



IceCap  
Asset Management Ltd.



Local heritage,  
Global experience.

Our view on global investment markets:

*January 2012 – Great Expectations*

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## Never assume

Most Canadian pension funds are banking on 7% annual returns forever. Over the next few years, this unrealistic expectation will cost the respective governments and companies millions in shortfalls.

In the USA, the California Public Employees Retirement System assumes it will earn over 7.75% annual returns. This false hope will result in over \$6 billion a year in lower than expected investment income, that will also have to be paid by the financially challenged state (ie. taxpayers).

Meanwhile, Thelma O'Keefe continues to quietly sock away 5% of her paycheck each and every week and has no idea what all the fuss will be about when she is eventually told her pension benefits will be *slightly less* than originally promised.

Over 50 years ago, the average worker started to earn pension benefits and has been dreaming of working less, and golfing more, ever since. The Defined Benefit Pension Plan has been the rock of this dreamy foundation and is certainly a costly beast to say the least. Once the auditors, actuaries, custodians, lawyers, administrators, consultants, performance measurement guys, trustees and investment managers have been paid for their services, is there little wonder most of these retirement funds are running a little short.

Yet, the primary reason most people fall asleep with even a slight mention of the words "pension funds" is due to the complexities and confusion resulting from this cumbersome investment scheme.

However, after 3 quick espressos you'll see that the entire pension spectrum boils down to an educated guess as to how much money the pension plan will have to **pay out** to its retirees, and how much money its investments will **pay in** to the pension plan itself.

This "pay-out-in" dynamic is a precarious balancing act to say the least. Should guesstimates for either one fall short, the difference will have to be made up by tax payers for government pension plans, and by profits for company pension plans.

It is widely known by now that practically every government in the Western World is drowning in debt with no signs of growth anywhere on the horizon. Unfortunately, this looming pension funding problem could not have come at a worse time for these government supported pension funds.

Meanwhile, most companies are certainly flush with cash and are infinitely better off than their public pension fund counterparts. However, even this enviable position will not help due to the expectations of great stock and bond market returns.

Ever since the Western World pushed the **debt envelope** too far and proceeded to allow its governments to orchestrate one ill conceived bailout after another, investors of all shapes and sizes – including billion dollar pension funds and the little old ladies, have had to push their **risk envelope** too far and assume way too much risk in an effort to increase their investment returns.

## No Country for Old Men

All non-investment humans would certainly agree that this excessive risk taking is a touch unfair. However, this unfairness will turn into deep skepticism once this group realizes that they've been lead down the garden path.

### How did this happen?

They say no one remembers the 60s, or even the 70s for that matter. In the investment industry, this forgetfulness is one of convenience. During these awful investment years, the average person didn't hold any mutual funds – buying stocks and bonds was a rich man's game. The relentless rise in interest rates from 5% to 20% successfully put the inflation genie back in its bottle yet it also produced a horrible period for stock and bond investors.

In the early 1980s mutual funds were becoming mainstream, and financial markets were just embarking on a golden age. Unknown to many at the time, 20% interest rates were about to become a fable from the past, and the pivot point to a romantic 27 year period of warm and loving returns for both stock and bond investors as well as a boon to every person to enter the investment profession during that time.

As with every mystery, the key to solving it lies with simply following the money. And when it comes to stocks and bonds, *the cost of money or interest rates*, is the money to follow.

**The reason why there is so much emphasis placed on interest rates is because they are *THE* most significant driver of investment returns.** When rates rise and fall, they directly impact bond prices. As well, when rates rise and fall they directly affect PE (Price to Earnings) ratios which happen to be the key driver of stock market prices.

