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MARKETS AT A GLANCE

SPROTT ASSET MANAGEMENT LP

Fooled By Stimulus

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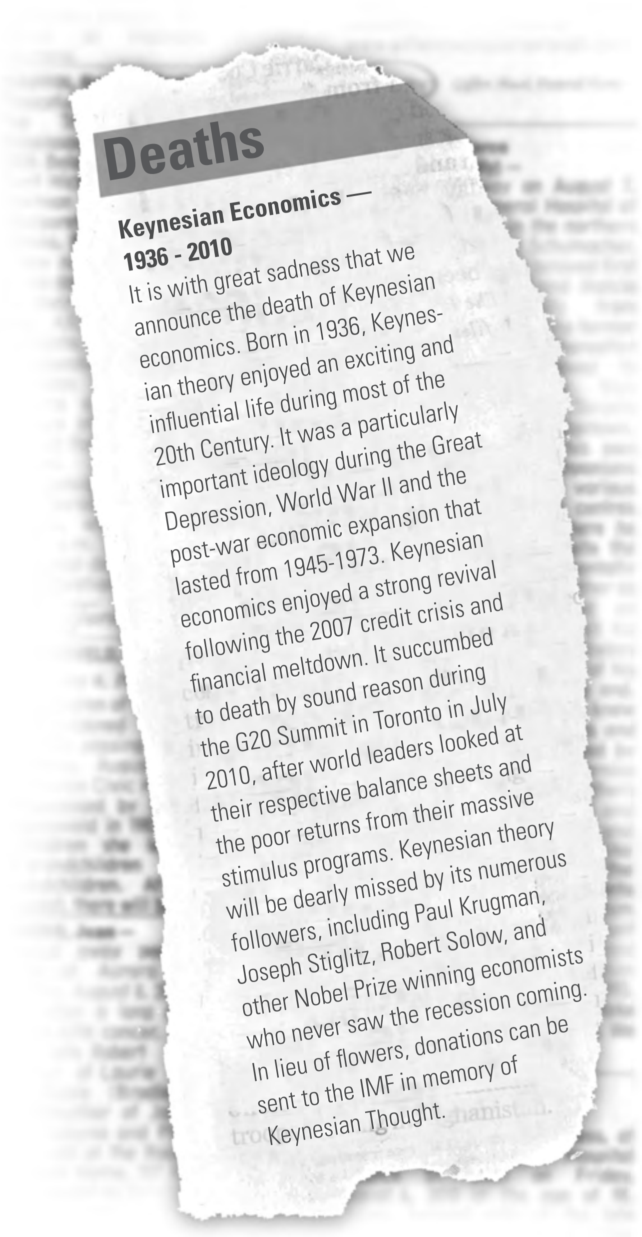

Deaths

Keynesian Economics — 1936 - 2010

It is with great sadness that we announce the death of Keynesian economics. Born in 1936, Keynesian theory enjoyed an exciting and influential life during most of the 20th Century. It was a particularly important ideology during the Great Depression, World War II and the post-war economic expansion that lasted from 1945-1973. Keynesian economics enjoyed a strong revival following the 2007 credit crisis and financial meltdown. It succumbed to death by sound reason during the G20 Summit in Toronto in July 2010, after world leaders looked at their respective balance sheets and the poor returns from their massive stimulus programs. Keynesian theory will be dearly missed by its numerous followers, including Paul Krugman, Joseph Stiglitz, Robert Solow, and other Nobel Prize winning economists who never saw the recession coming. In lieu of flowers, donations can be sent to the IMF in memory of Keynesian Thought.

Despite our firm's history of investing primarily in equities, we've spent much of this past year writing about the government debt market. We've chosen to focus on government debt because we fear its impact on the equity markets as a whole. Government debt is an intrinsically important part of the financial landscape. It is the bellwether by which we measure risk, and we believe we have entered a new era where traditional "risk-free" assets are undergoing a tremendous shift in quality.

