



The Fed is Twisting but the Markets are not Dancing!

George Washington (1732 – 1799), 1st President of the United States: “To contract new debts is not the way to pay old ones.”

Thomas Jefferson (1743 – 1826), 3rd President of the United States: “To preserve our independence, we must not let our rulers load us with perpetual debt. We must make our election between economy and liberty, or profusion and servitude.”

Investment Update

A. Perpetual Debt

One of the age-old monetary debates concerns the use of debt by governments. How much debt, if any, should the government contract, and for what purposes? Is there a correct term to maturity, when applied to government debt? Does it matter? These questions are not new. In fact, they undoubtedly go back to the earliest days of humanity, given man’s proclivity to live beyond his means, on the one hand, and man’s desire to enslave and control his neighbor, on the other hand. The first recorded discussion on the subject that we are aware of takes us back to Moses and the Levitical law, revealed to the Israelites approximately 3,500 years ago. In the book of Leviticus, a year of Jubilee was to take place every fifty years. This was the year in which slaves and prisoners would be freed, and all debts would be fully amortized or forgiven. The year of Jubilee, helped to ensure that debts would not be perpetual and obligate the debtor unjustly. Their understanding was clear, excessive debt would strip borrowers of their dignity, freedom and wealth and would eventually lead to an undue concentration of wealth. As a result, debt was to either amortize within finite periods of time, or be forgiven. Whether the Israelites ever instituted Jubilee

or not, is open to debate; but, one thing that is not open to debate is that the use of perpetual debt at the State level always leads to serious abuse and eventually results in an inflationary default, or in a deflationary restructuring and write-down of debts.

Today, it is no different. In fact, we live in a world that has created the largest amount of perpetual debt in the history of mankind, all by “Ph.D.” design! It is not an overstatement to assert that the whole global economy is built on debt, with little concern over paying down any outstanding principal. Sorry to be the bearer of bad news, this experiment is not going to end well. Ask yourself a simple question: How can country after country add compounding levels of debt on their citizens, including unborn citizens, without eventually hitting a wall? A simple understanding of compound math would instruct one as to the madness of such economic policies; you don’t need an economics degree to figure this out. Who are the most significant peddlers and exploiters of perpetual debt? You guessed it, our “efficient and morally upright” global governments. Not exactly a trustworthy lot!

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Governments love to use debt with no intention of every paying it off because they love to promise things to their citizens for “free” without having to extract it from them on a timely basis by running balanced budgets. Governments seldom have any regard or concern for the long-term consequences of their actions, particularly, as they grow and become a larger and larger percentage of the economy. As governments expand their presence throughout the economy, their number one objective is to stay in power, at all costs, which simply leads to more promises, more money printing, more inflation and, of course, much more debt. What most people seem to overlook is, over time, governments seldom cover their obligations. By their very nature, governments will coerce their populations and future generations into unconscionable amounts of debt until they are forced to outright renege on their promises and start all over again. Make no mistake; the worst institution in the world to trust with debt is the government! This is why the best term for government bonds remains “certificates of confiscation”.

What should make all of us anxious is that our whole global monetary system is founded on government debt, with little true collateral. This is what makes the current situation in Europe so preposterous. The Europeans are faced with a catastrophic banking crisis (they have denied repeatedly, and still deny, despite three banks being nationalized during the first week of October) because their banks are leveraged and stuffed with overpriced government debt, which forms their capital base. What is the European solution? Capitalize the banks with more government debt! But, I thought that was the problem, you ask?

The Sarkozy-Merkel performance is utterly disgraceful in its dishonesty and its treatment of its own citizens as utter fools. We are not fooled by this nonsense. Europe’s love affair with perpetual debt is about to get very ugly and we are staying as far away as possible from the financial institutions throughout Europe. Expect to see a wave of Bank nationalizations which will only serve to further undermine the credit ratings of the European countries. This is a vicious cycle we want to carefully avoid.

