IceCap
Asset Management Ltd.

Our view on global investment markets:

November 2013 – That’s why I’m richer than you

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It's only money

As CEO of JP Morgan, Jamie Dimon is one of the most powerful people in the banking world. His morning espresso always arrives extra fast, his usual lobster lunch is always succulent, and his grass fed, American beef dinner is always grilled to a rare perfection. And that is only a Monday. The rest of the week and weekends are even better.

Meanwhile, Mike Mayo is just a banking analyst. His Monday routine involves waking before the crack of dawn just to sharpen his pencils. And who can blame him? After all, in his line of work, a sharp pencil, a sharp mind and the confidence to ask sharp questions separate the respected analyst from the herd.

It was only a matter of time before they crossed paths. And, when you consider the pit bull-like tenacity of each, everyone knew the outcome would be rather interesting, to say the least.

And then it happened. The February 2013 JP Morgan earnings call kicked off like any other bank analyst meeting with management congratulating themselves for making so much money, followed by countless analysts lobbing softball like questions for them to hit out of the park.

At this point, Mr. Dimon was everything that the king of Wall Street should be – he was laughing, chuckling and grinning. The only thing he didn't do was mock anyone. That was about to change.

As Mr. Mayo took the floor, everyone braced for the only real-life questions to be asked. After all, if not for the generosity of both the American tax payer (and everyone else in the world who depended upon interest income to buy everything but lobster and grass-fed beef) JP Morgan and other big box banks would not be alive today. The bailouts from 2008, 2009, 2010, 2011, 2012 and 2013 continue to help pad their bottom line; yet somehow these banks don't seem the least bit grateful.

From the first, second and even third glance, Mr. Mayo's question wasn't the least bit inflammatory or provocative, he simply asked Mr. Dimon why would a client choose JP Morgan over the better capitalized, UBS?

Mr. Dimon's jovial mood quickly soured, and instead of answering the question, he fired back his own question, incredulously mocking Mr. Mayo for even suggesting someone wouldn't choose JP Morgan. And then, to add the cherry on top, Mr. Dimon finished the questioning with the now most infamous and condescending banker statement of all-time "and that's why I'm richer than you."

Of course, fast forward to today and it has now become plainly obvious why Jamie Dimon and his JP Morgan are richer than everyone else – they have to be richer. The social and political climate has certainly shifted against our global behemoth banks.

The recent decision to fine JP Morgan $13 billion for contributing to

Big shifts are taking place

the debt crisis is the latest whopper. Of course, people also shouldn’t forget the $1 billion fine for improper trading, HSBC’s $2 billion fine for money laundering, nor Standard Charter’s $327 million fine for helping Iran circumvent US sanctions.

As the unintended consequences from the 2008 debt crisis continue to swirl, investors and non-investors alike should understand that just as public and political sentiment towards the big banks has shifted, so too has the political slant and governments’ quest for a solution to countries declaring bankruptcy.

The culmination of these shifts, is having an unorthodox effect on financial markets. In the most simplest terms monetary, fiscal, political and economic forces continue to deteriorate which will create perhaps the biggest paradox of all – a higher stock market.

What a bunch of whiners

First there was Mexico, then France and now Germany. Apparently, it’s pretty easy to get the leaders of these countries upset over a little thing called privacy.

A few months back, anyone who wasn’t already lulled to sleep by our smooth talking world leaders received a rude wake-up call from American Edward Snowden. At the time, Mr. Snowden informed the world that the American government was recording and collecting all forms of your communication. Emails, texts, phone calls, Instagrams and even your beloved Facebook minutiae were all being gathered for safekeeping in a very special building in Utah.

The official reason for this massive IT project is to protect us from the terrorist. In fact, upon Snowden’s revelation, the National Security Agency (NSA) quickly announced that this project already prevented “54 different terrorist-related activities” including one to strike at the heart of America – Wall Street.

As for Mr. Snowden, he has officially been declared an American traitor as well as someone who fibbed about how much money he made. To further soil whatever of his name remained, apparently he also had a cute girlfriend and he ate apple pie. This is one bad dude.

Yet, those who actually read the reports and listened to his interviews, were quickly disappointed. Mr. Snowden wasn’t a modern day Daulton Lee. He did not help his high school friend sell top secret stuff to the Soviets or Chinese. In fact, as far as we can tell all he did was tell the world that the American government was spying on its own people. Obviously this hit a nerve or two and confirmed one thing – in America, it is illegal to report on the illegal activities of the government. Going forward, freedom of speech and the 4th Amendment are to be ignored.

