



Our view on global investment markets:

*November 2011 – The Return of the Dollar*

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## We can't believe it either

During the 19<sup>th</sup> century, the sun never had a chance – the British Empire spanned the globe soaking it up 24 hours a day. Eventually, the Empire grew too big, became too bloated, and had too many interests in too many places. Its eventual decline should have surprised no one.

Next up to rule the World was America. Millions of eager immigrants flooded the New World and planted the seeds which created the most powerful empire since the days of Julius Caesar. Yet as all good things must come to an end, so to will the American Empire.

While nobody is exactly sure when the transition will occur, America's bloated debt problem and unfunded future liabilities all but ensures the day will come. And when that day arrives, we are confident the US Dollar will be worth considerably less than it is today.

However, a funny thing happened on the way to USD devaluation – Europe is getting in the way. Thanks to a disastrous handling of Europe's debt crisis, Ben Bernanke and the US Federal Reserve will become the recipients of billions of Euros, Swiss Francs, British Pounds and other currencies resulting in a strengthening of the USD.

All money needs a home. And due to its status as the World's reserve currency, the USD becomes the home of choice for everyone during times of crisis. As the debt crisis in Europe rolls into Rome, everyone everywhere should fully expect the USD to strengthen as a result.

### Setting the record straight

Before we go any further, we feel it is important to share our long-term view of the USD. In short, it's going to stink. Just as Europe is facing an enormous debt problem, the US is also facing a difficult fiscal squeeze with no easy way out.

However, unlike the Europeans the Americans do have a plan to get out of their debt crisis – after all, they didn't develop into the World's sole superpower without one. Forget about trying to be like the Europeans and creating some sort of confusing bailout fund – the Americans already have their bailout fund in the form of the US Federal Reserve. Plain and simple.

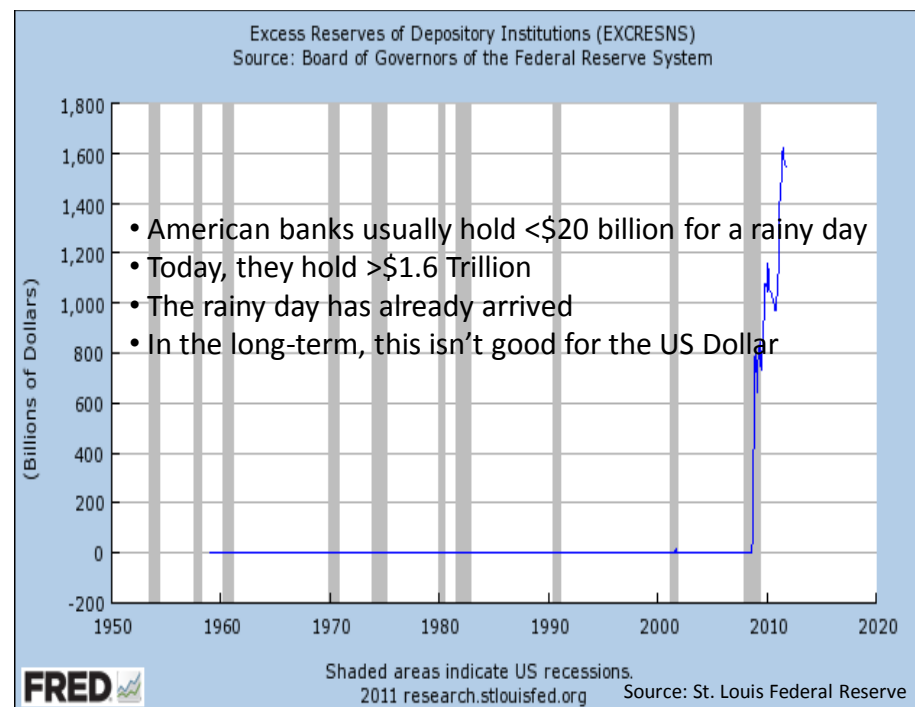
While others often say the US will default on its debt at some point, we have a somewhat different view. Yes we believe a default will occur, however it won't be the typical default whereby the US simply stops making interest & principal payments. The US Federal Reserve has the capacity to print unlimited amounts of USDs and they will use this capability to eventually make the USD considerably less than it is today. After all, a cheaper USD means America's products are cheaper for foreigners to purchase, and these cheaper goods means more jobs in the long run – and who doesn't want to work?

