IceCap
Asset Management Ltd.

Local heritage,
Global experience.

Our view on global investment markets:

August 2011 – The Gong Show

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First publication June 2010

Chuck Barris for President

A *free market* is one in which government intervention and regulation is limited to tax collection, and the enforcement of private ownership and contracts.

A *controlled market* is one in which governments directly regulate how goods, services and labour are priced and sold – the dynamics of economic supply and demand are ignored.

Then there is the *gong show market*. Until recently, this type of market has only been available to 1970s TV game shows. Yet today, this exceptional form of dark comedy has been adopted by our global leaders as an acceptable approach to dealing with the World's debt crisis.

Unfortunately for every human being that fully grasps the enormity of the financial problems facing the World today, the reason for their dissatisfaction with the response from our global leaders is simply due to them not knowing the rules of the Gong Show.

For your convenience, we provide them as follows:

- amateurs only
- dubious talent
- celebrity judges
- ridiculous prizes for the winners

Now that we know the rules, let's further enhance your viewing experience by introducing today's players:

Amateurs only
- Barack Obama, Nicolas Sarkozy, Angela Merkel

Dubious talent:
- Ben Bernanke, Jean-Claude Trichet

Celebrity judges:
-Goldman Sachs, Warren Buffett, and Jimmy Buffet

Prizes:
- Used Hewlett Packard printer, American $1 Bill, a map of Belgium, the original EMU Treaty

Until recently, this consortium (and their predecessors) have managed to create one financial bubble after another. While previous versions of the *Gong Show* were successful at entertaining themselves with seemingly one-off financial accidents, the current version has accomplished the unthinkable.

During the last 4 weeks, little old ladies on fixed pensions, Walmart greeters, as well as the hardened nose-to-the-grind workers have all seen their financial savings soar and crash, then soar and crash, and then soar yet again. Whereas 500 point days in the Dow Jones Industrial Average rarely occur, the Gong Show managed to produce 4 in a 4 days span.

The Over 30 Club

Where do we begin?
Over the last 30 years, we have seen interest rates decline to 0%. Over the last 30 months, we have seen the US dollar decline 15%. And finally, over the last 30 days we have seen the stock market decline 15%.

One thing that's for sure - the "*Fan*" is obviously getting closer. Which naturally leads to another thing that is for sure – *more money printing*.

Since 2008, the US Federal Reserve has printed close to $2 trillion. In addition, the US Treasury spent billions more bailing out the likes of Fannie Mae, Freddie Mac, and AIG. All of this "free" money wasn't "free" of course, rather it has come at the expense of savers all over the World. With Central Banks from the G7 countries all keeping interest rates as low as possible, income-seeking investors have been forced to invest in much riskier investments to meet their annual income objectives.

While this central bank strategy has been a disaster for the little old lady who is living off her savings, it has been an absolute boon to the banks. The banks are quite happy to pay out close to 0% on any type of savings account, while simultaneously investing the little old lady's savings in longer-dated bonds earning 3% and more. Now, this isn't uncommon at all in the banking world – that's how banks work. What is uncommon is what the banks are doing, or should we say, not doing with the excess money they are making with this trade.

