IceCap Asset Management Ltd.

Our view on global investment markets:

January 2020 – "The Invisible Man"

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The opinions and views expressed in this publication are those of the firm and the author.

I can see you

"I'll show you who I am"

And with that one line - the world of invisibility was born.

The 1933 blockbuster film, "The Invisible Man" launched a genre that would span decades, producing many enjoyable and many unenjoyable movies of things and people we can't see.

Next up was "The Invisible Man Returns", followed by "The Invisible Man's Revenge", "The Invisible Boy", "The Invisible Mom", "The Invisible Mom 2", and let's not forget the Chevy Chase classic "Memoirs of an Invisible Man."

Through the humour, terror, and mystery, the one thing that was constant throughout these stories was - consistency.

The consistency was in the way the story was told, the path it took and the usual predictable ending.

Unseen and definitely unappreciated by most investors today, the global financial world is missing an important factor that is crucial to keeping the world humming along in a predictable pattern. A pattern that rewards success, punishes failure and then sets the scene to begin the cycle all over again.

This missing factor is none other than the Invisible *Hand*.

Unfortunately, the Invisible Hand is hard to see. It's never discussed by the media, big banks, and certainly never discussed by the central banks - after all, they're the ones who caused it to go missing in the first place.

As you sit back to enjoy and appreciate this latest edition of the **IceCap Global Outlook**, we ask you to use your vision to see and understand why today's markets have been displaced, and what happens with the next great story - *The Return of the Invisible Hand*.

Industry vs Markets

2019 was quite the year. A few weeks after the New Years celebration, investment managers, advisors, and mutual fund salespeople around the world will eagerly explain to their clients what a fantastic year it was for their investment portfolios.

For those invested solely in equities, most investors should see returns between +18% to +25%.

For those invested solely in a regular bond fund, most investors should see returns between +5% and +8%.

Yes, it was a really nice year.

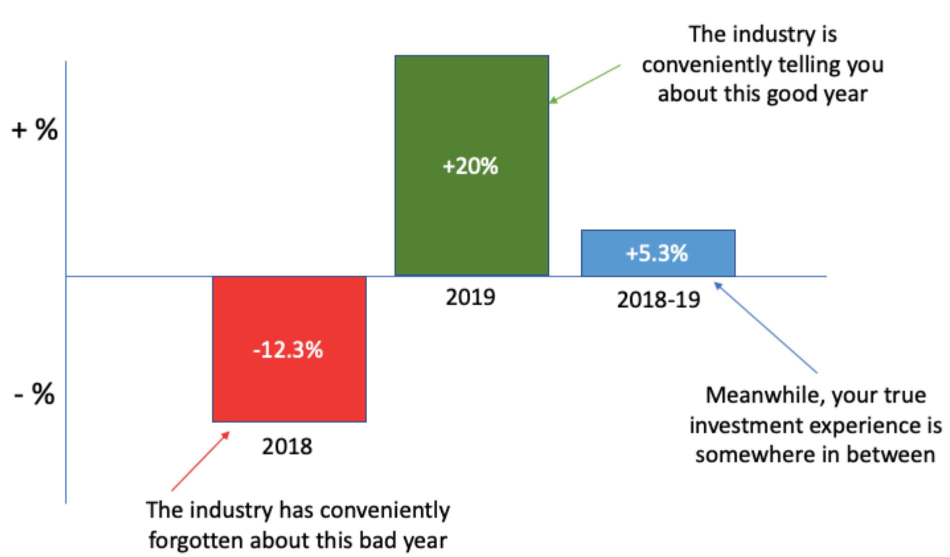
Unless of course you consider the starting point for measuring performance was the end of 2018, which just so happens to be a very low starting point.

Don't forget

And when it comes to measuring investment performance, a very low starting point acts as a catapult towards awesome returns.

To keep things real, consider the 2-year annual return for most equity investors will be between +5% to +9%. [Note: US stocks performed +9% and most other markets are closer to +5%].

Illustration: Canadian Stock Market Performance 2018 and 2019



Meanwhile, bond investors are eating a 2-year annualized return between 0% and +2%.

The point we make with these observations are two-fold:

First, the investment industry is VERY good at conveniently forgetting/ignoring the bad years.

Second, bond market returns have likely peaked.

At IceCap, it's our fiduciary duty to consistently emphasize to investors that there's a big difference between the investment industry and investment markets.

As well, as investment managers we constantly assess all financial markets for their risk-return dynamics.

And as 2019 closed, we share with you our view that bond markets continue to offer the worst risk-return opportunities across most investment markets.

In other words, that 2% annualized return over the last 2 years perfectly illustrates our expectation that the high end of returns across bond strategies is in the +2% to +4% range while the downside is minus 20% or more.

Yes, this isn't exactly warm and fuzzy holiday news for conservative investors.

Yet, there's a reason the world's most conservative investors have been stuffed with gobs of bond funds - they've asked for them!

With interest rates around the world anchored to -0.5% to +1.5%, savers have been financially choked to death.

