IceCap
Asset Management Ltd.

Our view on global investment markets:

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The Baffle Scale

dis·com·bob·u·lat·ed: confused, baffled, bewildered, puzzled.

When it comes to discombobulated people, the financial World has a bunch of them. Leading the pack during the roaring 1990s was the King of Confusion himself – Alan Greenspan. His money reign at the US Federal Reserve was highlighted by bailing out Wall Street's biggest hedge fund, which planted the seed for the dot-com bubble.

Unfortunately for the market, only the combination of retirement and hindsight allowed Mr. Greenspan to become less confused when he admitted he had found a *"flaw"* in his economic philosophy.

Next up on the baffle scale has to be the Eurozone. The decision in 1995 to create a common currency was actually brilliant. The final watered down product - not so much.

For the euro to work, it appears you do in fact need a single government entity with the power to institute tax policy and government debt issuance. Fifteen years later, half of Europe remains discombobulated as to why they needed the bailout in the first place, while the other half remains discombobulated as to why they have to bailout the other half. Once again, confusion reigns.

On a broader scale, during the last three years, money printing and bailouts have saved financial markets no fewer than 6 different times. Those who identified these risks have spent many sleepless nights figuring out ways to get through this mess.

Those who did not identify these risks, carried on as if it was the 1990s all over again – buy, hold and prosper.

Determining who was right is no simple feat. Perhaps famed American journalist Edward Murrow got it just right when he said, "anyone who isn't confused really doesn't understand the situation."

For now, as markets roll into the fall, investors, politicians, and central bankers remain just as discombobulated as ever.

Déjà vu all over again

Not too long ago, in a land far, far away called Europe, a few Norwegians came to an interesting conclusion. They determined that the then newly elected President Barrack Obama was deserving of the 2009 Nobel Peace Prize, based on his unwavering commitment to peace on earth.

Fast forward to today, and it appears that once again, President Obama could be in the running to become the first ever repeat winner. We are told that just as the World was preparing for yet another American led conflict in the Middle East, President Obama summoned his innermost diplomatic skills and successfully talked the World down from the possible beginnings of WWIII.

In the investing World, there are times when geopolitics can be absolutely market moving and times when they are in effect a dud. The events in Syria are very real and very much a part of a very big picture - in short, it's important.

Repeat, repeat, repeat

While the media and official government releases focused on the use of chemical weapons as the driving force behind heightened tensions, the other less talked about story focuses on natural gas.

The European natural gas market is one of the largest in the World, and the biggest provider of this natural gas is Russia. During the sultry European summer nights, it is Russia who keeps the air conditioners running. Six months later, it is again the Russians who provide the heat to keep the espresso and croissants just right. Russia does not merely control the European natural gas market – it owns it.

Enter Qatar. It is not only a smallish, rarely mentioned country from “over there”, but it is to natural gas, what Saudi Arabia is to oil. Yes, Qatar is floating in the stuff and it would love to tap into the highly profitable European gas market controlled by Russia.

There’s just one problem – Syria.

The only way for Qatar to transport its natural gas to the sleepy nights in Brussels is by running a pipeline straight through Damascus. And, with the Russian supported Assad Government, there’s little chance of this happening. Unless of course, Assad’s government collapses and a new, Qatari friendly government emerges.

Should you dig deeper behind the Syrian crisis, you’ll also discover that Qatar is providing funding to the rebels, which so happen to be al Qaeda.

Peeling back yet another layer, you will discover a Saudi Arabian proposal to offer Russia a global oil pact if they walk away from Syria. As a kicker, the Saudi's have offered complete assurance that Chechnyan rebels would stay away from the 2014 Sochi Olympics. How’s that for a sweetener?

And if you really want to explore the rabbit hole, brush up on the latest verbiage between Israel and Iran. Just the slightest military accident could be the spark to light the fuse between these two long time running enemies.

And, not to be outdone the Americans also have an incentive to remain relevant in the region. With Russia clearly announcing to the World its return as a super power, America needs to provide the counter balance. A cynic might even suggest that the folks in Washington would welcome a little distraction from the ongoing financial problems plaguing the country as they head into another round of debt ceiling negotiations.

