IceCap
Asset Management Ltd.

Our view on global investment markets:

July 2010: Somewhere Over the Rainbow

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The rainbow crested in the early 1980s…

July 12, 1980: Sitting at his desk as head of the US Federal Reserve, Paul Volcker decided he was going to break the back of inflation. At the time, the price of bread was rising 13%, a letter mailed to grandma was increasing 20%, and tickets to see the rock band KISS were climbing even higher. Overall, inflation was running at 13%. Mortgage rates were higher and credit card rates higher still. Let's face it, they were tough times for anyone who needed to buy money.

To put his strategy in place, Mr. Volcker began a wildly unpopular process of increasing interest rates. The first move was from 9.0% to 9.6%. Wall Street cried. Next, he increased them to 10.9%. Bond investors cried. Then to 12.8%. His Mother cried.

In the end, Mr. Volcker raised rates from 9.0% to 19.1% over an 11 month period. During this time, bond investors did not have fun, stock investors had less fun, the economy didn't party either. Yet when it was all over, inflation was dead.

Mr. Volcker gave the economy its medicine and it responded by getting rid of the disease called inflation. Having proven that inflation can be broken, central banks around the world now only had to adjust interest rates every time inflation reared its ugly head; or, if inflation was tame, they could lower interest rates to stimulate growth. Of course, a successful interest rate strategy also had to rely upon the government at the time to control its spending – spending less during inflationary times and spending more when inflation was low. Together, this combination would ensure stability in the global economy and allow central bankers to coast for the remainder of their careers. **Until that is, they run out of room to cut interest rates.**

In 1990, 747 small savings and loans banks failed. Interest rates were cut to help the economy.

In 1998, a hedge fund called "Long-Term Capital Management" (which was actually created by a couple of Nobel Prize winners) went under and had to be rescued – interest rates were cut to help the economy.

In 2001 the technology bubble popped, and interest rates were cut to help the economy.

However, instead of quickly restoring interest rates to a higher level, the Federal Reserve left them at 1% for a long time. Long enough to create another bubble, one so big that when it burst it would have disastrous effects.

From 2002 to 2007, cheap and easy access to money fueled the credit bubble, which also fueled the housing bubble. The credit binge was full on and it was too late to soften any blow from its ultimate demise. **After the credit bubble burst, interest rates were cut once again – this time to zero percent.**

From the mid 1950s to today, interest rates have followed the arc of a rainbow. From 1% in 1954, up to 19% in 1980 and then down to 0% (see Chart 1 on the next page). We ask ourselves: are zero percent interest

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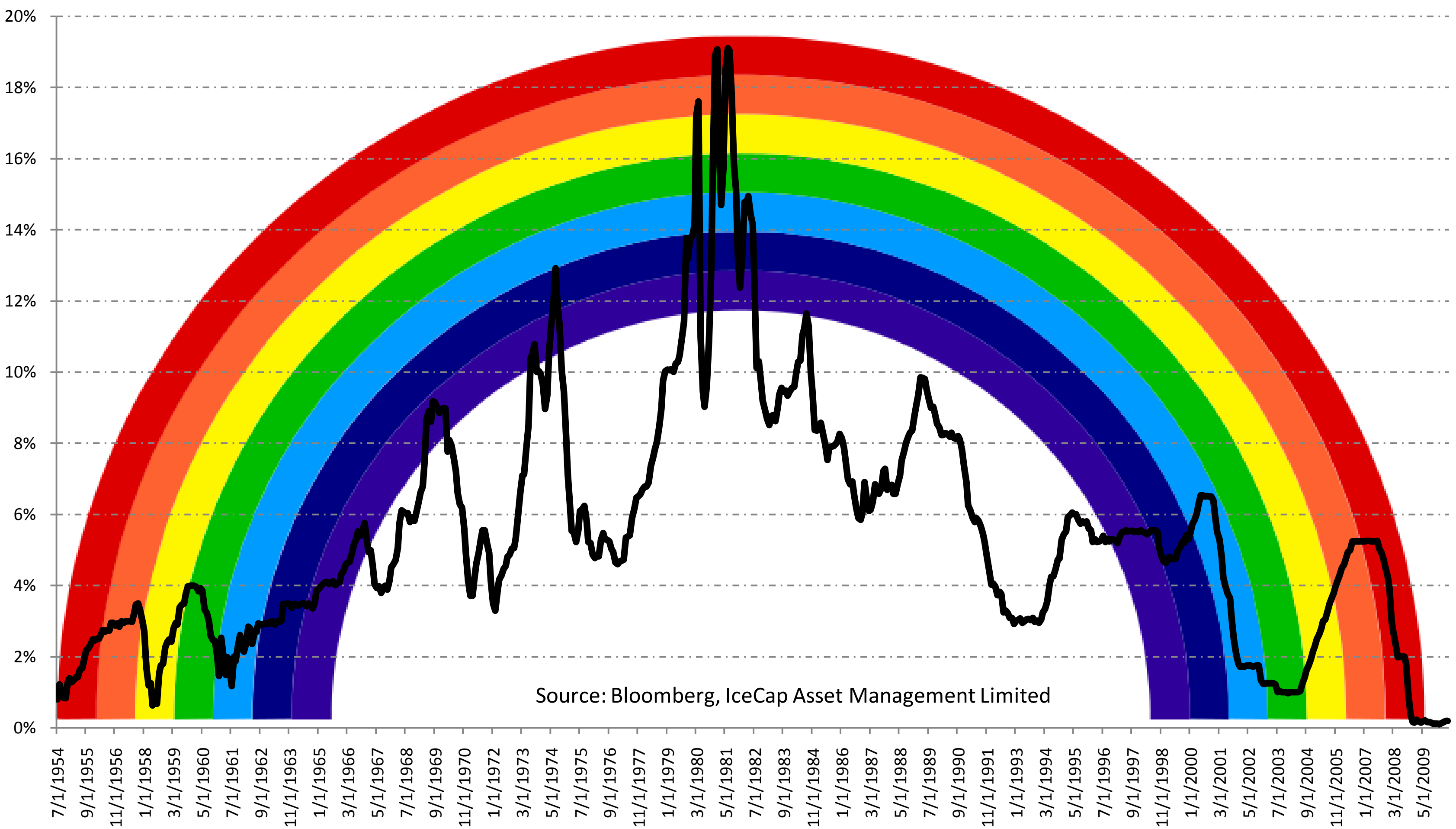
and has slowly grown to complete its form to zero %...

