



Our view on global investment markets:

*February 2012 – Tug of War*

Keith Dicker, CFA  
Chief Investment Officer  
[keithdicker@IceCapAssetManagement.com](mailto:keithdicker@IceCapAssetManagement.com)  
[www.IceCapAssetManagement.com](http://www.IceCapAssetManagement.com)

## The Pursuit of Happyness

In Berlin June 1922, Alia Schmidt paid 3 German Marks for a really nice loaf of bread. A very quick six months later, the same loaf of bread cost her 700 German Marks. The German decision to print money caused inflation to skyrocket. No one was happy and Mrs. Schmidt had to stop eating bread.

In Tokyo 1994, Makishi Satou paid a whopping 217 Japanese Yen for a delicious McDonalds hamburger. A very long 18 years later, Mr. Satou is still enjoying hamburgers, yet he is only paying 216 Japanese Yen for this very same delicacy.

The Japanese decision to print money resulted in zero inflation. Yet, despite a full belly, Mr. Satou and others are not at all happy with their money printing experience and the subsequent -77% decline in their stock market and the -90% fall in their property market.

Today, future economic historians are lucky enough to both see and experience what will happen as Europe (lead by Germany), Japan, Great Britain and the United States fully engage in the biggest, coordinated, money printing experiment in the history of the Universe.

In its simplest form, only three scenarios are possible:

- 1) Money printing has absolutely no impact on prices rising or falling
- 2) Money printing results in a return to the 1922 German experience
- 3) Money printing results in a return to the modern day Japan experience

No worries though - the very competent hands of today's central bankers, on the surface at least, appear quite confident that their money printing games will successfully engineer a very serene road to prosperity. The mere mention of the probability of scenarios 2 or 3 occurring are casually dismissed as easily as an offering of a third espresso.

However, what should make you a little concerned is that central bankers in both 1922 Germany and 1990 Japan came to the very same conclusion before they commenced their devastating money printing strategies.

Any investment manager worth their salt these days will tell you that the probability of scenario 1 occurring is lower than the real odds of England winning the next World Cup.

The elimination of scenario 1, naturally leaves us with a **tug of war** between a **hyper-inflationary World** or a **deflationary World**. Both outcomes are certainly extreme, yet what else could you expect when we have the World's biggest central banks implementing extreme monetary policies in the form of money printing?

### What is inflation?

While inflation can be measured in several different ways, for the average person it simply means the price of stuff is becoming more expensive. We all remember paying 20 cents for a tin of Pepsi. Today, the same tin of Pepsi is now fetching \$2.00 – that's inflation.

## Spare change

Now, inflation isn't necessarily bad - as long as your salary increases at the same rate as inflation you are no worse off. However, if inflation is rising faster than your salary, you have a problem. In 1922, Germany had a problem.

### 1922 Germany

All wars are expensive and World War I was no exception. For starters, to pay for the war Germany decided to stop backing their currency with gold. Next, they borrowed money to pay for the war.

The Allied Powers won the war and the peace treaty stated that Germany would pay 269 billion gold marks (equivalent to USD \$442 billion in 2012 value) to the Allies for all losses and damages suffered.

Naturally Germany didn't have that much actual gold, therefore the only way for them to pay was by using their paper money – the German Mark, to pay the money owed. Germany would sell their German Marks and buy foreign currency. This foreign currency was then used to pay the Allies.

The inflation ball really started to roll when Germany literally started to print more German Marks (to buy more foreign currency) causing the German Mark to plummet. This rapid decline in the German Mark made it prohibitively expensive for Germans to buy anything that was made by another country.

As they say, the rest is history. Thanks to money printing, Germans

had to use wheelbarrows to carry their spare change.

Germany, 1923



### What is deflation?

Deflation is really the opposite of inflation – instead of rising, the price of stuff falls and continues to fall over time. While it has always been pretty easy for governments to create (both intentionally and



## People of Wal-Mart

unintentionally) inflation – they have to be exceptionally talented to create deflation.

For most people, when they hear about falling prices they naturally think Wal-Mart. After all, who doesn't enjoy paying a lower price to buy something? Persistent deflation however is a little bit different and certainly has an ugly side.

