IceCap
Asset Management Ltd.

Our view on global investment markets:

August 2015 – Let him Eat! Let him eat!

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Hold the mustard

"Let him eat! Let him eat!" the crowd chanted as disgruntled former hot dog eating champion, Takeru Kobayashi watched intently from the audience as his nemesis Joey Chestnut prepared to gorge himself with 60+ hotdogs at the 2010 Nathan's Hot Dog Eating Contest.

The 6-time champion had lost his title (and honour) 4 years earlier to the young American up and comer. Yet, this year the good folks at Nathan's refused his entry into the competition due to the former champion's wish to compete in a rival hot dog eating league.

On this brutally hot summer day, the scene was intense; something was about to happen and it did. I don't know if it was the crowd egging him on, or the hot dogs themselves taunting him, but Mr. Kobayashi suddenly leapt onto the stage and mayhem ensued. Mr. Kobayashi was arrested for trespassing and 10 minutes and 54 hot dogs later Joey Chestnut was once again champion.

Five very hot summers later, the crowds have long forgotten about Takeru Kobayashi – after all, lazy summers and lazy heat can have that effect on people.

While the 2015 summer is drawing to a close, the heat in global financial markets has only begun to turn higher.

And in a cruel twist of fate, it will be autumn when the heat really turns up on financial markets.

Greece

Well, if you're not Greeked-out by now you should be. After all, the Greek debt crisis has been spinning in and out of control for 5 years and counting.

Why should it be any different this time?

Everyone knows there is no way on this earth that Greece will ever be able to repay these debts. Unless the Greek economy can grow faster and longer than it has ever grown before, AND it can avoid the political temptation to never again spend more money than it collects in taxes – then just maybe it stands a chance of paying off some of the over $400 Billion it owes.

Greece	Debt	Result
Crisis # 1 - 2009	$ 140 Billion	couldn't pay back - needed bailout
Crisis # 2 - 2012	$ 240 Billion	couldn't pay back - needed bailout
Crisis # 3 - 2015	$ 400 Billion	???

In today's age of money printing, negative interest rates, and bank bailouts, many have become somewhat desensitized to "billions" and "trillions". Yet, we assure you $400 billion for Greece is a lot of money.

For perspective, Australia owes about $1.3 trillion in various loans. If Australia suddenly entered a debt crisis on the same scale as Greece, its debt owing would skyrocket to nearly $2.5 trillion, or put another way – about $106,000 for every man, woman and child.

 Let him eat!

It just can't work…

For Greece, it's mathematically impossible to repay its debt. If anyone else tells you otherwise, it means they have no understanding whatsoever of how real economies actually work.

The sharpest and brightest minds at the IMF, the EU and the ECB (collectively referred to as the TROIKA) all agree that the solution to the Greek crisis is for Greece to pay more in taxes, for the Greek government to spend less money, and to continue to pay off its debt.

Let's think about this for a very quick second:

1 - Greeks have to pay more taxes, which means less money is available for spending

2 - the Greek Government has to spend less money, which means less money is available for spending

3 - and of the money that the Greek government does spend, more of it has to be used to repay its debt, which means less of it is available for real spending;

And considering that economic growth is a function of aggregate spending, how on earth can any sane person expect the Greek economy to recover and grow?

The answer: they can't. For further proof why it doesn't work and it will never work, you just have to look at Iceland.

Iceland was the very first country wiped out by the 2008 global debt crisis. The Icelandic government and the Icelandic banks completely mismanaged everything for which they were financially responsible.

And when everything hit the fan – no one come running to save them, in fact, the complete opposite happened. Both Britain and the Netherlands threatened to completely wipe Iceland off the global financial map.

At the time, Icelandic banks offered regular banking accounts in Britain and the Netherlands that paid 6% interest. Considering other global banks offered 3% and less, and also considering that the vast majority of people in the world have no idea how a bank is structured; thousands of British and Dutch savers blindly ploughed their savings into these Icelandic bank accounts.

After all, it was a bank deposit, it was guaranteed by the bank and 6% is greater than 3%. Where was the risk with this?