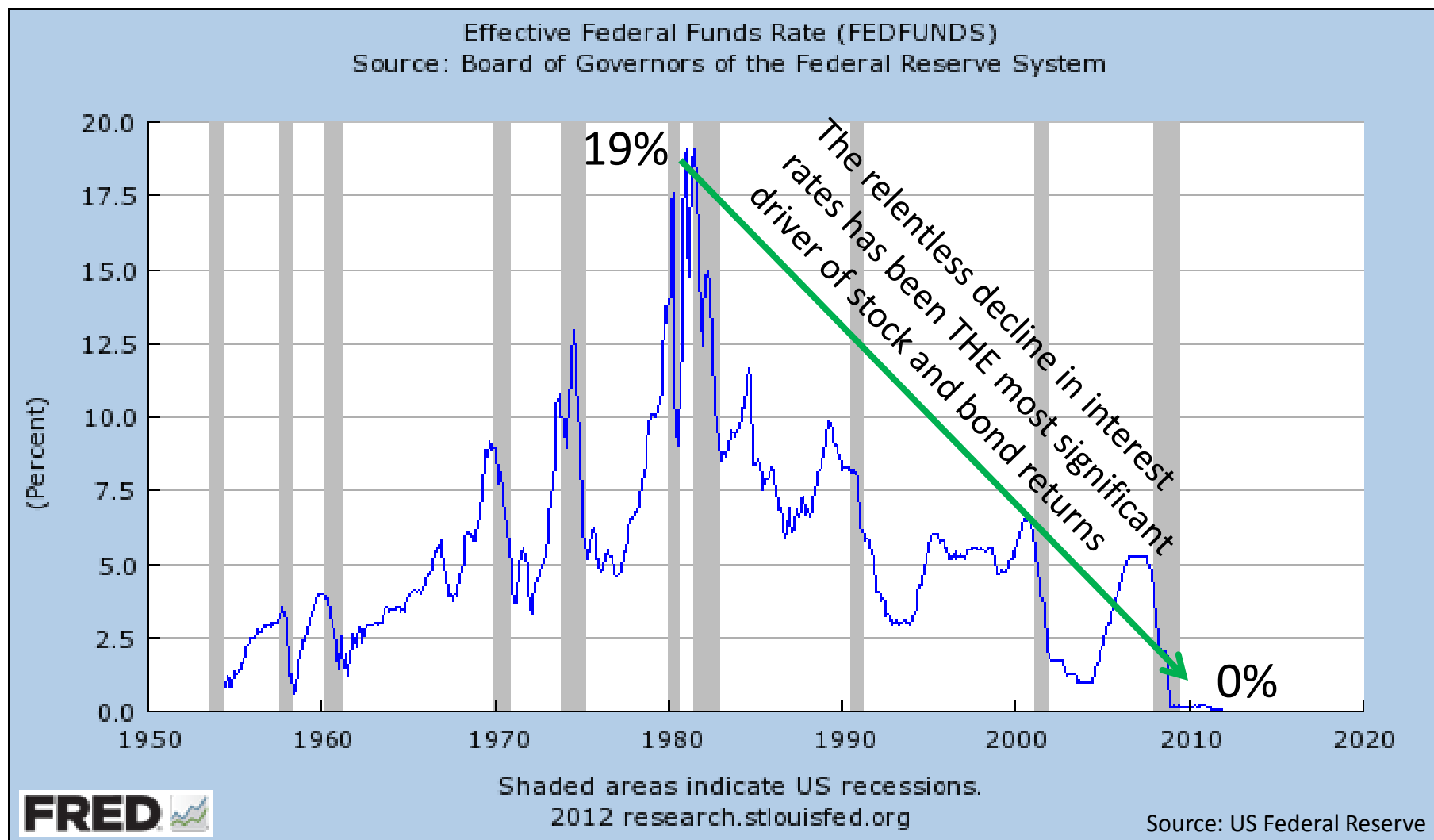
The PE ratio is yet more industry jargon and can simply be viewed as a number that measures how much investors appreciate every \$1 dollar of profit from a company. In general, the more investors appreciate a company, the higher the PE ratio.

The attribute of the PE ratio which makes it special however, is that it acts as a lever to a company's stock price. Ask any company executive if they'd rather see their company's profits double or see the PE ratio double and you'll be surprised how unimportant profits are relative to the mighty PE.

Unfortunately, as mighty as the PE may be it will forever be greatly influenced by interest rates. And one thing is for certain, higher rates are not kind to this all important financial ratio.

We acknowledge that the price of money or interest rates have been changing since the dawn of time. ***Why should this time be any different?*** Chart 1 on the next page should clean up this false logic in a hurry. Simply put, interest rates cannot go any lower than where they are today, leaving "up" as the only long-term direction of change which is inevitably bad for stocks and bonds.

Chart 1: US Fed Funds Rate



## 2% is a privilege

Short term rates in every developed country are essentially at 0%. Meanwhile, long-term interest rates are also at all-time lows. Since 1981, interest rates have declined to never-before-seen levels. You can point to many reasons why rates have fallen, yet the fact remains every time rates have declined, stocks and bonds received an unprecedented boost to investor returns.