If you were about to buy one of those really nice flat screen TVs, you would likely wait for it to go on sale. Now consider the situation where you knew the same TV would be even cheaper next month. And then when next month rolls around you suddenly determine the TV will be cheaper still the month after. The result sees people suspending all purchases until they absolutely have to buy the item.

For you and I, this isn't necessarily bad. However, for companies that are making these products and services, it is not good for their bottom line. And when the bottom line isn't good, companies tend to stop hiring and reduce their spending – both actions which are bad for the economy.

Long periods of deflation rarely happen – and when they do, it is extremely difficult for governments to stop the downward spiral. The difficulty lies with the fact that governments are not willing to make the correct decision to stop deflation in its tracks – and for incorrect decisions, there's no better place to look than Japan.

### 1990 Japan

The Japanese economy in the 1980s produced an economic miracle. The Japanese export machine was producing high end products – and a lot of them. The local economy was also humming along and everyone was enjoying the ride - until that is, the ride stopped.

Of course, today it is widely recognized that the Japanese miracle was in actual fact just another good old investment bubble. When the bubble burst the stock market naturally collapsed, but another very important thing happened – property markets also collapsed. And it was this collapse of the Japanese property bubble and the subsequent inaction by the government that really caused deflation to persist for the next 22 years.

At the time, the Japanese benefitted from a very strong currency and a very high savings rate by individuals. This combination flushed Japanese banks with lots of cash of which they freely loaned to anyone with a heartbeat (ironically, this is somewhat similar to what is happening in China today). At its peak, commercial property prices in Tokyo reached **\$93,000 per square foot**. Today, prices are about **\$164 per square foot**.

What *didn't* happen next in 1990 Japan is exactly the same as what *didn't* happen in the US today.

The collapse of the Japanese real estate market devastated Japanese banks. And, just as the US government refused to allow the American

## Everyone *should* care

banks to die a natural economic death, so too did the Japanese government.

In both cases, most banks should have been closed with their assets sold to the highest bidder. Instead, the Japanese & American governments decided not to let the banks fail and instead the banks were permitted not to write-off their bad real estate loans as losses.

**The important point to understand here is that this happened in Japan over 20 years ago – and they continue to struggle with this mess today. Meanwhile, the Americans and Europeans are effectively in Year-3 of their financial fiasco and despite using the exact same “solutions” as the Japanese, they sadly believe they will experience a better outcome.**

The reason we are diving into this torturous story about 1990 Japanese banks is because today, the Americans (and the Europeans) are both using the exact same medicine to cure the bad debt disease.

In both situations, it was the bursting of a property bubble [industry investment jargon refers to this as an “asset bubble”] that caused all the trouble in the first place. Throughout time, whenever the World saw a property bubble burst, the after effect has always been years of people, companies and governments struggling to pay off their debts and saving more money. Subsequently, this “de-leveraging” has always resulted in less spending by everyone which meant lower and slower growth.

The bursting of Japan’s property bubble was unique in that it occurred in isolation to the rest of the World – it was a Japanese problem, so no one else cared. However, what makes the US and Europe’s bubble breaking problem more sinister is that they have occurred at the same time – resulting in the entire World being exposed to the actions and inactions of these two behemoth economies. Today – everyone should care.

### **Tug of War – Inflation vs. Deflation**

The 1922 German hyperinflation experience was undoubtedly propelled by printing massive amounts of money. Yet, the Japanese money printing experience has had no impact whatsoever on inflation.

Here we are in 2012, and the World’s four main central banks (USA, Britain, Europe and Japan) continue to print gobs of money. **Will the outcome be 1922 Germany or 1990 Japan?**

**An important point to understand is whether the printed money actually flows through to the economy.** In the 1922 German case – yes, it definitely did. The printed money circulated in the economy causing the German Mark to plummet against other currencies which resulted in extreme inflation.

Today, trillions of Dollars, Yen, Euros and Pounds are being printed – yet this new money is certainly not being distributed into the economy. Instead, big banks everywhere are hoarding the newly

## Feeling trapped

minted cash for a rainy day. In economic parlance, this is referred to as a **“liquidity trap”** meaning there is plenty of cash available, however the cash remains trapped and is not being used. This makes today’s situation, perilously closer to the Japanese experience.

