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MARKETS AT A GLANCE

SPROTT ASSET MANAGEMENT LP

Is it all just a Ponzi scheme?

By: Eric Sprott & David Franklin

In our May/June Markets at a Glance, "The Solution…is the Problem", we discussed how much debt the US government would need to issue in order to balance the budget for fiscal 2009. We calculated they would need to sell $2.041 trillion in new debt - or almost three times the new debt that was issued in fiscal 2008. As a thought experiment, we separated all the various US Treasury owners and asked our readers whether each group could afford to increase their 2009 treasury purchases by 200%. In the end, we surmised that most groups couldn't, and prepared our readers for the worst.

Almost seven months later, however, nothing particularly bad has happened on the US debt front. There have been no failed auctions, no sovereign defaults, no downgrades of debt and no significant increase in rates…not so much as a hiccup in the treasury market. Knowing what we discussed this past June, we have to ask how it all went so smoothly. After all – it was pretty obvious there wasn't enough buying power to satisfy the auctions under 'normal' circumstances.

In the latest Treasury Bulletin published in December 2009, ownership data reveals that the United States increased the public debt by $1.885 trillion dollars in fiscal 2009.[1] So who bought all the new Treasury securities to finance the massive increase in expenditures? According to the same report, there were three distinct groups that bought more than they did in 2008. The first was "Foreign and International Buyers", who purchased $697.5 billion worth of Treasury securities in fiscal 2009 – representing about 23% more than their respective purchases in fiscal 2008. The second group was the Federal Reserve itself. According to its published balance sheet, it increased its treasury holdings by $286 billion in 2009, representing a 60% increase year-over-year.[2] This increase appears to be a direct result of the Federal Reserve's Quantitative Easing program announced this past March. Most of the other identified buyers in the Treasury Bulletin were either net sellers or small buyers in 2009. While the Q4 data is not yet available, the Q1, Q2 and Q3 data suggests that the State and Local governments and

US Savings Bonds groups will be net sellers of US Treasury securities in 2009, while pension funds, insurance companies and depository institutions only increased their purchases by a negligible amount.

So who was the third large buyer? Drum roll please,... it was "Other Investors". After purchasing $90 billion in 2008, this group has purchased $510.1 billion of freshly minted treasury securities so far in the first three quarters of fiscal 2009. If you annualize this rate of purchase, they are on pace to buy $680 billion of US treasuries this year - or more than seven times what they purchased in 2008. This is undoubtedly the group that made the US deficit possible this year. But who are they? The Treasury Bulletin identifies "Other Investors" as consisting of Individuals, Government-Sponsored Enterprises (GSE), Brokers and Dealers, Bank Personal Trusts and Estates, Corporate and Non-Corporate Businesses, Individuals and Other Investors. Hmmm. Do you think anyone in that group had almost $700 billion to invest in the US Treasury market in fiscal 2009? We didn't either. To dig further, we turned to the Federal Reserve Board of Governors Flow of Funds Data which provides a detailed breakdown of the owners of Treasury Securities to Q3 2009.[3] Within this grouping, the GSE's were small buyers of a mere $5 billion this year;[4] Broker and Dealers were sellers of almost $80 billion;[5] Commercial Banking were buyers of approximately $80 billion;[6] Corporate and Non-corporate Businesses, grouped together, were buyers of $11.6 billion, for a grand net purchase of $16.6 billion.[7] So who really picked up the tab? To our surprise, the only group to actually substantially increase their purchases in 2009 is defined in the Federal Reserve Flow of Funds Report as the "Household Sector". This category of buyers bought $15 billion worth of treasuries in 2008, but by Q3 2009 had purchased a whopping $528.7 billion worth. At the end of Q3 this Household Sector category now owns more treasuries than the Federal Reserve itself.[8]

So to summarize, the majority buyers of Treasury securities in 2009 were:

1. Foreign and International buyers who purchased $697.5 billion.
2. The Federal Reserve who bought $286 billion.
3. The Household Sector who bought $528 billion to Q3 – which puts them on track purchase $704 billion for fiscal 2009.

These three buying groups represent the lion's share of the $1.885 trillion of debt that was issued by the US in fiscal 2009.

We must admit that we were surprised to discover that "Households" had bought so many Treasuries in 2009. They bought 35 times more government debt than they did in 2008. Given the financial condition of the average household in 2009, this makes little sense to us. With unemployment and foreclosures skyrocketing, who could afford to increase treasury investments to such a large degree? For our more discerning readers, this enormous "Household" investment was made outside of Money Market Funds, Mutual

Funds, ETF's, Life Insurance Companies, Pension and Retirement funds and Closed-End Funds, which are all separate reporting categories.[9] This leaves a very important question - who makes up this Household Sector?

