Sprott Asset Management LP

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It's the *real* economy, stupid

MARKETS AT A GLANCE

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We are now in the early stages of a depression. The economic indicators we follow to track *real* economic activity are all signaling a slowdown of massive proportions. You wouldn't know it reading the mainstream papers of course – they all focus on the relative decline in the slowdown's intensity. Reading about the slowdown 'slowing down' is not the same as growth however, and does not warrant excitement in our opinion.

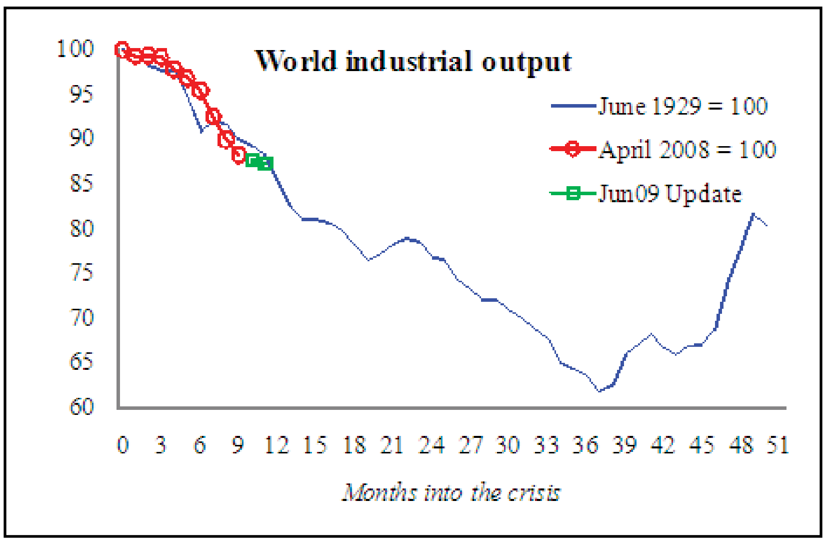
Our title this month paraphrases one of Bill Clinton's presidential campaign messages from 1992. As one of the three key themes in Clinton's campaign, "The economy, stupid" was printed on a sign in his headquarters in Little Rock to help campaign workers stay on message. This month we're keeping it simple by focusing on the real economy and its implications for the stock market.

Here is the real economy summarized in numbers:

Industrial Capacity Collapse:

- US industry used only 68.3% of available capacity in May 2009, according to a monthly report from the Federal Reserve.[1] That represents almost one third of all US industrial capacity sitting idle. Prior to the current recession, the lowest rate recorded since the Fed started this series of records in 1967 was 70.9% in December 1982.[2]
- CHART A depicts worldwide industrial production in a comparison between April 2008 and June 1929.[3] Very similar trajectories.

CHART A



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[1] Federal Reserve Statistical Release, Industrial Production and Capacity Utilization – G.17 (June 16, 2009). Retrieved on July 10, 2009 from: http://www.federalreserve.gov/releases/G17/Current/default.htm
[2] Gallagher, Thomas (June 16, 2009). Industrial Capacity Use Hits Record Low. Retrieved on July 10, 2009 from: http://www.joc.com/node/411908
[3] Eichengreen, Barry and O'Rourke (June 4, 2009) A Tale of Two Depressions. Retrieved on July 10, 2009 from: http://www.voxeu.org/index.php?q=node/3421

Government Tax Revenue Declining:

- 32 of the 46 states whose fiscal year ended midnight July 1, 2009, did not have budgets signed by their Governors. States are grappling with deficits totaling a collective $121 billion, and all states but Vermont require that their budgets be balanced.
- Personal income tax, which accounts for more than a third of state revenues, dropped by 26% in the first four months of 2009, according to the Albany, New York – based Rockefeller Institute of Government. [4]
- The US government has spent $2.67 trillion thus far in fiscal 2009, but has only collected $1.59 trillion.
- The US government collected $685.5 billion in individual income taxes so far this year, a 22% drop from the $877.8 billion the government took in during the first nine months of 2008.
- US corporate income taxes plunged 57% to $101.9 billion in 2009, down from $236.5 billion in the first nine months of fiscal year 2008.[5]

Retail Sales Slump:

- The International Council of Shopping Centers (ICSC)/Goldman Sachs same-store sales tally for June was down 5.1% from June 2008, worse than the latest forecast for a 4.5% decline.
- Privately held luxury department store Neiman Marcus Group Inc. posted a 20.8% drop in same-store sales. Abercrombie & Fitch Co.'s same-store sales fell 32%, even more than the 26.6% decline Wall Street had projected. [6]

Unemployment Catastrophe:

- The June 2009 jobless rate reached 9.5%, the highest since 1983.
- 4 million Americans have been looking for work for more than 26 weeks, representing 29% of the unemployed – the most since records began in 1948.
- During the last 30 years, Americans who lost their jobs took an average 15.8 weeks to find new positions. In June 2009, the average duration of unemployment was 24.5 weeks, the longest since records began in 1948.
- The number of people collecting unemployment benefits reached a record 6.88 million in the week ended June 27, 2009.
- Approximately six people are seeking work for every job opening, the most since the government began keeping such records in 2000. A year ago, the ratio was a little more than two-to-one.[7]

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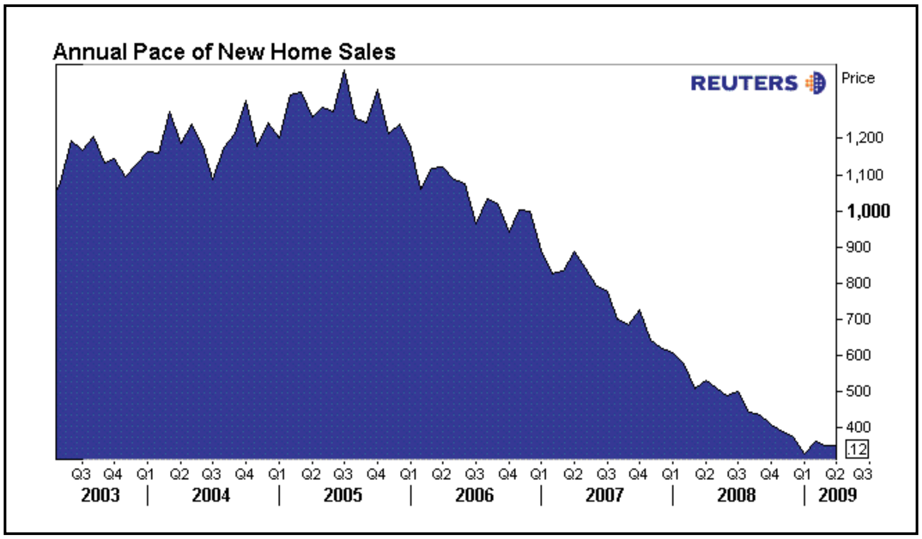
[4] Randall, Kate (July 1, 2009). US states budget crisis fuel massive spending cuts. Retrieved on July 10, 2009 from: http://www.wsws.org/articles/2009/jul2009/budg-j01.shtml
[5] Clifford, Catherine (July 13, 2009). Uncle Sam is $1 trillion in the hole. Retrieved on July 13, 2009 from: http://money.cnn.com/2009/07/13/news/economy/treasury_budget/?postversion=2009071315
[6] D'Innocenzio, Anne (July 10, 2009). Weak retail sales in June raise worries. Retrieved on July 11, 2009 from:http://www.google.com/hostednews/ap/article/ALeqM5jEUOBuLQexhEw6Sbb1sU7mSLR6iAD99B0MO01
[7] Miller, Rich (July 10, 2009). Obama's Jobless Safety Net Torn by Rebecca Alvarez (Update1). Retrieved on July 11, 2009 from: http://www.bloomberg.com/apps/news?pid=20601109&sid=atnjG1uvDprY

US Housing Market Failure:

- The annual pace of new home sales is now 342,000, a whopping 32.8% below the rate in May 2008. At the current sales pace, there is 10.2 months worth of inventory overhang sitting on the market, dragging down prices and encouraging potential buyers to wait it out as prices deflate.[8]
- New home sales are down 73% from the all time high of 1,283,000 new homes sold in 2005 (mild recession?). See Chart B.[9]

CHART B



Rail Car Loadings Suffering:

- For the first 26 weeks of 2009, US railroads reported cumulative volume of 6,806,892 carloads, down 19.2% from 2008.[10] An excellent quote included in the June report from the Association of American Railroads stated: "Whenever Americans grow something, eat something, mine something, make something, turn on a light, or get dressed, freight railroads are probably involved somewhere along the line. Unfortunately, right now there's not enough mining, manufacturing and buying going on. So railroads, like most other business sectors, are suffering because of it."[11]
- Carloads are down 22.5% from the all time high set in the first 26 weeks of 2006.[12]

