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# Central Banks doing the Limbo

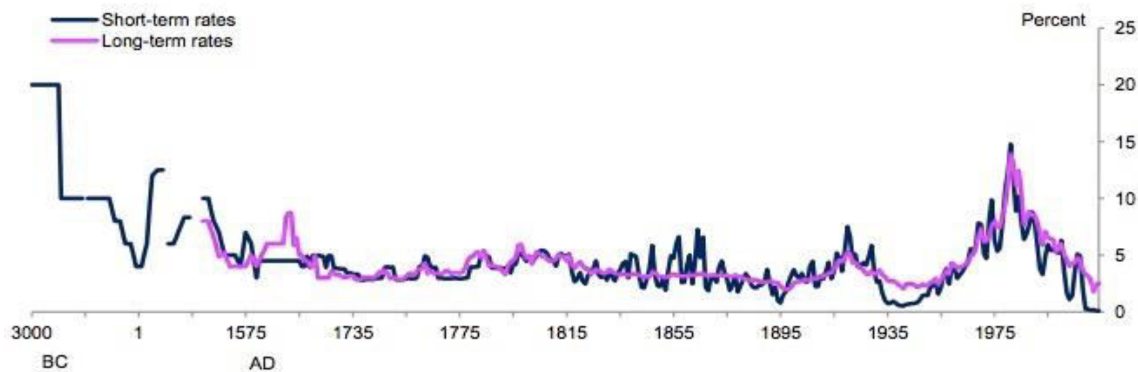
**"There is no more dangerous menace to civilization than a government of incompetent, corrupt, or vile men." Ludwig von Mises**

## A. Debt Tsunami Continues to Advance

In a recent article published in the Washington Post, Matt O'Brien[i] noted that **interest rates are lower today than at any time in history**. He based his comments on research conducted by Bank of England chief economist Andy Haldane. In the article O'Brien noted that:

> *"Interest rates are lower today than they were when FDR or Napoleon or Henry VIII or Genghis Khan or Charlemagne or Julius Caesar or Alexander the Great or even Hammurabi were around. Or, if you want to put a year on it, lower than at any time since the ancient Sumerian made the first loans payable in either silver or grain, back in 3000 B.C."*

As we have pointed out for several years now, interest rates are all but zero in the United States, UK, European Union, Canada, and for almost two decades in Japan. Collectively these countries make up over half the global economy. To think that rates could move this low and stay this low for so long was unthinkable only 8 years ago. (Note the history of both short term and long term rates pictorially displayed in the chart below.)




While many investors are excited by the low to zero interest rates, we are concerned! Holding rates this low, for so long, is damaging to the overall economy and an indication of sickness, not health. As we have outlined in previous newsletters, keeping rates this low will continue to have a detrimental effect on the global economy and its ability to grow. We have briefly listed eight negative impacts emanating from artificially low rates.

1. Structurally low interest rates encourage "a culture of instant gratification." A debt-based society is more interested in consumption than long-term economic growth.

2. Low interest rates punish savers and reward debtors. The longer interest rates remain below market rates the greater the pressure to misallocate capital.

3. The combination of low interest rates and printed money leads to massive asset price inflation, such as stocks, real estate and art. Young people get priced out of the real estate market despite record low rates. This makes the acquisition of personal wealth and capital more difficult.

4. Financial markets are structurally weakened by the reckless behaviour of market participants who use low cost funds to make more risky investments using excessive leverage.

5. Human behaviour is shaped in a negative manner with low interest rates and easy money policies. Any society that watches the continual erosion of its purchasing power will care less about frugality and thrift and will become increasingly comfortable with debt as a "rational" choice.

6. Incentives for fiscal discipline on the part of government decrease dramatically. Central banks buy time for governments. Large deficits don't seem so ominous, there is little incentive to implement reform or run the affairs of the State in a prudent manner.

7. You encourage the emergence of "zombie-banks and zombie-companies". Very low interest rates prevent the healthy process of creative destruction. Zero interest rates make it possible for companies with low profitability to survive longer than they should.

