IceCap
Asset Management Ltd.

Local heritage,
Global experience.

Our view on global investment markets:

May 2013 – The bouncing ball

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Not so funny stuff

Send in the clowns

Contrary to popular belief, Bozo wasn't the first clown to drop the ball. That honour goes to 16th century jester William Sommers. One fateful day, the usually wildly entertaining fella simply told one joke too many, and before he knew it, both his juggling balls and his head were hitting the floor at the same time.

Next up to drop the ball was the 1966 Swiss soccer referee Gottfried Dienst. His controversial decision to allow a disputed English goal to stand did give England a glorious win over their hated rival, yet it also falsely elevated the country's sense of self importance on soccer's global stage. 47 years later, the English still falsely believe they dominate the beautiful game. Yet whenever presented with the opportunity to delight the crowd on the international stage, the bounces just never seem to go their way.

Today, we have the making of the biggest financial clown of all time. As head of the world's most powerful institution, the US Federal Reserve, Ben Bernanke has lobbed one giant money ball into the global financial system. This ball continues to bounce along one market to the other, and so long as it doesn't touch the ground everyone is happy. Yet, should this ball grow so large it cannot be supported, one simple slip will be unfortunate for everyone. To follow the interconnectedness of markets, just follow Bernanke's bouncing ball.

That was weird

On May 16, 2013 it happened – stock markets around the world crashed. The fateful day started just like any of the other previous 124 days – up, up and away until the carnage began. Selling was indiscriminate, no stock was spared and by the time the final bell tolled the US stock market was down a whopping -0.53%.

Yes, that's it. A half point decline and the correction has come and gone – time again to load up the truck and stick granny in there for good measure because this rally of a lifetime is real and it will never, ever end. Despite a boat load of negative news, stock markets continue to shoot higher. In fact, truly amazing things are happening – markets can do no wrong.

A poor earnings season – stocks zoom higher. Bad US manufacturing reports – stocks leap higher. Deeper and broadening recessions in Europe – stocks skyrocket even higher if that's possible. Talk about a honey badger market – today's stock market really doesn't care, about anything.

Of course, we can only have two outcomes, either the real economy (the one with real people, real jobs, and real income) also zooms upward, or the stock market zooms back to reality. Which naturally raises the question – "who's zooming who"?

To answer the question, look no further than the talking heads. Whereas a few short months ago, experts on the Cypriot banking system crawled out of the woodwork. Today we have the same experts talking about the accelerating recovery and the soon to come economic nirvana.

Teen spirit

While "nirvana" sounds a little too easy for today's money masters to master, the newest and most used term by anyone with 30 seconds of fame is "accelerating recovery". Everywhere we read, watch and listen, these magical words dance through the air. Unsurprisingly, this newest and coolest term originated in America. But don't despair, pretty soon Europeans of all sorts will move along from chanting "the worst is over" and graduate to their very own "accelerating recovery".

Now as most people rarely read beyond the headlines, or question whether anything in print or full of pixels is anything but true, it's worthwhile to actually dig around for evidence of this accelerating economy. First up on the acceleration scale is the US housing market. There's no question that prices have rebounded sharply from the bottom, but to claim the housing market is once again accelerating might be taking it a bit too far.

Chart 1 (next page), shows US new home sales have accelerated right back to levels first reached in 1966. Now, many factors such as the number of homes available for sale, the number of new jobs created, and wage increases all contribute to the housing market, yet one of the most significant factors are mortgage rates. **Chart 2 shows the US 30-year mortgage rate**. Considering we are in a period where banks are reluctant to lend, one must understand that it is only the good graces of money printing by the US Federal Reserve that have allowed mortgage rates to reach all-time lows.

Moving swiftly along, we ask you to study **Chart 3 and identify the acceleration of the US manufacturing industry.** To help you with this chart, just remember that in the geeky World of economics any number <50 represents a decline. Considering the last 3 months have seen slower and slower manufacturing growth, perhaps deceleration might be a better word to use.

Next, with millions of students hitting the graduation job trail it's only a matter of time before they realize the new job market isn't accelerating either. In fact, the only thing likely to be accelerating will be calls from the debt collector asking about repayment on their student loans. With **employment in Chart 4**, we finally have the opportunity to offer a glimpse of acceleration, except this time the only thing accelerating is the number of people who have stopped looking for work. To truly appreciate the twisted World of economics, when more and more people give up hope of ever finding a job they drop out of the labour force which actually causes the unemployment rate to get better.

And to truly appreciate the accelerating potential for anything in Europe, spend a few minutes with **Chart 5**. This beauty shows the unemployment rate for Europeans under the age of 25. If anyone is concerned that the worst is actually not over in Europe, simply determine when universities finish for the summer and then watch as both the heat and student unrest increases. Over the last year, we've already seen youth riots in London and France, the odds of this spreading elsewhere across the old World is very real indeed.