**Chart 1 on the next page shows the amount of money not being distributed into the economy by the very big American banks.** Once this money is eventually released (via loans) into the economy, the cost of things could rise very quickly – similar to 1922 Germany.

We (and many, many others) have been very critical of the American, European and British central banks. We freely admit that these people all have very good intentions – they truly do want the World’s economy to return to normal.

Yet in our opinion, it is their analysis of the problem that is leading them to make a very big mistake. **The central banks fully believe that the World is currently suffering from what they would call – an aggregate demand problem.** They believe growth is slow around the World because people and companies are not spending as much money as they normally would.

**To many of the big banks, stock brokers and mutual fund sales people, this “aggregate demand problem” sounds no different than any other economic slow down – it’s a part of a normal business cycle.** And during a normal business cycle, the solution to encourage people and companies to spend more money has always been

1) lower interest rates and 2) increased government spending. And if the situation becomes untenable as it is today, you can add 3) money printing to the list.

The reason this combination isn’t working today is due to the flawed belief that all of this extra money sloshing around in the economy will naturally entice people and companies to spend their hard earned (and borrowed) money again.

With trillions in freshly printed money, sub 2% growth, widening government deficits and continued bailouts to banks, it has become crystal clear that the central banks’ money printing strategies are not working.

**The reason it isn’t working is simply due to the fact that all of this free money being provided to the banks, is not being distributed back into the economy. US and European banks are hoarding this free money and as a result - the transfer mechanism is broken.**

For the game of Tug of War - it is this lack of liquidity-flow-through that is hugely supportive of a return to the 1990 Japanese experience. The lack of spending by people and companies in favour of paying down their debt and increasing their savings guarantees sluggish growth at best.

However, it is also critical to know that despite the hoarding of cash by the big banks, the act of money printing by the central banks

