

Europe and the Economics of the Cube

Arnold Toynbee: “Civilizations die from suicide, not from murder”

Investment Update

Looking Back on 2011

The year 2010 will go down in modern history as the year in which the major central banks proved that if you print enough money (aka: quantitative easing) you can buy a little more time and put off the effects of a global debt crisis. The reality: we exit 2010 with more debt than we began. The toxic assets created during the last decade still course through the veins of our global economy. Most remain unrecognized by our accountants, who mark almost nothing to market anymore. As a result, very little debt has been written down and even less has moved into stronger hands via debt restructuring. Bank balance sheets in most developed countries are still loaded with distressed loans; pension funds and insurance companies are holding too many assets that are overvalued and are in need of a serious haircut.

When diacetylmorphine (aka: heroin) is injected into a body experiencing pain there is an immediate feeling of ease and a significant reduction in pain. Regrettably, further injections of heroin lead to increased tolerance which in turn leads to physical dependence and then finally, to addiction. Beyond this point further injections, in time, kill the patient. The money printing, dishonest accounting, record low interest rates and enormous fiscal deficits are killing the economy. These subcutaneous stabs are all short-term actions that exacerbate the debt problem and merely punt it into a rapidly approaching future.

Let me be candid! The irresponsible printing of money by the US Federal Reserve, Bank of Japan, Bank of England, Bank of China and the European Central Bank does nothing to solve our debt addiction. Worse, the printing of money aids and abets poor investment decision by individuals, corporations and governments. Why are central banks pursuing such debauched policies? There are at least 5 reasons given for this short-termism.

First, the expansion of the money supply far in excess of the underlying growth rate in the economy is inflationary, creating more money to chase the same amount of goods and services. A debt addicted economy “needs” inflation to support its addiction since it allows debtors to pay off their debts with devalued currency. In the end, this is simply a transfer of wealth from creditors to debtors and a form of theft. Central banks have a history of pursuing inflationary policies.

Second, the printing of money allows the central banks to buy securities in the open market. The large scale purchase of securities lifts the price of the asset the central bank is purchasing. In the case of treasury bonds, central banks buy the bonds the bond prices rise, and this triggers a drop in interest rates. As a result, central banks are able to keep interest rates at lower than normal levels. The hope is that this will make it easier for debtors to service their debts. The largest beneficiaries of low interest rates are the biggest debtors which happen to be our governments and financial institutions. In

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the case of the government, low rates allow them to run higher debt levels, for a period of time, but make them vulnerable to increasing interest rates as we are currently witnessing in countries such as Greece, Portugal and Spain. In the case of financial institutions, low rates enhance their returns by allowing them to borrow on the short end of the yield curve at very low rates, from depositors, and lend long at much higher rates. The problem: banks profit at the expense of savers, who earn little to nothing on their deposits. Abnormal low interest rates do little to encourage the long-term formation of capital which is so desperately needed in an economy burdened with debt.

Third, governments are able to run larger budget deficits knowing that their central banks will purchase most, if not all, of the deficit. Currently the US is running a budget deficit of \$100 billion per month. The Federal Reserve has committed to purchasing \$75 billion of this each month for the next 9 months. This cannot continue without destroying the value of the US dollar. This is referred to as monetizing debt which means that budget deficits are increasingly being paid for with worthless paper currency collateralized by nothing more than “trust” in government. Unchecked, the careless monetizing of debt has always led to the destruction of fiat currencies. History has repeatedly shown us that all fiat currencies eventually go to zero!

Fourth, when central banks engage in asset purchases and hold interest rates down the text books tell us that all asset prices should increase. If home prices, stocks and other capital assets increase in value, people will feel wealthier and head out to the shopping malls! This in turn leads to a strengthening of our economy and makes everything “hunky-dory” again! The reality is that it will only

perpetuate the same cycle that hurled us into the mess we are in now! We need to stop consuming and start making long-term investments.

Lastly, central banks through aggressive purchases of assets can help push off the day of reckoning by buying the most toxic of assets and putting them on their balance sheet. Whether it is the US Federal Reserve buying toxic mortgage backed securities (\$1.4 trillion in 2008 and 2009) or the European Central Bank buying toxic Greek bonds, financial institutions can exchange their worst assets for freshly printed cash.

In each case, the rationale for printing money does nothing but perpetuate the problem. Global debt levels and entitlement promises are out of control. When we consider the staggering level of global indebtedness coupled with the massive unfunded entitlements sitting on the books of our national governments we should be infuriated with this nihilistic approach to economics. Yet, this is what we are left with today and we must be prepared!