The alternative is to watch (in horror) as long-term interest rates rise which is a sure economy killer if there ever was one. You can bet a box of Krispy Kremes that the Federal Reserve will do everything possible to prevent that from happening. In the end, the Federal

## Chart 1: US debt outstanding



## Chart 2: Bank excess reserves at the US Federal Reserve



Reserve has been very clear with their strategy – expect plenty more USD weakening policy moves. When you consider the American's debt crisis (above Chart 1) and the condition of their banks (above Chart 2) the outlook for financial stability and economic growth is low.

At the end of the day, we see the US Federal Reserve continuing with USD devaluing policies – in their eyes, it's their only way out of this mess.

From an investment perspective, this creates an interesting dilemma for the Americans. As the US relies upon foreigners to fund their debt and deficit, a weaker USD certainly makes US Treasuries an unattractive investment – you lose on the currency.

If you lose on the currency, then naturally you need to be compensated on the amount of interest you receive. Here is where the dilemma arises. While foreigners will accept a weaker USD, they



## Plan B

will not accept a simultaneous lower yield on their investment. In effect, something has to give – the Federal Reserve cannot have it both ways, unless of course they have impeccable timing (and luck) to be implementing these policies at the exact same time as the European financial experiment implodes.

Remember, when it comes to currencies it doesn't matter how you look in isolation – it's how you look when lined up next to your neighbour. It is for this reason, we see the USD strengthening in the near-term.

### A Bailout Fund for the Bailout Fund

When it comes to Europe, everyone should know that there is no plan B. To add further insult, their plan A is doomed to fail.

The European Financial Stability Facility (EFSF) was created as a bailout fund to support countries in the Euro-zone who need supporting. Money for the EFSF is suppose to come from the countries who make up the Euro-zone, and if any of those countries are unable to contribute (think – Ireland, Portugal and Greece), then that's ok as the remaining countries will pick up the slack.

While the EUR 440 billion has yet to actually be received by the EFSF, (remember, participating Countries have “*promised*” to contribute), it has already started the process of borrowing more money to increase the size of the fund to EUR 780 billion. Unfortunately, the recent attempt by the fund to borrow was a flop. Due to a lack of demand,

the original amount of EUR 10 billion was quickly changed to EUR 5 billion. If that wasn't embarrassing enough, even that amount wasn't receptive to the marketplace.

In the end, the EFSF was only able to borrow EUR 3 billion. On Wall Street, 3 billion is chump change – Goldman Sachs can raise that amount during the 50-50 draw at their office Christmas party. Yet, Europe had to go begging on its hands and knees to China and Japan, and when that didn't fully fund the issuance, the Europeans simply lent the money to themselves.

So, what happened to the EFSF? Well for starters, the fact that no country has actually contributed yet may have something to do with it. You also might want to consider that the 3<sup>rd</sup> (Italy) and 4<sup>th</sup> (Spain) largest contributors will soon be unable to contribute themselves, leaving the bulk of the responsibility on the shoulders of the French and Germans – which we think might be a tough sell in those countries in itself.

With the recent EFSF bond issuance now history, they are now actually discussing ways to create side-pockets to help support the EFSF. In the business, we call this a credit enhancement structure – for everyone else, you may call it a “bailout fund for the bailout fund.”