Chart 1: US New Home Sales

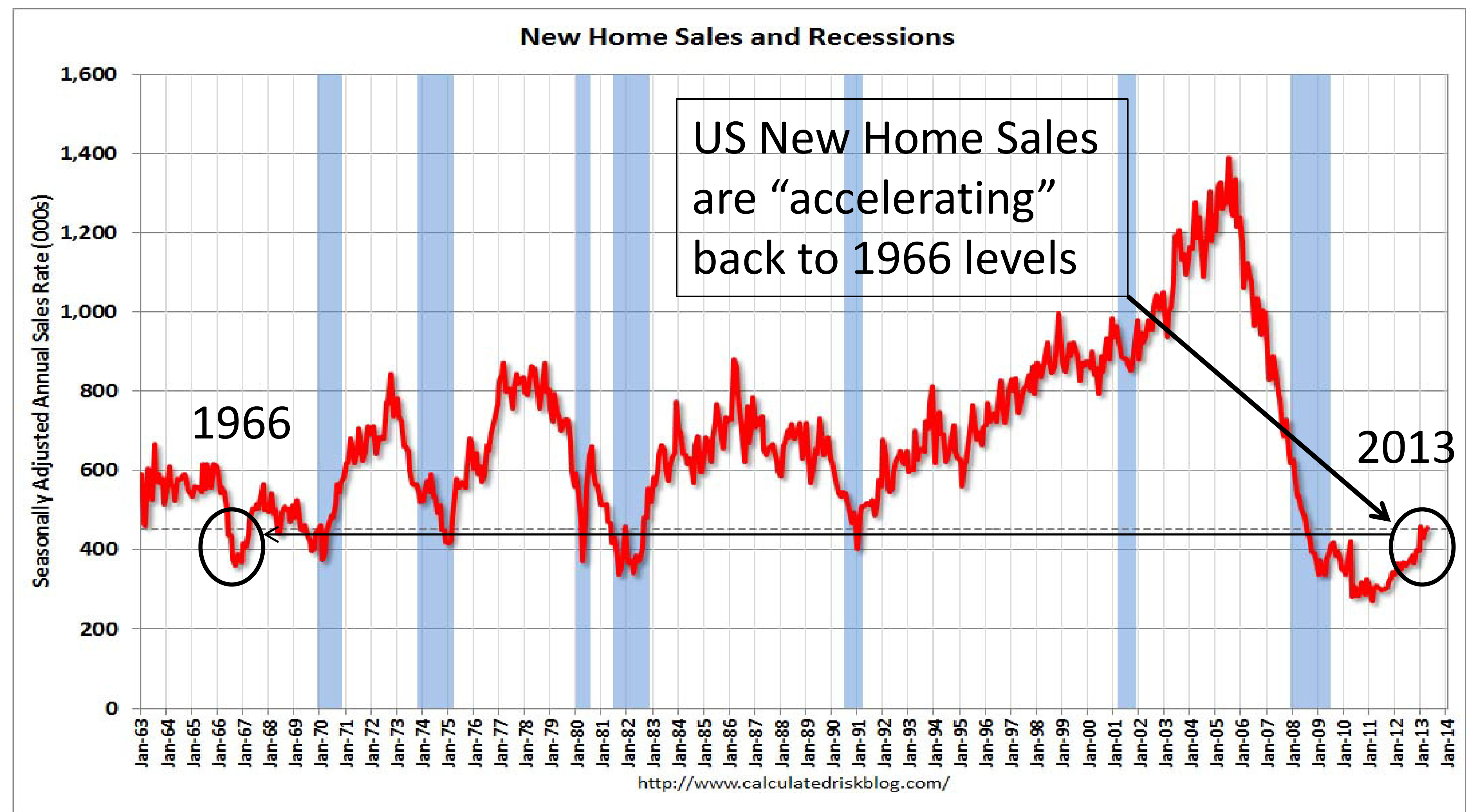


Chart 2: US 30-year mortgage rates

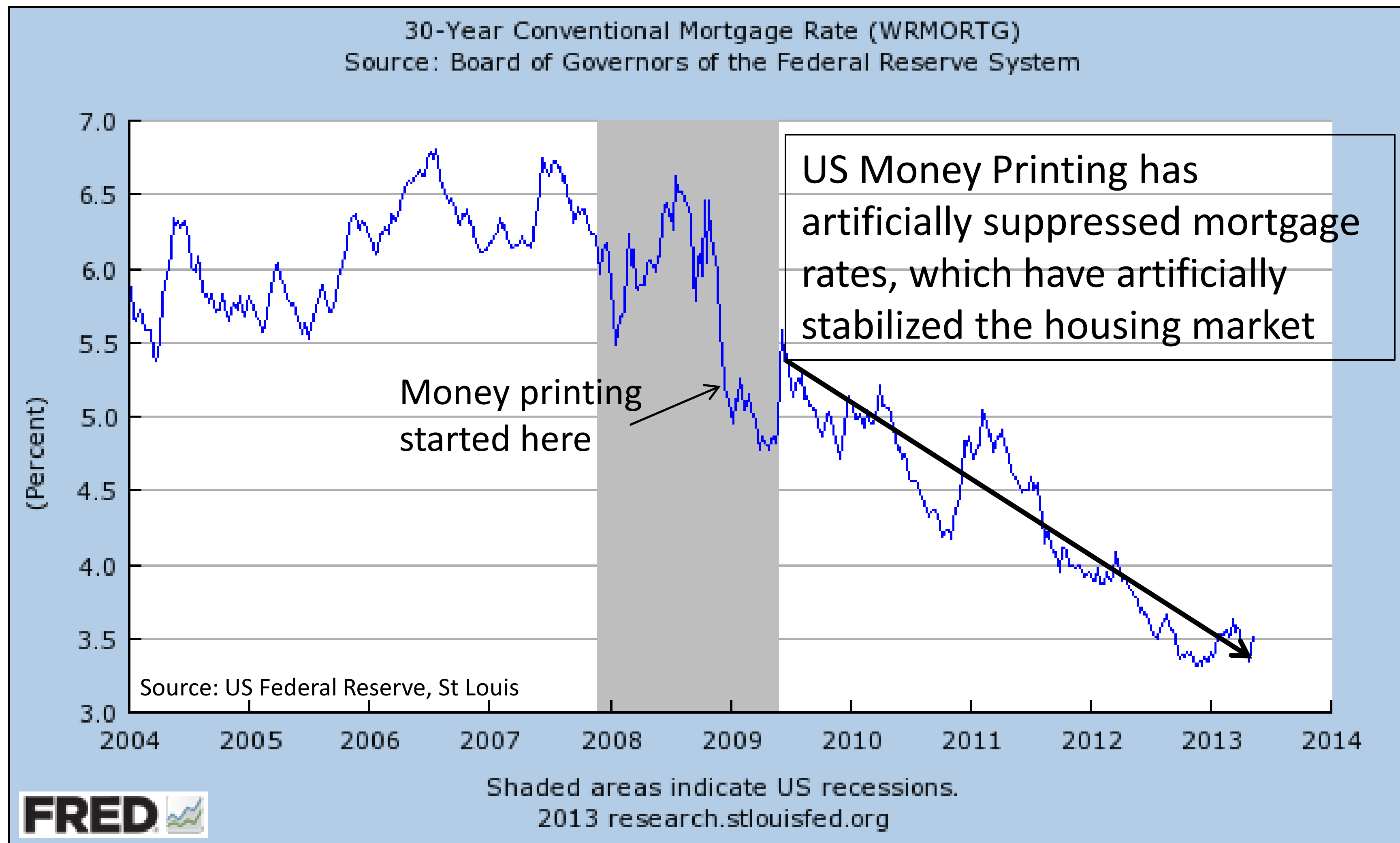


Chart 3: US Manufacturing

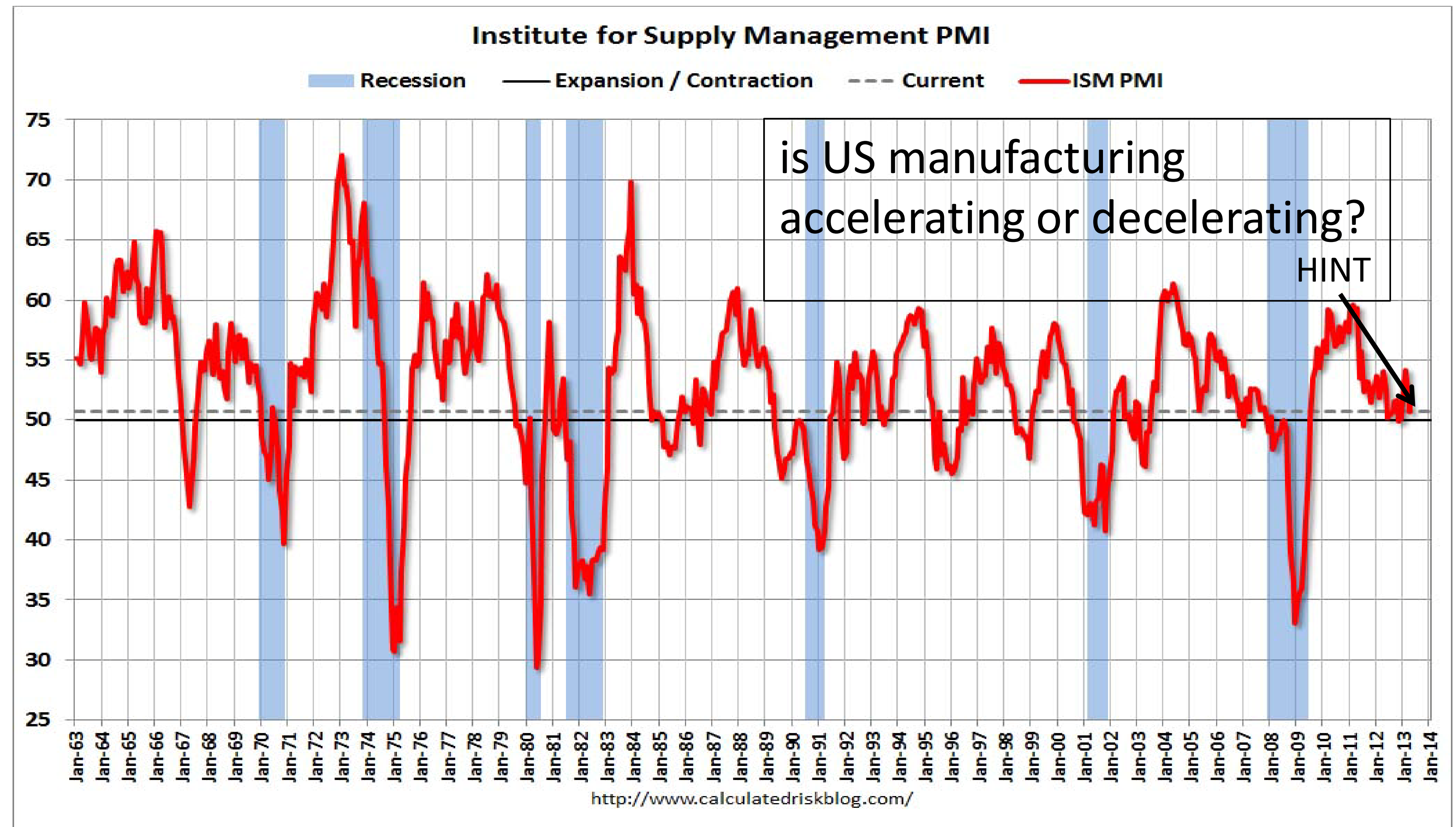


Chart 4: US employment

Civilian Unemployment Rate (UNRATE)
