



IceCap
Asset Management Ltd.



Local heritage,
Global experience.

Our view on global investment markets:

October 2011 – The Tip of the Iceberg

Keith Dicker, CFA
Chief Investment Officer
keithdicker@IceCapAssetManagement.com
www.IceCapAssetManagement.com

'berg straight ahead

In the wee hours of April 15, 1912, the RMS Titanic cruised through the Atlantic ocean on a collision course with history. Naturally everyone knows the story of how the big, old mean iceberg knocked the socks off the mighty ship. The lack of a well thought out strategy was the primary reason for this tragedy – *not the iceberg itself*.

It's certainly not lost on us that IceCap's corporate logo is an iceberg. Besides being a cool logo we do feel the iceberg is a perfect mirror of global investment markets. On the surface, attractive opportunities will always exist and appear achievable for everyone. However the real risks within the market are normally underneath the surface and should they tilt the market in one direction or another, financial markets, just like the iceberg can be turned upside down.

How exactly is the global iceberg looking today? Are the risks above water as many of the big bank investment advisors proclaim or are they below the surface? At IceCap we are confident that one day soon, we will wake up to see the most spectacular investment opportunities of our lifetime, until that day however we must remain very mindful of the risks below the surface.

Our chart on page 2 shows the most significant risks for financial markets today. As we plunge deeper into each risk, we'll explore the likely outcome and how we expect financial markets to perform.

The Top of the Iceberg – it's very beautiful up here

We have to say, the continuous unbridled enthusiastic cheerleading for the stock market to go higher has us puzzled. Yet, many of investment leaders from the big box banks and mainstream media continue to shout about buying the dip, proclaiming stocks are cheap as well as touting the merits of the one-size-fits-all balanced fund for every investor for every occasion.

While we genuinely believe that today this view will lead many to financial despair, it's important to recognise why this view is shared by the hands that hold the savings for many people in the World.

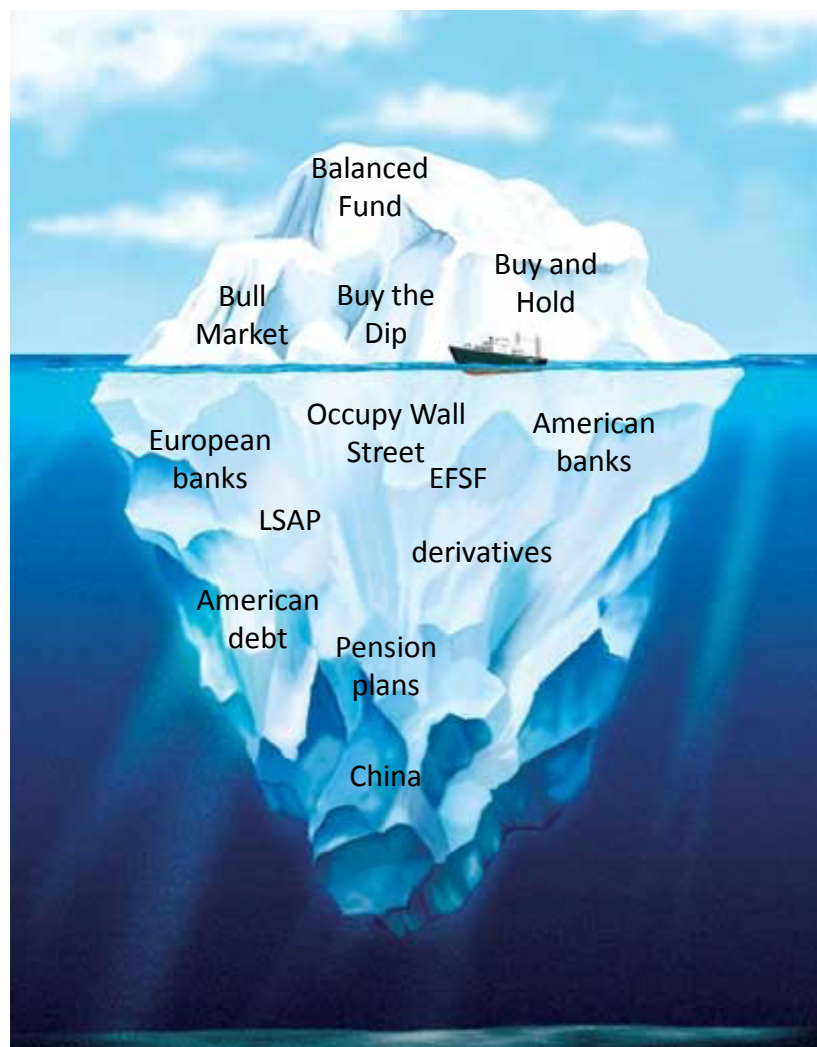
For starters, many of the industry's largest players simply do not have the product available nor the expertise available to properly guide the average person during these dramatic economic times.