The lack of space for interest rates to fall any further dramatically removes the wind from the stock and bond markets. This overly simplistic observation is the primary reason why future return expectations are unrealistic.

Today, the governments of Canada and the USA will happily pay you 2% a year for the privilege of lending them money for the next 10 years. The only way for these investors to earn greater than 2% is for long-term rates to decline further. Put another way, should long-term rates increase, this bond investor could very well lose money on their safest of bond investments.

Returning to the pension fund dilemma, it is quite obvious hitting a total return in excess of 7% from the bond market is beyond impossible. Let's assume the average pension fund has 40% of its money in bonds and is able to earn a generous 4% return from its bond holdings (by taking on a lot of risk). In order for the pension fund to achieve a 7% total return, it will need its stock portfolio to increase by 9%.

Most investment professionals are likely rolling their eyes at this point. After all, from 1980 to 2007 stocks *always* averaged greater than 9%. Yet, this back-slapping, gregarious group has chosen to conveniently ignore the fact that interest rates declined from 20% to 0% during this time frame.

There are however 2 scenarios that can propel stocks significantly higher. Since we know that it is unlikely (or down right impossible) for interest rates to go much lower, significant PE expansion is out of the question. The only other way for stocks to go higher is for profits to accelerate.

Since profit margins are currently near all-time highs, it remains unlikely that companies will be able to squeeze out additional profits by cost cutting or dare we say it – price hikes. This means the only other way for profits to grow is through good old fashion sales growth.

Considering US growth has stagnated at 2% while Europe is headed for -2% growth at best, and having just seen China downgrade their growth estimates, global GDP will be lucky to achieve a +2% to +3% annual growth rate. Needless to say, companies everywhere are going to be stretched to significantly grow their top line.

## Lunch is never free

All is not lost however. Pension funds (and investors everywhere) should know there is another, much simpler way for stocks to increase significantly and it only involves the push of a button.

It is not lost on anyone now that the World has too much debt and the governments involved absolutely refuse to let the *real World* act as it really should. By *real*, we simply mean allowing banks to lose money on their bad investments – the bad debt has to be written off.

Most Western countries have borrowed and lived excessively beyond their means for many years. **Our charts on the next few pages shows for a fact that the World's central banks and their fondness with money printing are 110% committed to not allowing this debt pyramid to unravel.**

Unknown to many people is that over the last three years, extreme money printing moves have been and will continue to be implemented by these central banks. In another attempt to delay the inevitable, the Europeans have introduced the Long Term Refinancing Operation (LTRO) as their latest response to save the banks and Italy/Spain. This is yet another way for Italy, Spain and every European bank to borrow more money indirectly from the European Central Bank for free.

The Italians and Spanish hail this plan a success. It has been so successful that markets are now expecting the European Central Bank

to announce a second version of the LTRO. The net new amount created could easily top EUR 1 trillion. **For investors in the stock market, you should understand the propensity for the market to drive higher is now fully hitched to central banks and their propensity to print money.**

We completely believe that there is no free lunch anywhere in the World. While it may appear that one group is receiving a free lunch, there is another group paying the bill. Presently, global banks and sovereign countries are receiving the free meal. Meanwhile unbeknownst to many, conservative investors and tax payers are the ones actually receiving the bill.

For our pension fund readers, we ask you to be kind to your plan sponsor – it's not their fault market equilibriums have been distorted due to money printing. As a plan member however, it is your duty to ensure your plan's trustees are embracing their duty of care by grasping the importance of interest rates and their direct impact on long-term returns for both the stock and bond markets.

**For our politicians, public servants and private plan sponsors, we suggest you invite your consultants in for a very long discussion about the level of interest rates and expected market returns.**

For everyone else, a similar and subtle (or direct) reminder to your financial advisor may provoke some interesting responses as well.