Two things are certain

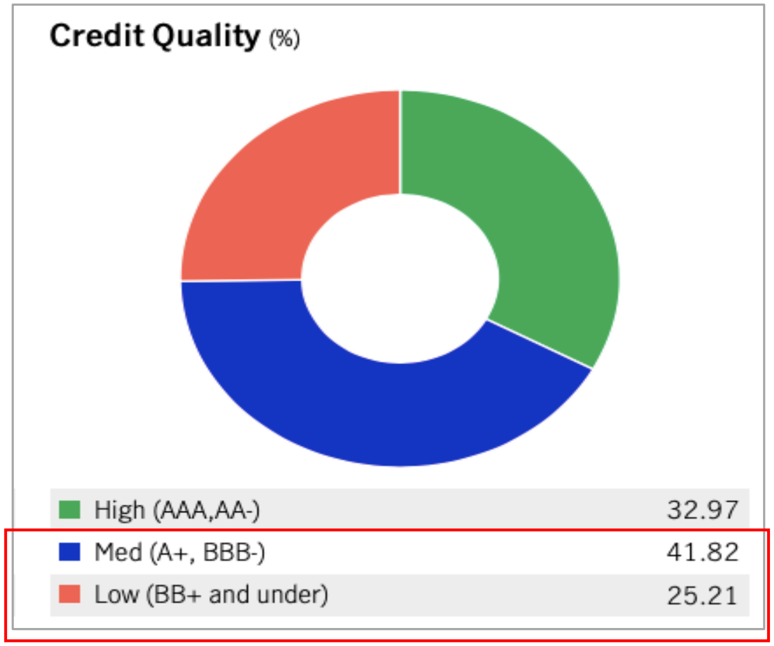
Instead of paying their dearest respects, the investment industry has a different idea - revive the dearly departed and set them up for another, more gruesome death in the future.

That gruesome future death has appeared in the form of bond funds that have been stuffed to the gills with long maturity bonds combined with emerging market bonds and junk bonds.

To demonstrate, below and to the right is the description of a typical fixed income fund being sold to Canadian investors.

While there are few certainties in life, in the investment world these types of bond funds face two.

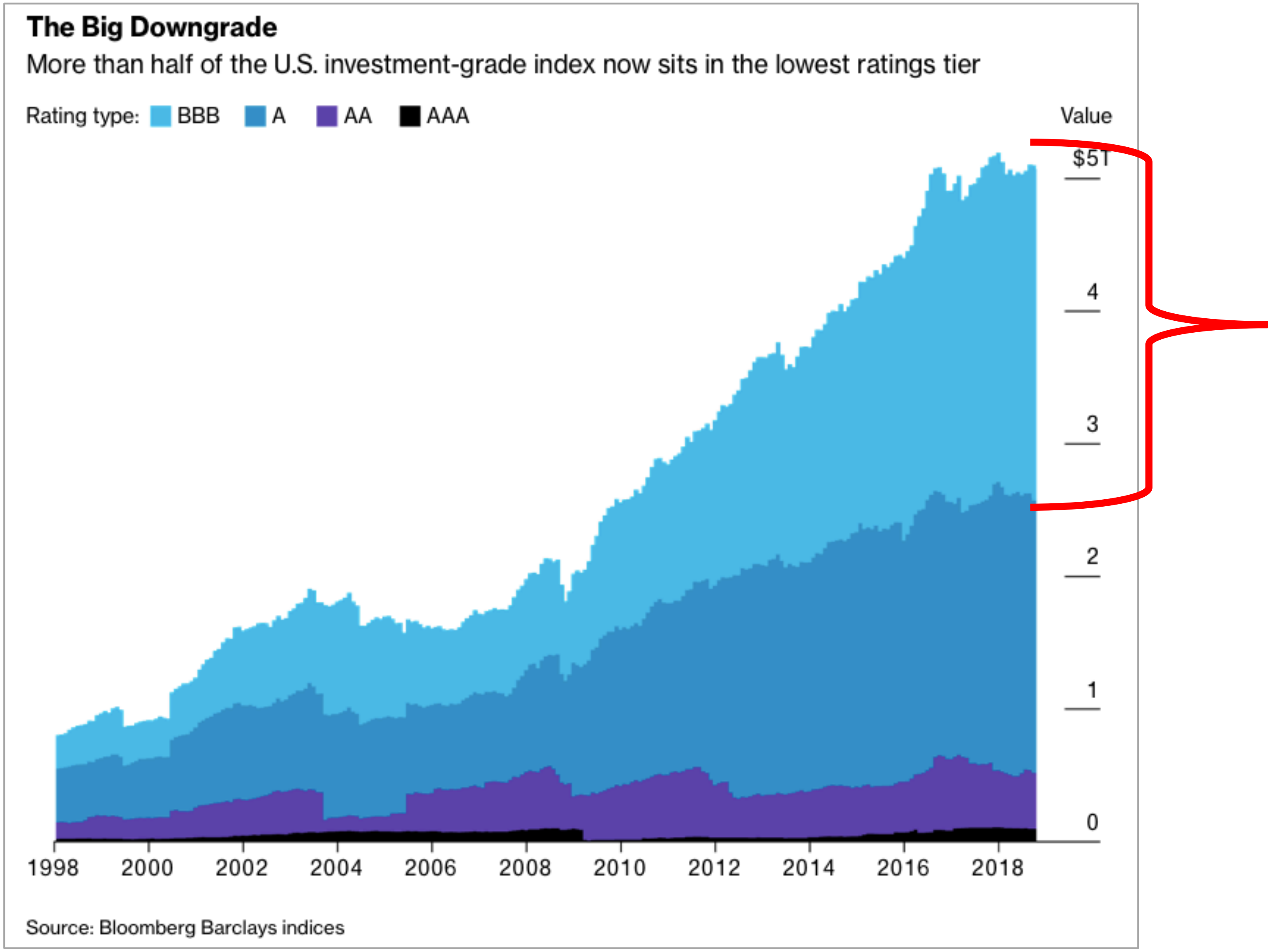
For starters, if a recession never again occurs, then these bond funds should perform very well.



