



Our view on global investment markets:

June 2012 – “Cool things from Europe”

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The Eagle has landed

Europe is a very cool place. It provided the background for the classic Clark Griswold movie as well as other Hollywood mega hits. Plus, who can ever forget Eddie “The Eagle” Edwards and other gifted European athletes who always amaze us with their strength and agility. And, let’s remember that practically all of the really good non-processed foods have originated from the old World.

Let’s face it – Europe is a cool place.

In addition to being cool, Europe is also without a doubt the most creative and imaginative place outside of Middle Earth. Its ability to consistently baffle itself certainly warrants valuable space in IceCap’s global market outlooks.

Financially speaking, Europe is broke - it no longer works.

Figuratively speaking, Europe has entered its golden age.

Unworkable solutions dreamt by an unworkable political system is consuming all real and electronic ink known to mankind. A day doesn’t go by where local newspapers are not bursting with news on Greece, Spain and their Euro-cousins. This sudden love-in with Europe has surely removed America from the global spotlight. But, be patient as this will change later during the year.

To demonstrate the absurdity of this place called Europe, one has to understand nothing else except the legalities behind Europe’s rules

for selling cabbage to each other.

Mike Shedlock (Mish’s Global Economic Trend Analysis) points out that only in Europe, would regulations for selling this very basic vegetable require a 26,911 word document. For comparison, the entire US Constitution with all 27 Amendments only used 7,818 words.

To further understand this cool place called Europe, we’ll introduce you to the main groups responsible for providing a solution to their debt crisis.

European Union

There shouldn’t be anything baffling about the formation and structure of the European Union, but there is.

It seems that this select group of countries has agreed to do business together through **a system of supranational independent institutions and intergovernmental negotiated decisions by the member states**. We have no idea what this means.

There are also many very important institutions in the EU including the European Commission, the Court of Justice of the European Union, the European Central Bank, the Council of the European Union, and the European Council. Don’t laugh, but the Council of the European Union and the European Council are two different groups - we kid you not.

There must always be an “e”

We'd be embarrassed if we forgot to mention the **European Parliament**. This eclectic group sits in Brussels with each member receiving very nice pay cheques and benefits yet at the end of the day they play second fiddle to the elected governments from each country within the European Union.

Speaking of countries, members of the European Union includes Europe's favourite 27 countries. To be a member you simply have to be a country not called Switzerland or Norway. Yes, neither Switzerland nor Norway are members.

Baffled yet? Then, let's move on.

Euro-zone

If the European Union didn't baffle you, well perhaps the Euro-zone will.

The Euro-zone is another member only group that includes 17 countries of the 27 countries that make up the European Union. Each of these 17 countries converted their currency into Euro's. Meanwhile, the remaining 10 countries continue to use their own currency while remaining a part of *the system of supranational independent institutions and intergovernmental negotiated decisions by the member states*.

And, in case you are curious, it's unimportant to know that this currency mish mash hasn't changed anything of substance at the

Council of the European Union or the European Council.

Now not just anyone can become a part of the Euro-zone. First, you must be a member of the European Union and be willing to relinquish control over interest rates and other important monetary policy tools.

More importantly, you must sign the Maastricht Treaty which explicitly states financial criteria necessary to become a member of the Euro-zone. Criteria includes:

- 1) Annual government spending must never be more than 3% of the taxes you collect
- 2) Your total debt outstanding should never be more than 60% of your economy's GDP.

Considering no European country except Switzerland and Norway has ever achieved these rather unlofty goals, the Maastricht Treaty certainly ranks high up there on the bafflement scale.

The European Central Bank (ECB)

Every country that has its own currency, needs a central bank to administer the currency, set interest rates and print more money should the need arise.

Members of the Euro-zone created the ECB to be its central bank.

Germany will foot the bill

Just like other central bankers around the World, these fellas are pretty smart with most of them having worked previously at Goldman Sachs at some point during their career.