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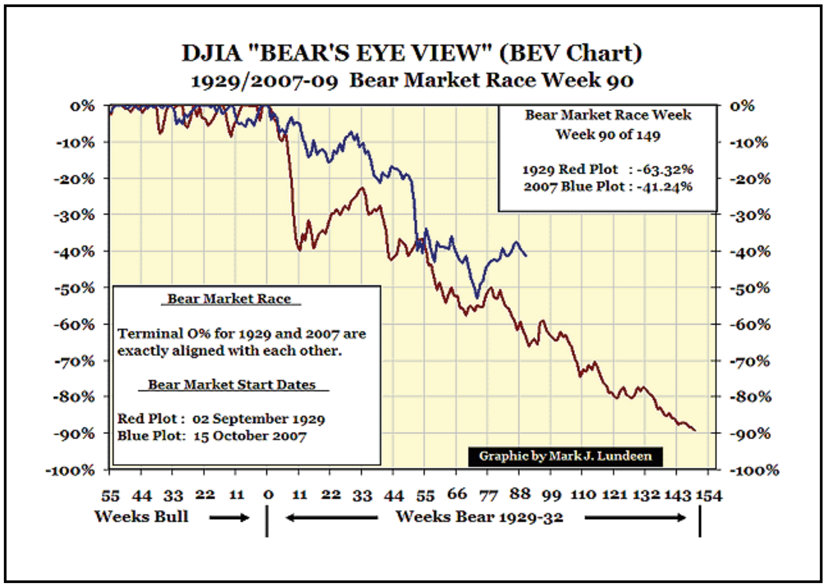
[8] New Home Sales Stagnate. April Revisions Mitigate May Decline. Retrieved on July 10, 2009 from: http://www.mortgagenewsdaily.com/06242009_new_home_sales_stagnate_april_revisions_mitigate_may_decline.asp
[9] US Census Bureau – New Residential Sales. Retrieved on July 13, 2009 from: http://www.census.gov/const/soldann.pdf
[10] American Association of Railroads (July 9, 2009). Rail Freight Traffic Remains Down During Holiday Week. Retrieved July 10, 2009 from: http://www.aar.org/NewsAndEvents/PressReleases/2009/07_WTR/070909_Traffic.aspx
[11] American Association of Railroads (July 2, 2009). Rail Freight Traffic Down in June. Retrieved on July 10, 2009 from: http://www.aar.org/NewsAndEvents/PressReleases/2009/07_WTR/070209_Traffic.aspx
[12] American Association of Railroads (July 6, 2006). Led by Coal and Intermodal, U.S. Rail Traffic Up in June. Retrieved on July 14, 2009 from: http://www.aar.org/NewsAndEvents/PressReleases/2006/07/Led%20by%20Coal%20and%20Intermodal%20U,-d-,S,-d-,%20Rail%20Traffic%20Up%20in%20June.aspx

Dow Jones Industrial Average:

- Chart C below plots a return comparison of the Dow Jones Industrial Average between 1929 and 2007. Another frightening comparison to 1929.[13]

CHART C



The big question now is what effect all this bad data will ultimately have on the stock market. Stock valuation can often be wonderfully complex – but it ultimately rests on two main foundations: earnings and investor sentiment. The 'earnings' component is concrete; it is a stream of profits that companies expect to generate in the future for their shareholders. The 'investor sentiment' component, however, is not concrete. It dictates what investors are willing to pay to buy corporate earnings, and can fluctuate widely depending on perceptions of future growth. The relationship between these two components is vital in gauging market direction. The price-earnings (P/E) ratio is the classic investment fraction that combines these two factors into a usable metric. It deserves mention here because its analysis helps to illustrate the point we are trying to make.

In Chart D, we provide data by Robert Shiller that plots the *real, inflation-adjusted* P/E ratio of the S&P 500 stock index from January 1900 to June 2009.[14] As the chart illustrates, as at the end of June 2009, the S&P 500 traded at an inflation adjusted P/E ratio of 16.08, implying that investors were willing to pay an average of 16 times earnings for a share in the S&P 500 index.[15] Sixteen times earnings is well below the all time, inflation-adjusted high of December 1999 (44 times), but also well above the lows of 1932 (5.57) and 1982 (6.64). As it turns out, 16 times is almost exactly at the 109-year monthly average P/E ratio – so stocks are trading at their long-term *average* P/E level in the current environment.

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[13] Lundeen, Mark J. (July 3, 2009). Bear Markets and Horror Movies. Retrieved on July 10, 2009 from: http://www.gold-eagle.com/editorials_08/lundeen070509.html
[14] Shiller, Robert J (2005) Irrational Exuberance [Princeton University Press 2000, Broadway Books 2001, 2nd ed., 2005]. Data set downloaded on July 3, 2009 from: http://www.econ.yale.edu/~shiller/data.htm
[15] Bloomberg reports the P/E for the S&P 500 Index in June 2009 as 14.58. The discrepancy to Shiller's data is for several reasons: a) Shiller reports using June 10 closing data b) Shiller uses a rolling average value for Real Earnings when calculating the P/E ratio c) Shiller uses extrapolation for estimates of the CPI data when calculating real earnings for June 2009. Despite these minor variances, we found this publicly available data set to be the most complete comprehensive historical review of P/E ratios.

