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Our view on global investment markets:

June 2010: The Crazy Aunt in the Attic

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Everyone is learning Greek...

We are very excited to offer our first Global Markets Outlook. The objective of this publication is to provide a simplified perspective of what is happening in the global economy; with a view that is not being discussed by the main stream investment companies. The global economy is a complex system, but it doesn't have to be presented that way, or worse still; ignored all together. The better investors are able to understand these complexities, the more comfortable they will feel with their investment strategies.

It seems like everyone these days is learning Greek. However, **the financial crisis in Greece is a symptom of a much bigger problem.** Back in 2008, the Americans were the first to experience any "symptoms" and it nearly caused the global financial system to collapse. After throwing a few *trillion* at the symptom, many were reporting the illness was cured. With the explicit intent of not putting our readers to sleep during our very first publication, we won't be providing a history of subsequent countries that also experienced the very same symptoms as the US and Greece. Nevertheless, all we have to say is that Greece wasn't the second country to experience problems and they certainly will not be the last. **In fact, over the next few years we are going to see some spectacular train wrecks in financial markets.**

As we all know, if you are ill you can treat the symptoms all day long and it still won't cure the illness. Within this context, **the illness in today's global economy is debt.** People, companies and countries have too much of it, they are overleveraged and for some the day of

reckoning has come. In Greece's case, they need to pay back debt that is coming due, and they also need to borrow more money to simply keep their country running.

If you remember back to your grade school days, there was always a day when a friend needed to borrow money (maybe to buy a snack). But very early on, grade schoolers learned that some of these friends would sometimes not pay back the money they owed. What happened? These young borrowers were shut out of the credit market and unable to borrow again. The other side of the coin had a young investor (or lender) who suddenly had to kiss his loan good bye. In other words, he had to write-off his investment. After this experience, the young lender was very reluctant to lend again, **making it much more difficult for other kids to borrow money from him.**

Today, Greece is the young kid who can't borrow and now Spain is another kid who has always paid back their loans, but now other lenders are a bit nervous because of their experience with lending to Greece. After Spain, comes Portugal, Ireland, Italy, Hungary and even France. When this happens, to encourage investors to lend them more money, countries have to offer a higher return (or yield) to their lenders. Since some countries are obviously in a better financial situation than others, investors will view them as being relatively safer, while other countries will be deemed to be riskier. The difference between what these countries have to pay for interest on their loans is referred to as "credit spreads." **And in fact, if you really**

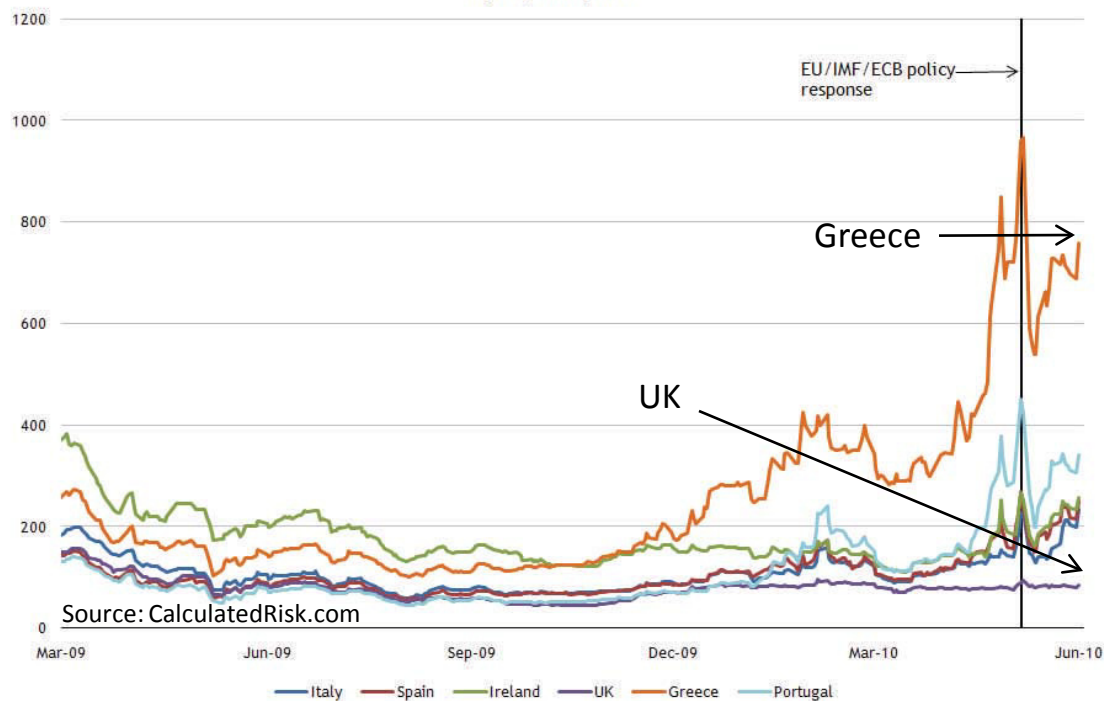
while school children firmly understand banking...

