Our view on global investment markets:

*September 2012 – “3 days that shook the World”*

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Elvis Presley was the King. Whenever he jumped on stage and got “all shook up” the World took notice. His kind of shaking was fun for everyone.

On the other hand, American President Kennedy and Soviet Premier Khrushchev didn’t quite get to shake the World, but they certainly forced the World to hold its breath over a tense 13 days. Unlike the King’s version, this kind of shaking wasn’t fun for anyone.

Meanwhile, in September 2012 the World’s central bank superpowers are at it once again. This time however, the orchestrated shaking is intended to provide the best of both Worlds – fun for everyone who chooses to play along with the money printing schemes, and not so much fun for those who recognise the stress it is creating throughout the World’s financial system.

To fully appreciate this current shaking, one must first understand the simple law of diminishing returns.

The Law of Diminishing Returns
While there are plenty of complex laws to keep lawyers happily billing forever, there is one law that is very simple and is never mentioned by those responsible for the good health of our global economy - the law of diminishing returns.

This un-billable law becomes a nightmare for anyone trying to produce more of anything. It occurs when despite putting increasingly more effort into an activity, the desired outcome becomes less and less rewarding.

Case in point, one just has to consider America’s growth of borrowed money and the resulting growth in GDP over the last 50 years.

Chart 1 on the next page shows that in the 1950s, America had to borrow just $1.36 to grow their economy by 1 extra dollar. That’s not so bad until you consider that over the next 50 years America had to borrow more and more to produce less and less GDP. In fact, during the 2000s America had to borrow $5.76 to grow its economy by an extra buck – that’s progress.

Now, we’re sure that over the years all of this borrowed money was put to great use. After all, the future never comes so why worry about it. Unfortunately, the future is today and the “credit cliff” is quite steep (see chart 2 page 3). The debt reaper is knocking on the door and he wants his money back. There’s just one minor problem – no one has the money to repay him.

No problem, the central banks & governments have plenty of money tools available to beat back any financial challenges presented by the debt reaper.

To make you feel more uncomfortable, let’s review the tricks in their money bag:
## Chart 1: US diminishing returns from borrowing

### DIMINISHING RETURNS FROM DEBT FINANCING BY DECADE
12/31/1949 - 3/31/2011

<table>
<thead>
<tr>
<th>Date Range</th>
<th>Decade Change in Debt (billions $)</th>
<th>Decade Change in GDP (billions $)</th>
<th>Debt/GDP</th>
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<td>12/31/1949-12/31/1959</td>
<td>337.6</td>
<td>248.0</td>
<td>1.36</td>
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<td>752.1</td>
<td>491.3</td>
<td>1.53</td>
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<td>2785.2</td>
<td>1654.9</td>
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<td>12549.6</td>
<td>4026.0</td>
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<td>12/31/1999-12/31/2009</td>
<td>26876.7</td>
<td>4669.6</td>
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<tr>
<td>12/31/2005-3/31/2011*</td>
<td>11324.4</td>
<td>2094.7</td>
<td>5.41</td>
</tr>
</tbody>
</table>

*Last 5.25 years using most recent data available*

Source: Ned Davis Research
Chart 2: US Total Credit Market Debt / GDP

Total Credit Market Debt as a % of GDP

3/31/2012 Debt = $54.584 Trillion
3/31/2012 GDP = $15.454 Trillion

= 353.2%

Indicates amount of debt required to produce extra $1 of GDP

Source: Ned Davis Research
On one condition...

Money tool # 1 = deficit spending. For years, the G7 countries have believed that spending more than you make, will create jobs and prosperity. To measure the success of this strategy, we invite you to hang out in Spain, Greece or Italy.

Money tool # 2 = cut interest rates to 0%. All the really smart people in the World know that lower interest rates encourage people and companies to borrow more money and spend this money. To measure the success of this strategy, we invite you to hang out at the US Federal Reserve and help them count the $1.5 trillion in excess money held by the big banks.

Money tool # 3 = when all else fails print money. Everyone knows by now the reason the Great Depression was great was because no one had the idea to print money to kick start the economy. To measure the success of this strategy, we definitely do not invite you to visit Japan. The Japanese have been printing money for over 10 years and that hasn’t shaken their economy from its funk one bit.

As we enter the always dangerous months of September and October, central bankers and governments just can’t get their heads around the fact that their cherished money tools are not shaking the World. Never one to quit, someone somewhere muttered “we must do something” – and something they did.

Day 1 – September 6, 2012
Up to this point, the European Central Bank (ECB) has provided over EUR 1 trillion in bailouts to banks and countries with two separate Long Term Refinancing Operation (LTRO) schemes. It was thought that these two initial financial bazookas would be enough to restore confidence, but it wasn’t.

