



IceCap
Asset Management Ltd.



Local heritage,
Global experience.

Our view on global investment markets:

June 2011 – Hitting the Fan

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

When it becomes serious, you have to lie

Only if you are human

If you are a human being, you should hold yourself to certain standards, amongst which include - *not lying*. When you are the Prime Minister of a country, one would think, as an elected official, you should certainly adhere to the *not lying principle*.

Now, if you are a human being, the prime minister of a country, AND the head of financial ministers for the Euro (2nd largest currency in the World), one would think and hope (keep your fingers crossed) that you would simply never ever lie.

Not so for the *dis*-honourable Prime Minister of Luxembourg, Jean-Claude Juncker as he plainly stated that "*when it becomes serious, you have to lie.*"

The European financial system is a "serious" mess. Greece is insolvent, Portugal and Ireland are not far behind. Spain is also clearly struggling as are certain Italian banks, meanwhile Belgium doesn't even have a government. Mr. Juncker: here's an idea – instead of *lying*, force the banks to accept losses on their bad investments in bonds from the just listed countries.

Investors can use all of the information available in the World to make decisions, however when very powerful individuals resort to lying to keep things together you have to be concerned.

[Editor's note: "hope" is never a good investment strategy, and we hope investors are not hoping Mr. Juncker et al are telling the truth].

Even I am smart enough to know that occasionally people lie, or at least stretch the truth a little. That's the World we live in and we have to accept it. However, at some point in time every lie is exposed and the liar has to accept the consequences. Sometimes the consequences are inconsequential. Other times people and feelings are hurt. However, when really big lies are exposed, this is when the stuff hits the fan.

Chart 1 on the next page shows classic moments in recent financial history when stuff hit the fan.

1998 – a hedge fund called Long Term Capital Management borrowed too much money and made bad investment decisions. A little bit of stuff hit the fan which caused stocks to fall -18%.

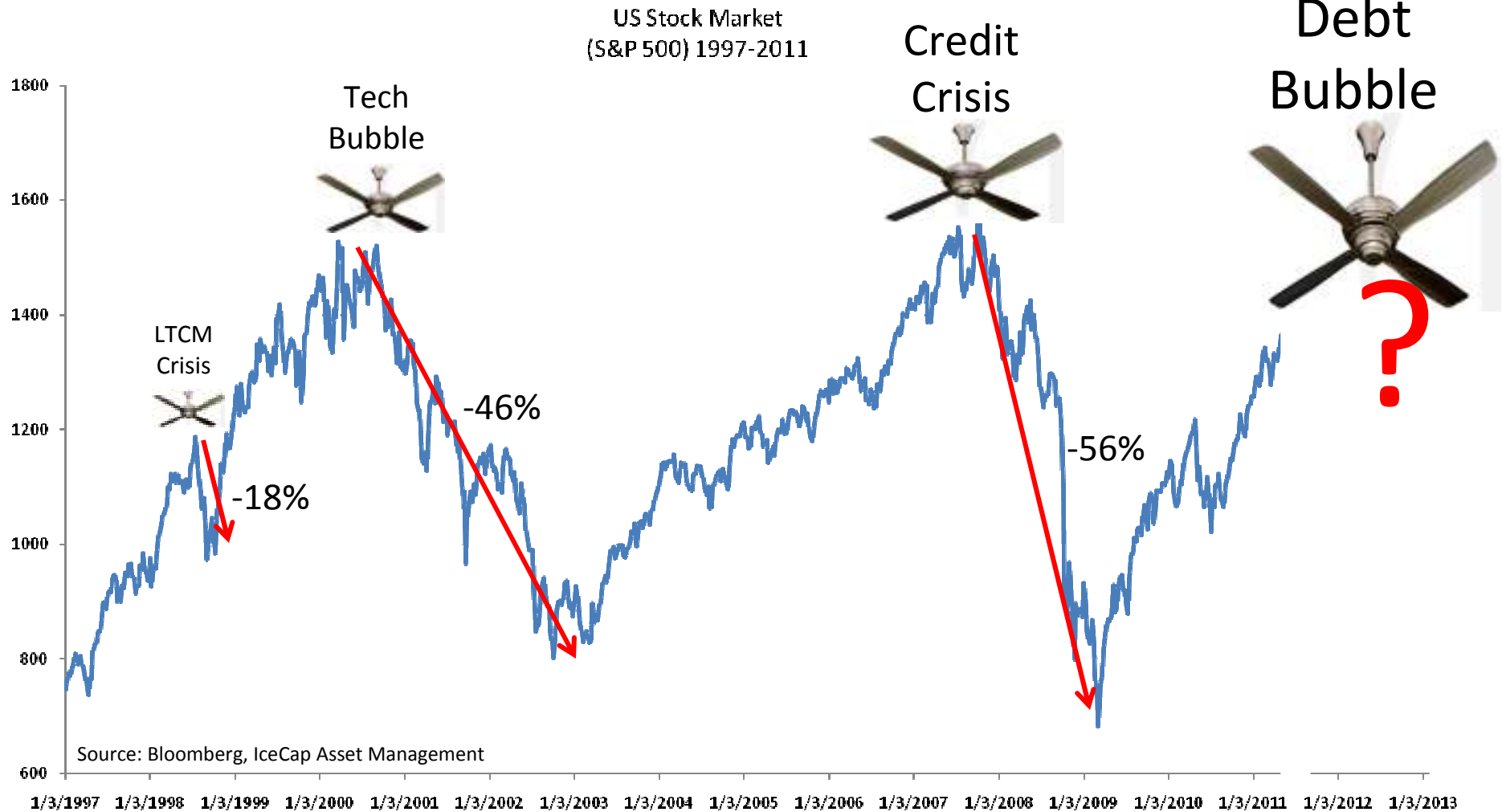
2000 – the internet bubble floated way too high and hit the fan. Stuff flew everywhere resulting in stocks falling -46%.

