IceCap
Asset Management Ltd.

Our view on global investment markets:

December 2011 – The Smiling Faces of Ben Bernanke & Marc Faber

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Don't stay in school

Dr. Ben Bernanke went to school and never left. He is an academic who has never worked in the private sector yet controls the fate of trillions of Dollars, Euros, Yens and Pounds. Today he is smiling.

Dr. Marc Faber also went to school, but he didn't stick around. He has worked exclusively in the private sector and today is considered one of the most prescient investors on the planet. Today he is also smiling.

To better appreciate all the smiling, one must understand exactly what happened or better still, what didn't happen in Brussels last week.

In the eyes of Dr. Bernanke and Dr. Faber, the historic 17th emergency summit meeting by the Europeans to solve their money problems went off without a hitch. Not only did the Euro-Elite fail to resolve their debt crisis, they failed miserably at even coming close to recognizing the problem. It's this distinct lack of recognition that is turning frowns into smiles.

Dr. Bernanke is smiling of course because he is a money printer. The continuing inability of the Euro-Elite to solve their problems virtually guarantees a 2012 recession in the Old World. In return, this will also create a recession in the US which will provide plenty of excuses for Mr. Bernanke to once again print money under the guise of QE3.

Dr. Faber's uncanny ability to understand the big picture and foresee the response from financial markets allowed him to predict the 1987 crash, the 2008-09 crash, and the resulting 2009 stock market rally. Dr. Faber is smiling today not because he agrees with Dr. Bernanke's fondness for money printing, but rather because the global financial system is developing exactly as he has envisioned. This vision of course is a money maker for both him and his clients.

Dr. Faber once proclaimed that Dr. Bernanke's US Federal Reserve is an evil institution – it robs from the poor to give to the rich. By anchoring short-term interest rates at 0% and longer-term rates at 2%, central banks around the World have perfected the art of being a modern day anti-Robin Hood.

This manipulation of interest rates is forcing investors of all sorts to stretch, tug and pull their portfolios in search of higher yields but with assuming higher risk.

Witness:

- Instead of buying 0.5% guaranteed deposits, the little old lady in Saskatchewan is now fully invested in BBB rated unguaranteed bonds. She has no choice – she needs the income.

- Rather than maintain their traditional allocation of 60% to top rated bonds, the local charitable trust in Alaska is now investing heavily in bank and insurance stocks to receive the juicy dividends – they need the income.

What happens in Brussels, stays in Brussels

Meanwhile, the big banks around the World continue to benefit from very cheap funding courtesy of Dr. Bernanke and the comfort of knowing they will never ever have to realize losses on any bad investments, again courtesy of Dr. Bernanke.

We wonder if the little old lady in Saskatchewan or the charitable trust in Alaska will receive the same fairy tale-like treatment should their portfolios lose money.

It's at this moment Dr. Faber shakes his head in disgust while Dr. Bernanke digs out the atlas to locate Saskatchewan and Alaska on the map.

What happens in Brussels, stays in Brussels

At a certain level we can excuse the Euro-Elite for conveniently forgetting about a small, minor issue facing their troubled nations.

It was now 4 am and after mocking Britain's Prime Minister David Cameron for 2 hours, the French and Germans had moved on from espresso and crepes, to Cristal and then more Cristal. Their little ploy to strangle democracy while enforcing austerity on everyone was cause for celebration.

While financial markets and media were shouting for joy that the Euro was saved, no one was talking about the debt elephant that was still in the room. Yes, the Europeans may be able to agree that they will try to balance the budgets – yet no where in any communiqué was there any mention of writing off the bad debt.

Correct us if we are wrong, but wasn't the bad debt problem the reason for getting together in the first place?

By now, everyone who isn't a banker or politician understands that these decisions to lend money to many European countries and banks were simply poor investment decisions. For everyone else in the World, if you make a poor investment and lose money – you lose money. No one will call you up and give you money to recover your losses.

This is the way capitalism and free markets work. This simple relationship between risk and return is the mechanism for allocating capital for investment. It's the reason why kids love Disney World and not the State of California's Department of Fun and Recreational Center. Sadly today, this mechanism is close to being destroyed.

Meanwhile back in Brussels, what exactly did the Euro-Elite achieve?

For starters, they managed to turn Britain's Prime Minister David Cameron into a folk hero. The European Union (EU) consists of 27 countries including Britain. The EU is a special club that allows its members mobility for seeking work, lower taxes on trade and common rules to follow.

Of these 27 countries, 17 of them have adopted the Euro as their

Cameron is good for a laugh

currency and the European Central Bank as their puppet master. This 1999 agreement eliminated French Francs, Italian Lira, Greek Drachmas and the German Deutsche Mark to name a few.