Considering the complexity of the Syrian crisis, it’s perfectly normal to be discombobulated over the entire ordeal. However, from an investment perspective, some clairvoyance is needed.

For starters, any escalation in the crisis certainly has the potential to drive oil prices significantly higher. At the very minimum, should a resolution to the Syrian situation be short coming, oil prices will stay elevated due to the embedded risk premium. Higher oil prices could prove to be a drag on the shaky global economy.

It's a self preservation thing

Additionally, should the crisis in the region escalate, higher defense spending and lower tax receipts will undoubtedly cause deficits to deteriorate anew. And, while all of this happening you should expect to see a stronger US Dollar.

As for the stock market, history has shown that in general stocks actually perform pretty well during periods of war. However, all stock markets would not necessarily benefit, as those markets (and currencies) most exposed to the region should in all-likelihood be avoided.

And, considering the current positioning of the American and Russian navies (**Chart 1 next page**), we better hope that the folks in Norway will have the opportunity to make President Obama the first repeat winner of its Peace Prize.

The German Elections

A few months ago in our publication entitled "Achtung Baby", IceCap discussed the importance of the September 22, 2013 Federal election in Germany. Now, with only days before the all-important event, investors should wonder if the outcome will be as expected – a yawner, or perhaps something else.

The importance of the election is based upon the fact that Germany is the financial super power in Europe. Without it, the EFSF, ESM, GLF, Bilateral, EIB, EBRD and the phantom OMT, bailout programs would simply not exist.

And of course, if the bailout programs did not exist the Council of the European Union and the European Council would have to create new reasons to meet. In addition, the deflationary recessions in Greece, Cyprus, Portugal, Spain, Italy, Ireland and France would not exist either. As you can see, from a Brussels perspective of self-preservation, the outcome of the German election is of monumental importance.

While current polls are providing reason for hope (there's that word again), past German election results have shown these very accurate and precise polls to actually be inaccurate and anything but precise.

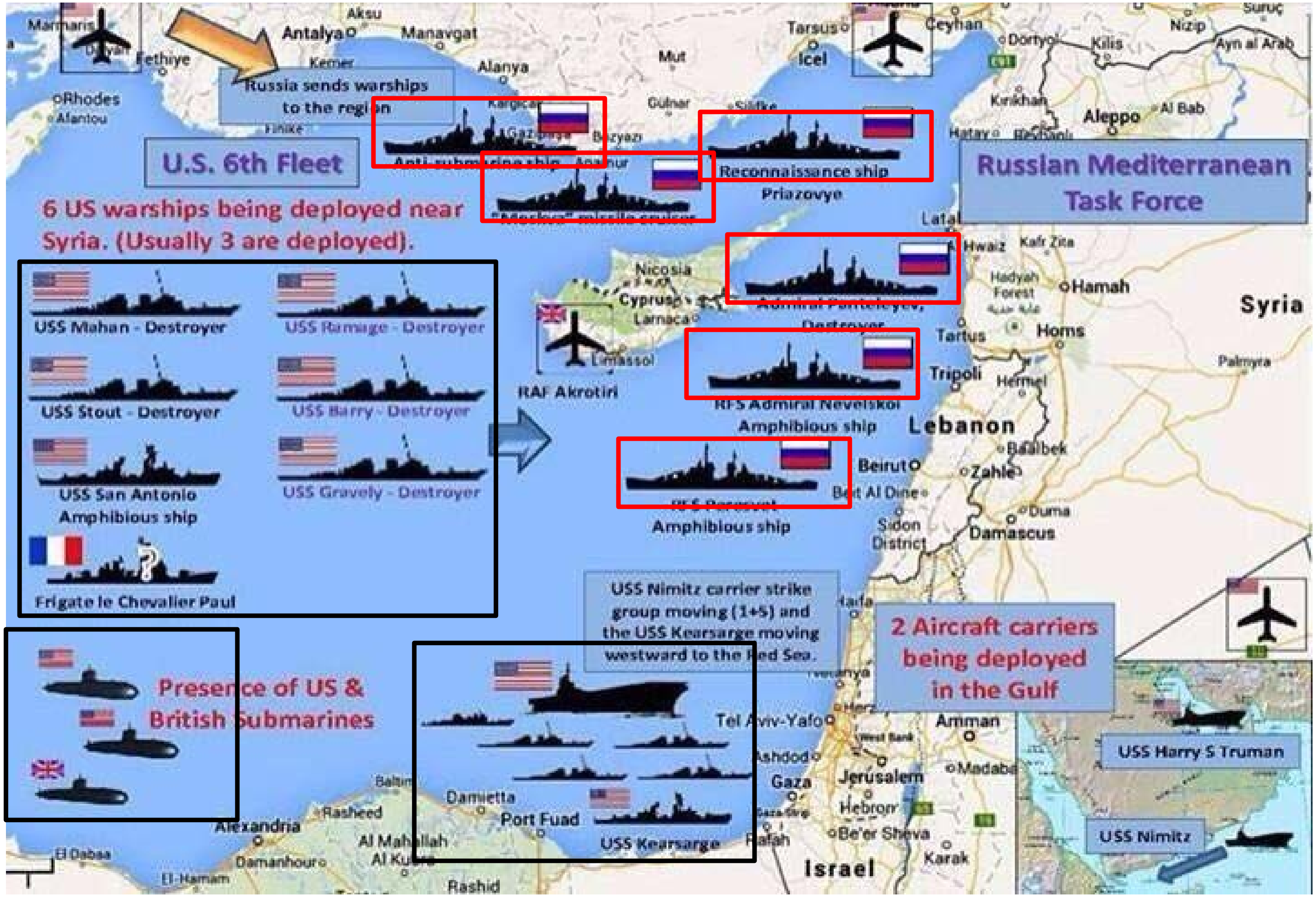
And it is this very imprecision that has Brussels and Angela Merkel very worried.

