



Our view on global investment markets:

March 2011 – Kudlow’s Foot Meets his Mouth

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Kudlow's foot meets his mouth

Japan

The massive earth quake and subsequent tsunami and nuclear risks are creating many tragedies for the Japanese. The emerging stories of survival and loss are truly heart wrenching.

Sadly, financial markets are cold hearted – that is, if they even have a heart to begin with. The most infamous cold hearted comment to date came from CNBC's Larry Kudlow who chimed "The human toll here looks to be much worse than the economic toll, and we can be grateful for that."

With the World Bank estimating the rebuilding cost to be USD\$325 billion, it's nice to know what side of humanity Larry lines up for. And for those who forget, CNBC was born from the dot com bubble and, together with Goldman Sach's Abby Joseph Cohen, became the biggest cheerleaders for financial markets that would crash not once, but twice while they waved their pom-poms. Nothing like a good-ole disaster to get their eyebrows rising again.

There are several economic and financial outcomes that will arise from Japan's rebuilding efforts. In our opinion, the most obvious is the long-term impact on commodities. While the global demand for commodities is already strong, the addition of rebuilding Japan will only add to global demand. As a good portion of it's energy sources has been lost – this will increase demand for coal and oil. Meanwhile, the tsunami has salted farmlands, rendering them useless for sometime to come – global prices for rice and wheat will undoubtedly rise as a result. Finally, the amount of lumber, copper

and steel required for new buildings can only have an upward effect on base metal prices.

While others are focused on the Yen and the Japanese stock market, we believe the earthquake will have a devastating knockdown effect on Japanese bonds. While this outcome will not occur immediately, the amount of new government debt necessary for the rebuilding effort will add mightily to the already enormous debt load (see chart 1 on page 3).

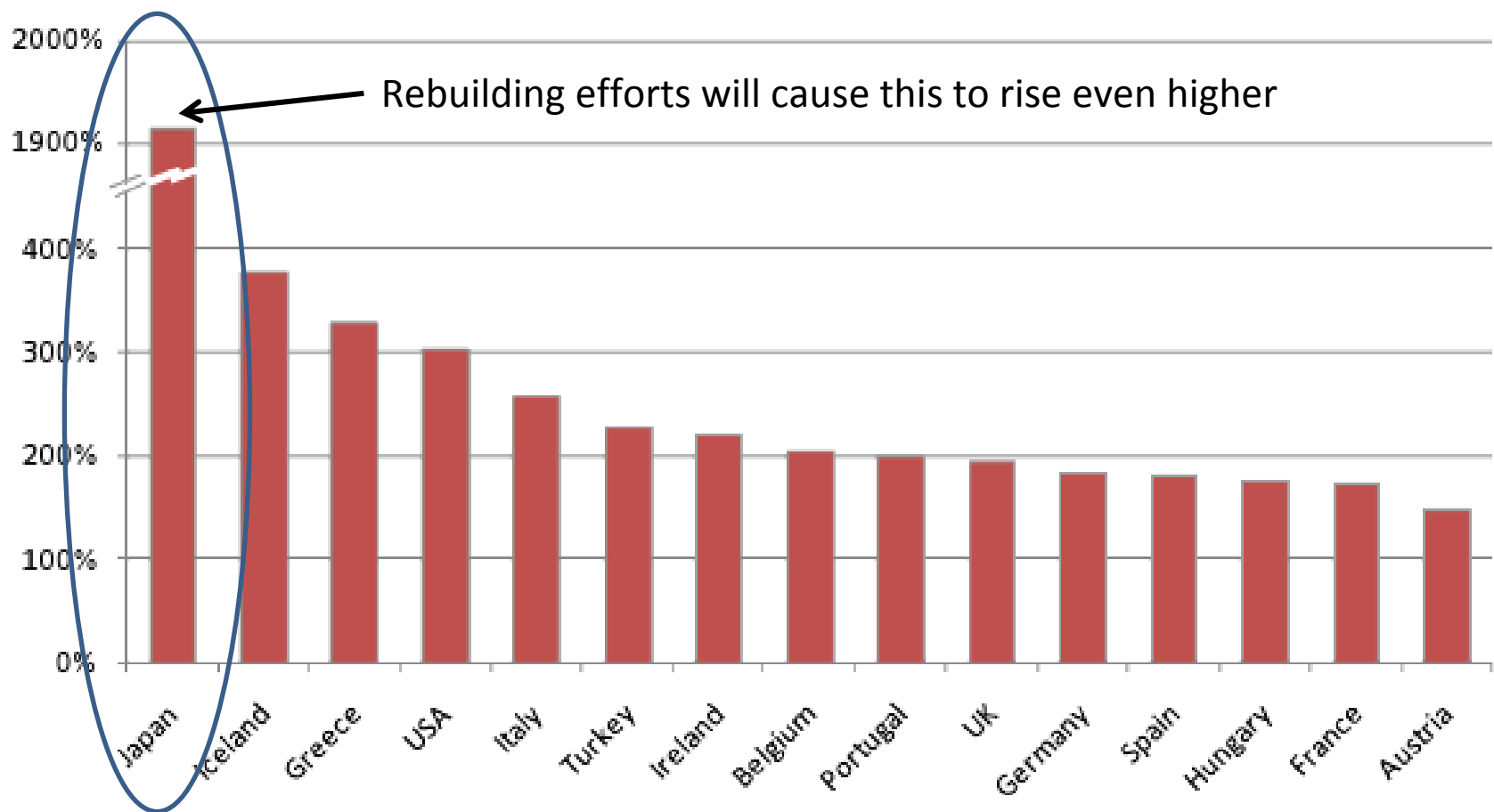
Recall that Japan has been in recession for over 20 years. To stimulate the economy during this time it has repeatedly printed money and built countless bridges to nowhere. While this effort hasn't put a dent in improving their financial fate, it has performed miracles by defying the rules of financial gravity – that is the freedom to borrow and spend continuously without falling flat on your face.

