



Markets At A Glance Road To Ruin

It should come as no surprise to our readers and fund investors that we are negative on the financial markets, and have been so for quite some time. We believe there are compelling reasons to be such, and have explained our views in detail in previous articles. Although the vagaries of short-term trends and the prevalence of myopic market sentiment can make us bears look foolish at times, we believe our long-term thesis remains firmly intact. At the risk of sounding like a broken record, allow us to summarize why we are finding it difficult to be bullish in this environment of egregious excesses and unprecedented financial imbalances.

First, the ever-widening US trade deficit that continues to know no bounds month after month. It surpassed \$60 billion in November, an increase of almost 8% over the October deficit which was already a record. The October deficit, in turn, was 10% greater than the trade deficit reported in September. Just when one thinks it can't get any worse, it indeed does. For the year the US trade deficit will handily exceed \$600 billion and will shatter by over 20% the record trade deficit posted the year before. This in spite of a currency that has lost a third of its value against other world currencies in the past three years. The declining dollar **should** have improved US competitiveness, thus leading to increased exports. It also **should** have reduced America's voracious appetite for imports. Alas, it has done neither and has in fact had the opposite effect, making the trade balance worse and worse. For the J-curve effect to last this long is unprecedented. We believe a dollar crisis is in the making and it will doubtless be disastrous for the financial markets.

Then we have the mixed economic signals, which in our view clearly show that the US economy has slowed considerably since the first half of last year. As we mentioned in our last article, if a recession were to occur this year it could prove to be absolutely ruinous for the US economy given the very limited opportunity for further monetary or fiscal stimulus. Due to the unprecedented stimuli deployed in the past three years, the tools needed to counter a recession are today virtually nonexistent. We strongly believe, and have for quite some time, that whatever apparent strength that remains in the US economy is entirely the result of unsustainable factors – factors which, once they have run their course, will greatly disappoint the economic bulls when they discover that the emperor has no cloths.

Add into the mix the deteriorating household balance sheets of overstretched and over-indebted consumers, the reliance on the housing bubble (and the stock markets) to sustain consumer spending, no meaningful wage growth, a near-zero savings rate, rising energy prices, and the mounting threat of inflation, and it quickly becomes apparent that the American consumer will sooner or later run out of steam. Furthermore, we also have an environment where stock market earnings multiples continue to be out of whack with historical averages, and credit spreads in the bond markets that are razor thin. Financial market instruments of all ilk are priced for perfection. Are we the only ones who are worried? It would appear so, but over-optimism of the crowd does a market top make.

Indeed, if we were to make a "Top Ten" list of reasons to be bearish we would have difficulty choosing only ten. One thing for certain, however, near the top of our list would be the atrocious deterioration in US government finances witnessed over the past three years. We're not just talking about the reported budget deficit, which at \$412 billion and climbing is disturbing in and of itself. Rather, we're talking about the **real** deficit of **\$11 trillion** that was incurred by the US government in fiscal 2004. **No, this in not a typo.** Nor does this number come from our own in-house calculations. Believe it or not, this budgetary monstrosity comes straight from the US government itself, courtesy of the Treasury Department, in a recently released report titled "2004 Financial Report of the United States Government". We urge our readers to see this mind-boggling report for themselves at www.fms.treas.gov.

In the article we wrote back in October, titled “The Long Nose of Government”, we already alluded to the 2003 version of this report. In that report, which uses the accrual method of accounting or GAAP, the present value of the US government’s liabilities (including Social Security and Medicare) exceeded the present value of its assets by \$35 trillion in 2003. This net liability was an increase of \$3.7 trillion over the prior year. This, in our opinion, is the “real” deficit that the US government incurred in fiscal 2003. GAAP, or Generally Accepted Accounting Principles, is the same method of accounting that corporations use to report their financial statements, and is a fairer and more accurate representation of an entity’s finances than the cash basis of accounting that governments traditionally use. Unlike cash accounting, GAAP accrues for future expenditures and commitments.

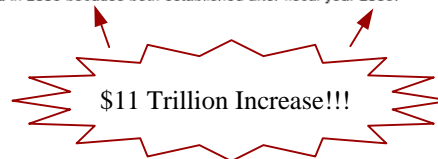
US GOVERNMENT’S FINANCIAL RESPONSIBILITIES

Overall Perspective
(in billions of dollars)

	2004			2003			\$ Change
	Balance Sheet	Additional Responsibilities	Combined Amounts	Balance Sheet	Additional Responsibilities	Combined Amounts	
ASSETS							
Inventory, cash	\$ 359	\$ -	\$ 359	\$ 372	\$ -	\$ 372	\$ (14)
Property, plant & equipment	653	-	653	658	-	658	(6)
Loans receivable	221	-	221	221	-	221	(0)
Other	165	-	165	154	-	154	11
Total Assets	\$ 1,397	\$ -	\$ 1,397	\$ 1,405	\$ -	\$ 1,405	\$ (8)
LIABILITIES & NET RESPONSIBILITIES							
Social Insurance							
Medicare (Parts A, B, & D) ¹	-	(24,615)	(24,615)	-	(15,006)	(15,006)	(9,609)
Social Security (OASDI)	-	(12,552)	(12,552)	-	(11,742)	(11,742)	(810)
Other (Railroad Retirement)	-	(112)	(112)	-	(110)	(110)	(2)
Subtotal, Social Insurance	-	(37,279)	(37,279)	-	(26,858)	(26,858)	(10,421)
Fed. empl. & veterans pensions/benefits	(4,062)	-	(4,062)	(3,880)	-	(3,880)	(182)
Federal debt held by the public	(4,329)	-	(4,329)	(3,945)	-	(3,945)	(385)
Other liabilities	(716)	-	(716)	(675)	-	(675)	(41)
Other responsibilities	-	(903)	(903)	-	(862)	(862)	(41)
Total Liabilities & Net Responsibilities	\$ (9,107)	\$ (38,182)	\$ (47,289)	\$ (8,500)	\$ (27,720)	\$ (36,220)	\$ (11,070)
BALANCE (Total Assets minus Total Liabilities & Net Responsibilities)	(\$7,710)	(\$38,182)	(\$45,892)	(\$7,094)	(\$27,720)	(\$34,814)	(\$11,078)

¹ Part D's Medicare Prescription Drug & Transitional Assistance Accounts not included in 2003 because both established after fiscal year 2003.
Note: Details may not add to totals due to rounding.