Civilian Labor Force Participation Rate (CIVPART)

As fewer and fewer Americans look for a job, it causes the unemployment rate to look better and better

Unemployment rate

Labor force participation rate

(Percent) 10.5 10.0 9.5 9.0 8.5 8.0 7.5 7.0

(Percent) 66.5 66.0 65.5 65.0 64.5 64.0 63.5 63.0

2009 2010 2011 2012 2013 2014

Shaded areas indicate US recessions.
2013 research.stlouisfed.org

UNRATE (Left)
CIVPART (Right)

FRED

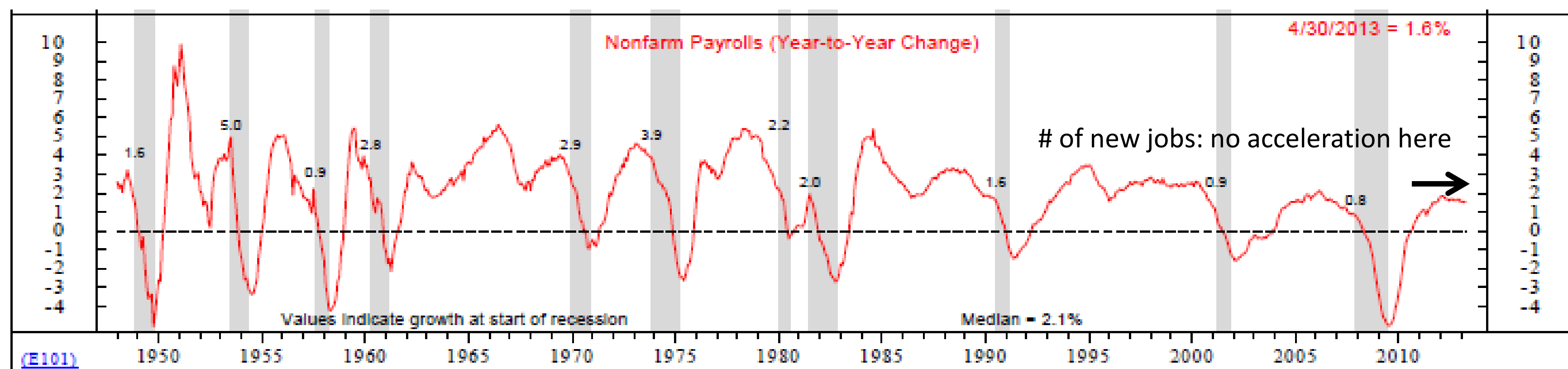
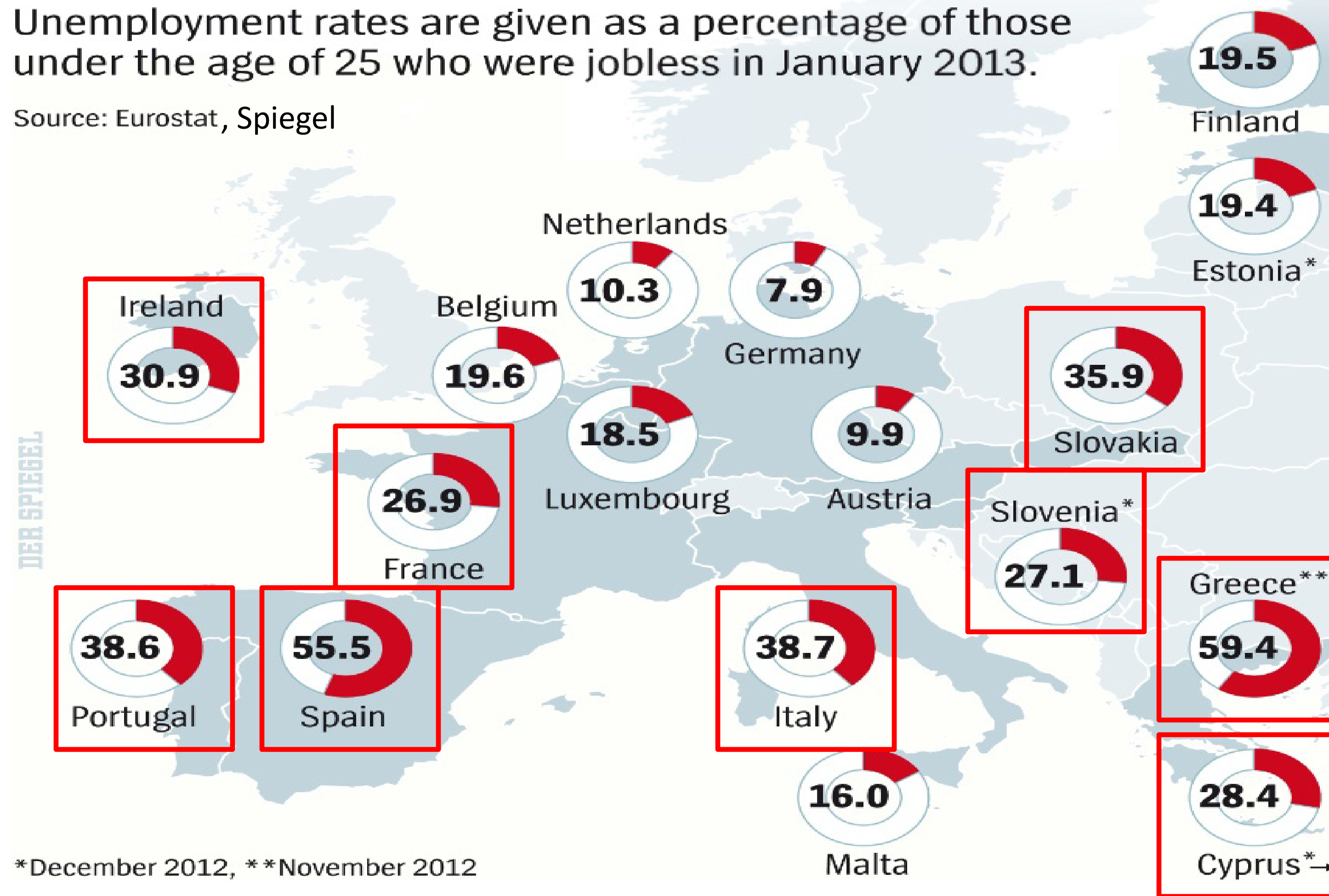


