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Quantitative Oppression: Watch out for Euphemisms

Investment Update

Samuel Adams, one of the Fathers of the American Revolution wrote in 1776, “How strangely will the tools of a tyrant pervert the plain meaning of words!” This statement is extraordinarily relevant today. When politicians, central bankers and economists resort to the use of euphemisms and pervert the plain meaning of words, we need to stop and take note, since euphemisms are usually used for one purpose: to obscure the truth.

One of the most overused phrases in the financial world today is the phrase “quantitative easing”. Have you asked yourself the question: what does this phrase mean? On the surface it sounds so harmless (unless you are a proctologist)! The expression certainly doesn’t sound menacing or dishonest! But, what is quantitative easing? In the old days, it was referred to as seigniorage, but even that term is no longer used today. Seigniorage refers to the profit made by the government when the value of the money it issues is greater than its cost of producing the money. In the good old days of “sound money”, this meant that the gold or silver content of the coins was quite close to the face value of the coins. Today, things are much different. Our coins are made of worthless metals and our paper bills are backed or collateralized by nothing beyond the promises of our government. In the old days, which we might witness again, our money was backed by gold reserves, held by our central bank. Now that the creation of money has gone digital, the cost of creating new money is virtually zero, we don’t even need trees

anymore! Our central bankers have created the ultimate high margin business! A journal entry here and a journal entry there and poof, you have the creation of money. Unfortunately, wealth is not created so easily and this is a problem! What appears to be a high margin business for the indebted governments and financially irresponsible, is actually destruction of wealth for the savers and true owners of wealth.

Quantitative easing, which is simply the printing of money, is nothing more and nothing less than financial debauchery. Debasing one’s currency is, in the end, government sanctioned theft. For those of you who are familiar with history, this is nothing new to be sure; but that does not change the reality, it is morally wrong and shameful. This is the reason I entitled this quarterly update, quantitative oppression and not quantitative easing. I have very little use for euphemisms. Governments that print money and increase its supply, far beyond the magnitude of wealth being created in the economy, are literally oppressing savers and owners of wealth. There is nothing easing about it! Why are the major governments around the world increasing the money supply at record rates and committing to further money printing in the future? Have we learned nothing from history when it comes to the impact of currency debasement? Do our leaders realize that they are planting the seeds of wealth destroying inflation by undermining the value of our already under collateralized paper currencies?

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Addiction to Debt

The problem is we live in a world profoundly addicted to debt financed consumption. Whether it is individuals, companies or governments, most have no intention to repay their outstanding debts. When debt comes due, we simply replace it with new debt, and usually in larger size. Some accurately refer to this as a Ponzi scheme. This proverbial kicking the can down the road has “worked” for several decades, but the problem today is: we are very close to the end of the road. One more kick and the can will be bouncing off the wall and coming back at us!

A concise breakdown of the total global debt and where it resides is very instructive. The chart below compares the size of the economy in terms of global GDP and the percentage of the global debt each major group is responsible for. Note that the largest economies (G5), which includes the United States, Japan, United Kingdom, Germany, and France have proportionately a similar level of debt as the PIIGS (Portugal, Italy, Ireland, Greece and Spain), despite all the criticism of the PIIGS. As we wrote earlier in the year, the whole developed world is filled with PIIGS! We are all addicted to debt. In fact, we continue to rack up more debt in a failed strategy to solve our debt crisis! Only a well trained economist could proffer piling more debt on debt to solve a debt crisis. A cocaine addict does not solve his cocaine addiction by increasing his consumption of cocaine! Note the debt levels below.

	Global GDP Weight	% of Debt
G5 Countries	43.7%	68.3%
PIIGS	6.7%	11.2%
Emerging Countries	37.6%	10.5%

This very simple chart illustrates for us two important points. First, the developed economies are just as indebted as some of the weakest economies in the world. Second, the developing or emerging economies have very little debt and therefore are in far better positions to grow. One point that cannot be deduced from the chart but should be underscored is that in the case of the G5 countries and the PIIGS their situation is far worse since the numbers in the chart do not consider the massive off balance sheet entitlement programs (pensions and healthcare) that do not exist in most of the emerging economies.