2008 – the credit bubble drifted too close to the fan and - SPLAT! Serious stuff happened. Banks were saved, millions lost their jobs and the stock market fell -56%.

In each case, central banks resolved the crisis by using various bailouts including lower interest rates, more debt and printing money. The result in each case was to "fix" the current crisis, but only to sow the seeds for the next crisis. Which naturally, leads to the question "when will the next crisis hit the fan?"

Chart 1: historical growth of the “fan”

Sovereign Debt Bubble



Everyone can make money with a 1-way bet

The Next Crisis

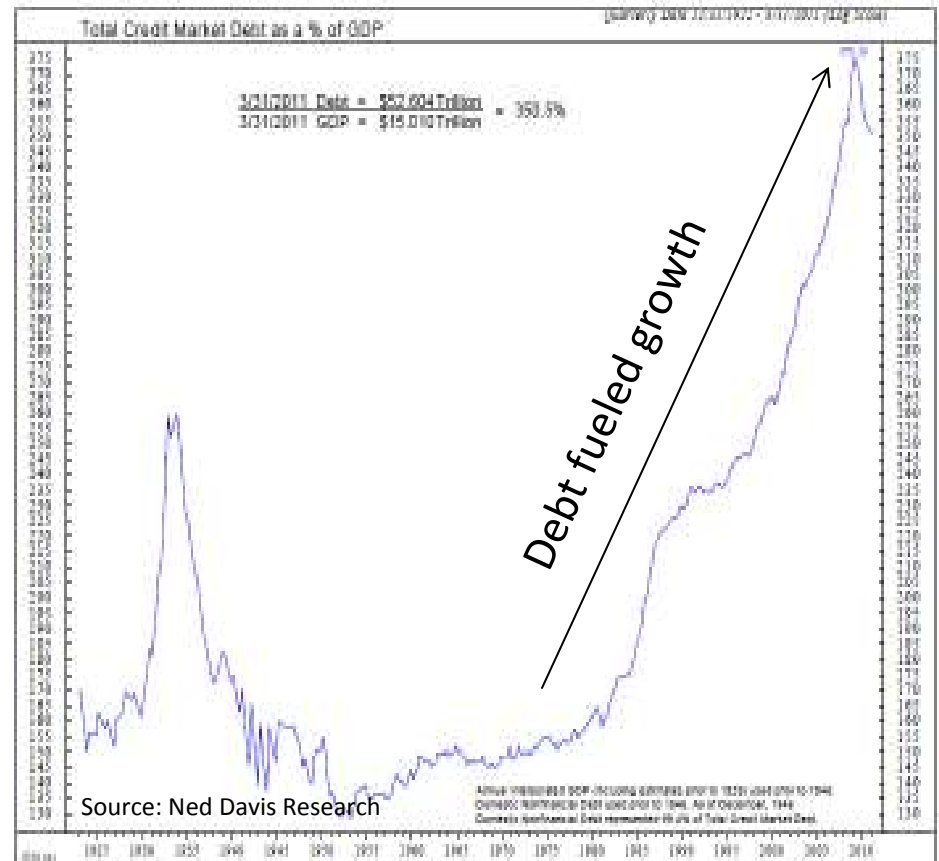
Here at IceCap we are not trying to grind a doomsday machine. Rather, we feel everyday ordinary people should be made aware of the risks within our global financial system. Many people and companies have made a very good living by singing the good song – *stocks always go up, invest for the long-term, and buy the dip.*

Unfortunately, financial markets are a bit more complicated than that. First of all, we'd like to reiterate that the single biggest driver of returns for both the stock market and the bond market is interest rates.