Like every bank, the ECB needed initial capital, about EUR 5 billion to be exact, to get the ball rolling. Naturally, this meant the 17 countries that use the Euro would contribute 70% of the total. The remaining 10 countries who chose not to use the Euro currency had to contribute 30%. Fourteen years later, we're pretty sure these 10 countries view that investment as the best money they ever spent.

Today in Europe, the financial crisis is all about not having enough money to pay off debts. Since the ECB has a money printing machine, every country (except Germany), is begging the ECB to print money to lend a hand to non-German Euro-zone members.

Not one to disappoint, the ECB has done exactly that. However, whereas it seems (on the surface anyway) the American and Japanese central banks simply do whatever they want whenever they want, the Europeans do follow rules – after all, they do have the Council of the European Union and the European Council as overseers.

In response to being asked to bailout everyone, the Europeans have been forced to dig deep into their baffling skills to pull out the following bailout programs:

EFSF – European Financial Stability Fund is suppose to be a EUR 440 billion temporary fund to provide bailouts to Euro-zone countries only (ie. not banks). While no country has actually contributed any money to the EFSF, this fund receives its funding by actually borrowing money. *All Euro-zone countries except those receiving bailouts, are responsible for the money borrowed by the EFSF.* To remove all ambiguity from this ambiguous bailout program, you just need to know that this European solution to its debt problem is to borrow more money to pay off the debt.

ESM – Next up is the European Stability Mechanism. The ESM is the next generation of the EFSF. It will supposedly contain EUR 500 billion in bailout money. To get this program kick-started, it is hoped that the Euro-zone countries who are not already receiving a bailout will contribute EUR 80 billion to the fund. Naturally, the remaining EUR 420 billion will have to be borrowed. Again, to remove all ambiguity from this ambiguous bailout program, you just need to know that the European solution to its debt problem is more debt.

SMP – Moving along, we have the Securities Market Programme which was created by the ECB for the purpose of directly bailing out countries. The ECB has already used over EUR 200 billion to buy Spanish and Italian bonds which have subsequently declined rapidly in value. If the ECB were an investment manager, they would have been fired over this move. But since no one in Europe can be fired, ECB board members are safe for now.

They have a money printing machine!

ELA – Let's not forget the Emergency Liquidity Assistance program. This ultra secretive program is administered by the ECB and to date has indirectly provided over EUR 140 billion to banks in Ireland, Portugal and Greece. In exchange for this EUR 140 billion, the ECB unconditionally accepted real estate and other loans as collateral. As we said, it's a good thing the ECB isn't an investment manager.

LTRO – Last but certainly not for long is the Long Term Refinancing Operation. This puppy has actually been the most effective yet. Effective that in that it directly loaned EUR 1.018 Trillion to European banks, who very promptly lent the money to their respectful governments. Not as cumbersome as regulations for cabbage, but cumbersome nonetheless.

Summary

If all of this is confusing and baffling, it's because it is. Seriously – is it any wonder Europe is in a mess? Behind all of the smoke and mirrors, the European solution to their debt problem is simply more debt.

And, to make this even simpler – the crisis has now reached the point where markets are no longer being fooled and the one and only hope for Europe is if Germany agrees to bailout everyone.

The German Response

The European Union has had 19 special meetings to resolve once and for all the Euro-zone debt crisis. 19 very cool meetings where countries using 16 different languages, told Germany that they had to

bail out everyone. Being as efficient as usual, Angela Merkel's response was in only 3 languages – nein, non and no.

Not to worry though, as soon as the press gathered for the interviews and photos everyone smiled, held hands and joked about England's chances of winning the European soccer championships – which are about the same as Europe resolving its debt crisis.

The Cool Scale

Admittedly, on the cool scale IceCap ranks far behind Europe. Yes, IceCap certainly has a cool name. We listen to cool music and we know all about every cool movie made in the 1970s. Yet, we clearly do not have enough swag to top the Europeans.

However, when compared to Ben Bernanke and the US Federal Reserve – our cool confidence meter shoots even lower. For starters, Ben and the boys actually have a money printing machine. Think about that for a moment – they have an actual money printing machine.