Truthfully, while the Edward Snowden story was going full frontal,

Can you hear me now

many other countries were probably giggling to themselves over this latest naughty American predicament. However, fast forward a few months, and these giggles have been turned upside down. It turns out, this wasn't simply a story about Americans spying on Americans. It was also a story about Americans spying directly on French President Francois Hollande, German Chancellor Angela Merkel and Mexican President Enrique Pena Nieto. No one is safe.

Some will scoff at this story, claiming that spying has always and will always exist. However, it's our view they are missing the point. It's become very clear that this isn't an exercise of targeting suspicious characters – in this exercise everyone is suspicious. What happens next is very easy to predict – if you spy on everyone, everyone will simply change their online behavior. Well, everyone except those people on FaceBook – that's a group we should keep our eye on.

From an investment perspective, this creates another potential geopolitical risk. An ongoing sluggish recovery, combined with crazy interest rates and even crazier money printing is putting a few people on edge. Shifting a spy scandal from the back pages to front page news has the potential to really shake a few cages and ignite a spark to create the next crisis within a country or region.

The Edward Snowden affair is fascinating, and we encourage all readers to spend a few objective minutes following this story and to consider what might happen next. This is just getting started.

The Super Tax

It's no secret by now that governments in Europe, Japan and America have spent and borrowed beyond their means. Including both current debt and future unfunded liabilities, it is estimated America owes over $87 trillion dollars, while the Eurozone countries are on the hook for over $89 trillion. That's a fistful of dollars.

From a tax perspective, the inability of these super economic powers, becomes all the more clear. America's annual tax revenue is only $2.5 trillion, while in Europe, they manage to squeak out roughly $5 trillion. From this view, America is leveraged 34.8x their tax revenues, while the Eurozone is leveraged at 17.8x their tax revenue.

Since we have all become numbed by talks of billions and trillions, let's put these numbers on the dinner plate of the average American family. According to the OECD, the average American family has income of about $31,000 per year. If this average family borrowed like the American government, it would have over $1.078 million in loans to pay. Good luck finding a bank to lend you that amount of money.

The good news is that the bulk of this debt is owed by the country – not individuals directly. The 2008-09 debt crisis forced many people and companies to tighten their belts and to live within their means.

European, American and Japanese governments, on the other hand,

Be prepared for higher taxes

continue to spend more than what they collect in taxes. Naturally, this means the money owed by these countries is always increasing. More worrisome is the fact that when interest rates eventually rise, the interest owed on this debt increases exponentially.

Even more worrisome, considering these countries are deeply committed to defying the laws of mathematics and never defaulting on their debt, only one outcome is assured – taxes have to increase, and government services have to decrease. In the end, everyone has to pay. Despite what Brussels may say, there is no magic solution.

Chart 1 (next page) shows the trend in taxes since 2010, for simplicity just note there are an awful lot of green "up" arrows. Don't expect this to change anytime soon.

Yet, the real questions behind the upcoming tax hikes are 1) why it will happen and 2) what will be taxed.

And more importantly – what is the Super Tax?

Why taxes are about to increase

2010, 2011 and 2012 were all about saving the stock market. Multiple times during each year, both the US Federal Reserve (FED) and the European Central Bank (ECB) explicitly stated they wanted to see a higher stock market. Their thinking was that if the stock market doesn't return to 2009 levels, people and companies will once again feel rich (or maybe not poor) and therefore spend, spend and spend which would naturally create jobs, jobs and more jobs.

With hindsight, we now know that Europe came perilously close to imploding: first with Greece, and next with the banking crisis in Spain, followed by the big one – Italy. We know this today, thanks to the tell-all book authored by Italy's former big-6 insider at the ECB - Lorenzo Bini-Smaghi.

This real nice fireside book reveals how then Italian Prime Minister Silvio Berlusconi, told the ECB, German Chancellor Angela Merkel and then French President Nicolas Sarkozy in person that Italy was pulling out of the Eurozone. This act of course would have had dreadful reactions around the world.

For starters, Italy would have defaulted on its debt which would have closed its banks. The next dominos to fall would have been practically every other European bank. Even Germany, the bastion of financial solitude would have lost over EUR 570 billion in loans to other central banks. Asian, American and Canadian banks would have also been swept up in this tangled web. In short it wouldn't have been fun.