Perhaps a better approach would be for the Europeans to buy back Vivendi Entertainment and turn this entire farce into a reality show –

## Chart 3: Country commitments to the EFSF

	New EFSF Guarantee Commitments (€m)	New EFSF contribution key (%)	EFSF Amended Guarantee Commitments* (€m)	EFSF amended contribution key* (%)
Austria	21,639	2.78	21,639	2.99
Belgium	27,032	3.47	27,032	3.72
Cyprus	1,526	0.20	1,526	0.21
Estonia	1,995	0.26	1,995	0.27
Finland	13,974	1.79	13,974	1.92
France	158,488	20.31	158,488	21.83
Germany	211,046	27.06	211,046	29.07
Greece	21,898	2.81	-	0.00
Ireland	12,378	1.59	-	0.00
Italy	139,268	17.86	139,268	19.18
Luxembourg	1,947	0.25	1,947	0.27
Malta	704	0.09	704	0.10
Netherlands	44,446	5.70	44,446	6.12
Portugal	19,507	2.50	-	0.00
Slovakia	7,728	0.99	7,728	1.06
Slovenia	3,664	0.47	3,664	0.51
Spain	92,544	11.87	92,544	12.75
<b>Total</b>	<b>779,783</b>	<b>100</b>	<b>726,000</b>	<b>100</b>

Source: European Financial Stability Facility

they would make billions in advertising alone, add a few social media platforms and then they could turn the entire show into a fund raising telethon. This has to be a better option than the EFSF.

Pushing reality aside for a moment, we're sure the EFSF people are considering what actually happens to their fund when everyone but Germany, France, Finland and the Netherlands needs to be bailed out. As Chart 3 above shows, the very real possibility of the bail out

fund needing a bailout is very real indeed.

### The Real Economy

The European economy is slowing dramatically...and how can it not? Austerity measures to increase taxes and cut spending has been either adopted or forced upon the Irish, Portuguese, Greeks, British and now the Italians and soon to be Spanish. Chart 4 on the next page shows the sudden and simultaneous slowdown across Europe.

Everyone in Europe is now expected to pay more taxes, and those who are fortunate enough to still have a job are seeing their wages reduced and benefits cut. If that isn't enough reason to avoid shopping, they also have to wade through the countless public demonstrations to even find the shops.

Let's face it, Europe is headed for a major recession and those thinking the German export machine is strong enough to pull everyone along with it – think again. German exports to the rest of the European Union is equal to 60% of their total exports. That's going to be one major drag on the revenue stream for many companies. For all of you analysts out there, be sure to sharpen your keyboard as you research which companies have this exposure – don't forget to monitor days of accounts receivables, this is where you'll begin to see the cracks in the system.