Chart 5: European Summer Powder Keg



Crowded House

And finally, everyone's favourite economic measuring cup – GDP (Gross Domestic Product). **Chart 6 shows US GDP growth since 2003**, and the only thing accelerating lately is the distinct lack of anything accelerating. In 2009, the US Federal Reserve started printing money to save the World. In many ways, the Fed's money printing experiment has been successful at self arresting the economic plunge that was ironically caused by the US Federal Reserve itself. Yet, trillions of dollars later – the 3.5% to 4.0% growth needed to achieve escape velocity is no where to be seen.

As it's obvious that "accelerating" and "escape velocity" are not quite that accurate when assessing the US economy, why then are financial markets acting as if the economy was in fact zooming higher?

For the answer, look no further than Ben Bernanke's bouncing ball. While the real economy is showing no signs of accelerating, the same cannot be said about financial markets. Contrary to the recovery story being sold by mutual fund sales people, financial planners and talking heads - the current surge in stocks is attributed entirely to Ben Bernanke, the Federal Reserve and their money printing experiment.

In order to fully grasp the degree of interconnectedness of today's global financial markets, one simply has to understand that all money needs a home – there's no such thing as sitting on the sidelines. And, even more important is the growing distinction between private and public capital.

The "crowding out effect" is one classic economic theory which has held up over the test of time. It describes the reaction of private capital to significant interventions by government money. Today's market place has significant intervention by central banks (i.e. government) with their quantitative easing (money printing) programs. Now, central banks and Wall Street economists will tell you that the objective of printing money is to lower interest rates which in theory should have a snowball effect of encouraging people and companies to borrow and then spend again.

Yes, interest rates have certainly declined to all-time lows, however the demand for loans remains close to all-time lows as well. As the World's brightest economists continue to scratch their heads over the ineffectiveness of money printing to produce accelerating growth, they are also keenly aware of the unintended consequences of money printing.

America is printing about $80 billion a month. Unknown to many, this scheme also has a snowballing effect, not on the economy but on financial markets around the World. To understand what happens, just follow **Chart 7 and Bernanke's bouncing ball**.