Chart 2: US Federal Reserve Balance Sheet

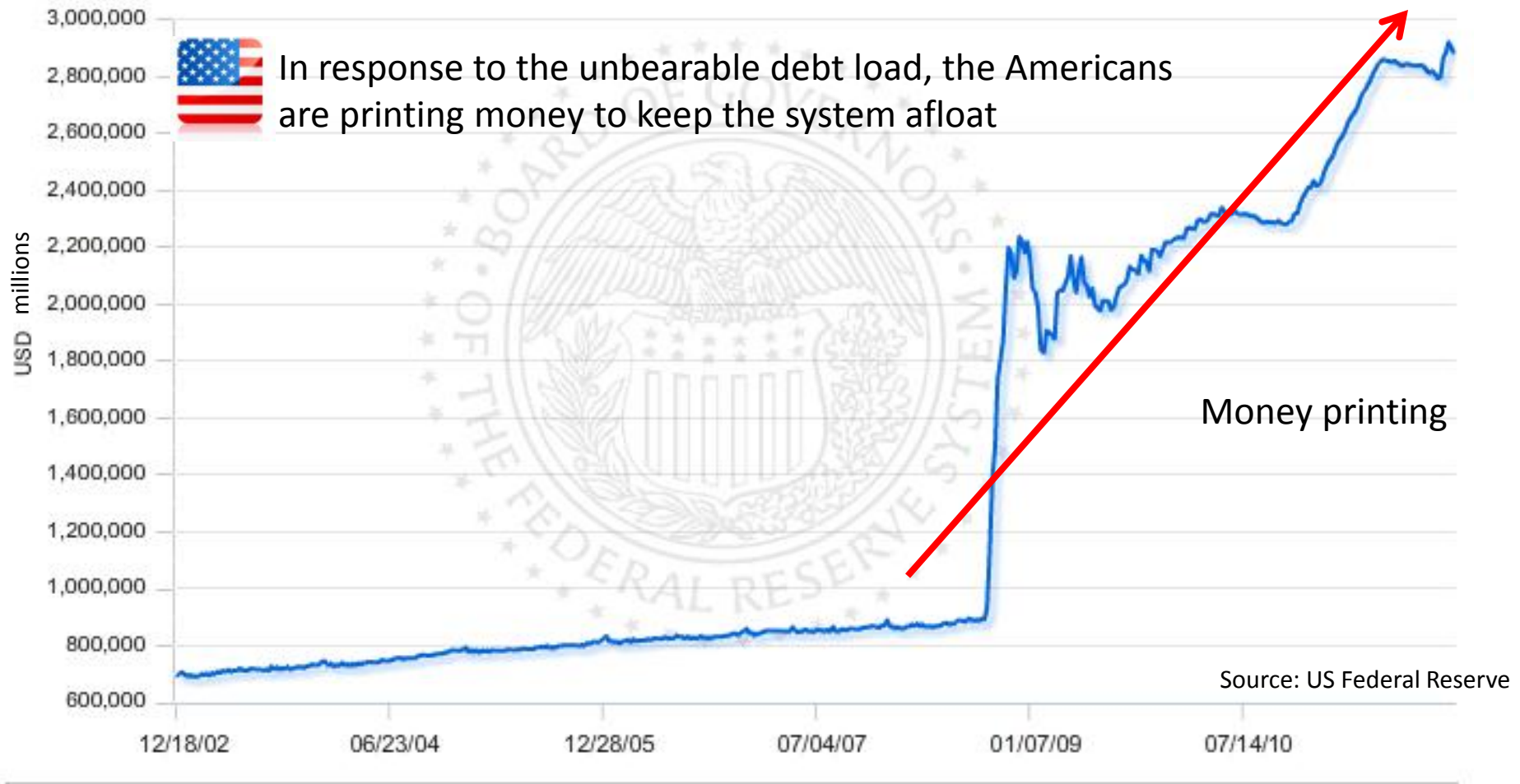
