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MARKETS AT A GLANCE

SPROTT ASSET MANAGEMENT LP

Weakness Begets Weakness: from Banks to Sovereigns to Banks

By: Eric Sprott & David Franklin

The Greek debt situation has been an interesting case study for students of the sovereign bond markets. If there's a lesson to be learned from Greece's experience thus far it's that sovereign bailouts are far more complicated than bank bailouts. They require more sophisticated negotiations and proposals and involve an extra layer of diplomacy that makes them especially difficult to accomplish. As we write this, the European Union has recently announced new lending terms to support the Greek government, with great efforts made to assure the markets that these new terms do not constitute a 'bailout'. The problem with the Greek situation is that an actual bailout would involve an almost impossible coordination among all the major powers within the EU. It would require the unanimous pre-approval of all the EU heads of state. It would involve the European Commission, the European Central Bank and the International Monetary Fund (IMF) all visiting Greece to perform financial assessments.[1] And finally, it would involve at least seven EU countries affirming support through parliamentary votes - all of this before a single euro is spent. A true bailout involves an almost impossible number of hurdles that essentially guarantee nothing will happen until all other avenues of rescue are exhausted. However, judging by the recent increase in yields on 10-year Greek bonds, Greece may soon need more than a loan package proposal to solve its fiscal problems.

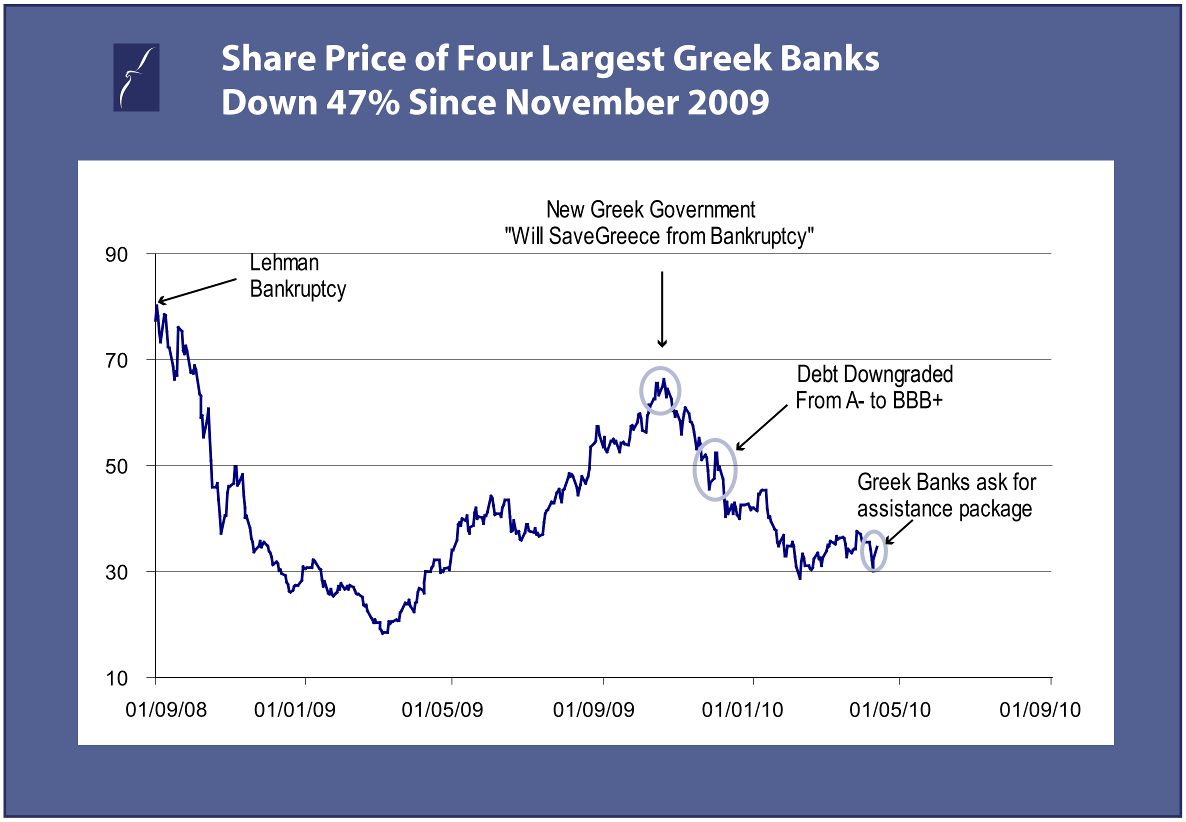
One aspect of the Greek situation that has been obscured by all the recent political wrangling is the crisis' impact on the Greek banks. Although the banks were supposed to be rock solid after all the government-injected capital they received (not to mention zero-percent interest rates and generous lending terms from the European Central Bank), data shows that Greek bank deposits have fallen 8.4 billion euros, or 3.6 percent, in two months since December 2009.[2] With no restraints on capital flows within the European Union, Greek savers are free to transfer their assets elsewhere. Given that bank deposit guarantees in Greece are the responsibility of the national government rather than the European Central Bank, we suspect Greek citizens are pulling money out of their banks because they question their government's ability to honour its domestic deposit guarantees. We envision Greek depositors asking themselves how a government that can't raise enough money to stay solvent can then turn around and guarantee their bank deposits? It's a fair question to ask.

