Sprott Asset Management

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# As Safe As Gold

## MARKETS AT A GLANCE

*Eric Sprott*
*Sasha Solunac*

What are phrases that connote safety? Two that come to mind are: "Like money in the bank" or "As safe as houses". Given events of the past year, these two phrases no longer seem to hit the mark, do they? These days, the one word that signifies safety is "gold", being far safer than both cash and houses. It therefore stands to reason that a more accurate phraseology would be "Like gold in the safe!" or "As safe as gold!" Yes, the barbarous relic is back… and with a vengeance.

As our readers may have already surmised, we like gold around here, and evidence suggests the world is beginning to like it more and more too. We therefore hope our readers can forgive us for harping on the same theme over and over. For the past seven articles including this one, the subject of gold has been a dominant theme, if not the prevailing theme in four of these articles; namely, "The Phony Express" (August 2008), "Cash or Gold" (October 2008), "Surviving the Depression" (December 2008), and now "As Safe as Gold". Although we may seem obsessed, there is a method to our madness.

Not coincidentally, the past seven months have also coincided with the worst financial crisis the vast majority of us have ever seen in our lifetimes, as well as the worst global economic contraction the world has seen since the Great Depression. As we wrote in our previous article, "So You Think 2008 Was Bad? Welcome to 2009", the world is currently in an environment where weakness only begets more weakness, and furthermore, the olden days of economic prosperity through endless credit creation are likely **never** coming back. That's right; we believe there has been, and will continue to be, a paradigm shift in the way financial markets function going forward. We believe this last point is a very important distinction to make – one that fundamentally distinguishes the current environment from a run-of-the-mill recession. The implication is that current government policies, which are all focusing on bringing the olden days back (this time through endless government credit/debt creation) are in fact ruinous strategies that will have dire implications for financial stability and investment portfolios going forward.

If one believes the above (indeed, it seems increasingly difficult not to), then it should go without saying that, from an investment perspective, these are extremely challenging times. It has become very difficult to preserve wealth, let alone create it. Just like a rising tide lifts all ships, a receding tide tends to ground them one and all. You could have bought almost anything in 2003-2007 and made money (provided, of course, you got out by the beginning of 2008!) Likewise, right now you can buy almost anything and lose money. Those who have been "bargain hunting" on the way down have been taken to the cleaners. There was a time not that long ago when big bank stocks were considered conservative and 'safe' investments. Today this notion seems laughable. Bank stocks are now the biggest dogs on the planet – the common equity of which, in its current form, will be shown to be completely worthless in our opinion. Thus, buying bank stocks remains a sucker's game – at any price. But there isn't much solace to be found elsewhere. The direction for almost everything, in any industry, remains down. You show us an investment and we'll tell you why it'll lose money.

**Sprott Asset Management**
Royal Bank Plaza
South Tower
200 Bay Street
Suite 2700, P.O Box 27
Toronto, Ontario
M5J 2J1

T: 416 943 6707
F: 416 362 4928
Toll Free: 888 362 7172

**www.sprott.com**

There is one exception, a very rare one at that, and that is Gold. It's the only investment that's a no-brainer, and is therefore the *only* investment worth buying right now in this financial crisis *cum* global depression. Recently, the price of gold came within a hair's breadth of matching the all-time highs it saw in March 2008. This in US dollars no less, a relatively strong (or should we say, relatively least weak) currency… for now. Is there any other investment near its 52-week high? We think not. As I write this sentence, the Dow and the S&P 500 are both at **fresh 12-year lows**. Even all-mighty US Treasuries have been beating a hasty retreat over the past two months, with the yield on the 10-year rising more than 120 basis points, likely signaling the end of the temporary (and misplaced) enthusiasm the world had for US government bonds. Meanwhile the price of gold, in the vast majority of the world's currencies, keeps hitting new all-time highs. There aren't many investments out there that can make that claim. We bet the people of Hungary, Poland, and Russia wish they owned gold instead of the forint, zloty, or ruble.

All financial assets and fiat currencies are somebody else's liability. Increasingly, this 'somebody else' is having a harder time of it, making all liabilities increasingly onerous to meet. This day and age, no investment is safe. Counterparty risk abounds. There is but one exception: physical gold. Physical gold has nobody else's liability attached to it. Short of outright theft, there is absolutely nothing that can occur, neither default nor debasement, that would render your physical gold worthless. There is absolutely no policy decision that governments or central banks can make, short of outright confiscation, that could make you worse off for owning gold. Quite the contrary, gold is the perfect insurance against the inevitable and immutable stupidity of governments and central banks. In our opinion, it's the safest investment there is right now. Safer than money in the bank, safer than houses, and far safer than any government promises.