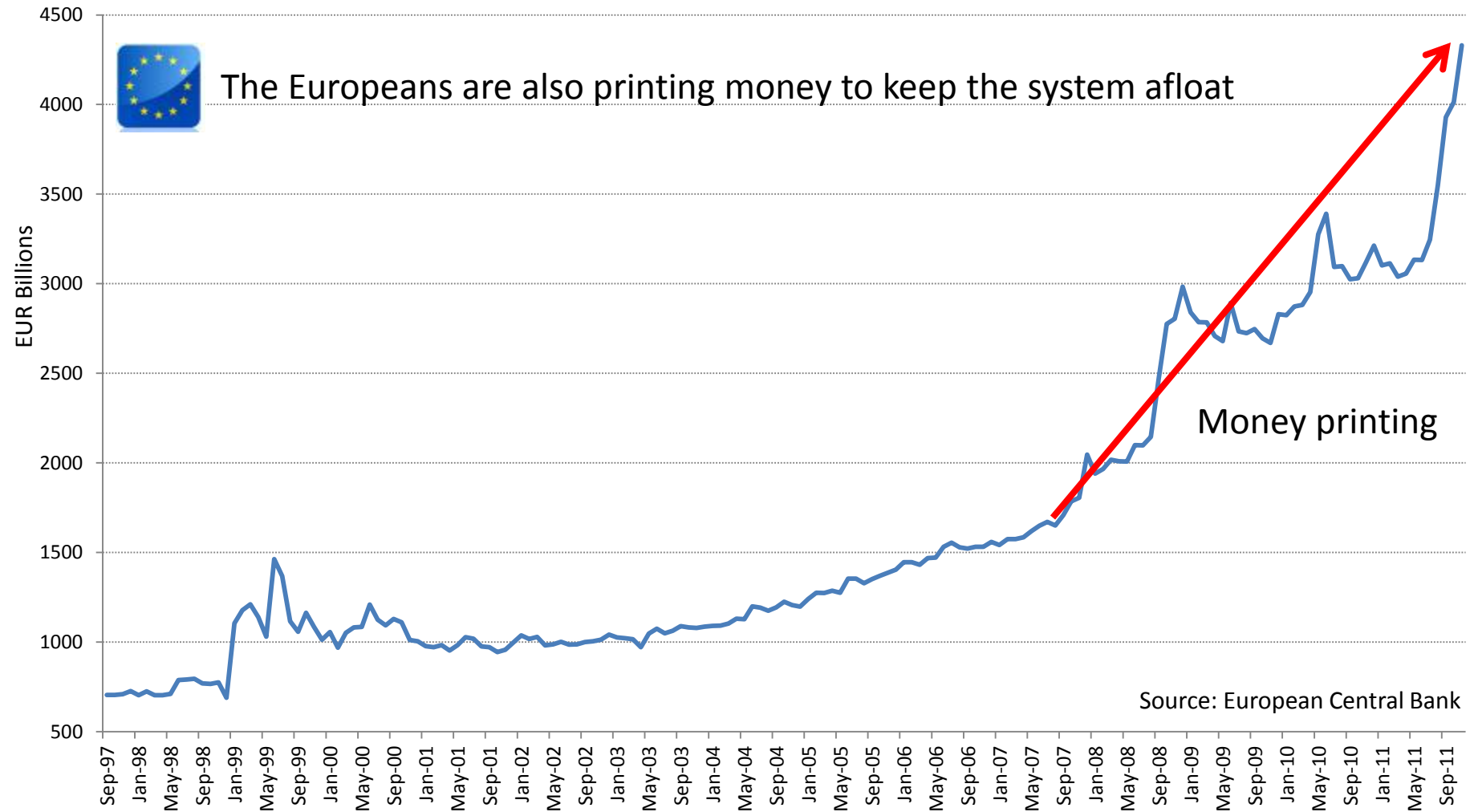
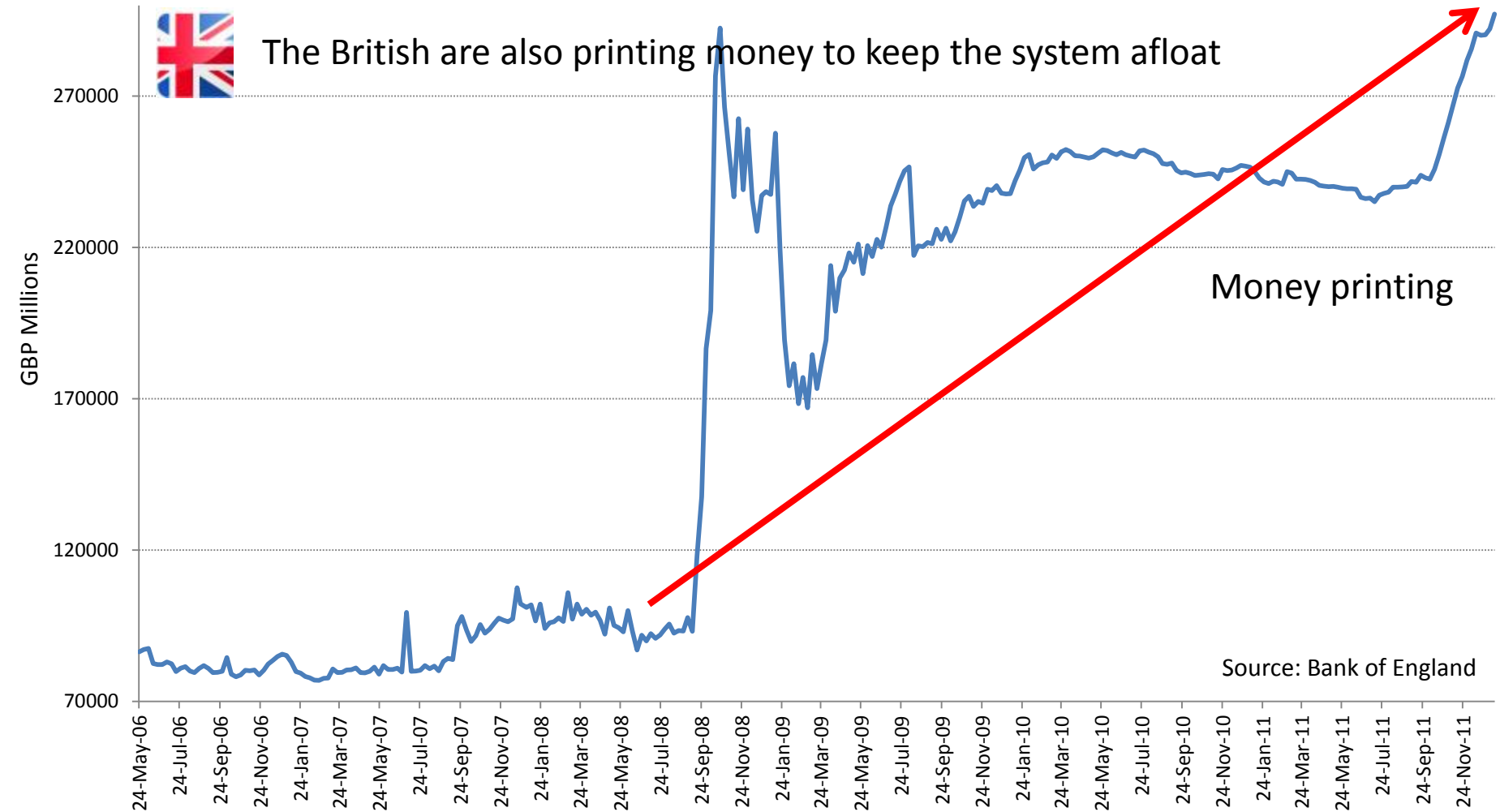