Investment Highlights

The strategic fixed income team believes returns can be generated by investing primarily in a portfolio of global government and corporate bonds, including emerging markets and high yield securities. Currency management is employed to further diversify the portfolio, mitigate risk and add value. By expanding the investment universe to include multiple sectors and currencies, they believe they increase their potential to add value while reducing risk.

The Fragility of the Bond Universe



When the next recession occurs and/or interest rates rise - this entire block of bonds is at risk of declining rapidly

Never, never happens

For enders, if long-term interest rates never rise, then these bond funds should perform very well.

Considering most of the world has now enjoyed nearly 10 years of positive economic growth, combined with the fact that many economies are experiencing deteriorating economic conditions, the likelihood of a recession being near is considerably higher than what is communicated by these bond funds.

Meanwhile, long-term rates everywhere are at not only the lowest points in our lifetimes, but also at the lowest points across 1000s of years. They have remained at these low levels due to artificial suppression policies by our central banks - it's only a matter of time before they spring higher.

Bond Funds Drift Into Risky Debt, Adding to Angst Over Liquidity

Making the grade: How risky are BBB bonds?

Economic uncertainty has increased investor focus on the possibility of BBB-rated bonds being downgraded to junk. Investors should weigh this risk with their search for yield.

The Recession

Since 1967, the United States has experienced 7 different recessions.

And since 1967, the Survey of Professional Forecasters collectively, have predicted exactly zero recessions.

This 0% batting average can be interpreted two ways:

1) Collectively, this group isn't very good at their job.
2) Forecasting or predicting recessions is next to impossible.

Yet, the beat goes on.

Recessions can be measured in different ways.

The Professional Forecasters focus on a collective decline in industrial production, employment, real personal income and sales.

A more common definition used by the big box banks and mainstream media is two consecutive quarters of negative GDP growth.

Meanwhile the most popular definition of a recession is when YOU lose your job.

What we do know, is that a normal economy moves in a cycle where there are highs and lows.

The highs are the good times. While the lows are the bad times.

Good times are followed by bad times

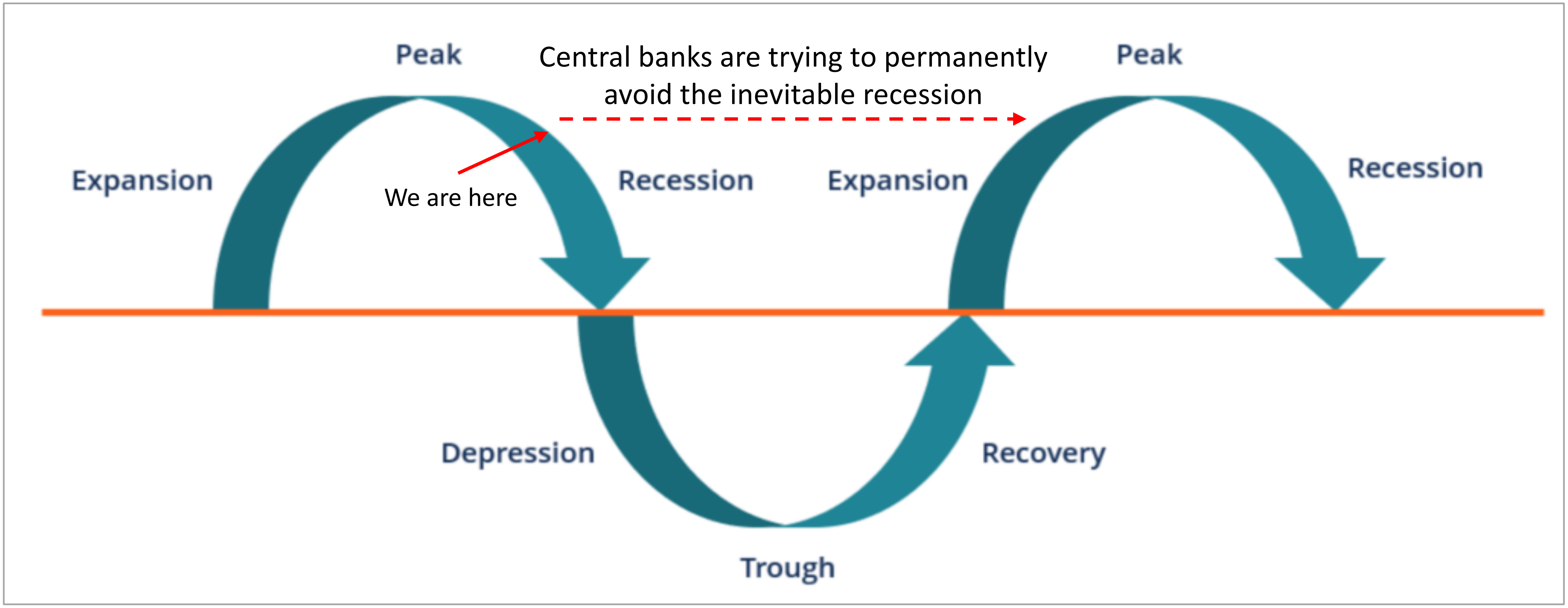
To illustrate the typical economic cycle, consider the below chart. What's really neat about the business cycle is that over time, it flows in a logical and somewhat predictable direction.