A brief historical excursion should help put some perspective on this issue. Within the British Empire, it is Prime Minister Sir Robert Walpole who is credited with the introduction of a perpetual debt funding system in England during the 1720s. British acceptance of perpetual debt aided and abetted its growth throughout much of the developed world. Unfortunately, as we have already discussed, this system is open to enormous abuse. It doesn’t take long before the national debt of a country is used, not only in times of war or other extreme circumstances, but becomes a way to fund grandiose national projects and social programs with little to no lasting value. This is made particularly convenient when you can “purloin” from the next generation who has no voice in the matter.

It is interesting and helpful to note that the United States, for the first 100 years of their formal existence, viewed government debt as temporary, to be issued only for pressing national purposes and discharged within the lifetime of the generation who contracted it. In a 1789 letter to his friend James Madison, Thomas Jefferson raised the philosophical and moral question of whether “one generation of men has the right to bind another.” He believed the answer was no, “that the earth belongs in usufruct to the living.” He believed it a principle of “very extensive

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application and consequence, in every country.” Applying it to government borrowing, he argued that it was unjust and unrepublican for one generation of a nation to encumber the next with the obligation to discharge the debts of the first. After all, the following generation cannot have given consent to decisions made by their fathers, nor will they have necessarily benefited from the deficit expenditures.

For Jefferson, every generation has the same right to enjoy the bounty of nature and fruits of their labour as the preceding ones, without being bound or encumbered by the profligacy or desire of those who went before. “No generation can contract debts greater than may be paid during the course of its own existence,” and if they do so, the following generation is under no obligation to pay for it. “They and their soil are by nature clear of the debts of their predecessors.” Wow, how economic theory and practice have changed! When Jefferson was President of the US the national debt was under \$100 million and remained quite low for the next 100 years. It wasn’t until the American Civil War when the national debt started to explode, rising from approximately \$75 million in March 1861 to \$2.8 billion in August 1865. But, that increase is truly comparable to a grain of sand on the seashore, when contrasted to the amount of debt that has been piled up since the introduction of the Federal Reserve in 1913. The irony is that the Federal Reserve was instituted in order to maintain pricing stability and sound money in the US. They have done the exact opposite, which should surprise no one with a functioning cerebrum.

British empiricist David Hume (1711-1776) referring to intergenerational debt and the abuse of debt by governments stated, “The practice, therefore, of contracting debt will almost infallibly be abused, in every

government. It would scarcely be more imprudent to give a prodigal son a credit in every banker’s shop in London, than to empower a statesman to draw bills, in this manner, upon posterity.” What an understatement when we consider the outrageous levels of debt that have been contracted by governments around the world, all on the backs of a “future” generation! Unfortunately, given the compounding nature of debt, we are becoming that future generation!

Let’s zero in on the US and look at what happens when you incorporate perpetual debt into your economic policies. Over the past 100 years the national debt in the US, the most powerful and wealthy country in the world, has increased from \$3 billion to over \$15 trillion. This represents an annual compound growth rate of approximately 9%. Stop immediately and let that number sink in. Do you understand what this means? 9% compounded for 100 years! Do you get a sense of addiction here? Do you understand that this level of compounding will self-destruct? At a growth rate of 9% their debt will double every eight years, which is impossible, without huge debasement (inflation) to their monetary base (Note: since 1913 the US dollar has lost approximately 97% of its value). This does not even begin to include all their entitlement promises that increase their total debt including obligations to \$100 trillion or 6-7 times their annual GDP, but who is counting? Unfortunately, this level of debt, coupled with empty promises, is not unique to the US, but is found in virtually every country around the world that has had access to a debt facility and an investment banker and has imbibed the nonsense of modern economic and financial theory, as taught in our “elite” universities.

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When we consider the total global debt, the best estimation is that our global debt is now in excess of \$200 trillion USD (2.5-3 times global GDP). Over the past 10 years alone, we have witnessed a 150% increase in the level of global debt (this does not include unfunded liabilities/entitlements). During the past 40 years, ending in 2007, the annual growth rate of debt in the world far outstripped the annual GDP growth. Simply stated, all those “things” we have loaded up on, were largely bought on credit! The numbers are so large that they are difficult to fathom. Note that these numbers do not account for the tens of trillions of derivatives and synthetic derivatives that exist, purely for speculative reasons, providing our friends on Wall Street, something to trade in their spare time.