Next, when the crisis hit Iceland – all bank accounts were frozen, and the savings of many British and Dutch investors melted away.

Suddenly, the risk with 6% was crystal clear.

Naturally, the British and Dutch governments both demanded their citizens be repaid for making stupid investment decisions.

Bankers in jail

The Icelandic government meanwhile, finally woke from their frozen state and assessed the situation. Not only did the government not have enough money to repay bank depositors, it didn't have enough money to pay themselves.

And since no one would lend Iceland any money – the country was officially broke. The rivers would stop running, the glaciers would stop flowing, and the thermal baths would stop steaming – or so we were told.

Instead, Iceland allowed its banks to collapse, allowed its currency to drop by over 70%, decided not to pay back all of the money it owed, and finally – it actually imprisoned certain bank executives for putting the country into such a financially toxic position.

A comparison between the Icelandic approach and the European approach forced upon Greece is as follows:

Factor	Iceland	Greece
Bank closures	✔	✘
Currency devaluation	✔	✘
Debt default	✔	✘
Bankers in jail	✔	✘

And as for the outcome, **Chart 1 on the next page** clearly shows the economic recovery experienced by both countries, over the exact same time frame, and using complete opposite solutions.

Iceland's economy has recovered from the depths of the crisis and is now only -3% less than where it was in 2008.

Greece's economy continues to plummet to deeper depths and is now -33% less than where it was in 2008.

The Icelandic recovery has not been perfect. Locals and foreign investors have been unable to get money out of the country. Originally, capital controls were expected to last 6 months. 7 years later they are finally being relaxed. That's a long time not being able to access your money.

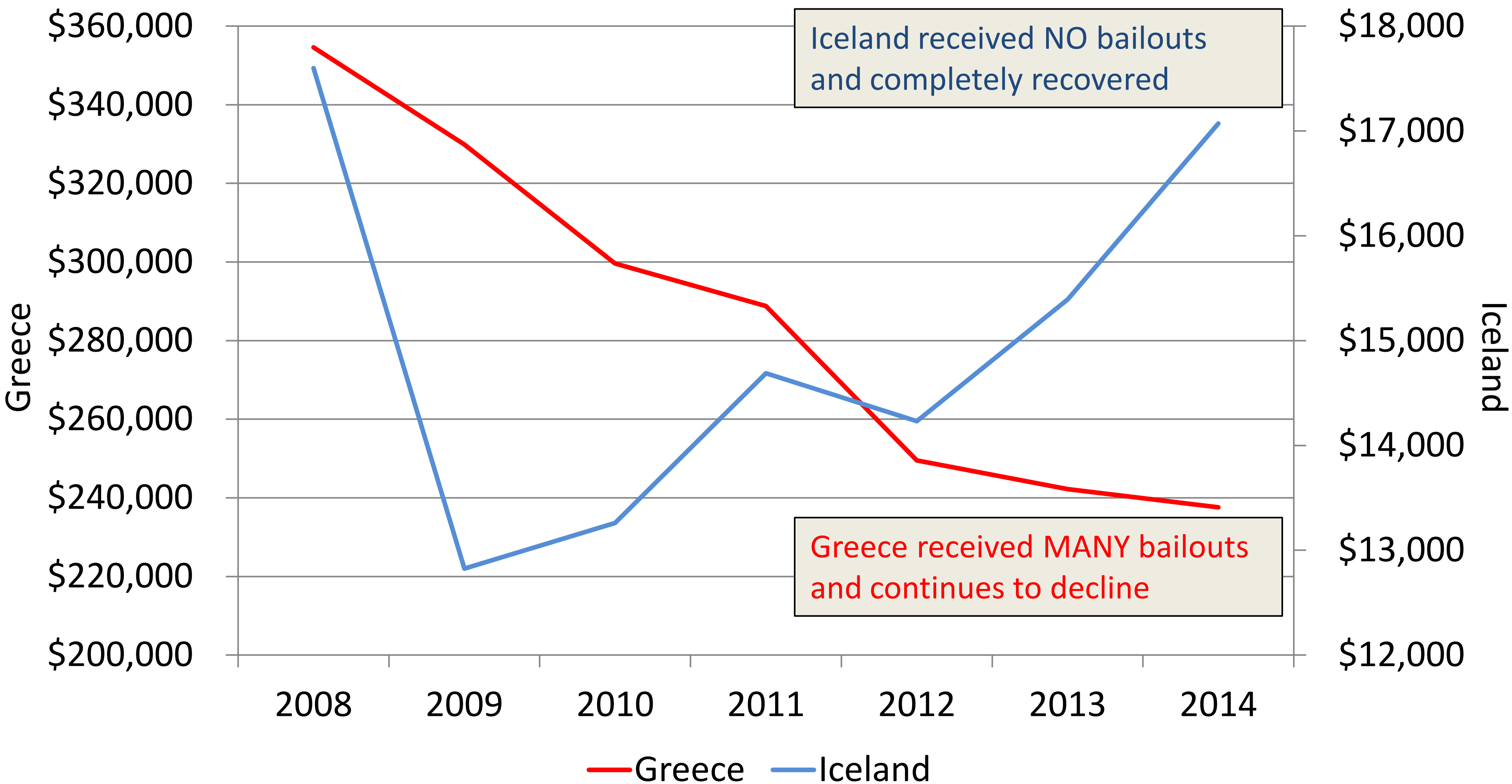
In addition, prices for all things soared with inflation hitting 20% at one point. Job losses also soared with unemployment tripling.