Of course this didn't happen. Instead, Brussels decided to immediately remove Berlusconi as the Italy Prime Minister and replace him with one of their own. In addition, the ECB stated it would do whatever it takes to defend the Euro. And unsurprisingly, they've been defending it ever since.

Chart 1: There won’t be any tax errors in your favour

Table 9. Tax Measures in Selected Countries, 2010–13

Country	Personal Income Taxation		Corporate Income Taxation		Value-Added Tax		Social Security Contributions		Excises		Property	
	Rate	Base	Rate	Base	Rate	Base	Rate	Base	Rate	Base	Rate	Base
Advanced economies												
Australia		↑		↓				↓				
Austria		↑		↑		↑		↑	↑			
Belgium	↑	↑		↑		↑	↑		↑		↑	↑
Canada	↑	↑	↓						↑			
Czech Republic	↑	↑		↑	↑		↓	↓	↑			
Denmark	↑	↑		↑		↑			↓	↑		
Finland	↑	↑	↓		↑				↑			
France	↑	↑	↑		↑	↑	↑		↑			
Germany		↓					↓		↑			
Greece	↑	↑	↑		↑	↑	↑		↑		↑	
Hong Kong SAR												
Iceland		↑	↑			↑	↑		↑			
Ireland	↑	↓			↑	↓	↓	↑	↑		↑	
Israel	↑	↑		↓	↑		↑		↑			
Italy	↑			↓	↑				↑			↑
Japan			↓									
Korea	↑	↑	↑									
Netherlands	↑	↓	↓		↑				↑		↓	
New Zealand	↓		↓		↑				↑			
Norway												↑
Portugal	↑	↑	↑		↑	↑	↑		↑		↑	
Singapore			↓								↑	
Slovak Republic	↑	↑	↑		↑		↑	↑	↑			
Slovenia	↑		↓						↑			
Spain	↑	↑		↑	↑	↑			↑		↑	
Sweden		↓	↓						↑			
Switzerland		↓			↑							
United Kingdom	↓	↑	↓	↓	↑		↑		↑		↑	
United States	↑	↑					↑					

Source: IMF Taxing Times October 2013

Elvis has left the building

Since then, European debt markets have become anything but an open market. Pricing of all sovereign debt has been frozen in stasis. With the pricing mechanism clearly broken; capitalism and free markets have certainly left the building. However, there are always unintended consequences. And the unintended consequences of the European strategy to completely eliminate pricing discovery, economic cycles and animal spirits is showing up in the private sector.

Whereas public sector money continues to do its thing, private capital has already left specific Eurozone countries, and it is only a matter of time before it begins to leave the entire continent.

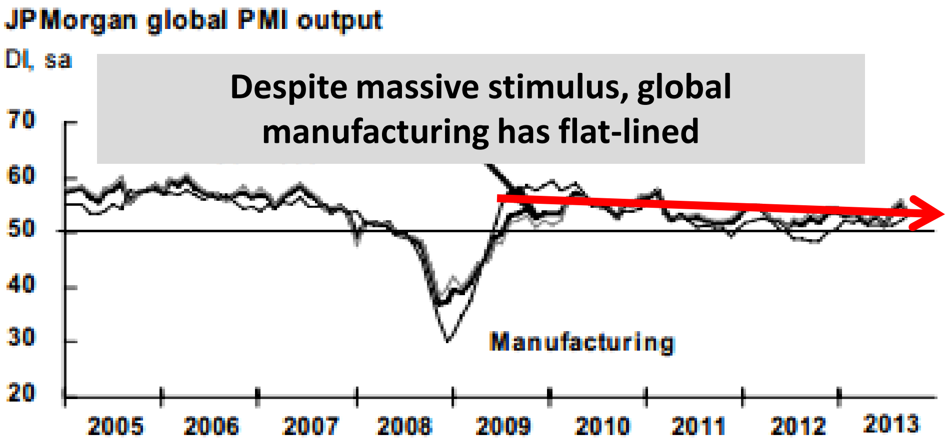
During these pivotal years from 2010-2012, many people still do not realize that the markets nearly did return to the 2009 levels. Yes, markets really were that close to tumbling over and a capital preservation strategy was indeed the choice of rational and informed people.