While this is no reason to ignore the little guy, perhaps and even more alarming is that the industry's largest players actually *believe* that investors really should buy the dip and employ other successful strategies from a bygone era.

Either the cognizance to understand the realities of 0% interest rates, money printing, and a risk free investing game for banks is missing, or they firmly believe actions by central banks and governments will save us all.

On the other hand, considering that in 2008 all major countries

Chart 1: Global Financial Iceberg



showed no hesitation whatsoever with pushing the average investor and tax payer under the bus, in return for saving their beloved banks – expecting a similar response this time around, maybe isn't that crazy after all.

If this is the view and reason for the super-enthusiastic bulls, then we see your point. **The slightest potential for a solution to Europe will certainly provide markets with joy for a few minutes.** Then, once this joy wears off you can prepare for America's venture into LSAP (which we discuss on page 8), which is certain to launch stocks into outer space.

Should neither of these developments occur, then we'll need to see dramatic improvements in the global economy and funding markets for banks before the next bull market resumes.

The question we do ask however, is how long, economically, and politically can the bailouts continue? From a pure mathematical perspective, the exact point in time when there really is too much debt has already passed for some and is on the horizon for others. Meanwhile, from a pure social perspective the exact point in time when people finally shout "we can't take this anymore" has certainly arrived in Athens and Rome. And unless the perceived inequalities improve, suspect social unrest will likely grow further – maybe even onto Wall Street.



The sign says

Below the surface of the Iceberg - Occupy Wall Street

What initially started in the local cafe with a few people discussing the merits of monetary & fiscal policy, the fractional reserve banking system and lobbying reform is slowly turning into a national, make that, international movement.

While no one can definitively define the “Occupy Wall Street” movement, it is spreading around the World faster than a speeding macchiato. London, New York, Tokyo, Halifax – no major financial centre has been spared.

How can it be stopped? It must be stopped. Debt must continue to grow. Banks must not lose money on bad investments. Maybe more tax breaks will help quell this petty annoyance. If that doesn't work perhaps discounts on Blackberry purchases, or maybe even permanent bans on short selling French banks. It must be stopped.

Now, our observation is admittedly cheekish, however we do hope those on Wall Street, Threadneedle Street and George Street pause to recognise this growing unease with today's economic unrest is very real indeed.

To many in the World, the trillions of dollars, Yen, Euros and Pounds spent to save the banks has done nothing for the plight of the average person. Many remain jobless. Many more live in houses worth less than their mortgage, and many many more are starting to see the divide between the very rich and everyone else. The frustration is growing.



Source: The Internet

Exactly how the Occupy Wall Street movement can move the established status quo is no secret really. Should the protesting groups grow in size and breadth, some leader, somewhere will take notice and react. And who knows, maybe the small reaction will actually be the one that forces the bad debt to be cleansed from the system.

Until then – continue with the signs.

Where do we start??

Below the surface of the iceberg - Europe

Our readers know by now that IceCap has been writing and talking non-stop about Europe for over a year. We forgive you for tuning out now and then.

And since the Great Economic Circus of Europe continues to produce ahhs and ooohs, it is our duty to update everyone on the facts – not the rumors – as they continue to be released and then denied every hour on the hour.

For starters, **let's quickly dismiss the comparisons of Greece to an American state.** Many media outlets and misinformed investment houses are quick to point out that Greece's annual GDP of about \$300 billion, is similar to that of Maryland. We do agree that should Maryland quietly or loudly rolled into the sea, it certainly wouldn't drag the other 49 states with them. Therefore, why is Greece such a big issue for Europe? There are two reasons.

First, America's 50 states have both a fiscal and political union. They share the same tax code, monetary policy, heads of state, and military. Stating the obvious, it is one country – plain and simple.