The Japanese, unlike the Americans, have been able to completely "pay" for these stimulus measures themselves. The amount of money saved by the Japanese on an annual basis has been enough to "buy" the new bonds issued by the Japanese government.

With many Japanese savers entering their "non-saving" retirement years, this balancing act was already about tip over. The addition of even more debt to pay for the rebuilding effort will pressure Japanese bond yields to rise. And this is where the pain will be felt. As Japanese bond yields rise higher and higher, the ability to borrow will go lower and lower. While we do not know the outcome of the Yen in the near-term, the longer-term outlook is not pleasant to say the least.



Chart 1: Japanese Government Debt / Revenue



Source: Hayman Capital Management



National Lampoons Vacation

European Vacation

Years ago as a kid, I remember watching the TV show *The Price is Right* award the big winner a trip to Europe, hi-lighted by visiting 9 countries in 7 days. The winner always jumped up and down and often cried with happiness. Well today in Europe, the European Central Bank (ECB) and members of the European Union (EU) are taking this exact same trip. While they continue to cry, they are not jumping up and down with excitement.

Their current day travels across the old World is instead focused on throwing money at the many problems that continue to linger within the various countries. The Greeks, the Irish, the Portuguese, the Spanish, the Belgians, the French, the Italians – did we miss anyone? Ah yes, the Germans. Let's remember that no one in Europe is happy with their current lot in life and everyone expects Germany to bail them out. This is one of those classic no-win situations. And because "this time it isn't different" we laugh at the latest bailout plan (we've lost count if it is the 4th or 5th...it's irrelevant).

While major news stories focused on Japan and the Middle East & North Africa (MENA) have justifiably pushed Europe's financial problems to the back of the paper, they are still very much real and will certainly return to the front page soon enough.

We stated it before and we'll state it again – the crisis in Europe is no where close to being resolved. When Greece broke the seal and revealed that they've been fudging their economic data for years, it

