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Self-Deception, Economics and the Capital Markets

Winston Churchill: “The farther back you can look the farther forward you are likely to see.”

Business Update

We are now entering our 16th month as a new company and have been blessed with a wonderful roster of clients. The opportunity to build and manage our own firm is terrific. We are pleased with the growth of our business and appreciate the referrals we have received. It is rewarding for us to tell you that virtually all our new client growth to-date has been the result of referrals from existing clients. This expression of trust is something we value highly and take seriously.

Since our clients have customized portfolios talking about specific performance is difficult. Instead, we will give you some overall ranges and encourage you to contact us for your specific performance numbers. Over the past 12 months (period ending February 28, 2011) we have averaged across our client portfolios between 15 - 25%. The amount will vary depending on the actual percentage allocated to fixed income investments and cash. This compares to approximately 22% for the TSX (100 percent equity) and 13% for the S & P 500 denominated in Canadian dollars. Although we don't have the final numbers for the first quarter of 2011 it is shaping up to be an excellent quarter with equity returns of approximately 10%. Our positions in oil and gas firms, precious metals companies, and agricultural businesses along with a perennial favourite, TD Bank, has served us well this year. It is important to note that despite the strong and consistent performance so far, our core objective is to protect your wealth through both the ups and downs of the

market. Hence, our focus is on generating absolute rates of return.

Investment Update

Self-Deception Abounds

Let's shift our attention to the economy and how we are approaching the current environment. It would be a gross understatement to say that we are concerned with the systemic risk in the global economy. As we have discussed in previous newsletters, the number one problem facing the developed economies is the massive debt burden that continues to grow. Although the global economy appears to be improving, the “improvement” is being driven by the most aggressive pro-cyclical fiscal and monetary policies the world has ever witnessed. Without the massive government deficits, the close to zero interest rates and the monetizing of debt (printing money also known as quantitative easing) economic growth would probably be non-existent, and in fact, using economic measures, would be contracting.

We don't believe that a contraction in the GDP would be bad, provided it was the start of a process to clean up the debt mess of the last 40 years. A mess created by Keynesian spending, debt financing and entitlement promises, or lies, depending on how you look at the situation! Unfortunately, the short-termism of our culture coupled with the lack of leadership throughout our Western world, in government offices and corporate boardrooms, means that the situation will continue to deteriorate before it gets better. Our response is simple, be prepared in

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advance. At the end of this newsletter, we will sketch out our thoughts on how best to mitigate the damage, and most importantly, make some money out of this state of global economic self-delusion and folly.

There are two major areas in which our economists continue to fool themselves with their brilliant use of spreadsheets and econometric models rooted in either a contempt or ignorance of the past. The two areas are i) their belief in a zero interest rate policy (ZIRP) and ii) their blind faith in Keynesian economics. Let's take a quick look at these two areas.

ZIRP

Zero Interest Rate Policy, otherwise known as ZIRP, is a serious monetary trap to fall into. You could easily refer to ZIRP as a drug addiction, easy to develop, very difficult to break! Charlie Munger once quipped, "Easy money corrupts, really easy money corrupts absolutely". As developed Western economies bounce along at close to zero interest rates, few people realize or acknowledge that ZIRP is becoming an inescapable trap. If low interest rates had been used to pay down debt and restructure the economy that would have been positive. But, when heavily indebted nations pursue ultra low interest rates to avoid painful restructuring within their debt markets and, in fact, borrow more and more, the reliance or addiction to the low rates becomes absolute. The average person is probably shocked to learn that our economic response to the debt crisis has been to artificially lower interest rates (redistribute wealth from savers by rewarding debtors) and double down on more debt! At the same time, our governments have continued to run, in many cases, double-digit fiscal deficits. Fortunately, in Canada there was not as large a transfer of debt from banks (private sector) to the government, but we should not be

smug or complacent, since we still have the issue of increasing private and public debt. (Just think about the profligacy of the Ontario government where our accumulated debt is now in excess of \$220 billion and our annual deficit is over \$15 billion. What is the government response, to fiddle and do nothing until the next election! This is an utter abdication of responsibility and they should pay dearly at the polls.)