We don't care what anyone says - that's cool.

Next, Ben and his team never have to work in the real World. Sure they receive a paycheck every couple of weeks and they occasionally fight traffic during their commute. But do they have to worry about sales growth, net margins and work safety inspections? Of course not, after all they have a money printing machine!

Bonds can be cool

While the World was glued to activities in Greece, Spain, Ukraine and Poland, Ben was quietly preparing for another very important meeting on June 20, 2012. This was the meeting where the US Federal Reserve would once again crank up the old money printing machine and spit out gobs of bills once again.

The stars were aligned – the US economy is clearly slowing once again. People without jobs are increasing by the day. Plus, the ultimate measurement of wealth, the stock market – has dropped an astonishing -9% since April 2012. How on earth can this be tolerated - go ahead Ben hit this one out of the park.

At exactly 12.30 pm EST, it didn't happen. Ben and the boys decided NOT to print more money. Now they certainly didn't stop printing all together. Instead, they decided to repeat the same strategy they initiated on September 21, 2011 – they will merely “twist” their balance sheet by reinvesting US Treasury Bond maturities into longer dated US Treasury Bond maturities.

This move certainly isn't cool. After all, it is merely another ploy to depress interest rates across all maturities. While initially helping the banks, this old trick is now actually starting to depress their earnings as well. Yet, don't feel sorry for the banks rather save your sympathy for all the savers in the World who are forced to accept either very small interest on their savings, or to take on excessively more risk to earn income. Socializing private market losses is definitely not cool.

The stock market was definitely expecting more. However, the stock market being the stock market simply interpreted this as “Ben didn't print a lot of money today but he will definitely print a lot more later this year.”

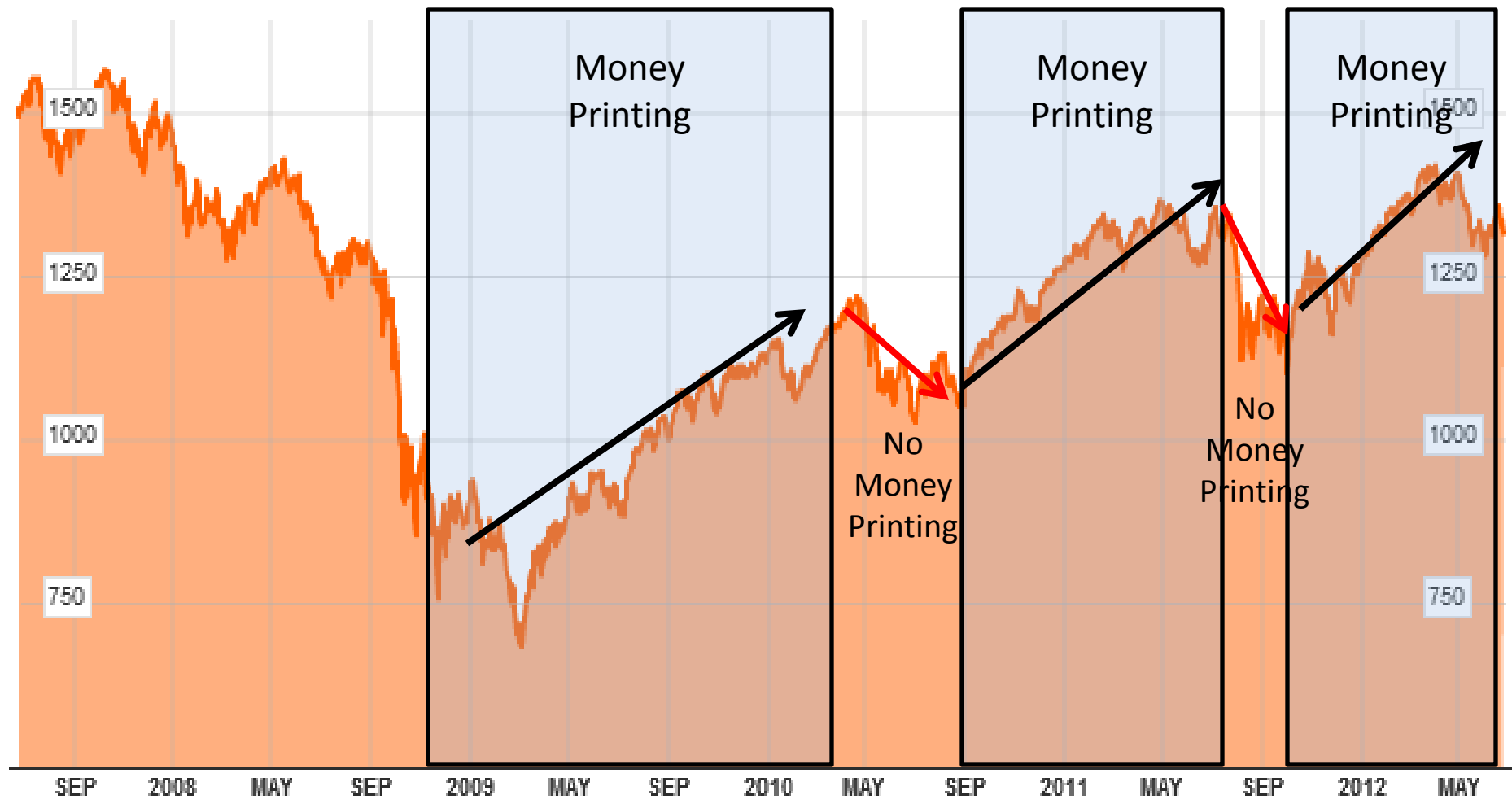
Just in case we lost anyone, you need to know that earnings, dividend yields, inflation and PE ratios simply do not matter anymore. **Chart 1** on the next page shows how daily, weekly, and monthly stock market returns have become completely dependent upon actions by the US Federal Reserve and central banks from Britain, Europe and Japan.

