



Our view on global investment markets:

April 2011 – a picture is worth 1.8 trillion words

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

Total recall

It is now very likely that the US Federal Reserve will end their QE2 experiment on June 30, 2011.

Recall that QE stands for quantitative easing. Also recall that quantitative easing is really a fancy term for money printing. And finally, we also ask you to recall that when the World's top central bankers print money, they are effectively wetting their pants to stay warm. Yes, this has created an uncomfortable situation and how it unfolds should be of interest to everyone

While what we are about to say certainly isn't a bold prediction – in fact it is probably the surest bet you can make – there will be another financial crisis. Considering the following, we challenge anyone and everyone to convince us otherwise:

- Enormous sovereign debt loads combined with unfixable deficits and unfunded social benefit liabilities guarantees a tipping point will be reached
- The very low interest rate environment cannot last forever. Every 1% increase in either short-term or long-term rates will have a disastrous effect on the enormous debt loads of many countries and individuals
- The policy response of money printing will have unintended consequences that cannot be easily and quietly fixed

Except for Japan and USA, every central bank in the World has already started the process of raising interest rates, or “tightening monetary policy” as they prefer to say on Wall Street.

The American situation however is very different. Due to its position of being the largest economy in the World, the USD is the World's currency of choice for international trade. Whether you are trading oil, sugar, bonds or I-Pads, the USD is involved. To further explain the status of the USD, also consider that it has just been discovered that the bank that received the biggest bailout from the US during the 2008 credit crisis was none other than.....Dexia – a foreign bank!

This Belgian bank had not one retail branch in the entire USA, yet it was the one that almost brought municipalities to it's knees [Ed note: we apologise to Bank of America and Wells Fargo – you both deserve honourable mention for your contribution to get the bailouts rolling].

So, after printing trillions of USD, nationalising the housing market and auto industry, propping up the big American banks, secretly giving money to foreign banks – how exactly does the Federal Reserve unwind this mess, or “reduce their balance sheet” as they say on Wall Street?

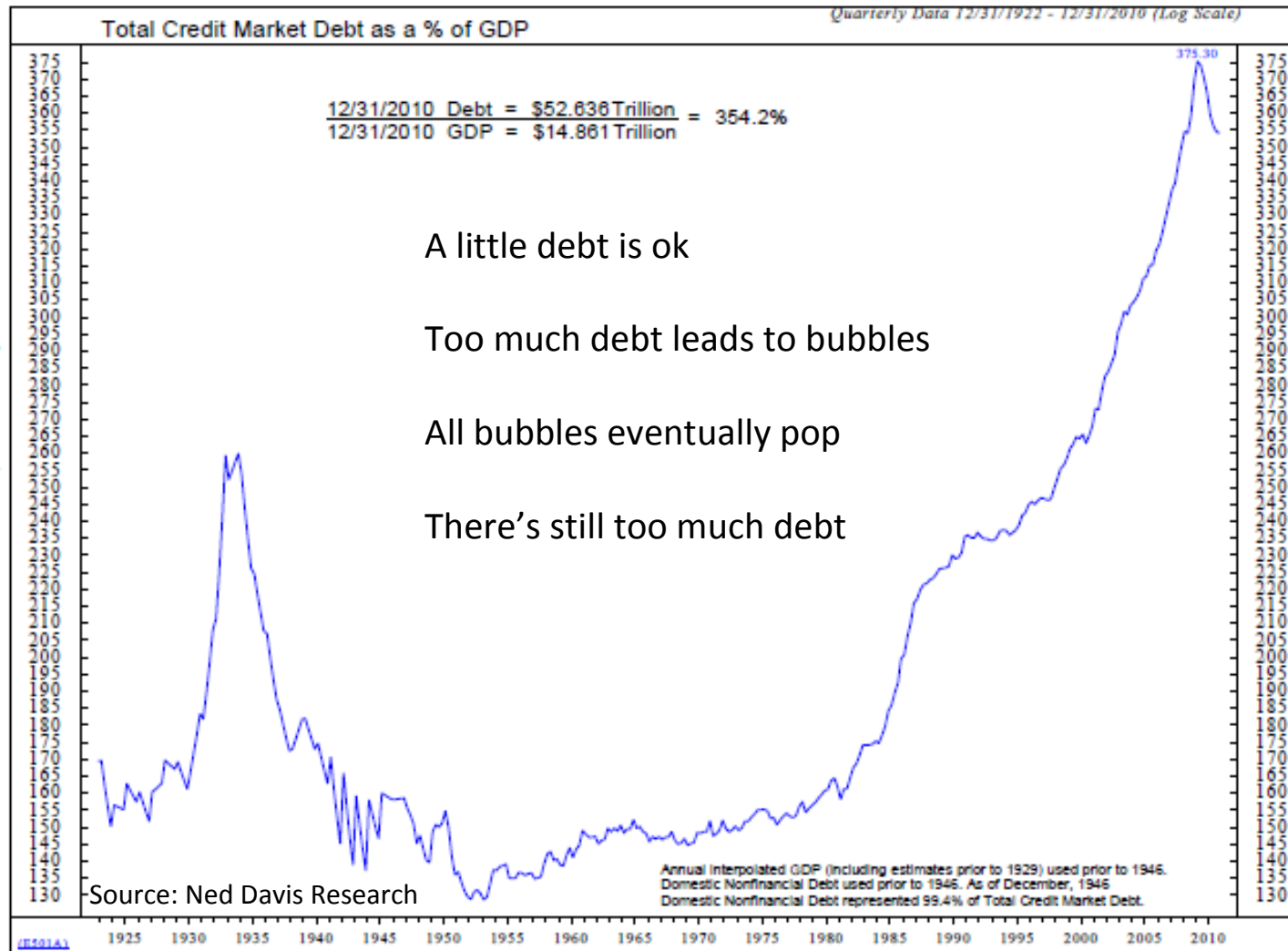
The answer – slowly. First: The Fed has to stop printing money. Next, it has to sell the bonds it purchased and then it may start to raise interest rates. Don't expect the latter to start until 2012 at its earliest.