When the good times roll, they really roll. Yet eventually, momentum runs out of the economy and the good times gradually slow to a point where good times turn into bad times. But then, slowly the bad times end, and a recovery and the beginning of the next good times begins again.

Of course, to be more technical, the global economy is simply a function of changes in money supply and demand for credit.

Yet, everyone who has ever studied economics eventually comes to the same realization - the economy absolutely moves in ebbs and flows, and eventually it is always guided by an invisible hand.

Now, those with an interest in economics are quick to recognize



Everyone likes pizza

this "Invisible Hand" as the discovery by Scottish economist Adam Smith, as a way to describe how an economy will function if governments left people alone to buy and sell freely amongst themselves.

If left alone, the prices of most goods and services would be determined by what people are willing (or able) to pay.

As an example, if all pizzerias are charging $20 for a pie eventually someone will enter the market and make the equivalent quality pizza and charge $15.

This enterprising pizzeria will take customers away from everyone else, until they too decrease their prices to match the $15.

Alternatively, another new pizzeria might look at this market and determine they can make a significantly better pie and charge $25. This enterprising pizzeria will take customers away from everyone else until they begin to match the higher quality.

This movement of people making and eating pizza is being guided by an invisible hand - and it works.

Now, let's consider what happens to the invisible hand if our dear governments saw what was happening and for whatever reason declared by law that no pizza could ever be sold for more than $10.

In this case, several things happen.

For starters, the pizzerias will have to find ways to reduce their costs to compensate for the lost revenues per pizza sold.

Some will succeed but by only using even lower quality ingredients.

Others will simply take a bow and close up shop.

What happens next, is similar to what is happening in the financial world today.

Now, as governments eat pizza like everyone else, eventually they realize that the quality of pizza has deteriorated and there are less pizzerias than what previously existed.

Never to let a crisis go to waste, governments next announce they'll pay each pizzeria $10 per pizza to compensate them for the lost revenues from not being able to charge the original price of $20.

Two things have now happened.

First, government involvement in setting prices has completely distorted the pizza industry.

Second, the "invisible hand" has been completely blocked out and unable to keep the market in balance.

Today, the exact same story is playing out in the world of interest rates.

Comrades

When the financial world blew-up in 2008-09, governments and central banks around the world made a coordinated decision to become involved in uncountable ways to affect the monetary system.

And in its most simplest forms - central banks have decided that instead of letting Adam Smith's invisible hand determine the correct price of money (ie. interest rates), they would set the price of money.

This price of money has ranged from NEGATIVE % across Europe and Japan, to near ZERO % across everywhere else.

This crowding out effect is having two effects on our money world:

One - the economic cycle has been temporarily suspended.

Two - zombie companies and governments now roam the lands.

Recall how on **page 5** we showed how a regular economic cycle weaves and bobs over time.

The interference in interest rates by central banks has completely flattened cyclical economic movements and instead has changed the economic cycle to appear as a flat line - one characterized as having no growth and no contractions.

Some might say this is a good thing. Afterall, it would mean steady eddy economies, one characterized by consistency in everything.

Yet, a successful flat-lined economy is one that doesn't exist now, it hasn't existed in the past and will not exist in the future.

For those in disagreement, note that this kind of a controlled economy has been tried numerous times over the years.

Those that tried include:

The Soviet Union (Marxism-Leninism)
Germany (Nazi National Socialism)
China (Maoism Communism)
Cuba (Communism)
Venezuela (National Socialism)

Each of these failed states attempted to eliminate the invisible hand from doing what it does best - rewarding economic success, or put another way, not rewarding economic failure.

Unknown to most today, the global financial system has taken on economic characteristics of socialism/communism.

And it is happening right before your eyes in the form of central banks setting interest rates at zero % and negative %, as well as their policies of printing money to help stimulate the economy.

These monetary policies have been ongoing now globally for 10 years and while the creators of these policies hail them as a resounding success - others declare the opposite has happened.

The Invisible Zombie

From an economic perspective, 10 years of zero/negative rates combined with trillions in money printing has only achieved muted economic growth (**see Chart Page 10**).

America's economic expansion is now the longest on record

The Economist

Yet

The record-breaking boom has proved disappointingly weak

Europe is unable to achieve consistent growth >1.5%.

America is unable to achieve consistent growth >2.5%.

Japan is unable to achieve consistent growth >1%.

China is unable to achieve consistent "official" growth >6%.

But this attempt to break the invisible hand is also having another far more devasting effect that is never discussed by the big box banks, the mainstream medias and the mutual fund salespeople - 1000s of companies and governments have turned into financial zombies.

From a corporate perspective, the lack of growth is causing many companies the inability to generate enough revenues and profits to not only pay off their debt, but to simply pay the interest on their debt.

The only reason they remain alive is due to interest rates being so low, that interest owed can be met by borrowing even more.

Once the invisible hand returns (it always does), interest rates will surge higher, making it impossible for most of these companies to operate with their debt loads.

And in case you're wondering - these borrowings by these zombie companies are actually bonds.

And guess who owns these bonds from these zombie companies - many of the new bond funds like those described on **page 3**.

Put another way, bonds from zombie companies are also known as junk bonds which are wrapped up nice and neat and sold to investors as high yield bonds.