Yes, bad times were had – yet the country and economy survived. Greece meanwhile, continues to be subjected to a 100% guaranteed doomed strategy.

Now, if everyone knows this, then why is Germany and the rest of Eurozone so willing to flush good money down the Greek toilet?

<u>Answer</u>: it is a deterrent to Portugal, Spain, Italy, Ireland and soon to be France from also trying to leave the Eurozone.

Chart 1: Nominal GDP - Iceland vs Greece



Source: CEICdata.com, IceCap Asset Management Limited

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No one is European

To fully grasp the enormity of the situation in Europe, one must first understand that the Eurozone is made up of about 333,253,416 people living in 19 individual countries. And if you ever met any of these people - not a single person would first tell you they are European. Instead the answer would be French, Italian, Spanish etc.

In many ways, this is the most important non-financial reason why the Eurozone doesn't work. The entire premise of creating the European Union and then the Eurozone was to create a unified, United States of Europe. Everyone would become European – the north would love the south, the east would love the west, and everyone would love the Germans.

Except that hasn't been the case at all. Instead, the creation of this dysfunctional currency union has created even more rifts <u>between</u> countries, and even bigger rifts <u>within</u> countries.

Naturally, many would disagree with this statement – after all, here at IceCap none of us are European and many would say this disqualifies us from correctly understanding what it means to be European.

That's half true. Yes we are not European, however this provides us with an objective view and perspective. Instead, we are not clouded with hidden or external agendas. We have the luxury to see it as it is.

And what we see is a very large, monetary and political experiment that does not have the unwavering support of the people affected most by this union of European countries. Essentially, support for/against the entire Eurozone can entirely be broken down to who benefits from the monetary union and who suffers from being in the monetary union.

In Brussels, about 33,000 people live, breathe, eat, sleep and work directly for the European Union. The European Debt Crisis has created the awkward situation whereby they have nothing to gain, and everything to lose – talk about an incentive for the status quo.

Segment	For	Against
European Union government workers	✓	
European Union elected members of parliament	✓	
Senior receiving government pensions	✓	
Banks & insurance companies	✓	
Youth		✗
Everyone else		✗

Effectively, the split across Europe and within individual countries is divided between pensioners versus youth, government workers versus non-government workers, and the poor versus the wealthy.

As investment managers, we can offer a solution – yet it will fall on deaf ears. Instead, we need to objectively assess the situation, and

What's a Balance Sheet?

conclude whether financial, economic and social conditions are stabilizing, improving or deteriorating.