Meanwhile now that the FED is declaring that the war has been won, we feel it is best to assess what progress has been made during this money printing experiment by looking at some pictures.

April 2011

A picture is worth 1.8 trillion words

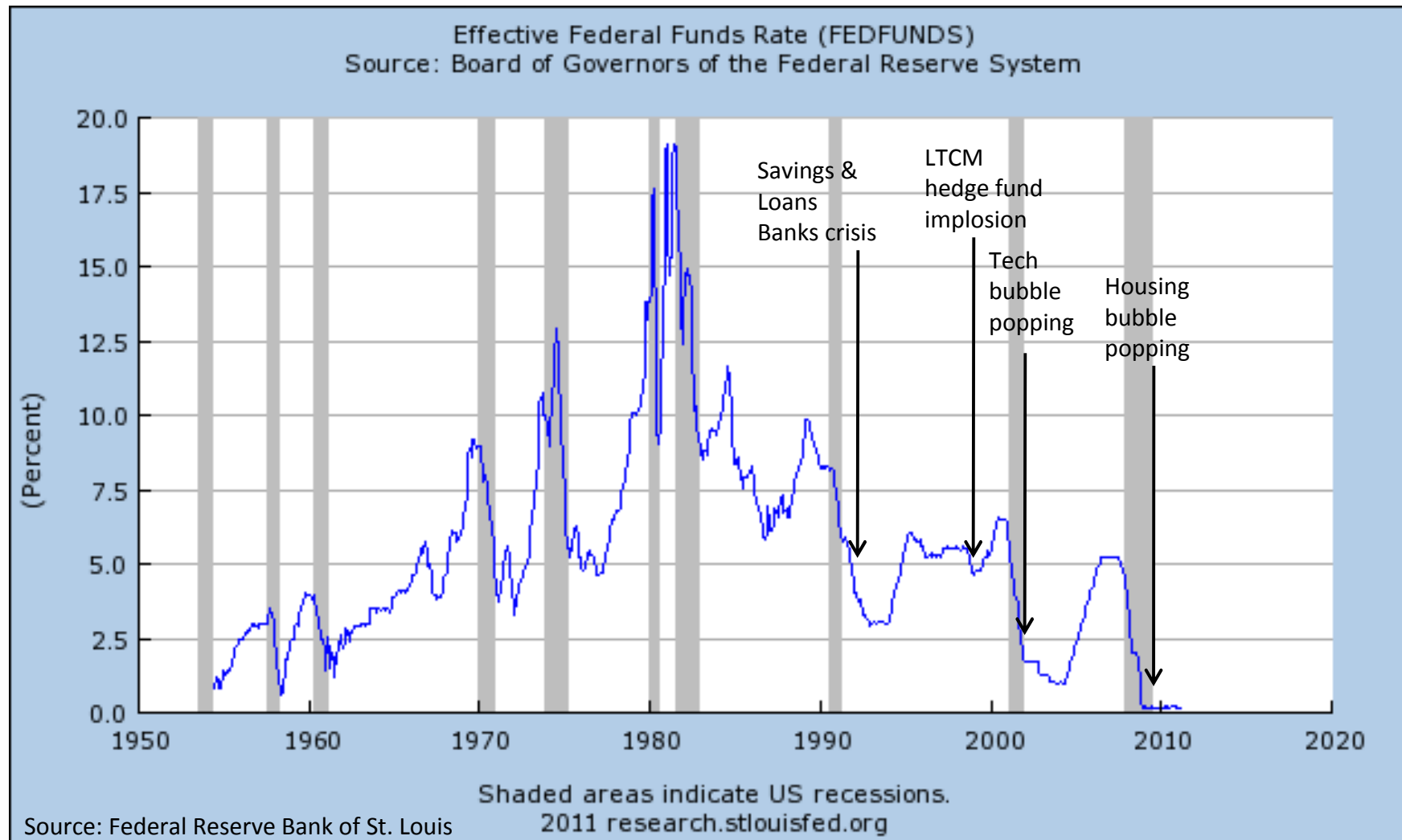
Picture 1: The mountain of debt has reached unsustainable levels



