Our view on global investment markets:

*February 2013 – The worst is over*

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Don’t stop believin’

The dark ages were an awful time. Considering the brightest days delivered constant warfare, the burning of books, and the fear of barbarians, no one ever looked forward to the darkest days.

Fast forward 1,600 years, and the darkest days of the European debt crisis are finally over - not because the bad debt has been written off or due to the consolidation of all debt, but simply because everyone has said so.

First up to declare the worst is over was European Commission Vice President Ollie Rehn who announced “the worst is over”.

Next up, everyone’s favourite socialist president Francois Hollande of France confirmed “tonight I have the confirmation that the worst is behind us”.

The French President was then confidently followed by the meticulous German Finance Minister Wolfgang Schauble who droned “we have the worst behind us”.

And then to leave no doubt whatsoever, the scandal plagued Spanish Prime Minister, Mariano Rajoy convincingly reported “I’m totally and absolutely convinced that the worst has passed”.

And, just in case everyone needed a little extra convincing and confirming, European Central Bank President Mario Draghi blasted his favourite Journey song and told reporters everywhere to start believing because “the darkest clouds over the euro area have subsided”.

And that my friends, is how you solve the biggest debt crisis in the history of the World. If you say something often enough, pretty soon you’ll start to believe it. And when it comes to Europeans talking about the swift and miraculous resolution to their debt crisis, no one is singing off-key. Well almost nobody.

Since it is Europe, contradictions never run short. Just 4 short weeks prior to declaring “we have the worst behind us”, Wolfgang Schauble warned “the worst is yet to come.” Whatever very bad thing happened during those four weeks must have been a doozy, as it certainly caused Mr. Schauble to change his tune.

Of course, this was nothing compared to the moment of clarity shared by France’s Labour Minister, Michel Sapin who described his country as being “totally bankrupt”.

And, just to keep things real we should always remember Luxembourg Prime Minister Jean-Claude Juncker’s confession that “when it becomes serious, you have to lie”.

Exactly who is telling lies and who is telling the truth will only be determined in due course. Our view is that before declaring victory over this debt crisis, investors must remember a few things.

First of all, in the real World a resolution to a debt problem usually
Paper losses are not real

involves losses of some kind. Normally, when a person cannot repay the money they owe, they stop making payments and the lender takes the loss. Today in Europe, the lenders are the banks, pension funds, and insurance companies – and taking losses would make life very uncomfortable for all of these guys.

Another version of the bad debt story occurs when instead of repaying all of the money, only a partial repayment is made and the timing of these partial repayments are stretched out into the future. Again, the lender still loses money, but at least not all of it.

And then we have the European (and American) version of the bad debt experience. In both of these cases, losses are certainly occurring, but those bearing the brunt of the losses are not the original lenders but rather the tax payers.

Initially, this socialization of bad debt losses was lost upon tax payers. Yet, as this magical economic recovery continues, those without jobs, those without pay raises, and those without banker-like bonuses are slowly waking up to the fact that maybe everything isn’t so right after all.

During the 2008-09 credit crisis, bad debt didn’t disappear, it was simply transferred from the private sector to the public sector. In more simpler terms, instead of allowing investors to take losses for their bad investment decisions, these losses have been transferred to all tax payers.

To put this into even simpler terms, even if you had all of your wealth in safe cash during the crisis, and proudly told everyone of your investment savvy - you are still paying for the losses incurred during those dark days. And to stir-up even more fumes between your ears, this transfer of losses has not been restricted to the United States and Europe. Yes, even Canadians who didn’t experience any crash in their housing market, nor collapse of their iconic banks are paying for this very unfair policy decision by the Americans and Europeans.

Let us explain. Losses can come in many forms. The obvious losses are for those who bought Apple or RIM Blackberry at the top. Mind you, these losses are only paper losses so they are not real.

The other less obvious loss occurs in several forms. First up, your taxes. The bursting of the credit bubble and the ongoing debt crisis has unexpectedly woken the austerity giant. Deficits must be slayed, and with no exception, everyone will be paying higher taxes in one form or another. In Canada for example, not wanting to actually increase property taxes, local politicians are instead aggressively reassessing property values producing 10%-20% tax increases for many. It’s a nice tax grab if you can get.

Next up, interest from your investments. In response to the 2008-09 market collapse, central banks everywhere cut interest rates to near 0%. In addition, their decision to print money has forced long-term interest rates to decline to all-time lows as well.

