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Unjust Weights & Measures & the Minsky Moment

Leviticus 19:35-36; "You shall do no wrong in judgment, in measurement of weight, or capacity. You shall have just balances, just weights, a just ephah, and a just hin; I am the LORD your God, who brought you out of the land of Egypt."

Investment Update

A. Unjust Weights & Measures

The monetary "weights and measures" used within the financial markets today have become increasingly abstract as the global financial system has expanded and "financialized". The term financialization refers to the process by which financial institutions and markets increase in size and influence relative to the total economy, and in particular, relative to the real economy of tangible goods and services.

Two powerful implications of financialization have been the massive increases in debt throughout the global economy and the unprecedented growth of derivatives (paper contracts which derive their value from an underlying asset). While there are numerous theories discussing why this phenomenon has occurred, there is little doubt that much of this financialization and massive expansion of debt and derivatives was made possible by the relativizing of money (taking away its store of value) and the final abandonment of the gold standard in 1971.

Without the imposed discipline of the gold standard, it is virtually impossible to maintain honest money. But, without honest money and financial integrity as the cornerstone of the economy, governments and their citizens will opt to spend the future today, rather than save, build, and grow the economic engine for the next generation. Overindulging and creating debt instruments to spend next years wealth, is not new, but has been made easier because of massive growth of the financial sector with all its exotic financial instruments. For example, the growth in derivatives is even more staggering than the expansion of debt. From a value of derivatives in the hundreds of billions only 25 years ago, derivatives today are valued, at over one quadrillion, or more than 13 times the total value of the global economy.

Financialization has also led us to another reoccurring historical human problem, the promotion of unjust or dishonest weights and measures! Today with the power and influence of the financial sector at its peak, the manipulation of markets has never been more pronounced. Consider two financial weights and measures that have been "rigged" or mispriced over the past few years: interest rates and the value of our money. Unfortunately, these are two of the most important weights and measures. If you get these wrong, then virtually every other asset in the economy, is going to be mispriced! This is one of the greatest challenges today for money managers. How do we value securities in a zero interest rate environment? How do we value securities when our global central banks are deliberately working to devalue and debase our money, through quantitative easing? When your very unit of exchange is corrupted, what are you to do?

Throughout the Biblical text the prophets and apostles emphasize the importance of true weights and measures. Leviticus 19:35-36 prohibits cheating in commerce by falsely measuring

length, weight or quality, and is made very specific by reference to scales and stones, the standard equipment of trade in that day. The various measurements mentioned in the text indicate that this rule should be applied across a wide spectrum of tangible goods from pieces of property to the measurement of dry and wet goods. It also included money and the collateral or content value within each coin. The Hebrew word *tsedeq* (translated "just") appears four times in Lev. 19:36 and denotes a character that is right, it speaks of integrity and being without blame. Ultimately the concept of justice is rooted in the character of the Infinite-Personal Creator, and therefore, is absolute and unchanging, not relative, and never whatever we want it to be.

The bottom line is that all weights and measures should be accurate and consistent. In short, buyers should get what they have paid for and changing standards is immoral. John Calvin the great Western theologian states it clearly in his commentary on this subject; "if the laws of buying and selling are corrupted, human society is in a manner dissolved; so that he who cheats by false weights and measures, differs little from him who utters false coin; and consequently one, who, whether as a buyer or seller, has falsified the standard measures of wine, or corn, or anything else, is accounted criminal."

This takes us to our current day. The two most dishonest measures at the heart of our financial system continue to be interest rates and the value of our money. What is of particular fascination is that we have created an economic system that is foundationally prone to abuse given it is built upon debt. Why? Because a system built on debt, will as the debt compounds in size, be pressured to manipulate interest rates lower, in order to service the debt. There will also be the pressure to expand the money supply, by printing money, in order to create inflation so that the nominal value of the debt decreases. The economist's view that we need "limited inflation" is just another way of saying "a little corruption" is good for everyone. But a society that accepts this view and economic arrangement, in order to live beyond its means, is ultimately complicit and deserving of its eventual end. History informs us, that a system built on debt is not sustainable and over time will need to be restructured. We need to have portfolios that can weather this restructuring.