Source: 2004 Financial Report of the United States Government p. 11



Needless to say, and as we predicted, the 2004 financial report released last month shows that the state of US government finances as per GAAP deteriorated even further – and even we were shocked by the extent of the deterioration. The net liabilities of the government now stand at **\$46 trillion**, an increase of **\$11 trillion** over the previous fiscal year. To put this in perspective, the GDP of the United States was about \$11 trillion last year. To wit, the ‘deficit’ that was incurred by the government in **one year** was equivalent to the **entire economic output** of the country that same year. This puts a whole new meaning to the word ‘recklessness’. To put another perspective on how unfathomable this sum is, it amounts to almost \$2000 for every man, woman, and child **on the planet!**

We emphasize, this \$11 trillion is only one year’s deterioration in a net liability that increases by trillions each and every year that nothing is done about it. In fact, this liability is already trillions higher as we speak. The 2004 financial report calculates the present values of Social Security and Medicare obligations at January 1, 2004 – data that is already over a year old. The toxic thing about present values is that they work in the same way that compound interest does – growing exponentially each and every year. As we all know, compound interest is a virtue to a saver... but a vice to a debtor! The same phenomenon occurs when dealing with

present values. The closer the liabilities become the more onerous they get, especially when (as is the situation currently) nothing is being done to pay down the 'debt', let alone the 'interest' on said debt.

Even with all the data staring it in the face, the financial markets are still loath to realize that this is a huge problem. The general consensus of market participants appears to be that the retirement of the baby boomers, and the fulfillment of the promises that have been made to them by the government, are either too "long run" or are not "real" cash obligations. This, in our view, is the height of myopic folly. The baby boomer generation begins collecting social security starting in 2008... a mere **three years** away! Three years after that they start to become eligible for Medicare. The time when the "accrued" obligations start to become "cash" obligations is imminent. It's a burden that **this** generation will have to bear and is no longer something that can be passed on to our children.

We find it ironic that the Bush administration, after having embarked on one of the most reckless tax cuts and spending binges in history, is only now starting to realize the extent to which America's financial future is in peril. Both Bush and Cheney have been recently making headlines pounding the table on pension reform. As is typical of politicians, they waited until after the election to state the obvious: Houston, we have a problem. But although they are singling out Social Security as the culprit, an even bigger problem is Medicare, which has a present value of obligations that is double that of Social Security. Ironically, the Medicare Prescription Drug Plan enacted last year by the Bush administration alone added \$6.3 trillion to the Medicare total. This, of course, was done before the election to win the vote of the seniors. Make promises before the election... sound the alarm afterwards... but in the end do nothing. Do we have any confidence that this financial catastrophe can be averted? Sadly, it is all too clear that the nature of American politics is such that there is absolutely no political appetite to deal with this problem. This fact will ensure that it only gets worse year after year until bankruptcy becomes the only option.

One last point we would like to make with regards to the "2004 Financial Report of the United States Government", are the endless qualifications in the audit opinion given by the Comptroller General. For those of you unfamiliar with auditing, a qualified auditor's opinion is a bad thing. If the financials are clean and in accordance with GAAP, then an audit opinion is only a few paragraphs and is unqualified. The Comptroller General's opinion has qualifications galore and runs for 25 pages, citing material accounting deficiencies, weaknesses in internal controls, and even makes mention of the growing fiscal imbalance. If a corporation were to get such a horrendous audit opinion, it would be bankrupt and doomed. There would be public inquiries and lawsuits by shareholders and employees, and the general public would be up in arms. Isn't it strange how we don't hold the governments that manage trillions of our tax dollars to the same standards?

We'll end this piece by taking a fitting quote from the Comptroller General's audit opinion starting on page 35: "In addition, while the size of the nation's long-term fiscal imbalance grew significantly during the fiscal year, the retirement of the "baby boom" generation is closer to becoming a reality. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress will be necessary in order to address the nation's large and growing fiscal imbalance."

The information contained herein may not be reproduced, quoted, published, displayed or transmitted without the prior written consent of Sprott Asset Management Inc. ('SAM'). The opinions expressed are solely those of the author. They are based on information obtained from sources believed to be reliable, but it is not guaranteed as being accurate. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. Any opinions expressed in this report are subject to change without any notice and SAM is not under any obligation to update or keep current the information contained herein. SAM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this report. SAM is the investment manager to the Sprott Canadian Equity Fund, Sprott Gold and Precious Minerals Fund, Sprott Energy Fund, Sprott Hedge Fund L.P., Sprott Hedge Fund LP II, Sprott Bull/Bear RSP Fund, Sprott Opportunities Hedge Fund L.P, Sprott Offshore Fund, Ltd., Sprott Strategic Offshore Gold Fund, Ltd. Important information about these funds, including management fees, other charges and expenses is contained in its simplified prospectus and/or offering memorandum. Please read them carefully before investing. Mutual funds are not guaranteed; their unit values and investment returns will fluctuate. Performance data represents past performance and is not indicative of future performance. Performance comparisons are drawn from sources believed to be accurate. This is not a solicitation.