The financial state of the global economy as we have continually pointed out to you is precarious. In fact, strictly speaking, the global economy is so laden with perpetual debt that it is now insolvent (it has to issue new and growing levels of debt at manipulated interest rates in order to roll maturing debt and cover existing deficits). The worst offenders are the US, Japan, UK and Europe. China is also in very poor shape, despite their ability to disguise some of their problems. Experts familiar with China note that China’s debt to GDP ratio is now in excess of 200%, when all state sponsored entities are included. The very idea that communism can create wealth and allocate resources efficiently over time is straight out of fantasyland. Corrupt and power hungry human beings, regardless of race or gender, without strong checks and balances cannot create a new society for the betterment of humankind! What they will create is trouble. China is a time bomb facing as many challenges, if not more, when compared to the top 10 countries in the world.

Debt-based money systems operate best when they can grow exponentially forever. Of course, this is impossible, which means that all debt-based systems must eventually collapse and restart again.

B. ZIRP (Zero Interest Rate Policy)

Let’s take a few moments to consider one of the monetary pillars of our current global financial system, the belief in zero interest rates! Over the past thirty years, as our addiction and dependence on debt has grown, we have been able to fund this increase by taking our interest rates down from over 20% to almost zero. After all, if you don’t have to pay down your principal and you can borrow for almost nothing, you can afford a gigantic amount of debt! That is, until the rates go up or someone wants their money back and you can’t find a sucker to give you more money! Talk to the Greeks on that one! This has led to what many refer to as ZIRP (Zero Interest Rate Policy).

We believe that a policy of zero interest rates is a total abdication of financial responsibility on the part of our leaders. It is also a clear indicator of our desperate financial position. When interest rates are manipulated by the State to levels that are far below your inflation rate and the mere holding of government bonds (certificates of confiscation) ensures your erosion of capital the system has become corrupt. Below we mention six serious problems created by this short-term policy to prop up suffocating and irresponsible debtors.

1. Addiction to low interest rates has placed the whole global economy in a position where we cannot afford higher rates. Any material increase in interest rates (as little as 2-4%) would quickly destroy the

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financial viability of most governments along with their indebted and indentured citizens. The credit risk of sovereigns has never been higher yet, interest rates have never been lower.

2. ZIRP contributes to the misallocation of capital by forcing savers to make more speculative decisions that are not optimal. Money or capital must have a cost in order to be respected and treated efficiently. Capital must have a scarcity if it is to maintain value and act as a medium of exchange. Projects and capital investments must be held accountable to their ability to generate real rates of return, if wealth is to be created. Profits without productivity (i.e. Financial Innovation), can only go on for a finite period. Profits must emanate from enduring industries and businesses that create products and services needed by Main Street. Consuming our balance sheet or running it through our income statement, without replenishing long-term investments in capital, will destroy the viability of our economy.
3. With interest rates approaching zero, we have created a bond bubble of historic proportions. We face years of low to negative performance in many fixed income investments. This will be a major contributor to the ongoing underfunding of pensions and the inability of pension assets to pay in real dollars their actuarial obligations. Defined benefit plans in general are finished! ZIRP is the final blow to any surviving defined benefit plans.
4. Balance sheets of Financial Institutions will be stressed to the maximum, placing the capital and solvency of such institutions at risk. Too much bank capital is represented by overvalued

sovereign debt. Most major banks and many life insurance companies in the world are currently insolvent (mark-to-market accounting would wipe out most, if not all, of their capital). As rates increase, many of their holdings will have to be written down making substantial capital raises necessary in order to survive. Any capital raised in the private markets would probably be very dilutive to existing shareholders. Any capital raised by borrowing more debt from the State will prove to be increasingly futile.

5. Stealing from the savers to pay the irresponsible debtors (ZIRP) will further weaken our economy over time. An economy cannot function, nor grow its wealth, living in an environment of manipulated interest rates where the yield curve is fiction and looks like a straight horizontal line at close to zero! ZIRP is monetary economics rooted in pure short-termism with no concern for the future.
6. Bonds are denominated in currencies and most currencies have lost substantial value and, given the debt crisis, expect most currencies around the world to lose substantially more value!

