ROCKLINC

Worth. Investing.

"Debt Storm"

"I can calculate the motions of heavenly bodies, but not the madness of people."

Isaac Newton

Investment Update

A. Major Challenges are not Abating

Looking forward to 2013 it is important for us to stay focused on the long-term fundamentals of the market and on the businesses we own. As we have pointed out in previous newsletters, the challenges facing the global economy are substantial and will eventually have to be addressed in an honest fashion. The most important financial challenge remains the preposterous level of debt we have accumulated over the past 40 years. In a recent video update, I provided you with a list of 10 major challenges facing the global economy. Let's briefly take a look at each one.

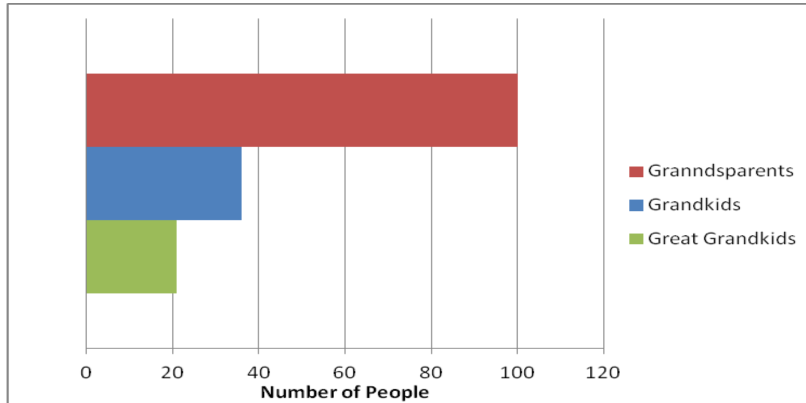
1. The level of global debt and derivatives continue to escalate. Governments are by far the largest contributors to the growing debt. Every major government in the world continues to run massive fiscal deficits. This means the debt storm is getting worse, not better. In terms of derivatives, the global banks continue to expand the volume of derivatives. Consider two important markers: total global credit market debt is now well over $225 trillion, up from $80 trillion just 10 years ago. Global derivatives now exceed $1.1 quadrillion. Putting those numbers in some perspective, the global GDP is approximately $68 trillion. The growth in debt and derivatives is not sustainable.

2. Given the rising global debt, the overall debt/GDP ratio of the OECD countries (developed world) is at an unprecedented level of 110%, and rising. In 1970 the debt/GDP was 40%! Current debt levels are unprecedented and not sustainable.

3. Unfunded entitlements, such as pensions and healthcare are estimated to exceed the total global credit market debt of $225 trillion. Take a moment to think about what this means! Governments have promised social benefits of over $225 trillion with no money set aside to make good on these promises. These entitlement promises are not sustainable.

4. The majority of the world is experiencing a dramatic aging of their populations. Lower birth rates, high levels of abortion and the undermining of the traditional family is leading to conditions that can only be described as catastrophic. In figure 1 below, we graphically show that a birth rate of 1.3 children per woman (average in many developed countries) translates into the following: 100 grandparents will lead to approximately 22 great grandkids! For indebted nations addicted to State run healthcare, early retirement, subsidized education and all sorts of other welfare schemes, this population inversion will inevitably lead to a social collapse with the economy not far behind. Our demographic profile is not sustainable.

Figure 1: Population Inversion = Social Collapse



5. ZIRP (Zero Interest Rate Policy) continues to punish savers, erode long-term capital investments and make the population more dependent on the government. In addition to these problems it has also contributed to an overpricing of bonds and an addiction to artificially low interest rates. As investors, we must be careful to avoid overpriced assets. This is why we are not investing in long term fixed income investments, and other assets that are pricing in low interest rates forever! Don't be fooled, interest rates will rise again! A zero interest rate policy is not sustainable.

6. Increasing money supply, also known as money printing or quantitative easing, is taking place at an unprecedented pace. With all major central banks in the world printing money, the money supply over the past five years has increased from $3 trillion to over $13 trillion. Central bankers and their economists can call this what they want, but the truth is, that this expansion of the money supply, is the debauchment/debasement of our money. It is the logical end of a system where debt is capital and governments and their citizens are corrupted by fiat currency. Printing money to solve a debt crisis is not sustainable.

7. Unemployment of young people is rising in all developed economies. The excessive level of debt coupled with zero interest rate policies is strangling economic growth. Businesses in general are not prepared to commit capital long-term in this environment. This is resulting in slow job growth, and in most countries, increasing unemployment amongst the youth. Youth unemployment levels that range from 25% - 50% are not sustainable.

8. Taxes across the board are on the rise. This includes taxes on income, capital gains and dividends. Instead of penalizing debtors and allowing interest rates to move up, governments around the world are increasingly confiscating the wealth of savers and investors by lifting tax rates. Increasing taxes on the productive class is not sustainable.

