



IceCap
Asset Management Ltd.



Local heritage,
Global experience.

Our view on global investment markets:

September 2010: Vroooooom...not so fast!

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Get you're butt moving...

"I'm the fastest man in the World...I'm the fastest man in the World...but, boy I sure feel slow today."

Two full years after running faster than a gazelle at the Beijing Olympics, gold medal sprinter, Usain Bolt is feeling nothing like a bolt. His arch rival, American sprinter Tyson Gay breathed slowly, as his legs and arms swung in unison propelling him far ahead of the fastest man alive. Hundreds of viewers watched the upset in the making and asked: How? Why? What happened?

The truth be told, after running like a bat out of hell his entire life, Mr. Bolt was quite simply – *tired*. The speed to which he, and us, had become accustomed had disappeared. And let's face it, a sprinter without speed is like a burger without cheese, it just isn't good.

In the global economy, speed or velocity, is also of the utmost importance; for the World's economy to grow, money has to literally move around. **The faster money moves, the faster the economy grows.** In 2008, the velocity of money dropped like a stone (see Chart 1 next page). Since then, despite heroic attempts from the World's most powerful central banks and equally powerful governments, the velocity of money slowed even further.

If anyone can figure out how to resurrect Mr. Money, please inform your local central banker – you will not only get a high paying job, but quite possibly a Nobel Peace Prize for Economics as well.

As you can tell by now, the World is very focused on Gross Domestic Product (GDP). GDP is an economic term that captures the total value of all the goods/services produced in a country over a period of time. **You can also think of GDP as the total sales or revenues for a country.**

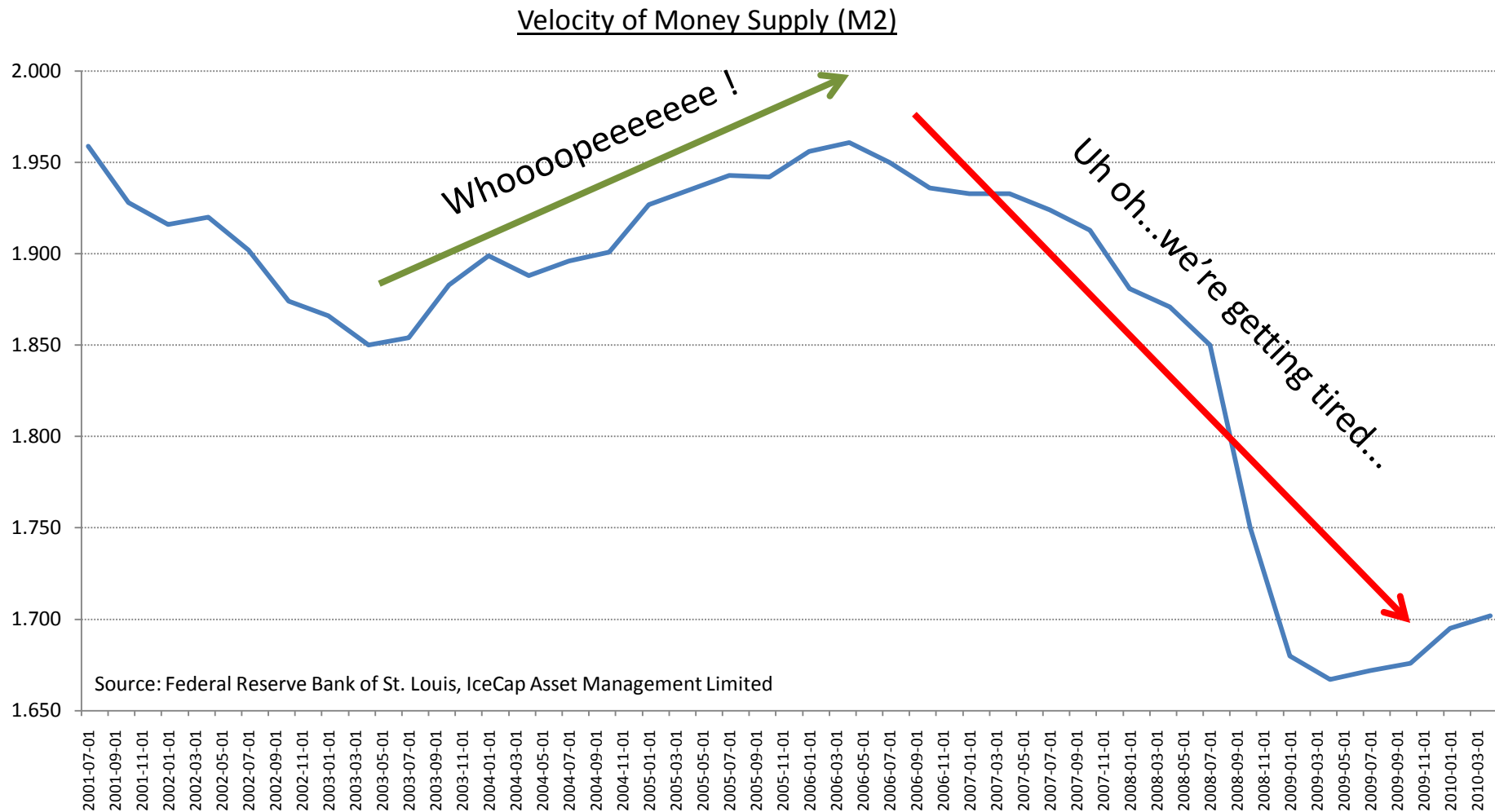
The common calculation of GDP is as follows:

- + everything purchased by **people**
- + everything purchased by **businesses**
- + everything purchased by the **government**
- + everything shipped **outside of the country**
- everything shipped **into the country**
- = GDP for the country

Simple enough. The value of all this in the USA is \$14 Trillion. To put this into perspective, the second place winner is a tie between Japan and China at \$5 Trillion each. Canada's GDP = \$1.3 Trillion. As you can see the health of the USA is very important in gauging your own economic health. If the USA becomes sick, its germs cannot be contained solely within its borders – it is just too big to be self contained. **Add Japan to the infirmary and now we're talking about a few days off school – serious stuff going on here.**

Now, another more simpler way to view GDP is = money supply * velocity of money. Basically, money supply is controlled by the central

Chart 1: Velocity of Money (2001 to 2010)



or we'll stall the engine...

banks. They can turn on the money supply tap or turn it off at will. That's the easy part, and expanding the money supply has been a key strategy by the Federal Reserve to rescue the economy. This strategy has always worked in the past, *except for now*. The other key component of the GDP equation is velocity of money. **Unlike the money supply, the velocity of money cannot be controlled by anyone, except you.**

Velocity of money occurs when you take your money to the local pizza shop to buy your supper. The pizza shop owner then takes your money and buys cheese, pepperoni and flour for his business and even a new hat to wear for the upcoming winter. The stores from which he purchased the hat and pizza supplies then uses that money to buy a new truck and perhaps a Vanity Fair magazine. And so on and so on. **This movement of money throughout the economy is referred to as velocity, and the faster it moves, the faster the economy and GDP grows.** Of course, the opposite is also true if you don't buy that pizza, velocity will slow, so too will the economy.

Returning to the original formula for GDP, the one that effectively broke down GDP across spending by people, businesses, the government, and foreigners – you will find that **while the government substantially increased their purchases, the main driver of the bus, people, has not.** In the USA, spending by the general population contributes about 70% to total GDP. The contributions from the government, businesses and foreigners are all important, but spending by the average Joe trumps all others. And, the last time

I checked, people without jobs spend a lot less than people with jobs.

We are now learning what was suspected for some time, the recent recovery in GDP was entirely supported by government spending and with the expiration of these programs we are starting to see what the true underlying growth is within the US economy. **This brings us to the latest catchy phrase amongst both the nerdy and cool economists – Stall Speed.** [Editor's note: I like to think I am a part of the "cool" camp, however most others disagree.]

Stall speed is defined as "the speed below which the airplane cannot create enough lift to sustain its weight." Note that the plane is still flying, but it cannot gain anymore altitude, nor can it slow further without crashing. With growth 1-2% growth, the US economy is experiencing *Stall Speed*.

This stall speed concept is important because we've all been groomed to think that as long as the economy's growth rate has a "+" sign in front of it all is well. The higher the number the better of course, but a recession isn't occurring until we see the dreaded "-" sign.

