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Whirlybird Economics

There is no ejection seat on a helicopter!

A. Market Update – First Half of 2016

The first half of 2016 was filled with non-stop action, some positive and some not so positive! This action helped fuel a significant amount of volatility, much of it late in the second quarter, coming on the heels of the "Brexit" vote! To the surprise of many, and contrary to the polls, Britain voted on June 23rd to leave the European Union with 52% in favour supported by a 72% voter turnout. The immediate reaction in the world's stock markets was very negative. From the high in June to the low in June, the S&P/TSX was off 4.7%, the S&P 500 was down 5.6% and the Euro Stoxx 600 fell 10.9%. Interestingly, by June 30th, all three markets had bounced back by 2.7%, 5.1%, and 7.6% respectively. At the time of writing, Canada and the United States have fully recovered all lost ground and are trading at this year's highs, spurred on by the prospects of even more aggressive monetary policies, on the part of the world's central banks!

The Canadian equity market performed very well in the first half of the year, buoyed by the increasing prices of various commodities and in particular, gold, silver and oil. The S&P / TSX gained 9.8% when factoring in dividends. The price of gold increased 24.6% and silver was up by 32.4%! The improvement in both gold and oil prices contributed roughly three quarters of the Canadian index returns in the first half of the year. The rollercoaster in oil prices was even more dramatic! We watched the price for a barrel of WTI (West Texas Intermediate) gain about 85% from its 14-year low of USD $26 per barrel reached in February of this year! The rise in the price of oil marks the best quarter since 2009. With the significant decrease in U.S. shale oil production coupled with other disruptions including the massive forest fires in Fort McMurray and terrorist attacks on pipelines in Nigeria the excess global oil supply has started to decrease, albeit slowly. If the fundamentals for oil continue to improve for the rest of the year and into 2017, along with the prospects for other commodities, including precious metals, this should bode well for the overall Canadian stock market. Some of this action is captured in the following table.

	June 30, 2015	Dec. 31, 2015	June 30, 2016	6 Month	1 Year Return
CAD/USD	$.8006	$0.7225	$0.7742	+7.16%	-3.3%
Oil WTI (US $)	$59.47	$37.04	$48.33	+30.48%	-18.73%
Gold (US $)	$1,172.60	$1,060.85	$1,322.00	+24.61%	+12.74%
Silver (US $)	$15.74	$14.13	$18.71	+32.41%	+18.87%
S&P/TSX TR*	14,553	13,010	14065	+9.8%	-.20%
S&P 500 TR*	2,063	2,044	2,099	3.84%	3.99%
Cdn 10 yr	1.68%	1.39%	1.06%	- 29 bps	- 62bps
US 10 yr	2.36%	2.27%	1.47%	- 9 bps	- 89 bps

* Includes Dividends Reinvested (Total Return)

Turning our attention briefly to the U.S., the S&P 500 Index gained 3.8% when factoring in dividends in U.S. dollars. Adjusting for the Canadian dollar, U.S. equities were actually

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down by approximately 3%. Despite a slowly expanding labour market and a strong housing market fed by historically low interest rates, the U.S. market continues to be volatile and quite anemic. Despite the anemic nature of the U.S economy it is better than Europe and Japan both of which are mired in recessionary-like economies. From an investment perspective, companies continue to struggle in their ability to grow profits. Too many firms are still resorting to massive share repurchases to make their earning per share look more attractive. Unfortunately this means that many firms are not investing for the long-term. We anticipate that the current volatility will continue for the foreseeable future, given weak global growth, record low interest rates, (that are starving savers and distorting markets negatively), and record levels of debt!

