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"Welcome to the Hotel California"

Investment Update

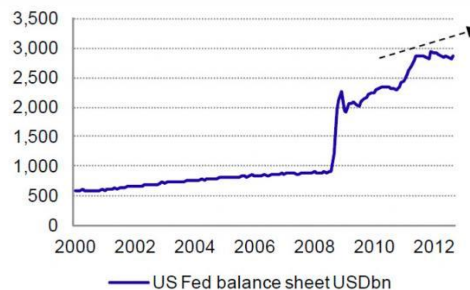
A. QE to Infinity

On September 13, 2012, the Federal Reserve (Fed) announced that it would begin a third round of quantitative easing, referred to by many as QE3. As we have discussed in previous newsletters, quantitative easing, is nothing more than a euphemistic expression for the printing of money. The Fed, in a press release, justified their latest actions by stating they were "concerned that, without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in the labor market conditions." But stop for a moment! What did they just assert? Did they state that printing money would lead to increased economic growth and an improved labour market? Are they serious? Unfortunately, they are deadly serious! The majority of economists and central planners today, believe that printing money, otherwise known as the debasing of one's currency, creates wealth! If it were that easy …

Back to reality, how does boosting the money supply of a nation encourage greater capital formation, financial discipline and long-term investments? What does debasing the currency have to do with increasing the entrepreneurial drive and creativity of the society and its citizens? How does loose and easy monetary policies, help slow and reverse the long-term ethical and moral decline throughout developed nations? The strength of a nation is rooted in the virtue and integrity of its people and their faith commitments, not the debauching of a countries currency and consuming things you cannot afford! How does money printing help force the downsizing of our out of control public sector? How does it help us deal with the mother of all entitlement bubbles (pensions and healthcare)? We think you get our point. Printing money does nothing to solve our long-term systemic problems. In fact, we would argue that any delay in dealing with our debt problems only make matters worse, and by delaying, with no long-term plan, we are casting our developed economies into an economic purgatory.

It's important to note that the balance sheet of the Fed was as small as $800 billion in 2008. The balance sheet of the Fed is important because it is equivalent to the money supply. During late 2008 through 2011 the Fed launched both QE1 and QE2 that added respectively $1.3 trillion and $600 billion to their balance sheet (money printing). By September 2012, the Fed's balance sheet, or money supply, was approximately $2.8 trillion, an increase of $2.0 trillion (250%) in less than 4 years. See Figure 4 below, taken from a recent presentation by Deutsche Bank that pictorially shows the increase in the Fed's balance sheet. Despite this massive increase in money supply, along with $6 trillion in cash deficits over the past 4 years, the real GDP of the US is still below its peak reached in 2007. Something is seriously wrong.

Figure 4: US Fed balance sheet expansion continues...



Source: Deutsche Bank

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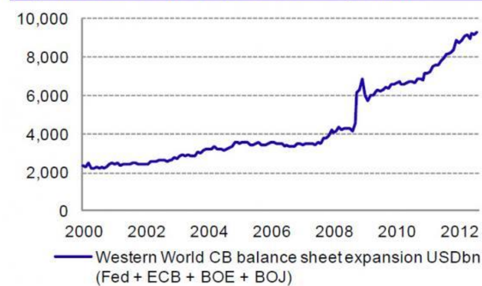
Although we have been discussing the US in this newsletter, let us remind you that the economic conditions in Japan, Europe and the UK (which we have touched upon in the past) are far worse than the US! It's also critical to point out that all the major central banks in the world, including those of Japan, Europe, UK, Switzerland and China are printing money at unprecedented rates. James Rickards, author of the book entitled, "Currency Wars", nailed it when we provided a blueprint for what to expect over the next few years. His bottom line: countries and their central banks will print, print and print some more as they attempt to debase their way to prosperity. Saddled with debts and obligations that have no chance of ever being paid, governments and their debt laden citizenry are choosing what history tells us they will always opt for; to debauch the value of their money, extend and pretend as long as possible. This is not a revelation to anyone who has read a little financial history and understands human nature.