If the prophet Isaiah or the other Old Testament prophets were speaking into our own day and addressing the issues in our own economy they could literally repeat many of the same words they pronounced to the nations in their day. Isaiah in 750 B.C came before the nation of Judah and condemned them for their immorality which included economic immorality, demonstrated by the watering down (printing money or as we say ***quantitative easing***) of their money; "Your silver has become dross, your wine mixed with water." (Isaiah 1:22)

B. The Minsky Moment

Recently, Steen Jakobsen, chief economist of Saxo Bank wrote an excellent article. It is so well written and apropos that we have reproduced a portion of the piece for our clients. In this article Jakobsen deals with the eventual problem of a debt based, currency-debasing economy, where unjust weights and measures eventually catch up with you. Jakobsen begins his article with a classic proverb! It underscores why perpetual debt will always fail!

'Interest on debt grows without rain' – Yiddish proverb

Jakobsen writes:

> "This proverb explains most of what goes on in policy circles these days. We are now

watching Extend-and-Pretend, Episode VI: Promises for improvement amid ever growing debt levels.

In brief, we're still working with the same dog-eared script we were introduced to all of five years ago, when markets had stabilized in the wake of the financial crisis: maintain sufficiently low interest rates to service the debt burden. In other words, pretend to have a credible plan, but never address the structural problems and simply buy more time. But while we were able to get away with this theme for an awfully long time, the dynamic is now changing as the risk of low inflation (and even deflation) is a brick wall for the extend-and-pretend meme. Yes, interest does grow without rain, and the cost of maintaining and servicing debt grows especially fast in a deflationary regime. Mads Koefoed, Saxo Bank's macro economist, projects US growth at around 2.0% for all of 2014. That will be the sixth year with US growth near 2.0%, so despite lower unemployment and a record high S&P500, the economy has a hard time escaping that 2.0% level.

The US may be getting back to work, but why are growth rates so stubbornly stuck at the 2.0% mark? Any talk of higher interest rates is hard to take seriously when US growth is going nowhere and world growth is considerable weaker than was expected back in January (or as recently as July, for that matter). It seems everyone has forgotten that even the US is a part of the global economy.

The fourth quarter is always the most politically interesting time of year. Countries need to get their new budgets in order. The EU, IMF and World Bank will need to pretend they agree or accept the weaker data, which has to mean bigger deficits.

It's a tiresome exercise to watch denial-in-action as EU governments and other policymakers try to make something so obviously unpalatable go down easy in their internal reporting. It's obvious that buying more time (extending) is always the number one priority, followed by projecting (pretending) that forward looking growth will reach an ever-higher trajectory in order to make the budget fit within the supposed constraints. Or in France's case, the recent unilateral abandonment of meeting budget targets for the next two years is already a fait accompli. Who's next?

Such behaviour would cost you your job in the private sector, but in the economic model of 2014, which reminds us more of the Soviet Union than a market based economy, it's par for the course. But, many would protest, it would be even worse if we hadn't done so much to "save the system", right? Well maybe, except for the fact that those economies where the belief in State Capitalism is strongest – Russia, China and France – are all at the end of the line. Time has caught up.

Negative productivity, capital flight and a system built on protecting the elite is failing. France is now moving from recession to depression. China is moving quickly from denial towards a mandate for change, Russia's future has not looked this bleak since the late 1990s. Meanwhile, the US continues at a sluggish 2.0% rate of growth. Investors and pundits seem to have forgotten that we were promised 2014 would be the end of the crisis.

China's efforts to build a better, more prosperous society has led to a rethink of its economic policies in the last 12 months. Instead, we are speeding towards the inflection point at which debt becomes harder to service because pretend-and-extend policy making has created a depression in investment and consumption.

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The public debt loads continue to inflate across Europe: Portugal's public debt has ramped up to a staggering 130% of GDP, up from about 70% in 2007. Greece's public debt load, even after the restructuring of Greek debt a few years ago, has swelled to 175% of GDP. The EU now has far more systemic risk than it did at the beginning of the crisis.

With zero growth or as our economist Mads sees it, 0.6% with the arrow pointing down, **debt levels continue to rise relative to GDP**. And most importantly, the current flirt with deflation will make servicing the growing debt even more expensive.