Today things are quite different; yet you will not read this in your regular big bank quarterly report. The big bank reports continue to guide their sheep along the rosy path of an accelerating economic recovery. No surprise that not much has ever changed in these investment outlooks. In fact, for some weekend humor dig up your big bank reports from any month over the last 30 years; while the then current events are different – the conclusion has always been the same – buy the balanced fund.

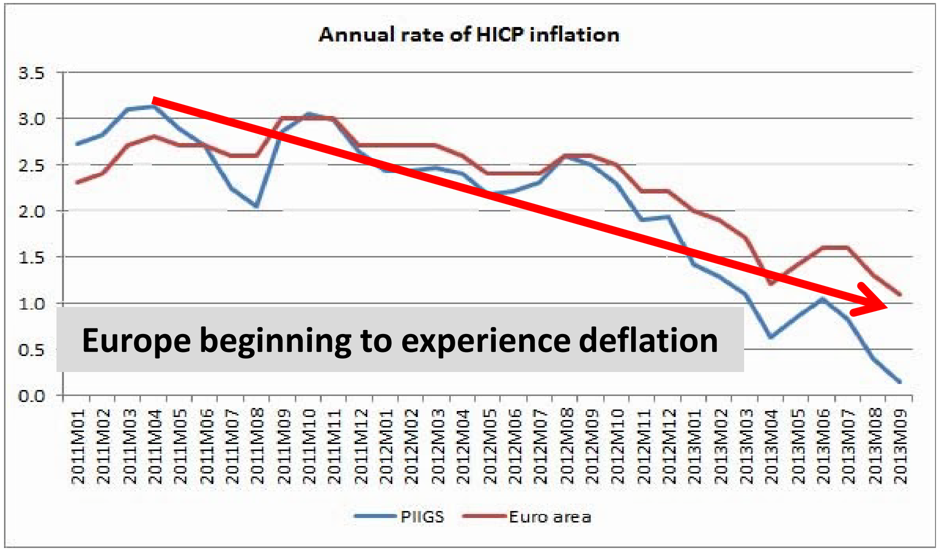
In some ways, you cannot fault them. Considering 20 of those 30 years occurred during the greatest secular bull market of all time, it's no wonder the conclusion sounds like a broken record – the big banks don't know any better.

If the economy really was clipping along at an ear to ear grinning pace, several things would have happened by now. First up, central banks in the US, Canada, Britain, Europe and Switzerland would have all begun to raise interest rates. Not too mention, the money printing machines would have also begun to grind slower.

In addition, employment should be going gangbusters, while everyone's favourite measurement of a stronger economy – inflation would be accelerating as well. Yet, none of these events are occurring.



Common sense



Those that truly follow global markets and understand the very big picture painted by our central banks and government finance departments understand that financial markets today do not represent the economic reality that we have all been trained to believe. After all, the confusion emanating from financial markets, individual companies, and macro data points certainly bakes one big confusion pie. It just seems that nothing makes sense. Or does it?

From our perspective, we actually see a lot of common sense. Mind you, not from the public sector, but rather from the private sector. As demonstrated during the recent American debt ceiling crisis, the nonsensical whims from Washington alone supports our view that our governments have completely lost touch with reality. After all, it has become quite clear that long-term, multi-generational thinking certainly does not reconcile with the 4-5 year elected mandates.

Whereas the good companies have long-term visions for growing their revenues and controlling expenses, even the best elected officials become swamped with in-house political agendas, and not to mention a sea of lobbyists.

Putting it all together, it becomes very clear that significant, generational changes will not occur. In fact, it has become crystal clear that both central banks and governments will do everything possible to prevent financial markets from properly pricing the bond market for government and bank issued bonds.

Since losses or write-downs will only be delayed, we should understand that the only way for governments to seemingly get their fiscal house under control is first to rely upon a significantly stronger economy - the kind of economic miracle that will allow a country to *grow* out of their debt problems. This mystical economic miracle has never occurred: don’t hold your breath waiting.

This leaves our governments with the option of increasing taxes and/or reducing spending. As we’ve seen in Europe and America, governments are simply incapable of spending less. They may find a way of slowing the amount of spending growth, but at the end of the day the net effect is still more spending, more deficits and subsequently – more debt.

The city of light

In their minds, this leaves higher taxes as the only option. And, of course when their eyes spy who, and what, they can tax – the transformation from tiny pupils to mammoth saucers is complete; the wealthy are about to get hit with some pretty big tax bills.