April 2011

A picture is worth 1.8 trillion words

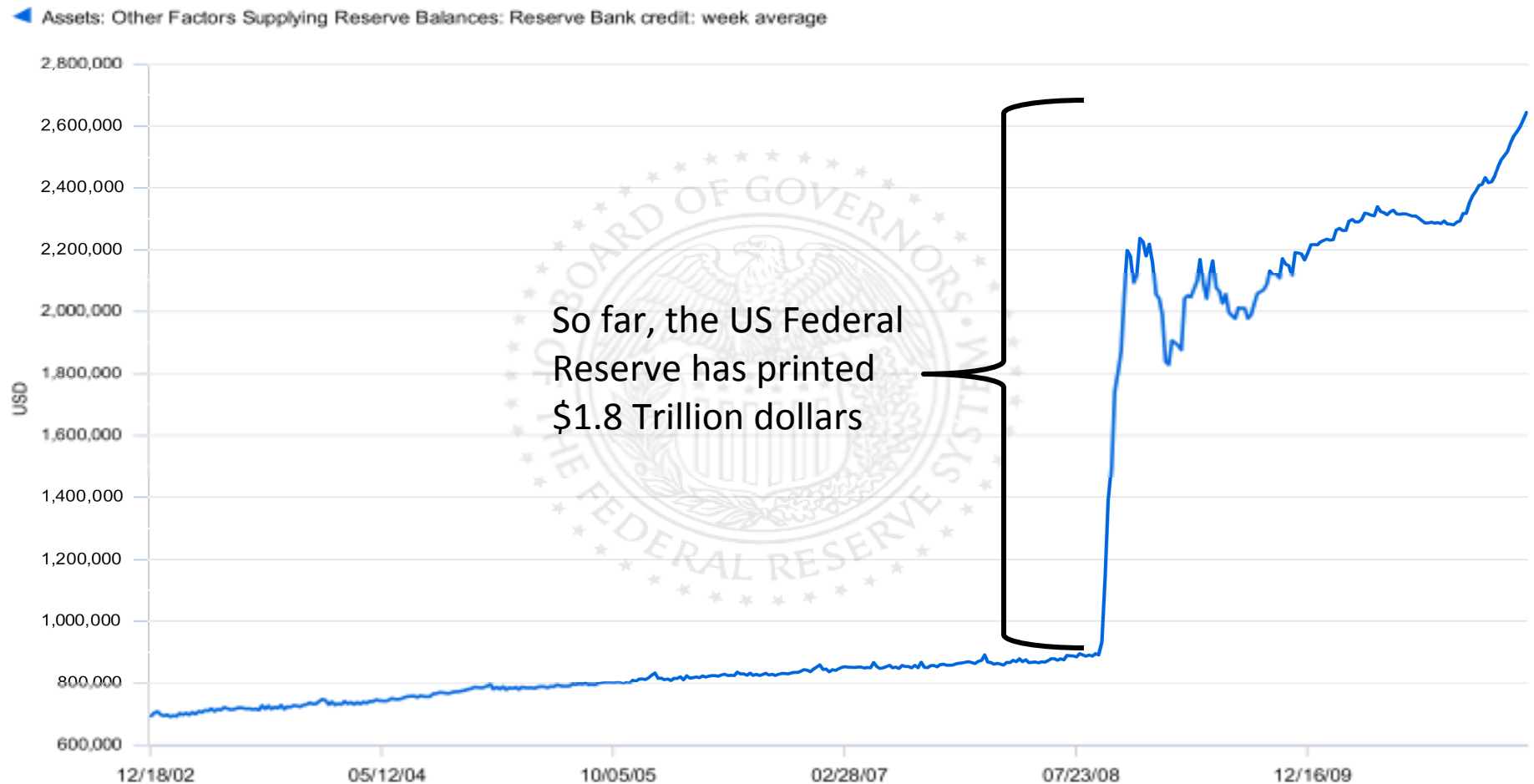
Picture 2: The response to EVERY financial crisis has been to cut interest rates