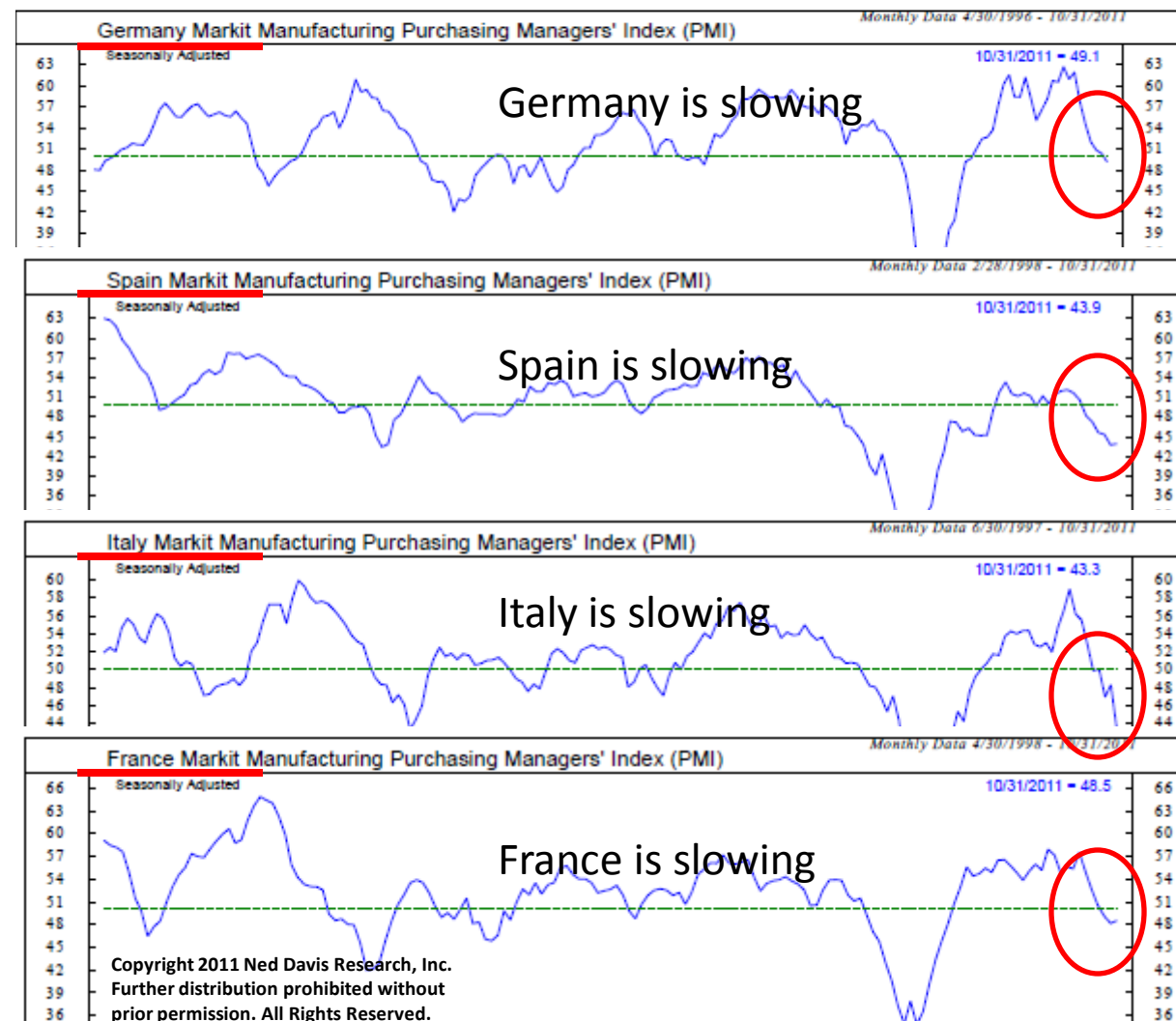
### Blame it on the Speculators

At IceCap, we are still not sure why the investment industry tarnishes





# Chart 4: All major Euro-zone economies are starting to decline



anyone who has a negative or “bearish” view on the market. We often hear investment professionals from the big banks make condescending references to competitors who are bearish. I guess if the executive investment teams have been perpetually positive or “bullish” on the market, then that could permeate throughout the organization – yet, that’s still no excuse for a lack of independent thinking and good manners.

Nevertheless, this admonishment against the bears by the media and now sovereign states is taking it a step too far. Just recently, an independent thinking analyst very publicly stated that the Canadian tree giant, Sino Forest was a sham. Initially this analyst was tarred and feathered. Today, he has been proved to be 110% correct, yet we still await the apologies this sharp analyst deserves.

The same disdain towards “bearish” views is also being effectively employed by the Europeans as a strategy to deflect attention away from the real problem. **On countless occasions we read of speculators attacking Italian, Spanish and now French bonds.** For starters, we anxiously await for these same defenders of sovereign states to



## Evil speculators

attack the evil speculators the next time a stock, despite no supporting reasons, goes to the moon - just a subtle reminder that speculation can go both ways.

As we know by now, recently the prices of bonds issued by Italy, Spain and France are dropping like a stone (note that when bond prices decline, yields rise). And once again, we hear of the bond speculators as the #1, #2, and #3 reasons for blame – nothing is mentioned of the rising debt burdens and increasing inability to make interest and principal payments.