The Euro-zone however consists of 17 countries. They share the same monetary policy but that is where the similarities end. 17 countries means 17 different tax codes, 17 different heads of state, and 17 different economies which equals $(17 \times 17 \times 17)^3 = 118.6$ billion reasons why the Euro-zone is not the same as America.

Second, you'll often hear that Greece's economy and GDP is only 2% of the total Euro-zone total economy, therefore don't worry about this little hiccup called Greece. This is a schoolboy error of the worst kind. Let us explain.

In a simple way, the GDP for a country represents the total sales/revenues produced during a given year. It does not account for any debt or money borrowed. The challenge facing Greece is not sales/revenue related, rather it is debt related. The country has simply borrowed too much money and it cannot pay it back.

Sadly, the problem doesn't end there. The problem becomes even bigger due to who actually lent Greece this money – *European banks.*

Once you consider how banks are structured, the problem then becomes bigger still. Banks everywhere around the World borrow money themselves. In fact, they typically borrow between 10-20x of what they actually have as equity. Compared to the 4-5x leverage for the most indebted countries in the World, banks' appetite for risk puts Greece to shame.

To further aggravate the issue, some of the money that European banks actually own themselves is invested in Greek bonds. When Greece eventually fails to payback what they owe, these European banks will suffer losses on their investments and due to their liberal use of leverage, many of these banks can conceivably be wiped out.

We promise to promise

Below the surface of the iceberg - Europe

Mark your calendars for yet another all important European date with destiny. Ever since the beginning of the end for the Euro-zone and its currency, one European leader after another has floated an idea to resolve the debt crisis. As with most ideas, very few are great ones – and make no mistake, the Europeans will have to create a pretty remarkable idea to solve the already dangerous debt crisis.

Politicians and investment forecasters know the cardinal rule of predictions – never draw a line in the sand. Once the line is drawn, there is no going back. Well, French President Sarkozy and German Chancellor Merkel have drawn a line in the sand, and a very big line at that. For once and for all, on October 23rd or 26th, 2011 at 3:27 PM this dynamic duo is going to announce THE plan to save the Euro.

THE plan is going to focus on the creation of a super-duper-debt-charged bailout fund to bailout the entire Old World. Fund proceeds will be used for the following:

1. Provide never ending loans to Greece
2. Secure future loans for bankrupt Ireland and Portugal
3. Special loan backing for Italy & Spain
4. One very big credit card for Belgium
5. Invest unlimited capital with no restrictions, interest or dividend payments for every European bank
6. Create insurance (for banks only) against any other investment that loses money

Yes, we've heard all of this before and yes IceCap has gained a few friends (and saved clients' money) at the expense of the Europeans. Yet apparently, this coming weekend all will be saved without the slightest loss possible for any European bank.

To fully understand exactly how messrs Sarkozy and Merkel will achieve this miracle, we ask you to consider the features of the new and improved EFSF (European Financial Stability Facility):

1. The EFSF is an actual company incorporated in Luxembourg whose objective is to preserve the Euro-zone
2. All Euro-zone countries including Ireland, Portugal and Greece promise to provide money EUR 440 billion to the EFSF
3. Should a country be unable to provide money, the remaining countries will have to promise to provide more
4. Since this promised pool of money will not be enough to bailout everyone and it is impossible to have the Euro-zone countries promise more money to the fund, the EFSF will borrow money using the promised money it doesn't have as collateral
5. Borrowed money will equal between EUR 2 to 2.5 trillion, bringing the grand total of the EFSF to about EUR 3 Trillion
6. One final point, who will be crazy enough to lend the Europeans this EUR 2 to 2.5 Trillion? The answer: the Europeans themselves of course.
7. Ultimately, the EFSF will in effect become another tail wagging the dog

In the end we doubt the World will see any real form of debt

Dexia – the strongest European bank ever

restructuring. No one will end up taking true market losses on their bad investments and we'll simply be back to where we started but with even bigger debts that cannot be repaid.