The Greek bank stocks have been thoroughly punished throughout the crisis. Chart A plots an index consisting of the four largest Greek bank stocks and shows an average decline of 47%

1 Thomas, Andrea (April 11, 2010) German MOF: Euro Zone's Plan For Greece Not A Decision To Give Aid. Dow Jones Newswires. Retrieved on April 19, 2010 from: http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201004111740dowjonesdjonline000263&title=german-mofeuro-zones-plan-for-greece-not-a-decision-to-give-aid

2 Papadimas, Lefteris and Papachristou, Harry (April 7, 2010). UPDATE 2-Greek banks ask for rest of EUR28 bln support deal. Reuters. Retrieved on April 19, 2010 from: http://www.reuters.com/article/idUSLDE6360ZA20100407

Chart A



since November 2009. The deposit withdrawals from these banks have been so damaging to their respective balance sheets (remember bank leverage?) that the Greek banks have asked to borrow 17 billion euros left over from a 28 billion euro support program launched in 2008.[3] You see the connection here? Greece experienced a financial crisis, followed by a sovereign crisis, followed by another financial crisis. There is no doubt that the Greek crisis has helped drive the gold spot price to its recent all time high in euros. Gold is a prudent asset to own in times of crisis, and it's possible that a portion of the Greek deposit withdrawals were reinvested into the precious metal. The fact remains, however, that if the Greek government cannot stem the outflows of deposits soon, the EU will have no other choice but to undertake a real sovereign bailout with all its bells, whistles and arduous protocols.

It's a vicious spiral from financial crisis to sovereign debt crisis to banking crisis, and there is no reason it can't spread to other European countries suffering from similar fiscal imbalances. With Spain and Portugal next in line with their own sovereign debt issues, we can expect depositors in these countries to make similar runs to the bank for their cash. "Guaranteed by Government" is truly beginning to lose its potency in this environment. The International Monetary Fund (IMF) seems to be preparing for such a scenario with its recent announcement of a tenfold increase in its emergency lending facility. The IMF's New Arrangements to Borrow (NAB) facility is designed to prevent the "impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system."[4] The NAB facility has grown from US$50 billion to US$550 billion with the mere stroke of a pen. Does the IMF know something that the market doesn't? Is this a pre-emptive measure to repel an attack by bond vigilantes' on Europe's fiscally-weakened countries?

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3 Melander, Ingrid (April 7, 2010). Greek banks seek more aid as spreads widen again. Reuters. Retrieved on April 19, 2010 from: http://www.reuters.com/article/idUSTRE6361QK20100407

4 International Monetary Fund (April 12, 2005). IMF Executive Board Approves Major Expansion of Fund's Borrowing Arrangements to Boost Resources for Crisis Resolution. Retrieved on April 19, 2010 from: http://www.imf.org/external/np/sec/pr/2010/pr10145.htm

Sovereign Ratings

In our examination of the Greek situation this past month, we kept coming across various sovereign credit ratings. In an effort to better understand the Greek situation, we decided to look at how the ratings agencies generate their actual rankings and built our own model to determine a country's credit risk.[5] We used common metrics such as GDP per Capita, Government Budget Deficits, Gross Government and Contingent Liabilities, the inflation rate and incorporated a simple debt sustainability metric in order to generate our own sovereign ratings. What we discovered in the process was quite puzzling.

It should first be noted that the rating agencies are in the business of offering their 'opinions' about the creditworthiness of bonds that have been issued by various kinds of entities: corporations, governments, and (most recently) the packagers of mortgages and other debt obligations. These opinions come in the form of 'ratings' which are expressed in a letter grade. The best-known scale is that used by Standard & Poor's ("S&P") which uses AAA for the highest rated debt, and AA, A, BBB, BB, for debt of descending credit quality.

In our opinion, as they relate to sovereign debt, the ratings provided by the agencies are highly suspect. While these agencies claim to provide ratings that consider the business credit cycle, there appears to be very little forward-looking information actually factored into their credit models. In some cases, the agency ratings end up looking absurdly optimistic. This of course should come as no surprise - we all remember the subprime mortgages that were rated AAA that are now worth pennies on the dollar.