More importantly, every member country of the Euro 17, agreed to keep their debt no higher than 60% of their GDP, and they all promised to never let their spending exceed their tax revenues by more than 3%. This all seemed reasonable of course – yet not one country was able to achieve these unlofty goals.

Nevertheless, here we are 11 years later with debt levels for some exceeding 100% of GDP and budget deficits remaining far away from the 3% target.

Now as none of the previous 16 attempts at solving the too-much-debt crisis haven't worked, IceCap's confidence level preceding the Brussels meetings was less than 0. Naturally, the Euro-Elite didn't disappoint as they produced the following agreement:

1 – All 27 European Union countries will agree to letting Germany control their spending and taxes

2 – All European Union countries will agree to letting France control everything else

While this proclamation was just grand for the Spanish and Italians, it caused Britain's David Cameron to laugh espresso straight out of his nose. Once he realised it wasn't a joke, Mr. Cameron politely and elegantly declined the invitation to board the 2011 version of the Titanic. While this was the headline grabber, we're pretty confident that within the next few months more and more countries will choose to decline this invitation to lose their sovereign independence.

After Mr. Cameron was escorted from the building, the Euro Elite managed to announce the following *might* be accepted by the remaining 26 countries:

1 – Fiscal Union, which really means a balanced budget, which will result in higher taxes and lower government spending. Once this maniacal plan is put into action it will guarantee a recession, guarantee even more bad debt and guarantee even higher interest rates on said bad debt.

2 – No joint bond issuance, which really means Germany isn't *that* interested in saving the Euro.

3 – No losses for private investors (ie. banks) which really means the Euro-Elite actually do understand their banking sector is desperately short of capital.

Without a doubt, the biggest jaw-dropper occurred during the European Central Bank's (ECB) press conference when it firmly stated it would not engage in money printing to save the Euro.

Can anyone spare $4 trillion?

This was a stunner. While most expected to be completely underwhelmed with the Brussels Summit, many were fully expecting the ECB to announce that they would in fact become the lender of last resort to all of Europe.

After all it is a fact that recent bond issuance by Italy and Spain have been strongly supported by the ECB. Without this explicit support, the cost of borrowing for these profligate countries would be well above the current 6-7% range.

It is also a fact that European banks are hanging by a thread. **Total assets for European banks is about $40 trillion. While ignored by many, it has been estimated that the system needs $3 trillion to make itself whole again – we've bumped the estimate to $4 trillion**, just to make the math easier. After all, what's a few trillion between friends?

Once the euphoria of the ECB decision wears off, its important for investors to understand that the reason for the ECB deciding not to print money is due to it being explicitly stated in their charter.

As soon as the French and Germans tire of berating the British, they too will understand this fact, and simply change the ECB's charter to allow for money printing. There is however one small counter-point to this simple act, all Euro-zone countries will have to agree to this monstrous change. And, as we know by now – nothing changes very quickly in Europe. Suddenly, the clock is ticking louder.

Math is hard

Well here we go again. Just as the hangovers from Brussels were starting to kick-in, the Euro Elite once again chose to conveniently forget the laws of mathematics. Long before the second bailout fund (the EFSF) was created, the Euro Elite created the ESM – European Stability Mechanism.

This ESM was created in 2010 and sold to everyone as having EUR 700 billion in firepower that would be made available to any European member state who required financial assistance. It has been super easy to criticize any European solution - trust us when we say, the ESM won't disappoint.

For starters, while the original ESM fund was announced in 2010, it was decided the fund would be available in 2013. As the World knows by now, a lot can happen between the 2010 and 2013.

Secondly, in keeping with the European culture of dragging out every decision possible on anything in order to gain 100% acceptance by everyone, it was decided once again to ignore the natural laws of mathematics. **This uniquely European skill was quite able to turn EUR 700 billion into EUR 40 billion**. Come again?

Well, once again the European solution isn't what it appears. Since no one has the cash available, nor the inclination to throw good money after bad, the actual amount of real money being contributed to this ESM fund is only EUR 40 billion – a full EUR 660 billion short of the

Check under the mattress

stated goal. Again, what's a few billion amongst friends?

USD Swaps

Unknown to many, misunderstood by others, and unappreciated by the rest, **the November 30, 2011 move by the US Federal Reserve to make more USD available to Europe is the most significant policy move in 2011**.

As a refresher, USD is the currency of choice for global trade. Buying oil? You need USD. Selling little plastic toys from China – you'll receive USD. For this reason, all banks in the World consistently need USD to meet their clients' needs.

The people lending USD are primarily investment funds of various kinds (insurance, pension, mutual funds etc) and it is referred to as the shadow banking system. As bankers instinctively (but not practically) don't like to lose money, they want to be real sure they will receive their USD back after making a loan. This is where the real problem starts.