Investors became bored with Greece and its 25th final bailout and now all the attention was turning to Spain. The rapid decline in Spain’s real estate market was causing an even rapider decline in the health of Spanish banks. In fear of losing their life savings, people and companies were yanking billions of deposits out of the country.

This bank run was serious stuff. So serious that investors began refusing to lend not only to the banks but to the Spanish government itself. And if Spain wasn’t bad enough, Italy has the potential to be even worse. Yes, the dreaded contagion had started again and this time the hats had seemingly run out of rabbits.

And then it happened. The ECB announced that they would provide unlimited amounts of Euros to any European country that required a bailout. But – because this is Europe, there was a small catch. Any country who wanted the money had to first formally apply.

While this may sound a lot like “pretty please” it isn’t. Unsurprisingly, Germans are growing tired of using their money to bailout it’s southern European friends. Reluctantly, the Germans agreed to this latest save Europe scheme but only if the bailout contained conditions. Now, you can’t really blame Germany for this
requirement. After all, it was only a year earlier when Italy pulled the
old switcheroo and reneged on its promise to raise their retirement
age after receiving bailout money from Germany. Lesson learned.

On hearing that the ECB would provide unlimited amounts of money
over an unspecified time, markets naturally soared on the news. Hey
– it’s free money! How could you not like this?

While you would assume this conditionality clause would be deemed
fair everywhere else in the World – not so in Europe. Naturally, the
Spanish and Italians have a beef – they were under the impression
that money is always free, never wrapped tightly with any kind of
strings.

Now the World patiently awaits for the Spanish to formally request a
bailout, yet the Spanish have an entirely different plan and that plan
involves anything to keep Brussels and the IMF away from Madrid.

The Spanish government’s fear (which will soon become reality) is
that as soon as these non-Spanish accountants and bureaucrats
discover how bad the finances really are, someone might actually
lose their job, government car and government expense account.

The irony of course, is that the mere announcement of the ECB’s
unlimited money for an unlimited time scheme has had the effect of
pushing Spain’s (and Italy’s) cost of borrowing down. No money or
conditions have changed hands, yet markets are reacting as if it
already has.

This brings us to a stalemate - as long as Spain’s cost of financing
remains low, it will not formally request a bailout. However, we ask
you not to fret and frown. As soon as Spanish interest rates shoot up
again and thousands of protesters march in Madrid and Barcelona,
Mr. Rajoy and his government will be forced to raise the white flag.

What isn’t known just yet, is what happens once the rest of the
World discovers how bad Spain’s finances really are. And of course,
bailouts aside – none of these money tricks will have any impact on
economic growth or job creation.

Nevertheless, everyone in Europe slept well that night – at least for
another six days anyway.

Day 2 – September 12, 2012
It was all fine and dandy for the ECB to announce six days earlier that
they would provide unlimited money to anyone who formally
requests a bailout from Brussels. The ECB however, forgot to mention
just one itty bitty tiny detail called Germany.

After three years, the German public have started to become
increasingly uncomfortable with giving their money away to Greece,
Ireland and Portugal. As one would expect, eventually politicians hear
their common man and actually exercise their duty of representation
by government.

In effect, the German “no more bailout” snowball has started to roll
and its first encounter is the question of whether Germany can legally participate in the European bailout fund – the ESM. While the Law of Diminishing Returns racks up zero billable hours for lawyers, German lawyers had a field day with the legality behind the ESM issue. The decision would be decided by the German high court and a ruling against the legality of the ESM bailout fund would effectively end the whole Euro experiment once and for all.

When the announcement hit the news wires, the result was unsurprisingly “for” the ESM bailout fund (whew!) yet the decision also came with a twist, similar to the twisted twist delivered by the ECB a few days earlier.

While the German high court stated that the ESM was not against the German constitution, it did set a cap on the maximum amount Germany would contribute to the fund – EUR 190 billion.

This cap can be increased, but only if agreed to by a vote in the German parliament. And considering the taste for additional bailouts is not exactly being embraced by the voting population, this is a significant caveat.

The significance behind this “capped” amount cannot be overstated, and it is only a matter of time before the French catch on to the fact that they’ve just been hoodwinked by the Germans.

With Germany now capping their ESM bailout liabilities at EUR 190 billion, the question must now be asked “who picks up the slack?”

Unfortunately for the French, they have no idea what just happened.

While the good bankers in La Défense are cheering the latest run up in stock prices, the rest of the French population are about to be baguette in the side of the head.

Considering that France just decreased the retirement age, increased minimum wages while slapping a 75% tax on anyone earning greater than EUR 1 million, the likelihood of it eliminating its fiscal deficit and then reducing its debt are slim and none. Yet, with Germany now drawing a line in the bailout sand, France’s commitments have suddenly increased significantly.

