

# MARKETS AT A GLANCE

Sprott Asset Management<sup>LP</sup>

## The Financial System is a Farce: Part Three

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2011 was a merry-go-round of more bailouts, more deferrals and more denial. Everyone is tired of the Eurozone. It's not fixable. There's too much debt. The politicians don't know what's going on. Nothing has structurally changed. We're still on the wrong path. There's more global debt than there was a year ago, and it's the same old song: extend and pretend, extend and pretend,... around and around we go,... and it isn't fun anymore.

Just as we wrote back in October 2007, and again in September 2008, we feel compelled to state the obvious: that the financial system is a farce. It's a complete, cyclical farce that defies all efforts to right itself. This past year continued the farcical tradition with some notable scandals, deferrals and interventions that underscored the system's continuing addiction to government interference. With the glaring exception of US Treasuries and the US dollar (which are admittedly two of our least favourite asset classes), it was not a year that rewarded stock picking or safe-haven assets. Many developments during the year bordered on the ridiculous, and despite some positive news out of the US, we saw little to test our bearish view. If anything, our view was continually re-affirmed.

Let's start with MF Global. With more than two months passed since the scandal broke, federal officials are still unable to find the estimated US\$1.2 billion of missing customer funds.<sup>1</sup> The whole episode has been a disaster for the CME, the self-regulatory body in charge of making sure the futures brokers play by the rules. Normally in instances of broker bankruptcy, the CME is supposed to backstop client accounts and keep them liquid – i.e., allow them to continue trading while the bankruptcy gets settled. It never happened in this case. Client accounts were frozen for weeks. Funds have remained missing for months – an eternity for clients who were caught short. The great shock was watching how inept and incapable the CME was in 1) preventing the fraud in the first place and 2) recovering client assets during the aftermath. The CME essentially copped out of their responsibility, offering little more than some perfunctory press releases along the way. They were also surprisingly quick to offer excuses for their non-action. According to CME, it really wasn't their fault, since CME had "no control over the disposition of customer segregated funds that are held by MF Global and not by CME Clearing."<sup>2</sup> Their on-site review of MF Global's operations the week before its bankruptcy suggested that the brokerage firm was in full compliance of all the rules, so it wasn't really the CME's problem. But of course it was their problem. That's what the CME is there for – to protect clients in cases of fraud or bankruptcy. To protect the "integrity of the exchange"

1 Associated Press (January 11, 2011) "MF Global trustee will meet with customers". The Wall Street Journal. Retrieved January 11, 2012 from: <http://online.wsj.com/article/APcb5dba3691894bb4a61b19357ebe8824.html>

2 CME Group (November 6, 2011) "CME Group Statement Regarding MF Global". CME Group. Retrieved January 5, 2012 from: <http://cmegroup.mediaroom.com/index.php?s=43&item=3202&pagetemplate=article>

In the weeks that have passed, a curious web of transactions have surfaced between MF Global, JP Morgan and Goldman Sachs. Before its bankruptcy, MF Global had been drawing down a \$1.2 billion revolving line of credit with JP Morgan. In bankruptcy court, JP Morgan was able to negotiate a lien on some of MF Global's assets in exchange for paying \$8 million towards bankruptcy costs. According to Reuters, "The lien puts JPMorgan's interests ahead of MF Global customers who have not yet received an estimated \$900 million worth of money from their accounts, which remain frozen as regulators search for missing funds."<sup>3</sup> It is also alleged that JP Morgan accepted a roughly \$200 million transfer from MF Global the day before its bankruptcy to cover an overdraft in MF Global's trading account held with them (it still isn't clear if JP Morgan has the cash).<sup>4</sup> MF Global also appears to have sold hundreds of millions worth of securities to Goldman Sachs in the days leading up to its collapse, but did not immediately receive payment for them from the MF Global's clearing firm, none other than JP Morgan.

To be fair, on November 22nd, the CME did offer to pledge \$550 million as a guarantee to the SIPC Trustee in the event that they did not recover all of the missing client funds, but we cynically wonder if that pledge was made after they finally figured out where all the money had gone. The CME seems to have had a good idea by early December, based on comments made by Commodity Futures Trading Commission (CFTC) member, Jill Sommers.<sup>5</sup> The bottom line is that MF Global's client interests and security appear to have been side-stepped to buy time for bigger, more important players to cover their losses (asses), and that is not the way the regulatory system is supposed to function. We're not naïve – we know the government will always protect the interests of the big banks over paltry retail investors, but do they have to be so brazen about it? The MF Global episode is basically shameless.