want to judge the health of financial markets, don't look at the stock market. The bond market and credit spreads do a much better job of telling the true story.

Chart 1 does a great job of showing the difference in credit spreads between different European countries. You'll notice that the relative cost to the UK to borrow has remained steady, while the relative cost for Greece and others has exploded upwards. Even after the announcement of the \$1 Trillion bailout, the cost to borrow has started to rise again.

From a different perspective, **it's the same as your bank increasing the interest rate on your mortgage from 6% to 18%**. That doesn't exactly feel very nice, but that's exactly how these countries are feeling right now. To make matters worse, Greece (and others) can now only borrow because they have the backing of the ECB (European Central Bank) and the IMF (International Monetary Fund). Spain, Italy and other Euro-zone members can also be protected under this policy. However, what makes this an Abbot & Costello routine is that the money from the ECB is coming from the Euro-zone member countries which include Spain, Italy and so on. I'll lend you a dollar if you lend me a dollar - **you can't make this stuff up.**

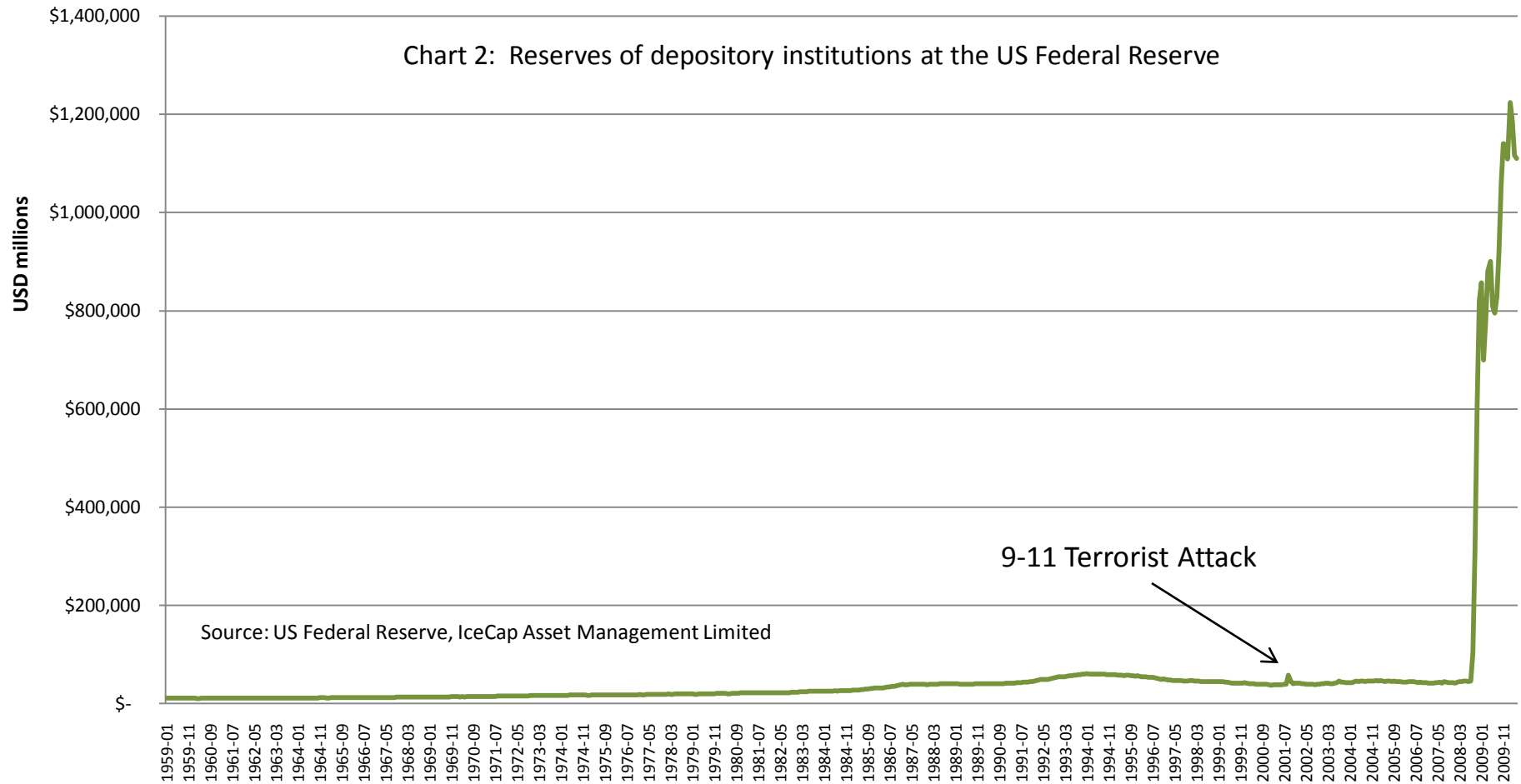
Chart 1 European CDS Spreads
5-year, basis points



