Sprott Asset Management LP

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Special Issue

The Solution…is the Problem

MARKETS
AT A GLANCE

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The US government raised $705 billion worth of new debt in 2008. The debt was raised to pay for a $455 billion budget deficit and $250 billion in “supplemental appropriations” for the wars in Iraq and Afghanistan. In 2009, the US government will (and must) sell $2.041 trillion in new debt. This debt will pay for a projected budget deficit of $1.845 trillion, supplemental appropriations of $196 billion for Iraq and Afghanistan, a fund for pandemic flu response and a line of credit to the IMF. **In fiscal 2009, the United States must find buyers for almost three times the debt that was issued last year.**

Table A presents the ownership breakdown of current outstanding US debt as of September 2008. Each of the debt buyers presented will have to buy three times the debt that they bought last year, by September 2009, in order to balance the accounts of the United States Government.

TABLE A

Ownership of US Debt
September 2008[1]

Holder	Ownership	%
1. Intragovernmental Holdings[2]	$4,212,428,000,000	42%
2. Foreign and International Holders	$2,801,900,000,000	28%
3. Mutual Funds	$617,700,000,000	6%
4. State and Local Governments	$535,700,000,000	5%
5. Federal Reserve[3]	$480,272,000,000	5%
6. Other Investors	$471,500,000,000	5%
7. Pension Funds – Private	$289,700,000,000	3%
8. US Savings Bonds	$194,300,000,000	2%
9. Pension Funds - State and Local Governments	$167,200,000,000	2%
10. Depository Institutions	$130,900,000,000	1%
11. Insurance Companies	$123,200,000,000	1%
TOTAL US Public Debt	**$10,024,800,000,000**	100%

Given the current state of the economy, it seems frighteningly apparent that a threefold increase in the debt purchased by the account holders listed above is a mathematical impossibility. There is simply not enough money in the present economy to support a tripling bond issue in the normal course of business. To confirm this, we have grouped together similar debt holders in order to assess their potential buying capability for fiscal 2009, which ends on September 30th.

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[1] Ownership of Federal Securities. TABLE OFS-2.—Estimated Ownership of U.S. Treasury Securities. Retrieved on June 18, 2009 from: http://fms.treas.gov/bulletin/index.html
[2] A deduced value by removing Federal Reserve holdings from “Federal Reserve and Intragovernmental Holdings” as reported by the Treasury Department.
[3] Federal Reserve Statistical Release, September 25, 2008. Retrieved on June 18, 2009 from http://www.federalreserve.gov/releases/h41/20080925/

We begin with the largest buyers of debt outside of the United States – 'Foreign and International Holders' (#2). This group accounts for the largest source of external capital for US debt purchases and represents a very important group to float the deficit. They collectively purchased $564 billion last year, and the US will require them to increase their purchases to $1.6 trillion in 2009. Thus far, they have only purchased $465 billion to March 2009, which is halfway through US fiscal year - and well behind the pace needed to triple last year's purchases. Current data does not bode well for further purchases either. In fact, April Treasury data revealed that 'Foreign and International Holders' were net sellers of US debt from March to April 2009[4] . This is not surprising given the public comments from officials in China, Japan, Russia and Brazil concerning the level of debt issuance by the United States and its potential impact on the US dollar.

Next we assess the pension funds. We combine 'Pension Funds - State and Local Governments' (#9) and 'Pension Funds - Private' (#7), as they both purchase US debt for similar purposes. Last year they collectively purchased a combined total of $52.6 billion of US debt, and under our tripling scenario they must purchase over $150 billion worth of US debt this year. As at the end of December 2008, the last date for which we have data, records show that they have purchased a mere $8.5 billion - so they have a long way to go. In fact, the Canada Pension Plan Investment Board recently stated that "it would be dangerous to increase the fixed-income portion of our portfolio at this point."[5] If the Canada Pension Plan is any indication, it is unlikely this group will carry their weight in fiscal 2009.