The ESM bailout fund is structured so that if a country requests a bailout it no longer has to accept its share of liabilities. Considering this entire charade is being orchestrated to bailout Spain and then Italy – it directly results in France having to pick-up the tab not being absorbed by Germany.

The numbers are staggering to say the least. Frances’s ESM liability increases from EUR 143 billion to EUR 226 billion. From another perspective, France’s ESM commitment will soon equal over 44% of the government’s tax revenues for the year.

While today, everyone in France is talking about Germany we’re quite confident that at some point soon, everyone in France will be talking about France.
Bolster your bank account

Day 3 – September 13, 2012
With the Europeans clearly taking the lead in shaking the World, you knew it was only a matter of time before the Americans would take note. And why not – America continues to have the World’s largest economy, the World’s largest debt burden and the World’s largest money printing machine.

Since telegraphing its newest money printing intentions from Jackson Hole a few weeks earlier, the only surprise available from Ben Bernanke and the US Federal Reserve was how much money they would print. Guesstimates ranged from $250 billion up to $700 billion. No matter what happened, bankers everywhere had Bollinger Champaign sitting on ice.

Never one to disappoint, Mr. Bernanke’s announcement to print $40 billion a month until eternity was too much for even the talking heads to comprehend. America has now committed to printing money forever – or at least until the job market improves.

This new approach by the Federal Reserve is interesting on several levels. First, previous goals of printing money was to bolster the housing market. It was believed that fixing the housing market would boost the economy out of its slump and save the day. Well, today millions of homes remain worth less than their mortgage and millions more sit in the shadows waiting to be sold. The only bolstering that happened was of the big banks’ bank accounts.

But that’s ok. The Federal Reserve had another trick up its sleeve. Instead of targeting the housing market, it would instead target “wealth creation.”

“Wealth creation” is another academic, economic, and prehistoric belief that if everyone was wealthier, they would spend more money. And as we have all been told, spending your money is a guaranteed way to prosper. Unfortunately for the Federal Reserve, the old wealth creation thingy hasn’t quite worked out either.

And with two strikes in the count, there was nothing left for Ben Bernanke and the US Federal Reserve to do except close their eyes and swing for the fences. And swing they did and they will keep on swinging until something, anything, happens.

Well, one thing is for sure – something will happen.

As for what, we have little confidence it will involve a rebound in the economy or a rebound in new jobs – you need “real” not “manufactured” prosperity for this to happen.

What will happen, will be a continued widening in the rift between financial markets and the economy.

There is little doubt this new edition of money printing American style will bolster financial markets, the fact remains that the real economy in the US, Europe and Japan will not begin to recover.
9.6 million new jobs waiting to be created

until the central banks and the governments simply allow bad debt to be written off. At this rate, don’t hold your breath as the bad debt scenario will not be allowed to happen anytime soon.

The US Job Market
The US Federal Reserve has stated that their latest scheme to print money will continue until the job market improves.

It sounds simple enough, yet like everything else in the financial World, it isn’t that simple, nor easy to understand. For starters, most people and politicians think about jobs in terms of the unemployment rate. During normal business cycles, the unemployment rate is a pretty good indicator of health in the economy. And it should, as it is supposed to measure the percentage of people who cannot find work.

It sounds easy enough but it isn’t. For starters, this seemingly easy to understand number has so many adjustments that many economists and analysts don’t even understand how it is calculated.

While there are many, the most important flaw of the unemployment rate calculation is that as people literally give up looking for work, the unemployment rate actually improves. The illogic behind this trusted number is that if you are no longer looking for work you are not considered a part of the labour force.

And since the unemployment rate measures the number of people in the labour force who cannot find jobs, any decline in the labour force is positive for everyone involved – except the people who still cannot find work.

To truly understand the sad state of the American job situation, look no further than the labour force participation below.

If Ben Bernanke really wanted to help create jobs, his $40 billion a month could be spent in much better ways. Perhaps, the simplest would be to actually hire people to do things. The back of our envelope shows Ben’s $480 billion/year ($40 billion/month) could create 9.6 million new jobs paying $50,000 a year doing whatever needs to be done.

It really can be that simple.
Real versus not real

Defcon 1

Today, all newspapers, banks and mutual fund sales people are demonstrating their best impersonation of irrational exuberance. And why not? Stock, gold and commodities are all zooming higher.

While no one, including the Germans, want to be a party pooper, it’s absolutely vital for your financial health to understand what just happened in America and Europe.

The real economies are now so bad that the central banks have just hit the Defcon 1 button. For those not familiar with Defense Readiness Conditions, just consider that “Extreme alert,” “get the heck outta here,” and “run for your lives” also qualify as appropriate descriptions.