Chart 1: US Federal Reserve Effective Funds Rate

1954 to 2010 (monthly)



meanwhile, people & countries have accumulated too much debt...

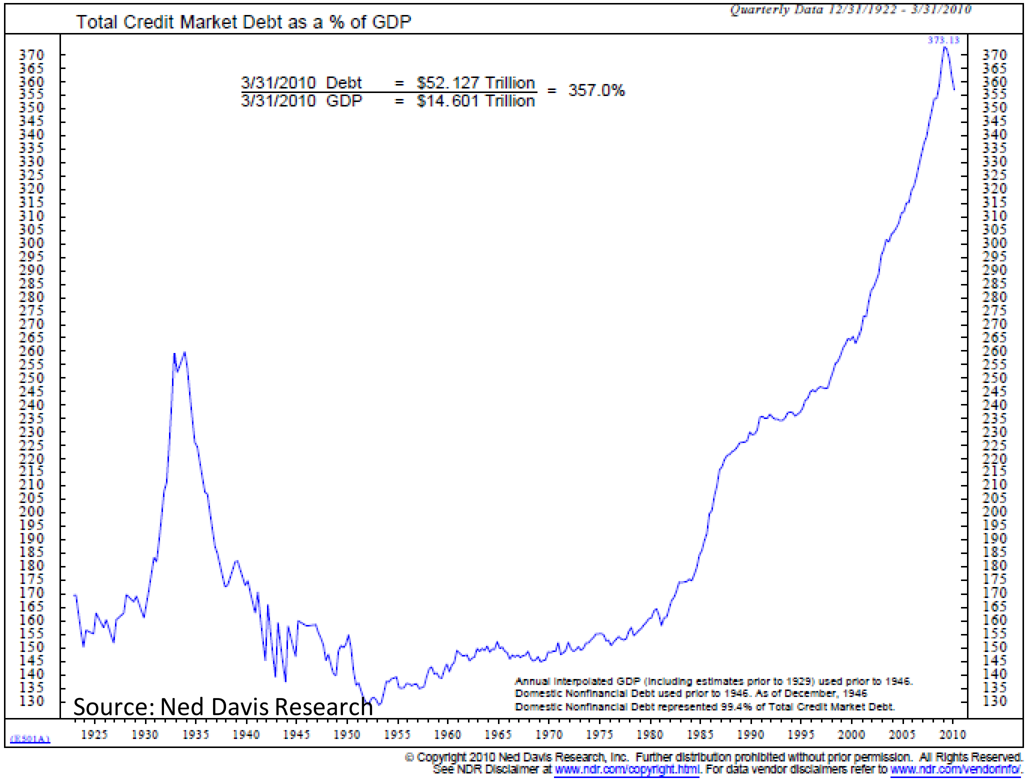
rates significant, what may be at the end of this rainbow and how do we invest our clients' money?