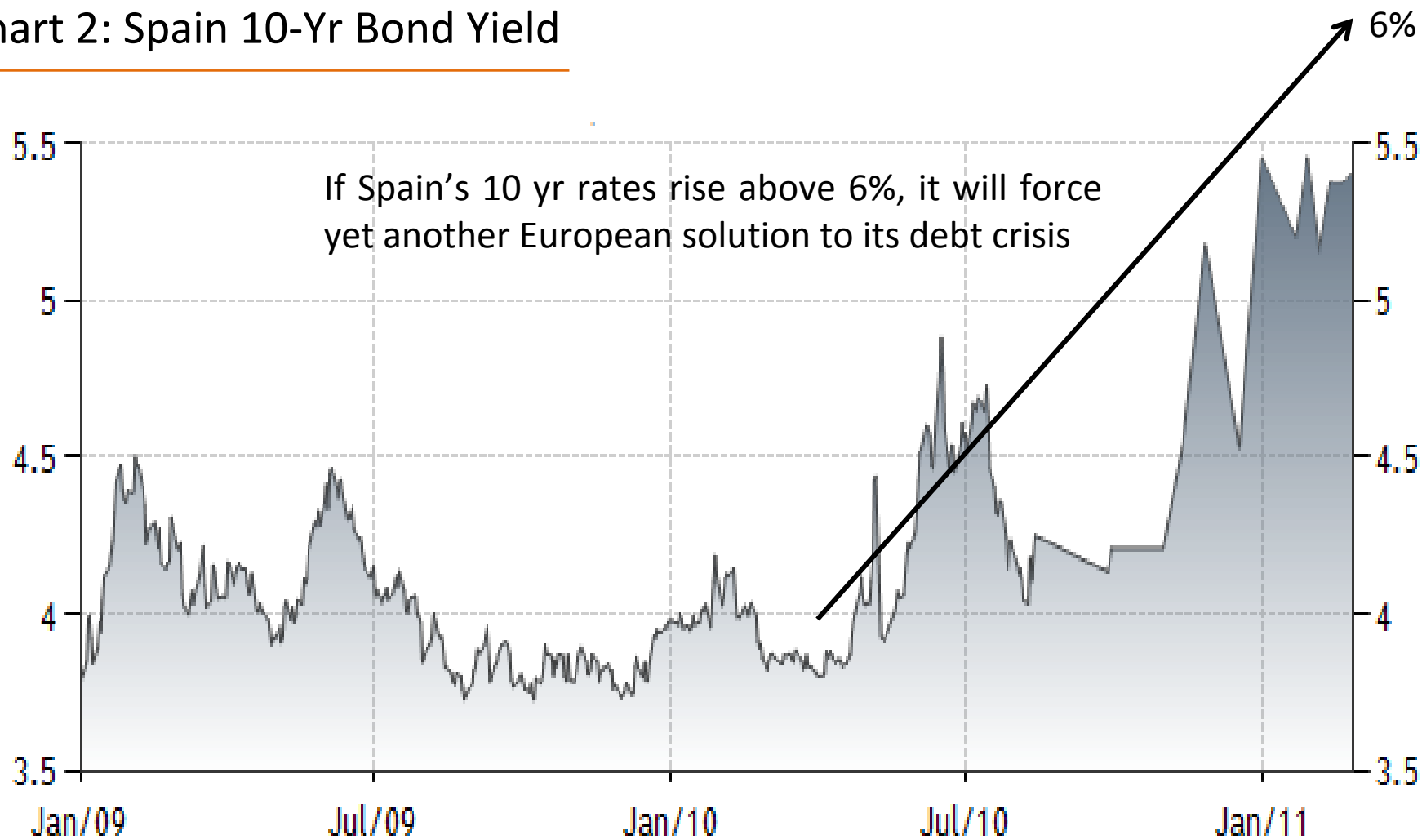
was seen by the experts as a one-off event. Europe quickly, I mean, slowly (do the Europeans ever make a quick decision?) wrapped the Greeks' knuckles before giving them EUR 110 billion to make the problem go away. Next, Europeans tried to convince themselves and the market that Ireland was sound and it wouldn't need any financial help. This too was wrong of course as an additional EUR 85 billion was required to bail out Ireland.

Now we turn to Portugal where ironically, even a prime minister named Socrates wasn't smart enough to turn around the fiscally strapped country. Initial estimates put the cost of their bailout at EUR 70 billion. On the face of it, these bailout numbers are manageable but only for those who have the money available to actually do the bailout. Recall that these bailouts come from a pool of money contributed by the countries who are a part of the European Union (EU). As ridiculous as it sounds, Ireland contributed to the fund for its bailout. Portugal will be doing the same as well. Even Britain, who is baring the load of severe budget cuts and tax hikes, is contributing to the bailout funds. This strategy works until the line in the sand has been crossed – and that line is Spain.

As of today, Spain is able to meet it's funding requirements however its banks remain stuffed with bad real estate loans and its economy remains burdened with 20% unemployment. Just like Greece, Ireland and Portugal, Spain's financial stress is measured by the interest rate it has to pay to borrow money for 10 years (see chart 2 on page 5). So far, so good. However, any movements towards 6% and vacations in Europe will become a lot cheaper for non-EUR travelers.