The sad part concerning ZIRP is that it is an explicit part of an economist playbook. Crazy as it seems, economic theory presupposes that net credit expansion and the piling up of debt is a necessary precondition for growth. This belief is ridiculous and dangerous. What happens when the real cost of money returns and interest rates increase? What always happens to nations, corporations or private citizens that overleverage at low interest rates and then are faced with higher rates? How about default? Believe it or not, the total credit market debt in the world has gone from \$80 trillion to \$200 trillion in the last ten years, an 11% annual growth rate, while GDP has grown by 4%. This gap is unsustainable! Despite this record amount of debt, the IMF is proposing to add many more trillions of "credit" (let's call it what it is, debt) to the global system in the next 5 - 10 years. If you feel like shaking your head, please do, that is the proper response!

Consider the United States' balance sheet, which "backs" the reserve currency of the world! The United States is rapidly approaching the Congressional mandated debt ceiling of \$14.2 trillion dollars. Every one percentage point move in their weighted-average cost of capital or interest rate will end up costing an additional \$142 billion annually in interest alone. A move back to 5% (which is currently less than the real inflation rate), would increase their annual interest

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expense by almost \$700 billion annually against current US government revenues of \$2.3 trillion. Even if US government revenues were to reach their prior peak of \$2.57 trillion last seen in 2007, the impact of a rise in interest rates would be brutal. How would your personal financial affairs look if your interest costs as a percentage of your income went from less than 10% to 30% in a short period of time? The US simply cannot afford an increase in their interest rates. What about the proposed deficits that are projected to add up to another \$9 trillion over the next decade and be added to the existing \$14 trillion? You don't have to be a whiz in mathematics to see the craziness of what is happening. Unfortunately, the US is not alone when it comes to ZIRP and over indebtedness. All of the major economies such as the UK, EU, and Japan are faced with the same challenge. In fact, 50% of the global economy needs to restructure its debt.

There are many other problems associated with ZIRP. Let us outline a few of them:

1. The gross overpricing of fixed income investments (bond bubble).
2. Given massive government deficits in the developed economies as well as existing debt that must be rolled over, an increasing amount of debt is being purchased by the central banks. Call this money printing! This printing of money driven by the preoccupation to keep interest rates low is undermining the value of currencies and leading to higher inflation.
3. Low to zero rates leads to the misallocation of capital. It encourages investors to take on greater risk than they should in order to stretch for yield/income.

4. Government manipulation of rates means there is a lack of proper price discovery within the capital markets. The government's involvement continues to distort prices and delay the proper/market pricing of whole asset classes. One example is the real estate market and related securities associated with mortgages.
5. Pension fund assets that hold significant bond portfolios (at inflated prices) risk incurring substantial losses and/or significant underperformance in the years ahead. This will create challenges for pensioners relying on cash flows from retirement plans.
6. Financial services firms with large weightings in long-term bonds are at risk of substantial short falls in capital as increasing interest rates produce losses on fixed income holdings. We do not believe many of these firms know how to hedge, particularly, in the midst of a crisis. Stated more bluntly, everything is correlated to 1 when the proverbial "crap" hits the fan!
7. In the case of banks that hold substantial amounts of sovereign debt their capital is materially overvalued. This is a nice way of saying they are undercapitalized and investors should sell their securities in most banks around the world as soon as possible! Stress tests to-date have been nothing short of a farce. Remember that within months of the European stress tests last summer banks that passed with flying colours had to be bailed out!

It's absolutely essential that we get the world's central banks out of the interest rate manipulation business and allow the market to restore the proper level of rates going forward. We need to take the pain now so we can restart the system and truly move

forward. We don't see this happening voluntarily!