Preparing for 2011

Looking forward to 2011 we can make a very safe prediction; the debt crisis plaguing the global economy is going to deteriorate. We as investors must be positioned and ready for a series of sovereign defaults. As investors, our goal is to turn these problems and challenges into out-sized opportunities.

We view the most vulnerable region in 2011 and 2012 to be the European Union. This does not mean that the US, UK and Japan are in much better shape! In fact, these countries are broke and borrowing money to pay

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interest on their accumulated debts which qualifies them as Ponzi scheme economies. Our focus on Europe means that we believe Europe is worse off and their runway is shorter! Let's consider some of the economic challenges facing Europe.

First, the debt levels in Europe's weakest economies, without including entitlements such as pensions and healthcare, have reached catastrophic levels. The debt levels are so bad within the weakest countries that the capital markets will not roll over their debt without charging much higher interest rates. The problem is that given the new interest rates demanded by the markets, the peripheral countries of Europe are essentially insolvent!

We can argue about the exact debt levels but, according to a recent report, the debt of the PIIGS in USD is as follows: Portugal - \$290 billion; Ireland - \$870 billion; Italy - \$1.4 trillion; Greece - \$250 billion and Spain - \$1.1 trillion. To make matters worse these weak countries own each other's debt. This creates a web of debt that is strangling the whole region. For example, approximately 33% of Portugal's debt is held by Spain. Italy owes France over \$500 billion or nearly 20% of the French gross domestic product. Germany, the "strongest" country in the European Union, is owed approximately \$705 billion from the 5 weakest countries in the Union which amounts to 22% of German GDP.

The bottom line: when you look at the European Union there is no way it can bear up under the current debt burden. To complicate matters further, much of this debt is sitting on the balance sheets of the European Banks that are largely undercapitalized. In Europe, the sovereign debt crisis is elegantly intertwined with a banking crisis! In a

previous RockLinc newsletter, we discussed the fraud that existed in the "stress tests" that were administered to the European banks this summer. We also discussed the shortcomings of Basel III. Little did we know that within five months of the "stress tests" all the Irish Banks that had passed the tests with flying colours would fail!

What the world is finally realizing is that the monetary union (sharing of a currency) forged in Europe without a fiscal union (sharing tax policies) was doomed to fail right from the outset. Despite all the warnings, the political elite in Europe rammed this experiment down the throats of their citizens with little regard for the truth or interest in democracy. It was widely known that countries wanting admission to the European Union, but were financially weak, simply lied and deceived their way into the Union. No one should be surprised by the current state of affairs.

The German's, who are footing the bill for the European experiment are now realizing that their financial assets are denominated in a currency backed by no government, no taxation system and no military! The real irony is that the euro is the ultimate faith-based initiative in a continent that has self-consciously tried to rid itself of faith!

Some economists argue that a weak euro is a great racket for Germany given its large export economy. They suggest that a weak euro is such a competitive advantage that Germany would not leave the European Union. While this is partially true, it misses a more important point. Germany has seen 1 trillion euros or two-thirds of their entire savings since 2002 leak out to fund the European Monetary Union party in southern Europe. This is not a good deal for Germany

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and more than offsets any benefit gained from a cheap euro!

Will Germany surrender its fiscal sovereignty and pay open ended transfers to southern Europe? It is interesting to note that this burden is up to six times the reunification costs with East Germany! According to the UK Telegraph, transfers to East Germany are still running at 60 billion euros per year, two decades after the fall of the Berlin Wall. Is Germany really prepared to take down its economy for the ideal of the European Union? We don't know the answer to that question, but to be honest, it doesn't matter. Either way there isn't enough equity in Europe to support the amassed debts. The bottom line is that Europe along with North America, the UK and Japan must restructure their debt. In the case of Europe, we believe this day is fast approaching. If Germany, and to a lesser degree the French, saddle their populations with the debt from southern Europe the game continues a little longer. If Germany and France say "no way Jose", get ready for some serious restructuring that will reverberate around the globe. We are prepared for the inevitable, even if our timing is off by a few months or a year.

As yields on debt continue to rise into 2011 there is a substantial amount of money that must be raised in euros during 2011 by some of the weakest countries. This includes Portugal at 38 billion, Belgium at 85 billion, Spain at 210 billion, and Italy who must raise 374 billion. Note: Greece and Ireland are already on life support and will be rolling over their debt with the help of the European Central Bank (ECB) and the IMF. We find it very hard to believe that the capital markets will provide the necessary funds to roll over the debt in these other countries at rates that will not force them into the hands of the ECB and IMF.

