IceCap
Asset Management Ltd.

Our view on global investment markets:

May 2014 – Wind of change

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The return of the hair band

The wind of change

On February 3, 1960 British Prime Minister Harold Macmillan addressed the South African Parliament and noted "the wind of change is blowing through the continent." This astute recognition of upcoming independence movements in Africa would become a polarising subject for years to come.

"Wind of change" was also a power ballad by the German rock band, the Scorpions. The smooth, lung gripping vocals would go on to sell 14 million copies and become the anthem for political change in Germany and the Soviet Union. Powerful stuff indeed.

Of course, as everything happens in three's, the Scorpions could be on the verge of collecting even more royalties perhaps in as little as two weeks from now. The May elections to the European Parliament are rapidly approaching and the unexpected is about to become the expected.

First a little background.

Nothing in Europe is ever simple. The political structure of the European Union is so complicated that it would make neuroscientists blush. Our June 2012 publication "Cool things from Europe" detailed the distinct lack of common sense in most things put together by the European Union.

Perhaps the best example of the absurdity behind the money eating machine in Brussels is demonstrated by the 26,911 word document stipulating the rules for selling cabbage across the old world. By comparison, the entire US Constitution with all 27 Amendments only used 7,818 words.

Politically, the European Union currently consists of 28 individual countries, each with their own democratically elected governments. Adjacent to national governments, each country also elects officials to the European Parliament. It is this European Parliament that sets the rules for selling cabbage, amongst other things.

Until recently, few cared about EU Parliament Elections. With voter turnout routinely less than 20%, the only people who really cared were those who stood to benefit, everyone else went about their own business and complained about local politics only. Brussels was irrelevant – until now.

The ongoing European debt crisis has produced wild political swings with some countries seeing jaw-dropping shifts from capitalism to socialism, and others seeing the reverse. Yet, after 5 years with no economic improvement from either political stand, people are becoming a tad restless and are beginning to search for political alternatives from the main stream parties. And the upcoming EU Elections are proving to be the perfect platform for disgruntled voters to voice their displeasure.

In the United Kingdom for example, the United Kingdom Independent

Watch it on YouTube

Party (UKIP) has just vaulted to the top of the polls. This eclectic group certainly has a few polarising views that causes anyone at anytime to turn their heads with a grimace. Yet, it is their adamant stance that the EU is a complete waste of money; draining jobs away from local lads, as well as enriching an elite few in the bureaucratic heaven called Brussels that is drawing support.

Whereas a few years ago, this group barely registered in the polls, today UKIP has claimed over 38% of voters intentions compared to just 27% and 18% respectively for the rather very traditional Labour and Conservative parties.

The UKIP party is lead by Nigel Farage and truth be told, this fella has turned into somewhat of a folk hero standing against everything the EU shouldn't be. Mr. Farage himself is currently a Member of the European Parliament and his regular and eloquent criticisms of the very organisation that pays him his weekly cheque can be found on any YouTube search. It is well worth spending a few minutes listening and watching.

Yet, once you peel away Mr. Farage, the rest of the UKIP party wears very thin with many inconsistent and insulting views. Depending upon the day of the week it may or may not even have an official party platform.

Within London, the mere mention of UKIP draws snickers and disapproving sneers. Yet, outside of the global financial super city, UKIP is very popular. It stands for the man on the street and this is the reason why it has earned space within our global market outlook.

Everywhere in the world today you will find increasing interest and coverage of the growing income inequality between the rich and poor. And this is where political parties such as UKIP capitalise.

Throughout economic history, every time there has been a severe downturn which has required hitting the reset button, main stream political parties have fallen to the wayside. It happened in ancient Rome, Greece, and China, and today's version will likely be no different.

First we must understand, that as long as you have a job and a full belly you are unlikely to express your dissatisfaction on a national level. Let's face it, after a long day at the office, and then an early evening of yard work and looking after the kids, the last thing anyone would want to do is drag themselves down to the local square to protest.

This is certainly true in Canada – the economy isn't booming or busting, everyone is simply trudging along with full bellies. Yet, in other parts of the world, and especially in Europe this isn't the case. Since money and economies are intricately connected in today's global money world, these parts of the world with growing discontent, decreasing morale and not quite so full bellies should be of interest to everyone with a bank account.

Everyone wants to leave – where will they go?

Everything is booming

The stock markets are booming, the economy is booming, and the main stream media is booming with stories about both. Yet, if one looked closely between all of this booming, one would find that everything isn't quite booming after all.

For starters, the latest Wall Street Journal/NBC poll reported 54% of respondents would vote to replace EVERY member of the American congress if the ballot option was available. Let's think about that for moment – the majority of people in the most democratic country in the world would boot out every single elected official in Washington.

This isn't exactly a booming vote of confidence.

The same poll also reported that 66% believe the American economy is on the wrong track and 65% said their representative didn't deserve another term in Washington.