Looking abroad to Europe and Japan, both economies continue to struggle with weak economic growth. The situation in these two important areas is so bad that their central banks have actually introduced negative interest rates, (see our discussion on this topic in our first quarter 2016 newsletter). Can you imagine lending your bankrupt and corrupt government money for up to 10 years, and not receiving any interest payments? As we discussed in our recent video update, negative interest rates are not spurring on more spending, but are actually causing households and businesses to rein in their spending and protect themselves, from what is obviously a dangerous and futile policy! Equity investors in these regions have voted with their money! As measured by the MSCI Indices, during the second quarter of 2016, European stocks fell -4.6% and Japanese stocks fell -5.4% in U.S. dollar terms. In Canadian dollar terms, the declines were larger at -10.3% and -11.1% respectively. The broader MSCI EAFE Index, (Europe Asia & Far East), which is a gage of collective international stock markets, fell -4.4% or -10.2% in Canadian dollar terms. Fortunately, our investors had minimal direct exposure to these regions. We continue to emphasize North America and glean our international exposure through wonderful global businesses, almost all domiciled in North America.

Bonds continued to be slightly positive performers in our client portfolios. You will note (see table on page 1) that the yields on bonds (we use the 10 year bonds as proxies) in Canada and the US have continued to decrease, over the past 6 months and one year. As yields drop, the value of bonds increase. Eventually, this thirty-four year trend of lower rates will reverse and we need to be careful. In the interim, we continue to invest in short-term high quality bonds for two reasons. First, they help dampen volatility in client portfolios. Given the wild swings in the stock market, it is a good idea to have some investments that are not volatile and help stabilize portfolio values. Second, all the fixed income (bonds) positions we own, are liquid and can be sold quickly, in the event the world's stock markers sell off and we need some cash to take advantage of cheap equity prices! The mantra, buy low and sell high, never goes out of style.

B. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate across all our accounts, they increased by 8.2% and 9.3 respectively, over the first half of 2016 and year over year. Our average annual compound rate of growth over the past 3 years has now risen to 10.4%. These returns are after all fees have been deducted. It is important to note these numbers are based on an asset mix of 63% invested in equities with the remainder invested in short-term deposit accounts, bonds and preferred shares.

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When we look into our numbers more deeply we find that our basket of equities actually increased by 12% and 13.5% respectively over the past 6 months and 12 months. The annual rate of return for our equity holdings over the past 3 years is approximately 15 percent. Given the conservative nature of our portfolios, and the overall weak stock market performance, we are pleased with our progress, but never satisfied. We know that our investors are much more interested in the future than the past! We are working hard to dig out unique opportunities for your investment portfolios, opportunities that should weather the inevitable challenges that we will face as we move forward.

Year-to-date the five best performing sectors in our portfolios and their percentage change (January 1, 2016 – June 30, 2016) are:

1. Precious Metals +68%
2. Real Estate +25%
3. Infrastructure +17%
4. Water (Industrial) +12%
5. Consumer Staples +6%

Clearly the precious metals sector is on fire after 4 years of "pain and suffering". In fact the first half returns represent some of the strongest returns seen in over 30 years! Currently our largest holding within our Rocklinc portfolios is the world's leading gold, silver and oil royalty company, Franco-Nevada, which increased by 56% during the first six months of the year. Our best performing precious metals business was Royal Gold, which increased by almost 100%! Our other two major positions in the precious metals sector, Silver Wheaton and Sandstorm Gold increased 77% and 62% respectively.

Our exposure to this sector (across all our ROCKLINC clients) is approximately 9% or 15% of our equity exposure. We see no need to reduce our exposure given the massive challenges facing the global economy. The three largest financial challenges are; first, the massive and unsustainable levels of debt (which we have discussed many times with our investors), second, the low level of interest rates, which continue to drop as the world fears the specter of deflation. Third, the addiction to money printing that continues at unprecedented levels, throughout most of the global economy! Unfortunately, all this monetary "juice" has done nothing to help the global economy, and in our view, has only put it at greater risk.

After years of pursuing low interest rate policies, central banks have maneuvered themselves into a lose-lose situation. Both continuing and ending the low interest rate regime leads to considerable risk. In an attempt to finally achieve the desired boost to growth, several central banks have imposed negative interest rates. In this environment precious metals are even more attractive. It used to be said that gold doesn't pay interest, today it can be said that it does not cost interest! The great investor Richard Russell summarized it well when he stated; "gold always does what it should do… it just never does it when we think it should." We might not know where gold is going in the short run, but we do know gold will protect us in the long run against this monetary insanity! When we can buy excellent businesses operating in this critical sector, we step in with both feet!