The nightmare for both the European Central Bank and the world is deflation, as it's a tax on debtors and a boon to net savers. The new reality is that we currently stand face-to-face with the very deflation risk that just about everyone denied could ever happen when Q1 outlooks were written.

Two other global threats (or time bombs, if you will) outside of the EU are risks from the growing costs of servicing debt in China and the US. According to a Societe Generale analyst, total debt service costs (including maturing debt and roll overs) in China are at nearly 39% of GDP. Compare that with the closer to 25% of GDP for the US in 2007.

In the US, interest on US government debt cost over 6% of budget outlays in 2013. This is relatively down from its worst levels when interest rates were much higher, but only because the Federal Open Market Committee has so drastically lowered the costs for the US government to issue debt with a zero interest rate policy.

And now the debt load is vastly larger than it was before the financial crisis, at 80% of GDP (net debt according to IMF) versus 45% of GDP a mere 10 years ago.
So are we actually to believe that the Federal Reserve can lift the entire front-end of the curve from 0-1% (current rates out to three years) to 2-4% over the next two years without adding massive further stress onto the deficit, and only adding to the debt?

Whatever the timing, the US, China and Europe are all headed for another Minsky moment: the point in debt inflation where the cash generated by assets is insufficient to service the debt taken on to acquire the asset."[i]

We do not believe that you need binoculars to see the Minsky moment!

C. Deleveraging? What Deleveraging?

A recent report (released on September 29, 2014) on the world economy entitled "16th Geneva Report" confirms ROCKLINC's view along with that of Steen Jakobsen. While the money printing and lowering of interest rates have lifted the value of financial markets nothing has been done to take down the aggregate debt levels to more "sustainable levels". In fact, global debt has increased over the past five years, not decreased. This should come as no surprise! **A system built on debt, and one that must resort to unjust weights and measures, as its standards, cannot fix itself.**

The 16th Geneva Report has far harsher words than we have used. Here is an excerpt taken from the Financial Times of London reporting on this new study.

> "A poisonous combination of record debt and slowing growth suggest the global economy could be heading for another crisis… The 16th annual Geneva Report, commissioned by the International Centre for Monetary and Banking Studies and written by a panel of senior economists including three former senior central bankers, predicts interest rates across the world will have to stay low for a "very, very long" time to enable households, companies and governments to service their debts and avoid another crash.
>
> The warning, before the International Monetary Fund's annual meeting in Washington next week, comes amid growing concern that a weakening global recovery is coinciding with the possibility that the US Federal Reserve will begin to raise interest rates within a year. One of the Geneva Report's main contributions is to document the continued rise of debt at a time when most talk is about how the global economy is deleveraging. The report documents the continued rapid rise of public sector debt in rich countries and private debt in emerging markets, especially China. It warns of a "poisonous combination of high and rising global debt and slowing nominal GDP [gross domestic product], driven by both slowing real growth and falling inflation.
>
> The total burden of world debt, private and public, has risen from 160 per cent of national income in 2001 to almost 200 per cent after the crisis struck in 2009 and 215 per cent in 2013. Contrary to widely held beliefs, the world has not yet begun to deleverage and the global debt to GDP ratio is still growing, breaking new highs, the report said."[ii]

As we have stated many times, the world continues to take on more and more debt. The belief that the global economy will somehow magically spin out of this quagmire and back to normalcy with little volatility is the stuff dreams are made of. We are not operating in a normal economy. The weights and measures have been radically impacted and altered, in order to support an unsustainable global financial system, built on debt and government promises. Are there two weaker supports than these?

D. Third Quarter Review

The third quarter turned out to be quite a roller coaster for investors, with many of the gains in the first half of the year given back during the summer months, and in particular September. The chart below details some of the primary movements on the various indexes including a number of key commodities. The S&P/TSX Composite Index (Toronto Stock Market) actually declined during the quarter by approximately 1% but is still ahead this year by approximately 12%. With the exception of the large capitalization US Stock Markets (DJIA, S&P 500& NASDAQ) most global equity markets were down for the quarter and have not advanced at all in 2014. Smaller market value companies in the US are actually down approximately 4% year-to-date. There are many reasons for this overall lackluster performance throughout the global markets. The one reason we continue to point to - the complete lack of growth within the developed economies and the declining rate of growth in China. Let's be blunt, the only two things that have grown consistently are our global debt and our global money supply! Not exactly the best barometers of economic vitality!