The bond market is a different story. Now, we ask everyone not to tune out whenever we say “bond market.” After all, the media and mutual fund sales people ever only talk about the stock market. This is either because they do not understand the bond market or because they get paid a lot more for talking about the stock market. Actually, it's a combination of both, yet we digress.

For those people ambivalent towards the bond market, we'll let you in a not so little secret – the bond market is always ahead of the stock market. Each morning when the honest-to-goodness investment manager wakes up, he immediately checks not the stock market, but the bond market.

While the American stock market has held up reasonably well lately suggesting all is well, bond markets around the World are telling a different story. In times of trouble, investors want safety and to many

Chart 1: S&P 500 Index 2008 to 2012



Source: Bloomberg, IceCap Asset Management Limited

Complacency

investors, safety comes dressed up in US, Canadian, German and Swiss government bonds. In fact, investors are so fearful of Europe that they have driven select government bonds to all-time highs.

In times like this, investors simply want a return OF their capital – a return ON their capital is pure gravy at this point.

To really appreciate the situation look no further than Switzerland where recently investors were willing to accept guaranteed negative returns for holding Swiss government bonds. In effect, these investors were willing to take a -0.1% loss rather than throwing their money into the European banking system governed by the Council of the European Union and the European Council.

The Stock Market

Amongst the world stock markets, France and Japan are now inches away from their 2009 market low. While Spain, Italy, Greece, and Portugal have already blasted through their respective 2009 market lows.

Meanwhile, Canadians and Americans confidently, nonchalantly, or complacently (take your pick) continue with their investment lives as if there were no worries whatsoever. Maybe, these uber bullish people are right - maybe, just maybe, economies in Asia, Europe and South America can deteriorate without having any effect whatsoever

on our bullet proof economies, but we doubt it.

The Canadian economy (and currency for that matter) is highly influenced by commodities. And the last time we checked, the biggest consumer of commodities in the World is slowing considerably.

China, that miracle machine of growth seems to be slowing. The days of 10% economic growth are long gone. 9%, 8%, 7% are growth numbers from the past. Going forward anything above 6% will be a cause for celebration.