Chart 2: Spain 10-Yr Bond Yield



Source: TradingEconomics.com



For financial markets, it's all about oil

MENA (Middle East & North Africa)

While the World has quietly forgotten about Tunisia & Egypt, the struggles within each country will continue for some time to come. Yes, the “hard part” may have already passed, yet the real work of actually forming new governments and then implementing policies have only begun. Egypt is an especially complicated country and its transition process will be long, and it will shape the region for years to come. Presently, financial markets are saying they can handle this.

Of course, now we have a full on civil war in Libya. Gaddafi, being Gaddafi, has made it very clear that he is not going without a fight. Whereas Tunisia and Egypt export no precious crude oil, Libya is a significant exporter of the black gold with practically all of its exports being sent to Europe. Yes, Colonel Gaddafi is a dictator and terrorist who hangs out with Chavez – this alone should have attracted more attention from the UN Security Council, add oil to the mix and then suddenly we have a “no fly” zone which will be followed soon enough by UN troops, an eventual new government and then 10 years of occupation by UN peacekeepers.

In isolation, Financial markets are correct to “yawn” over the lost oil output of about 500,000 bpd. After all, Saudi Arabia has announced they can easily open their taps a bit more to make up the difference. Yet, it is Saudi Arabia & Bahrain where things become a bit tricky – and this isn't garnishing the attention it deserves from financial markets.

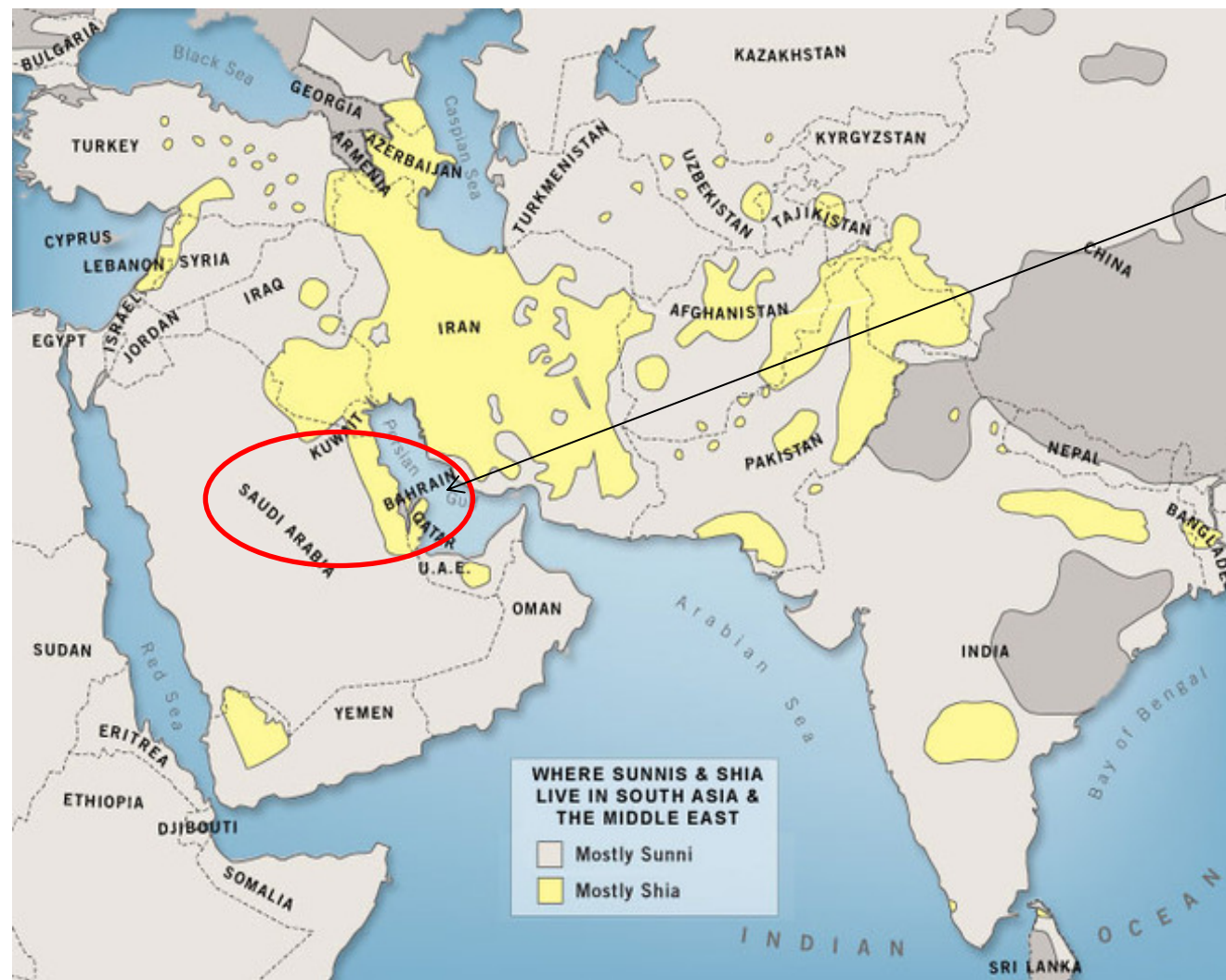
From a simplified perspective, the Muslim World consists of about 85% Sunni Muslims and 15% Shiite Muslims, with most of the Shiites being in Iran, southern Iraq and southern Lebanon. However, there are also significant Shiite communities in Saudi Arabia and Syria (as well as Afghanistan, Pakistan and India (see chart 3 on page 7). While the initial split between the two Muslim groups was violent, peace has generally existed for some time. However, the current uprisings in the region threaten stability and is the powder keg that has Western governments worried.