Economics

Asset Bubbles to Zombie Companies: The Dark Side of Rate Cuts

By Sarah Ponczek, Anchalee Worrachate, and Laura Benitez
July 29, 2019, 8:00 PM ADT

Other forms of bonds at risk include leveraged loans, and private credit. Beware - bond market risk comes in several forms.

The absence of the invisible hand is not only setting up the most conservative investors with unrecoverable future losses, but it's also

Translation:

wreaking havoc within the sharpest and brightest minds on Wall Street.

As you can imagine - the world of finance is complicated.

There are many markets, in many currencies with all trading in either public or private transactions.

And within each of these many markets, there are many factors that have either a material or immaterial impact on pricing.

And to make matters even more confounding, there are times when the material factors are material and other times when these very same factors are immaterial.

However - there is always one factor that plays a significant role in helping market participants (and the invisible hand) determine an appropriate price.

This factor is interest rates.

In the next column, we demonstrate how the sharpest and brightest minds in the industry have recognized that something is unusual, different, or uncertain.

The cause of this uneasiness and confusion - the absence of the invisible hand.

> Very little is certain in the current environment. "I don't think I've ever seen a choppier market, more difficult to predict, than the one that we find ourselves in today as fixed-income investors," Walsh said. "The signals aren't very clear."
>
> The yield curve has been a particularly confusing indicator. "We've seen a tremendous amount of change in the shape of the yield curve," she said. It has flattened, steepened, and inverted, taking every possible shape since 2008, Walsh observed. And it remains unstable and difficult to analyze.
>
> Source: Anne Walsh, CFA Guggenheim

Translation: the invisible hand is missing from bond markets.

> - **Financial models and algorithms – which essentially are a matter of looking for and profiting from deviations from historic relationships – may not work as well as they did in the past**, since history (all of which has been based on positive interest rates) may be out the window.
>
>   Nobel prizes have been awarded to economists that developed concepts such as the efficient frontier, the Capital Asset Pricing Model and the Black-Scholes option pricing model. But when a negative value is assumed for the risk-free rate in these types of models, fair value results shoot off toward infinity. With trillions of securities and derivatives dependent on these models, valuation is critical. (Jim Bianco, *op. cit.*)

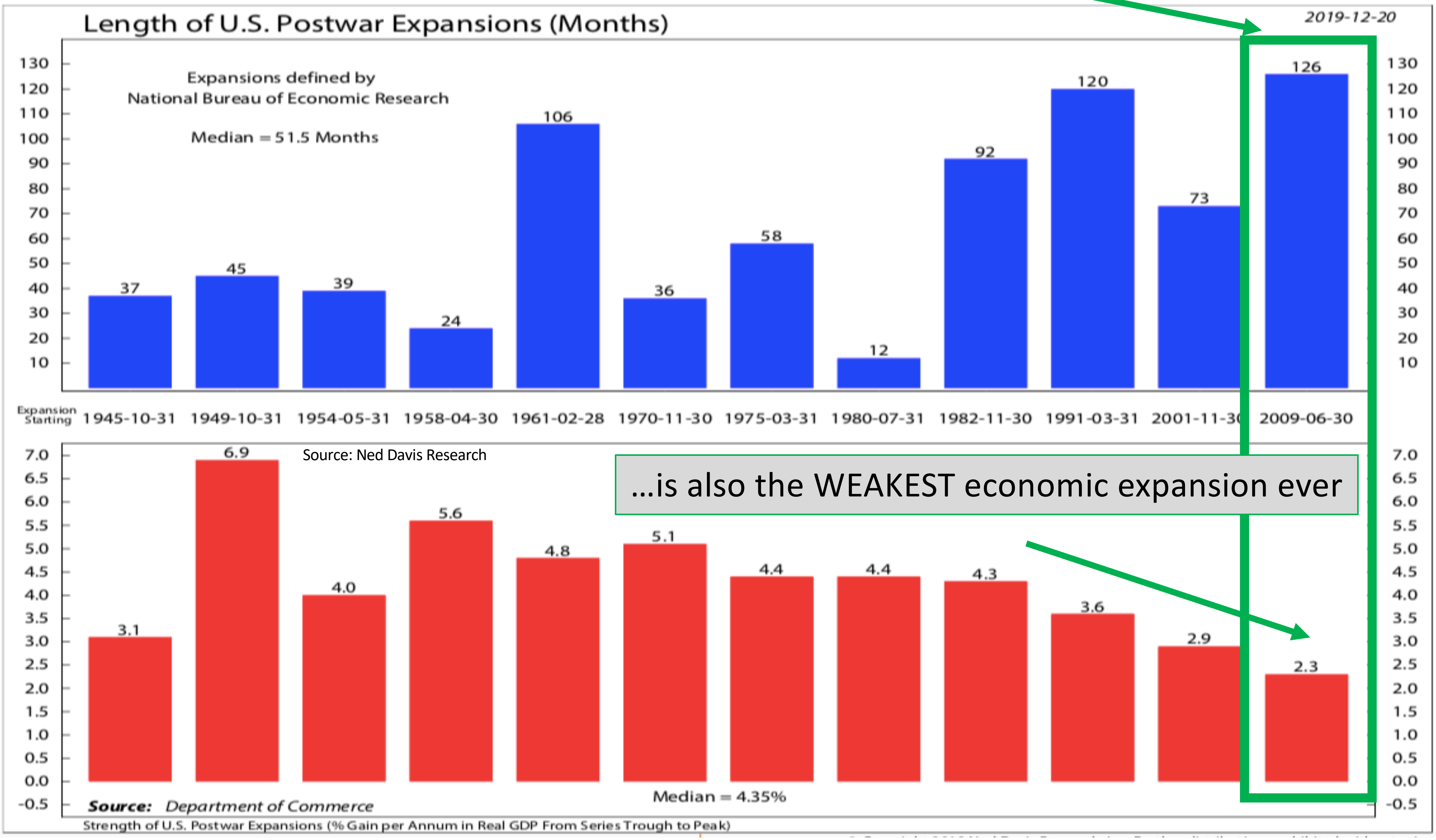
Translation: the invisible hand is missing from financial modeling.