April 2011

A picture is worth 1.8 trillion words

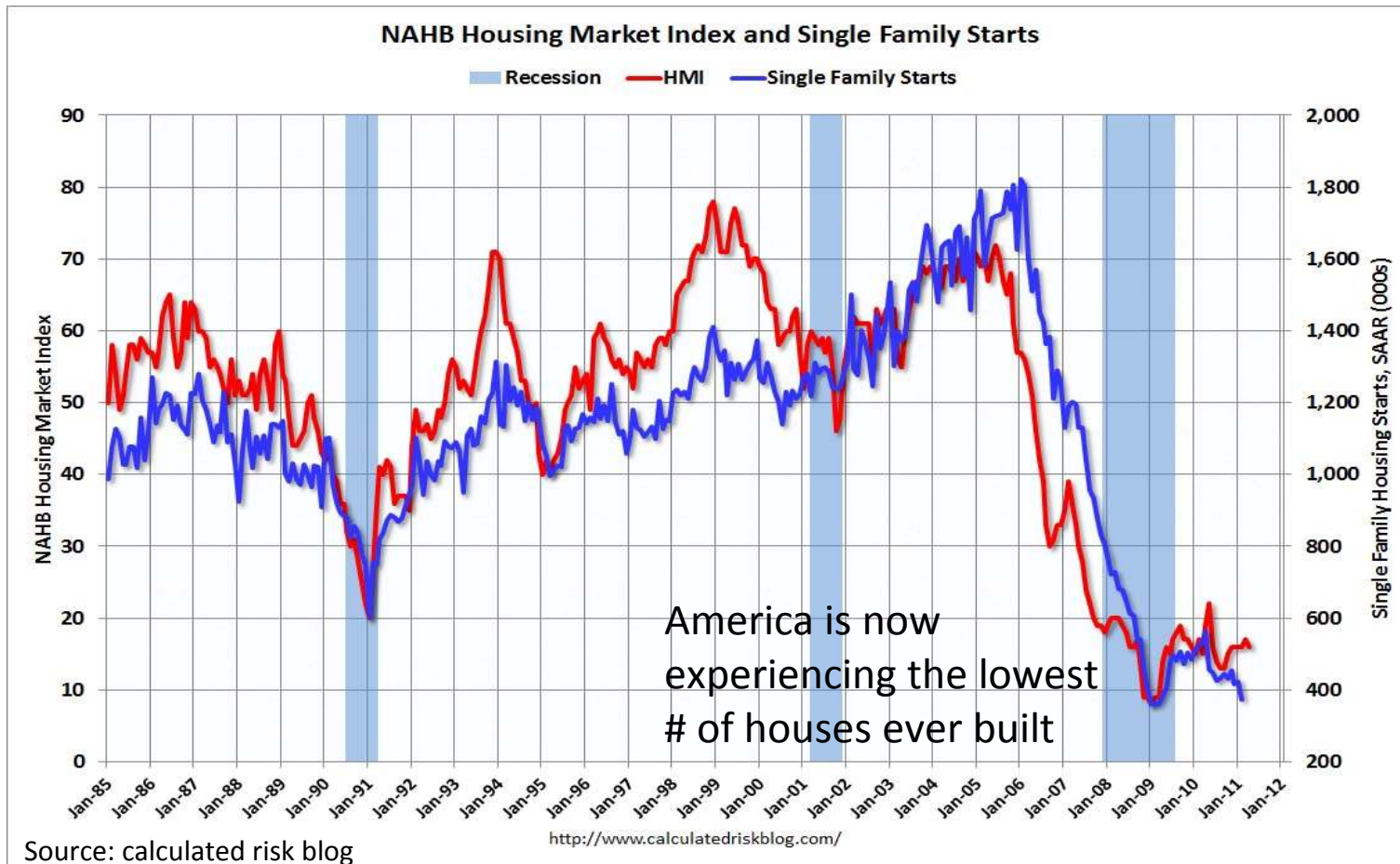
Picture 3: since there are no interest rates left to cut, they printed money instead