8. Unjust redistribution of wealth takes place in an environment of zero rates and fresh money printing. Monetary expansion is never neutral! There is a permanent transfer of wealth to those who get access to the money first from those who receive it last!

Given all these risks and their negative impact on the economy, why do central banks want to keep the rates so low and continue printing so much money? The reason is actually fairly simple. The massive build up of debt over the past 3-4 decades is leading us headlong into a significant period of deflation (decreasing asset prices)! It is this deflation that is terrifying to the world's central bankers! **Their number one objective is to avoid deflation! WHY? If deflation hits and asset prices drop (ie. home prices, financial assets), can you imagine the pain? Homeowners with large mortgages would watch their equity vanish and banks would not have sufficient collateral supporting their loans. With personal net worth crashing and banks experiencing significant losses the economy would almost certainly enter into a significant depression.**

This is why the central banks are more interested in creating inflation! In a debt-based economy, deflation is seen as devastating while a good dose of inflation is seen as helping in the reduction of the nominal value of debt. In essence the central banks "deal" with the debt issue by inflating it away! Let's use the case of the homeowner again. The homeowner's mortgage stays the same but the value of their home goes up due to inflation. Homeowners feel wealthier even though their purchasing power has probably not improved given stagnating wages. If you already own a home you are less impacted, but for those who hope to own a home they are increasingly kept out of the market given the increasing home prices that far outstrip wages. In the case of inflation, in the short run there is the **illusion of wealth** being

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created/maintained. But whether it is inflation or deflation the end result is clear. The debt must be reduced!

As we talk to investors and clients many are still shocked to learn that the debt situation is getting worse and not better! We have included two charts from a recent study by McKinsey & Company. The first chart highlights the point that it is the "wealthiest" countries that are the most indebted! Refer to the chart entitled "The World's 20 Heaviest Debtors". Note that since the financial crisis of 2008-2009, the actual level of global debt has **increased by USD $57 trillion or 40%!** And that is only to the end of 2014! In essence citizens and their governments have dealt with the debt crisis by going further into debt!

## The World's 20 Heaviest Debtors

**McKinsey & Co. recently ranked the globe's 20 most indebted countries by debt-to-GDP. Besides Malaysia, all the countries on this list are developed nations. Just outside the Top 20 – but still serious offenders – are Germany at 188%, Australia at 213%, and Canada at 221%.**

| Country | Debt-to-GDP | Country | Debt-to-GDP |
|---|---|---|---|
| Japan | 400% | France | 280% |
| Ireland | 390% | Italy | 259% |
| Singapore | 382% | U.K. | 252% |
| Portugal | 358% | Finland | 238% |
| Belgium | 327% | United States | 233% |
| Netherlands | 325% | South Korea | 231% |
| Greece | 317% | Hungary | 225% |
| Spain | 313% | Austria | 225% |
| Denmark | 302% | Malaysia | 225% |
| Sweden | 290% | Norway | 224% |

*Sources: McKinsey & Co., Money Morning Staff Research*

The growth in debt and the breakdown of the debt by sector is given in the second chart entitled "Global Stock of Debt Outstanding." Note that the sector within the economy that is growing debt the fastest is the government sector. Unfortunately this is the worst of all