Since 1980, interest rates have only gone in one direction – down. The long-term decline from 20% to 0% has been nothing short of the biggest and best wind you could ever have on your back. That's 30 years of great sailing. Unfortunately for investors, most investment professionals have only ever experienced the good times. Double-unfortunately, most investment professionals conveniently forget about the extreme market declines experienced when bubbles burst. In our opinion, this combination can lead to unrealistic expectations.

Next, it's important to understand the unintended consequences of this continual decline in interest rates. Lower and lower interest rates made it cheaper and cheaper to borrow money. Companies borrowed for capital investments, individuals borrowed to buy houses and iPods, and governments borrowed because the lobbyists

told them to borrow. The result has been an enormous spike in debt outstanding. We have published the chart below in previous publications, yet the importance of the message cannot be overstated.



GDP only tells ½ of the story

Debt Fueled Growth

Every 3 months, investors and politicians are fortunate to receive the latest GDP (Gross Domestic Product) figures from their respective country. In its simple terms, GDP is the summation of all the good and services produced within a country. If your economy is growing, your GDP is naturally higher, from time to time with recessions it is naturally lower.

However, GDP only tells you ½ of the story. GDP measures *spending*. It does not measure where the money came from to provide the money to spend.

While the chart on the previous page, clearly shows the ratio of debt/GDP has skyrocketed over the years, the following table shows that it has taken more and more debt every decade to produce less and less GDP.

Put another way, consider a World with no credit cards or bank loans (all bankers can “gasp” here). Once you have spent all of your salary/savings, the only way for GDP to grow is for you to receive a salary increase.

Now imagine a few bankers fell from the sky and started to lend money to people for them to spend on anything of their choosing (all bankers can shout “hooray” here). GDP starts to rise and continues to rise until people cannot borrow anymore. The point we are trying to make with this awkward explanation is that much of the GDP

DIMINISHING RETURNS FROM DEBT FINANCING BY DECADE 12/31/1949 - 3/31/2011			
Date Range	Decade Change in Debt (billions \$)	Decade Change in GDP (billions \$)	Debt/GDP
12/31/1949-12/31/1959	337.6	248.0	1.36
12/31/1959-12/31/1969	752.1	491.3	1.53
12/31/1969-12/31/1979	2785.2	1654.9	1.68
12/31/1979-12/31/1989	8562.8	2922.3	2.93
12/31/1989-12/31/1999	12549.6	4026.0	3.12
12/31/1999-12/31/2009	26876.7	4669.6	5.76
12/31/2005-3/31/2011*	11324.4	2094.7	5.41

*Last 5.25 years using most recent data available

Source: Ned Davis Research

growth over the last 2 decades has been driven by lower interest rates and more borrowing – a concept rarely discussed by the masses these days. It is virtually assured that the Western World has hit the debt ceiling (America has literally hit the debt ceiling) – the borrowing binge is now over, which naturally means there will be less new debt available to fuel GDP growth. Sub 2% GDP growth may be the best we see for a long time, until that is, all of the bad debt is written off.

When exactly does the next crisis hit the fan?

If we knew the precise answer we’d likely not be sharing it with our non-clients. However, we do know that the next crisis is happening before our eyes and it is up to you to see it. The next crisis will be a sovereign debt default. A country that rhymes with “meece” is insolvent and it is only a matter of time before “the good of Europe” allows this to happen.

The “Fan” can only be pushed out so far

To further clarify the Greek debt challenge, consider that Greece’s annual GDP is about EUR 230 billion, while its total debt outstanding is about EUR 340 billion or 157% of debt. No country in modern times has ever had debt/GDP at these levels and avoided defaulting on their debt.

How did Greece’s finances get so out of control? For starters, in 1999 Greece was denied entry into the Euro-zone. Greece was told their finances were very un-German-like. Miraculously, just 2 years later Greece completely turned around their finances and we’re welcomed with open arms. [Ed note: it turns out the Greek financial miracle was a miracle in disguise only – a disguise deceptively structured by the “great vampire squid”...Goldman Sachs].