To correctly answer these questions, it's actually better NOT to be European. It places us on neither side of the FOR or AGAINST fence, and allows our mind to function in a clear and thoughtful state.

To further understand why Europe continues to bailout the likes of Greece, Portugal, Ireland, Spain, Italy and Cyprus – just know that without the bailouts, practically every bank in the Eurozone would have collapsed.

We've written before how few people, including most investment professionals, really understand how a bank is actually structured financially.

The media and mutual fund sales people are always quick to jump over how much profit a bank makes. Yes, profits are a good thing and they are always reported in a company's Income Statement. Yet, the Income Statement only shows one-side of the true financial picture of any company.

The other side of the picture is detailed in a company's Balance Sheet. While profits and losses are fun to look at, a real investment analyst will first dive into the Balance Sheet. After all, this is where you can see where the company gets money, and then you can also see what they do with this money.

Regulators demand that banks park their money in safe investments, but not just any safe investments – it must be invested in government bonds.

In Canada and the United States, only federal government bonds qualify as safe investments. Bonds from States, Provinces and cities can be held, but they do not qualify as a safe investment.

In the Eurozone however, there is no such thing as federal bonds. Yes, there are bonds issued by each individual country within the Eurozone, but there isn't any bonds issued by the United States of Europe.

And it is this distinction that separates the men from the boys.

Whereas Canada and USA require their banks to hold federal bonds as risk-free regulatory capital, the Eurozone has no such thing. Instead, European banks can hold government bonds from ANY country in the Eurozone and all of these bonds are deemed to be risk-free.

In other words, from a banking risk perspective - Greek government bonds are deemed to be identical to German government bonds.

Naturally, we all know by now that the odds of the Greek government not being able to repay their bonds are quite high. Yet, in the financial fantasy land called Europe – both Greek bonds and German bonds are deemed to be equal.

 Let him eat!

Jaw meet floor

As banks are profit seeking entities, one way for them to maximize their profits is to hold investments that will generate the highest return possible given a certain level of risk.

And, since the Eurozone considers all country bonds as equal, the easiest way for a European bank to increase their profits is to hold the European government bonds that paid out the most interest.

While the folks who created the Eurozone congratulate themselves for being very clever – it turns out global financial markets were even more clever.

Even before the Greek debt crisis began, financial markets priced Greek bonds as riskier than German bonds. This resulted in Greek bonds paying a higher interest versus German bonds.

The result of course was for European banks to maximize their holdings of Greek government bonds, and to minimize their holdings in everything else.

European banks absolutely loved this risk-free investment strategy and stuffed themselves to the gills with Greek, Irish, and Portuguese bonds. And just when you thought they were stuffed to the max – they actually borrowed money to buy even more of these so-called risk-free bonds.

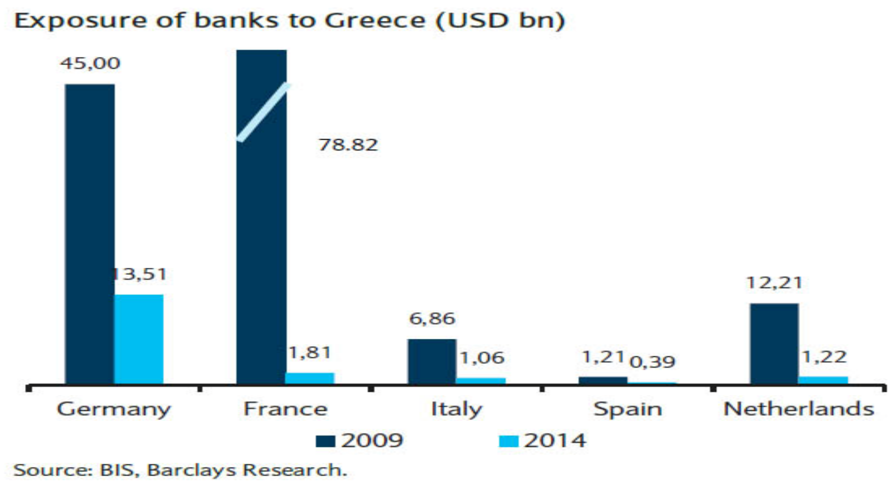
Of course, the 2008 crisis came around causing everything to hit the fan except for the jaws of senior bankers at the really big European banks, which promptly fell to the floor.