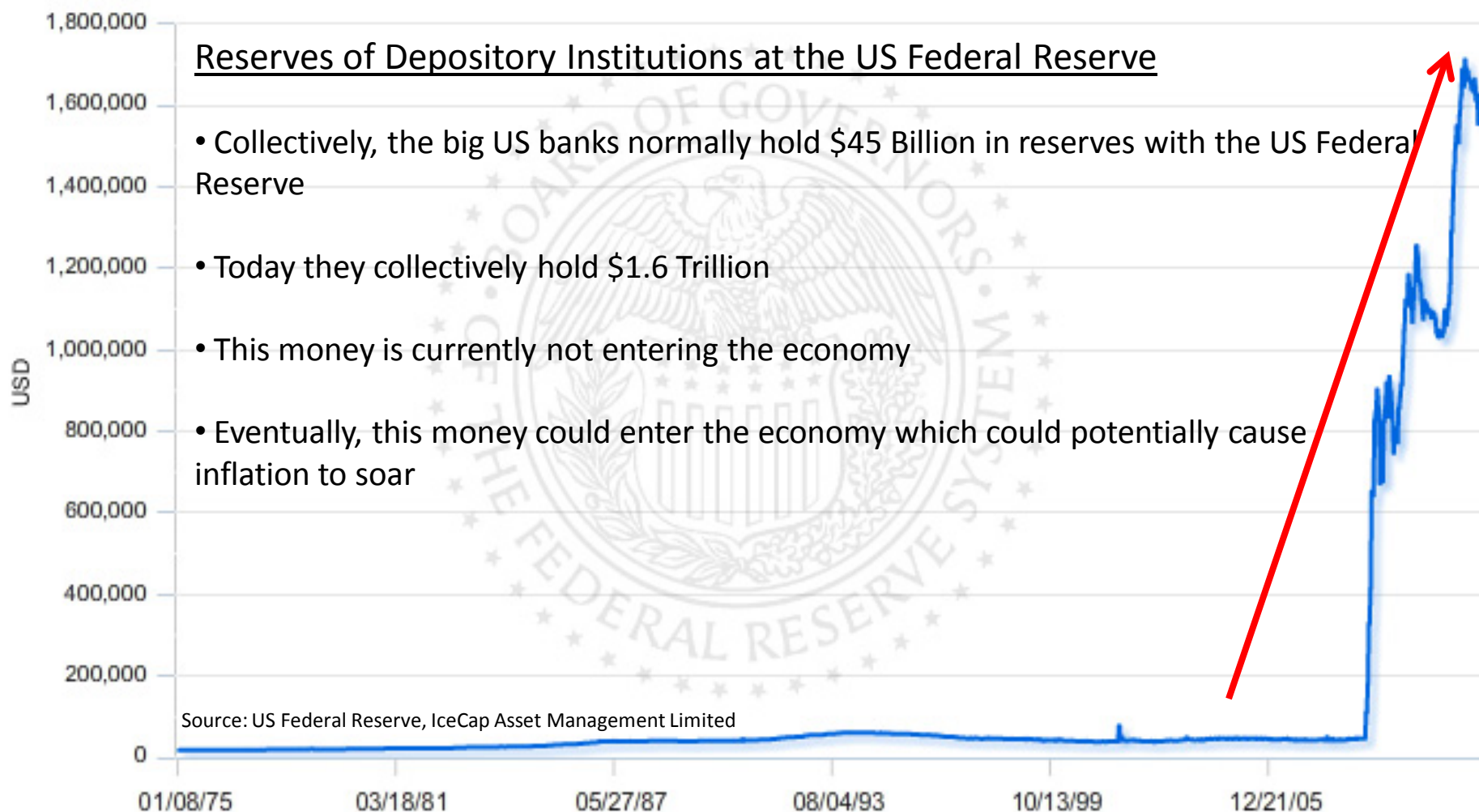


Chart 1: This is what can ultimately cause inflation

### Reserves of Depository Institutions at the US Federal Reserve

- Collectively, the big US banks normally hold \$45 Billion in reserves with the US Federal Reserve
- Today they collectively hold \$1.6 Trillion
- This money is currently not entering the economy
- Eventually, this money could enter the economy which could potentially cause inflation to soar

Source: US Federal Reserve, IceCap Asset Management Limited



## Chart 2: This is what can ultimately cause deflation





## Patience

strongly encourages investors to shun low paying bonds and cash, and instead focus on stocks and commodities.

This by product of money printing has two effects. First, it pushes commodity prices higher, which inevitably causes the prices of some things to also rise higher (when you have a chance, check out the price of gasoline these days).

Secondly, while a higher stock market does help everyone who owns stocks, it just so happens to help the very wealthy a lot more. It is this growing divide which is fueling the bitter tax debate in the US, as well as being the spark for the recent “Occupy Wall Street” movement. Today, you can also include it as the indirect spark which will lead to the eventual social uprising in Greece.

**The bottom line is as follows – the combination of the bursting of property prices and the refusal of the big banks to write-off the corresponding bad debt is resulting in a big wave of deflation.** We expect this to continue. Yet, we also are mindful enough to know that pockets of inflation will occur in various countries and within various industries.

The real threat of hyper inflation will occur when a major currency collapses. Any country that leaves the Eurozone will undoubtedly see extreme inflation during their transition years. Outside of the Eurozone, Britain remains at risk due to it being a key center of global finance and at risk should the World’s super-size banks implode once

again.

Next up on the at-risk barometer is Japan. Despite a continual decline in economic growth and stock market, Japan has always been able to fund their deficits through local investors. The Japanese have traditionally been terrific at saving money, and the Japanese government has benefitted the most from this envious skill.

However, the day has just about arrived when many of these Japanese savers are retiring which means they will not be saving as much money as they had before.

**Why is this bad for Japan?** Instead of borrowing from their local citizens at very low interest rates, the Japanese government will now have to start borrowing from foreign investors. Just add Japan to the already long list of governments that will depend upon foreign investors to lend them money.

Now, Japan will be able to borrow, however the cost of them borrowing will undoubtedly rise from the very low interest rates from which they have become accustomed. Ironically, this upcoming problem will lead to a decline in the Japanese currency which will inevitably create the inflation which has been much sought after over the last 22 years.