The most significant move during the quarter was the large increase in the US dollar, relative to other major currencies in the world. Although our Canadian dollar dropped by over 4% during the quarter other currencies such as the Euro and Yen dropped even more. Most

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emerging markets currencies were hammered, with many down more than 20% on the year. The biggest impact on us as investors and as Canadians has been on commodities. The increasing US dollar has put significant downward pressure across the whole commodity complex, since commodities are denominated in US dollars. In the short run, the prices of commodities are inversely related to the value of the US dollar. For our investors, the major commodity exposure we have remains the energy industry (oil and gas) along with precious metals. Our investments in these two areas are purposeful (hedge to weakening currencies) and long-term. As a result, we have used some of the volatility in the businesses operating in the energy and precious metals space to our advantage, by building larger and more opportunistic positions. These changes will be reflected in your accounts at the end of this quarter and we can discuss directly with you.

Fluctuations in the US dollar will in no way deter us from investing in great businesses in the energy sector nor in the precious metals sector. The US dollar for the moment is the least ugly of the global currencies but is still an ever-debasing piece of paper that cannot be trusted. Regardless, our focus as investors is on the businesses. Our largest positions within these two areas are Suncor, Birchcliff Energy, Exxon, Franco-Nevada and Silver Wheaton. Each firm is highly profitable, each one continues to grow and with the exception of Birchcliff pay a healthy dividend. Price volatility has simply allowed us the opportunity to selectively add to our positions at amazing valuations, in the midst of a fairly pricey market!

Here is a distillation of approximate stock price changes (converted to Canadian dollars and including dividends) during the third quarter for 10 of our largest 15 equity positions. You can see from this list, significant moves up, significant moves down, and some with little change. What is not expressed in the stock prices movements is the wonderful quality of the companies we own. We are confident that the majority of our companies enhanced their intrinsic value during the third quarter and are as well prepared for the challenges ahead, as possible.

Alaris Royalty	+8.0%
Brookfield Infrastructure	-3.3%
Brookfield Renewable	+10.0%
First Capital Realty	-5.0%
Franco-Nevada	-9.0%
Johnson & Johnson	+7.0%
Nestle	0.0%
Suncor	-10.0%
TD Bank	+2.0%
TransCanada Corp.	+14.5%

Lastly, we would like to comment on the movement of interest rates during the quarter, and for the first nine months of the year. Throughout the world, yield curves have been flattening. What this means is that interest rates, especially longer-term interest rates, have been declining and the yield differential, between long term rates and shorter term rates, has been narrowing. This flattening continues to catch most market participants by surprise. Who would have predicted that Spanish 10 year bond yields would drop to only 2.14% when the US 10 year treasury yield is higher at 2.45%? Who would have predicted that German 10 year yields would fall below 1%! Our view, which has not changed, is to own high quality government and corporate bonds with an average maturity or duration of approximately 3-4 years. This allows our investors to collect a small amount of interest and minimize the risk of losing money on the bond through interest rates swings. By purchasing only the highest quality bonds, we minimize our clients credit risk.

A number of our clients have asked us; how can interest rates fall so much, to the point they are offering negative real rates of return (return after inflation)? The answer in one word is DEFLATION! The massive build up of debt throughout the global economy is putting massive deflationary pressures on the global economy. So while the stock markets have been showing the "all clear" signal, bond markets are saying the exact opposite. We must be very careful and move forward with extreme caution.

	Sept. 30, 2014 Close	3 months
S&P/TSX Composite Index	14,960	-1.0%
S&P 500 (USD)	1,972	1.0%
Dow Jones Industrial Average	17,042	1.5%
FTSE TMX Canada Universe Bond Index	935.8	1.06%
CADUSD	$0.8930	-4.7%
Brent Crude Oil Spot	$94.85	-14.6%
NYMEX Gas – 12month	$4.12	-4.6%
Gold Spot (USD/Oz)	$1208	-8.1%
Silver Spot (USD/Oz)	$17.06	-18.3%
Copper Spot (USD/lb.)	$3.00	-5.0%

This section provides our clients with more information about their investments.
Some Key Events during the Third Quarter: (Click on the link for news article)