The central banks and elected officials are telling you that although
Stealing from the poor to give to the rich

they do not agree with these policy moves, they are a necessary evil to help banks recover, the housing markets to rebound and to help create new jobs.

As for everyone who really appreciated earning 4-6% on their GICs, Term Deposits, and government bonds – you’re out of luck. Someone has to pay, and sadly it is the orphans and widows who have traditionally relied upon these predictable streams of income.

In effect, the central bankers of the World have become anti-Robin Hoods. Their policies of 0% interest rates and money printing are helping to steal money from the poor to give to the rich. Not cool.

Overall, increasing taxes, decreasing spending, and significantly lower interest income can only have 2 outcomes; lower growth and major political changes.

**Lower growth**
A funny thing happens when people, and companies pay more in taxes and receive less interest income on their investments – recessions. It’s pretty simple - if you have less money in your pocket, you have less money to spend.

It doesn’t matter if you are in America, Asia, Europe or South America – slowing growth is a fact. Just last month, IceCap suggested that the American economy was growing a lot slower than what the big pens on Wall Street were predicting. Truth be told, not only was Wall

Street wrong, but IceCap was wrong as well. Despite keeping interest rates at 0%, a continuation of extended social support programs and printing a quarter of a trillion dollars, the American economy came to a grinding halt in the 4th quarter. And by halt we mean halt. The economy neither grew, nor did it shrink – it just stopped. In fact, this 0% growth rate perfectly illustrates the stagnate state of global growth.

While we continue to expect American GDP to flap around between -1% to +2%, maybe there is something more sinister happening. It turns out that even People of Wal-Mart are less enthusiastic about spending their money at their favourite store.

Whereas Caterpillar, Nestle and Louis Vuitton provide glimpses into global growth, Sam Walton and the boys at Wal-Mart are THE best barometer for growth for the lowest taxed segments in the US. And when the mega retailer starts using words like “total disaster” and “worst start to a month I’ve ever seen” maybe Mr. Bernanke’s wealth effect game isn’t reaching everyone after all.

Moving along to Europe. In some ways we cannot blame the headline politicians for their optimistic assessments about their crisis. After all, less than a year ago both Italy and Spain were on the brink of collapse. No private investor in the World would lend money to these countries.

**Chart 1** on the next page shows borrowing costs for both countries.
Chart 1: The worst is over – ECB has artificially pushed down interest rates

Italy 10-Year Bond Yield

Spain 10-Year Bond Yield

Source: Bloomberg
February 2013

The worst is over

Chart 2: The worst isn’t over – ECB cannot artificially create growth

Euro-zone 17 GDP Quarterly (Annualised)

“the worst is over”
“the worst is behind us”
“the worst has passed”
“the darkest clouds have subsided”
“when it becomes serious, you have to lie”

Source: Eurostat, IceCap Asset Management Limited
Either way, Schauble will be right

As you can see, today financing rates for each country has improved considerably. Yet, Chart 2 (previous page) shows economic growth for Europe, and what you see here is a lot of red ink and a lot of negative growth.

So which is it? Sovereign funding costs say the worst is over, yet growth, employment and property markets show the worst is yet to come. Either way - Schauble will be right.

Obviously, reconciling the improvement in funding costs for Spain/Italy with the deterioration in the European economy is a futile exercise, unless of course you consider the money printing ways of the European Central Bank. It’s no coincidence that the dramatic improvement in Italian and Spanish interest rates occurred at the exact moment in time the ECB announced to the World it would do “whatever it takes” to save the Euro.

To no surprise, “whatever it takes” means threatening to print boat loads of money to buy any and all Spanish and Italian debt from the past, present and future. Obviously this line in the sovereign-debt-sand has been extremely effective as sovereign interest rates everywhere are partying like it was 1999 all over again. Maybe our page 1 politicians are right after all, maybe the worst is over.

Then again, if you asked any of the 55% of jobless Spanish youth, or the 1/3 of all Greeks who are in poverty, or any wealthy French tax payer if the worst is over and we feel you may hear a different response.

Major Political Changes

Without a doubt, the winds of change are blowing. Originally, Europeans believed the reason for their misfortunes was due to the political right. Across the old World, center-right governments met their economic fate and were discarded by either a democratic process or simply by decree from Brussels. Either way, it didn’t matter – left leaning governments were mandated to lead the way.