German newspaper, De Spiegel provides a very nice review of the near disastrous results for Merkel during the 2005 election. Leading up to that very important election, polls showed Merkel winning with her eyes close. Yet, just hours after the voting stations closed, Merkel opened her eyes to witness that the margin of victory was no where near levels representative of her administrations earlier confidence.

Fast forward to 2009, and yet again the polls showed a convincing lead by Merkel and her coalition. And then once again, the actual winning margin was much less than expected.

This of course brings us to 2013, and a new German financial and

Chart 1: American vs Russian military buildup in the Mediterranean



Secular change

political landscape, dominated by bailouts to every southern eurozone country. And an increasing awareness of the cost of these bailouts, with the assistance of a new political party in German – the Alternative for Germany (AfD).

The AfD was created to directly address Germany's newest short comings – namely, a unwavering support for the euro. Despite only polling at 3-4%, the AfD has certainly hit a nerve or two. Merkel refuses to even acknowledge the AfD – after all, if she directly campaigns against the AfD, she is implicitly confirming the legitimacy of this small party with very good points. On other nights, AfD rallies are aggressively and sometimes violently interrupted by supporters of the far left Green party.

That's a lot of attention for such a small and new party.

Now, investors shouldn't believe the AfD will win the election – this is very unlikely. However, there are two aspects that continue to make this election such an interesting story.

First, the swing vote could potentially shift results by up to 10%. If this level is reached, the probability of Merkel's coalition gaining the majority of seats in the Bundestag drops considerably.

Secondly, a party needs a minimum of 5% of the vote to gain all of its seats. The risk here is that current Merkel coalition partner, FDP fails to cross this magical 5% line.

Should both of these events occur, then be prepared for a few rather interesting days in Berlin. Since no party or coalition would have the seats necessary to form the government, either a super, grand coalition would occur, or something new altogether. And this is where it becomes tricky for Europe, the euro and the entire patchwork of bailout programs. It is entirely possible the new, grand coalition could actually *exclude* Merkel as Chancellor. If this were to happen, Europe would instantly become a rudderless ship, or at least a ship with one less captain.

Meanwhile, to further demonstrate the seriousness of the potential for the euro breaking apart, consider this jaw-dropping news out of Italy. The latest best seller to hit the stands is the tell-all book by former European Central Bank executive board member, Lorenzo Bini Smaghi.