Of course, the absence of the invisible hand is also having a dramatic effect on governments too.

The worst kept secret on the planet is how all governments are unable to spend less than what they collect in taxes.

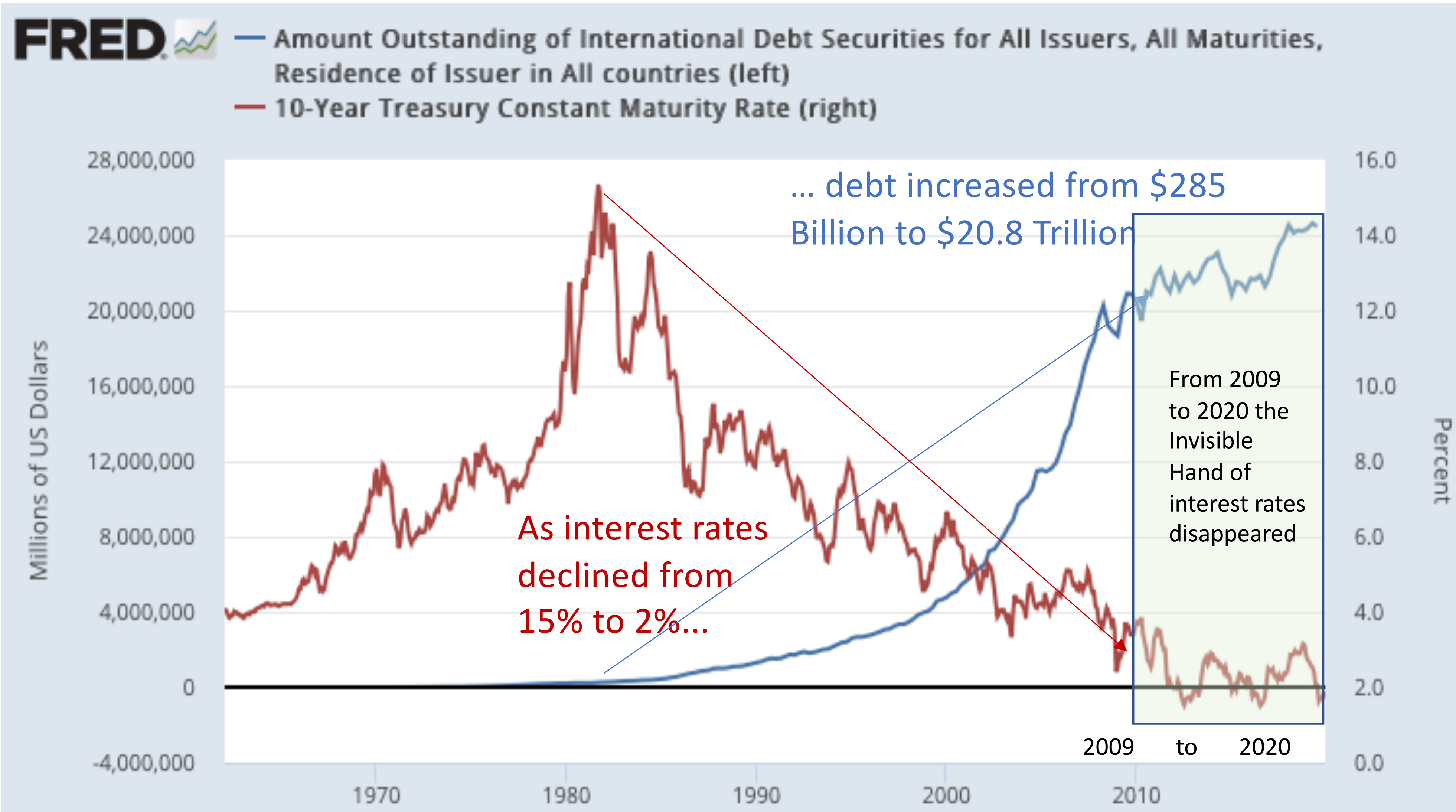
Stimulus Isn't Working

The longest economic expansion ever…



…is also the WEAKEST economic expansion ever

The weakest ever expansion has been supported by debt and low rates



Spend, spend, spend!

This lack of financial control is called the deficit and boy-oh-boy are governments running this puppy home.