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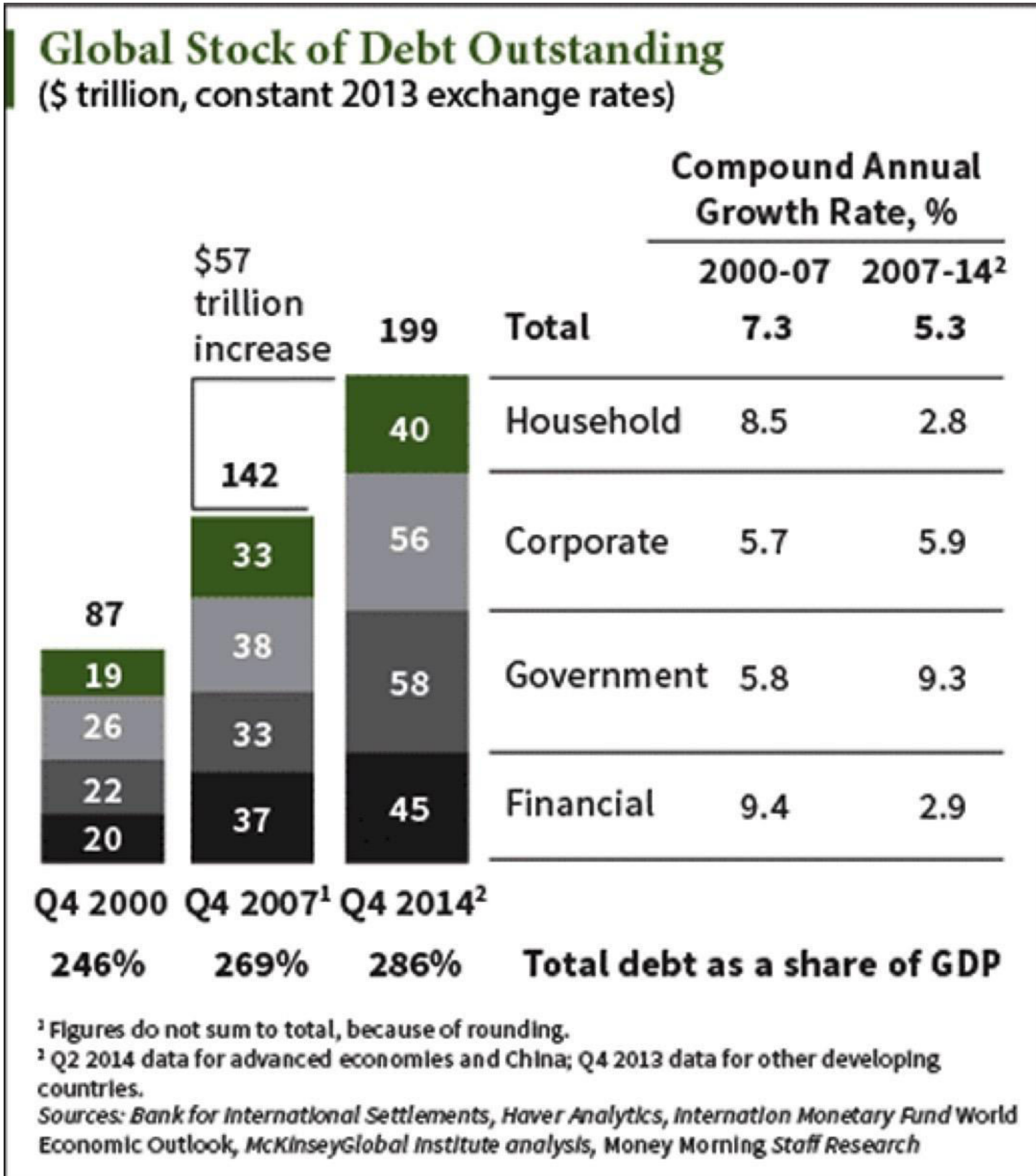
financial decisions because it puts more debt and spending in the hands of the most inefficient, wasteful and incompetent sector in the economy. The debt tsunami shows no sign of slowing down.



## B. Central Banks Doing the Limbo? How low can they go?

Several questions must be asked; what happens if all this money printing and zero interest rate policy on the part of the world's central banks does not create the necessary inflation to chip away at the value of all this debt? What happens if the global economy continues to grow the level of debt faster than the capacity of the global economy to service it? The answer that seems to be emerging is shocking. If zero interest rates don't work why not take them lower? How about negative interest rates? Why stop with ZIRP (zero interest rate policy) when you can go NIRP (negative interest rate policy)!

Recently, Andrew Haldane, the chief economist at the Bank of England, gave a highly talked about speech that provided all of us a window into the minds of central bankers. Now that their zero interest rate policies (ZIRP) have failed in their objectives to grow the economy and create inflation, what is next?[ii]

Of course, Haldane does not honestly and openly admit to ZIRP failing, but the fact that the global economy is in the tank and debt levels continue to escalate shows everyone how ineffective their monetary policies have been. What is particularly worryingly for central bankers is that with interest rates at the zero bound, they cannot drop rates any further, or can they? How low can they go?