In studying the government debt market, we have inadvertently been led to question the economic theory that most fervently justified recent government spending programs: that of Keynesian economics. The so called "beautiful theory" of Keynesian economics is arguably the most influential economic theory of the 20th Century, shaping the way Western democracies approached the balance between free market capitalism and government initiatives. Like many beautiful theories, however, Keynesianism has ultimately succumbed to the ugly facts. We firmly believe the Keynesian miracle is dead. The stimulus programs are simply not producing their desired results, and the future debt costs associated with funding these programs may cause far greater strife in the future than the problems the stimulus was originally designed to address.

Keynesian economics was born with the publishing of John Maynard Keynes' "*The General Theory of Employment, Interest and Money*" in February 1936. Keynesian theory advocates a mixed economy, predominantly driven by the private sector, but with significant intervention by government and the public sector. Keynes argued that private sector decisions often lead to inefficient macroeconomic outcomes, and advocated active public sector policy responses to stabilize output according to the business cycle. Keynesian economics served as the primary economic model from its birth to 1973. Although it did lose some influence following the stagflation of the 1970s, the advent of the global financial crisis in 2007 ignited a resurgence in Keynesian thought that resulted in the American Recovery and Reinvestment Act, TARP, TALF, Cash for Clunkers, Quantitative Easing, etc., all of which have been proven ineffective, ill-advised and whose benefits were surprisingly short-lived.

The economic historian, Niall Ferguson, recently described a 1981 paper by economist Thomas Sargent as the "epitaph for the Keynesian era".[1] It may have been the epitaph in academic circles, but the politicians clearly never read it. Almost thirty years later, we now get to experience the fallout from the latest Keynesian stimulus binge, and the results are looking pretty dismal to say the least.

There are a number of studies we have come across that suggest stimulus is the wrong approach. The first is a 2005 Harvard study by Andrew Mountford and Harald Uhlig that discusses the effects of fiscal policy shocks on the underlying economy. Mountford and Uhlig explain that from the mid-1950's to year 2000, the maximum economic impact of a two percent increase in government spending was an ensuing GDP growth of approximately three percent. A two percent spending increase inevitably requires an increase in taxes. Due to the nature of interest costs, however, the government would have to raise taxes by MORE than two percent in order to pay back the initial borrowing. According to their data, this increase in taxes would generally lead to a **seven percent drop in GDP**. As they state in their study: "This shows that when government spending is financed contemporaneously that the contractionary effects of the tax increases outweigh the expansionary effects of the increased expenditure after a very short time."[2] Stated simply, 'borrowing to stimulate' has never worked as planned because the cost of paying back the borrowed funds surpassed the immediate benefits of the stimulus.

In a follow-on study, Harald Uhlig estimated that an approximate $3.40 of output is lost for every dollar spent on stimulus.[3] Another study on the same subject by C'ordoba and Kehoe (2009) went so far as to say that, "massive public interventions in the economy to maintain employment and investment during a financial crisis can, if they distort incentives enough, lead to a great depression."[4]

If the conclusions of these studies are even close to being correct, we are now in quite a predicament – not just in the US, but across the Western world. Remember that the 2007-08 meltdown was only two years ago, and as we highlighted in April 2009 in "*The Elephant in the Room*", the US government has spent more on stimulus and bailouts, in percentage of GDP terms, than it did in the Gulf War, Operation Iraqi Freedom, the Vietnam War, the Korean War and World War I combined.[5] All that spending was justified by the understanding that it would generate sustainable underlying growth. If it turns out that that assumption was wrong, have the governments made a fatal mistake?