ZIRP has rewritten the rules on fixed income investments and government debt. What were some of the safest investments in the world have become the riskiest investments. The highest quality investments are those that are essential and scarce and will re-price under even the toughest economic circumstances. The best assets are not debt assets nor are they assets burdened with debt.

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Bottom line: minimize your exposure to paper assets and in particular to government paper. Governments are becoming the worst counterparty risk as we approach the end of this latest episode in debt based monetary madness.

C. Operation Twist

Despite the close to zero interest rates that have been engineered by our monetary authorities around the world, the global economy continues to worsen. In September, the Federal Reserve decided that it was necessary to attempt to take what little interest rates still existed on bonds to even lower levels! Enter Operation Twist! We entitled this write up “The Fed is Twisting but the Market is not Dancing” in order to have some fun with the origin of the term which comes from the early 1960s, and is named for the Chubby Checker hit “Twist and Shout”. Unfortunately, for the global economy this is more like “Twist and Shout in Pain”.

Here's what Operation Twist is really all about, once the hype has been stripped away. It simply refers to the policy that the Federal Reserve, which has a balance sheet of approximately \$3 trillion in short-term treasuries, will sell some of their short-term treasuries (approximately \$400 billion), and replace them with longer-term treasuries in the open market. It is the same as you and I selling our 6-month bonds and replacing them with 10-year bonds. The net effect that is hoped for is that long-term bond rates will come down even further from their historically low levels, as the Fed bids up the price of long-term debt, thereby driving down their yields. This twisting from short to long-term treasuries shows how serious the overall debt crisis is when rates, that are already too low and causing extraordinary long-term problems, have to be dropped even further to keep the patient, in this case the global

economy, from going into complete cardiac failure. To think that dropping long-term rates by another 25-50 basis points is going to make a difference is sheer academic twaddle.

Operation Twist is twisted and perverted economics and the markets have no reason to dance along with this twisting. The global debt binge is reaching its ultimate end and we need to make sure we are well prepared.

D. Gold Mining Shares – Uniquely Priced

Few would dispute that the twelve-year (and still counting) bull market in gold has been the opportunity of this investment lifetime. Even fewer have truly participated in this dramatic move. From its 20-year bear market low in August of 1999, bullion has appreciated more than seven fold. That works out to a \$US compound return of 18.0% compared to 0.7% for the S&P 500. Despite this growth, it is estimated that there are only about \$2 trillion of investments in gold, or approximately 1% of all global financial assets. Despite all the hype in the news media, gold is far from a mainstream investment and is not widely held. The opportunity to invest in gold and gold related securities has been missed by almost every conceivable category of investor including pension funds, endowments, mutual funds, and central banks, all of which are severely underweight the metal and overweight dubious financial assets.

But, to regard the lengthy bull market in gold as an isolated fact would be simplistic and superficial. The media, and most of the financial community, are captivated by daily price action but do not see the big picture at all. To most, gold is viewed as a speculation, an overcrowded trade, and maybe even a bubble. It is seen in the narrowest of terms,

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as an odd curiosity that will at some point just go away. But after 6,000 years, gold is going nowhere but into the hands of the most sophisticated investors concerned by the outrageous levels of perpetual debt that have been contracted by the world's largest governments.

Since the demotion of gold to non-monetary status by the Nixon administration in 1971, fiat money, and credit based upon it, have been a fundamental source of global wealth generation as we have discussed. But, what is the value in real terms of the \$200 trillion of "wealth", mostly debt which is denominated in currency, if nobody wants the paper?

One of the best ways to get exposure to gold is to buy the businesses that actually mine the gold. Despite the significant rise in gold over the past decade, gold mining shares represent one of the most rational ways to participate in what appears to be the end game for paper currencies. While gold bullion seems popular, gold stocks are not! The divergence between gold bullion and gold shares has become very large over the past 9 months. With gold rising 29%, gold stocks (using the XAU index) have actually declined approximately 5%. Since the 1999 bear market low in bullion, the XAU has underperformed the metal by over 300% or 12% per year. We believe that gold shares will eventually make up much of this divergence as gold continues to inch higher in response to the global debt crisis.

The primary points given for the underperformance of gold shares boil down to three main reasons:

1. ETFs - have absorbed some of the flow of

funds that would have been allocated into mining shares in the past.