Practically every European bank and insurance company depends upon loans from US institutions. This is where they get their USD. However, the escalating crisis in Europe is causing US institutions to become nervous about lending to European banks – and rightfully so.

As a result, European banks are now starving for USD to the point where several are on the verge of collapsing. This is where once again, the US Federal Reserve has stepped in and agreed to lend as many USD as needed to the European Central Bank (ECB). The ECB in return then lends the USD to the European banks.

You can call it stealth lending or stealth bailouts, but one thing is for sure both President Obama and Dr. Bernanke have stated that the US will not bail out Europe. Every time this happens, we can hear Dr. Faber smiling all the way from Asia.

Fleeing the Country

The 2008-09 crisis forced Canada, US and Britain to recapitalize their banks – not so for Europe. Even prior to the crisis, European banks were more leveraged compared to others. However, due to the escalating debt crisis in Europe, Europe's banks are becoming even more vulnerable due to their bad housing loans and poor investments in sovereign debt.

Every 2 seconds another Euro leaves a European bank. The financial situation in many European countries has become so severe that most sane people are pulling their money from their local bank and storing it in a nice safe place such as Switzerland, Germany or Canada. Greece in particular is experiencing massive withdrawals.

As each European country struggles to raise funding simply to meet their daily expenses, the additional capital required to plug the gaping hole at their banks grows exponentially larger by the day.

Don't exercise in public

And, when you consider that there is no appetite for private investors to bailout these banks, these virtual bank runs will prove devastating once the final bailout bill comes due.

IceCap – you were right!
A year ago, we boldly announced "*We will be absolutely shocked if there isn't another financial crisis in Europe in 2011. So shocked, that if one doesn't materialize we will be very happy to do push-ups for all to see this time next year.*" We also encouraged everyone to "*have fun shorting the shirts off the European sovereign debt of your choosing*"

Obviously we won't have to suffer the humiliation of exercising in public, and we stand proud of this fact.

It is the holiday season and since IceCap is feeling especially generous this year, we'll offer a buffet of 4 events to help you make or save money in 2012:

1 – Greece will leave the Euro-zone, causing severe funding stress for other Euro sovereign states
2 – The European Central Bank will launch QE1 (money printing)
3 – The US Federal Reserve will launch QE3 (money printing)
4 – The Swiss National Bank will abandon its peg to the Euro.

As for the sequence of the above events, the first will be either a Greek default or QE3 by the US Federal Reserve.

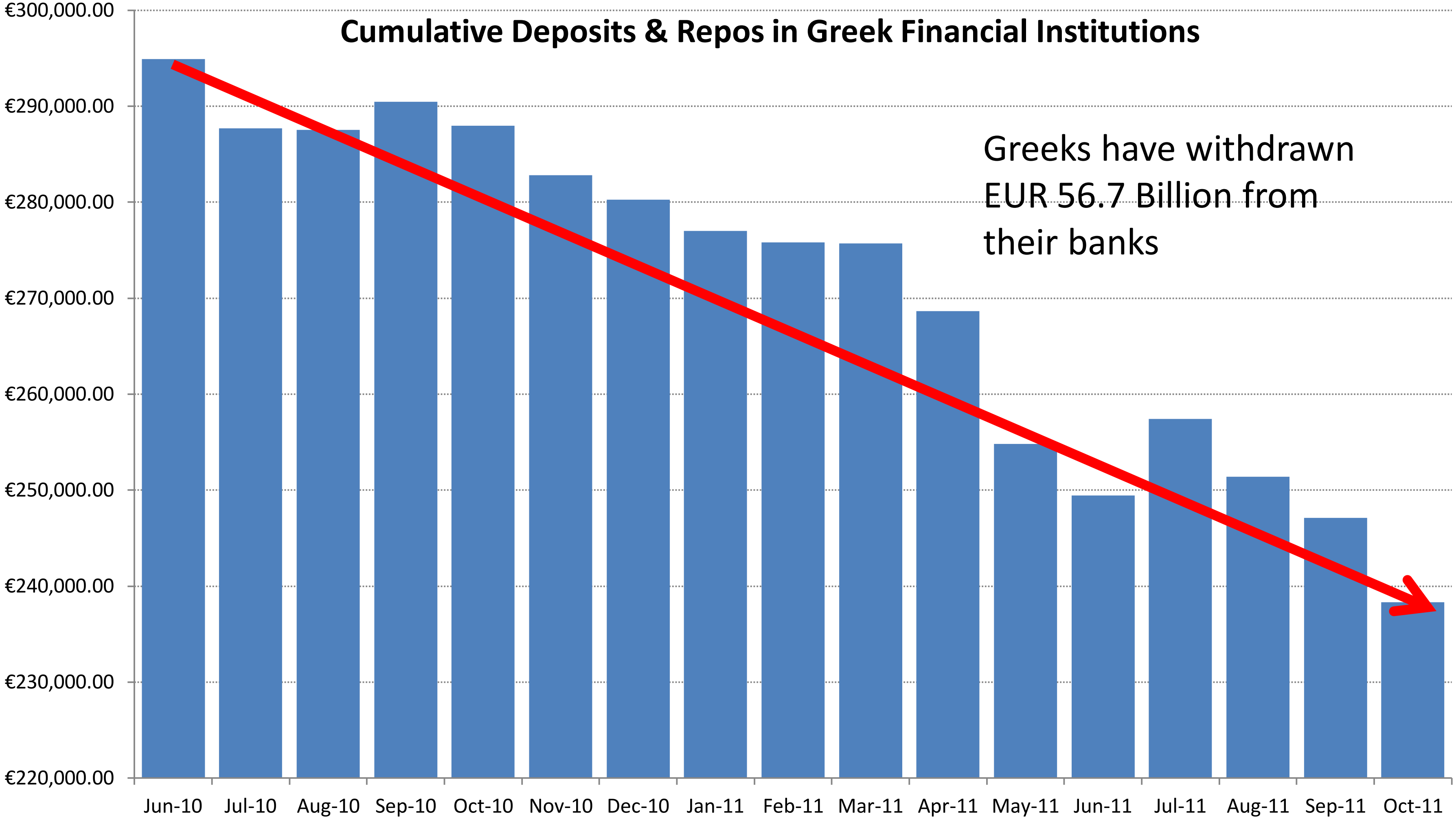
A Greek default is based simply on the fact the Greek banking system is on the verge of collapsing. While everyone is aware that the Greek government needs bailouts to survive, these bailouts do not provide funds for the Greek banks. As Greeks withdraw their deposits (see Chart 1 next page) and the value of Greek loans and investment portfolios decline, banks will be forced to shut their doors. This will be a very difficult time, however there is no avoiding it.