In reality (and reality is usually true from time to time, unless you work for the ECB), Greeks’ lost appetite for paying taxes, collecting taxes, and living within their means created the giant baklava ball we are writing about today.

Conditions attached to the bailouts requires Greece to actually start collecting taxes and reducing spending and benefits – if you are wondering how excited the Greeks are about these upcoming improvements to their lives, check out any live web-cam on Syntagma Square in Athens – *it ain’t pretty*.

The only way Greece (or any other country) can continue its spendthrift ways is to borrow money each and every year.

After the first Greek bailout in early 2010, Greece was expected to reduce its fiscal deficit to -3% of GDP by 2012. Fast forward one year and the real deficit will actually be closer to -13%. It is virtually IMPOSSIBLE for Greece to achieve the fiscal targets and conditions forced upon it by the European Union, the ECB and the IMF.

It is very obvious that Greece simply has too much debt. So, what is the cure for Greece’s fiscal problems? More debt of course.

Absurd as this sounds, one needs to understand the real agenda behind the European Union and the ECB for prescribing more debt to Greece. These two entities fully know that Greece is insolvent and that it will never be able to repay its debts.

Yet the real reason for the continued bailouts is if Greece defaults, then the likelihood of Ireland and Portugal also defaulting increases substantially. And if Ireland and Portugal follow suit, global capital markets will then refuse to lend to Spain and Italy. Meanwhile, Europeans everywhere will rush to withdraw their savings from banks – and let’s face it, a bank without deposits is like a boat without water, it just doesn’t float.

It is at this point the “Fan” becomes really big and the splatter-effect will be wide and far.

Now you can understand by Jean-Claude Juncker et al will lie at every turn.

Same message, different person

Can Greece “grow” out of their problems? Acceleration in domestic growth is highly unlikely. The EU/ECB austerity medicine of higher taxes, lower wages and layoffs is guaranteed to reduce spending on everything. By default (pun intended), the only other option for Greece is to “export” its way to growth and prosperity.

Now please excuse our ignorance, however we are not aware of (m)any Greek products or services that are of high value, needed all around the World and offered by no one else. Compounding the export challenge, is the inability of Greece to de-value their currency to make their exports cheaper.

At the end of the day, it’s a “Heads Greece loses, Tails Greece still loses.” The only difference is how soon the “fan” comes back into play.

Don’t be a Weiner

When you continue to hear the same message from the same person over and over, the message inevitably becomes lost.

With that, our final words on Europe and Greece come from the following:

- Mr. Yanis Varoufakis, Professor of Economics, University of Athens:
“When you are insolvent you do not solve things with new and larger loans”

- Mr. Dennis Gartman, The Gartman Letter:

“If Greece cannot pay the loans it has presently outstanding, how can it be expected to pay those loans and another several hundred billion EURs more?”

- Mr. Scott Gardner, Chief Investment Officer, Verdmont Capital:

“Don’t be a Weiner – short the EURO”

We’re pretty sure Mr. Gardner’s quotable quote is the most memorable, however to fully grasp the Herculean task for Greece to avoid a default on its debt we present the following conditions for default courtesy of Bloomberg:

“A restructuring event can be caused by a reduction in principal or interest, postponement or deferral of payments or a change in the ranking or currency of obligations, according to ISDA rules. Any of these changes must result from deterioration in creditworthiness, apply to multiple investors and be binding on all holders.”

Should the Troika of the ECB, EU and IMF patch together a new bailout that gets around triggering a default, they deserve very big, year-end bonus – or a party in Brussels at the minimum.

The comfort of the fence

Our Strategy

Having reduced exposure to risky assets over the last 2 months, our portfolios are well positioned for the binary outcome from the Greek Debt Crisis. As we write, Greece is voting to accept whether to accept or reject further bailouts and the added austerity measures that come along with it.

It is our view, that should Europe manage to restructure yet another bailout for Greece, the “fan” will be pushed along the ceiling a bit further, allowing for a summer rally in stocks and commodities.

Should Greece spin out of control and drag Ireland & Portugal into its vortex, then you should be very prepared for the effects from the “fan.”

We continue to hold about 15% in gold bullion for clients. Any investor who does not hold gold, is implicitly showing complete faith in the US Federal Reserve, US Treasury and the European Central Bank to restore a sense of normalcy to our global financial system.

Unlike Mr. Juncker, we believe that when it become serious you have to tell the truth.

If you'd like to chat further about our view and our unique investment solutions, please feel to contact:

Horst Finkbeiner at hfinkbeiner@bcb.bm or

Alasdair Younie at ay@icm.bm

Thank you for sharing your time with us.