Chart 3: European Central Bank Balance Sheet



Source: European Central Bank

Chart 4: Bank of England Bank Balance Sheet



## When in doubt, slam the British

### Game Over?

With a subtitle like this, one would think it wouldn't be buried on page 10 in our global macro outlook. Yet, what more can we say about Europe? Over the last 18 months, IceCap has beat this drum to a point where even Neil Peart would be proud. Day after day, month after month we strive to find more important investment stories to cover, yet, the allure of the upcoming European financial train wreck is impossible to ignore. And, quite frankly if it is ignored you do so at your own peril.

The latest action to cause greater consternation was the January 13<sup>th</sup> announcement by Standard & Poors that practically every European country except for Germany, Finland, the Netherlands and Luxembourg would have their credit ratings downgraded.

The impact is actually quite significant for several reasons. For starters, it means all of these countries will have to pay more interest when they borrow new money. Next, and most importantly – this inconvenience throws a huge monkey wrench in the main European bailout fund – the EFSF (European Financial Stability Facility).

Without confusing everyone with banal details, this enormous bailout fund has officially (unofficially, anyone without rose coloured glasses knew this all along) become a lot less functional. We believe the EFSF will dissolve into the sunset and be long forgotten about one year from now.

The final reason for all the hoopla surrounding this announcement, is so elegantly demonstrated by the reaction from the French when officials responded that if France is downgraded, ***then Britain must also be downgraded.***

Truth be told, in the fantasy world of government sanctioned credit agencies, the French are actually correct with this statement. Yet, for the rest of us who do not live in this convoluted fantasyland one cannot help but to think of the pettiness amongst our World leaders.