To get the ball bouncing, each month the US Federal Reserve takes their $80 billion and buys US mortgages and US Treasury bonds. This first step is the most important and kick-starts the "crowding out effect". As the Fed is buying the majority of Treasury bonds and mortgages available for sale each month, those investors who

Chart 6: US Real GDP Growth (annualized)

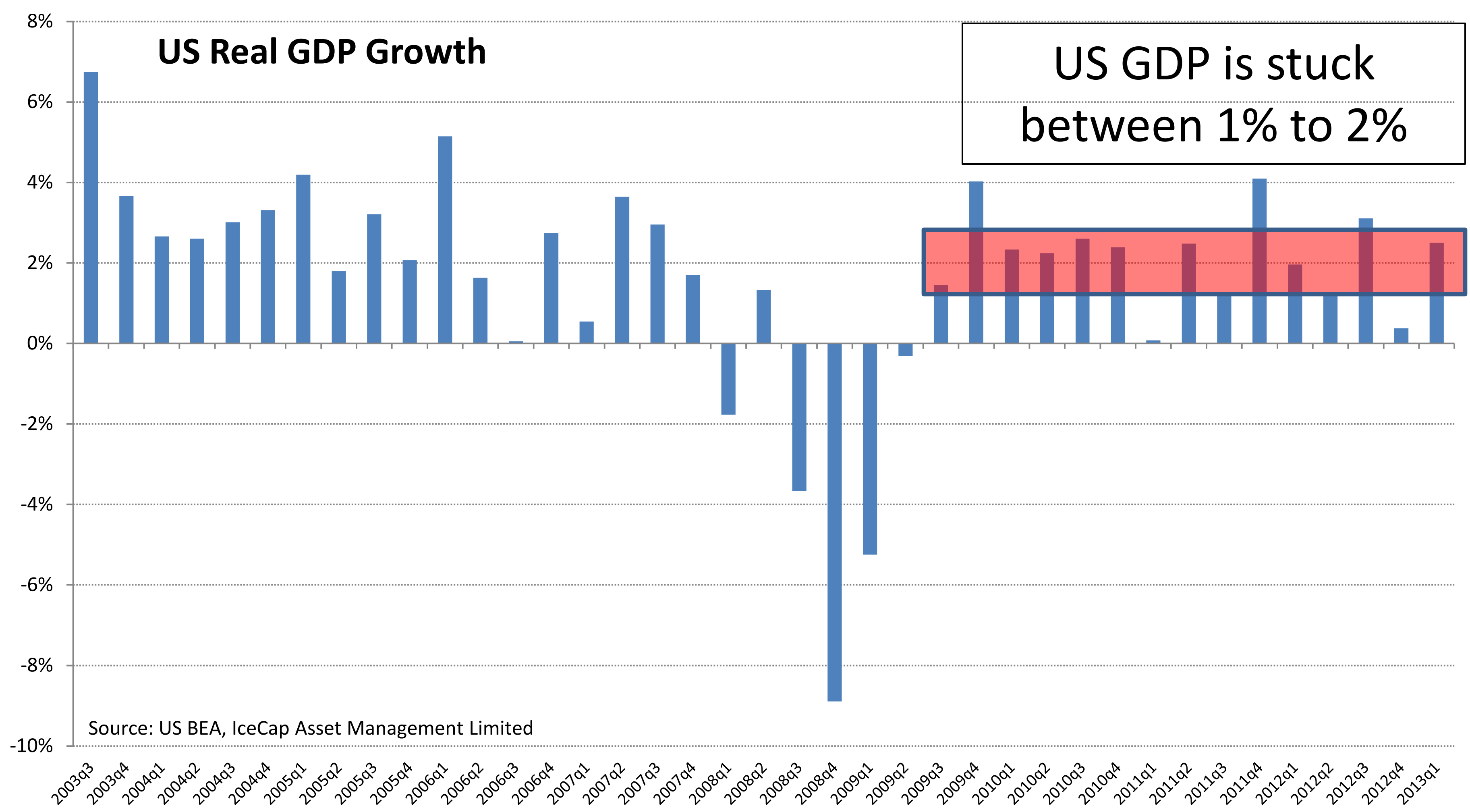
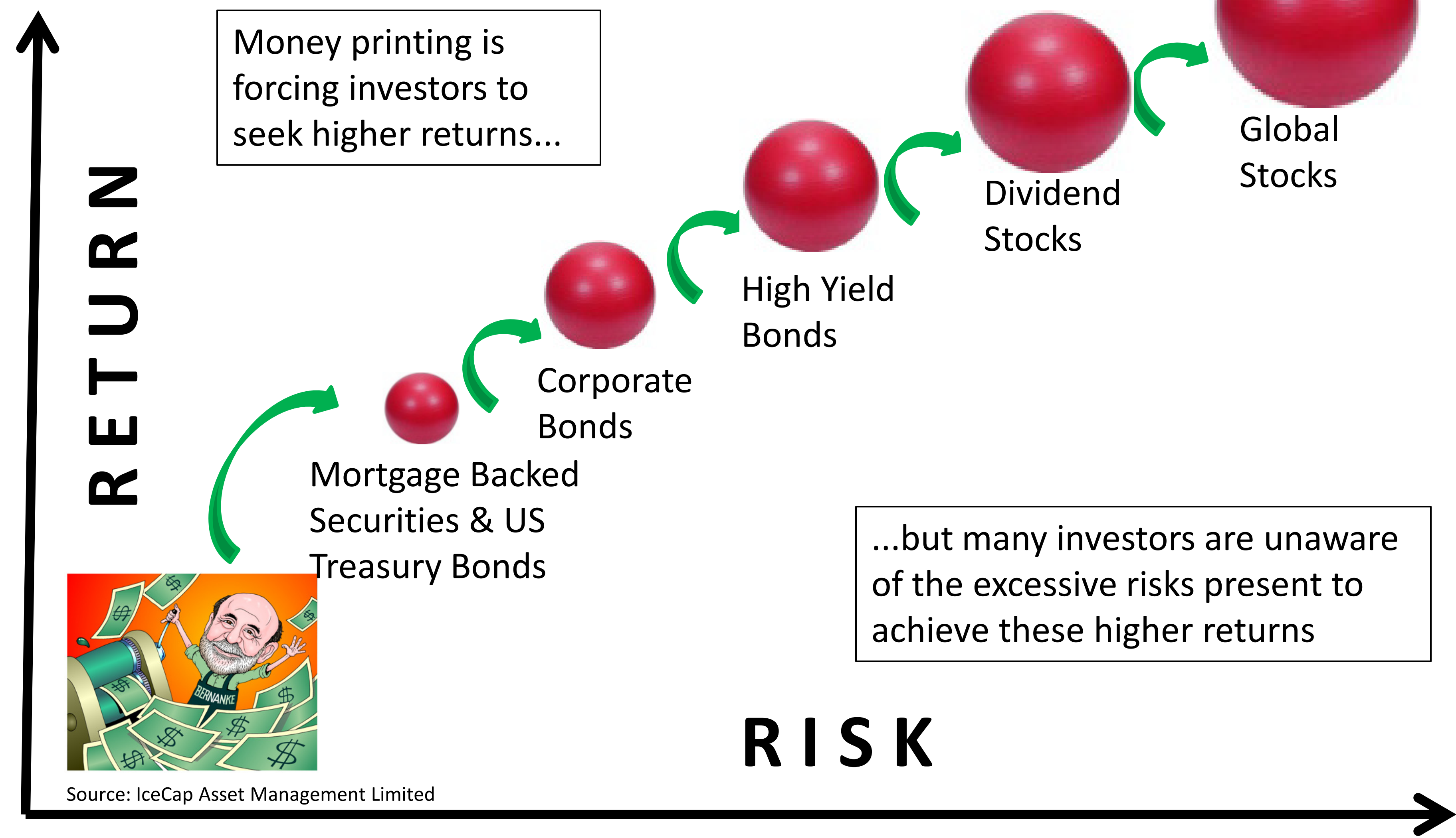