But, the economy and the stock market are booming.

Shifting our attention to Europe, the big media and governments are also reporting that the stock market is booming and the economy is also booming once again – just as the governments hoped (there's that word again) it would.

Yet, if the stock market and the economy are booming why do we see:

- UK considering leaving the European Union
- Scotland voting to leave the UK
- Catalonia voting to leave Spain
- Venice voting to leave Italy
- Greece not being allowed a vote on leaving the Eurozone.

From our perspective, the only thing booming in Europe are separatist movements – no one wants to stay, except of course those who have a vested interest in the status quo.

And when it comes to the European status quo, there's no better status quoy place than France to regain control over the entire world – yes France, the bastion of the socialists movement.

A couple of years ago, we commented that France was heading up Merde Creek without an economic paddle. And that was before current President Francois Hollande was elected. Since then of course, France's economic plight has worsened to the point where an astounding 88% of French voters have absolutely no confidence in their President to turn things around.

In fact, financial conditions have become so bad in France that both the rich and the poor want to leave France – and both for the very same reason.

The rich are leaving due to horrible economic conditions created by the French government. Meanwhile, poor French students are also

Merde Creek

leaving due to horrible economic conditions created by the French government.

On some levels, getting two distinct and economically different groups to agree on something is a sign of political success.

Of course, at this very moment President Hollande and his crack economic advisors are brewing yet another economic recovery plan to hopefully (there's that word again) kick start the economy yet again.

All we can say is don't hold your breath.

The obvious structural changes necessary include: less red tape for business, and less government workers overall. Unfortunately, there is no hope for these needed changes. Instead, the world is treated to such bizarre anti-business announcements such as restricting a company's ability to contact their employees via mobile phone or emails after the work day is over. Or better still, making limousines wait 15 minutes before they are permitted to pick-up their client.

So much for meeting those tight deadlines.

Meanwhile, Brussels is directing France to raise taxes further and to cut spending further. Of course, the only effect these austerity policies will have is to push France even further up Merde Creek.

To fully appreciate France's slippery economic slope, simply understand that the young and unemployed are writing books detailing how bad it is to live in the land of baguettes.

Unfortunately, since economic policy within France is a disaster, and economic policy across the rest of Europe is no better, we see no hope of any economic recovery.

<u>Upcoming wealth taxes and higher property taxes will only further drive private capital away. Yet, the irony is that European leaders believe their actions will help to restore investor confidence, when in fact it is doing the exact opposite</u>.

As can be expected, the very kind folks over in Frankfurt and the European Central Bank see things differently. One thing is for certain, the one-dimensional thinking of this uninspiring group never ceases to amaze us. Here at IceCap, we have consistently expressed our view that monetary and fiscal policy adopted by our governments and central banks is deeply flawed and if continued will create an economic and social storm that will dwarf the 2008 crisis.

Albert Einstein once said that the definition of insanity is doing the same thing over and over again, and expecting a different result. Considering central banks in Japan, USA, Britain, Switzerland and Europe have all warmly embraced 0% interest rates and money printing, and with each one experiencing absolutely no acceleration in economic growth, one would think someone in the meeting room

In my 30 years of experience....

would have the courage to raise their hand and question the effectiveness of these crazy economic policies.

Don't hold your breath waiting for this to happen either – why bite the hand that feeds you?

As can be expected, the people in France are now as confused as ever. When you think about it, they should be forgiven. After all, in 2007 they overwhelmingly elected Nicolas Sarkozy to President.

Sarkozy, his super-model spouse and his super-right-wing political agenda was suppose to return France to its rightful place amongst the world's elite countries. Five long years later, Sarkozy, his spouse, and his right wing views were gone and France performed a political 180 degree turn, landing squarely in the lap of the left-hugging political machine known as Francois Hollande.

Truth be told, Mr. Hollande was simply in the right place at the right time. The 2008 economic crisis screamed for political change everywhere – his campaign platform simply adopted the opposite of everything Sarkozy stood for.

Two very quick years later, President Hollande has one of the lowest approval ratings of any elected official in the history of the universe - not a proud achievement by any means.

As a French voter, you now know the political right didn't work, and now you know the political left doesn't work either – hence the confusion. Yet, when you compare France to any other Eurozone country, there really isn't that much of a difference. Sure the names, faces and numbers are a bit different, but they are all swinging in the same direction.

Now to our readers outside of Europe, this may all sound unimportant. How can the political landscape in France affect economies in Canada, America, Australia and elsewhere? This conclusion is actually 100% correct – but only if you are using economic history from 1980 to 2007.

While many market pundits and larger investment houses commonly wheel out the "in my 30 years of investment experience, I've never seen [this or that happen]...." Truth be told, the world's financial, economic and political history actually predates any Smokey and the Bandit movie.