Naturally, the ever present and always bullish managers will object to our always lucid analysis. However, before you run off to buy more balanced mutual funds, let's review the latest results from the European Union's Bank

EBA stress tests: ISP 2012 Core Tier 1 ranks among the best under the adverse scenario

Main peers	CT1 2012 ⁽¹⁾ Stress	CT1 2012 ⁽²⁾ Stress (with additional measures)	CT1 2010	Δ CT1 2012 ⁽¹⁾ Stress vs CT1 2010	Δ CT1 2012 ⁽²⁾ Stress vs CT1 2010 (with additional measures)
Dexia	10.4%	10.4%	12.1%	-1.7%	-1.7%
Nordea	9.5%	9.5%	8.9%	0.6%	0.6%
BBVA	9.2%	10.2%	8.0%	1.2%	2.3%
Intesa Sanpaolo	8.9%	9.2%	7.9%	1.0%	1.3%
ING Bank	8.7%	8.6%	9.6%	-1.0%	-1.1%
C. Agricole	8.5%	8.5%	8.2%	0.2%	0.2%
HSBC	8.5%	8.5%	10.5%	-2.1%	-2.1%
Santander	8.4%	8.9%	7.1%	1.3%	1.8%
Erste Bank	8.1%	8.1%	8.7%	-0.6%	-0.6%
BNP Paribas	7.9%	7.9%	9.2%	-1.4%	-1.4%
Lloyds Bkg Gr.	7.7%	7.7%	10.2%	-2.4%	-2.4%
UBI	7.4%	8.1%	7.0%	0.5%	1.1%
Barclays	7.3%	7.3%	10.0%	-2.7%	-2.7%
BPCE	6.8%	6.8%	7.8%	-1.1%	-1.1%
UniCredit	6.7%	7.2%	7.8%	-1.2%	-0.6%
Soc. Générale	6.6%	6.6%	8.1%	-1.5%	-1.5%
Deutsche Bank	6.5%	6.5%	8.8%	-2.2%	-2.2%
Commerzbank	6.4%	6.4%	10.0%	-3.6%	-3.6%
RBS	6.3%	6.3%	9.7%	-3.4%	-3.4%
MPS	6.3%	8.8%	5.8%	0.5%	3.0%
B. Popolare	5.7%	6.2%	5.8%	-0.1%	0.4%
Total 21 peers	7.7%	7.8%	8.9%	-1.2%	-1.1%

(1) Including capital base strengthening measures realised by April 2011

(2) Including capital base strengthening measures realised by April 2011 and additional strengthening actions planned or adopted (for ISP sale of branches to Cré Agricole and disposal of Findomestic, transactions already carried out)

Source: ZeroHedge.com

INTESA SANPAOLO

(9)

Stress Test. As we know, these stress tests were designed to help restore market confidence in the health and stability of the European financial system.

After numerous minutes of number crunching, the European Union determined that Belgian bank, Dexia was indeed the strongest and safest of all. Yes, this is the same Dexia that received billions in bailout money from the US Federal Reserve in 2008 (Editors Note: exactly why the Americans had to bail out a Belgian bank is a question that requires an answer).

As the table to the left show, apparently a major bailout combined with three years of growth was more than enough to rank Dexia #1 on the European Stability Scale.

Update 2011.10.09 – French & Belgian governments announce that the recent banks stress results were a sham and that Dexia is actually insolvent and will be taken over by the French and Belgian governments.

If the #1 rated and safest European bank can go under in a heart beat, what does it say about any European bank? Or any European bank confidence building report?

No need to worry, this will all be resolved by this weekend.



Large Scale Asset Purchases

LSAP

Get ready for the next catch-all phrase to grip Wall Street, the media and your dinner table. By this we refer to LSAP, or Large Scale Asset Purchases. Last month when the US Federal Reserve announced its newest strategy to stimulate the economy, we do hope you didn't think it would be their last.

At some point soon, you'll see that "Operation Twist" was merely the pause that refreshes for Mr. Bernanke and the Federal Reserve. The pause is necessary as it does provide these hard-at-work central bankers the opportunity to catch their breath before they announce that **their next strategy will involve purchasing corporate bonds and possibly stocks.**

This is significant for investors everywhere. If you enjoyed the short-term boosts to your stock and commodity portfolio caused by Quantitative Easing I and II, the 3rd version will likely be a major sugar high. And, as we are all prudent investors, be sure to have some cash ready for this next event which will likely occur early in the new year.

The Bank of England

Long before the World's economic power shifted to the USA, the global economic powerhouse was England. As the sun never set on the British empire, its many influences are still with us today. As many of you read this we know you are smiling as you privately thank the British for their most influential contribution to the World – the sandwich. However, while Britain is certainly a nation of sandwiches, it also home to the venerable Bank of England (BOE).

With the Americans and Europeans hogging all of the spotlight recently, it's no surprise that the announcement by the BOE to launch their second version of money printing flew largely under the radar.