Canada says budget deficits larger than forecast, will continue spending

EU Warns Italy, France Over Budget Overspending

Whoever Wins in Britain's Election, Big Government Spending Is Back

Conservative Boris Johnson has plans costing billions; Labour's Jeremy Corbyn has even bigger ideas

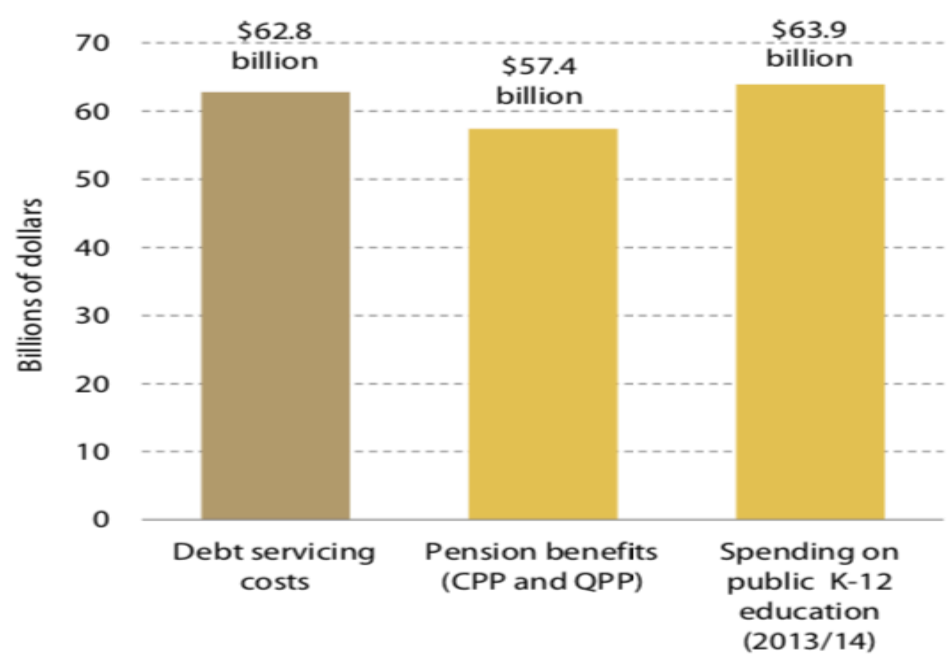
Coalition cuts forecast surplus as budget update reveals economic slump

Midyear budget update wipes $21bn off surplus over forward estimates amid poor wage growth and weak consumer spending

Now, this is important to understand - <u>the ONLY reason these governments are able to continue the greatest financial charade known to mankind is due to the absence of the invisible hand</u>.

Using Canada as an example, Provincial and the Federal Governments currently spend as much on Interest Cost as they do on pension benefits and education - and this is when rates are at record lows.

Figure 2: Consolidated government debt servicing costs compared to other expenditures, 2015/16



Even if it's invisible, it's easy to see

As reminder, <u>today's</u> debt was really used to buy stuff in the <u>past</u>.

In other words, all this money spent on today's debt servicing costs is for yesterday's spending sins.

Of course, considering education, social security and pension costs are growing significantly faster than the economy - expecting these governments to turn around and balance their books is foolishness at its finest.

To make matters even more clear, once the invisible hand reappears, interest rates will surge making the amount of debt servicing costs increase <u>exponentially</u>.

In the world of finance, the interest on these borrowings MUST BE PAID FIRST.

Bond interest is paid before pension benefits.

It's paid before teachers' salaries.

And it's even paid before the salaries of members of parliament, congress and other government workers.

What this means is that when the invisible hand of interest rates returns to the world, there will be less money available to fund basic and critical government spending.

And when this happens, the prices of bonds everywhere go down in value.

Government bonds decline in value.

The highest rated corporate bonds decline in value.

And the flavour of the day - high yield and emerging market bonds decline in value.

In some ways, economics has become a dismal science.

Forecasting recessions and expansions and inflation and everything else with a number is difficult.

Yet, one area of economics that isn't difficult to understand is the science of cycles and the invisible hand.

Cycles and the invisible hand haven't disappeared, they've just been hiding in the wings.

Which means, two things have become CERTAIN in today's economic world:

1) A recession is coming
2) Long-term interest rates are going higher.

Which indicates, even if it's invisible, it's still easy to see.

Stay Calm

Repo Markets

Readers who follow markets closer than the average person know, but may not understand specifically why the repo crisis has started.

Meanwhile, readers who think they follow markets closely but are unaware of this repo crisis, should really pay attention.

In very simple terms, the repo market is a $1 Trillion/day credit eating machine.

Banks, quais-banks, shadow banks, investment managers and money market funds all borrow and lend to each other every day and then repeat the process again the next day.

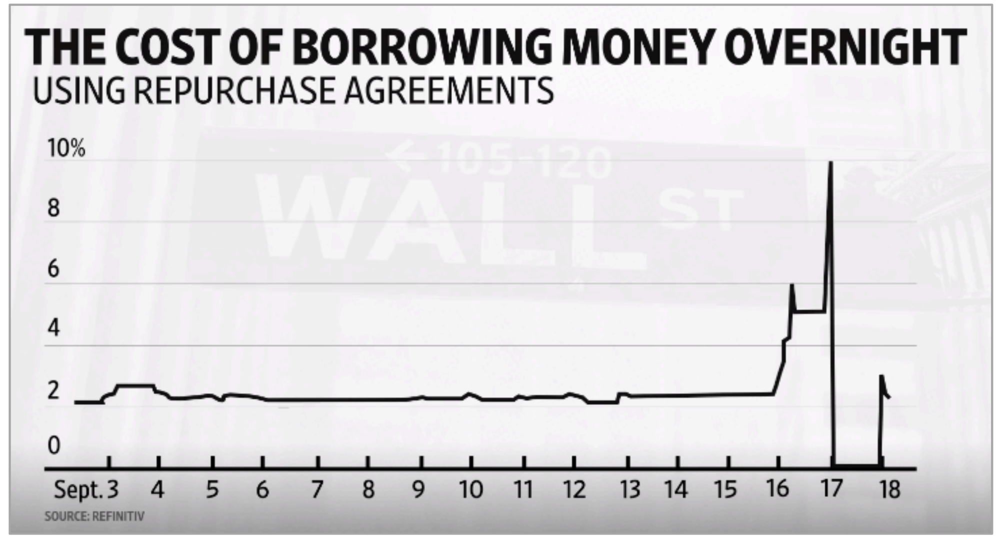
To avoid diving deep into a rabbit hole - just know that the premise behind repo markets is that one side will sell an asset (a bond for example) to another firm with the promise to repurchase that very same asset the next day at a slightly higher price.