But then again, those media drooling headlines from yesteryear were clearly supported by a capital investment strategy pursued to create jobs and keep the villagers happy. Yes, a few new cities were clearly needed, as we're new roads and cars. However, now that everything has been built some people have the audacity to question why the new shopping malls are closed, the roads are carless and believe it or not, why entire new cities are empty.

As for china's inventories of commodities, well they certainly are not empty. In fact, many inventory levels are sky high. Regardless if this stock pile is for further capital investment, or even a new commodity backed currency - future demand has likely been dampened which is certainly reflected in commodity prices.

Suspended economic belief

It's no secret that China is strategically shifting its economy away from capital investment and more towards spending by individuals. One dimensional thinking has always proclaimed that they will do this by simply having consumers spend more money.

Yet, the other more likely strategy is to simply have less capital investment. The end result is the same but this perspective elbows conventional thinking right in the belly.

While the World remains fixated on Greece and now Spain, China's strategy to dealing with the 2009 financial crisis has been to quietly pursue a mega capital investment program. Build, build and build some more. Jobs are created, profits are made and everyone is happy.

Unfortunately the inevitable economic hangover is always inevitable - even in the land of suspended economic belief. The hangover occurs when everything has been built and there is no person left to buy that last condo, no company left to lease that last office space, and more importantly, no bank left with money available to lend.

Here at IceCap we devote a lot of attention to understanding the world's banking system. Without a solid and safe system, money simply doesn't move around which means economies do not grow. In China, the banks have been instructed to lend money hand over fist and unfortunately the time has come where many of these loans are not being repaid. While we doubt anyone has accurate and timely

data on any of China's banks, anecdotal evidence of rising commodity inventories, lower electrical consumption and perhaps the best metric for China – a slowing Australian economy shows that something isn't quite right in China.

Of course, as the Western World slows, so too will spending by everyday folks. This less spending by the everyday folks directly translates into less demand on Chinese factories to produce their goods.

While the World remains fixated on Europe, be sure to connect the dots – declining growth in Europe will eventually hit the manufacturing plants in China. In addition, we ask you to remember that when banks over extend themselves they are asking for trouble – Chinese banks are no different than any other banks in the World.

Our Strategy

IceCap has sometimes been accused of being too conservative and we take this as a compliment. If we are starting to sound like a broken record, it certainly isn't because our investment strategy is broken. If anything, our outlook and cautious approach may have been a little early but in the investment World, it's better early than late.

The financial conditions that created our cautious view have not changed. If anything, financial market stress has definitely intensified yet we remain skeptical that the big decision makers are capable of

We're still worried

making the decisions necessary to get the system going again.

From our perspective, the debt loads in the Western World remain excessive. The American consumer has become more frugal – whether by choice is an entirely different matter. Yet the fact remains that bad debt in the US is being reduced, mostly by defaults but nevertheless it is being reduced. This is good.

Meanwhile, debt levels at the American Federal, State and Municipal governments are an entirely different story. This is bad.

The European debt crisis remains a disaster. What initially started as a sovereign debt problem has now morphed into a complete financial system problem. Countries and their respective banks are becoming insolvent and this drains market confidence. In Europe these days, banks will not lend to each other and countries only want to lend Germany's money to each other. This too is bad.

European economies are in recession and this will spread around the Globe. Canadians and Americans must realize that our economies will be affected. In addition, Canadian and American banks will also be affected should the European crisis escalate. If one very large European bank runs into trouble, all other banks around the World will feel the ripple.

We like to think authorities are able to clean up this mess. Yet, three years later the situation has become worse – not better and this is

what continues to make us a concerned investment manager.

While the initial reaction to the June 28, 2012 EU Summit was positive, few details have been provided. What we know is that a fiscal and monetary union will not happen in our lifetimes. We also know that the bailout funds have not increased, and we also know that no debt will be written off. There was a discussion of having a centralized banking authority – but not until 2013. Once the euphoria wears off, markets will once again ask for details.

Meanwhile, our portfolios continue to emphasize cash, bonds and gold, with limited exposure to stocks and commodities.

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.