Source: Federal Reserve Board 2011

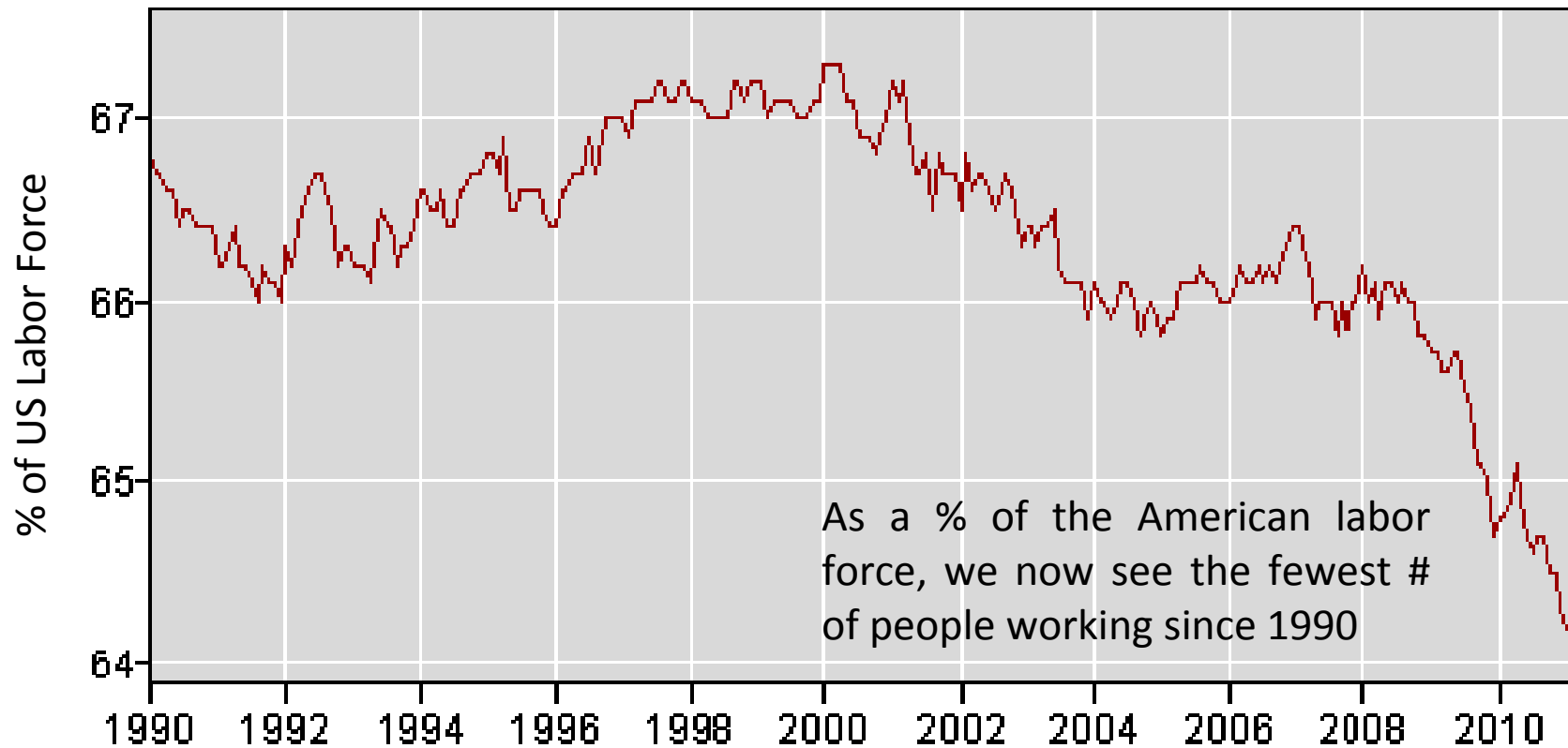
Picture 4: where did all of the printed money go?

It didn't go into the housing market



Picture 5: where did all of the printed money go?