While the entire preceding rambling may induce a deep sleep, we ask you to note the extent of the economic slowdown in all European countries. As of writing we see the following:

- 1 – manufacturing is declining
- 2 – banks refusing to lend to people
- 3 – bank refusing to lend to other banks
- 4 – mounting job losses as companies prepare for the worst
- 5 – money supply growth plummeting

### So, what happens next?

It does appear that Greece may finally get their chance not to pay back their debt. Up to this point, the IMF and European Union have been lending money to Greece so that they can pay back previous loans to the IMF and the European Union – *yes, we cannot make this up.*

Once Greece defaults, it will not be pretty. For starters, the entire European financial system may freeze. In addition to Greece; Italy,

## Tantalization

Spain, Portugal and ever other European country will be scrambling to protect themselves and their banks. Meanwhile, governments and banks in North America and Asia will also be seeking to protect themselves.

Amidst the chaos, there will be one very important phone call – the European Central Bank will call the US Federal Reserve. We'd like to think they have already devised a cheeky code word similar to "blue horseshoe", yet regardless of what they say, we know what they will do – and that's press the shift-F7 key to begin printing a helicopter load of new money.

When you look at the amount of money that has already been printed and pushed to the banks, and the resulting muted impact on the economy we cannot help but be a tad concerned.

Let's face it, with the ECB and the FED covertly pushing over \$3 trillion to the banks and it having a negligent impact on the broad economy, one should be very worried. The resulting trillion dollar question – "will the central banks continue with more of the same, or do something different?"

We expect another full on money printing assault by both the Europeans and the Americans. The trillion dollar question of course is whether they pull the trigger before or after a liquidity freeze.

The Europeans are likely to act before solely due them having the

political capital to do so. The American money printers however are a little less fortunate as the 2012 Presidential Election is squarely in the way. With current data showing US growth and unemployment stabilizing, the US Federal Reserve cannot be shown to be doing anything to tilt the tantalizing World of American politics.

Yet, should employment and growth data suddenly deteriorate then the Fed will certainly have a green light to start the printing presses once again. The other scenario to allow the Fed to begin printing again is a sudden liquidity freeze in Europe. We place a much higher probability on the latter at this point.

### ***But, what if...***

Current market chatter says the Greeks may actually strike a deal whereby private investors accept a 70% loss on their investments. Market reaction to this will undoubtedly be positive, yet the next reaction will certainly see the Irish and Portuguese governments also demanding the same treatment. Once that occurs, the momentum will then shift to Italy and Spain demanding the same treatment.

Before we know it, private investors everywhere will have taken their lumps and losses. Simultaneously, these same investors will refuse to lend new money to these deadbeat countries, leaving the ECB as the lender of last resort. By this time, the money printing machine will have easily cranked out in excess of EUR 3 trillion.

Yet (and this is an important "yet"), we may not get the chance to see

## The shame of it all

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this scenario develop. While the European profligate countries are receiving all the attention, let's not forget the very deep divide that is developing within Germany. The ultra strong German tradition of sound monetary policies remains alive and could very well ignite the not talked about scenario whereby **Germany** is the one who leaves the Euro-zone.

Both scenarios are bearish for the Euro, yet Germany leaving would be downright grizzly.

Our advice to Mario Draghi and the rest of the ECB – change your compensation structure to Deutsche Marks. It will be the best move of your career.

### Our Strategy

2012 has gotten off to a nice start for the stock market. The increasing likelihood of additional money printing is also providing yet another boost to gold bullion. While bond markets have traded flattish, the real surprise has been the ongoing strength of the US Dollar.

For this short-term trend to hold, we'd need to see stabilizing economic data from the US and a return of private investors to the European funding markets. As headline data from the US seems ok at this time, European funding markets are effectively frozen. Based upon this very simple observation, financial markets are 110% relying upon additional help from the European Central Bank -

should this not happen, we expect markets to revert back towards the stagnant holding period that has frustrated so many investors over the last 18 months.

In this environment, investors looking to become aggressive to make an extra buck or two may find themselves on the wrong side of the trade.

Our portfolios remain conservative, and well positioned for the eventual return of money printing from both the US Federal Reserve and the European Central Bank.

### Shameless Self Promotion

Unlike American and European banks, and certain European governments, IceCap does not receive free money to support our lifestyle.

As always, we'd be pleased to speak with anyone about our investment management capabilities, as well as chat with pension funds about our new **Global Investment Intelligence Service**.

Please feel to contact:

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Thank you for sharing your time with us.