This latest round of money printing that was announced on September 13th, QE3 as it is affectionately referred to, will materially enlarge the money supply through the purchasing of $40 billion in mortgage-backed securities each month. Over the next 12 months the Fed will create, out of thin air, close to $500 billion in new money! Most importantly, the Fed did not provide any end date! According to Chairman Bernanke, the head of the Fed, they (the experts at the Fed) will discern when enough money printing is sufficient and the economy is operating according to their fancies. But, this belief that a handful of bureaucrats have the knowledge to manipulate the economy through the price fixing of interest rates and the controlling of the money supply is sheer arrogance. The truth is the opposite; the Fed has hardly gotten anything right over the past 100 years, since their inception. Central bankers have proven over and over again that while they think they are omniscient, in reality, they do not have a clue what they are doing. The path we are on is utter folly.

This latest round of QE, in continuity with the two previous rounds, displays their total lack of knowledge, believing that the creation of endless amounts of counterfeit currency is a solution to anything, rather than a road to financial perdition. Given the open-ended nature of QE3 many commentators have simply referred to this latest round of money printing as "QE to eternity and beyond"! But what does this mean for investors? What does this mean for you? How can nations continue to expand their money supply without deleterious results? Is it really different this time?

In summary: the Fed (along with every major central bank in the world) is hiding behind euphemistic terms such as quantitative easing in order to justify their reckless actions. The fact remains, they are printing money, they are printing a lot of money and they are addicted to the printing of money. See Figure 13 below which aggregates the magnitude of the money printing by the four largest central banks in the world. Note the almost 5 fold increase in money supply over the past 12 years! All the economic mumbo jumbo in the world should not take our focus from today's most important economic reality. That reality: the developed world is drowning in debt and it is loath to own up to its debt addiction.

When printing money, fiscal deficits and holding real interest rates (interest rate – inflation) to less than zero are the only proffered solutions by our economic soothsayers, it does not take a rocket scientist to figure out we are facing some major challenges. Pimco's bond king as he is known, Bill Gross, states it as follows, "the US and its fellow serial abusers have been inhaling debt's methamphetamine crystals for some time now, and kicking the habit looks incredibly difficult."



B. What's the Real Story?

As we have been writing about since the inception of ROCKINC back in January 2010, we are in the midst of the greatest debt bubble in recorded history. When the US removed the gold or collateral backing from the dollar in 1971 (and therefore all currencies, since the US dollar is the global reserve currency) the nature of money changed. The result was an explosion of credit that not only transformed the size and structure of the global economy, but also brought about a transformation of the economic system itself. As Richard Duncan points out in his newly released book, "The New Depression – The Breakdown of the Paper Money Economy", the production process ceased to be driven by savings and capital formation as it had been since the Industrial Revolution. Instead, borrowing, debt and consumption began to drive the economy. Credit creation or debt replaced capital accumulation as the vital force and "foundation" of the economic system.

Although it is difficult to believe, credit expanded by 50 times between 1964 and 2007. As a point of reference, the total value of debt/credit within the global economy is now over $200 trillion with a world GDP of $70 trillion. Ten years ago global debt was $120 trillion with the world GDP at the time of $32 trillion. This does not include derivatives and unfunded liabilities that exceed $1,000 trillion!

As long as credit expanded during this period, economies grew, asset prices increased, jobs were created and corporate profits expanded. In 2008, after a period of more than 40 years of rapidly expanding credit, the bubble started to leak. As the total amount of credit began to shrink the whole economic system built on credit fell into crisis. In 2008, we reached the inevitable debt saturation point where the level of credit (or debt) exceeded the ability of those who owed it to service the debt, even at very low interest rates. In particular, the private sector began a long and needed process of deleveraging (reducing debt). Unfortunately, this deleveraging led to a contraction in credit that increased the probability of a debt deflation that governments and central banks around the world do not want. A debt deflation would wipe out large portions of the debt and force a complete downsizing of government. Social welfare schemes and entitlement programs would be eviscerated, as tax revenues would collapse. A debt deflation would also take down leveraged financial institutions such as banks as the collateral value supporting their loans would drop in value and put their capital base at risk.