In 2008, the BOE printed \$350 billion to help their economy. Fast forward to today and you'll see that the global economic slowdown is having a strained effect on the U.K.'s export markets. And, when combined with the funding strains resulting from the Euro-zone debt crisis, it is little wonder the BOE decided to try and kick-start its economy once again. This time, the BOE will be printing about \$120 billion to help move things along.

The Bank of Canada

Mark Carney potentially received a major boost to his resume. Currently the Bank of Canada exists only to fight inflation, and they have done a marvelous job of meeting this objective over the years.

Now however, the Canadian government is starting to explore opportunities to expand this mandate to include the "right to respond to economic shocks or dangerous buildups of credit" (source: CTV News). What does this mean for the average Canadian? Well besides potentially elevating Mr. Carney to the same celebrity status as the money printers from the US, Europe, Britain and Japan, it will all but ensure you'll have something else to talk about between periods of the latest hockey game.

Stay tuned.

Ghost Cities

Below the surface of the iceberg – China

In response to the economic devastation caused by the 2008-09 market collapse, the US and Europe has been wasting billions of dollars in non-productive investment schemes (cash for clunkers, housing rebates, subsidized latte's). China however took a completely different approach. **Instead of trying to encourage Chinese banks to lend, Beijing simply demanded their banks lend.** And lend they did. Total Chinese bank loan growth has increased over 60% since 2008. One thing is for sure, while the rest of the World has stagnated, there has been no lack of capital or liquidity in China.

But at what price? By now, many are familiar with the Chinese ghost cities – entire brand spanking new cities with not one resident to be found. There are also many more empty buildings and shopping malls, as well as carless bridges.

In economic parlance, we refer to these as capital investments. Capital investments are good as they normally create a long-term return to the economy. However, in exchange for stimulating its economy and avoiding social upheaval, the Chinese has used capital investment as a tool to subsidize an immediate slow down in the global economy.

Unfortunately, this over investment was meant to mask over a lack of domestic demand and to provide a bridge until the Western World recovered. Yet, with the Western recovery nowhere in sight the Chinese are now faced with too many empty cities and a huge pile of bad loans starting to accumulate within their banking system.

Granted, compared to any other country in the World, Chinese economic growth is miles ahead. However, **a Chinese economy slowing from 13% growth to 9% is the same as America slowing from 3% to 1%.** Just as 1% stall speed growth isn't creating enough jobs in America, 9% growth won't be enough in China. Maybe we'll see an Occupy Tiananmen Square rally soon enough, or maybe not.

With all of the distractions coming from Europe it is very easy to forget about the slowdown and banking problems in China. Keep your eye on this ball.

Defined Benefit Pension plans

For all of our defined benefit manager readers, we do offer our sincere empathy, after all there is nooooo way you will ever meet your 6%+ assumed rate of return criteria. With *long-term rates* below 4%, and every equity risk premium model being distorted due to short-term rates at 0%, the faintest hope of achieving anything near 6% or [gulp] higher is a stretch at best.

For all of you stock pickers out there, we subtly suggest you check up on every company's unfunded pension liabilities (don't worry about unfunded healthcare liabilities as they are unimportant to the accounting World, for now). We do acknowledge Halloween is just around the corner and certainly do not mean to frighten anyone, however this non-headline topic is a very big concern for every plan sponsor. If Europe should ever fade from the spotlight we know the pension problem will become front and centre news.

A cautious bunch

Our strategy

We've had some great conversations recently with clients, prospective clients and media outlets. During these exchanges, our strategy and perspective hasn't changed. Since IceCap was first launched as a firm we have maintained that the best strategy for today is one focused on capital preservation. **There will be amazing opportunities to make ridiculous amounts of money, however that time isn't today.**

Meanwhile, we continue to exist in a binary investment World with daily 4% intraday market swings – due undoubtedly to the hourly rumor mill emanating from Brussels.

Ultimately, we will see a resolution to the global debt crisis, and then you can certainly be assured IceCap will be the market cheerleader. However, until then we'll remain a cautious bunch, constantly analyzing the threats below the surface of the iceberg. During this time, we'll continue to preserve capital for our clients.

If you'd like to chat further about our view and our unique investment solutions, please feel to contact:

John Corney at johncorney@IceCapAssetManagement.com or

Keith Dicker at keithdicker@IceCapAssetManagement.com.

Thank you for sharing your time with us.