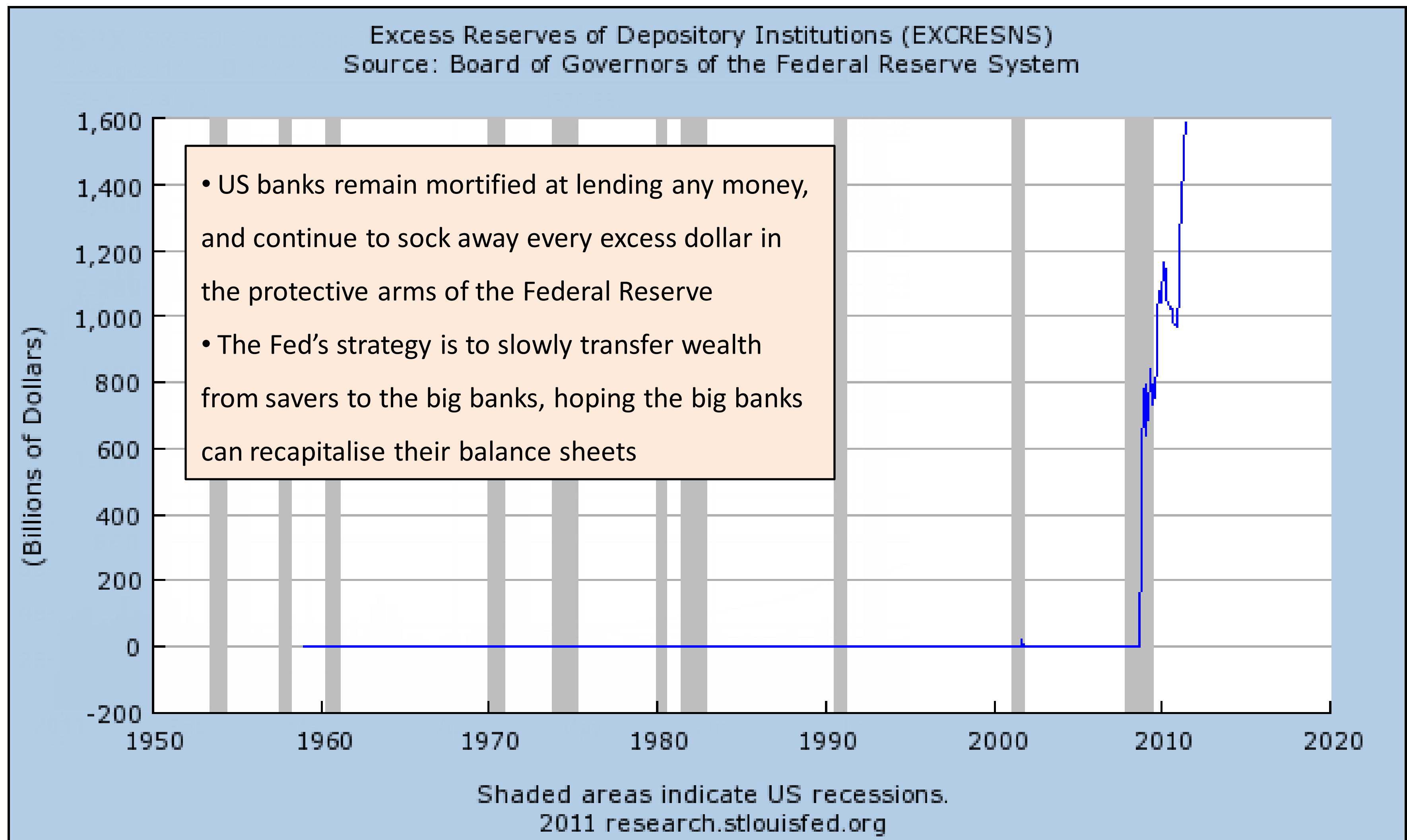
IceCap's June 2010 "The Crazy Aunt in the Attic" introduced this "excess reserve" story to its readers. At that time, we hi-lighted that American banks usually keep about $2 billion in rainy day money, or excess reserves earning < 0.25%. Any amount above $2 billion was always lent to borrowers who were ~~forced~~ willing to pay 4% or more for a mortgage or other type of loan. Again, the complicated world of banking actually makes sense – why earn 0.25% on your money if you could earn 4% on your money.

This is where the Gong Show really gets going. Chart 1 on page 4 shows today's greatest American banks are holding over $1.6 trillion in excess reserves earning 0.25%. Why is it these banks are foregoing the 4% returns available to them from lending and instead settling for 0.25%?

Two reasons actually. First, the majority of bank lending is for the housing market and everyone knows the US housing market crapped out 3 years ago. Sadly, another 10-15% decline in house prices is likely over the remainder of this deleveraging period. In this environment, banks are skeptical that many of these borrowers may not actually pay back what they owe.

Second, as a business, banks apply leverage to maximize their profits. For every $1 of equity investment in their bank, the bank may lend out another $10-$20. Every time one of these loans turn sour, it means they have less money available to pay back to the original depositor. When a bank has a whole bunch of loans that have gone sour, it had better find new investors.

Chart 1: The Crazy Aunt is Back



Soc-Gen is getting socked

Given these two reasons, it is little wonder the American "Too Big To Fail" banks are stashing away every spare penny they have. In effect, they know the rainy day is not too far away and when it comes the rain may come as hurricane.

A bank run – 2011 style

The classic bank run shows little old ladies lining up around the block to withdraw their money from their local financial institution. This event occurred often during the Great Depression and was made most famous in the movie classic "*A Wonderful Life*."

No bank manager on any planet wants to see a run on his bank, especially one lead by the little old lady (it isn't very good publicity). With all of the innovations in financial innovation, bankers felt confident that this would never happen again – yet this is exactly what occurred with British bank Northern Rock in 2007. Today, another bank run is occurring as we speak. However, thus far the little old lady has yet to arrive – *after all, that is so 2007*.