In this page-turner, Bini-Smaghi details how in 2011, the then Italian Premier Silvio Berlusconi privately expressed his desire for Italy to leave the Eurozone. Free thought is fine and dandy, except when you share these thoughts with the leaders of Germany and France. No sooner had Berlusconi shared his anti-euro views with Europe's real decision makers, he was politely invited to resign as Italy's Premier and to sail off into the sunset.

Of course, never one to lay low, Mr. Berlusconi has actually returned from political exile and once again is pulling the strings of the European puppet called Italy. While Angela Merkel received the gift of a quiet, crisis-free European summer, investors in no uncertain

He was also in the Facebook movie

terms should see this as a resolution to the European debt crisis.

In fact, these days Europe is very much like a duck in a pond. On the surface, everything is calm, serene, and beautiful. Yet, underneath the paddled feet are moving a mile a minute to stay a float.

Those who believe the debt crisis is indeed over, we ask you to show evidence of any declines in debt levels across any country in Europe. After all, for the debt crisis to be resolved, one should expect to see a corresponding reduction in debt.

Every eurozone country continues to run deficits – end of story. The belief that these countries can grow their way out of their debt mess are misplaced. For this to occur, tax receipts must grow faster than new money borrowed and the interest paid on the existing and new debt.

And when it comes to actually counting all the money owed, these countries might want to include all of the money that they owe. This would require that Spain include the guarantees gifted to their banks. For Italy, this would mean including derivative losses from their banks. Lastly, for France, this would include a tally for the liabilities associated with its bloated civil servant pension plan.

The point we make is that while Europe has enjoyed a very quiet, summer of economic and political content, this period was void of any structural changes consistent with the promoted road to recovery.

Europe remains just as discombobulated as ever, and as soon as the German election is over, one should prepare for a return to the European debt twilight zone.

And if you think you are confused…

Try being Ben Bernanke for a day.

Just three months ago, Mr. Bernanke stunned the financial World by announcing the Federal Reserve had seen the light and it was indeed time to put an end to all of this money printing nonsense. The market reaction was anything but discombobulated – everything declined in value. Many bonds declined between minus 2-10%, while stock markets around the World were clobbered between minus 10-20%.

Ben Bernanke told a story that the US economy was accelerating, new jobs were abundant, and inflation was starting to increase. In central bank school, these are the main criteria for putting on the breaks and slowing this economic train down before it creates more bubbles and more unintended consequences.

The message was loud and clear – be prepared for higher interest rates and adjust accordingly.

Then a funny thing happened, the Federal Reserve returned from their summer holidays and discovered that the economy actually wasn't accelerating, new jobs were mostly low paying and part-time, and inflation numbers were lower than expected.

Central Bank School

In central bank school, these are the main criteria for pushing the pedal to the metal before the economy completely stalls.

Of course, this conclusion and the Fed's resulting reverse decision will go down in history as the most discombobulated moment in monetary history.

As for now, stocks, bonds, gold, and commodities really liked this about face and everything zoomed higher once again. Which kinda brings us right back to where we were before – economies around the World remain stagnant at best, and worse still – the American economy cannot survive without money printing.

Think about that last statement for a moment, it's stunning to say the least.

Considering the American policy responses to Syria and the economy, one thing is very clear – there's a lot of discombobulated people in Washington right now.

And if you think you are really confused…

Try being Larry Summers for a day.

Most people couldn't give a hoot about working at the US Federal Reserve, and justifiably so. Jobs at the Fed are notorious for their low pay, out dated offices and mandatory participation in the dreaded secret Santa gift exchange.

However, a position at the Fed does have one perk – *power*. And, it is this power that makes the Chair of the US Federal Reserve such a desirable job.

As the current Chair of the Federal Reserve, Ben Bernanke is now just a few months away from leaving; the scrambling for his office has been nothing short of frenetic. Whereas both Ben Bernanke and Alan Greenspan were appointed during good economic times, the new leader of the Fed is certainly taking the helm during the most interesting economic time in the history of the World.