Europe and the Economics of the Cube

Now, I come to the title of this newsletter and the crux of the issue. What are the economics of the cube? Let me explain. In 2005 George Weigel, a Senior Fellow of the Ethics and Public Policy Center in Washington, D.C. wrote a powerful book entitled, "The Cube and the Cathedral". On a visit to France, Weigel had the opportunity to visit La Grande Arche and recounts the experience for his readers. Weigel notes that the arch's three-story high roof houses the International Foundation for Human Rights. For Francois Mitterand, who had the arch built, he intended La Grande Arch as a human rights monument celebrating the bicentenary of the French Revolution and the Declaration of the Rights of Man and Citizen. What caught Weigel's attention was in the guidebook describing the arch it emphasized that the entire Cathedral of Notre-Dame - towers and spire included - would fit comfortably inside the Great Arch. Weigel then asks some tough questions. Which culture would better protect human rights? Which culture would more firmly secure the moral foundations of democracy? The culture that built this stunning, rational, angular geometrically precise but, essentially, featureless cube? Or the culture that produced the vaulting and bosses, the gargoyles and flying buttresses, the nooks and crannies, the asymmetries and the holy "unsameness" of Notre-Dame and the other great Gothic cathedrals of Europe?

Weigel points out that "Europe's problem" is its rejection of faith and belief in truth. In its place, Europe has succumbed to moral relativism in all its ugly forms. Europe's rejection of faith and truth is seen most profoundly in its short-termism and lack of hope in the future. Weigel is not alone in pointing out that the ultimate demonstration of hopelessness for any culture is demonstrated by its failure to create

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“successor generations.” As Weigel notes “while Europe’s demographic winter is undoubtedly the result of a complex of causes, something is clearly awry in the realm of the human spirit when an entire continent - wealthier, healthier, and more secure than ever before - depopulates itself, not because of war, natural disaster, or plague, but by its own will.”

Here’s the real situation in Europe. Their debt spiral is a death spiral brought on by a rejection of faith and truth. European countries simply cannot pay off their debts in real euros nor meet their entitlement promises. Their demographics will not allow it! Europe with a fertility rate of approximately 1.3 children per couple means that 100 grandparents end up with 42 grandkids. Europe is a culture in retreat because it is dying! History tells us that fertility rates this low, mixed with time, can only lead to societal collapse. Niall Ferguson puts it simply: Europe’s problem is senescence. The massive aging of the European population ensures that these economies have no choice but to default, default and default all day long! The economics of the cube is suicidal.

Allowing a geriatric economy to go out and binge on debt and promise each other benefits from the next generation that they refuse to produce will go down as one of the most foolish episodes in financial history! Only well trained economists with doctorates from some of the best schools in the world could generate economic models to rationalize and justify such stupidity!

Investing Wisely in a Debt Crazy World

Having read the foregoing you might get the idea we are pessimistic about the global economy. Actually, we like to look at it differently. Given the challenges, where are

the opportunities? We are optimistic that we can invest in the right sectors and businesses and weather the challenges. Adversity can lead to very unique opportunities, if prepared. Our overall view is the global economy must restructure its debt and eliminate many of the entitlement promises made by national governments. This will occur through a combination of inflation (printing excess money - implicit default) and the direct write downs of debt (explicit defaults).

Let’s review our core strategy by asset class:

1. Bonds:

Focus on high quality yield from the strongest corporate bonds (largely non-cyclical industries, well capitalized and liquid balance sheets with minimal refinancing needs). Given the low level of interest rates and the increasing pressure on yields we are only adding bonds with maturities of less than 3 years. We are very concerned about a brewing bond bubble, particularly in the face of the money printing we discussed earlier in this newsletter.

2. Equities:

- i. Focus on sustainable dividend growth and yield. This provides consistent cash flow into your portfolio for either reinvestment opportunities or supplemental income.
- ii. Focus on sectors in the economy that are essential and scarce and can re-price their product or service in the face of a changing cost structure and volatile exchange rates in the global currency markets. This leads us to focus on businesses with lower fixed

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costs, high barriers of entry (preferable if business operates in an oligopolistic industry), and inelastic demand such as utilities, agriculture, water and healthcare.

Overall, our clients have exposure to the following sectors: Canadian banking (under review given Canadians indebtedness), oil and gas, infrastructure (including real estate, pipelines, utilities, railroads, timber lands and ports), agriculture, information technology, water, consumer staples and precious metals.

3. Independent of whether the investment is in bonds or equities we focus on businesses that have very low leverage, significant liquid assets and transparent balance sheets. We are particularly concerned with leveraged financial stocks and have limited our exposure to this sector. Global debt restructuring will not be kind to many financial businesses.
4. Precious metals: Gold and silver mining businesses provide a hedge or insurance against the excessive printing of money. As we have pointed out previously, over thousands of years gold and silver have effectively operated as wonderful stores of value and protected investors from the money printing, currency devaluations, trade frictions between countries and confiscatory government policies.