CHART D

If this is average – how low is low if investors turn their backs on stocks? There's the real economy which generates the earnings, and then there's the investor sentiment/perception which dictates the multiple they are willing to pay for those earnings. We already know that the real economy is in severe decline. What happens if investor sentiment changes? We assess three scenarios below:

1. Earnings stay constant; P/E ratios hit cycle lows: We assume a scenario where investors are nervous, people need to sell stocks to pay for lost wages, or for retirement, but the companies continue to perform as of June 2009. Assuming a P/E of 6, which is close to the all time low, and using an earnings value of $63.04 for the S&P 500 Index, we derive an S&P 500 Index value of 378.[16]

2. Earnings get halved; P/E stays constant: Earnings have been half of their current value three times over the last 30 years – so it is entirely within the realm of possibility that they could be halved once again. In the late 1970's, early 1980's and early 1990's the S&P 500 Index generated half the earnings per share that it did this year in 2009 dollars. Using today's P/E multiple of 16.08 results in an S&P 500 value of 506.

3. Earnings get halved; P/E ratios hit cycle lows: double trouble. If we combine these cases where earnings are cut in half from today and the P/E ratio drops to a cycle low, it implies an S&P 500 Index value of 189 (depression territory).

What about inflation? All three of the above scenarios are calculated using 2009 dollars. Doing so adjusts for the effects of inflationary periods over the last 109 years and allows for the historical comparisons we have discussed. As we mentioned, a stock price is based on pricing the future stream of a company's profits. Over the long-term, inflation erodes the value of those earnings and with it the multiple that investors are willing to pay for them - ultimately lowering the value of stocks.

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[16] Bloomberg S&P 500 earnings per share for June 2009 not included in Shiller dataset.

CHART E

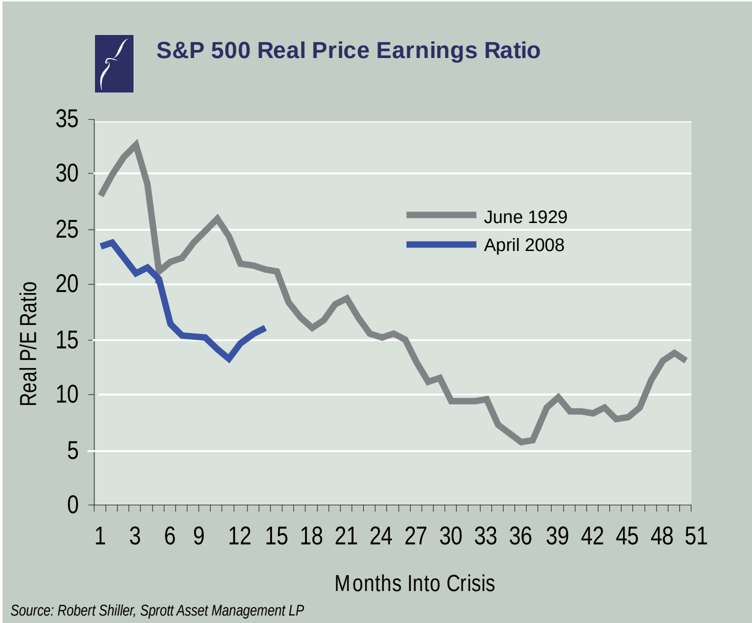

Chart E plots the real P/E ratio of the S&P 500 Index fifty months out from 1929 and compares it to the recent real P/E ratio performance from April 2008 to June 2009. We find the similarity between the 2008 economic collapse and the 1929 economic collapse disturbing. Don't get sucked in… the real economy is still struggling and the market has yet to reflect this. In 1932, the Dow Jones Industrial Average bottomed 90% below the September 1929 peak. The S&P 500 Index peaked in October 2007 at 1,576, and from our brief analysis above we can easily calculate a drop in the S&P 500 of as much as 88% from that peak using our 'double trouble' scenario. At the very least, under all of our scenarios it appears that the S&P 500 Index will test the March 2009 low of 666. Judging by the continued declines we are seeing in the real economy, we expect that test to happen sooner rather than later.

In our view, the only thing propping this market up is investor sentiment. Earnings have not improved. Keep it simple, stupid - investing is and has always been about the *real* economy, and this market is ignoring the hard data. You can invest in sentiment if you want to, but as we have said before, we prefer to invest in *real* things.

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