There's no escaping it. The wealthy make up a minority, meaning they do not control the vote. How much the wealthy can really contribute, is irrelevant; as President Obama says they must "pay their fair share." Of course, what is swinging in the wind is the subjective definition of the all important word – fair.

To begin with, the IMF produces a very nice, voter friendly summary chart below of the exact benefits of taxing the super rich. Reading the tea leaves, it shows a 1% tax on the top 10% of the richest Americans will produce tax revenue equal to 1.7% of GDP. Better still, if the Americans taxed the really, really rich an extra 1% on top of the already proposed 1%, this will dream up a wind-fall of 3.1% of the GDP.

On paper, this sounds marvelous. With America running about a 7% spending deficit in 2012, this new IRS Form will help to cut the deficit almost in half. Better still, if we can all hope (there's that word again) for real economic growth of 4% - deficits everywhere would be under control.

Now, this dream of taxing the super rich is not only beginning in America, it is already doing full-on cartwheels in the most socialist country in the world – France. Now, to clarify – we absolutely love France. Paris is easily one of the most beautiful cities in the world.

Table 12. Potential Revenues from Recurrent Net Wealth Taxes
(Percent of GDP)

	Survey Year	1 Percent Tax on Wealthiest 10 Percent of Households[1]	Progressive Tax Rate Schedule: 1 Percent on Top 10 Percent and Additional 1 Percent on Top 5 Percent[1]
Canada	1999	0.6	1.1
Germany	2006	1.1	2.0
Italy	2004	1.0	1.7
Japan	2003	1.2	2.0
United Kingdom	2000	0.8	1.3
United States	2006	1.7	3.1
Unweighted average		1.1	1.9

Sources: Luxembourg Wealth Study database; Organisation for Economic Co-operation and Development; Eurostat; and IMF staff estimates.
[1] Tax applies only to the portion of wealth above the 90th percentile.

Source: IMF Taxing Times October 2013

The 10% Super Tax

The architecture is gorgeous, the food is gorgeous – everything is gorgeous. Yes, we like France.

However, a bizarre overnight announcement that anyone earning more than EUR 1 million would be taxed at 75% has had a rather unexpected result – the rich are leaving. What started out as an exodus of successful business people and actors, has now spread to the near-holy world of soccer. Apparently soccer players don't appreciate this new tax either and are staging walkouts as the French professional season comes to an end.

If that wasn't enough, France's new tax on trucks has also hit the skids as farmers united and rioted to defend their right to a subsidized idyllic life in the countryside.

The point we make, is that many countries around the world have now reached the stage where they realize the tax noose is their only way out of fiscal hell.

The other point we make, is that people are catching on and are in the process of moving their wealth to protect what they have earned.

Yet, this battle between the rich and the state will eventually pause as soon as the state realizes that they have to tax *everyone*.

And this brings us to the Super Tax

The IMF has also figured out that taxing the mega rich alone will not be enough to turn the debt tide. Not to worry – a solution has been found and whereas IceCap is calling it the Super Tax, the IMF has named it a wealth tax.

A few weeks ago, the IMF published a whopper of a tax study. For some reason, the main stream media either ignored the most important policy paper of the year, or maybe they were simply distracted with Washington's debt ceiling crisis. Considering, one is the result of the other, it's only prudent for your investment and tax professionals to consider the implications.

The so-called Super Tax is buried deep on page 49 and a snapshot summary is in our **Chart 2 on the next page**. In its simplest form, the IMF suggests taxing <u>everyone 10% of their net worth</u>. Yes, net worth – not your income. The good news is that in the minds of the IMF, this will restore some level of debt sustainability.

The biggest jaw droppers include the recommendation that this 10% be implemented overnight, without any warning whatsoever. The IMF believe that if the super tax is implemented overnight, people will actually feel all warm and fuzzy as they'll instantly believe the tax will never be repeated and that it will not distort tax payer and investor behavior.

In addition, although the IMF does not state it in the paper, it also believes in the Santa Claus, the Easter Bunny and the box office success of the latest Stallone/Schwarzenegger movie.

Chart 2: The IMF suggests a one-off 10% wealth tax

Box 6. A One-Off Capital Levy?