Just think of all the money Japan could have saved if only they had remained a little more patient and simply waited for their people to grow older.

# The Troika

## Greece Fatigue

Anyone else tired reading, watching and writing about Greece? Here at IceCap, we know we are definitely feeling a little sleepy over the entire affair. By sleepy, we certainly do not mean to offend anyone and everyone involved with the crisis, rather we believe the time has come to finally resolve the situation.

Europe has grappled with Greece for the last 2 years. Initially, the situation was severe enough to completely topple Europe right over and the global financial system along with it. Since that time, Europe (in co-ordination with the US) has slowly tried to ring fence the Greek problem so that it wouldn't harm anyone else. In the eyes of the European Union, they may finally be at that point.

**Or are they?** In truth, no one knows for certain – and that's what all the fuss is about. What we do know is that during the deep dark days of 2008 just before the American investment bank Lehman Brothers collapsed, those in charge thought they had everything under control.

As we know now, nothing was in control and in fact “out of control” was a much better description of what followed. It is this potential for more “out of control” that has IceCap worried these days.

One concern involves the continual withdrawal of money from Greek banks. A fatal flaw in the Troika bailout is that it isn't allowing enough for additional capital required by the Greek banks. One must believe that this is a very clear sign that Germany ultimately wants to see

Greece leave the Eurozone – after all, the rest of Europe is very focused on rebuilding their banks. Without money, banks simply do not function – at this rate, Greek banks will very soon become dysfunctional.

Next, Greek Prime Minister Lucas Papademos was never elected to office in Greece. Instead, in November 2011 he was *appointed* to lead the country by the European Union lead by Germany and France.

His sole mission is to ensure the Greek parliament accepts more and more bailouts from the European Union, International Monetary Fund and the European Central Bank, collectively referred to as *the Troika*. Presently, of the Troika bailout money given to Greece, only 19% of it stays in Greece. The remaining 81% is paid back to Europe for loan repayments.

So, let's get this straight. The Troika appoints the leader of Greece who forces the Greek parliament to accept yet another bailout of which 81% of it is immediately paid back to the Troika. We cannot speak for anyone else, but it seems to us like the Troika is bailing out the Troika. Sadly, we wish we were making this up, but we are not.

The Troika has also been active in Italy, as the Italians also get to enjoy having Germany and France appoint their leader. As the economic situation deteriorates further in Portugal, we're pretty sure they too will get to their enjoy their own Troika appointed leader. And as for Spain – the clock is ticking and you are hereby on notice as well.

As you'll agree, Europe is becoming more interesting by the day.

## Remain flexible

### Making sense of it all

Here at IceCap, we refuse to draw a line in the sand and to never change our view. If the facts change, then so too will our strategy.

Like 1922 Germany, today inflation may ultimately be caused in an individual country as a result of a severe decline in a single country's currency. We could also see a severe global rout of inflation precipitated by the collective and excessive money printing ways of the World's 4 major central banks in the US, Europe, Britain and Japan.

In both of these scenarios, we expect gold bullion to do very well. In addition, stocks and commodities will undoubtedly return better than cash and bonds.

Alternatively, investors must understand that people and countries are de-leveraging as they are starting to pay down their debt, and banks are not allowing their excess money to re-enter the economy. This combination is creating slower growth which could make the World a little closer to 1990 Japan.

In this situation, bonds and cash will perform significantly better than stocks and commodities. However, should this occur you should also be prepared for a continuation of additional money printing which in our opinion only further increases the likelihood of a financial blunder. This key risk supports a position in gold bullion in the portfolio as well.

At IceCap, we do not believe this is a time for investors to remain complacent. This global game of Tug of War may not be known to everyone, yet as the World's central banks continue with their money printing strategies, it will certainly drive your investment gains (or losses) going forward.

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.

Please feel to contact:

John Corney at [johncorney@IceCapAssetManagement.com](mailto:johncorney@IceCapAssetManagement.com) or

Keith Dicker at [keithdicker@IceCapAssetManagement.com](mailto:keithdicker@IceCapAssetManagement.com).

Thank you for sharing your time with us.