What really has us concerned today is the more radical measure of "helicopter money" being considered within the halls of the various central banks around the world. (We

discuss this issue in more detail in the next section.) The idea of pumping even more "counterfeit money" into the economy by circumventing the banking system and giving it directly to governments to hand out to citizens in order to boost aggregate demand is the height of folly and a display of unrivalled haughtiness. We must protect ourselves from such blatantly inflationary and confiscatory polices. As a result, we continue to invest in precious metals and other "hard asset" sectors and businesses and don't expect to take any profits, in the near term!

C. Whirlybird Economics

If you are listening to the financial news, you will probably be aware that there is a great deal of talk concerning "helicopter money." While most of our clients will be unfamiliar with the meaning of this expression, it is important that you get up to speed with what appears to be the latest and greatest Keynesian nonsense. We have over the past seven years talked about ZIRP (zero interest rate policy), NIRP (negative interest rate policy), QE (quantitative easing), OT (operation twist) and forward guidance. These are all academic constructs that central bankers have injected into our global economy in order to boost "aggregate demand" or spending. These have all been last-ditch efforts to provide the monetary steroids to increase spending and inflation. The problem is none of them has worked in any sustainable fashion. Reality is, we did not expect any of them to work in the first place. Rather than back off and let the market clean up the mess created by the central bankers, they continue to press on with even more interventionist policies. It appears that the next game in town is this idea of "helicopter money" or as we refer to it as, "whirlybird economics."

Helicopter money is a reference to an idea made popular by the American economist Milton Friedman in 1969. In the now famous paper "The Optimum Quantity of Money", Friedman included the following parable:

"Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community. Let us suppose further that everyone is convinced that this is a unique event which will never be repeated."

The basic principle is that if a central bank wants to raise inflation and output in an economy that is running substantially below potential, one of the most effective tools would be simply to give everyone direct money transfers. In theory, people would see this as a permanent one-off expansion of the amount of money in circulation and would then start to spend more freely, increasing broader economic activity and pushing inflation back up to the central bank's target.

From that paper, other academics including former Federal Reserve Chair Ben Bernanke and economist Willem Buiter developed the theory further. Bernanke raised the possibility for monetary-financed tax cuts, whereby a government could cut taxes in a slump with the central bank committing to purchasing government debt (with printed money) in order to prevent interest rates from rising. In essence, the government would directly pump printed money into the economy by running deficits that the central bank would pay for with the digital printing press!

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Back in 2002, Ben Bernanke famously stated:

"A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices. Even if households decided not to increase consumption but instead rebalanced their portfolios by using their extra cash to acquire real and financial assets, the resulting increase in asset values would lower the cost of capital and improve the balance sheet positions of potential borrowers. A money-financed tax cut is essentially equivalent to Milton Friedman's famous 'helicopter drop' of money."

The picture below is one that humorously captures the essence of Bernanke's "helicopter drop."

So how is this different from conventional quantitative easing (QE), and the printing of money that we have already seen over the past 8 years? How is it different from the policy that has not worked, and has created innumerable distortions in our economy?

The difference is subtle. Current QE programs undertaken by central banks since the financial crisis have involved the large-scale purchases of assets from financial markets. These have predominantly targeted government bonds, but individual central banks have also bought up a range of alternative assets, including commercial debt, mortgage-backed securities and even stock market exchange traded funds.

The major difference between QE as it has been carried out and helicopter drops as envisaged by Friedman and the current cabal of central bankers, is that the vast majority of purchases have been through the banking system. While this has helped the banks and lowered government borrowing costs, the transmission of the new printed money to the real economy has been indirect and "underwhelming" which is code for unsuccessful. It

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has helped banks and those who get their hands on the money first but this has not included the broader economy, other than bidding up the price of real estate, and indebting the middle class even more! As such, current forms of QE have not provided much bang for the buck, and if anything, have stagnated the economy and income levels.

The idea of helicopter money is to make direct transfers into people's accounts! This could be accomplished in a number of ways including substantial tax breaks, government spending through social programs or any other method that would put money directly into consumer's hands![i] The bottom line is that up until now, the printing of money was largely placed through the banks and the financial intermediaries, and not directly into the hands of the government who would distribute the money out to the average person through any assortment of government programs.