In the face of private and corporate deleveraging, governments and central banks around the world hit the panic button and have tried to fill the decrease in credit and debt by increasing government spending and deficits. The problems with this strategy are many; let us provide you with two. First, government deficits over the past five years have been growing at rates that far exceed the level of economic growth. When deficits are added to the accumulated debt, along with entitlement promises, the debts are not payable in real dollars. This financial position saddles younger generations with a debt burden that is unbearable and is now putting a stranglehold on economic growth while destroying opportunities for jobs in our economy. This problem will

increasingly be borne by our youth. In most European countries, youth unemployment is over 25% and in some cases closer to 50%. Second, solving a debt problem with more debt is insanity. What makes this new debt even worse is that it is not going into long-term capital projects within the private sector and hence, not based on economic returns. Market based investments would actually create wealth and enhance the long-term productivity of our economies. Unfortunately, much of the current government spending and increased debt is being used to grow outsized social programs and entitlement schemes that actually need to be slashed not grown in size. Current social programs are not only unsustainable, they undermine the work ethic of the recipients and force governments to eventually steal (redistribute sounds kinder) from producers to give to the non-producers. This theft can take place directly through increased taxes on the so-called rich or through the manipulation of interest rates to below market levels where savers or capital accumulators are forced to subsidize irresponsible debtors including the government.

Consider the following redistribution of wealth from savers to the debtors that is currently taking place throughout the world. We will limit our example to the US where the numbers are readily available. In 2008, US household interest income from assets was approximately $1.4 trillion. If interest rates had remained unchanged in 2012 from 2008 the amount of interest income from assets in the US would be approximately $1.5 trillion. Instead, the amount of interest income in 2012 is expected to total $950 billion. Bottom line: the Fed's interest rate price fixing has taken, on an annual basis, **$550 billion** out of the hands of savers and capital accumulators and placed it into the hands of bankers and debtors, the worst being the government. As Bob Janjuah of Nomura so clearly stated it, "central banks are attempting the grossest misallocation and mispricing of capital in the history of mankind." This is the world we live in and the one we must invest in!

C. 21st Century – Debt Gone Wild

William Buckler the author of The Privateer makes the following observations concerning the fiscal situation in the US. If these numbers do not shock you and underscore what we have been saying, nothing will! I paraphrase his thoughts from a recent article.

> For all intents and purposes, there have been two US Presidents thus far in the 21st century - George W. Bush and Barack Obama. If we take Mr. Bush's two terms to cover fiscal 2001 to fiscal 2008, the total rise in official Treasury funded debt over that period was $US 4.350 TRILLION. If we take Mr. Obama's first term to cover fiscal 2009 to fiscal 2012, the rise over four years was $US 6.050 TRILLION. **Add the two together and you get a grand total of $US 10.4 TRILLION. That's almost two thirds (65 percent) of the total funded debt of $US 16.066 TRILLION as of September 28, 2012.**
>
> An American celebrating his or her 100th birthday this year was born at a time when the TOTAL debt of the US Treasury was $US 2.8 billion. In fiscal 2012, the US Treasury borrowed that amount in about 19 hours. An American celebrating his or her 50th birthday was born at a time when the funded debt of the US Treasury was $US 300 billion. In fiscal 2012, the Treasury borrowed that amount in less than three months. An American celebrating his or her 12th birthday today was born at the beginning of the 21st century. That person doesn't have much to celebrate, given the fact that almost two thirds (65 percent) of the total funded debt of the US Treasury has been amassed in their lifetime.
>
> Here is a very simple observation, which goes to the root of the entire global monetary morass of the 21st century. An American celebrating their centenary in 2012 was born into a nation of just over 95 million people. A newborn American is being born into a nation of just under 313 million people. One hundred years ago, the US had a bit less than one-third of its current population. How did it function with a TOTAL government debt of $US 2.8 billion? Today, that same government is running a funded "tab" of more than $US 16,000 billion and a total "tab" (including UNFUNDED liabilities) of well over $US 200,000 billion? In fiscal 1912, total Treasury debt increased by $US 10 million or a bit less than ten cents per

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> capita. In fiscal 2012, funded Treasury debt alone increased by $US 1,276,000 million or a bit less than $4,100 per capita. The unfunded debt increased much more than that. These numbers are grotesque. In less than three presidential terms of office, $US 10.4 TRILLION has been added to the Treasury's funded "tab". At the rate of expansion over the 12 years since the turn of the century, another 12 years would see the funded debt blow out to $US 26.5 TRILLION by 2024. If we project the rate of expansion over Mr. Obama's one term as president for the next 12 years, the total by 2024 would be $US 34.2 TRILLION.

Clearly the situation is unsustainable. Please note that the build-up of debt in Japan, Europe and the UK is no better. The pressure to print money is not going to abate any time soon. QE to eternity?