Chart 7: Bernanke's bouncing ball



Source: IceCap Asset Management Limited

Fed's Choice: stop, slow or mow

normally buy these securities have to invest their money elsewhere. Those who normally invest in Treasury bonds and mortgages, now take their money and start buying corporate bonds. Bouncing the ball up to the corporate bond market increases demand for these investments which has the effect of increasing the price for corporate bonds as well as driving down the yield, or income to investors.

Now, those who normally buy corporate bonds become frustrated with the new low yields offered and many decide to look elsewhere for higher income paying investments. This results in these investors bouncing the ball up to the high yield bond market.

For those not familiar with high yield bonds, they are commonly referred to as junk bonds. Now don't be alarmed, many of these companies that issue these bonds are top notch and always pay back the money they owe. However, the term "junk" is a relative reference to higher quality companies who issue bonds in the corporate bond world (or investment grade as we like to say). Because there is a higher probability of these "junk bond" companies not paying back the money owed, investors demand a higher rate of return.

Those investors who normally buy high yield bonds have also become frustrated and they react by taking the ball up to the stock market to buy high quality dividend paying stocks. The rationale is that in many cases they can buy stocks that are paying out the same yield as high yield bonds, and they have the opportunity to capture upside if the stock goes up.

This makes sense, except suddenly you have investors who usually buy bonds investing in the stock market. Apparently dynamics of the entire risk-return spectrum have ceased to exist.

Of course, the bouncing ball isn't finished yet, those who usually buy dividend paying stocks have now been pushed out to broader stock markets, as well as small cap and emerging market stocks.

Naturally, as investors unconsciously bounce up the investment food chain, many are unaware of the excess risk they are now assuming in order to achieve ever higher yields and ever higher returns. The crowding out effect and the search for stocks will continue until either someone decides not to catch the bouncing ball, or the US Federal Reserve decides to stop, slow, or mow down the amount of money they are printing.

As for when it stops, we don't know. But we do know this money printing cycle cannot continue forever, and eventually when the music does stop we are sure the rush to the door will be both orderly and mannerly – at least that is what Ben Bernanke claims.

As for when the Fed will eventually end, stall, or taper their money printing scheme no one knows for sure – not even the Fed itself. Based upon everything muttered by this eclectic bunch, they remain just as confused as ever. Our view remains consistent – it will be a very long time before the Fed stops their money printing ways. And the only way they will end the scheme is when they are *forced* to stop.

Dreaming the impossible dream

Not too long ago

It was only a very short 5 months ago the US Federal Reserve publicly stated 2 goals for their money printing scheme; a 6.5% unemployment rate, and a 2.0% inflation rate. This of course is in addition to their previous statement of targeting a higher and higher stock market. Once these goals have been achieved, the Federal Reserve would begin to end their money printing experiment.

Looking at the job market, the only way America will reach 6.5% unemployment is if the labor force participation rate continues to decline. As you now know, statistically when more and more people simply give up looking for work, it has the effect of lowering the unemployment rate – we're willing to bet this isn't exactly the type of improvement hoped for by Ben Bernanke.