Next, we group together 'Depository Institutions' (#10) and 'Insurance Companies' (#11). Together they have been net sellers of US debt so far this fiscal year, selling a combined total of $20 billion in US bonds. As a group they made no new net purchases last fiscal year, and were sellers of debt as of the first quarter of this fiscal year. This should come as no surprise, as these institutions have had to deleverage their balance sheets to survive the financial crisis of 2008 and the devastating economic climate of 2009. The US Government will not be able to raise new funds from them, so we can cross them off our list.

Next, we examine 'State and Local Governments' (#4). As you have probably already heard, the majority of State governments are in serious financial trouble. The latest estimates show income tax revenues down a whopping 26% from last year.[6] The State of California, which represents the 10th largest economy in the world, is currently on the verge of collapse from economic stress. Seeing as how they were net sellers of US debt last year, we will assume, given their difficulties, that they will be net sellers this year as well - so no help here.

'Mutual Funds', #3 on our list, drove a surge in debt purchases last year as the financial collapse took hold. They purchased $311 billion in 2008, so the US needs them to purchase close to a trillion this year. How are they doing thus far in 2009? A paltry $151 billion as at the end of December - and current data doesn't look promising for further purchases. Assets in money markets funds fell by $72.85 billion over the past week alone, including a large portion of which was comprised of US debt.[7] We can safely assume that 'Mutual Funds' will fall short of their one trillion dollar quota for fiscal 2009.

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[4] Department of the Treasury/Federal Reserve Board, Major Foreign Holders of Treasury Securities. Retrieved on June 18, 2009 from: http://www.treas.gov/tic/mfh.txt
[5] Canada Pension fund wary of bonds, Retrieved on May 22, 2009 from http://www.ft.com/cms/s/0/eb0061bc-465c-11de-803f-00144feabdc0.html
[6] State Income-Tax Revenues Sink. Retrieved on June 18th from: http://online.wsj.com/article/SB124527624327024867.html

[7] ICI: Money-Market Fund Assets Fall $72.85B In Latest Week. Retrieved on June 18, 2009 from: http://online.wsj.com/article/BT-CO-20090618-715091.html

‘US Savings Bonds’ (#8), which represents US domestic buyers of government debt, were net sellers in 2008 and net sellers again in 2009. This is no surprise to us given the state of the economy. There are no buyers in this category.

‘Other Investors’, #6 on our list, is a catch-all category. It includes individuals, government-sponsored enterprises, brokers and dealers, bank personal trusts and estates, corporate and non-corporate businesses and other investors. They collectively purchased $141 billion last year, and have currently purchased $158 billion to December 2008. As a group they are on track to purchase over $600 billion in debt this fiscal year. They are the only group realistically capable of tripling the purchases they made last year.

We have shown that the majority of traditional buyers of US debt will be unable to increase their debt purchases this year, so we must question how the United States is going to cover this colossal shortfall. Is there anyone else who can buy the required US debt in 2009? Surely the US Government can find someone willing to increase their debt holdings.

It may not surprise you to learn that the largest percentage owner of US debt is the United States Government itself. Perhaps this doesn’t make immediate sense to some readers, but it is a fact. The debt holdings are held in accounts for the various trust funds the US manages for its future obligations - the largest of which are set aside for Social Security and Medicare. These trust funds are lumped together and referred to as “Intragovernmental Holdings”. The only ‘assets’ held by these ‘trust funds’, however, are special-issue Treasury Bonds. Why? Because the US Treasury takes the Social Security and Medicare payroll taxes and uses these funds to pay for anything from aircraft carriers to education to welfare. To cover this drawdown, special-issue Treasury Bonds are deposited into the trust funds for Social Security and Medicare as IOU’s. When the government issues a bond to one of its own accounts, it hasn't established a claim against another entity or person. It is simply creating a form of IOU from one of its accounts to another. Put simply, there are no real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury, that, when redeemed, will have to be financed by raising taxes, increasing borrowing or reducing expenditures. For all intents and purposes, Social Security and Medicare receipts are essentially considered to be another source of government tax revenue that can be spent each year.