Now, how do we solve the problem? Unfortunately for the World it is not going to be solved by addressing the symptoms. **Bailing out the likes of Greece and Spain in Europe, or AIG and Fannie Mae in the US does not cure the illness.** It simply treats the symptom and shifts the debt from one investor to another. The bad debt still exists; this strategy merely kicks the can down the road so to speak. The bad debt will still have to be addressed, just at a later date. At the end of the day, everyone has too much debt and the investors that made the bad loans will likely not be repaid.

and the big banks actually understand it too...

We will be discussing this in future editions of our Global Markets Outlook. This brings us to **Chart 2 (below) and The Crazy Aunt in the Attic.**



while they create the Loch Ness monster...

Most are familiar with some form of the “Crazy Aunt in the Attic”. Everyone knows the crazy aunt is in the house, however for numerous reasons we don’t really want to let her out of the attic to socialize. If she is let out, the range of outcomes is vast and unpredictable. We know something memorable is guaranteed to happen, yet we have no idea what it may be. **For the global economy, the Crazy Aunt in the Attic is the amount of money that the big US banks have placed on deposit with the Federal Reserve.** For starters, it is unbelievable that she actually exists. Yet it is even more astonishing of what may happen when she is let out of the attic.

Even if one has never looked at a graph before, or simply couldn’t care what new chart is dragged in front of them, you’d have to admit that Chart 2 is unusual. What stands out of course, is the virtual flat line from the beginning of time to the abruptly formed vertical line in 2009. **In the investment business we call this type of graph a Loch Ness Monster.** Let us explain why.

In the US, the Federal Reserve (The FED) is the central bank for the country. It isn’t your ordinary bank where individuals can make deposits and withdrawals. Rather, it is THE bank that happens to set short-term interest rates for the US. However, whereas individuals cannot make deposits with the FED, very large US commercial banks can make deposits (as well as borrow if needed). In a normal economy, these banks never borrow from the FED (they can borrow from other banks at a lower interest rate), nor do they place money

on deposit with the FED (they can place deposits with other banks and receive a higher interest rate).

The key phrase here is “normal economy.” Chart 2 shows that on average, the **big US commercial banks usually hold about \$2 billion on deposit with the FED.** That was the case from 1950s to 2008. This suddenly changed with the bursting of the credit bubble and **today these same banks have over \$1.1 trillion on deposit with the FED.** Think about these numbers for a minute. They are actually quite shocking and truly deserve significantly more attention than what is currently being reported in the mainstream media.

Naturally, the question to ask is: “why, the substantial increase?” **Why would banks choose to receive 0% interest on these deposits rather than lend them out in the form of mortgages, car loans, or credit cards at 4% to 30% interest?**

Everyone is familiar by now with the US housing crisis and how prices have fallen by over 50% in the most heavily hit areas. This has resulted in one-in-four home owners having houses that are worth considerably less than their underlying mortgage. Many have lost their jobs and are struggling to make their payments. While others have used some type of exotic mortgage that has resulted in their payment doubling, leaving them unable to make payments. In the world of banking; this isn’t good. It ultimately means the bank will have to foreclose on the mortgage, take possession of the house, and then re-sell it to recover whatever they can. Quite simply it is a bad

which shows how worried they really are...

loan, which the bank has to record as a loss.

The quirky world of accounting however, says that banks do not have to realize these losses and report them until they are absolutely sure it is a loss. Accounting rule changes, and government mandates to forestall foreclosures are allowing banks to delay the inevitable recognition of these losses.