**This of course is nonsense. The Europeans have made it illegal to short sell anything. They've also effectively made the trading of insurance (Credit Default Swaps) against these bonds worthless. Let's face it – evil speculators are being shut out of European bonds.**

The real perpetrators are those pension, mutual and insurance funds that are selling these bonds before they fall another 30%. How dare they meet their fiduciary obligations to their clients.

Blaming others of course is a timeless strategy to deflect attention, and it shouldn't be any surprise that it is being utilized again in Europe. It is always easy to blame the "bears," however just as Sino Forest was uncovered for what is it, we are confident the European debt crisis will also show its true colours very soon.

### Isn't it ironic

1990s rock star, Alanis Morissette's hit single "Ironic" is quickly becoming the new anthem in the dark corridors of Wall Street and across Europe. After all, it only seemed like yesterday when capitalism ruled the World and Thomas Friedman declared the World to be flat. Government involvement only created inefficiencies – let the private market determine what goods and services were wanted and at what prices for which they would be sold.

Fast forward to today, and these same champions of private enterprise are screaming and begging for more and more government intervention. Without ongoing bailouts, subsidized interest rates, credit support, and funky witchery from central banks the World's inner power circle would fall off the end of their beloved flat earth.

In the investment business, we often talk about the Efficient Market Hypothesis – considering all the interventions from the World's central banks, we are a bit puzzled how anyone could use the words "efficient" when analyzing today's financial market.

A brief visit to the central bank hall of fame will notice:

- US rates at 0%, and long-term rates at 2%
- Portugal, Ireland, Italy, Greece and soon to be Spain unable to borrow from private investors
- Switzerland wasting billions to keep the Swiss Franc artificially low
- Japan printing zillions to keep the Yen from appreciating

## The World isn't flat after all

- Bank of England printing money to keep their rates low
- Bank of Canada using good 'ole moral suasion to maintain the status quo amongst the central banking World.

Without central bank intervention, we envision:

- US long-term rates at 6-8%
- Portugal, Ireland, Italy, Greece and Spain defaulting on their debt and a corresponding collapse of the Euro-zone
- Swiss Franc 50% higher
- Japanese Yen 50% higher
- British long-term rates 8-10%
- Bank of Canada fading off the World stage

Considering the above, maybe it is better to be controlled by big brother. Oh and by the way – the World is round, not flat.

### Missing the Point

The loudest, most resounding perspective being communicated today is that the World is not doing enough to save the Euro-zone. Of course, we've seen puny isolated initiatives to first save Ireland, then a band-aid wrapped around Portugal sandwiched by several bailouts of Greece – yet none of these have worked to stop the debt disease from spreading.

And now the unthinkable has happened, the private sector is refusing to lend to Italy. This is BIG news. Italy has borrowed over EUR 1.6 trillion, it makes Greece insignificant. They need to borrow to pay

their daily bills and they need to borrow to pay back debts that are coming due. If Italy is unable to borrow, a lot of people lose money – a lot of money.

With this background, we can see why the average person is only presented with one perspective – Italy and Europe must be saved. One must understand that Italy's debt (and Ireland, Portugal etc) is someone else's investment. If Italy fails to repay money it borrowed, the person who lent them the money must take a loss. This of course is the overriding reason for the ongoing bailouts in Europe, it isn't to save Greece and Italy, it is to save the investors who lent them the money in the first place.

However, being an equal opportunity investment manager we must consider the only alternative of this “Euro-saving plan” is the “not saving the Euro plan.”

In this alternate time-line, the whole of Europe would become a little Greek. The average Greek is suffering today. Regardless of whether it is their own fault for living beyond their means, we must understand what happens within a country when it is on the verge of financial collapse.