While there were some similarities in our rankings (for example, our model ascribed AAA ratings to the local currency debt of Australia, Canada, Finland, Sweden, New Zealand which matched the ratings given by S&P), we found some glaring inconsistencies in the rating results for less fiscally prudent countries that left us scratching our heads. A good example is South Africa. The agencies currently rate South Africa an A+ entity, while our model calculated a 'BBB-' rating for its debt using our estimates. 'BBB-' is the lowest 'investment grade' rating for local currency sovereign debt - one level above junk. We arrived at this rating without having factored in South Africa's resource endowment. A significant contributor to South African GDP is derived from mining, particularly gold mining.[6] While South Africa has been the largest producer of gold until very recently, their below-ground reserves have not been revised since 2001 when the country held 36,000 tonnes of gold (or about 40% of the global total). Recent stats from the United States Geological Survey (USGS) estimate that South Africa now has only 6,000 tonnes worth of economic gold reserves remaining. Further review by Chris Hartnady, a former associate professor at the University of Cape Town, using similar techniques to those of M. King Hubbert (the Peak Oil theorist), suggests that South Africa could have only half of the gold reserves estimated by the USGS.[7] If these new estimates are correct, South Africa could have 90% less gold than claimed – and it's not even factored into our BBB- rating! So what's South African debt really worth? An 'A+' from the ratings agencies seems far too generous based on our cursory review of the country's fundamentals.

The rating agencies' ranking of the United States is even more disconnected from reality. To believe that the US sets the benchmark for sovereign debt credit ratings is preposterous. While we have written *ad nauseam* about the excessive debt issuance by the United States, we found a recent update written by United States Government Accountability Office (GAO) to be particularly instructive. The update noted the US's budget deficit equivalent to 9.9% of GDP in 2009 - the largest

5 Standard and Poor's. Rating Methodology: Evaluating the Issuer. Retrieved on April 19, 2010 from: http://www2.standardandpoors.com/spf/pdf/fixedincome/methodology.pdf
6 Department: Minerals and Energy. Republic of South Africa. South Africas's Mineral Industry 2007/2008. Retrieved on April 19, 2010 from: http://www.dme.gov.za/minerals/sami_2005.stm
7 Sergeant, Barry. (November 17, 2009). SA gold miners on final deathwatch as scientist finds gold reserves more than 90% less than claimed. Mineweb. Retrieved on April 19, 2010 from: http://www.mineweb.co.za/mineweb/view/mineweb/en/page34?oid=93062&sn=Detail

since 1945 - and stated that without significant policy changes the US government would soon face an "unsustainable growth in debt". This was not news to us. It goes on to state, however, that using reasonable assumptions, "roughly 93 cents of every dollar of federal revenue will be spent on the major entitlement programs and net interest costs by 2020."[8] This *is* news! In less than ten years, using reasonable assumptions, there will essentially be no money left to run the US government - 93% of all tax revenues the US government collects will go to pay social security, Medicare, Medicaid and the interest costs on their national debt. This implies no money left over for defense, homeland security, welfare, unemployment benefits, education or anything else we associate with the normal business of government. And the US government is rated AAA!?

The historian Niall Ferguson recently wrote that, "US government debt is a safe haven the way Pearl Harbor was a safe haven in 1941."[9] It's hard not to agree given the foregoing statements by the GAO. The risk inherent to investors, of course, is what happens when the bond market begins to realize and react to this new level of risk. In a speech earlier this month, Jürgen Stark, who is a member of the board of the European Central Bank, stated, "We may already have entered into the next phase of the crisis: a sovereign debt crisis following on the financial and economic crisis."[10] The activities of the IMF would confirm this statement. The question we must now ask ourselves is whether "backed by government" actually means anything anymore. In the depths of the 2008 crisis it was the governments that stepped in to provide a guarantee on financial assets. It was the governments that backed our savings accounts, money market funds, day-to-day business banking accounts, as well as debt issued by US banks. But what happens when confidence in the government guarantee begins to erode? We've seen what happened to Greece. Leverage inherent in the banking system elevated a bank run, equivalent to a mere 3.6 percent of deposits, into another full blown banking crisis. In our view it's time for investors to acknowledge sovereign risk. The ratings agencies can opine all they want, but it seems clear to us that the only true AAA asset to protect your wealth is gold.

8 United States Government Accountability Office. The Federal Government's Long-Term Fiscal Outlook January 2010 Update (GAO-10-468SP). Retrieved on April 19, 2010 from: http://www.gao.gov/new.items/d10468sp.pdf

9 Ferguson, Niall (February 10, 2010). A Greek crisis is coming to America. Financial Times. Retrieved on April 19, 2010 from: http://www.ft.com/cms/s/0/f90bca10-1679-11df-bf44-00144feab49a.html

10 Taking stock: where do we stand in the crisis? Speech by Jürgen Stark, Member of the Executive Board of the ECB at BMW Stiftung Herbert Quandt, Washington D.C. April 15, 2010. Retrieved on April 19, 2010 from: http://www.ecb.int/press/key/date/2010/html/sp100415_1.en.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