It's our view that Investors today are facing a financial landscape that hasn't been seen during the last 100 years and likely not again during the next 100 years. The sooner investors realise that major financial turning points are in the distant future the better for their financial health.

The events leading up to Europe shedding its Euro and fiscal union will have far reaching effects around the world. Global economic growth will undoubtedly decline, European bond markets will face

With arms wide open

major losses as will their bond holders: the pension funds, insurance companies and banks. These losses of course will be initiated by private investors taking their money and running to a safer place. And it is these safer places that will provide the opportunity to both protect your wealth and provide opportunities for growth.

Of course, the reason why Europe remains mired in a deathly debt spiral is due to its illogical insistence to use more debt to cure a debt problem. To really appreciate the effect of this asinine approach, look no further than Portugal.

Portugal

In 2007, Portugal had EUR 116 billion in debt and collapsed into the open arms of the European bailout machine notoriously referred to as the Troika.

This Troika, consisting of the International Monetary Fund (IMF), the European Union (EU) and the European Central Bank (ECB), forced Portugal to accept a EUR 78 billion low interest loan, or else – Portuguese children for generations to come would have no future, so they were told.

Today, after 5 years of Troika imposed tax increases, job losses and less retirement and healthcare benefits, Portugal owes EUR 214 billion in debt – giving millions of future Portuguese children billions of reasons to be unthankful to the Troika.

Today, both the Troika and the Portuguese government have declared that financially, Portugal has been saved.

Yes, it seems that only in the mathematical fantasy land called Europe can a country be cured from a debt problem by taking on more debt, and not just a little more debt but a boatload of debt – Merde Creek style debt to be exact.

Naturally, it's at this point armchair economists insist that more debt is okay so long as you have more growth to go along with it. **Chart 1** and **Chart 2** details exactly how Portugal has faired since the generous helping hands of the Troika came along.

As for more growth, consider the following:

- 2008 Portugal's economy was growing at +2.4%.
- 2013 Portugal's economy was growing at -1.4%.

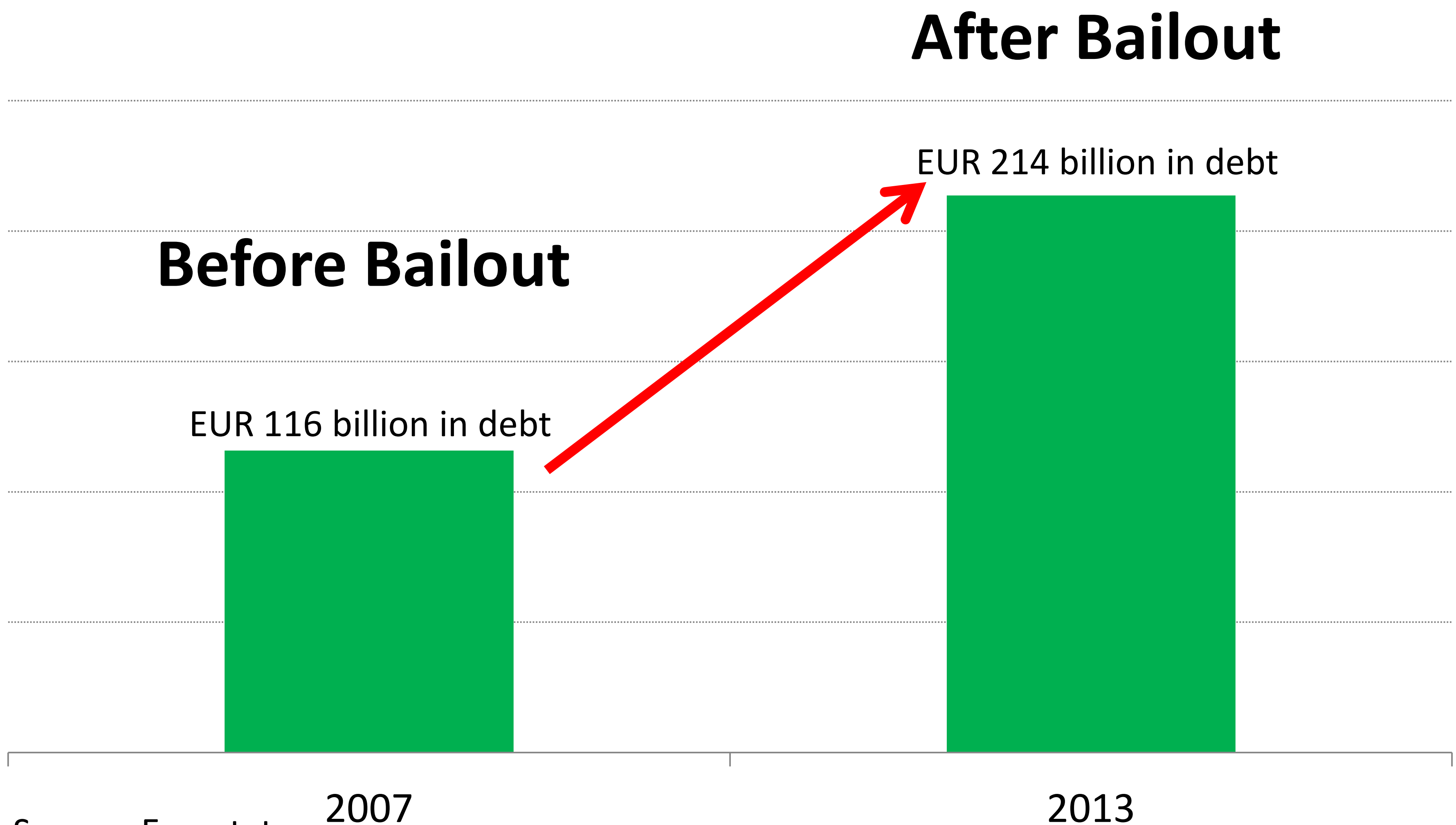
So much for more debt creating more growth.