Back when Greenspan ran the show, and during Bernanke's early years, discussions about printing money, 0% interest rates and bailing out Europe were nonexistent. Yet, the new Chair is faced with all of these untried tactics and an ever expanding Fed mandate.

Additionally, any candidate for the position can look forward to having the media, politicians, and past-their-prime Hollywood stars monitor their each and every move. Suddenly, everyone is interested in monetary policy and central bank actions.

The early front runner to assume control of the Fed was Janet Yellen. Ms. Yellen is the current Vice Chairwoman of the Fed, and since graduating from Harvard in 1976, she has been ensconced in academia and various government sponsored institutions. In effect, she's a lifer.

Ms. Yellen is very well liked, and the only knock against her is that

More of the same

throughout the current crisis, she has consistently called for more money printing, more stimulus, and then when that has been exhausted, the use of even more stimulus. It can be said with confidence she represents even more of the same.

However, as the crisis continues, Ms. Yellen's economic prescription is increasingly being viewed as a perfect example of Einstein's definition of insanity - *doing the same thing over and over again and expecting a different result.* Considering this rather awkward development, President Obama needed an alternative and his name was Larry Summers.

Like Janet Yellen, Larry Summers also hung out at Harvard, and then proceeded to develop a long and distinguished career as a civil servant. In addition to serving as President Clinton's Secretary Treasurer, the President of Harvard and the Chief Economist for the World Bank, Mr. Summers was also known as being the "smartest guy in the room." Heady accomplishments indeed.

Now, Mr. Summers differs from Ms. Yellen in two very distinct ways; whereas Ms. Yellen is known for never being in a social or professionally awkward moment, the same cannot be said for Mr. Summers. Mr. Summers' awkward moments included a rather ungraceful exit from Harvard, as well as a penchant for sleeping during important public presentations.

In fact, the social discord created by Larry Summers has been so strong, his nomination for Chair of the Fed has invoked unusually strong protests from all walks of life, including Bette Midler – yes, Bette Midler the actress/singer of "the wind beneath my wings" fame.

Whereas the political and social courts will focus on Summers' social setbacks, the most important difference between he and Ms. Yellen is how they want to address the current economic crisis. Whereas, Ms. Yellen definitely prefers more of the same, Mr. Summers prefers less of the same – in fact a lot less of the same. This of course would mean a certain end to money printing, but it would be replaced with more government borrowing and spending.

This did not bode well for Larry, given that Wall Street loves money printing, Congress is once again hitting the debt ceiling and Bette Midler is campaigning against you. Larry, we are sorry, but 3 strikes and you are out.

Which of course means, we should all welcome and congratulate Janet Yellen on eventually becoming the next most important person in our economic World. And, while we are at it, we should also prepare to welcome a more passive Federal Reserve than what was originally expected a few short months ago.

Welcome to the discombobulated World of the Federal Reserve.

Today's risk has shifted

Our Strategy

Since the May global market sell-off, stocks have traded sideways in anticipation of the beginning of the end to money printing. The shocking announcement by the Fed to delay this very important decision has created much confusion in markets.

Over the last 3 years, the risk in financial markets have clearly laid within the stock market. Each and every time stock markets teetered, central banks rushed to the rescue by printing more money to save the day.

Today, the risk is different. With long-term interest rates on the rise, and a distinct lack of any solution to cure Europe's debt woes, risk is now shifting towards the bond market, and the non-USD bond market to be exact.

The confusion created by the Fed's decision to continue printing money will not return market risk to its previous state. Interest rate risk remains at elevated levels, and when combined with a non-accelerating recovery portfolios must consider the reaction of private capital and where it will shift next.

As the World continues to increase taxes and regulation, institute bail-in plans, and confiscate pension plan assets, more and more people and companies will shift their wealth away from the perceived risky areas and towards safer countries and currencies. This will be a slow moving rotation that will eventually see a significantly stronger US dollar, and ironically, stronger stock markets.

As a result, our portfolios are positioning for more exposure to US Dollars, stocks and less exposure to interest sensitive strategies.

As always, we'd be pleased to speak with anyone about our investment views. We also encourage our readers to share our global market outlook with those who they think may find it of interest.

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Thank you for sharing your time with us.