The 2011 version is happening with French and Italian banks, and the customer lining up to withdraw their money is not the little old lady but rather American banks and money market funds instead.

Every prudently managed bank and money market fund is selling (or not rolling over) euro commercial paper issued by French and Italian banks – in effect they are "getting the hell out of Dodge." Investors are not sticking around to see if today is or isn't 2008 – those banks that did survive the 2008 crisis want nothing to do with a similar crisis again. Obviously IceCap knows this, as do the French and Italian banks, the ECB, and the French and Italian governments. The response? The ECB struck a very quick deal with both governments to implement new austerity measures, in return for the ECB printing money to buy Italian and Spanish sovereign bonds. The ECB's EUR 22 billion was certainly well spent as the cost for Italy and Spain to borrow for 10 years has declined from 6% to almost 5% - an enormous move in bond market-land. [Editors note: as soon as the ECB refrains from purchasing more bonds, the cost of borrowing will soar higher once again.]

And just how necessary was it for Jean-Claude Trichet and the ECB to interfere in the bond market? Well, chart 2 on the next page, shows the cost of buying insurance on France's 2nd largest bank, Societe Generale (commonly known as Soc Gen) is soaring. At the same time, the stock price of Soc-Gen has plummeted over 50% since February 2011. Let's just say investor confidence in Soc Gen is getting socked.

Realizing a bank run has started on Soc Gen and Italian banks, both governments instituted a ban on short-selling. Obviously, it is quite apparent that the reason for money fleeing France & Italy has nothing to do with the over-leveraged banks and their poor quality investment portfolios. *The reason for the decline has to be the nasty short sellers*. This response shows that French and Italian regulators' understanding of capital markets is disturbingly limited.

For all of those at the French regulatory agency AMF and the Italian regulator Consob who disagree, IceCap will gladly change our

Chart 2: French bank Societe Generale is in crisis

The Secular Bear Market

statement as soon as we see you implementing policies to try to stop the next unsupportive rally in stocks when it next occurs.

It is our opinion that most investors are severely underestimating the severity of the European debt crisis. Over the last few days, many in the media have been adamant that recent market volatility does not mirror the sell-off in 2008. Our perspective is somewhat different as we view today's sell-off as potentially foreshadowing what will occur should the European debt crisis remain unresolved.

The Final Countdown

While many like to believe that the leaders of the financial World have combined to create a well oiled machine, others know better. The latest version of "*Turning Long-term Investors into Day Traders*" has just been completed.

August 26, 2011 will likely go down as one of the most anticipated days in financial history. On this little old Friday, the last day of the week, the one where most people are kicking off their day with cappuccinos and ending it with a few swifties at their local pub, market players will be waiting for 3 key events.

Luckily for investors, the order of these events is guaranteed to generate another 500 point day in New York. At 3 am EST, the starting pistol will be fired with the expiration of the short-selling ban on European bank stocks, followed next by the 8.30 am EST 1st revision to US Q2 2011 GDP number, and then the day will culminate with an afternoon announcement from Mr. Bernanke at the annual Jackson Hole conference.

The question is, will he speak central banker gibberish or rise to the occasion and announce the largest money printing scheme in history? Either way, there will be rioting in financial markets.