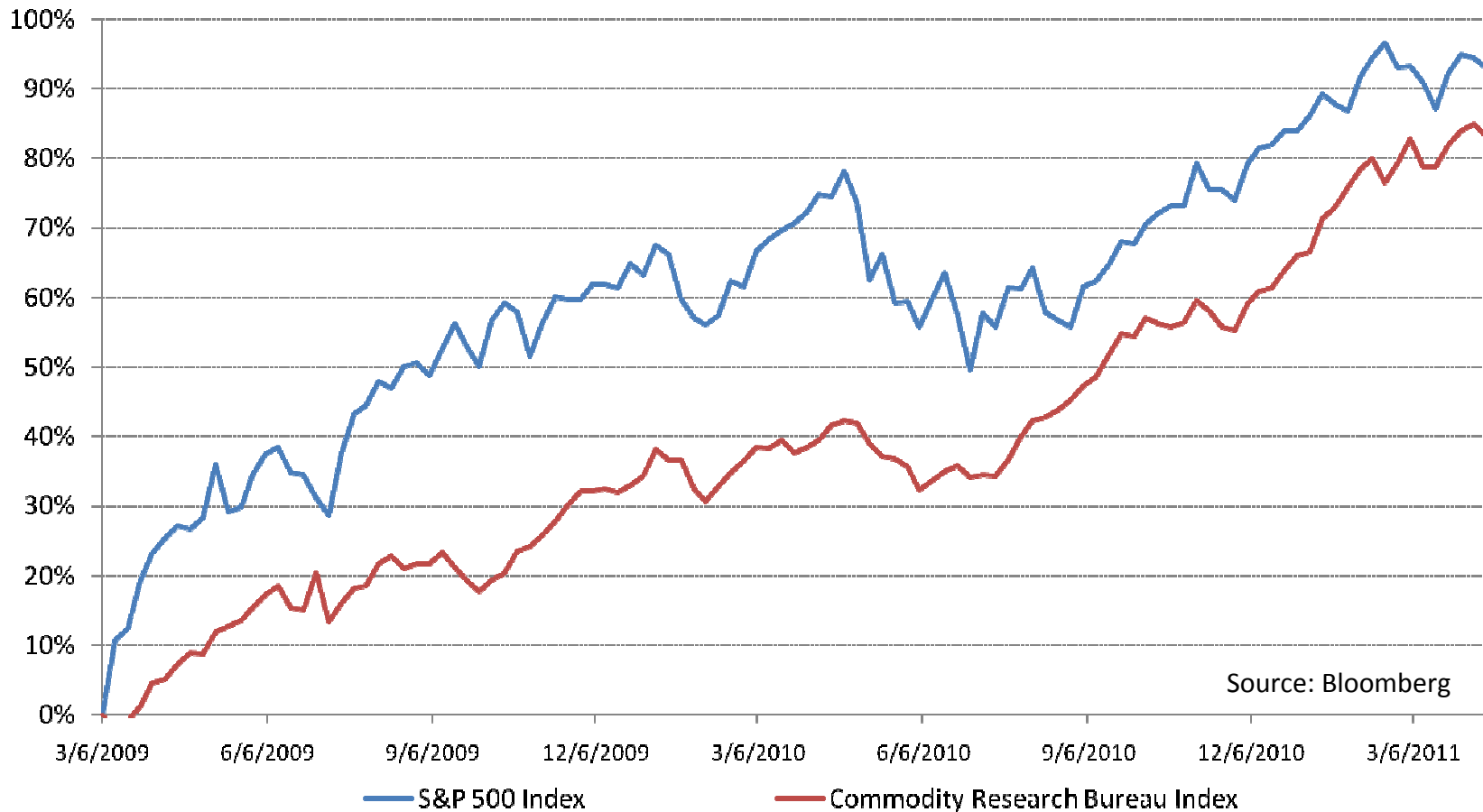
It certainly didn't create new jobs



Source: US Bureau of Labor Statistics

Picture 6: the money eventually did find a home

stock & commodity markets however, are shooting through the roof



Everything has gone up

You do the math

In his Nov 3, 2010 op-ed piece in the Washington Post, Mr. Bernanke stated what most knew all along – the real objective of printing money is not to lower interest rates, but rather to boost the stock market. This wealth effect would in turn make everyone feel better which would then result in people and companies spending money. All of this spending of course, would then in turn, make more profits for companies, more jobs for people and less bad loans for the banks.

Printing money certainly did cause the stock market to rise. It caused commodities to rise. It also caused gold and silver to rise. It even caused every currency in the World to rise. When you print money, the new money has to find a home somewhere. And, based upon this quick analysis, QE2 was successful. Yet, we remain unconvinced that the economy and job market is booming.

The credit crisis swallowed over \$5 trillion in various forms of bailouts and stimulus funds. Simultaneously, the Federal Reserve has been printing money to fund the \$1 trillion US deficit. The obvious question we now ask is – what happens once QE2 ends?

One view sees the economy continuing along a path of recovery with birds singing, children playing and the stock market making new highs. Another view sees long-term interest rates rising, which begs the more important question – who will buy all of the American bonds?

Our primary observation is that no one really knows what will happen once the money printing stops. Hopefully, the economy continues to plug along and financial markets stabilise to more reasonable levels. It would actually be fun to once again put clients to sleep while talking about PE ratios and dividend yields.

On the other hand, should the stock market and commodity markets tumble as a result of the sudden withdrawal of money from the system, you can be rest assured that QE3 will be quickly implemented. Yes – we did say QE3. And, if QE3 happens, so will QE4, QE5, QE6 etc etc.

A final note we'd like to share is that recently we've read and heard people talk about the FED raising rates and "tightening" their monetary policy. Even if the FED does begin to raise rates, they will not be raising rates above the rate of inflation. This will sustain the current "negative real rates" environment we are presently in which is a way to stimulate the economy, and ensure central bankers remain behind the ball into perpetuity.