For starters, money flees. Every Greek with a head on their shoulders is withdrawing their money, stuffing a bit under their pillow and sending the rest to Switzerland and other safe havens. Companies cannot get credit to pay its suppliers and employees, government departments also face a cash crunch and cannot provide services. International trade trickles to a halt as foreigners are reluctant to



## The barbaric relic

pass along their goods in exchange for a real nice IOU.

These scenarios are happening now in Greece and very close to happening next in Portugal and then possibly Italy & Spain should their cost of borrowing increase much higher. It's at this point Germany calls the US (France will be completely left out at this point) and then we get to see the final hands from all involved.

### The ugliest duckling

Our affection with the USD in the near-term is only due to it being the prettiest of the ugly ducklings. There is a solution to this currency stand-off and that is gold.

Yes, traditionally gold has been lumped in with coal, oil, copper and other economically sensitive commodities. Yet, over time gold has managed to exhibit the ability to move with commodities during the good times but disconnect during the down turns (see Chart 5 next page). This highly desirable characteristic has proven quite powerful especially during the commodity bull market as well as during the extreme market declines since the rise of the American subprime crisis.

Although it has long been forgotten, once upon a time every major currency was backed by gold. This was a good thing because the only way for a central banker to create more money was to ensure he also acquired more gold. This counter balance proved to be the ultimate compliance department for the central banks, until that is they decided to abandon the gold standard and the prudent monetary

principles attached with it.

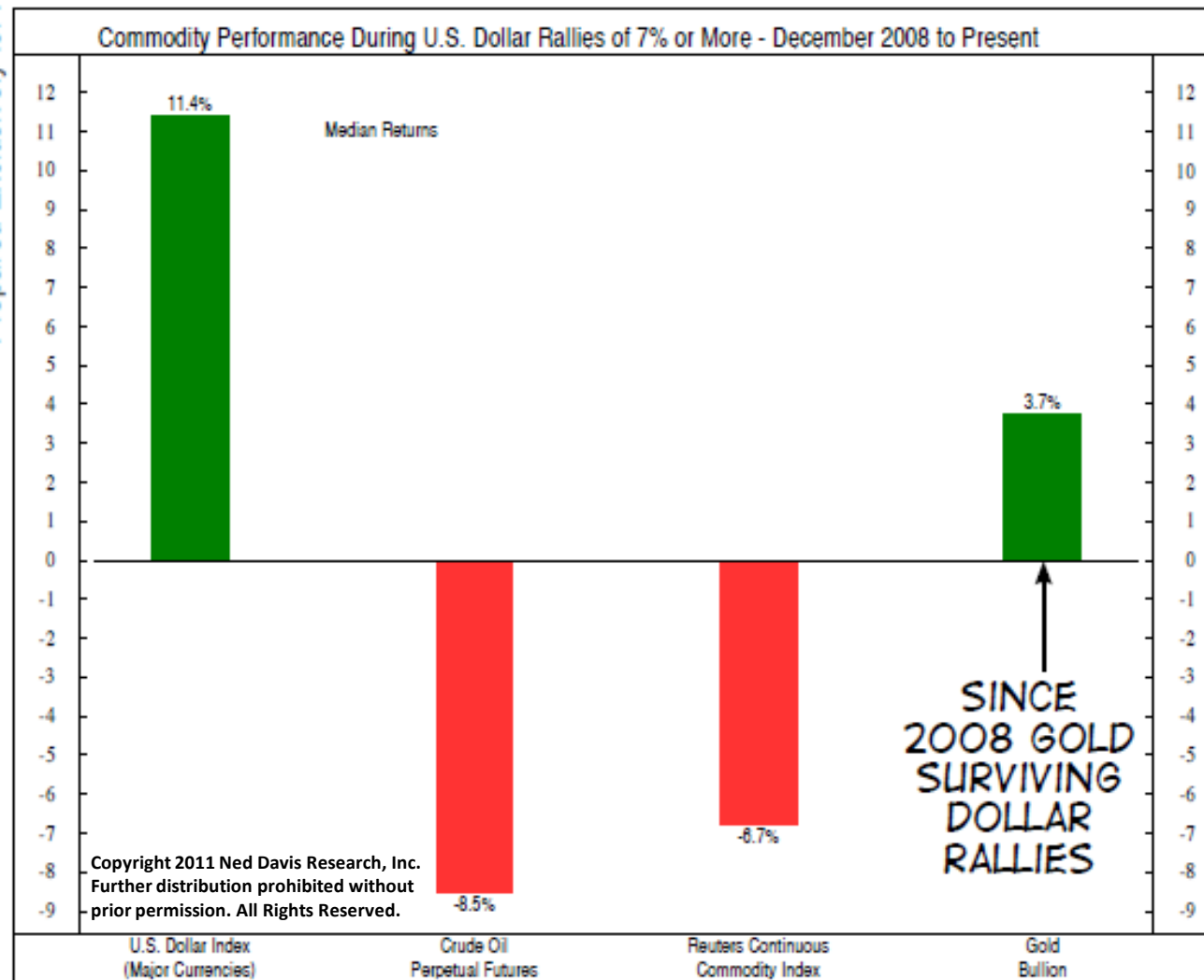
Despite the protests from everyone who believed in gold, economies around the World actually shook off its funk and used debt to fuel their way to prosperity. All the while this was happening, gold and its followers sat patiently and waited and waited for the debt machine to explode.