Then there's Dodd-Frank. Remember Dodd-Frank? It's the massive financial regulatory reform act that was signed into law by President Obama back in 2010. We are certainly not fans of cumbersome overregulation, but in its essence, Dodd-Frank was supposed to provide a new framework to address the potential failure of a too-big-to-fail bank. There's nothing wrong with that. Given the sheer size of the off-balance sheet derivatives market, we don't see a problem with at least attempting to prepare for another large scale banking failure in the US. But almost two years later, we have to laugh at how little of the Dodd-Frank framework has actually been implemented. According to law firm Davis Polk, a mere 21% of the act's 400 rulemaking requirements have become finalized since the law passed in July 2010. Of the 200 Dodd-Frank rulemaking requirement *deadlines* that have already passed, 74.5% of them have been missed to date.<sup>6</sup> The lawyers must be having a field day with all the paperwork.

One part of the Dodd-Frank story that interests us is the CFTC positions limits rule set to go into effect on January 17, 2012. The new position limits are aimed at preventing excessive speculation in the commodity markets which are believed by many, including ourselves, to have driven wild fluctuations in the gold and silver spot price over the past decade. Position limits are an obvious threat to large futures speculators like the big banks, so it was no surprise when two Wall Street lobby groups, the Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association (ISDA) launched a lawsuit against the CFTC demanding that the new rules on commodity trading be thrown out, or at the very least, delayed. The CFTC voted on the request to delay implementation and officially rebuffed it on January 4th, which is a heartening development in an otherwise cynical saga.<sup>7</sup> Back in December, however, the CFTC had already quietly waived the position limit filing requirements on all CME participants until May 31, 2012.<sup>8</sup> So even if the new rules go into effect this month, banks won't have to report their position levels until May 31st either way. Given the lobby groups' outstanding lawsuit against the new rules, combined with the CFTC's apparent tendency to grant temporary reprieves, we don't expect the new position

3 LaCapra, Lauren Tara and Goldstein, Matthew (January 3, 2012) "MF Global sold assets to Goldman before collapse: sources". Reuters. Retrieved January 5, 2012 from: <http://www.reuters.com/article/2012/01/04/us-mfglobal-goldman-idUSTRE80301V20120104>

4 Patterson, Scott and Lucchetti, Aaron (December 21, 2011) "MG Global Transfer Draws Scrutiny". The Wall Street Journal. Retrieved January 5, 2012 from: <http://online.wsj.com/article/SB1000142405297020405840457110761665602648.html>

5 Roeder, David (December 15, 2011) "Regulator: We know where MF Global cash went". Chicago Sun-Times. Retrieved January 5, 2012 from: <http://www.suntimes.com/business/9447562-420/regulator-we-know-where-mf-global-cash-went.html>

6 (January 3, 2012) "Dodd-Frank Progress Report". Davis Polk. Retrieved January 5, 2012 from: <http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/>

7 Protes, Ben (January 4, 2012) "New Limits on Commodity Trades Are Approved". DealBook. Retrieved January 6, 2012 from: <http://dealbook.nytimes.com/2012/01/04/regulator-refuses-to-delay-trading-rule/>

8 CME Group Market Regulation Department (December 20, 2011) "Temporary Waiver of Annual Update for Position Limit Exemptions". CME Group. Retrieved January 5, 2012 from: [http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/CMEGroup\\_RA1107-5.html](http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/CMEGroup_RA1107-5.html)

limit rules to be enforced any time soon. Once summer approaches, there will probably be more delays and more deferrals, granting the big players plenty of time to protect themselves. Extend and pretend. Delay and defer. That's the song we sing on the merry-go-round.

Then there's Europe and the European Central Bank (ECB). Back in December, the mighty ECB had to step in with yet another massive liquidity injection to avert a total meltdown in the EU banking system. On December 21st, they flooded 523 separate EU banks with a "Long Term Refinancing Operation" (LTRO) program totaling €489.1 billion (\$626 billion).<sup>9</sup> The program consists of loans that are due in three years and will charge an accommodating 1% interest rate. The liquidity injection will allow the EU banks to participate in a delightfully convenient carry-trade whereby they can take the borrowed money at 1% interest and invest it in various sovereign debt auctions that will likely pay them 3% or higher. The banks will keep the difference in profit, and the EU PIIGS countries get to breathe easier knowing they'll be able to sell their garbage paper to the EU banks at suppressed rates as long as the LTRO loan money lasts. And the best part? It doesn't involve any money printing, so there's really no risk of inflation, you see?