D. Hotel California

This brings us to the title of this update "Welcome to the Hotel California" the title song from the Eagles' album of the same name released as a single in February 1977. Many have provided various interpretations of the song, but the Eagles themselves described the meaning of the hit song as living the high life in Los Angeles. The lyrics describe the Hotel California as a luxury resort where "you can check out anytime you like, but you can never leave." The song tells a tale of a weary traveler who becomes trapped in a nightmarish luxury hotel that at first appears inviting and tempting but, in the end, is a destructive place that he cannot leave. The song is an allegory about hedonism, self-destruction, and greed in the music industry of the late 1970s. Or as the lead singer, Don Henley stated it more broadly, "it's basically a song about the dark underbelly of the American dream and about excess in America which is something we knew a lot about."

The current financial situation is a true "Hotel California." We have lived in excess. We have spent well beyond our means. We have indebted ourselves along with those that will follow us. Now the only thing that keeps the system "alive" is the printing presses of the central banks around the world. Print and debase, print and debase, extend, pretend and depend! "Welcome to the Hotel California, such a lovely place, such a lovely place …. You can check-out any time you like, but you can never leave."

Expect QE to continue until the system ultimately cannot sustain it anymore. The exit from this latest debt debacle will not come as a result of principled leaders making honest decisions rather it will be forced on us. As a result, we must be prepared for the restructuring of global debt and the erasing of significant entitlement promises.

E. Strategy – Unchanged

As we have stated many times, the best offensive is a good defense, and we are playing aggressive defense! We are adhering to Warren Buffet's two rules of investing. Rule number 1: don't lose your investor's capital! Rule number 2: go back to rule number 1.

We are determined to protect your capital, and grow it, through the economic "gales" ahead. As we have emphasized repeatedly, we cannot isolate you from market volatility and the price swings that inevitably occur in the short-term. What we can attempt to do is to avoid permanent loss of capital by investing in assets that can navigate their way through the inevitable economic storms. Despite the challenges we have discussed in this newsletter, they are not a deterrent for us when it comes to investing. We remain optimistic that a disciplined approach to asset accumulation will provide our investors with the best opportunity to protect their capital. Money buried in your backyard will not only yield nothing, it cannot protect you from the ongoing debasement of currency and concomitant loss of purchasing power.

When it comes to portfolio creation, we believe that there are three vital components. First, reject modern portfolio management theories as developed over the past 4-5 decades; second, protect your investments from bad counterparty risk and; third, ensure all your investments are collateralized with the highest quality assets possible. Let us elaborate on each briefly.

1. Reject Modern Portfolio Management Theory. Charlie Munger (Warren Buffett's partner) had it perfectly correct when he stated that modern theories of money management are all "twaddle". Much of modern portfolio management simply espouses massive diversification to the point that your investments simply become the market. We believe more than ever, one has to be focused when it comes to investing. Today, it is important to actually avoid large swaths of the market, given the global debt crisis. Risk management goes well beyond diversification and starts with contrarian thinking!

2. One crucial element when it comes to investing is to consider who is on the other side of your trade. This is referred to as counterparty risk. Can you trust your counterparty? Do they have the resources to make good on their commitment? Modern financial theory (incorrectly) tells us that governments are the highest quality counterparties. While this is true for brief periods of time, it is seldom the case over time, due to the corrupting influence of power and central bankers. In the current environment, governments have become some of the worst counterparties. The idea that government securities are risk free, a concept taught in our university finance courses, comes straight out of fantasyland not reality. Government securities are in many instances the riskiest of investments. That is why we do not have any direct investments in China, Middle East, India, Russia and large parts of Europe, both Eastern and Western. When it comes to your investments, the quality of the counterparty is crucial and it keeps us out of many investments when we cannot trust the national governments or particular businesses and their managers.

3. The last element of our investing is ensuring that all our investments are well collateralized. As each of you are aware, we break your portfolios into three types of asset classes: cash, fixed income and equities. The ratios in your portfolios will vary based on your individual circumstances.

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

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

    iii. Equities: the most important asset class that we invest in is equities (and preferred shares). Ultimately, it is the carefully selected equities that will protect and grow your capital. When we evaluate the types of equities we want to own, we are searching for assets that are characterized by scarcity, they must be essential or necessary assets with few substitutes and require work, capital and time to realize value. In other words, they are as insulated as possible from the debasement of currencies! The main industries of focus remain, precious metals (gold and silver), agriculture, water, infrastructure, real estate, oil and gas, basic staples, and fee based financials with minimal debt.