2. There remains a high degree of skepticism concerning the long-term price of gold.
3. Margin Pressure - mining companies, despite experiencing record gold prices, have not been able to grow their earnings as quickly as expected given the rising costs of production.

The main case for owning gold shares is captured in the following four points:

1. The world's major fiat/paper currencies are losing value at a rapid rate. With the debt problems the world is facing expect further decreases in the value of paper assets.
2. Buying the best gold companies provides you with organic growth opportunities, as the price of the underlying metal increases and as the companies expand their reserves through prudent exploration.
3. Dividends - more and more cash flow rich gold companies are declaring larger and larger dividends.
4. Mergers and Acquisition opportunities allow the best managed firms to buy up valuable gold reserves at attractive prices.

New Gold Inc.

One of the largest holdings among our ROCKLINC clients is New Gold Inc. The company is one of the highest quality intermediate gold companies in the world. When we conduct our research on a gold company we look for the following: a strong growth platform, firm is operating in safe geopolitical regions of the world, a very robust financial position (large net cash

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position, with no need to issue shares) and a talented and experienced management team that has the majority of their net worth in the business. In the case of New Gold, they also have a strategic investor, Seymour Schulich, who controls approximately 25% of the firm. Mr. Schulich helps, not only in terms of corporate governance, but also protects the firm from any unwanted advances or low ball bids.

Given the growth profile of the company and their ability to expand their operating margin, as their production increases, we believe the company will be worth substantially more in the next 3-5 years. In fact, over the next five years we expect the cash flow of the firm to increase significantly even at current metals prices. On a per share basis, we expect cash flow to exceed \$2.50 by 2016. With a typical multiple of 10-12 times, the stock price should be well north of \$25.00 and could easily exceed \$35.00 with increasing gold prices. Currently, New Gold is trading around \$11.75 at the time of writing. In our view, New Gold is the type of business that should grow the value of your capital, despite the ongoing debt challenges. As paper assets continue to be weighed down by the excessive global debt, more and more investors will be looking towards precious metals as one way to protect and grow their capital in these uncertain times. New Gold is a growth business in an exceptional industry trading at a very attractive price. While the Fed twists, shareholders in New Gold will be the ones dancing!

E. Volatility, Printing Money and the Way Forward

The one item that is certain going forward is that the markets will continue to be extremely volatile. The reason is simple. The global economy is facing some of the biggest head winds since the Great

Depression. It is important to realize that the headlines, which will range from dire to sanguine, will pull investors in every direction, especially investors who are not rooted in strong long-term investment principles. As we have consistently laid out to our investors over the last 21 months (since the formation of ROCKLINC), bad headlines and feeble leaders are not sufficient reasons to hide your debasing money under the proverbial mattress. Instead one must focus on the challenges, understand them, and find investments that can navigate through the treacherous waters safely. Here are our views on the various asset classes.

1. Cash - maintain higher than normal cash weights in portfolio. Cash is used to both buffer volatility and to make investments at opportune moments when stock prices become very inexpensive. Cash loves volatility.
2. Fixed Income - we continue to buy very short term fixed income investments of countries or companies that have the strongest credit ratings and are backed by tangible equity. The name of the game today is collateral!
3. Equities - our focus is on businesses with low leverage or debt operating in essential industries, safe countries and with high barriers of entry. The industries by level of importance are; precious metals, oil and gas, infrastructure, agriculture and water, financial services, real estate, consumer staples and healthcare.

As the debt crisis becomes more intractable, we fully expect our governments and monetary authorities to do what they do best and that is to expand the money supply and print more money. The calls for easier and easier monetary policy continue to grow with

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each passing day. No country really wants to own up to the severity of the problem and restructure. But, a global economy rooted in a culture that know very little about self-sacrifice and are perfectly content to rack up the levels of perpetual debt, cares nothing for the next generation, let alone themselves. History tells us, with absolutely no ambiguity whatsoever, that cultures like ours will lie, beg and steal until the game is finally up and the wall has been hit! We are working hard to make sure you and your capital are not part of that train wreck and that is why we are on a different set of tracks, plodding along slowly and carefully letting the fundamentals, current reality and history guide all of our actions. It is because of this we remain optimistic!

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