For the first time, central bankers are talking about what they say are the "only two options" left to deal with the global debt crisis. These two options are; first, continued money printing and second, taking interest rates below zero! Both of these options are not viable and neither will solve our debt addiction.

Alasdair Macleod in a recent article provides some helpful criticism of Andrew Haldane and his interest in ZIRP.

> *"Here is a brief summary of why, based on pure economic theory, NIRP is a preposterous concept. It contravenes the laws of time preference, commanding by diktat that cash is worth less than credit. It forces people into the practical discomfort of treating physical possession of money as worth less than not possessing it. Suddenly, we find ourselves riding the train of macroeconomic fallacies at high speed into the buffers at the end of the line. Of course, some central bankers may sense this, but they are still being compelled towards NIRP through lack of other options, in which case holding cash will have to be banned or taxed by one means or another. This would, Haldane argues, allow them to force interest rates well below the zero bound and presumably keep them there if necessary.*
>
> *One objective of NIRP will be to stimulate price inflation, and Haldane also tells us that economic modeling posits a higher target of 4%, instead of the current 2%, might be more appropriate to kick-start rising prices and ensure there is no price deflation. But to achieve any inflation target where ZIRP has failed, NIRP can be expected to be imposed for as long as it takes, and all escape routes from it will have to be closed. This is behind the Bank of England's interest in the block-chain technology developed for bitcoin, because government-issued digital cash would allow a negative interest rate to be imposed at will with no escape for the general public."*[iii]

In considering NIRP, Haldane's paper fails to address a much greater issue, which will eventually bring this insane monetary experiment to some end. By forcing people into paying

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to maintain cash and bank deposits, central bankers are playing a reckless game with the public's acceptance of state-issued money. Eventually the public will come to understand what some of us already know, that our fiat currency does not have much value! The cavalier attitude of economists and central bankers will be obvious to everyone when we come to see their latest policy suggestion, which is nothing but a prospective tax on personal liquidity/cash.

**Bottom line: central banks want to tax our cash holdings!** As Macleod points out in his article, NIRP makes the hidden tax of monetary inflation, of which the public is generally unaware, suddenly very visible. This is an important point, inflation is a tax but most people do not see it or understand its effects. In the case of NIRP everyone will see the "tax" and the corruption of the monetary system will be clear! This is why more and more of the central bankers are interested in a cash less economy and want all our money to be digital. Cash in the form of paper can be hoarded under the proverbial mattress! Digital money cannot be hidden and can be easily taxed or reduced in value, which in effect, creates a negative interest rate on our money. Crazy times bring forth crazy policies.

Let me mention one other area that should concern all of us and that is the viability of all our pension schemes both private and public. The policy of ZIRP over the past eight years has created enormous unfunded pension liabilities in both private and public sectors, by requiring greater levels of capital to be set aside in order to fund the needed income streams for pensioners. Most savers are unaware of this problem currently since the topic is generally not discussed in the broader media. If ZIRP kills the ability to fund pensions, given low rates of return, what on earth will happen to pension liabilities with NIRP? How can any pension obligations be met in an environment of negative interest rates?

Central banks are embarking on an unknown course. The likely outcome, if these policies are pursued, will be uncontrollable price inflation. Why would anyone maintain cash balances or trust government issued currency? "We need to watch closely how this debate over NIRP develops. If the Bank of England is looking at ways to overcome the zero bound on a permanent basis, it is a fair bet that it is being looked at by other central banks in private as well. And if NIRP gains traction at the Top Table, the life expectancy of all fiat currencies could become dramatically shortened."[iv]

How low can they go? Time will tell. In the meantime we must invest in a manner that protects your capital as best as possible from this monetary "limbo". As Ludwig von Mises rightly noted, "there is no more dangerous menace to civilization than a government (including central bankers – **my addition**) of incompetent, corrupt, or vile men."

## C. Third Quarter Review

The third quarter has been a tumultuous and volatile period for the global markets. The quarter began with Greece reaching another deal with its creditors. How long this deal will last is any ones guess! Throughout the summer most of the economic news that was released was quite weak and this led to successive rounds of market volatility, which left major developed market indices significantly lower on the quarter. In terms of the North American stock markets all of them were down between 6%-9% for the quarter. They were also down year to date a similar amount since markets were generally flat for the year at the end of the second quarter.