In 2008, the Treasury Department issued the “Intragovernmental Holdings” account $254 billion in bonds (IOU’s), and in the first half of fiscal 2009 this account actually became a net seller of bonds. Because the account is not broken down by individual trust fund, it is difficult to see which specific trust fund liquidated their bonds, but we suspect it was Medicare. The benefits currently being paid out of Medicare are already running higher than its inflows, so the difference must have been made up by sales of its IOU bonds.

Obviously this is a very troubling development for the US, and unfortunately it is likely to get worse. This year’s Social Security fund is only expected to balance, which is bad news for the government. Along with Social Security, Medicare is one of the trust funds that should be posting surpluses right now in anticipation of the massive future commitments the retiring Baby Boomers will require. As it stands, Medicare is in an operating deficit in 2009 with premiums coming in at $14 billion and outlays totaling $348 billion.[8] The difference will be supplemented by sales of its IOU bonds, which will ultimately add to the amount of new government debt that must be sold in fiscal 2009. We won’t speculate on what would happen to the Social Security program if new buyers for US debt disappeared, but we should all bear in mind that in that scenario the special-issue ‘IOU’s’ in the “Intragovernmental Holdings” account would be rendered worthless, and the US Government’s social ‘safety net’ would vanish.

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[8] Daily Treasury statement, June 17th. Retrieved on June 17, 2009 from: http://fms.treas.gov/webservices/show/?ciURL=/dts/09061700.pdf

This net selling by US Government trust funds add to the total amount of debt that needs to be marketed, so instead of facing a $2 trillion debt marketing problem in 2009, the US now has a debt marketing problem that is well in excess of $2 trillion.

So, after all this, it should be clear by now as to who is going to cover the difference this fiscal year. As the lender of last resort, the only purchaser left is the Federal Reserve. In 2008 they were net *sellers* of almost $300 billion of bonds, but in the first half of this fiscal year they have been *buyers* of almost $280 billion of bonds. The Federal Reserve is the lender of last resort and must support the market for US debt. The policy 'solution' that the Federal Reserve implemented in March 2009 is called 'Quantitative Easing'. Given our projections above, this was not an option for them, but a necessity.

Quantitative Easing was pioneered by the Japanese in the early 2000's. It is an extreme form of monetary policy used to stimulate the economy when interest rates are at or close to zero. In practical terms, the Federal Reserve purchases assets, including treasuries and corporate bonds, from financial institutions using newly created money. The Federal Reserve typically controls the 'cost' of money with interest rates, but since interest rates can't be negative, the Federal Reserve now manipulates the quantity of money itself by printing more of it. The official announcement proclaiming this practice was made in March of this year, and it was hailed as a new stimulative mechanism to kick start the economy.

The Federal Reserve's 'solution' to the debt problem is the problem. It has resulted in the Federal Reserve doubling the monetary base of the United States over the span of a mere nine months. Rather than stimulate the real economy, the QE program has instead resulted in increasing weakness in the international market for US bonds - the proof of which can be seen in the chart below. Bond investors are running for the exits, and our discussion above confirms what we see in this chart. Traditional buyers of US bonds are now sellers, and they are exercising a non-confidence vote in the US dollar and in US debt.

CHART A – US 10 Year Bond Price

Source: Bloomberg

As we hope the breakdown above has revealed, the future solvency of the United States as a nation state is currently in jeopardy. It is in far deeper trouble than the mainstream press cares to admit. There are simply not enough new buyers of debt on this planet to support the spending programs of the United States government - and it appears that current holders of

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debt are beginning to sell. Because it is impossible to balance the budget from outside sources of capital, the only source of funds left for the US, in all reality, is continued money printing.

The Federal Reserve's policy of Quantitative Easing is failing. The US budget is ludicrous, spending is out of control, spending promises are out of control, the world knows it - and we know it. For all the pundits who see the economy improving over the next year, we invite you to explain to us how this debt crisis will resolve itself without significant turmoil. We've tabulated the numbers above - and they do not lie. As we wrote this past January, welcome to 2009.

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