By the time these really smart bankers realised what had happened – it was too late. Greece, Ireland and Portugal were all bankrupt and anyone unlucky enough to hold their bonds were as well.

It was exactly at this point, bankers everywhere ran to their governments and explained that unless every tax payer contributed to a bailout fund for the banks, then the sun would never, ever rise again.

Voila – the fear mongering worked, and the bank bailout was born!

The chart below shows the amount of Greek bonds held by European banks both before and after the bailouts.



Voila – you're up Merde Creek

As you can see, prior to the crisis European banks were absolutely feasting on Greek debt. Bankers from all of the Eurozone countries were just as gullible as the next. Yet, French banks in particular were the worst. In fact, French banks were so far up Merde Creek it's astonishing that any French bank executive is not in jail – let alone still working in the industry.

The main point for everyone to understand is that not one-cent of any bailout money ever reached the local Greek economy.

Rather, 100% of the bailout money was simply given to these banks in exchange for their bad investments in Greek government bonds.

Instead of bank investors bearing the loss, losses were spread out across every tax payer in every European country.

But I'm not Greek!

It's at this point many of you are likely asking what all of this Greek and European debt crisis chatter has to do with you.

After all, many of you do not live in Greece, or the Eurozone and therefore all of the previous discussion doesn't affect you.

If only this was true.

Remember; the Greek debt crisis isn't THE crisis. Rather it is simply a <u>symptom</u> of a much larger global debt crisis. We've written before that governments all around the world have borrowed too much money and the weight of these debts are choking economic growth.

And to make matters worse – these very same governments and their central banks have implemented various plans that have only made matters worse.

Our view has not changed – the global debt crisis has escalated to a point where the government bond bubble has inflated itself to become the mother of all bubbles. It's going to burst, and when it does it wont be pretty.

Further evidence to support our view is as follows:

Canada – the collapse in oil and commodity markets has pushed the country into recession and the Canadian Dollar to decline to levels lower than that reached during the 2008 crisis.

Oil dependent provinces Alberta and Newfoundland remain in deep denial. Since everyone in these provinces have only ever experienced a booming oil market, many naively believe things will bounce back – and quickly.

Meanwhile, both Toronto and Vancouver housing markets also remain in denial as they continue to go gangbusters. Buyers today are likely buying at all-time highs.

 Let him eat!

Global crisis is spreading

And as we predicted last year, the Bank of Canada has cut (not raised) interest rates twice in the last 6 months.

We fully expect the Bank of Canada to eventually cut interest rates to 0% and start a money printing program as well. And for the stunner - NEGATIVE interest rates will not be that far behind.

Australia – Over the last 20 years, China has been viewed as the growth engine of the world, and justifiably so. With annual growth rates between 8% to 15%, China's economy was literally eating every rock, stalk and barrel of practically every commodity in the world.

And naturally, any country or company that produced these commodities made a tonne of money – including Australia.

Today, China's growth rate has slowed to about 3% which is a dramatic slow down compared to what it achieved in the past. This slowdown and China's effort to even maintain these rates, will have significant repercussions around the world.

And the first up to bear the brunt of this slowdown is its closest supplier of raw materials – Australia.

With dark clouds on the economic horizon, the Australian government and central bank is doing everything possible to prevent the unpreventable recession.

Interest rates have been reduced to all-time historical lows, meanwhile the Australian Dollar has plummeted -25% over the last year. Yet – the negative outlook has not improved.

Brazil – Like Australia, Brazil has benefitted immensely from China's growth. And now, also like Australia, it too is feeling the affects of the dramatic Chinese slowdown.

The economy has now declined for 12 consecutive months making it both the longest and deepest recession in 25 years.