Now this is where the armchair economists throw in the towel and rely upon the big bank economists to counter argue that growth follows employment which is getting better:

- 2008 Portugal had 5.2 million people working
- 2013 Portugal had 4.6 million people working

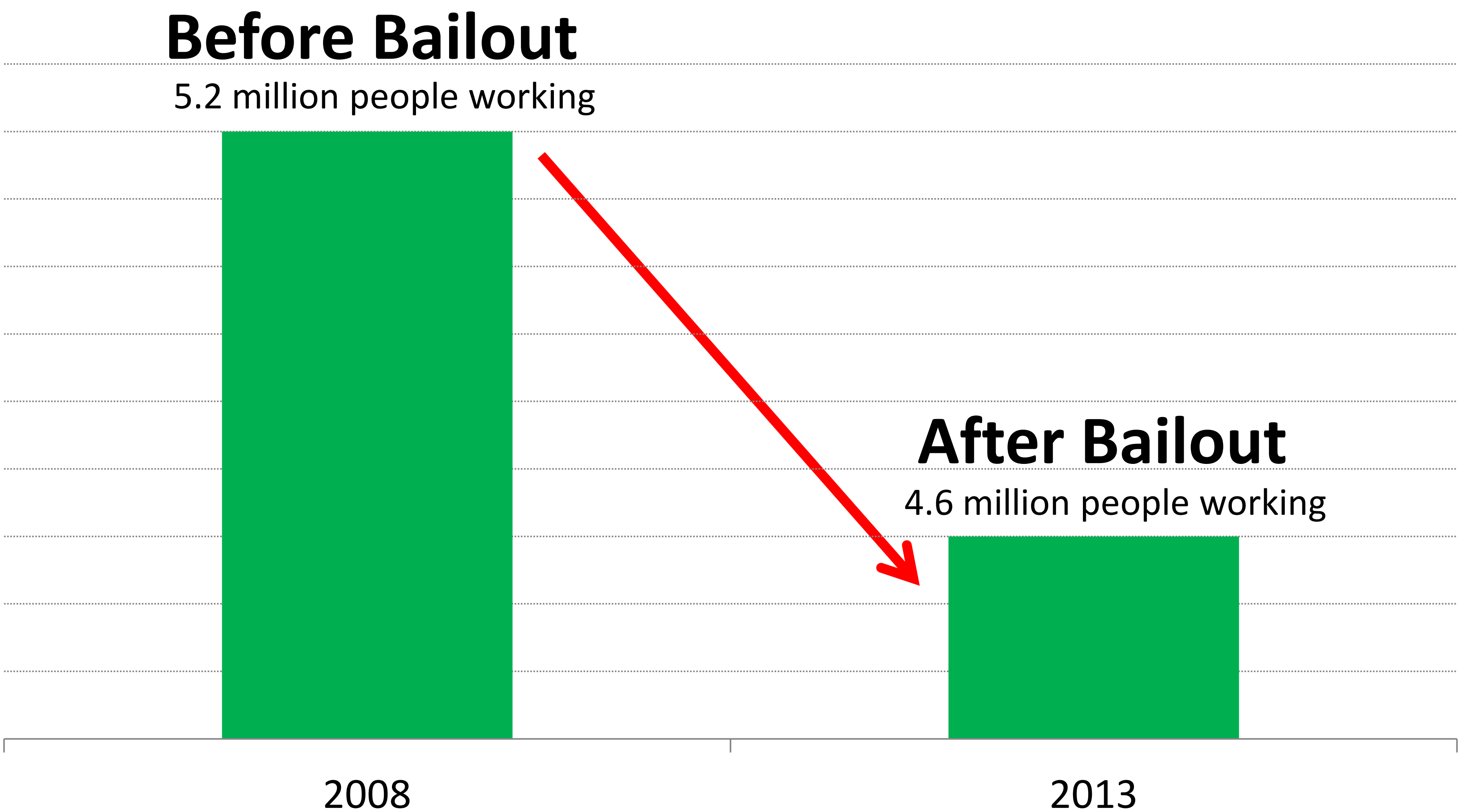
So much for more debt creating more jobs.