Unfortunately, this is incorrect. Somehow, somewhere, at sometime, someone in the US came up with the brilliant idea that it would be good to know when recessions actually started and when they ended. This would be useful information and everyone is more than happy to read about it, myself included. The organisation would be called the National Bureau of Economic Research (NBER), and their

forcing us into *Stall Speed*...

criteria for defining recessions is focused not just on GDP but also a broader and more meaningful representation of the economy. Specifically, the NBER's definition of a recession is "a significant decline in economic activity spread across the economy, lasting more than a few months" and normally visible in:

- a) real GDP
- b) real income
- c) employment
- d) industrial production
- e) wholesale-retail sales

All this makes sense and I support the process because it does paint a much bigger picture of what is really happening with the economy and how (and why) both central banks and governments are behaving as they are. This insight helps to determine an appropriate investment strategy. Whether an economy is still stuck in recession or is exiting has big implications as to how strategy is developed.

However, this is where common sense flies out the window. You see, the experts at the NBER are a tad slow with their conclusions. In December 2008, they concluded the US economy entered recession in December 2007. And, now in September 2010 these same good folks announced that the recession ended in June 2009. Unlike most other people on the planet, the NBER fully enjoys the benefit of hindsight, and uses it to the extreme. As you can see, it is very common for them to date the beginning and ending of recessions a full 6-18 months after the fact – great work if you can get it.

Table 1: IceCap's NBER defined US Recession Watch

Factor	Result	Comment
real GDP	positive	largely fueled by money printing & government spending
real income	stagnant	Still lower than before the recession started
employment	Stopped declining	Job losses beginning to stop, but strong pick up in new hires is absent
industrial production	positive	Boosted by inventory rebuilding, a bright spot for the economy
wholesale-retail sales	neutral	Improvements from the lows, but data remains weak
Conclusion:	Recession over	Employment needs to improve

Source: NBER, IceCap Asset Management Limited

To demonstrate the silliness behind this exercise, IceCap has taken the liberty to also reassess the US economy. Table 1 shows the 5 components used by the NBER to determine whether the recession has indeed ended. As you can see, collectively the 5 main factors are either improving or have stopped falling. And our final statement on to the NBER is as follows – hey guys..it only took us 20 minutes to complete this table, what took you so long?

which justifies a conservative approach

With the US economy seemingly stuck in recession or, at best, stall speed, and with the average Joe on life support – **it is highly likely that further stimulus will be used.** We will not be the least bit surprised to see further actions by the central banks, and additional stimulus measures by the politicians is also likely around the corner (just as soon as the November elections are over).

Meanwhile in Europe, cracks are starting to reappear on the edges as both Ireland and Portugal are experiencing stresses within their debt structures. **Assistance from the IMF is quite likely the next phase for them.**

On a related note, the best entertainment on TV these days is the exchange between the Bank of Japan and the European Central Bank. It's no secret that the time-proven strategy of letting your currency depreciate helps to increase exports and therefore lift you out of recession. Everyone knows this and, in currency land, it's actually a race to the bottom. However, everyone can't have a weak currency. Japan is ticked off because its currency is soaring which is very bad for their beloved Sony and Honda. They are doing everything imaginable to try to talk down their currency including asking the US and Europe for help. In a reversal of characters, the Americans politely and discretely declined to help, whereas the Europeans came out with their guns blazing telling the Japanese to mind their own business – thin skin in Europe these days! **And, to further rile up the Japanese, out of no where China began buying Japanese Yen helping to push-up the currency even further.**

But as Nic Lenoir from ICAP New York says **“At the end of the day though, a ninja's got to do what a ninja's got to do.”** For safety reasons, I suggest the Chinese and the Europeans sleep with one-eye open.

Considering all this, what will be the impact on financial markets?

All else being equal, any significant announcements of additional quantitative easing (money printing) and spending plans by the US will provide a short-term boost to the stock market, the bond market and a longer-term boost for gold. In short, it will be another attempt to kick the can a bit further down the road.

Our portfolio strategy

Our strategy hasn't changed, we remain consistent and continue to be conservative, preferring bonds over stocks and commodities. And until the debt problem is resolved, we also remain positive on gold over the long-run.

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

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Thank you for sharing your time with us.