chinese bank lending hit a record high of 7.37 trillion yuan.[7] Assuming their stimulus package is evenly split between 2009 and 2010, it equates to 8.37 trillion yuan of fiscal spending and lending by Chinese banks. For perspective, the Chinese economy generated 13 trillion yuan in the first half of 2008.[8] So in effect, **the Chinese have injected a stimulus equivalent to 64% of their first half 2008 GDP in the first half of 2009**. Please understand us when we tell you that this is unprecedented. The Chinese government has effectively spent and lent enough in six months to buy 122 Ford Class aircraft carriers at US$8.1 billion a piece. It is akin to the US government injecting (and US banks lending) almost $4.5 trillion USD to its citizens and businesses before July 2009…an ungodly sum that would impact every asset class under the sun. Is it any wonder then that the Shanghai stock exchange has more than doubled from trough to peak since its November lows?

What is perhaps even more surprising, however, is the fact that the Chinese stimulus has had a seemingly lackluster impact on the Chinese economy. Despite its massive size, the stimulus program has only generated a 7.9% increase in their 2009 GDP. For perspective, this represents a mere 1 trillion yuan return on a 9.37 trillion yuan stimulus - not a good return on investment. So if the money hasn't generated GDP growth, where did it go? It's gone everywhere. Their government-induced liquidity flood has "soaked" virtually every speculative asset class in China. Copper, nickel, steel, Chinese equities, Chinese real estate - they've all appreciated in spite of the obvious and acknowledged weakness in the global

[5] The Congressional Budget Office (CBO) reviewed the impact of the 2001 and 2008 tax rebates under the Bush Administration which would concur with economic model estimates that impact is felt very quickly. This can be found at: http://www.cbo.gov/ftpdocs/96xx/doc9617/06-10-2008Stimulus.pdf

[6] (November 11, 2008). World markets buoyed by massive Chinese stimulus plan. Retrieved on August 17, 2009 from: http://news.xinhuanet.com/english/2008-11/11/content_10341108.htm

[7] Wang, Aileen (August 11, 2009). INSTANT VIEW 5 - China's July lending and money growth slows. Retrieved on August 17, 2009 from: http://www.forbes.com/feeds/afx/2009/08/11/afx6763394.html

[8] (July 17, 2009) China's GDP up 10.4 percent in first half of year. Retrieved on August 17, 2009 from: http://english1.people.com.cn/90001/90776/90884/6452204.html

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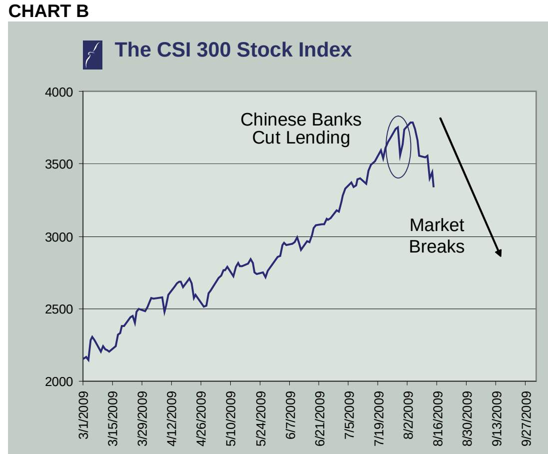
economy. It's been great in the short-term - but this money was LENT OUT remember, and must eventually be paid back. It is not a sustainable long-term growth model, and in the words of Wu Xiaoling, a previous deputy governor of the Chinese central bank, "will sow bad seeds for [China's] economic adjustment."[9]

It is our view that the world's combined government stimuli have completely distorted the global economy in the short term, and have encouraged a false sense of hope in the stock market. While the market has rallied, the real economy continues to struggle, and is notably worse in many areas. Rates of employment, corporate revenues, US housing prices and retail sales all continue to decline in the face of 'shock and awe economics'. In our assessment of recent economic data, there are only two possible explanations for the recent market rally. Either investors are discounting an incredible economic recovery that is just around the corner (hard to believe), or the extra liquidity injected into the economy has found its way into the stock market. We're leaning towards the latter alternative.

So what happens next? Will the Keynesian miracle take hold? Will the recovery be strong enough to pay back the increased debt load that was needed to jolt the economy back to life? It seems unlikely. On July 29th two Chinese banks announced that they would limit loans in the second half of 2009. Since the announcement, Chinese stocks have reversed into a considerable down trend. This is reflected in the chart of CSI 300 stock index, which tracks the performance of the largest and most liquid stocks traded on the Shanghai and Shenzhen stock exchanges (see CHART B). Now that the excess stimulus liquidity has been removed, all asset classes that previously benefited will begin to fall. The CSI 300 suggests this process is well underway.

CHART B



Source: Bloomberg, Sprott Asset Management LP

The Federal Reserve has embarked on its own monetary injections, called quantitative easing, by buying $1.745 trillion dollars worth of debt issued by Fannie Mae, Freddie Mac and treasury bills issued by US government. On August 12, 2009 the Federal Reserve provided guidance on their plans to ease the program. Interestingly enough, they extended the completion date from September to October 2009 in order to keep the option of boosting purchases later this Fall. If the Chinese experience is an early lesson, removing the stimulus liquidity from the market could be a dangerous proposition. We have already proven there are not enough buyers of US debt to support the budget deficit this year (please see "The Solution…is the Problem"), and we suspect that much of the US monetary stimulus used to purchase debt issued by Fannie and Freddie has actually made its way into the new US Treasury auctions - thereby supporting the record US budget deficit in 2009. This two step debt monetization process is a complicated topic that we will address in a future MAAG.

In the world of government stimulus, the size and speed of the injections are critical to their impact. Once the taps are turned on full bore, any reduction to the stimulus will have almost the same negative impact as removing it entirely. We are now seeing this reduction on three fronts: the Federal Reserve threatening to close the window on its 'quantitative easing' program; the tax cuts and transfers already paid out to US citizens; and the Chinese banks

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[7] Garnaut, John (August 12, 2009). China pulls back on bank-credit throttle. Retrieved on August 16, 2009 from: http://business.smh.com.au/business/china-pulls-back-on-bankcredit-throttle-20090811-egzv.html

now reining in their excessive lending. In trader terms - we will soon have no "dry powder" left to burn.

In their 2008 annual report, the Bank for International Settlements (BIS) recently reviewed previous banking crises and suggested that a sustainable recovery would require the banking system to take losses, dispose of non-performing assets, eliminate excess capacity and rebuild capital bases. The BIS concludes that “these conditions are not being met and any stimulus will therefore only lead to a temporary pick up in growth followed by protracted stagnation.”[10] We agree wholeheartedly, and have seen nothing yet to suggest that the real problems plaguing the world’s banking system are being addressed. In our view, the threat of a double dip recession remains real. When the stimulus effects wear off there will be nothing left to replace the artificial demand they have induced. Investors should be prepared for what awaits us beyond the stimulus.

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[10] Bank for International Settlements, Annual Report 2008/09 (June 29, 2009). Retrieved on August 16, 2009 from: http://www.bis.org/publ/arpdf/ar2009e6.pdf