Alternatively, it could also create 200,000 new jobs a month for 3 straight years. Considering this rare event has only ever occurred during the 1970s inflationary bust and then again during the 1990s tech bubble years, the odds of it happening again during the current global deflationary grind are low indeed.

Turning to the 2.0% inflation target – considering the current rate is closer to 1%, the odds of this number suddenly working towards 2.0% are long as well. Once again, this is where IceCap states our view that global deflation is currently overwhelming any sign of inflation. Now, this doesn't mean hyper inflation will not occur – to watch this money movie, look no further than Japan and selective countries in Europe for this price rising glory. As increasingly larger amounts of private capital flees specific countries, the probability of them experiencing higher long-term rates increases as well. Unfortunately, this regression in interest rates will also be reflected in their currency and then in their inflation rates.

For those in the US hyper inflation camp, its kinda important to understand that for every dollar printed by the Fed, about 40 cents goes to foreigners – in other words, the printed money does not stay in the country. As well, due to deteriorating economics in Europe and Japan, more and more private capital will flow to the USD, ensuring currency strength. In other words, American inflation will not approach 2% until *after* Europe and Japan have sorted out their money problems.

If there is ANY reason Ben, Janet and the boys will taper the amount of money they are printing it is due to their 3rd goal of reflating the stock market. As it has become plainly obvious that the so called wealth effect isn't affecting anything except the stock market – the Fed has to be both keenly and worryingly aware that they have created yet another stock market bubble. With both the tech bubble and the credit bubble caused by the Federal Reserve, we would hope these money maniacs understand the current Frankenstein they have created.

The only reason the Federal Reserve would stop their money printing scheme is to prevent a stock market bubble. Since they have struck

More addition by subtraction

out with both preventing and stopping the two previous bubbles, don't hold your breath waiting for them to stop the current bubble. Yet, in their defense should the Federal Reserve suddenly begin to unwind their money printing strategy they too are keenly aware that the odds of someone, somewhere dropping the bouncing ball is increasing. In short – the Federal Reserve has painted themselves into a corner with no way out.

Yet, somehow this isn't stopping some of the biggest market cheerleaders from shaking their pom-poms. Recently we had the pleasure of listening to one of the largest managers in the world convince everyone in the room that they should be buying stocks.

The reason - Americans need to save more money for retirement and due to bonds producing such low returns, these savings MUST go into the stock market. And with all of this money going into the stock market, stocks have no where to go but up.

This legend is correct on one point - the bond market will eventually hit the skids. Those 7% bond returns used by financial planners and their retirement software programs are dreams from the past.

As for the stock market argument, lets think this one through. Should Americans increase their savings rate, by default domestic spending decreases. Only the mathematical fantasy land called Europe can produce simultaneous higher spending AND higher savings - every other country in the world will see lower spending.

Now, if America saves more and spends less, exactly who is going to buy all the stuff produced in China and other exporting powerhouses? We guess China could finally rebalance their economy and reduce their savings in exchange for higher spending, but this also requires a disproportionate decline in capital investment; talk about a nirvana.

And just to complete the money circle, if companies are not selling more goods, the growth of real earnings becomes a tad bit tricky as well. So, if savings increase, spending decreases and earnings decrease - how does the stock market grow? More money printing of course.

Saying this, makes us realise maybe this legend is correct after all. If money printing does continue forever, maybe everyone should simply keep buying stocks forever.

Meanwhile over in Britain, a very few days ago the country was awestruck over the official announcement that, just as in Europe ,the worst was also over in Britain. This heady proclamation was based upon the Bank of England revising their guestimate for 2013 growth from 1.0% to 1.2%. The country, media and everyone on Threadneedle Street were ecstatic. And just think, this exuberance was over a +0.2% increase in a guess of future growth.

Imagine what would happen if the economy really did accelerate. Sadly, this excitement is likely for naught, as after the announcement

The cleanest shirt

of this economic miracle it was discovered that both British exports and imports declined, and to top this, consumer's were spending less as well.

Yet, if anyone is pleased with this economic miracle it would have to be Mark Carney. The Canadian banking star is now merely hours away from controlling the helm at the 319 year old Bank of England. Like the rest of the World, Britain's stagnant growth demands a response; Britain, Mr. Carney is about to light your fire.

As Britain begins to trot down the same money printing path as the Japanese, anyone with any interest in the British Pound should start preparing for a significantly weaker currency.

Our Strategy
Since our last update, we've reduced our exposure to high yield bonds in favour of higher quality corporate and government bonds. Movements in high yield debt are closely linked to global stock markets which remain at elevated levels. As we expect stock markets to either experience a sideways moving market for a few months, or a quick correction, the risk is to the downside.

It's our view that stock markets and the US Dollar are at a potential pivot point. Should economic, political or financial conditions in either Japan or Europe deteriorate suddenly during the coming summer months, there is a very high probability that both the USD and US stock markets skyrocket even further from current levels. We realize this sounds counterintuitive, however investors must understand that we live in a global market and conditions in both Japan and Europe are driving private capital away from these markets towards the cleanest, dirty shirt in the bin – America.

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.