In its basic form, 0% means investors earn a big fat donut for keeping their money in a savings account or term deposit – in reality, **central banks are forcing us to invest elsewhere, or alternatively to spend our savings.**

As we discussed in our **[June 2010 Outlook "The Crazy Aunt in the Attic"]**, the global economy is in a tough spot right now. The Crazy Aunt hi-lighted the reason behind the enormous cash reserves held by banks at the US Federal Reserve, despite the banks earning next to nothing on these deposits.

When we consider the amount of American debt outstanding, the 0% interest rate becomes especially significant. **Chart 2 shows the total amount of debt outstanding in the US relative to the their GDP.** This chart looks the same for the UK, Japan and Europe as well. Simply put, there is too much debt outstanding in the world and we have now started a period of de-leveraging; or paying back our debt.

Chart 2: US Total Credit Market Debt as a % of GDP



There is nothing wrong with tightening the belt and paying down debt. Yet, when everyone is doing it, the aggregate effect is reduced consumption. This is tricky for the economy because consumers are suppose to consume – without this, global growth slows. Due to the bursting of the credit bubble, the resulting precarious state of many banks, and all of this de-leveraging, our world leaders have become a little concerned.

To really understand the situation, we have to think like a central banker. We have already mentioned Paul Volcker as once being head of the US Federal

which should cause us to see what is at the end of the rainbow…

Reserve; Alan Greenspan also held the position, and now it is Ben Bernanke. **While all of these guys earned their stripes for watching inflation, the real threat that will keep them awake at night is deflation.**

Currently, virtually no country on the planet (except for the Japanese) has ever experienced deflation. Plainly, deflation is when prices go down. Think hard, when was the last time anything really decreased in price? At first you may say this is good – when stuff becomes cheaper it is better for my wallet. Sign me up for deflation. Yet, deflation rarely happens, and when it does it is a terrible mess to clean up.

Japan has been trying to clean up their deflationary mess since 1990 – and they've yet to succeed. **It is so hard to overcome that current Fed Chairman, Ben Bernanke announced that if deflation was about to take hold, to encourage spending he would fly around America and drop money from a helicopter.** Imagine that; the most powerful person in the World (from an economic perspective) would actually fly around in a helicopter and throw money out of the window. Desperate times indeed. So desperate that to this day, **Mr. Bernanke is referred to as Helicopter Ben.** You can't make that up.

The reason he wants to drop money from a helicopter is because once the thought of deflation begins to sink into the psyche of the masses, spending is postponed indefinitely. The expectation of deflation forces people to ask: "why buy that TV today when I know it's going to be $100 cheaper next month?" Next month rolls along and you ask the same question – with the result of once again postponing the purchasing decision. How do you get out of this downward spiral? **We know that merely cranking up the money printing machines isn't solving the problem.** The solution lies within the banking system itself. Just as Japan has refused to force her banks to write-down bad debt, so have the Americans, the British, and the Europeans. If they do write-off bad loans, it won't be pretty. If it doesn't happen it won't be pretty. Two "not pretty's" equals one ugly.

With the interest rate weapon gone, the only other powerful choice is quantitative easing. What the heck is quantitative easing? **In economic terms it is printing money. In every day street language it is equivalent to wetting your pants to keep warm.** The short-term effect may be ok, but the longer-term effect isn't the least bit comfortable.

As for Mr. Bernanke he wasn't kidding about making paper airplanes out of cash; "the US just celebrated its 234th birthday and yet over 50% of their money supply was created since Helicopter Ben took over the flight controls 4 years ago"*. **That's one pair of wet pants.**

With interest rates at 0% it's quite obvious that the next move can only be up. The question is when does it happen? Our forecast is that unless there is a financial accident, short-rates will not be going up significantly anytime soon. Global growth, consumer demand and the slack in the economy warrants an extended period with zero rates. A 'financial accident' could be a collapse of a bank or currency, or a

* David Rosenberg, Gluskin Sheff

where you'll find some gold

sudden spike in oil prices; any of these events could force a central bank to raise interest rates to defend their currency or tame inflation expectations. All else being equal, it is unlikely that you'll see interest rates rise substantially in the near future.

Our Portfolio Strategy

Are we pessimists? No. Are we optimists? No. Rather we like to say we are realists. The difference being we will adjust our view when the evidence warrants such a change.

The combination of 0% interest rates, money printing, excessive deficits, and suspect banks make the range of outcomes wide and varied. Believing that we are witnessing a normal economic recovery is delusional. **With the World's 4 largest currencies trapped in economic hell, gold should be a major component of most investment strategies**. Gold is the ultimate store of value and insurance policy, and has proven to be a terrific asset in times of market uncertainty. After all, isn't that what you would expect to find at the end of a rainbow?

This doesn't mean we avoid stocks, commodities or bonds. Markets never move in a straight line, and we anticipate a lot of opportunities to benefit from market volatility.

Currently in our portfolios, we are underweight in stocks and commodities, while preferring bonds over cash. Currencies remain at a neutral weighting.

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.