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1 Ferguson, Niall (July 19th, 2010) "Today's Keynesians have learnt nothing". *Financial Times*. Retrieved on August 10, 2010 from: http://www.ft.com/cms/s/0/270e1a6c-9334-11df-96d5-00144feab49a.html?ftcamp=rss

For those interested readers "The Ends of Four Big Inflations" by Thomas Sargent can be found at: http://www.minneapolisfed.org/research/WP/WP158.pdf

2 Mountford, Andrew and Uhlig, Harald (July 2005) "What are the Effects of Fiscal Policy Shocks" SFB 649 Discussion Paper Humboldt-Universität zu Berlin. Retrieved on August 10, 2010 from: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.88.592&rep=rep1&type=pdf, pg. 20

3 Boskin, Michael. (July 21, 2010) "Obama's Economic Fish Stories" *The Wall Street Journal*. Retrieved on August 10, 2010 from: http://online.wsj.com/article/SB10001424052748703724104575378751776758256.html

4 Uhlig, Harald (May 15, 2009) "Some Fiscal Calculus" Unpublished. Pg 13. Retrieved on August 10, 2010 from: http://www.princeton.edu/economics/seminar-schedule-by-prog/macro-s09/monetary-fiscal-policy-co/schedule/pdfs/uhlig_FiscalCalculus_v2.pdf

5 Sprott Asset Management, Markets at a Glance April 2009. The Elephant in the Room.

Another recently published Harvard study looked at stimulus at a micro-economic level and derived some surprising conclusions. Entitled "*Do Powerful Politicians Cause Corporate Downsizing*?", the authors compiled 232 occasions over the past 42 years when either a Senator or a Representative was voted into a controlling position over a big-budget congressional committee. Unsurprisingly, the ascendancy of the politicians resulted in extra spending in their respective districts – typically in the form of an extra US$200 million per year in federal funds. The researchers examined the economic effects of this increase in spending and found "strong and widespread evidence of corporate retrenchment in response to government spending shocks." The average firm cut back on capital investment by 15 percent and significantly reduced its R&D spending. Companies collectively operating in the affected state reduced capital investment by $39 million a year and R&D by $34 million per year. Other consequences included increases in unemployment and declines in sales growth.[6,7] Yikes!! That is not the response we're supposed to get from government spending!

The Canadian government's experience with Keynesian-style stimulus has been no better. The Fraser Institute reviewed the impact of the Government of Canada's "*Economic Action Plan*" and found that "the contributions from government spending and government investment to the improvement in GDP growth are negligible."[8] They state that, of the 1.1% increase in economic growth between the second and third quarter of 2009, government consumption and government investment contributed a mere 0.1%. Of the 1% improvement in economic growth between the third and fourth quarter of 2009, government investment and consumption contributed almost nothing. In the end, it was actually net exports that were the largest contributor to Canada's growth. No Keynesian miracle in this country.

Our own findings compare favourably to the academic studies cited above. We looked at government spending and current dollar GDP increases in our 'Markets at a Glance' entitled, "*A Busted Formula*". Our findings, using decidedly un-econometric techniques, showed similar results, and are presented in Table A below. We looked at current dollar increases in GDP as published by the Bureau of Economic Analysis (BEA) and current dollar expenditures and receipts for the US government taken from the Treasury. One current deficit dollar resulted in an increase in current dollar GDP of a mere 10 cents. Again - no miracle Keynesian multiplier here.

Table A

Stimulus and Deficit Impact on Economy[9]

	2008	2009	Q1 2010	Net Impact
GDP Change[3]	$363,800,000,000	($185,100,000,000)	$36,900,000,000	$215,600,000,000
US Federal Revenue[4]	$2,464,813,000,000	$2,044,758,000,000	$466,119,000,000	
US Outlays	$3,145,282,000,000	$3,516,053,000,000	$795,048,000,000	
Cash Flow Deficit	**($680,469,000,000)**	**($1,471,295,000,000)**	**($328,929,000,000)**	**($2,480,693,000,000)**

6 Reynolds, Neil. (June 9, 2010) "The Hidden cost of Stimulus programs" *The Globe and Mail*. Retrieved on August 10, 2010 from: http://www.theglobeandmail.com/report-on-business/commentary/neil-reynolds/the-hidden-cost-of-stimulus-programs/article1596810/