The initial trigger for the instability in the third quarter was China. After a meteoric rise in the Chinese stock markets they proceeded to drop by up to 40 percent during the quarter. This led

to a substantial amount of interference in the market by the Chinese government. This was followed by a very chaotic decision to devalue their currency in August. All of this left investors with a deep concern over the management of the world's second largest economy. This led to legitimate fears concerning China's economic slowdown and the falling demand for commodities. With excess supply in China, and a decreasing demand for commodities it was no surprise that commodities were the worst performing asset class of the quarter. Given that the Canadian economy is very dependent on the export of commodities this led to a further weakening in the Canadian dollar versus the US dollar.

In late September the US Federal Reserve decided to leave US interest rates unchanged, which seemed to surprise many market participants. The Fed was clearly responding to the very weak global economy along with a struggling US economy. This delay in increasing interest rates simply underscored the hesitancy of any central banks to increase interest rates in the face of the global debt crisis and the massive global imbalances that have built up over the years. We do not expect the Fed to increase rates any time soon and believe it is more probable that they stay at zero and a new round of money printing is launched by mid 2016. In the chart below we highlight for you some of the most significant changes in the prices of various assets and indices during the third quarter and year to date.

| | 30-Sep-2015 | Quarterly Returns | YTD 2015 |
|---|---|---|---|
| S&P/TSX Composite | 13,307 | -7.86 | -7.02% |
| S&P 500 (USD) | 1,920 | -6.9% | -6.7% |
| Dow Jones Industrial Average | 16,284 | -7.5% | -8.63% |
| FTSE TMX Canada Universe Bond Index | 985 | .15% | 2.52% |
| Canadian Dollar (USD per CAD) | $0.7510 | -6.3% | -11.6% |
| Brent Oil (US$/b) | $47.29 | -27.5% | -16.9% |
| WTl (US$/b) | $45.06 | -26.4% | -18.6% |
| Henry Hub Natural Gas Spot - (US$/mmbtu) | $2.47 | -13.4% | -27.1% |
| Gold Spot(US$/oz) | $1,114 | -4.87% | -5.86% |
| Silver Spot(US$/oz) | $14.54 | -7.62% | -7.27% |
| Copper Spot(US$/oz) | $2.35 | -17.4% | -18.1% |

*Source: Canaccord Genuity, FTSE TMX Canada Universe Bond Index, EIA, Kitco*

We performed well across our total book of business. Our book of business includes over 60 different households with an overall asset allocation of 62% in equities and 38% in short-term bonds, preferred shares and deposit accounts. Over the past 3 months we decreased by 1.5% and year to date we managed a small positive return of approximately 2.5%. Your returns will vary slightly from these numbers based on asset allocation and individual holdings. During 2015 we have benefited from the drop in our Canadian currency, our large underweight positions in oil and gas along with no exposure to one of the hottest and highly valued stocks in Canada, Valeant Pharmaceuticals. So far in October we have advanced significantly relative to the markets, given the large jump in precious metals, which has bolstered our holdings in this sector (see our second quarter commentary on our holdings in this area). As we have communicated before we expect our investments in the precious metals sector to reward us

handsomely, especially with the ongoing contortions we are seeing on behalf of the global central banks! The more limbo the central banks perform, the higher the prices for gold and silver will go!

## D. Input Capital Corp.

We continue to look for unique businesses that have tremendous long-term potential to grow and multiply your money. We believe that Input Capital is one such company. Many of you have noticed that we have been adding this company to your portfolios over the past 18 months. The company is currently one of our top 12 holdings.

Input Capital is a relatively new company based in Saskatchewan that helps finance the various needs of farmers. The firm was the world's first agricultural streaming company. In essence, the company helps finance the cost of "inputs" for a farm. These include fertilizer, seed and equipment. In return, Input gets a certain base tonnage from future production, also known as bushels per acre, which they buy at a reduced price from the farmer and then sell into the market. The agreements are typically structured to last for six years and they are called streaming agreements. This structure is very similar to other firms we own in the precious metals sector who help finance mining companies for a piece of their future gold and silver production. Examples of streaming companies in the precious metals sector that our clients own in various amounts include, Franco-Nevada, Royal Gold, Sandstorm Gold and Royal Gold.