But wait – it gets worse. Despite declining growth, inflation continues to soar higher causing interest rates to rise as well.

And if that wasn't bad, also know that the Brazilian currency has fell off the cliff at -53%.

Sweden – Unlike Australia and Brazil, Sweden relies very little on China as a buyer of last resort. Yet, the Swedish economy is also not very hot these days.

In fact, instead of spectacular and dramatic declines in anything, it is doing the exact opposite – it just isn't moving.

While Sweden isn't in the Eurozone, it is smack dab next to it and that in itself is reason enough for the lack of growth. We've written before how the debt crisis in the Eurozone is acting like a giant, slow moving

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The opportunity is right in front of you

tornado that is sucking the life out of the economy and everything near by. And unfortunately for Sweden, it is very near by.

While economic growth in the Nordic state hasn't declined, it hasn't accelerated either – and this is what has many worried.

So worried, that the central bank shocked everyone not once but twice, by first announcing that they would begin to print money, and then when they announced that interest rates would be NEGATIVE.

These actions are so severe, that we need to repeat them:

1) MONEY PRINTING
2) NEGATIVE INTEREST RATES

It is hoped that these actions will cause people and companies to loosen their wallets and start spending again. Yet, what the government and the central bank doesn't understand is that these actions will actually make the problem worse.

As the global economy continues to move as we expect, there is nothing Sweden can do to change what is coming – a global recession and a significantly weaker Krona.

China, Australia, Brazil, Canada, Sweden - it is beyond us how anyone can declare the crisis isn't spreading. Be prepared – there are going to be lots of opportunities to both make and lose money.

But first, you have to recognise what is happening.

Our Strategy

As the quiet, sleepy days of summer mow along, global markets continue to move along as we have expected.

Main stream media has mostly reported that the Greek debt crisis has once again been resolved – we completely disagree. We disagreed after the 1st bailout, we disagreed after the 2nd bailout and we disagree now after the 3rd bailout – if in fact it is actually accepted.

The Greek crisis remains a symptom of a GLOBAL debt crisis – those reporting and concluding that what happens in Greece will not affect the rest of the world, really have no idea what is coming down the pipe.

As autumn approaches, we expect to see extreme volatility across all asset classes. The ball will get rolling with the US Federal Reserve raising interest rates for the first time since 2006.

Ultimately, we see global markets being affected by collisions between global interest rates, global growth and global debt crises.

The next IceCap Global Outlook will cover this collision in detail as well provide our guidance for portfolio strategy.

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USD remains our favourite

Meanwhile, current strategy remains as follows:

<u>Stocks</u> – Most stock markets peaked earlier this spring. While the summer trend remains negative, we expect markets to trade sideways until the fall. Previously we reported our sale of emerging markets and energy sensitive strategies – both strategy moves were correct. No changes have occurred since our last Global Outlook, yet we are preparing portfolios for strategy changes as the summer ends.

<u>Bonds</u> – We believe the low-risk, high return days for both High Yield Bonds and Emerging Market Bonds are over. We exited both strategies in 2014, and have avoided the recent sharp whipsaws from both strategies. Our fixed income strategies remain focused on high credit quality and shorter maturities and duration. Bond markets have been in a bull cycle since 1980 and the good times are almost over.

<u>Currencies</u> – Our expectation for a significantly stronger US Dollar has been well documented and it is playing out exactly as we have expected. Our non-USD client portfolios have benefited significantly from our bullish view on the US Dollar.

Our Canadian Dollar portfolios have a 25% allocation to US Dollars. This position is completely separate from our Stock and Bond strategies, and it has increased over +13% in 2015, and over +20% during the last 12 months.

<u>Commodities</u> – The entire commodity complex remains very weak. The commodity market will eventually rebound, but we do not expect this to happen in the near or intermediate term.

As the debt crisis continues to intensify, money will leave all regions and markets to seek safety in the only market in the world big enough to absorb such capital flows – the US Dollar.

Our portfolio strategies have been positioned to benefit from these market movements, and will see further strategy changes as we enter the next phase of the crisis.

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.