9. Our public education system is deteriorating very quickly. The secularization of education leading to the undermining of moral absolutes and moral authority has proven devastating. Postmodernism, which is the rejection of truth, is now the religion of our public institutions. This religion sings the praises of tolerance but, is brutally intolerant to any dissenting opinion and does not breed a culture of innovation, creativity and entrepreneurship. Public education as state propaganda is not sustainable.

10. Increasing regulation and growing state intervention is leading to less personal freedom. Everywhere we look the state is playing a larger and larger role. This increasing presence throughout our economy devours more and more of our scarce resources and crowds out the private sector. But, without a growing and vibrant private sector, the extraordinary debt situation we face is intractable. The current size of the State is not sustainable.

Given the tremendous challenges we face, it is not a time for complacency. Returns will not be easy to obtain and we remain vigilant. Our focus remains on investing in the businesses that should be able to successfully navigate these unusual circumstances. Our most significant investment challenge is to protect your capital and grow your purchasing power over time.

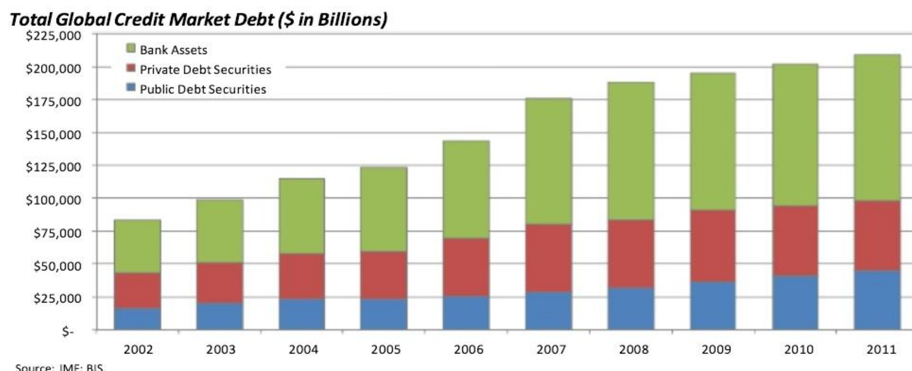
B. Debt Storm

"There are two ways to conquer and enslave a nation. One is by the sword. The other is by debt."

John Adams

In order to better understand the gravity of the debt storm we have compiled four charts for your consideration. We will provide a brief overview of each slide and then make a few summary statements.

Chart 1: Total Global Credit Market Debt ($ in Billions)



As we discussed earlier in this newsletter, the total global credit market debt has almost tripled over the past 10 years. This includes public or sovereign debt, private or personal debt and the loans provided by the banking industry. Despite the "credit crisis" of 2008 and 2009, the total credit market debt has continued to rise at an unsustainable rate.

Chart 2: Compound Annual Growth Rate of Various Economic Indicators (2002-2011)

Just stating that the total debt outstanding has virtually tripled over the past decade does not adequately express the seriousness of the situation. This build up of debt must be placed in a proper context. Chart 2 helps to contextualize the run up of debt. During this same period of time our global population compounded at 1.9% per year and our global GDP increased at a rate of 3.9% per year. In this backdrop we grew our debt at an annual rate of 10.7%. This is unsustainable. Note the last bar on the chart. During the past ten years, the world's central banks have grown the money supply (printing money) at a rate of 16.4% per year! In other words, all the economic growth experienced over the past 10 years was built on debt and supported by the printing of money.