Two Top Holdings: Where we are Making Money

Sprott Inc.

In 2010 we started adding Sprott Inc. to some of our client portfolios based on their investment profile. The company, based in Toronto, is operated by legendary investor Eric Sprott, who has over the past 25 years generated one of the best investment track records in the world. During 2010 the company, through both capital appreciation and purchases, became one of our largest holdings. Sprott is an excellent example of a firm that is well positioned for the challenges ahead. In fact, it is not an exaggeration to say that Eric Sprott has carefully positioned his firm to not only protect capital when the world is forced to restructure its debt, but make huge profits. It is the kind of business that can do well in poor markets and extremely well in very poor markets! The company has a powerful balance sheet with no debt and approximately \$90 million in cash and securities. Also of note, the company is expected to generate in excess of \$85 million in performance fees based on fund performance in 2010.

Briefly stated, Sprott is the largest asset management/private equity firm focused on the precious metals sector in the world. When you invest in Sprott, you take the other side of the trade on fiat currency! Approximately 65% of their assets under management and investments held directly on their balance sheet are in gold and silver. This includes mining companies, royalty firms and gold and silver bullion. During 2010, the firm launched two new exchange traded funds one focused on gold bullion and the other focused on silver bullion. These funds are now valued in excess of \$1.6 billion.

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Overall, Sprott Inc. consists of three business units: Sprott Asset Management, Sprott Private Wealth and Sprott Consulting. Sprott Asset Management is a leading independent asset management company based in Toronto, Canada. The firm manages the Sprott family of mutual funds, hedge funds and specialty products. The company also manages discretionary accounts and investments in a number of very interesting public companies. One of the public companies they have invested in is Sprott Resource Lending. In 2011, they will become the largest agricultural landowner in Canada.

Sprott Private Wealth is a high growth business focusing on high net worth private clients. The firm has over 2,000 investment accounts and recently announced the purchase of Global Resource Investments Ltd., Terra Resource Investment Management Inc. and Resource Capital Investments Corp. based in the United States. This acquisition adds further to their human capital, assets under administration and long-term growth potential outside of Canada. When the acquisition is complete, Sprott Inc. will be managing assets in excess of \$8 billion. Lastly, the company owns Sprott Consulting which provides management, administrative and consulting services to other companies including a number of related companies.

In light of the current environment, it would be very difficult to find a better positioned business than Sprott Inc. when it comes to protecting and growing your capital.

Nalco Holding Company

Consistent with our theme of investing in scarce assets that can survive the global debt restructuring, we believe the water industry is a wonderful place to take cover and make

some money. Over the past year, Nalco has returned approximately 25% for its investors. In terms of the industry itself, according to the OECD, nearly one in every two people will live in water stressed areas by 2030. Structural problems in the management of water resources have led to broad under pricing, which in turn has caused waste, pollution, and overuse. Water scarcity poses considerable economic, environmental, and social challenges throughout the world and, in particular, for the fast growing emerging markets. Most investors are unaware that only 2.5% of the world's water supply is considered freshwater and most of this is frozen. The other important point is that the limited freshwater resources we do have are unevenly distributed across countries and regions. In Canada, we are blessed with significant freshwater resources, but for many of the fastest growing countries in the world they are faced with significant shortages of freshwater. Shrewd investors recognize that where there is scarcity and need, great investment opportunities can emerge.

Nalco is a company that is taking full advantage of the increasing need and importance of water globally coupled with water's scarcity. Nalco is the world's largest sustainability services company, focused on industrial water, energy and air application as well as delivering significant environmental, social and economic performance benefits to their commercial customers. Nalco works very closely with their clients to increase the productivity of their businesses helping them to be more efficient with the use of key inputs such as water, energy and air. With growing water shortages, increasing energy costs and the need to limit air pollution, Nalco's services are in high demand around the world with the greatest amount of growth coming from the emerging economies of the world. In order to execute on their business plan, Nalco has over 7,000 technically trained

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experts serving over 50,000 customer locations in over 150 countries around the world. In the world we envisage over the next decade we believe a company such as Nalco will grow in importance and profits!

Summary

Equipped with sound information we continue to apply discipline, knowledge and understanding to the current environment. Each company we invest in, every bond we purchase (along with the time horizons we consider) are placed within the context of the challenges we envisage. We believe that the positions we have built and the companies we are currently adding to your portfolio, and even now researching, will be able to navigate the choppy waters. We are doing our best to expect what others view as the unexpected! Herein is our opportunity!

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