Canadian Holdings

AGU - Agrium, through Loveland Products, Acquires a Controlling Interest in Agricultural Biotechnology Company Agricen
ENB - Enbridge Inc. said Wednesday it is proposing to transfer its majority stake in the U.S. segment of a pipeline running from Alberta's oil sands to the U.S. Midwest to its Enbridge Energy Partners L.P. (EEP) affiliate.
FNV/SSL - Franco-Nevada and Sandstorm Gold Inc. have entered into a US$120-million stream financing agreement with True Gold Mining Inc. to assist in funding the construction of the Karma Project ("Karma") in Burkina Faso, West Africa. True Gold is targeting first gold pour at Karma by the end of 2015.
SU - Suncor Energy today announced that, along with The Pioneer Group Inc., it has reached an agreement to sell the assets of Pioneer Energy to Parkland Fuel Corporation for $378 million. Suncor, as one of the current joint owners of Pioneer Energy, will receive $182.5 million in cash for its share. The agreement includes the sale of 393 Pioneer-branded retail gas stations in Ontario and Manitoba.
TRP - TransCanada Receives Regulatory Approval for Northern Courier Pipeline Project

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International Holdings

DE - Deere & Company will review strategic options for its crop insurance business, which underwrites policies through John Deere Insurance Company, a business unit within John Deere Financial.
FCFS - First Cash Acquires 47 Pawn Stores in Mexico and Nine U.S. Pawn Stores in Colorado and Texas
IBM - Apple and IBM Forge Global Partnership to Transform Enterprise Mobility
KO - The Coca-Cola Company and Monster Beverage Corporation Enter into Long-Term Strategic Partnership
ORCL - The Oracle Board of Directors today announced that it has elected Larry Ellison to the position of Executive Chairman of Oracle's Board and appointed him the company's Chief Technology Officer.

E. Looking Ahead Opportunistically

Having read the first three sections of the newsletter you might have the impression that we are very negative in regards to the future! If we were only focused on the economy and the politicians and bankers we would be quite negative. But since we focus on buying great businesses and in investing in the long-term needs of the economy we consider ourselves opportunistic! As we have stated before we believe that many of our best opportunities lie ahead, in owning many of the businesses that can survive and take full advantage of the trials ahead of us! While a number of our companies have benefited from the significant rise in the capital markets over the past 5 years, others have lagged, not because they are not great companies, but because they are better positioned for tougher market conditions. It is these companies that should help to mitigate the downside in our accounts. We also maintain significant liquidity throughout most of our client accounts. Liquidity and volatility go hand in hand when you are opportunistic! As the prices of the companies we own, along with those we would like to own, go down, we can use this volatility to build positions in these companies. This is an enormous opportunity for the long-term investor.

Let us repeat again the words of value investment guru Ben Graham when he stated: ***"Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it - even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."*** We are positioned for what we believe are the long-term facts.

As we have stated many times, at some point, debt will matter, it always does! As Steen Jakobsen so clearly articulated earlier in this newsletter, the US, China, (let me add, Japan) and Europe are all headed for another Minsky moment: the point where the growth in debt can no longer be serviced by the cash generated by the asset used to take on the debt in the first place! Unjust weights and measures cannot obscure reality indefinitely! We remain vigilant and well prepared for this moment. The real fruits of our discipline should be evidenced in the overall protection of your capital.

In the mean time, we remain focused on buying great businesses, at attractive prices operating in vital industries. The most important characteristics of the businesses we are investing in continue to be: 1) firms that are well-financed (strong balance sheet), 2) prudent capital allocators, with rational dividend policies and share repurchase plans, 3) sell essential products

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or services, and 4) control and own scarce assets in safe countries that should be least impacted by our current easy monetary policies and ongoing currency debasement. Our largest sector exposures (alphabetically) continue to be agriculture, consumer staples, energy, financial services, infrastructure, real estate, precious metals, technology and water. Owning great assets at attractive prices in essential sectors, positions us for the inevitable ups and downs of the market.

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[i] http://www.zerohedge.com/news/2014-09-27/hope-not-good-policy-saxo-bank-warns-entire-world-headed-minsky-moment
[ii] http://www.zerohedge.com/news/2014-09-29/new-global-crisis-imminent-due-%E2%80%9Cpoisonous-combination-record-debt-and-slowing-growth