So just so we're on the same page, if everything goes according to plan this year, European sovereign governments will fund their debt auctions with borrowed money lent to them by over 500 European banks who have themselves borrowed hundreds of billions of euros from the European Central Bank, ... who as far as we can tell, borrowed those euros from the various EU sovereign states (or simply printed them). Do you get it? Do you see the circularity? Do you see the can being kicked down the road? And guess what? Since €489.1 billion is clearly not enough to avert disaster this year (most EU banks are so undercapitalized they've simply parked the borrowed LTRO money back with the ECB at 0.25% interest), the ECB has promised to launch another LTRO injection this coming February!<sup>10</sup> No wonder gold was down in December. They completely solved the European debt crisis!

Last but not least, we must mention an alarming component of this year's National Defense Authorization Act (NDAA) that was quietly signed into law by President Obama on December 31st, 2011. This year's defense bill, officially known as Senate Bill 1867, includes a specific provision that seems to grant the US government the power to detain accused terrorists, including US citizens, **indefinitely, without trial**.<sup>11,12</sup> There has been much uproar and confusion over the language used in the sections of the Bill related to the subject, and it's still not clear how the Bill will change the existing laws related to terrorism detention in the US, but it doesn't bode well for constitutional freedom within the country. There's obviously no direct market impact to the legislation, but we mention it only to remind investors how quickly the rules can change when governments feel vulnerable. 'Political risk' should no longer only be applied to mining investments in third world countries. In 2012, it may apply to us all.

It's very difficult to predict what lies in store for the stock market this year. Anything could happen. Government intervention in the financial system has never been more extreme. We hope the examples above have shed some light on that. As we enter 2012, there are significant debt-related financial risks festering within the three great economic theatres of the world: the US, Europe and China. The market may rally, it could crash, it could tread water, we just don't know. A lot will depend on how the central banks react. But we are eager to maintain the positioning that we held in 2011. We will maintain our exposure to precious metals equities and bullion. We will maintain our large gross short weightings in our hedge funds. We are confident that they will protect us on this farcical merry-go-round that seems to spin faster and faster with every passing day. 🚩

*For more information about Sprott Asset Management's investment insights and award-winning investment capabilities, please visit [www.sprott.com](http://www.sprott.com).*

9 Jones, Marc (December 21, 2011) "Banks gorge on ECB loans, market cheer short-lived". Reuters. Retrieved January 11, 2012 from: [http://www.reuters.com/article/2011/12/21/us-ecb-3yr-loans-idUSTRE7BK0MC20111221?feedType=RSS&feedName=businessNews&utm\\_medium=feed&utm\\_campaign=Feed%3A+reuters%2FbusinessNews+%28News+%2F+US+%2F+Business+News%29](http://www.reuters.com/article/2011/12/21/us-ecb-3yr-loans-idUSTRE7BK0MC20111221?feedType=RSS&feedName=businessNews&utm_medium=feed&utm_campaign=Feed%3A+reuters%2FbusinessNews+%28News+%2F+US+%2F+Business+News%29)

10 Cottle, David (December 21, 2011) "ECB's Massive LTRO Gives Risk Assets Wings". The Wall Street Journal. Retrieved January 5, 2012 from: <http://online.wsj.com/article/BT-CO-20111221-703943.html>

11 Miles, Donna (January 6, 2012) "Obama signs Defense Spending Bill despite having reservations". American Forces Press Service. Retrieved January 5, 2012 from: [http://www.fortgordonsignal.com/news/2012-01-06/Viewpoint/Obama\\_signs\\_Defense\\_Spending\\_Bill\\_despite\\_having\\_r.html](http://www.fortgordonsignal.com/news/2012-01-06/Viewpoint/Obama_signs_Defense_Spending_Bill_despite_having_r.html)

12 US Library of Congress (December 1, 2011) "112th Congress, 1st Session, S. 1867". (See Sections 1031-1032) Retrieved January 11, 2012 from: <http://www.gpo.gov/fdsys/pkg/BILLS-112s1867es/pdf/BILLS-112s1867es.pdf>

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