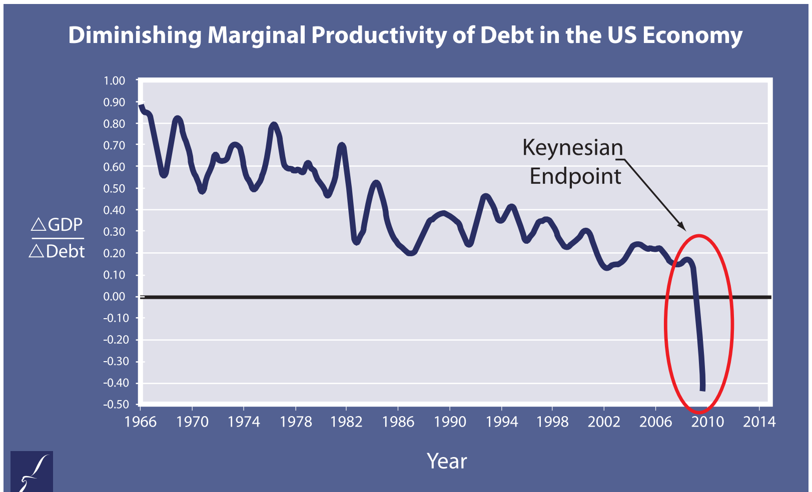
7 Cohen, Lauren; Coval, Joshua; Malloy, Christopher. (March 16, 2010) "Do Powerful Politicians Cause Corporate Downsizing?" Unpublished. Retrieved on August 10, 2010 from: http://www.people.hbs.edu/cmalloy/pdffiles/envaloy.pdf

8 Amela Karabegovic, Charles Lammam, Niels Veldhuis (March 23, 2010) "Did Government Stimulus Fuel Economic Growth in Canada? An analysis of Statistics Canada Data" *Fraser Institute*. Retrieved on August 10, 2010 from: http://www.fraserinstitute.org/publicationdisplay.aspx?id=15912&terms=stimulus

9 We used current-dollar GDP numbers provided by the BEA to determine the marginal impact of deficit spending on GDP. There is no separate data set generated by the BEA, however the number is published in their news releases. It is also worth noting the divergence between reported numbers from the BEA. While the current dollar measurement of GDP decreased by $185.1 billion or 1.3% on 2009, real GDP was widely reported as increasing by 0.1%. This divergence is due to seasonality adjustments in real GDP and the percentage change reported is a blended increase over the 4 quarters in 2009.

If we use the Fed's own numbers, the impact of debt on GDP is even more dismal. In Chart B below, we present the marginal impact of debt on marginal GDP since 1966 using data from the Federal Reserve. Deficit spending, which has generated smaller and smaller increases in GDP over time, is now generating a **negative impact on GDP** due to the costs of servicing the debt. The chart suggests we have already entered what PIMCO refers to as the "Keynesian endpoint", where the government can no longer afford to increase debt levels.[10] No debt = no stimulus. No stimulus = ???

Chart B



Source: Federal Reserve, Bureau of Economic Analysis & Sprott Asset Management LP

A more timely epitaph for our Keynesian funeral comes from a recent op-ed piece by Jean-Claude Trichet, President of the European Central Bank, that was published in the Financial Times and entitled "Stimulate No More". In it Trichet states that, "…the standard economic models used to project the impact of fiscal restraint or fiscal stimuli may no longer be reliable."[11] He explains that while debt in the euro zone has increased by more than 20 percent in only four years and by 35 to 40 percent over the same time period in the US and Japan, we have very little, if anything, to show for it. We agree. New housing sales are at all time lows, consumer intentions for auto purchases are at multi year lows, the University of Michigan consumer confidence index has turned negative, new jobless claims have started to increase, and the ECRI - a composite of leading indicators - is now forecasting a recession (see Chart C).

Since Keynesian economics is no longer relevant, some are now arguing that tax cuts will save the day. Two of the academic studies we reviewed suggest that tax relief is a much stronger stimulus to the economy than government spending, and under normal circumstances this is probably true. But we are not in a normal economic environment. Even if the tax cuts implemented by George Bush in 2006 are extended by the next Congress, the US will still face the 'Keynesian Endpoint'. A Government Accountability Office (GAO) report published in January 2010 states the following: "In our Alternative simulation, which assumes expiring tax provisions are extended through 2020 and revenue is held constant at the 40-year historical average; roughly 93 cents of every dollar of federal revenue will be spent on the major entitlement programs and net interest costs by 2020."[12] Extending tax cuts won't solve anything.