Input's success to date is based on the fact that farmers who use their financing should make more money with Input's assistance than without it. For example, with Input the farmer has easier access to capital to use throughout the calendar year, which can help farmers, cut their operating costs. Having the capital to buy fertilizer in the off-season can save the farmer up to 25% on the price of fertilizer. Also, streaming deals are not treated as debt, which enhances the farmer's balance sheet and provides them with more financial flexibility.

Another benefit is that in the past farmers were forced to sell their whole crop at the time of harvest, which also coincided with the greatest amount of supply, and seldom the best price! A streaming deal gives the farmer the financial flexibility to time their grain sales and hence increase the probability of procuring a better overall price.

Overall, Input Capital is filling a true void in the financial services industry, where there is often plenty of capital for mortgages and equipment but not for the every day working capital needs of a farm. As Input establishes more relationships with farmers it is also becoming clear by the growing number of streams that farmers will increasingly rely on this innovative firm to provide broader financing needs, displacing bankers, who are not well loved by farmers!

The best evidence for the success and appeal of this business model has been its growth to date. In 2013, when Input went public, they had 10 streaming agreements. As of their last press release in early October they had grown to 79 streams with expectations of growth over the next few years. We expect them to double and triple their streams over the next 3-5 years. With over 50,000 canola farmers in Western Canada alone they have a massive market potential. This does not even begin to factor in other regions in Canada, the US and other agricultural commodities aside from canola, which is currently their agricultural commodity of focus.

Most importantly for the shareholders of Input, the streaming agreements are very profitable. In pricing streaming deals with farmers Input prices in a 25% return on its capital. As streaming deals grow, the business model generates a significant level of compounding cash flows. According to our analysis the company should produce around 30-32 cents per share in cash flow for fiscal 2016 (which ends in March 2016). Currently the stock is trading at approximately C$2.65. At the current quote, the stock goes for just eight times cash flow. For a company generating 25%-plus returns on invested capital, that is debt-free and growing at over 30% per year the stock is quite inexpensive. We also like the management of the company and the fact that they own 20% of the stock. We will use any volatility in the stock price to add to our position.

## E. Conclusion

We remain conservatively invested in strong companies, operating in essential industries. We are prepared to take advantage of market swings and not only welcome the volatility but expect it! We continue to talk to companies on a regular basis looking for new opportunities. Generally we expect to add several new companies each year as opportunities emerge. Input Capital is a great example of an innovative finance company serving the farming community and offering substantial upside, even in a weak market.

As we have stated in other communications, the best offence is a good defense, and we have some great companies to provide us cover in a world that is increasingly under the influence of “monetary delusion”. In our opinion, Central Banks are completely out of control and we must protect your capital from their dangerous and reckless policies, which could include in the near future, perpetual money printing and negative interest rates. For this reason we continue to carry significant cash positions that can be quickly put to work! We appreciate your support and are committed to providing the highest levels of return consistent with a disciplined approach to risk management!

On a more personal note I am pleased to announce that on October 1, 2015 we added to our professional team with the hiring of Andrew Cheng. Andrew is a recent graduate of the University of Waterloo and has completed his CFA level 1. Andrew will be working in both administration and research. In the research area he will be assisting the team in ferretting out new investment opportunities as well as keeping on top of our existing holdings. We welcome Andrew to our team and are looking forward to his contribution.

**If you have a Facebook account you can like us at Rocklinc Investment Partners Inc. and follow our regular news updates.**

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[i] O'Brien, Matt. "This is the best time to borrow money. In all of history." The Washington Post, September 24, 2015

[ii] Haldane, Andrew G. "How low can you go? Speech given at the Portadown Chamber of Commerce, Northern Ireland, September 18, 2015.

[iii] MacLeod, Alasdair. "From ZIRP to NIRP", www.goldmoney.com

[iv] Ibid