The knockdown effect from this event, will be funding problems for other Euro-zone members, most notably Italy, Spain and (un)surprisingly France. Just as Greek banks experienced severe stress, so will other European banks. The ESM and/or EFSF and/or IMF will not be big enough to plug this hole – the savior of the system at this time will ultimately be the ECB.

Let's face it, the ECB knows it will have to print money to bailout the system. However, due to amounts involved it will wait until defaults occur prior to springing into action.

Meanwhile, admittedly the easiest to predict of all events – the Federal Reserve launching QE3 is such a certainty that we feel sheepish even listing it as an event. However, it is an important event and it becomes even more important to get the timing correct. To justify QE3, Dr. Bernanke requires either a deterioriating economy or a significant drop in financial markets. Is your portfolio positioned properly?

Chart 1: Electronic Bank Run in Greece



Source: Bank of Greece, IceCap Asset Management Limited

Patience is being rewarded

As for the Swiss, they certainly find themselves in a pickle – yet it is a pickle of their own choosing. It was just a short 4 months ago the Swiss decided enough as enough and locked the vaunted Swiss Franc directly to the Euro. Certainly the Nestlé's, Novartis' and ABB's were pleased with this move, however the average Swiss should be a touch concerned about the untold billions lost on this fruitless endeavor.

At some point very soon, the Euro will become significantly lower which will spiral further holes in the balance sheets of the European banks. It is then, the Swiss National Bank will blink and pull the plug on this ill conceived strategy which will once again cause the Swissie to soar.

Our Strategy

Heading into the last few days of the year, many perennial market bulls are once again begging for the reclusive Santa rally. And, with many stock markets around the World showing negative returns we're sure many are crossing both their fingers and toes.

Overall, it's been a difficult year for traditional strategies. Excluding one-off stock stories, the place to be has clearly been bonds and despite its recent correction, gold bullion.

Heading into 2012, we see the conditions that supported this outperformance by safety strategies continuing. For this reason we remain very conservative with overweight allocations to cash, bonds and gold bullion.

All is not bad, and just as Dr. Faber is smiling, you should as well. We feel global financial conditions have deteriorated to the point where drastic action in the form of money printing is coming from both the US Federal Reserve and the European Central Bank.

This combined effort could easily exceed $1 trillion. The question on everyone's mind is whether these central banks are proactive or reactive to market conditions. Either way, we expect a 25% market swing in one direction or the other.

Happy Holidays

IceCap sincerely wishes all of our friends a safe and happy holiday season. If you'd like to chat further about our view and our unique investment solutions, please feel to contact:

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Thank you for sharing your time with us.