Regardless, "helicopter money" is just a more direct form of QE! But it's still QE, it's still money printing, it's still more market manipulation, it's still bad policy, and it will not work in solving any of the long run problems that we face.

D. What is Wrong With Whirlybird Economics?

Let me be specific in providing seven problems with this next level of QE, otherwise known as whirlybird economics!

1. This policy legitimatizes the expansion of the Federal Government. Providing "counterfeit money" to the government so it can expand more of its ill-conceived programs to run even larger deficits will grow the State, reduce individual freedom both economic and political and as a result hamper long-term economic growth and wealth creation.

2. Whirlybird economics gives more power to the central banks. The problem is the central banks already have too much power! Central banks are comprised of unelected intellectuals with little to no real world experience. They have little to no regard for the average person, who is just a number on a spreadsheet, a person to manipulate with their "sophisticated algorithms". Their real mandate is to protect the banks and to cover for the financial profligacy of the State. Giving them even more power is a dangerous policy and a sure way to lose more individual freedom.

3. Whirlybird economics encourages the State to run progressively larger and increasingly unsustainable deficits. Spending the future without earning it, is simply stealing from the next generation. It is a sign of an immoral and decadent culture that accepts the premise that productive economic growth will result from printing money. Only a culture living a "past-less" present could be fooled into such a reckless notion. Those that do not know history are doomed to repeat it!

4. While there is still confidence in the system the cost of money (interest rates) will continue to ease lower and lower as more money is printed. As we have discussed in detail this has and continues to encourage businesses to misallocate capital (excessive share repurchases, poorly advised economic mergers, supported only by

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zero interest rates). Any misallocation of capital impedes the long-term growth potential of the economy and hurts the most vulnerable.

5. There is little doubt that “whirlybird economics” will eventually create the inflation desired by an indebted and bankrupt State. Controlling the level of inflation is not as easy as the central bankers think! If they have not been able to control it for the past 40 years, why should we expect them to control it over the next 40 years, let alone the next two years? Whirlybird economics is dangerous and heightens the risk of not only high inflation but of hyperinflation, the ultimate in theft and redistribution of money.

6. The whole premise of printing money, regardless of the specific mechanism, fosters the immoral view that you can get something for nothing. This policy undermines a proper work ethic, fosters a culture of greed and envy and undermines the most important moral values essential for a productive, honest and growing economy.

7. Bottom line: Whirlybird economics is simply monetary fraud. Once started it will be virtually impossible to scale back as governments promise more and decadent voters demand more. **There is no ejection seat on a helicopter!**

E. Conclusion - Moving Forward

Despite the challenges ahead we must press on. We will continue to invest in strong companies, operating in solid long-term industries and we will be prepared to take full advantage of market swings! Our basic strategy continues to be summarized in the following five points!

1. Diversify across asset classes, sectors and geographic regions.

2. Invest in businesses with strong balance sheets and backed by hard/tangible assets.

3. Invest in firms that produce essential products and services in growing industries.

4. Avoid/minimize highly leveraged financialized firms that have incomprehensible balance sheets loaded with risky derivatives.

5. Keep high quality liquidity in portfolios in order to take advantage of any extreme moves in the stock market.

If you have any questions pertaining to your account please call or email for an appointment

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ROCKLINC INVESTMENT PARTNERS INC.

Contact Information

ROCKLINC INVESTMENT PARTNERS INC.

4200 South Service Road, Suite 102

Burlington, Ontario

L7L 4X5

Tel: 905-631-LINC (5462)

www.rocklinc.com

Jonathan Wellum	jwellum@rocklinc.com	(ext. 2)
Andrew Cheng	acheng@rocklinc.com	(ext.5)
Jesse van de Merwe	jvandemerwe@rocklinc.com	(ext. 3)
Doretta Amaral	damaral@rocklinc.com	(ext. 1) maternity leave - Feb. 2017

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[i] Hirst, Tomas. "What is Helicopter Money", World Economic Forum