With the Canadian dollar trading well above the US dollar we will continue to look for businesses that provide us with global exposure. Although we believe that our Canadian prospects are better

than most countries, we are still a part of the overall global economy. Anytime our dollar trades up in value it's time to use that increased purchasing power to buy excellent assets around the world. Expect this trend to continue in your portfolios.

The famous value investor, Benjamin Graham, once stated that the stock market is a voting machine in the short-term but a weighing machine in the long-term. We continue to look for companies that weigh much more than the current stock market scales indicate. Our focus on collateral (balance sheets), counterparty risk and prudent portfolio management that concentrates on the finest assets should continue to prove out over time.

F. Precious Metals – Gold & Silver

We want to end with a few thoughts concerning precious metals. Since the overall financial community is not enthusiastic concerning gold and silver it is important to understand as much as possible about these commodities, which comprise approximately 15% of your portfolios.

Gold and silver to a lesser extent have been alternatives to fiat currencies for over 4,000 years. In the Old Testament in the first book of the Bible, Genesis the thirteenth chapter and second verse we read, "Abram had become very wealthy in live-stock, and in silver and gold." In 1 Kings 10:14, also found in the Old Testament of the Bible we are told that the great King Solomon received "the weight of gold that was equivalent to 666 talents yearly". He also received and traded in many other precious commodities. Note that a talent was approximately 94 pounds. This means that the total annual income that Solomon received in gold, in today's value would be close to $1.8 billion USD. Given Solomon's 40 year reign, the expansive nature of his empire, and his massive import and export businesses, there is no question that no one to date has exceeded his net worth.

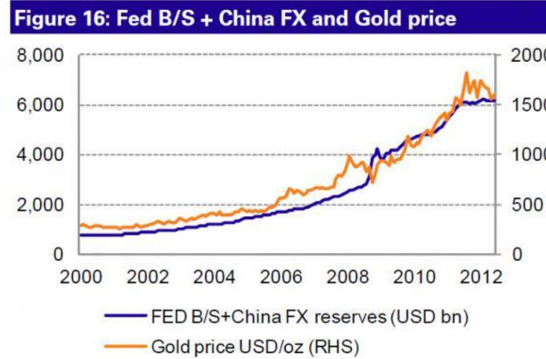
The point we need to focus on is that over long-term periods these two precious metals have acted as tremendous stores of value. When economists or other so-called experts denigrate gold and laugh at silver and other precious commodities, please ignore them and take the other side! The two main advantages that gold and silver have over all fiat currencies is they cannot be printed into existence and neither has any counter party risk. In an age of unprecedented money printing, by all of the major central banks, there has not been a better time to hold precious metals in our lifetime. This is why we are committed to maintaining a significant position in gold and silver. This is obtained through the direct investment in mining companies as well as royalty businesses that finance the exploration and mining of gold and silver.

Interestingly enough, one of the primary disadvantages of holding gold relative to fiat currencies it that gold does not pay interest, but this disadvantage is largely eliminated by the zero to negative interest rates in the current environment. With real interest rates likely to remain very low for the foreseeable future, gold, silver other precious metals along with tangible assets in general should be emphasized and over weighted in our portfolios.

Gold and silver are also being supported by a long-term secular increase in demand. Prior to the financial crisis of 2008, gold was substantially under-owned relative to financial assets, and despite stepped-up purchases of gold by central banks and sovereign wealth Funds, the shift towards greater holdings of the precious metal is still in its early stages. Shorter-term supply of most precious metals, in particular, gold and silver are tight with physical inventories running at very low levels. Any increase in demand for the physical assets themselves should be met with significant price increases in the underlying commodity. The ongoing debt crisis throughout the developed world has raised questions about the long-term sustainability of all fiat currencies. History is clear, all fiat currencies revert to zero while gold and silver have never gone to zero!

The last point we will make is that over time the value of gold is directly correlated with the size of the currency or money in circulation. Please see Figure 16 below, which tracks the price of gold

with the Fed balance sheet and Chinese holding of foreign exchange or IOU's (debt) primarily from the US. As central banks continue to print money, expect the price of gold to continue to rise. With QE to eternity well entrenched for the foreseeable future, we believe it would be unwise not to have a significant weighting in tangible assets led by silver and gold exposure!



If you have any questions or would like to talk with us please do not hesitate to email, phone or stop by the office. Thank you again for your trust and confidence. We do not take it for granted!

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