The Secular Bear Market Continues

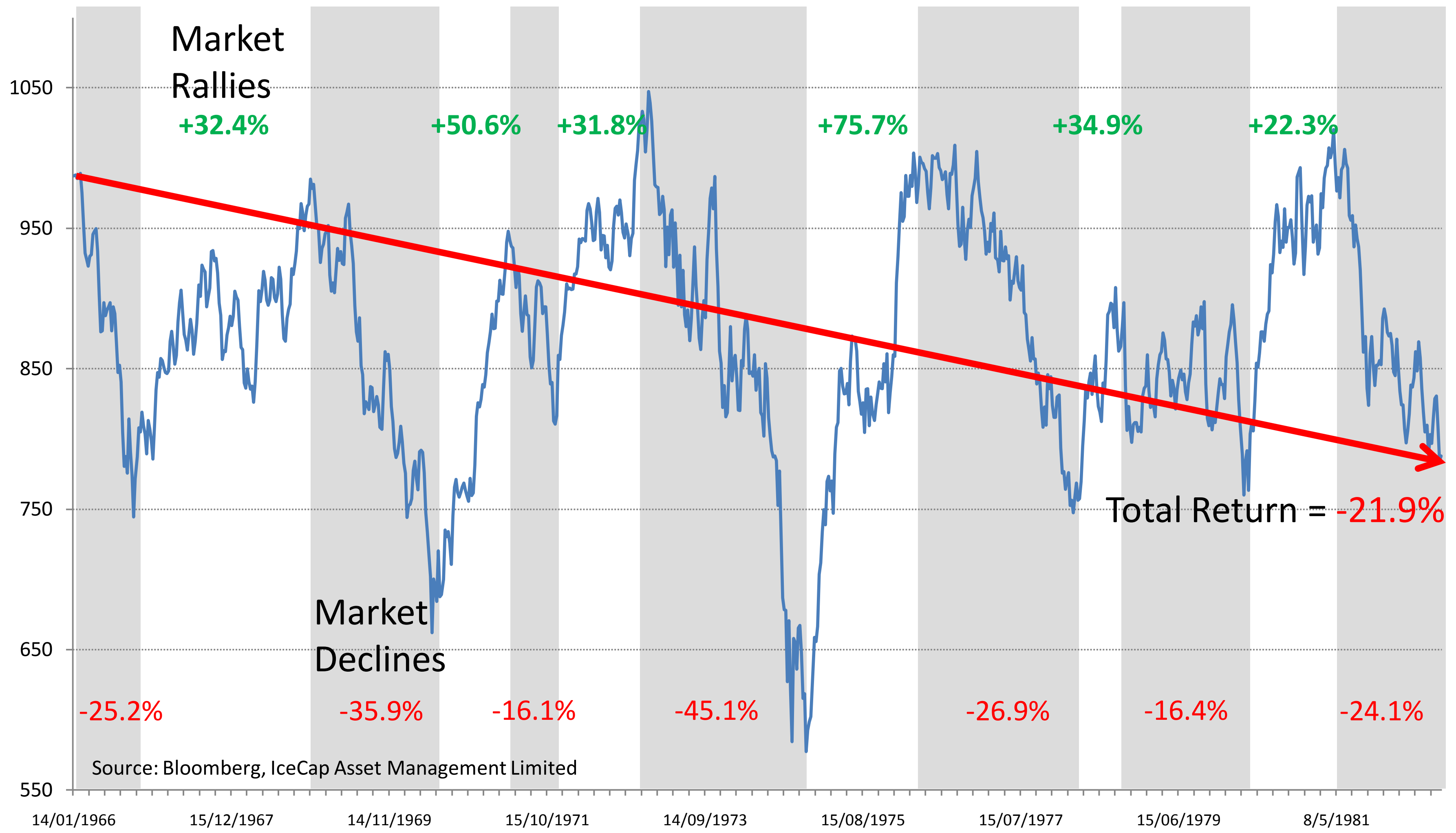
Just a little reminder from your friendly neighbourhood investment manager – the *Secular Bear Market* that began in 2000 continues.

Ignorance of this basic fact is leading your trusted advisor to continue to trumpet the merits of "buy and hold", and better still – "buy-the-dip." It is no fault of their own, after all for those who entered the industry in the 2000s, are simply learning from those who started in the industry during the booming 1990s. As we've said before, anyone can make money when interest rates are declining toward the big 0.

To help these wayward sons find their way, we politely point you to Chart 3 on page 8 and offer the following fact – "buy-the-dips" during bull markets and "sell-the-rallies" during bear markets. As for "buy and hold," we are confident this strategy will come back in vogue again someday...someday.

What will it take to kick-off another *secular BULL market*? From a practical perspective, we simply need to see a resolution to the global debt crisis. The solution is easy – write off the bad debt. Investors will lose buckets of money, yet the seeds will be planted for

Chart 3: Secular Bear Market 1966 to 1982 (Dow Jones Industrial Average)



Calling all delusionists

the next investment boom. What is critical for investors to understand is the following – there is only one final solution and it will happen, regardless of all interference from the Gong Show. However, the choice is theirs – they can allow nature to run its course or they can continue to kick-the-can down the road and cause an even bigger correction than would have been necessary.

For all of those delusional investment managers who fail to see the forest, let's assume they are correct and there is no debt problem and that the centralized planners of the World are very capable of smoothing out this little bump. **A return to a secular bull market in this scenario will only start after the stock market has experienced a significant decline due to either very strong, inflation or deflation.**

This combination is necessary to help restore appropriate valuation (PE) ratios that are always present at the beginning of secular bull markets. The final thought here is the following – this market decline can either be a sudden, violent move or it can be a longer-term move over a number of years. Either way, it is critical to understand that the secular bear market is simply not over.