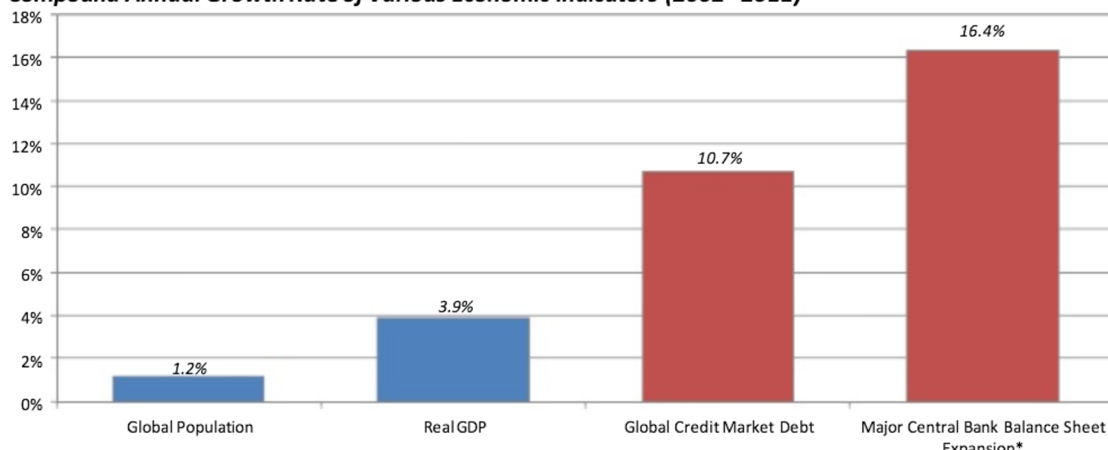
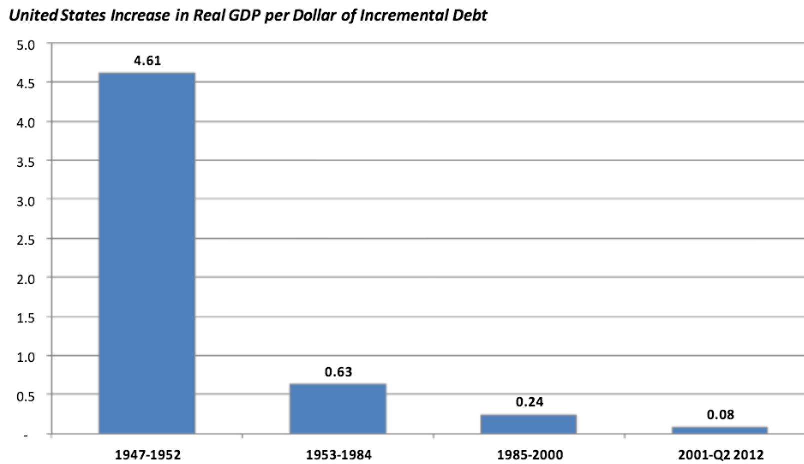


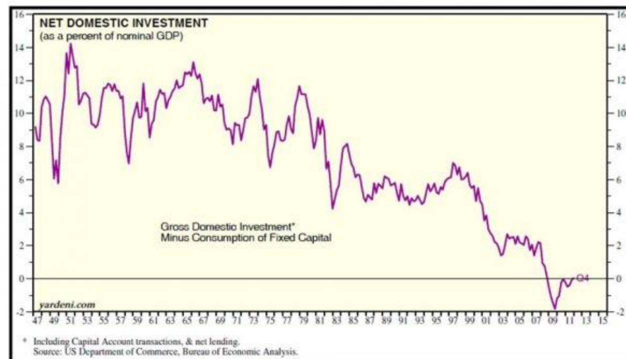
Chart 3: United States Increase in Real GDP per Dollar of Incremental Debt



The third chart we want to point out to you is the relative impact on economic growth of each incremental dollar of debt. You can see in Chart 3 that post World War II (1947-1952) each dollar of new debt produced $4.61 in real GDP growth. Economists often refer to this as the multiplier effect. Unfortunately, over time this multiplier effect has dropped substantially. In fact, over the past ten years when the build-up of debt has been unprecedented, each dollar of new debt only added 8 cents in new economic growth! This is telling us that our economic system is supersaturated with debt to a point where there is virtually no positive impact on growth with the addition of more debt. Yet our leaders continue to pile up more and more debt.

Chart 4: Net Domestic Investment as a % of GDP after Depreciation

NET US DOMESTIC CAPITAL SPENDING,
1947 - 2012



Source: Ed Yardeni; www.yardeni.com

The last chart lays out for you the net amount of capital investments over the past 60 plus years. The trend line is in one direction. Less and less money is being deployed in long-term capital investments. If you look closely you will note that over the past 4 years in the US, there has been no new net capital investments after depreciation. Why is this important? It is important because no economy can grow indefinitely without increasing investments in long-term capital. In essence, our developed economies that are running on yesterday's investments and using debt to consume more and more products and services we cannot afford and, in many cases, no longer manufacture. This cannot continue; a depleting capital base will lead to a shrinking economy over time.

C. Investing Strategy

Our focus continues to be the same, protect your capital. The global economy cannot continue to spend more than it collects, promise more than it can deliver and pay for it all through unprecedented levels of money printing. The debt storm is brewing and there will be serious economic consequences. We cannot predict when this debt storm will hit, but it will hit us! As a result, complacency is not a viable strategy and we remain vigilant.

As we have emphasized repeatedly, we cannot isolate you from market volatility and short-term price changes. What we can attempt to do is to avoid permanent loss of capital by keeping some cash on the sidelines and committing capital to only the highest quality of businesses operating in the most important long-term industries in the global economy. Despite the debt storm, we remain optimistic that a disciplined approach to asset accumulation will provide investors with the best opportunity to protect and grow your capital. Money buried in your backyard will not only yield nothing, it cannot protect you from the ongoing debasement of currency and concomitant loss of purchasing power we are witnessing all around the world.