Nobel Prize for economics will not be added to the mantel

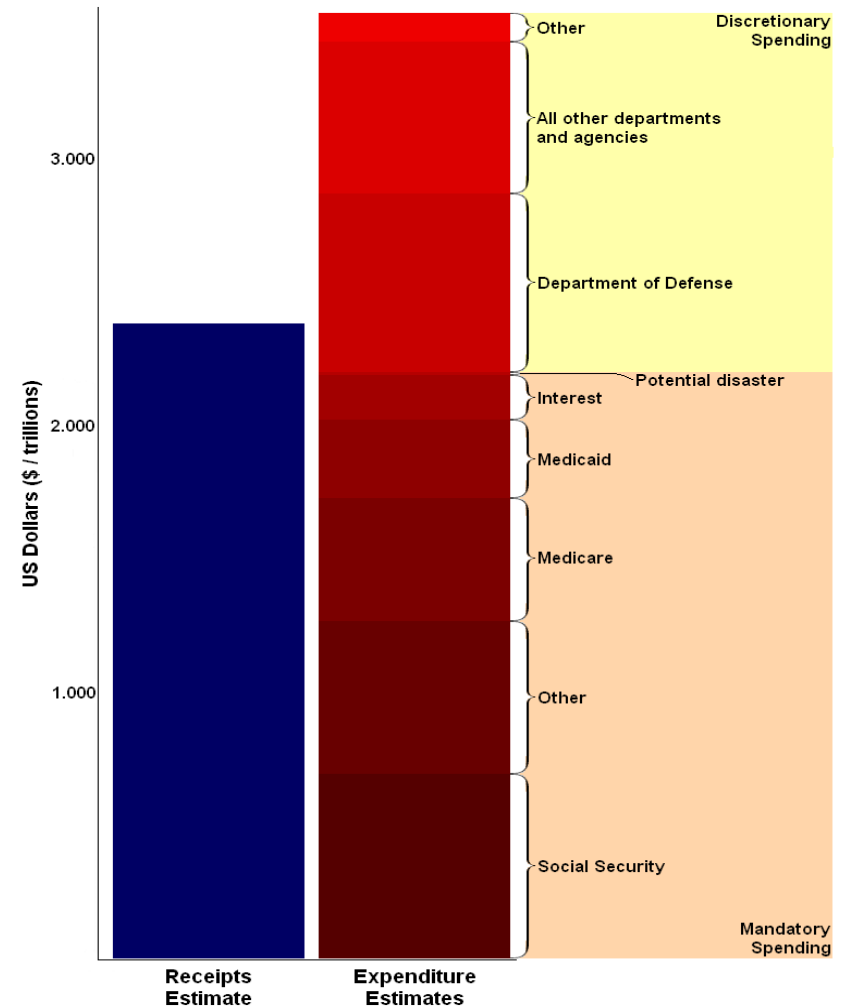
USA

The largest economy in the World also collects the most taxes in the World. Unfortunately, the elected government officials for the World's largest economy also choose to spend the largest amount of money in the World.

In 2010, the USA Federal government spent about \$3.6 Trillion while taking in about \$2.4 Trillion in tax receipts. Spending \$1.2 Trillion more than what you earned is no easy feat, unless that is you have a really big printer in the back room that can churn out freshly minted money on a daily basis. Otherwise, it simply isn't possible – just ask the Greeks, the Irish and the Portuguese.

To understand the very difficult job faced by Congress, one must understand that the American's have "mandatory spending" programs. Spending in these areas cannot legally be reduced. The chart to the right shows the main spending categories budgeted for 2010. Considering that 2010 total mandatory spending programs effectively equal total tax receipts, the only other components of the budget that can be cut are defense and other departments and agencies.

Currently, the US is the World's only super power and this wasn't achieved by spending on roads in Idaho. All else being equal, it is extremely unlikely any material budget cuts will affect the defense budget. And you can forget about trying to make cuts from the various state departments – that's politics within politics. That leaves the roughly \$105 billion categorized as "other" (you can only imagine what falls under this item).



Source: Wikipedia and 2010 United States federal budget

Back to the Future

Well, how will Obama balance his budget? Without cutting any spending, he could simply double taxes for everyone – but that wouldn't work; he'd have to tax the poor and the rich. Since the top 5% of wealthy Americans are already paying over 58% of total US taxes collected, raising their tax burden will likely force them to move to Canada (the land of lower taxes and really good money managers). Meanwhile, raising taxes for the poor isn't really a good way to get reelected in 2012.

So, what does Obama do?

Using his Nobel Peace Prize as inspiration, he crafts a plan that will cut spending by \$4 trillion over the next 12 years. Then, using his teleprompter for guidance, he orates this plan to congress and the American public in the smoothest of silk possible. It was a great plan, until his very own Vice President, Joe Biden, falls asleep during the speech and on national TV at that. But in hindsight, this was actually smart as it deflected attention away from the details, and as we all know – the devil is in the details.