The rest is history of course. Chart 6 on page 11 shows the performance of gold relative to USD, JPY, EUR, GBP and CHF. Our point is that considering the disarray caused by the current debt crisis and more importantly the fairly predictable reactions by the major central banks, gold should be viewed as a currency alternative and not a commodity.

Yes, this barbaric relic does not pay dividends and interest, nor does it make any cool apps for Apple, but we'll tell you something else it doesn't do: gold doesn't have anyone in charge telling it to do stupid things, gold doesn't have the ability to double or triple its size with the flick of a switch, and most importantly gold is not backed by the taxing authorities of any sovereign state. No one controls gold and during the current economic environment, this is a good thing.

While we do not know when this debt crisis will end, we are pretty sure bad debt will be written off at some point. During this period, gold will once again likely prove to be a good way to preserve and protect your capital, and should gold once again be used to back the World's currencies the sky is the limit.

# Chart 5: Gold, commodities and US Dollar since 2008 credit crisis



- Historically, gold has acted like the anti-dollar. When the USD decreased in value, gold soared and vice-versa.

- However, since the beginning of the credit crisis in 2008 gold has actually held its own against a strengthening USD.

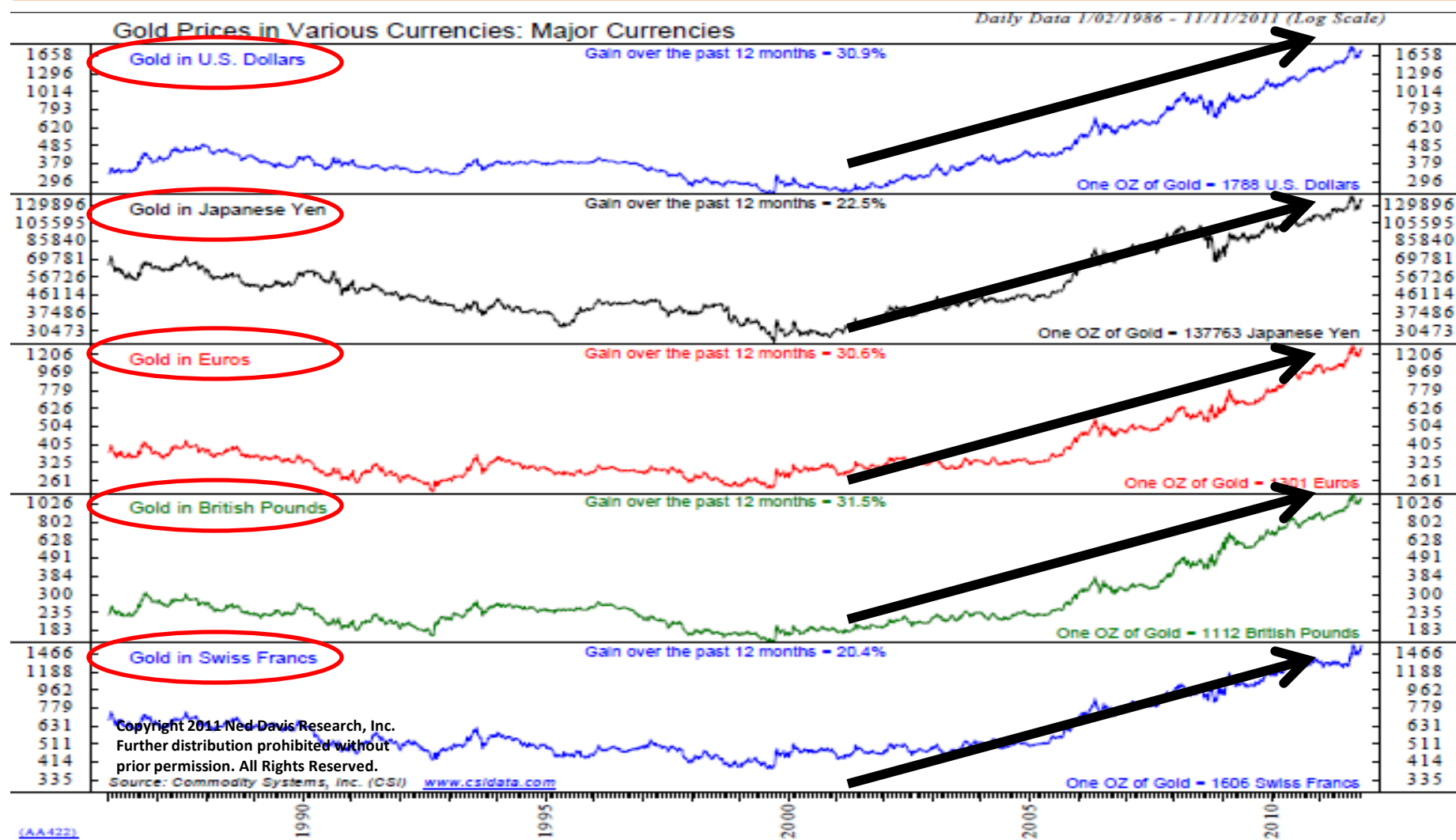
- Considering the World's 4 major currencies all have 0% interest rates and are printing money, we expect the USD and gold to outperform all other assets should the European crisis deteriorate.

- The key is to view gold as a currency and its ability to decouple from the commodity complex during times of stress.

- In other words, just because the USD can become very strong, it doesn't necessarily mean gold will plummet with stocks and other commodities.



Chart 6: During the Secular Bear Market, the BEST performing currency has been gold



## Staying conservative and patient

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### Our Strategy

Every day we ask ourselves “are we closer to a resolution to this debt crisis?” We think we are, and when it occurs IceCap will definitely change its investment strategy and outlook. We’ve written before how we yearn for the opportunity to bore clients with talk of PE ratios and dividend yields. Hopefully that day may come soon.

For that day to happen however, we expect to see a rather dramatic solution to the Euro-zone debt crisis. The solution will likely not be courtesy of a bailout friendly fund, rather it will likely be market induced. When this occurs, our clients will be very well positioned to capitalize on very good opportunities.

Coincidentally, we expect the Euro-zone debt problems to spiral beyond the control of France and Germany. This regression will be positive for the USD and ultimately result in the US Federal Reserve coming to the rescue of its friends across the pond.

At this time, IceCap portfolios across all currencies and mandates remain conservatively positioned. We are confident our patience will be rewarded.

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.