Chart 1: Portugal debt outstanding



Source: Eurostat

Chart 2: Portugal employment



Source: Eurostat

Debt cures everything

Of course, once the armchair economists, and the big bank economists walk away in despair, this leaves everyone's favourite global money group – the IMF, to defend their debt bullying tactics.

The conclusion from the latest IMF Review of Portugal is a hum dinger – all 94 pages of it. For starters, the message is loud and clear: if this debt bailout thingy doesn't work, it is all Portugal's fault. Yes, the IMF states very clearly that the "short-term outlook has improved and program implementation remains on track" but then adds "notwithstanding another adverse Constitutional Court ruling."

Despite all of the very good and nice intentions of the IMF, it appears that even the Portuguese courts are having trouble accepting the draconian 10% pension cuts dictated by the Troika. In fact the constitutional court concluded the required cuts were "unconstitutional" and that it "violated the principle of trust".

So much for more debt creating more trust.

As "trust" is often over rated, the Troika views this as a minor set-back. More importantly, the IMF report continues with the shocking news that Portugal "continues to confront major economic challenges".

So much for more debt resolving major economic challenges.

Apparently 5 years of recession, 5 years of job losses and 5 years of cutbacks in government services hasn't instilled confidence in people and companies to spend and hire again. We can only assume that the rumour of the Troika policy "the beatings will continue until morale improves" is true after all.

Many people don't realize that the Portuguese bailout (as was the Irish, Spanish, Italian, Greek and Cypriot bailouts) was simply a mechanism to bailout Europe's banks and insurance companies. Of the EUR 78 billion handed to Portugal, very little remained in the country. In fact, this new money was simply used to repay old loans that were coming due. Yes, new loans are used to pay old loans – Charles Ponzi would've have been prouder.

Going forward, as long as Portugal continues to spend more money than it collects in taxes, its debt outstanding will never decrease. In fact it will continue to increase until the Portuguese people say enough is enough and simply stops paying back the money it owes.

Current economic news on Portugal reports that the country has now exited European bailout programs and is once again able to borrow money on its own. In fact, today you can buy a Portuguese Government Bond that will pay you about 3.5% a year in interest over the next 10 years.

But wait, there's a catch – *there's always a catch*.

Whatever it takes

This 3.5% yield is implicitly guaranteed by the European Central Bank (ECB). Remove this guarantee and you can add another digit in front of the "3" – yes, that's the power of a money printing machine.

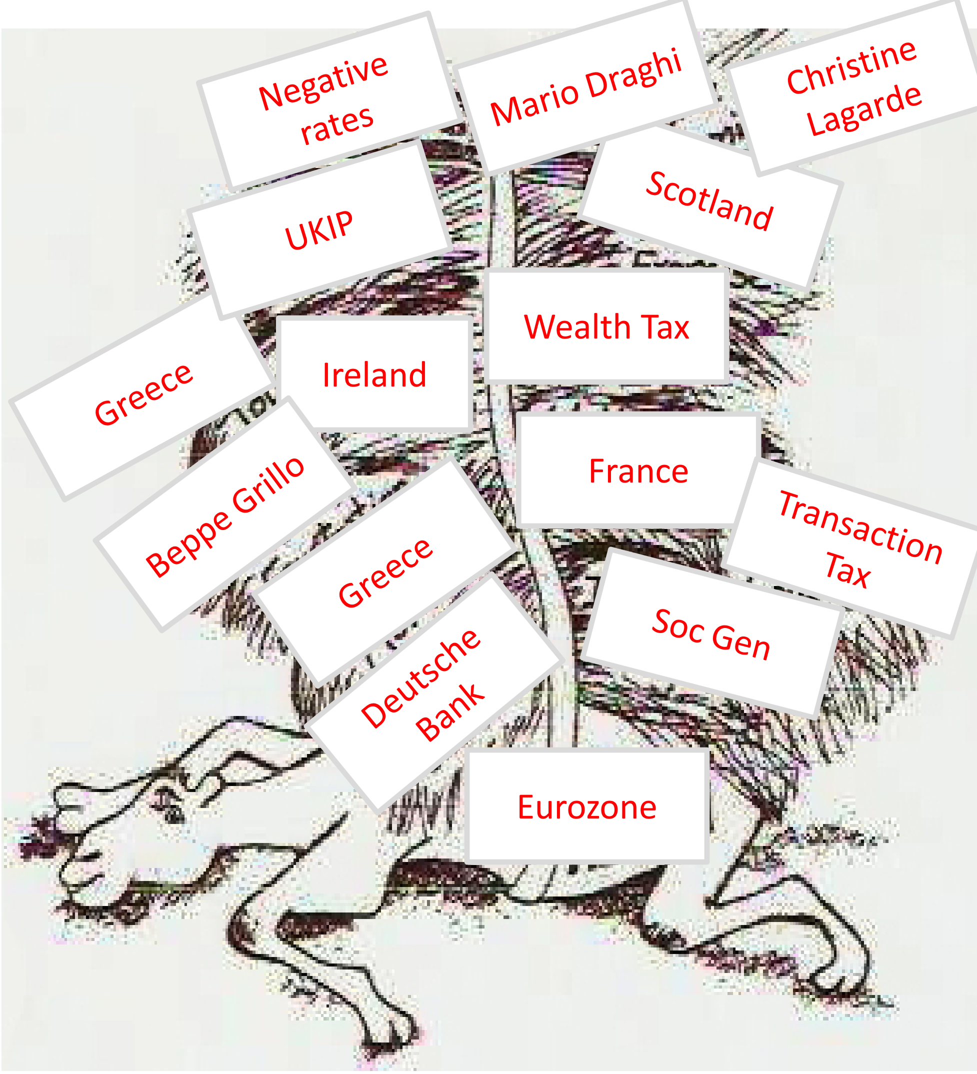
In 2012, the ECB famously announced it would do whatever it takes to defend the Euro. As odd as it may sound, if Portugal (or Greece, or Italy or anyone else for that matter) left the Eurozone, the Euro would likely collapse. This is the nightmare that keeps the Troika awake every minute of every night.