At IceCap when assessing risk and the resulting opportunities, we like to keep things real simple. For starters, we are quite confident that the developed World is experiencing a massive de-leveraging period. It started with the bursting of the American housing market in 2008 and will continue with the eventual bursting of the sovereign debt bubble. The debt problems are no where near being resolved. Again, we use the word "delusional" to describe anyone who thinks otherwise.

The bursting of any asset bubble is always followed by years of sub-par growth. In addition, over the long-run any country that tries to print money to make its problems go away will experience severe weakness in their bond market as well as steep declines in their currency. During this long period of sub-par growth, inflation expectations are going to swing wildly from foreshadowing hyper inflation to foreshadowing hyper deflation. In our opinion, portfolio strategies must be structured to recognise sensitivities to inflation.

When the next secular bull market does arrive we expect to see the following market conditions:

1. Money should be cheap and easily available
2. Debt bubble would have restructured
3. Large pent-up demand for goods and services
4. Stocks should be clearly cheap (single digit PE ratio)
5. Very deep pessimism towards the stock market and the economy
6. Major investors should have excessive cash positions

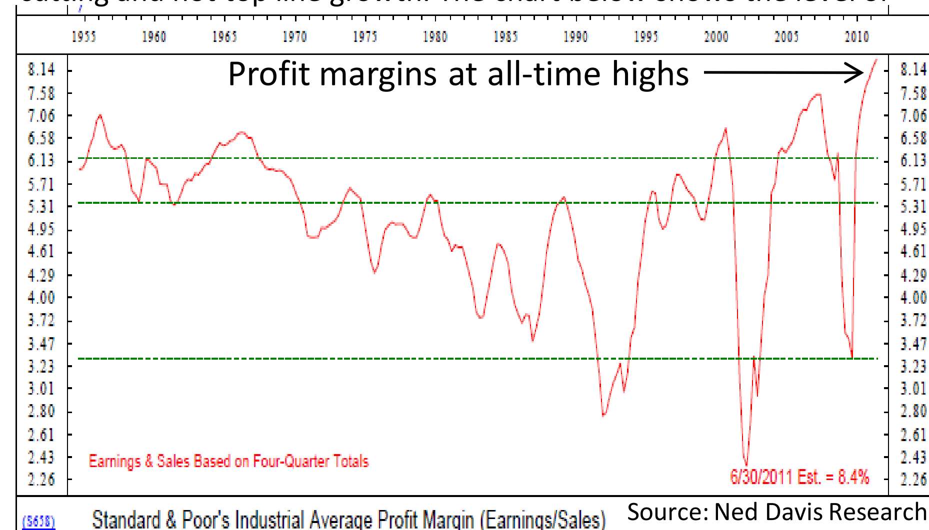
Until then, expect to see wild market movements, continued cheerleading from CNBC, and more nonsense from the *Gong Show*.

Profits may have peaked

Our Final Word

There's been an awful lot of talk lately from stock pickers about the fundamental strength of companies. Excluding many banks around the World, we completely agree with this comment. Yet, we also stress that the current global macro environment is so severe that it will completely overwhelm the stock performance of many of these companies.

It is fact that many companies have enjoyed exceptional profit growth over the last 2 years. The key driver behind this surge has been higher profit margins that were first supported by the massive layoffs during the 2007-09 crisis and then further supported by not rehiring during the recovery. Let's face it, profit growth has been boosted by cost cutting and not top line growth. The chart below shows the level of profit margins over time. It's pretty obvious that margins are now at all time highs, expecting stronger margins is unwise.



Source: Ned Davis Research

Without further margin expansion, the only way for companies to further grow profits is to increase their sales. Given the fact that every major economy is reporting slower than expected growth, and the possibility that both the US and Europe fall back into recession over the next year – this is hardly an environment for stronger sales.

As a result, it is very likely that Wall Street strategists will be reducing their earnings expectations for the S&P 500 over the next year which will of course have an adverse effect on the "cheap" PE ratios the stock pickers continue to talk about.

Our Strategy

Without sounding like a broken record, our strategy hasn't changed much over the last year. We remain very aware of the global risks caused by the Gong Show. Our portfolios continue to hold gold bullion as well as other strategies to protect capital.

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

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Keith Dicker at keithdicker@IceCapAssetManagement.com.

Thank you for sharing your time with us.