Unfortunately, it now appears that the economic miracles promised by the left are no more prosperous than those promised by the right. It doesn’t matter if you are looking at Greece, France, Italy, Spain or even Germany – there is an ever growing rate of dissatisfaction amongst the population.

In France, Sarkozy was voted out due to his attempt to raise taxes and tighten spending. Not even one full year into new French President Francois Hollande’s mandate and already France is in recession. And in case you haven’t noticed, you no longer see France paired together with Germany as the dynamic duo certain to save the Euro-zone. The French economy is in decline, and pretty soon it may be lumped in with the European peripheral countries.

Meanwhile, Italy is just days away from its latest national election. Recall that it was just 2 years ago when Brussels removed then Italian Prime Minister Silvio Berlusconi from office and replaced him with former Goldman Sachs Advisor Mario Monti.
He who shouts loudest

Mr. Monti’s mandate was to introduce the Italians to austerity. Initially, he was successful with implementing pension reforms but then the buck stopped there. Further attempts to increase taxes and reduce spending only resulted in one thing – being tossed out of parliament.

Since Italian politics is usually won by he who shouts loudest, there are few moments of silence leading up to the World’s next most important election. Voters can choose the old right, the old left, the Brussels/Goldman Sachs technocrat, the far far right, or the far far left, and then just when you thought you couldn’t laugh anymore, well known comedian Beppe Grillo has also entered the race and his anti-Euro/banker bent is proving hugely popular as well.

A giant stalemate will likely be the final outcome meaning another coalition government that can’t agree on anything. This status quo means no new austerity, no new growth initiatives and plenty of more implicit and explicit support from the money printers at the European Central Bank.

Now, this likely outcome certainly isn’t deterring Brussels from interfering. You may think what you like about Silvio “bunga bunga” Berlusconi, however he is ITALIAN. He has a right to run for Italian office and a right to free speech. Just don’t tell that to Germany. The latest European jaw dropping moment has the German President of the European Parliament warning Italians not to vote for Mr. Berlusconi. While everyone is certainly entitled to their opinions, having an official representative of Germany dictating to Italians on who to vote for, certainly isn’t cool. This would be the same as having American President Obama telling Canadians who they should vote for, or having British Prime Minister Cameron directing the Irish at the polls.

Moving along to Spain – the economy continues to decline and the swell of unemployed youths is making a lot of idle hands idler. We’re not sure what can be done to make things better, but we’re pretty sure the latest scandal to hit the prime minister will only fan the flames higher.

Apparently secret cash payments, secret Swiss banks accounts and secret records isn’t cool with anyone. As you can imagine, accusations and allegations are running rampant. Since thousands of people have no jobs and nothing to do, they are participating in massive demonstrations against the government.

It was a little more than one year ago when Prime Minister Rajoy and his People Party won office. At that time, they earned an approval rating of 48%. With today’s rating scraping along at 24%, and little glimmers of economic hope, Brussels must be preparing alternative arrangements - just in case the worst isn’t over.

As with everything in Europe, it begins and ends with Germany. Germans will also be heading to the polls later this fall, and while the soap operas called Italy, Spain, France and Greece continue, it is this election that will be a critical point for all of Europe.
This is fun

Slowly and surely, Germans are waking up to the fact that they are burdened with bailing out all of Europe. Ms. Merkel and her coalition are fully aware of the growing resentment towards the bailouts, which puts them in a predicament. Merkel is completely committed to keeping the Euro-zone together, however should she have to commit to any more bailouts before the German election, the probability of her winning re-election decreases significantly.

Therefore, the only person minding the gap between now and the fall will be the European Central Bank. But since the ECB has already committed to bailing out everyone forever, exactly what else they have left in their bag of tricks is a mystery to everyone.

Which of course brings us to financial markets

Without a doubt, global economic growth remains stagnate, yet stock markets are booming. The message is very clear – there’s money to be made in these markets. There’s no question that trend, sentiment and technical strategies are making money for investors. However, it’s those buy and hold investors who are not being told the other side of the very clear message – there’s losses to be made in these markets too.

Our message on financial markets remains very consistent – do not confuse strong financial markets with a strong underlying economy. While this may sound like hogwash to many investors and investment professionals, it is the extreme, unorthodox, and never-before-tried policies by the World’s central banks that is the reason for the march higher for stocks.

We fully respect everyone who says financial markets are going higher due to money printing. However, those who are telling investors that markets are going higher because the economy is recovering and stocks are cheap will eventually have some serious explaining to do during client meetings.