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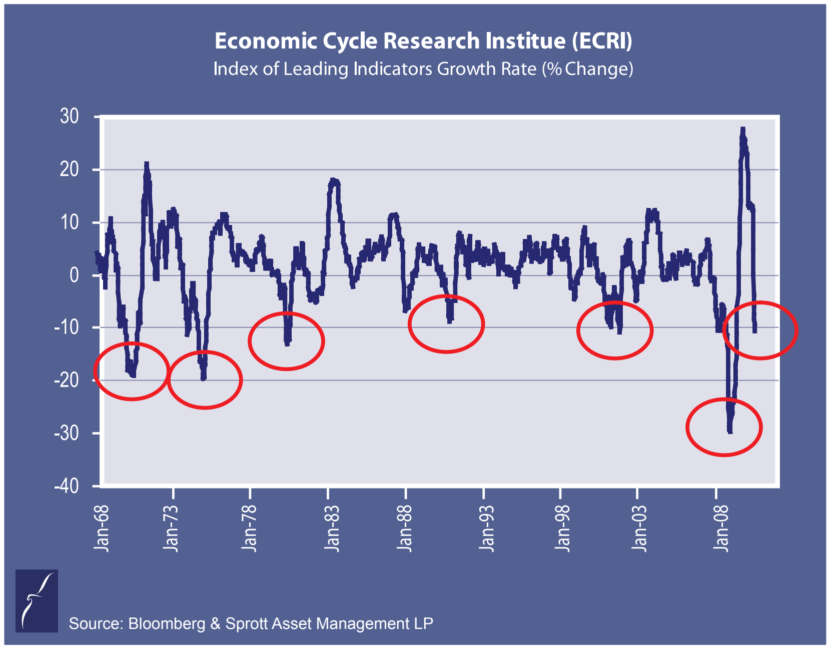
10 Goodman, Wes and Reynolds, Garfield (June 8, 2010) "Pimco's Crescenzi Sees 'Endpoint' in Devaluations (Update2)" *Bloomberg*. Retrieved on August 10, 2010 from: http://www.businessweek.com/news/2010-06-08/pimco-s-crescenzi-sees-endpoint-in-devaluations-update2-.html

11 Trichet, Jean-Claude. (July 22, 2010) "Stimulate no more – it is now time for all to tighten" *Financial Times*. Retrieved on August 10, 2010 from: http://www.ft.com/cms/s/0/1b3ae97e-95c6-11df-b5ad-00144feab49a.html

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

Chart C



In the end, Keynesian stimulus ultimately fooled us all. It roped in the politicians of the richest countries and set them on an unsustainable course of debt issuance. Recent Keynesian stimulus has even managed to fool the sophisticated economic models designed by central banks. The process of accounting for massive government spending 'confuses' the models into calculating a recovery trajectory when it doesn't exist. The Bank of England confirmed this with its announced £3.5 million overhaul of its current model due to its inability to generate accurate inflation and recession forecasts.[13]

Keynesian stimulus can't be blamed for all our problems, but it would have been nice if our politicians hadn't relied on it so blindly. Debt is debt is debt, after all. It doesn't matter if it's owed by governments or individuals. It weighs on the institutions that issue too much of it, and the ensuing consequences of paying off the interest costs severely hinders governments' ability to function properly. It suffices to say that we need a new economic plan – a plan that doesn't invite governments to print their way out of economic turmoil. Keynesian theory enjoyed a tremendous run, but is now for all intents and purposes dead… and now it's time to pay for it. Literally.

13 Aldrick, Philip (August 10, 2010) "Bank of England overhauls forecast model after errors" *Telegraph*. Retrieved on August 11, 2010 from: http://www.telegraph.co.uk/finance/economics/7935732/Bank-of-England-overhauls-forecast-model-after-errors.html

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