Stated another way, the major developed economies along with the PIIGS have unsustainable debt levels. These debts are so large that they cannot be paid down nor serviced (in real dollars) over the medium to longer-term by their aging populations. For example, Japan (one of the G5 countries) now

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spends 40% of its tax revenue on the interest costs of their debt! If interest rates increase by 1% Japan's interest cost on their debt would consume more than 60% of their tax revenues. That is one big problem! Is it any wonder the Japanese are now in the process of literally trashing the value of their yen by recklessly expanding the supply of yen and dropping their interest rates to zero?

We do live in an amazing world, when almost every country is running a big budget deficit while offering the lowest interest rates in recorded history and yet our economies are plagued by some of the worst unemployment levels since the Great Depression. So much for modern economic theory!

Dealing with our Debt?

What are the ways out of a debt crisis? Niall Ferguson, a noted Harvard historian, lays out the six ways in which a country can extricate itself from their debt burden.

1. Higher growth rate - grow out of the debt
2. Lower interest costs - decrease the servicing costs of the debt
3. Bailout - find a friendly country to cut you a cheque
4. Fiscal pain - austerity (cut in spending, increase in taxes)
5. Implicit default - print money or quantitative oppression (pay off debts with debased currency)
6. Explicit default - change the terms of your debt covenants including simply not paying

In the case of the developed economies the first three are simply off the table. Our growth rates will remain anemic (too much debt and aging populations), our interest rates are as close to zero as they can get and we are "too big to bail out"! This leads us with the final three options. Unfortunately,

few governments have ever followed through with austerity, although it remains a part of the solution. Now, we are left with the final two options: implicit or explicit defaults. In reality, both will probably be utilized. The most underhanded and dirty form of default is to debase your currency and pay your debts off with devalued or debauched currency. As you have probably guessed this is where we are headed.

We must be Prepared as Investors

The race to the bottom when it comes to currency devaluations is utter monetary folly. It reinforces the fact that our leaders and their constituents do not have the principles, ethics or intestinal fortitude to really deal with the challenges in a forth right manner. Today, countries representing two-thirds of the global economy are either holding down their exchange rates by direct intervention or steering currencies lower in an attempt to shift problems on to someone else. We have not seen anything like this, since the 1930s. Walter Lippmann's quote, "when all think alike, no one is thinking very much" is fitting!

Basel III

When we survey the economic landscape we see very little honesty in the financial numbers or policies emanating from the regulatory bodies, governments and central banks. The developed nations as a whole refuse to deal with the truth of excessive debt and the need for substantial restructuring of our obligations. Let me use one example to drive this point home. Basel III refers to the current work being done to put in place a new international regulatory framework for the global banking system. This should be of particular interest to all of us given the weak state of the global financial market, the excessive debt and the need to avoid another banking crisis. A banking crisis

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today would jeopardize the whole system, given the current levels of debt and the inability of governments around the world to strap on more debt.

With this in mind, you would expect the Basel III accord (which is in the final stages of completion this year - should be ratified December 2010), to faithfully, honestly and effectively deal with the debt crisis and its impact on the global banking system. Or would you? Unfortunately, we can expect very little of honesty and effectiveness from this cabal. Let me lay out three major problems or limitations that undermine this accord risking its usefulness in averting another banking crisis.

1. The time allowed for implementation (requiring the banks to increase their level of capital) is too long. We need to strengthen our banks around the world as quickly as possible. Capital ratios need to increase to levels reflective of the risk in the global market place, perhaps as high as 20%. This accord pushes the time line for implementation out over 8 years to 2019. We don't have 8 years to fiddle. We have serious problems today that need to be provisioned for and dealt with.
2. In most cases, the banks do not have to set aside any meaningful capital for their holdings of government or sovereign debt. This is truly amazing given the reality that sovereign debt is becoming riskier by the day and is now the new "subprime". With governments around the world implicitly defaulting on their debt by quantitative oppression, banks should be forced to set aside significant capital to protect their balance sheets from sovereign debt. This is particular

the case with the European Banks who are awash in sovereign debt from the PIIGS. Another problem with not penalizing sovereign debt with significant capital requirements is that banks are encouraged to take on greater amounts of sovereign debt at the worst time. Rather than encouraging banks to lend to private enterprises that create wealth, Basel III provides preferential treatment to the very entities (governments) that are absorbing the wealth and need to be hacked down in size.