This transaction replicates a loan and it happens every single day.

The effective rate of interest on these transactions is known as the repo rate. Effectively, it is very close to the rate set by the US Federal Reserve for their over night rate.

The reason this enormous market is unknown to practically most people in the investment world is because it is boring and never has a moment when it should attract attention.

This all changed 5 months ago when this happened:



Effectively, the interest rate on overnight borrowing through the repo market surged from 2% to 6% and then to 10%.

At this point, the US Federal Reserve had to get involved and pumped billions of dollars into the market to help restore a sense of calmness.

This is a big deal.

Let's make no mistake about it - it was so serious, that in order to ensure this key funding rate remained closer to the Fed Funds rate, the US Federal Reserve has been providing capital into the repo market every day since.

There is so much more

The reasons provided for this highly unusual market reaction and subsequent US Federal Reserve reaction range from banks and companies requiring additional monies for quarterly tax payments, to blaming the US Treasury for returning to credit markets to fund their trillion dollar deficit.

IceCap is telling you there is something much more significant happening.

The reason the repo crisis started was due to entities not accepting collateral from each other.

For whatever reason, suddenly Bank A is telling Bank B that they will not lend to them overnight unless they agree to pay 10% interest.

Put another way - a lack or diminished level of trust has returned to the banking system.

The USD is the world's reserve currency and it is used and needed by everyone around the world in one way or another.

Therefore, believing this is an American banking problem is naïve.

IceCap has written and talked extensively about our lack of confidence in the European banking system.

European banks operate in the repo market and in our opinion this is the epicentre of the crisis that is developing.

As was demonstrated during the 2008-09 crisis, banks have no idea what other banks are holding on their balance sheets.

We know for certain that Europe's banking risks were never cleansed from the system.

And here we are now after 10 years of negative rates, zero rates, bank and sovereign bailouts - maybe the invisible hand of the banking system is finally re-emerging.

The repo crisis has our attention.

Actions by the US Federal Reserve is NOT a simple extension of money printing/quantitative easing as is being bantered by the media and talking heads.

Quantitative easing targeted long-term interest rates. It's objective was to make the cost of borrowing cheap which in turn would encourage borrowing and produce economic growth.

This repo crisis is DIFFERENT.

The Fed's reactions towards the repo crisis is to ensure the banking sector regains enough confidence to ensure the enormous overnight lending market continues uninterrupted.

Once trust leaves the banking system, it is very difficult to retrieve.

Our Strategy

Stocks

There have been plenty of reasons to dislike equity markets based upon fundamental factors. Yet IceCap continues to maintain that since the explicit interference in financial markets by our central banks and governments, fundamentals have become meaningless.

Our non-fundamental equity models remain very positive and have resulted in our portfolios maintaining our equity allocations over the past year.

Having said that, once the data changes and our models produce different results so too will our allocations to equities.

Presently, we remain on downgrade alert and will continue to hold equity allocations.

Bonds

There is not too much else to say about bond markets. In our opinion, every bond market is priced to perfection and this pricing has created severe asymmetric risk-return relations across the fixed income and bond spectrum.

Chart top of next column illustrates how perfect corporate bond markets have been priced. Here we show you credit spreads and how they look relative to previous periods.

If there's a recession or surge in long-term rates, bond markets are toast.

Currencies

No changes. We are well aware of the myriad of reasons why investors believe the USD will decline rapidly and we continue to disagree.

The global financial system has been bottled up now for 10 years and we are increasingly seeing signs that a crisis will re-emerge which will send foreign capital seeking safety in USD.

Our portfolios remain well positioned to benefit from a rapidly appreciating USD.

Commodities

Gold remains on our want to buy list. We still expect it to have one more leg down when USD eventually strengthens rapidly. We remain patient.

IceCap Investment Solutions

IceCap Global Managed Portfolios

- Managed by IceCap Asset Management
- Available for private clients and institutional investors
- Separately Managed Portfolios consisting of Long-only strategies including equities, fixed income, currencies, volatility and commodities.
- Contact directly:
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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.

Keith Dicker, CFA founded IceCap Asset Management Limited in 2010 and is the Chief Investment Officer. He has over 25 years of investment experience, covering multi asset class strategies including equities, fixed income, commodities & currencies.

Keith earned the Chartered Financial Analyst (CFA) designation in 1998 and is a member of the Chartered Financial Analysts Institute. He has been recognized by the CFA Institute, RealVision, MacroVoices, Reuters, Bloomberg, BNN and the Globe & Mail for his views on global macro investment strategies. He is a frequent speaker on the challenges and opportunities facing investors today, and is available to present to groups of any size.