Now, what you will read next, will cause all fans of mathematics to cringe. Whether you are in elementary school, an investment banker or even a winner of the Nobel Prize for Economics what follows is an eye-roller. One of Obama's strategies for reducing spending is to cut a previously proposed spending item and count it as a cut in spending. Now, that's a bit wordy (especially for the investment bankers out there), but the strategy goes something like this – let's say in 2011

the US spends \$200 billion on Doritos as snacks, and then budgeted to increase this to \$300 billion in 2012. In the magical world of Obama accounting, reducing the Doritos expense back to \$200 billion will save \$100 billion. Yes, \$100 billion from the future has been hijacked as spending cuts in the present – you can't make that up.

How does this affect your investment portfolio? The long-term consequences of continued neglect of the American fiscal crisis will result in further weakening of USD and higher interest rates in the US. And as long as the USD remains as the World's reserve currency, this creates a going concern for everyone. For starters, a deteriorating USD will have profound effects on every bank in the World. It doesn't matter if you are a Canadian, Australian or Chinese bank – an unhealthy USD is going to clog up the system somewhere.

Since no one in Washington is answering IceCap's calls for change, someone had to step up to the plate – and that someone was the venerable credit rating agency *Standard & Poors (S&P)*. Yes, this S&P is the same S&P that together with Moody's (owned by Warren Buffet) and Fitch made an enormous contribution to the billions lost during the 2008-2009 credit crisis. However, despite its checkered past, on April 18, 2011 S&P did the unthinkable – they officially "warned" the World that the US has too much debt and their deficits are too large. The market response to this bombshell was predictable – everything declined except for gold. While this event isn't really news for most, it was more of a political move by S&P. Nevertheless, it was a shot across the bow. What did IceCap learn from this event? The next time we warn on anything - we should make it "official."

In Canada, hockey is more important than politics

It's True

The upcoming federal election in Canada is progressing just as the previous 3 federal elections have progressed with the likely outcome being no different than before it started. This is Canada's 4th Federal election in the last 7 years. We repeat – 4th election in 7 years. All we can say is “wow.”

Some of you may want to cover your ears – lifelong supporters of the Conservatives, Liberals, NDPs, as well as Republicans and Democrats have no impact on the outcome of *any* election. With politics it is important to understand the action of the undecided voter. They will always be the swing vote. When compared to the rest of the World, Canada has actually been a pretty nice place to live with few only minor disagreements over the last few years and this will result in few changes to the swing vote and even fewer changes in Ottawa come May 2, 2011.

Finland however is a different story. Unlike Canada, Europe has been firmly grounded in the vicious cycle of having ordinary taxpayers (teachers, lawyers, mechanics and so on) come to the rescue of the big banks that should have failed. We've shared our views on this many times with the internal promise to stop sharing our views, yet the story in Europe is becoming more interesting by the day. Whereas politicians in Greece, Ireland and Portugal refuse to stand up for the rights of their people - little, teencie, weencie Iceland has said no more and actually voted not to bail out the British and Dutch.

Yes, Iceland isn't a part of the Euro-zone therefore the actions of this diminutive country are not that relevant. Finland however, IS a part of the Euro-zone and an important one at that. Similar to what will happen in Canada, the Finnish just completed national election was won by...nobody. But this is where the similarities with Canada ends - while the National Coalition Party did receive 20% of the vote, the anti-immigration/anti-Euro True Finns received 19% of the vote and will be a part of the ruling coalition.

One can be excused for not knowing the intricacies of Finnish politics. However, EVERY politician AND banker in Europe is now very aware of the True Finns and their ability to withdraw Finland from supporting European bailouts. Unlike other Euro-zone member countries, in Finland the bailout decisions are decided by everyone in Parliament – not simply the party in power. Considering the results of the latest election, the True Finns party now holds the cards to the house of the European debt crisis. As the EUR and sovereign bond prices decline, we are reminded once again that Europe's banking problem is one that won't go away.

Money printing is boosting financial markets

Our Strategy

Looking at the central banks, we do not envy their responsibilities nor would we want their jobs – the economic and political call for action has to be at extreme levels. This of course creates a lot of uncertainty which we will continue to reflect with our investment strategy.

What we do know is that money printing and ultra low interest rates have directly contributed to both stocks and commodities producing double digit returns over the last year. It is our view that to believe this incredible run in markets is attributed to incredibly strong fundamentals is unwise.

Throughout this period, we have remained fully invested in both stocks and commodities and have enjoyed these returns for clients. At the same time, we remain cognizant of the actions of central banks and the unintended consequences of their actions. For this reason, we have held overweight positions in gold bullion which seem to be hitting new highs now on a daily basis.

As we approach the likely end (or pause) in the US Federal Reserve's quantitative easing program, we remain on alert for possible trend changing moves in all asset classes. Our technical and sentiment indicators will be of the utmost importance during this period.

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.