This affects our **Crazy Aunt in the Attic** chart in 2 ways. First, banks are frightened to death to make any new loans due to the expectation that many of these new loans will not be paid back. The only option therefore is to invest their money in the safest place possible – the Federal Reserve (some would argue that the FED is not the safest place to invest your money, and I wouldn't necessarily disagree with that view; we will discuss this in a future Global Macro Outlook). With the big banks doing this on a daily basis, it doesn't take long for their combined deposits to soar to the \$1.1 Trillion mark.

Second, US banks today have assumed that about 5% of their loans will not be paid back and have taken losses to reflect this assumption. This assumption however is just that, an assumption by the bank. In the accounting world, a bank can make whatever assumption it wants and it doesn't necessarily have to reflect the real world. Is this 5% loss enough? We don't think so. Every week in the US, the FDIC closes the doors of banks who have become insolvent and then re-sells their assets to the highest bidders. These loan portfolios are selling for

35 to 70 cents on the dollar. In the accounting world, this means the loans have realized 65% to 30% losses; not the 5% number being stated by the many large banks today. The big banks are very aware of this and as a result, they have no other choice but to hoard their cash at the FED; eventually the day will come when they will have to write-off the losses, and they will need cash.

Why is this a concern? If the US banks actually did write-down their loan portfolios, the entire US banking system would become insolvent. Make no mistake, this event would affect every bank and economy in the world (including Canada), not only through investment losses (investors, bond and equity alike will be wiped out) but also through higher interest rates, which will affect your ability to borrow and cause housing prices to decline. In other words, it is a big deal.

Let's take a different perspective; assume the loan portfolios are all solid with no write-downs to worry about. If you are one of the big US banks who owns a part of the \$1.2 trillion that is on deposit with the Federal Reserve, you are going to withdraw that money and lend it out. As previously mentioned, why earn 0% interest when you can lend it out to make a profit? When this money is lent out and it starts to circulate within the economy it will actually have a multiplier effect. Instead of \$1.2 Trillion hitting the economy, the impact is actually closer to \$7.2 Trillion to \$12 Trillion (6 to 10 time multiplier effect). Since the US is a \$14 Trillion economy, the impact of this much extra cash sloshing around is (to put it mildly) significant. How

as global growth starts to slow once again

significant? Let's just say the price of bread (and everything else for that matter) is going up – substantially. This is inflation at its worst.

Turning back to Europe for a minute. **The new buzzword of the month is austerity.** All countries in Europe are now embarking on a plan to reduce their fiscal deficit. Their goal is to start spending less than what they earn (what a noble idea). Austerity is just a fancy word for tax increases, pay cuts, and job losses. It will not be pretty. The Greeks have already taken to the streets. The same will happen in Spain, Portugal and Italy. If that isn't bad, just wait until the French Government tries to cut wages and jobs – it won't be pretty. **The outcome for Europe will be much slower economic growth and further loan losses for banks.** As a result, European banks will also be very hesitant to lend, not only to companies and individuals, but to each other as well. In effect, the Europeans are now on their way to creating their very own Crazy Aunt in the Attic.

Why is this important for your portfolio? The US remains the largest economy in the world by a long shot. It is 3 times bigger than #2 (Japan), and the same size as #2,3,4 combined (Japan, China, Germany). Another recession in the US will have a dramatic effect on global trade, and of equal importance it will also have an adverse effect on interest rates in other countries and currencies. And, with the debt crisis in Europe gaining steam, a slowdown there is also inevitable. **The second half of 2010 and 2011 will undoubtedly see slower growth around the World.**

It should therefore be no surprise to many that the economic fundamentals for the global economy are not very good. We know this, the Americans, Europeans, and Asians know this - everyone knows this. The policy response will be a continuation of very low interest rates, bailouts, and government spending. For an investment management perspective, this is equivalent to a green light. In a perverse sort of way, as long as the World struggles, the green light will stay on for financial markets and they should be able to produce positive returns. This will continue until some form of a crazy aunt is let out of the attic.

Our Portfolio Strategy, is to remain conservative with an underweighting in stocks and commodities, and an overweight allocation to gold, USD, and short-term bonds. This reflects our longer-term view of a troubled global economy. In the short-term however, our technical and sentiment indicators support the case for the markets to stabilize and for a summer rally to take hold. During this period we expect stocks, and commodities to perform better than other strategies and this will be reflected in our client portfolios.

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

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Thank you for sharing your time with us.