Whether it is China, America, Brazil or Europe - economic growth around the World is stagnant at best. We’ve written before about Stall Speed – the speed at which the economy will accelerate sharply in one direction, either up or down. The point we make is that economies cannot grow at a steady, constant rate. Regular business and inventory cycles produce the ebbs and flows that many expect during a normal economy.

The worrisome feature of today’s global economy is that despite trillions (we repeat: trillions) in various forms of stimulus, economies around the World have not returned to the pre-2008 growth rates. If Alan Greenspan and not Ben Bernanke was still Chair of the US Federal Reserve he would most certainly be as confused as ever and refer to this economic-monetary puzzle as a conundrum.

Bernanke of course simply refers to this as fun. Regardless, for those who honestly believe in the recovery, ask yourself the following questions:
1 – What would happen to current GDP growth rates if the central banks stopped their money printing programs?
2 – What would happen to short and long interest rates if the central banks stopped their money printing programs?
3 – What happens to all equity valuation models if interest rates are higher?

The quick answer to questions 1 and 2 are as follows: trick question. Central Banks are not going to stop their money printing programs. The central banks fully understand that the second they even hint of pulling the plug on money printing programs very naughty things will happen.

As for interest rates increasing, we see the probability of over night rates increasing as being very low. As long as the economy, employment and housing fails to accelerate, short-term interest rates are going no where.

As for long-term rates, that is a different story. Investors should understand by now that when central banks print money, they are using the proceeds to purchase long-term bonds (and mortgages) which has the effect of lowering long-term interest rates.

Again, we do not see this policy changing anytime soon. However, a number of things could happen that would cause long-term rates to increase and are beyond the control of central banks. Specifically, country specific inflation rates could move beyond comfort zones, or a systemically important bank could experience stress which would cause foreign investors to flee. Both scenarios would cause long-term rates to rise which would have negative effects on local financial markets and its currency.

As for question #3, this is really the enigma, wrapped as a riddle stuffed inside of a puzzle. Today, numerous valuation models show various financial markets as being cheap or fairly valued at worse. However, the key input variable for many of these models is interest rates.

With next to zero short-term rates and historical low long-term rates, it shouldn’t be a surprise that many models are proclaiming stocks to be cheap. Yet, what remains either unsaid or buried within the small print is that these hugely important input variables themselves are being purposely distorted by the central banks.

This direct interference with interest rates by central banks and the effect it has on valuation models, is really no different than the Lance Armstrong story. Yes, absolutely he rode his bike flawlessly for a number of years. Yet, today as the wheels have fallen off, we realize he was goosed-up all along. In the financial World, many valuation models are being goosed up by central banks.

Today, we suggest that at some point analysts and advisors who are relying upon these “cheap” market valuations will come to realize this money printing thing was bad after all.

Now, this isn’t to say that opportunities do not exist in current equity markets. At some point markets will have to adjust, yet in the meantime trend, technical and sentiment tools are proving effective for the non-buy-and-hold investor.
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The worst is over

Chart 3: Equity Market Sentiment

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Stay open minded

Chart 3 on the previous page has consistently been a useful tool for determining short-term entry and exit points. Today, this tool is telling us that stock market optimism is extremely high and that whenever this happens stock markets usually decline around -11%.

The points we’ll leave you with are as follows:
- financial markets remain disconnected from the real economy;
- money printing by central banks is directly responsible for keeping interest rates at historical lows which in return is directly responsible for producing questionable stock market valuation results; and,
- tools are available to help guide investors during these confusing times.

Our Strategy

Our decision to increase exposure to stocks in early December has proven correct and based upon our market sentiment research we have taken profits and closed this position.

We continue to accept that financial markets remain disconnected from the real economy, yet recognise there will be opportunities to capital across all asset classes. As we expect stock markets to correct from current levels, we will be patient and let our sentiment, trend and technical models guide us for a re-entry point.

Although we expect short-term corrections in global stock markets, and we remain uncomfortable with the unusual, unorthodox and extreme interference from central banks, at this time we do not see stress building within the financial system.

Should this occur, we will be changing our strategy rather quickly to protect capital. At this point however, any correction should not yet develop into another full-on crisis.

Last month we promised to provide our perspectives on Agriculture commodities and we assure you we will cover this market over the coming months. Thank you for your patience.

As always, we’d be pleased to speak with anyone about our investment management capabilities. As well, we encourage you to share our global market outlook with those who you think may find it of interest.

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Thank you for sharing your time with us.