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Since forming ROCKLINC three years ago, we have been able to keep pace with the TSX (Toronto Stock Exchange) which has produced annual compound rates of return of 4%, -2% and 7% respectively over the past 1, 2 and 3 year period. Given our larger than normal cash and short-term bond positions, we have been able to hang in reasonably well. Having said that, our positioning will be much more profitable to our investors when the debt storm starts to intensify and investors are shaken from their stupor.

When it comes to portfolio creation and asset allocation we continue to emphasize our ABCD approach that we mentioned a year ago. In a nutshell, we continue to invest in "Anything Bernanke Cannot Destroy". What we mean by this is we invest in assets or businesses that are scarce, essential and backed by tangible or hard assets. Our list of industries remains the same: agriculture, water, oil and gas, real estate, infrastructure (utilities, pipelines, railroads, ports etc.), basic staples, healthcare, precious metals (gold and silver) and low leverage financial services.

As each of you are aware, we break your portfolios into three types of asset classes: cash, fixed income and equities. The ratios in your portfolios will vary based on your individual circumstances.

i. Cash - we continue to maintain higher than normal cash balances. The cash balances help to moderate volatility and allow us take advantage of opportunities as they arise. We expect that volatility will remain elevated for some time. While we are waiting, we can take advantage of TD Bank's deposit accounts that currently yield 1.5% and can be bought and sold commission free with one-day settlement.

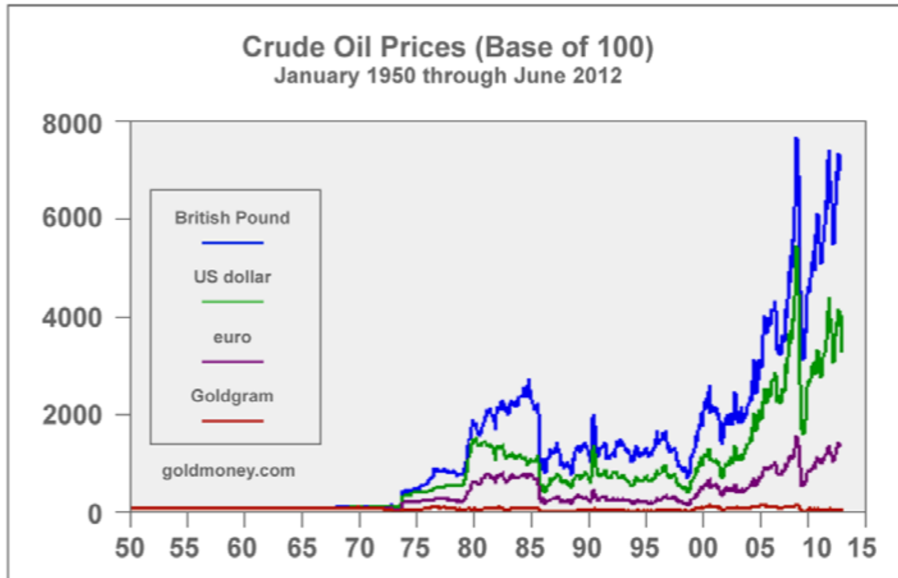
ii. Fixed Income – given extremely low interest rates, we continue to invest in bonds with less than 4 years in duration. In fact, most of the bonds we own have durations of less than two years. We restrict our bond purchases to entities with very strong and liquid balance sheets.

iii. Equities – the most important asset class that we invest in is equities (including preferred shares). Ultimately, it is the carefully selected equities that will protect and grow your capital. When we evaluate the types of equities we want to own, we are searching for great businesses that control scarce assets, operate in essential industries and are managed by smart people.

D. Summary

We have one more chart for you to consider. In chart 5, you can see that the value of an ounce of gold when priced in oil (and vice versa) has changed very little over the past 62 years! That might surprise some of you! After all, most of you can remember a time when gold was less than $100 per ounce and you could buy an imperial gallon of gasoline for less than 50 cents! But, look more closely at this chart. The only thing that has changed, and dramatically, is the value of our paper money! What this chart shows is that scarce commodities such as oil and gold actually hold their value over time. What does not hold value is the paper stuff we call money! The only reason gold and oil are more expensive today than 62 years ago is because we have systematically debased or devalued our money!

Chart 5: Crude Oil Prices



This should make sense to you when you consider the capital, sweat, ingenuity and time that goes into mining an ounce of gold and drilling for a barrel of oil versus the ease at which the Federal Reserve can create new dollar bills! Wealth cannot be created through printing money! Chart 5 is simply a reminder that our debt based economic system requires the debasement of money to survive.

Our issue is that there are times in the life of a debt based fiat currency system when the system has to die and start over. We believe we are close. Therefore, all our investments are geared to protecting your wealth in this environment and also profiting from these challenges by owning assets that cannot be debased since they are either productive assets or reflect long-term monetary substitutes.

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