We’re not quite sure how else to describe the situation, but we will try. The point we make is that how bad do you think the situation has become in order for the United States of America and Europe (soon to be followed by Japan and Britain) to jointly announce that they intend to provide unlimited bailouts and unlimited money printing until they see improvements in the economy?

This is very serious stuff going on here.

Since the Americans are now committed to printing money for as long as it takes for the housing market to recover, we should expect some bizarre behavior from the media and stock market.

Prior to the QE3 announcement, the American media and real estate associations have pulled every rabbit out of every hat imaginable to portray a healthy industry. After all, a healthy housing market is the second step in the great recovery (banking was the first).

Now however, the goal posts have been moved and we should now prepare for a complete 180 degree change in tone from the media (the realtor associations will never change their perspective) on each and every housing market data point.

Since more money printing means higher stock markets, you should now fully expect the talking heads to suddenly discover that the housing market is actually not recovering. This will be journalism at its best.

But, stocks are going up

The trillions of Dollars, Euros, Yen and Pounds being printed is a desperate attempt by the governments and central banks to prevent a severe recession. Some may ask what is wrong with this. After all, it sounds like a good thing. IceCap agrees that it sounds like a good idea – however, we also know that it is a futile attempt to stop the unstoppable.

The World’s financial problems today are the result of the Western world accumulated massive amounts of debt over the last 50 years. The debt outstanding and worse still – the unfunded liabilities of the future (pensions, healthcare and social security) simply cannot be
The disconnect

repaid. It’s very clear that the Western world has reached its financial tipping point, yet today’s central banks and governments believe they can create new laws of mathematics and miraculously save the day.

The irony behind this oncoming financial train wreck is that central bankers actually believe that when they commit to printing unlimited amounts of money for indefinite periods of time – investor confidence will return.

After all, if you believe the headlines, talking heads and mutual fund sales people this entire financial crisis is simply an inconvenience caused by a lack of confidence. Just boost people’s financial self-esteem and then watch markets, the economy and mutual fund fees explode upwards. We just have to feel better about ourselves.

Yet, this is where the irony comes in. As the head of Canada’s central bank, having Mark Carney scold companies for not spending their savings is comedy at its worst. The reason companies are reluctant to open new plants, invest in new technology and hire more people is because of the actions by Mr. Carney and his central bank brethren.

Holding short-term interest rates at 0% seemingly forever, and then printing money to keep long-term rates artificially low all while bailing out banks and sovereign states has created anything but a healthy economy. Much less an economy that would encourage a rationale business owner to invest his shareholders’ money.

The absence and withdrawal of capital by private investors is the real key to the crisis. Asking what’s wrong with central banks and governments’ trying to prevent a deep recession is the wrong question, instead everyone should be asking why private investors are withdrawing their capital from the real economy.

The answer: as long as central banks and governments continue with outrageous monetary and fiscal policies, a return of this oft-mentioned confidence will not happen.

Private investors will continue to flee the real economy - end of story.

Unfortunately, the path chosen will continue to see an ever increasing disconnect between financial markets and the real economy. The longer this continues and the wider this disconnect grows, the higher the probability of an undesirable event occurring grows.

We have to say, the dichotomy of views on the state of the global economy and financial markets is growing wider by the day. In one corner you have the status quo group lead by the big banks proclaiming all is well. Zero percent interest rates, money printing, and bailing out banks and entire countries is normal and healthy. Meanwhile in the other corner you have the independent managers non status quo group who openly ask where did the madness come from.
It’s now intense

**Our Strategy**

We currently live in two different Worlds. While largely absent in Canada, the main economic engines of the World are slowing dramatically while the European banking system dangles by a thread.

This frightening scene has certainly caught the attention of powerful central banks and governments. Despite past failed attempts, these groups remain more committed than ever to preventing financial markets from reflecting fair value. As a result, the recent all-in response of printing money for an indefinite period clearly reflects the seriousness of the situation.

As investment managers, we remain very concerned about the real economy and the long-term actions of the central banks. Yet, we must respect that financial markets will react positively in the near-term and based on our research we will be adjusting our strategy.

Our bond portfolios will maintain low duration yet increase our exposure to spread and high yield strategies. Meanwhile, within our stock portfolio, we note that gold miners have not rallied in-line with gold bullion and we believe there are opportunities within this space.

Overall sentiment for both stocks and commodities are at extreme levels and we will add to these positions as sentiment improves in our favour.

Gold bullion continues to be a core position in our portfolios.

In short, we have become increasingly concerned about the real economy, yet we have to respect that financial markets will respond positively to this new intensity of money printing by the World’s central banks.

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.