3. Off balance sheet liabilities are not properly accounted for despite being one of the major risk areas within the global financial markets. For example, when it comes to accounting for derivatives the net positions of the banks are taken into consideration and not the banks gross positions. Unfortunately, this assumes that the banks can effectively hedge their massive derivative positions, despite the experience of recent history to the contrary. The problem is that, in a crisis, when we really need the hedges and fancy financial formulas to work, they are ineffective and thereby expose the bank to more risk than anticipated!

The point is: the whole financial system remains excessively leveraged and is dynamically unstable. Regulators and policy makers continue to tinker with the system, but refuse to deal with the real problem: too much debt and not enough equity! We must invest in light of these realities and look for areas in which we can profit from this incredible short-termism.

Investment Strategy

The situation we find ourselves in simply means that we must be vigilant in our

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assessment of risk and in the execution of our investment strategy. Despite the challenges, if we stay focused on the strongest companies, operating in the best industries and buy them at compelling prices we should not only maintain your purchasing power but increase the capital value of your portfolio. I have provided a very brief outline of how we are approaching each of the major asset classes.

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, we continue to focus on bonds with maturities of less than 5 years. We are very concerned about a brewing bond bubble, particularly, in the face of the competitive devaluation of the world's major reserve currencies (Japanese Yen, US Dollars, Pound Sterling and Euro Dollars).
2. Equities: Focus on sustainable dividend growth and yield. This provides consistent cash flow into the portfolio for either reinvestment opportunities or supplemental income.
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 financial stocks and have limited our exposure to the sector. Specifically, we would not invest in any long duration financial business (i.e. life insurance companies). Clients should be highly skeptical of annuity products or any fixed dollar payout scheme in light of the monetary policies of debasement being pursued by our central banks.

4. 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 costs, high barriers of entry (preferable if business operates in an oligopolistic industry), inelastic demand such as utilities, agriculture, water and healthcare.
5. Precious metals: Gold and silver mining businesses provide a hedge or insurance against the quantitative oppression whereby the central bankers operating with the politicians are undermining the value of our paper money. 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.

For anyone who doubts the staying power of gold, take a moment to consider that the price of gold in 1913 was approximately \$20.00 per ounce. This was the year the Federal Reserve Bank was created. Note that the mandate of the Federal Reserve was to maintain pricing stability! Today, gold trades for over \$1,300 per ounce. Also note, gold has not gone up in value; rather, the dollar has plunged by over 98% since 1913. Beginning with 1971, the dollar has dropped approximately 97% against gold. Let's be serious, there are absolutely no reasons why we should trust our central bankers. In our view, it makes complete sense to take the other side of the trade when it comes to the central bankers.

We are armed with valuable information and it is incumbent upon us to apply discipline,

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knowledge and understanding to the situation. Every company we invest in and every bond we purchase are put through the foregoing grid. We believe that the positions we have built and the companies we are currently adding to your portfolio will be able to navigate the current challenges and maintain and grow value for the owners of these assets.

We live in challenging days. This in no way deters us from the job before us. We know that truth has stumbled in the streets of our land and is not palatable to many. But, the problems before us are real, they are not insurmountable and we have a plan moving forward. When our leaders treat us like children and speak to us in euphemisms we stand ready to protect our investments and indeed even make some outsized returns. The action is just beginning and we are ready. We will keep you informed as we move forward and encourage you to contact us if you have any questions. In the meantime, keep your seatbelt on - It is going to be a thrilling ride. We will try to avoid drop zone!

Contact Information

ROCKLINC INVESTMENT PARTNERS INC.

4200 South Service Road, Suite 102

Burlington, Ontario

L7L 4X5

Tel: 905-631-LINC (5462)

Fax: 905-333-9116

Jonathan Wellum

jwellum@rocklinc.com

Doretta Amaral

damaral@rocklinc.com

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