Lest one is not yet convinced of the stupidity of government (and yes we do mean all governments, even those with popular and charismatic leaders), one need only take a gander at the latest Obama budget. On top of having the inane title, "A New Era of Responsibility: Renewing America's Promise", the document is chock full of grossly overoptimistic assumptions, that show a government in abject denial of reality. Firstly, they project GDP growth of –1.2% for this fiscal year, i.e. a mild recession. Based on the huge negative revision to 4th quarter GDP just released (which, incidentally, is the first quarter of this fiscal year), for the budget's projection to be even close implies that the US is already out of recession **this quarter** and will grow strongly for the remainder of the year! Absolute nonsense, but it gets even more ridiculous. The budget then projects strong economic growth next year of 3.2%, to be followed over the next three years by real GDP growth of 4.0%, 4.6%, and 4.2% up to fiscal 2013. After this period of superlative growth under Obama's watch, the economy will then return to a 'normal long term growth rate' of 2.6% per year thereafter. All told, according to the budget, for the six years 2008-2013 inclusive (a period that includes a severe global financial crisis and a once in a lifetime global depression) the US economy is projected to grow a cumulative 17.1% which, moronically, is even greater than it would have grown if it grew by the 'long term growth rate' of 2.6% over this six year period (16.6% cumulative) instead. In short, the depression, the financial crisis and the banking catastrophe are good for the economy!! The US is projected to grow by more with them than it would have grown if they had never happened in the first place. Truly mind boggling logic!

The truth, for those who care to see it, is that depressions and banking crises are not good for the economy. Nor do historic declines such as those being experienced bounce back anytime soon. It took until World War 2, ten years later, for the US to get out of the depression that started in 1930. Japan still hasn't recovered, and won't likely recover for a long time to come, from its depression that started soon after its stock market and credit bubble crashed in 1990. Japan's GDP today is essentially unchanged

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from what it was in 1992. That's 16 years of economic malaise, and counting. In our opinion, one of the strongest cases that can be made for gold is the fact that the government of the world's reserve currency is living in La-La land, with policies and beliefs that are a negligent denial of reality, and racking up debts that are well beyond their ability to ever repay.

The US government is bankrupt, just like Citigroup, just like AIG, just like Fannie Mae. Citigroup, AIG, Fannie Mae, and countless others are being kept afloat only by the good auspices of the US government. Under whose good auspices will the US government be kept afloat? The US taxpayer? Don't count on it. The government has no assets. All they have is borrowing and taxing power, the former being based on the latter. But the taxing powers of government are useless during a severe economic contraction. It's like taking blood from a stone. When everybody's income is down, what is the government supposed to tax? Furthermore, instead of reporting capital gains, people will be reporting capital losses, and asking for tax refunds. The government's huge spending spree is coinciding with a precipitous fall in tax revenue. The projected $1.75 trillion deficit for fiscal 2009, a deficit that is over 12% of GDP, is double the size of any deficit as a percentage of the economy post-World War 2. Even this mind-boggling deficit is based on the assumption that we are in a mild recession, with strong growth to follow over the next several years. Not only is it a pipedream, it is ruinous. Rather than adopt austerity measures, as any government should during times of financial crisis resulting from over-indebtedness, the government is doing the exact opposite, spending beyond their means, and increasing the indebtedness of their citizenry even more. In and of itself, the massive bailouts and deficits incurred to 'save' the financial system will be a huge anchor on economic growth going forward. Even if the depression were to miraculously end tomorrow.

When we say gold is the only investment, we need to qualify this opinion. We mean *physical* gold: gold bars in the vault or gold coins. This is a very important distinction to make. Anything else is just another derivative, and thus subject to counterparty risks just like any other financial asset. Recently, the gold exchange-traded fund (ETF), as represented by the ticker GLD, has become a very popular investment vehicle for those looking to invest in gold. This ETF is now purported to hold over 1000 tons of gold, having reportedly bought 220 tons in January alone. At this rate, GLD is effectively buying all the gold that is being produced at any given time. That's just one ETF. Being gold investors ourselves, we know the difficulties involved in taking physical delivery of gold. To buy physical gold in that quantity in that short a timeframe would be a significant market-moving event. Did they really buy that much physical gold? Furthermore, is all that gold tucked away in some vault? Maybe it is… or maybe it isn't. GLD is a complex legal structure, with the Bank of New York as the trustee, and HSBC Holdings as the custodian, and a chain of subcustodians and sub-subcustodians, many of which are banks that are known to actively lease gold. In our opinion, owning physical gold is very different from owning a lease-receivable. If any of the numerous counterparties were to default, it could be very difficult for GLD to actually get the gold it is purported to own. We're not saying that it's a fraud. It's a structure whose price is meant to legitimately track the price of gold. That said, in our opinion, an ETF is not a substitute for owning physical gold. It defeats one of the main reasons to own gold during these times; namely, the fact that gold is nobody else's liability. This is not the case with GLD. It is essentially a creditor, whose assets are somebody else's promise.

Why take the risk? Especially when it will cost just as much, perhaps a little bit more, to own the real thing. Don't settle for a paper asset – a second-rate knock-off. In this environment, counterparty risk lurks around every corner. Buy the real thing: GOLD, not GLD.

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