Oil is the main (and only) source of wealth creation in Saudi Arabia, and to keep everyone happy the ruling family announced fiscal packages totaling \$36 billion for its people consisting of new jobs, pay hikes, scholarships and so on. Still, protests are building in the eastern part of the Country where the majority of people are Shiite Muslims. Bahrain is connected to eastern Saudi Arabia by a causeway and its protests are lead by Shiite Muslims against the Sunni Muslim leaders.

Meanwhile, the World's largest oil field (Ghawar) also lies in eastern Saudi Arabia and is very close to where the current uprisings are brewing. This is the reason why Saudi Arabia has been very aggressive with sending in troops to quell the uprisings in Bahrain. Success by the Shiites in Bahrain could carry over to the Shiite community in Saudi Arabia which would be a little too close for comfort to the massive Ghawar oil field. When you hear about \$200 oil – think of Bahrain.



Chart 3: Map of the middle east detailing Sunni vs Shiite Muslim split



"Everyone appears to have their own interests in the tiny kingdom of Bahrain -- Riyadh, Tehran, the Iraqi Shiites and even the Americans."

"Although Saudi Arabia's King Abdullah, the guardian of the holy cities of Mecca and Medina, endorsed the revolutions in Tunisia and Egypt and praised the courage of the rebels, he's not prepared to do the same thing when it's on his own doorstep. In his view, Bahrain must be ruled by Sunnis and remain autocratic, just like Saudi Arabia. Riyadh's double standard is so obvious that it's damaging. Still, on the Arabian Peninsula -- from Yemen to Dubai -- everyone else is applauding because -- after what happened in Tunis, Cairo and Tripoli -- all of the Arab power elites are at risk." source: Die Welt Newspaper.



Trio of black swans

Our Strategy

Considering the trio of events currently enveloping the World, the rebuilding of Japan will take time and will have a definite negative effect in the near-term that will be subsequently offset by a positive contribution to growth as the rebuilding phase progresses. We do not know if the new capital investment in Japan will produce better roads and buildings but we do know that the new resulting debt will last for several lifetimes.

Meanwhile, we remain quite certain that the ongoing debt crisis in Europe will continue with the outcome being something very different than what the big-bank owned investment houses are predicting. Using more debt to resolve a debt crisis will not work. Many non-Europeans ask why they should care about Europe. The answer lies within the banking system. The multitude of bailouts within Europe is a veiled attempt to protect the continent's banks. Should an Ireland decide it cannot make its bond or interest payments, the ripple effects will be felt within the banking systems of the UK, France and Germany, with the American shoreline not far behind. This is why Europe is important.

Of today's major events, our biggest concern lies with the uncertainty in the Middle East & North Africa. Most Westerners, ourselves included, do not understand the complexities of these societies. What we do (and need to) understand is that the situation today is at its most strenuous in any of our lifetimes. This region produces over 35% of the World's oil supply. Since current global production is

about 88 millions of barrels/day, and current global consumption at close to 86 millions of barrels/day, the slightest disruption of production from anywhere, especially the Middle East, will have profound effects on this delicate equilibrium.

In response to these unusual times, we are holding healthy allocations to gold bullion, crude oil and other commodities. We continue with our neutral allocation to stocks and will do so until our trend models signal otherwise.

In our next publication, we'll be discussing market implications of the US Federal Reserve continuing their quantitative easing (QE) program or letting it expire.

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

Thank you for sharing your time with us.