Amazingly, we discovered that the Household Sector is actually just a catch-all category. It represents the buyers left over who can't be slotted into the other group headings. For most categories of financial assets and liabilities, the values for the Household Sector are calculated as residuals. That is, amounts held or owed by the other sectors are subtracted from known totals, and the remainders are assumed to be the amounts held or owed by the Household Sector. To quote directly from the Flow of Funds Guide, "For example, the amounts of Treasury securities held by all other sectors, obtained from asset data reported by the companies or institutions themselves, are subtracted from total Treasury securities outstanding, obtained from the Monthly Treasury Statement of Receipts and Outlays of the United States Government and the balance is assigned to the household sector." (Emphasis ours)[10] So to answer the question - who is the Household Sector? They are a PHANTOM. They don't exist. They merely serve to balance the ledger in the Federal Reserve's Flow of Funds report.

Our concern now is that this is all starting to resemble one giant Ponzi scheme. We all know that the Fed has been active in the market for T-bills. As you can see from Table A, under the auspices of Quantitative Easing, they bought almost 50% of the new Treasury issues in Q2 and almost 30% in Q3. It serves to remember that the whole point of selling new US Treasury bonds is to attract outside capital to finance deficits or to pay off existing debts that are maturing. We are now in a situation, however, where the Fed is printing dollars to buy Treasuries as a means of faking the Treasury's ability to attract outside capital. If our research proves anything, it's that the regular buyers of US debt are no longer buying, and it amazes us that the US can successfully issue a record number Treasuries in this environment without the slightest hiccup in the market.

Table A

Federal Reserve Activity In the Treasury Market (billions)

	2008 Q4	2009 Q1	2009 Q2	2009 Q3
Total Treasury Securities Outstanding	$6,338	$6,804	$7,143	$7,521
Increased Quarter over Quarter	-	$466	$339	$378
Monetary authority (Federal Reserve)	$476	$492	$657	$769
Increase Quarter over Quarter	-	$16	$164	$113
Federal Reserve Purchases as a Percentage New issue Treasury Securities	-	4%	48%	30%

Source: Federal Reserve Flow of Funds Report (December 10, 2009), Sprott Asset Management LP

Perhaps the most striking example of the new demand dynamics for US Treasuries comes from Bill Gross, who is co-chief investment officer at PIMCO and arguably one of the world's most powerful bond investors. Mr. Gross recently revealed that his bond fund has cut holdings of US government debt and boosted cash to the highest levels since

2008.[11] Earlier this year he referred to the US as a "ponzi style economy" and recomended that investors front run Uncle Sam and other world governments into government debt instruments of all forms.[12] The fact that he is now selling US treasuries is a foreboding sign.

Foreign holders are also expressing concern over new Treasury purchases. In a recent discussion on the global role of the US dollar, Zhu Min, deputy governor of the People's Bank of China, told an academic audience that "The world does not have so much money to buy more US Treasuries." He went on to say, "The United States cannot force foreign governments to increase their holdings of Treasuries… Double the holdings? It is definitely impossible."[13] Judging from these statements, it seems clear that the US cannot expect foreigners to continue to support their debt growth in this new economic environment. As US consumers buy fewer foreign goods, there are less US dollars available for foreigners to purchase future Treasury securities. Foreigners are the largest source of external capital that can be clearly identified in US Treasury data. If their support wanes in 2010, the US will require significant domestic support to fund future debt issuances. Mr. Gross's recent comments suggest that their domestic support may already be weakening.

As we have seen so illustriously over the past year, all Ponzi schemes eventually fail under their own weight. The US debt scheme is no different. 2009 has been witness to spectacular government intervention in almost all levels of the economy. This support requires outside capital to facilitate, and relies heavily on the US government's ability to raise money in the debt market. The fact that the Federal Reserve and US Treasury cannot identify the second largest buyer of treasury securities this year proves that the traditional buyers are not keeping pace with the US government's deficit spending. It makes us wonder if it's all just a Ponzi scheme.

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8 Flow of Funds Accounts of the United States Flows and Outstandings Third Quarter 2009. Table L.209
Treasury Securities pg.89. Line 12 Monetary Authority had a Treasury Securities balance of $769.2 billion

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Household Sector held a balance of $801.6 billion
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Sprott Asset Management

Royal Bank Plaza, South Tower
200 Bay Street, Suite 2700, Toronto, ON M5J 2J1
www.sprott.com