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The Death of Keynesian Economics

It is amazing to us how economists can so blindly hold on to a theory that in its most basic elements has been tried over and over again and has a perfect and abysmal record of utter failure! The idea that the government can moderate business cycles (by spending money and increasing aggregate demand during a slowdown) and then turn around and pull money out of the same system a year or two later during the boom times, is simply outrageous. Why do we make such a claim? Three reasons: first, governments seldom act at the right time, nor do they have a better window on the future than anyone else. Second, governments as bureaucracies only know how to grow and expand, not contract. To suggest that governments by their very nature will increase and decrease taxes and steward tax revenues based on economic forecasts is right out of the twilight zone. Third, the electorate, over time, expects the government to give them more and more. People love to pick the pocket of their neighbours using the government as their inefficient middleman! The bottom line is that the very theory of Keynesian economics is flawed when applied to reality and will over time, if put into practice, bankrupt the simpletons who believe the theory.

Recently Eric Sprott, founder of Sprott Inc., pointed out that our addiction to Keynesian economics is producing deteriorating results. Forty years ago when the government borrowed and spent a one-to-one relationship might have existed. That means that a dollar spent in 1970 actually created close to a dollar in GDP growth. But, as our debt has grown and the size of government has expanded to over 40% of our economy, the effectiveness of government spending has dropped substantially. We know we are approaching the Keynesian endpoint when the relationship becomes non-linear.

At a recent conference, Eric Sprott produced the following numbers, which underscore the point that we are now at the Keynesian endpoint. All numbers are based on the US economy.

2009 GDP Change: - \$250 billion

2009 Debt Increase: \$1.47 trillion

2010 GDP Change: \$ 539 billion

2010 Debt Increase: \$1.56 trillion

Put 2009 and 2010 together and you get:

2009-2010 GDP Change \$ 289 billion

2009-2010 Debt Increase \$ 3.03 Trillion

During the last two years, the US Government increased the reported national debt by over \$3 trillion (22% of annual GDP) to squeeze out a net increase of \$289 billion in GDP. Let those numbers sink in for a moment! Then consider the following:

Between 2008-2010 Total Government Deficit (not broadly reported) when including the bailout of the housing industry (Fannie Mae and Freddie Mac) and the asset purchases by the Federal Reserve totaled \$9.4 trillion!

How can any economy take on close to \$10 trillion in debt and simply add several hundred billion to their GDP? Has unemployment dropped over this period? No. Has the housing market stabilized? No. Are continued deficits of over \$1 trillion annually expected for the next decade? Yes! I think you get the picture.

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What is occurring is that we are seeing a huge drop in the marginal productivity of debt throughout the developed and indebted world. In the 1960s, the change in GDP divided by the change in debt was close to 0.9; in 2010, it went negative! Yes, negative! Why are the economists of the world still preaching stimulus, stimulus and stimulus? There can only be one answer, they are self-deluded. They are blinded by their own misguided and groundless ideology, which places unconditional trust in government spending as the solution to our economic problems. The exact opposite is what we truly need!

Those that do not know history and how to interpret it will clearly repeat it over and over again. Here we go again! Maybe Harry S. Truman was right when he stated “there is nothing new, only the history you don’t know.” Our response: we must protect you from this folly. The monetary policies of the developed economies will remain lax until the market finally steps in and pulls the plug. We don’t know the day or hour but we know it’s coming and we will be ready.

Japan Update

The heartache and sorrow in Japan at this time is unimaginable. Although Japan is an amazing country, it is a country that has been in decline for two decades. Recent events simply hasten this decline. Let me summarize a few financial challenges faced by this country. First, debt levels will continue to get worse. Please note that Japan’s debt levels are the worst in the G20. Second, there will be a great deal of pressure on Japan to reduce its foreign currency reserves in order to raise capital for its rebuild. Currently, with most of their foreign currency reserves in US dollars any sales will put downward pressure on US bond prices and

upward pressure on yields. This is another negative for the US government and their massive deficits. Third, with the increasing global concern over nuclear energy, there will be a growing demand for fossil fuels and coal as a source of energy, both in Japan and around the world. Bottom line: remain long oil and gas stocks and don’t buy US bonds, especially, long-term maturities.