As such, it goes without saying that investors buying these shiny new bonds from Portugal are making a wager that the Eurozone stays together. It should be very clear that current governments in power and current policy makers – and we stress "current", completely support this stance. The reason IceCap is telling you this story is due to the fact that current governments are slowly losing their grip on power in society.

We are very confident that it is only a matter of when – not if, the Eurozone breaks and the breaking will be caused by either a planned election or a grass roots social movement to force change.

Now, there are numerous straws that can break the European camel's back – simply close your eyes and pick one. The point being, despite umpteen different bailouts, followed by umpteen different stimulus programs, neatly delivered by umpteen different election promises – current European governments are increasingly becoming less enamoured by its voting citizens.

Which straw will break Europe's back?



The Moody Blues

Current Markets

Depending upon which day of the week you purchased stocks, you may be up or down for 2014. Yes, it's been a topsy-turvy year already.

Yet unknown to many, an unusual and perhaps disturbing fact has emerged during the first 4 months of the year – the only day of the week that has seen the stock market increase on average has been Tuesday. We kid you not.

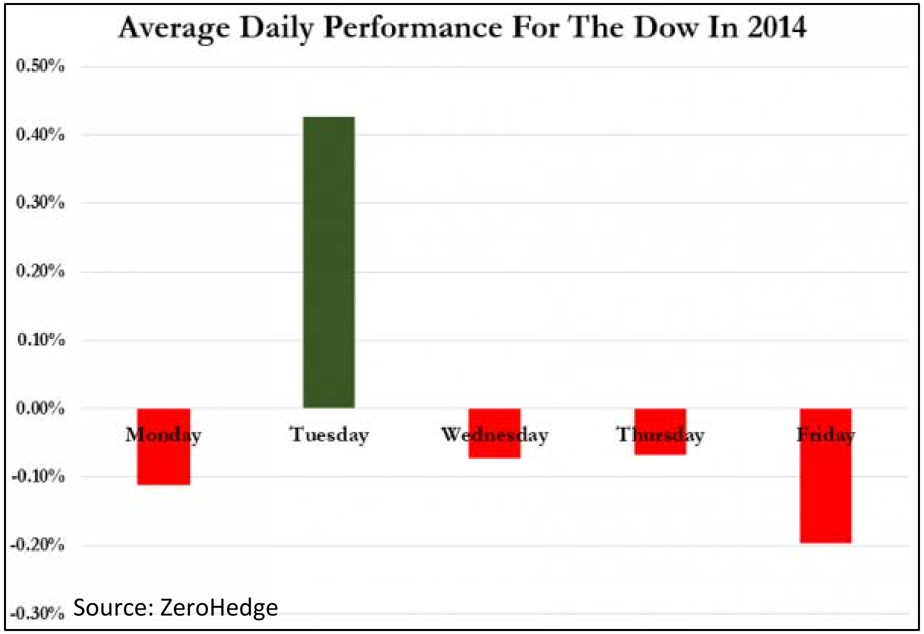
While most people are scouring the earth for the next Google or Apple, and while others are sharpening their minds to estimate next year's earnings for the entire market, and even more people are simply buying the dip (because we've been told this always works), the real easy money has simply followed the Federal Reserves' Calendar to determine which day of the week they would be printing money.