The sharp deterioration of the public finances in many countries has revived interest in a "capital levy"—a one-off tax on private wealth—as an exceptional measure to restore debt sustainability.[1] The appeal is that such a tax, if it is implemented before avoidance is possible and there is a belief that it will never be repeated, does not distort behavior (and may be seen by some as fair). There have been illustrious supporters, including Pigou, Ricardo, Schumpeter, and—until he changed his mind—Keynes. The conditions for success are strong, but also need to be weighed against the risks of the alternatives, which include repudiating public debt or inflating it away (these, in turn, are a particular form of wealth tax—on bondholders—that also falls on nonresidents).

There is a surprisingly large amount of experience to draw on, as such levies were widely adopted in Europe after World War I and in Germany and Japan after World War II. Reviewed in Eichengreen (1990), this experience suggests that more notable than any loss of credibility was a simple failure to achieve debt reduction, largely because the delay in introduction gave space for extensive avoidance and capital flight—in turn spurring inflation.

The tax rates needed to bring down public debt to precrisis levels, moreover, are sizable: reducing debt ratios to end-2007 levels would require (for a sample of 15 euro area countries) a tax rate of about 10 percent on households with positive net wealth.[2]

[1] As for instance in Bach (2012).

[2] IMF staff calculation using the Eurosystem's Household Finance and Consumption Survey (Household Finance and Consumption Network, 2013); unweighted average.

Source: IMF Taxing Times October 2013

You're making that up

Additional reading is guaranteed to produce heavy eye lids and frequent trips for the drink of your choice. It isn't light reading; the message is certainly a heavy burden to share.

One should understand, since 2008 the IMF has had its full attention focused on the Eurozone. This idea of a super tax is aimed squarely at Europe and the Eurozone. In addition, the relative success of the super tax in Cyprus has certainly been reason for Brussels to cheer. The lack of a significant reaction from the general public has only further boosted the self esteem of the European Council and the Council of the European Union.

To conclude – the crisis from 2008 has not been resolved. The losses have merely been transferred from the private sector to the public sector. Since losses are still losses – eventually they have to be recognized, today the public sector is trying to figure out how best to actually realize these losses. And as the rabbit hole gets deeper, it is becoming clearer that the losses will be realized through higher taxes.

And since we are discussing Europe, it's only fair we finish with one of those "you're making that up" observations:

Over the last 3 years, the EU has arrogantly demanded the Irish, Portuguese, Spanish, Italians, Greeks and Cypriots all reduce their spending, increase taxes and sell-off assets to improve their financial situation. Yet, today we learn that just as Washington has run out of money so too has Brussels - $3.6 billion to be exact. It seems the cost of running the European Council and the Council of the European Union is a lot higher than one would have thought. All told, this puts the deficit at over $19 billion for the year.

Whereas the bailed out countries were bullied into financial submission, there's no one watching the fox itself. Just as America has important elections in 2014, so too does the European Union. As it stands today, the 2014 elections are really shaping up to send a message that enough is enough. Meanwhile, we suggest you begin to monitor the fiscal and trade balances of your city and country. Then ask your elected officials how they plan to increase tax revenues and close their deficit.

Be prepared for fluffy answers, waffling around a growing economy and moves to attract new business. It will all sound very nice and warm, yet when you dig for specifics, it becomes all too clear everyone in the world is depending on this economic miracle that continues to be dragged around from the excessive debt loads around the world.

Absent economic growth, higher taxes are the only perceived option. Be prepared.

Unusual times continue

Our Strategy

Over the last few months, we have steadily increased the exposure to stocks and the USD in our portfolios.

We believe our view has been communicated very clearly – our expectation for a rising stock market and stronger USD is not related to an improving economy. Rather, central bank policy and fiscal positions in both Europe and Japan continue to deteriorate. And it is these trends that will drive investors away from these regions and towards the only market capable of absorbing such large allocations of capital.

We have to admit, today stocks are looking a little toppy with many sentiment indicators showing investor enthusiasm as being too high. From our experience, this suggests stocks are due for a pause or even a correction in the -5% to -10% range. Yet, we would view this as an opportunity to continuing adding to our positions in the stock market.

Meanwhile, our analysis of the global economy continues to show a lack of any acceleration. Instead growth remains quite stagnant. As a result, we fully expect to see tax increases in many countries with a particular focus on property taxes, surtaxes on the rich, as well as the potential for a one-off wealth tax on everyone but the poor.

Investors should expect unusual times to continue.

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.