European Update

In our December 2010 newsletter, I outlined our view of the EU and its economic prospects. In a nutshell, and there are plenty of nuts in Brussels, we stated that the EU must restructure the debts of the PIIGS which simply means they must write them down. It is important to clearly state that the Club Med countries cannot service their debt at market rates nor pay them down without massive assistance. Pretending they can is insanity and will only continue the domino effect that is underway. First it was Greece, then Ireland, now Portugal; soon it will be Spain, Belgium and then Italy. If we wait long enough, it will be France and Germany! The debt problem for the weaker countries is only made worse by a “higher” Euro, horrible demographics and the fact that the major European banks are stuffed with the overpriced debt of these collapsing countries. Don’t be fooled by EU meetings and conferences, which do nothing to solve their problem. Most of the financial institutions of the EU are insolvent along with their national governments. Expect a combination of defaults and Euro printing, they have no other alternatives. Honesty and integrity are long gone, financial debauchery is now in vogue.

Middle East Update

The challenges in the Middle East are religious and structural in nature, and they are not going to go away anytime soon. Kicking one

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bad government or dictator out to be replaced with another dictator or worse, Islamic clerics, will not better the lives of anyone in these countries, apart from the leaders who run the show. The conditions for freedom, democracy and wealth creation simply do not exist in the Middle East, outside of Israel. What does this mean for investors? Expect bad headlines for as long as the eye can see!

In terms of the importance of the energy assets in the region, the current problems simply place a premium value on long-lived reserves of oil and gas in safer countries, operating within the rule of law, and underpinned by strong democracies. Given the social unrest in the Middle East, less money will be invested in the long-term development of future energy sources. More money will be directed towards pacifying the restless populations. This will eventually lead to production declines in oil and gas throughout the region and greater dependence on countries such as Canada, which is rich in oil and gas reserves. You will be pleased to know that virtually all your investment exposure is in Canada and the US.

Here's something to consider. Now that the Saudis have promised their citizens over \$129 billion in new social welfare programs over the next few years, they currently need at least \$83.00 per barrel to balance their own budget. Dictatorships in the era of Facebook are getting very expensive! In the end, the Saudi government is like all governments, the more they earn, the more they spend. Don't expect oil prices to drop substantially for any extended period.

Looking Ahead

Despite the folly and economic self-delusion we must press on and allocate your resources wisely. As one famous commentator likes to say, there's always a bull market somewhere! As we have explained in previous newsletters, we remain invested primarily in businesses anchored in hard assets and in short-term bonds of well-collateralized businesses!

In terms of the businesses we continue to invest in, there are a number of key attributes we focus on. First, we only invest in profitable businesses with proven business models and competent management teams. Second, we invest in businesses that have the pricing power to re-price their products or services given the risk of future inflation and currency weakness. Third, we look for businesses that produce and sell essential products or services. When we consider essential we mean energy, food, precious metals, industrial, water, and retail lending and banking services as examples. Fourth, we invest in business that control scarce and valuable resources, whether people or hard assets in safe countries. Fifth, we invest in businesses that are "safe and cheap" to use an expression from value manager Marty Whitman. We don't want to overpay and we want to invest in businesses with fortress like balance sheets. When we find companies with the foregoing attributes we like to focus and not over diversify. That's why the majority of your portfolios are invested in 12 - 15 companies.

Although we don't know what the next month, year or decade will bring we do know that the investment principles we will continue to use will never go out of style and will serve us well. Overall, you own a handful of exceptional companies domiciled in strong industries and countries that are run by

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competent management teams. We are optimistic that we can navigate the challenges and generate strong risk adjusted rates of return. It won't be easy and it won't be without volatility. We will also be travelling a less travelled road. But, given conventional wisdom, we are happiest when we see as few people as possible on our road, especially economists!

Let us leave you with a terrific quote that speaks to some of the economic folly and envy that is rampant in these days.

*"You cannot legislate the poor into prosperity by legislating the wealthy out of prosperity . . . What one person receives without working for, another person must work for without receiving . . . The government cannot give to anybody anything that the government does not first take from somebody else . . . When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for, that my dear friend, is the beginning of the end of any nation . . . You cannot multiply wealth by dividing it." **

* Adrian Rogers, 1931*

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