We'll let you decide the winning day.

On the other 4 days of the week, we continue to have really good conversations with people from around the world regarding current market dynamics. Recently, there's been plenty of media hype over a possible market crash and in many ways you cannot blame them. After all, conventional thinking confirms that economic growth does not support current stock market levels.

In addition, when you consider the price investors are willing to pay

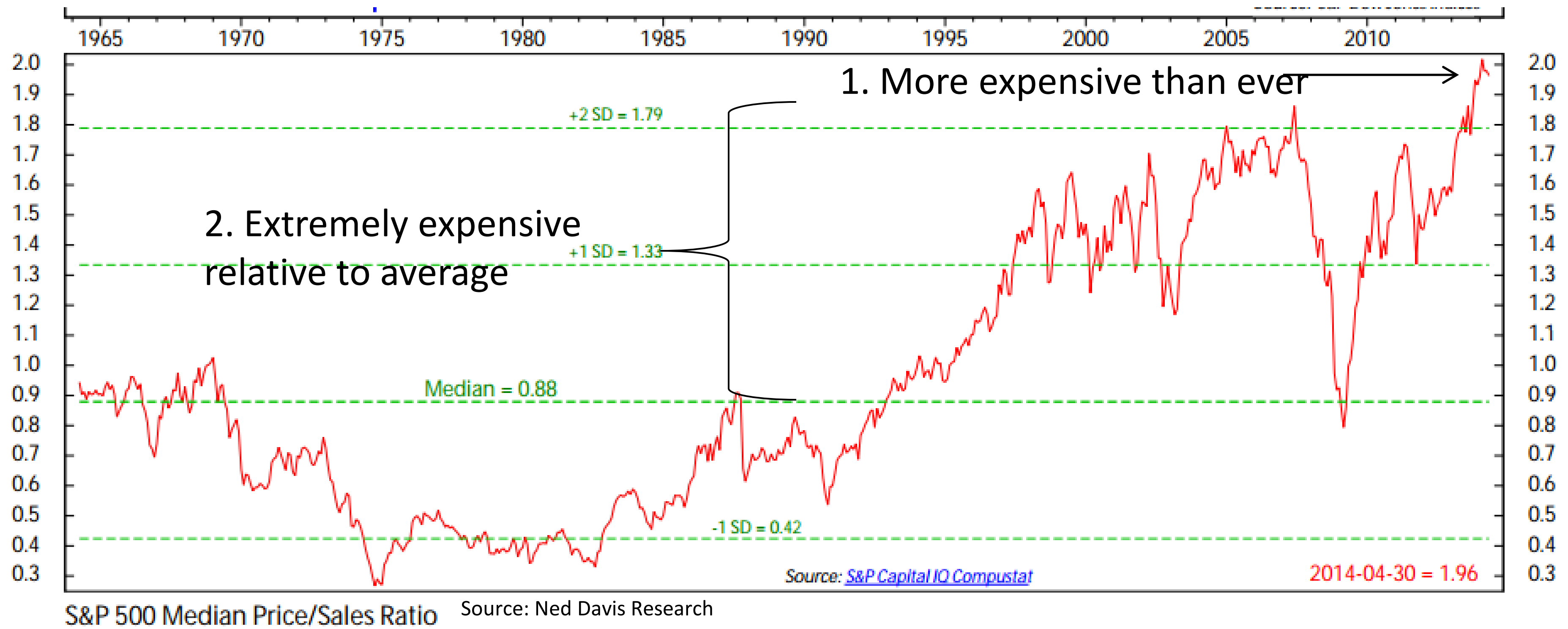
Chart 3



for current sales and revenue growth, it's little wonder investors are concerned. **Chart 4** (next page) shows the current Price to Sales Ratio for the American stock market.

While many market observers like to value the stock market based upon earnings or profits – the problem with relying upon earnings metrics for valuation models is that earnings have become easily affected by one-time charges, different accounting accrual methods as well as various smoothing techniques to reduce earnings volatility. In short – earnings are not always what they appear to be.

Chart 4: S&P 500 Median Price to Sales Ratio



Source: Ned Davis Research

One way to get around this valuation challenge is to rely upon good 'ole fashion revenue or sales numbers. It completely filters out the accounting noise and really provides a good view as to what is really happening at a company.

Using this metric in the above chart, two things should jump out at you immediately. First of all, American stocks are more expensive today relative to any other period shown in the study.

Secondly, today's valuation is over 2 standard deviations from the average valuation. In other words, stocks are not only expensive, but they are really expensive.

So, should investors be worried? The answer – yes and no. Yes, in that current markets are certainly due for a correction. Markets move in ebbs and flows and it's really only every now and then they are truly at fair value or truly represent the current state of the economy.

1,277 reasons to fear a market correction

That may sound odd, but markets will always overreact to both good and bad conditions – the trick is to understand the conditions driving current markets.

Today it is fact that we haven't seen a 20% market correction in the US market for a very long time – 1,277 days to be exact.

Mean Market Days Without Corrections			
	5% (Clip 2)	10% (Clip 3)	20% (Clip 4)
Secular Bulls	84	331	1105
Secular Bears	31	91	486
All periods	50	161	635
Current Case	66	628	1277

Source: Ned Davis Research

While a 20% market decline may sound rather harsh, it actually happens more frequently than you'd think. During Secular Bull Markets, we usually see 1,105 days before the dreaded 20% decline. Whereas Secular Bear Markets only manage on average 486 days before the 20% tumble hits.

Now, the situation isn't really that much different in other parts of the world either. Canada has journeyed 493 days without a 20% slide, and our **Chart 5** on the next page details the situation in Europe and emerging markets.

Within Europe, the United Kingdom has gone a mind blowing 1,307 days with a 20% correction. Maybe Mark Carney and the Bank of England have figured out how to completely eliminate the business cycle after all. Regardless, anyone with money invested in UK stocks should be prepared for a downturn – it's only a matter of time.

Elsewhere in Europe, the majority of national markets experienced their 20% decline less than 2 years ago. As all markets are positively correlated, a sharp decline in the US or the UK will absolutely affect Europe as well. But in general, European markets are not as vulnerable to the correction relative to others.

Within emerging markets, South Africa, Malaysia and Mexico are all on borrowed time and investors in these markets should also prepare for a bump in the road.

Quite frankly, current markets everywhere are due for a significant decline with some likely falling a lot more than others. However, despite a rash of reasons to be fearful of the much touted market crash – conditions are not present to suggest we are on the precipice of something evil.

Both market technical data and market sentiment data have not reached extreme levels, and until this occurs the probability of the big one hitting remain low.

Market conditions always change and evolve, yet as of today we would view a 20% market correction as an excellent time to buy.

Chart 5: Days without significant correction

Europe

	Correction Percent			
Region/Country	5.0%	10.0%	15.0%	20.0%
United Kingdom	0	221	654	1307
Switzerland	95	218	687	687
Denmark	14	220	675	675
Ireland	0	0	673	673
Germany	0	485	485	672
Europe ex. UK	65	223	493	671
Netherlands	0	491	669	669
France	98	222	492	669
Belgium	63	222	669	669
Norway	62	482	482	649
Sweden	64	219	481	649
Finland	0	218	480	480
Austria	0	0	217	478
Portugal	64	215	215	454
Spain	65	222	222	453
Italy	13	217	217	448

Vulnerable to significant correction

Vulnerable to any correction

Emerging Markets

	Correction Percent			
Country	5.0%	10.0%	15.0%	20.0%
South Africa	66	228	1348	1443
Malaysia	0	683	683	1441
Mexico	39	0	228	1348
South Korea	67	226	226	683
Taiwan	66	503	503	623
India	60	182	622	622
Poland	39	0	510	510
Egypt	23	175	227	227
China	0	35	227	227
Greece	0	0	0	213
Czech Republic	39	86	208	208
Indonesia	103	103	182	182
Philippines	67	105	181	181
Turkey	48	48	48	48
Brazil	39	39	39	39
Chile	70	70	70	0
Thailand	90	90	90	0
Hungary	0	40	40	0
Russia	9	40	0	0
Peru	33	112	196	0
Colombia	71	71	71	0

Source: Ned Davis Research

Markets are still being driven by central bank policy

Our Strategy

Over the last 5 years, the world's largest central banks have flooded the global economy with unprecedented amounts of stimulus. Yet, the expected acceleration in economic growth has not occurred.

This distinct lack of flow through to the real economy, should be at the top of the list of concerns for any serious investment manager. On a regular basis, we are seeing evidence of significant shifts in economic, political and social behavior – all of which are a result of the lingering debt crisis and the responses by policy makers.

As these trends continue to increase in severity; private capital and wealth will relocate to regions and markets that are perceived to be safe havens.

Longer-term, we expect the US Dollar to appreciate considerably relative to all other currencies. We also expect stock markets and high-end real estate to absorb a lot of private capital as well.

Our research currently suggests that the stock market is due for a correction and it could be significant if it occurs. However, this would likely be the last significant correction prior to another strong run up in stock prices. As we have clearly stated before, the attraction to stock markets is not due to strong economic growth, but rather due to inherent risks in global bond markets in Europe and elsewhere.

Longer-term, we are patiently awaiting the opportunity to significantly increase our allocation to equity markets. While in the short-term, we will also remain patient and await for signals from our research to identify whether to increase, or decrease our exposure to volatile markets.

As always, we'd be pleased to speak with anyone about our investment views. We also encourage our readers to share our global market outlook with those who they think may find it of interest.

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Thank you for sharing your time with us.