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Batten down the Hatches

A. Market Update - Third Quarter of 2016

During the third quarter, the Canadian equity market advanced by almost 5%! It is now up more than 10% year over year (October 1, 2015 – September 30, 2016). This is a welcome change from 2015, when the index fell by 8.3%, driven lower by the sharp decrease in energy prices. So far in 2016, the major upward move in the S&P/TSX has been powered by the energy and materials sectors. Within the materials sector, the best performing securities continue to be the gold and silver stocks. Over the past twelve months the price of gold has increased by 18.6% and silver has increased by 31.7%! The improvement in the prices of precious metals and the stabilizing of oil prices, contributed to the majority of the Canadian index returns so far this year. The rollercoaster in oil prices over the past two years appears to be causing OPEC some concerns, and rumours abound in terms of potential output cuts, in order to create a floor under the oil price. Time will tell whether OPEC is successful or not, at getting the price of oil up! We remain agnostic, with a relatively small weighting in the energy sector. The investments we do have in this sector are integrated oil and gas companies with business models and cost structures that can not only survive in a low oil price environment, but also prosper.

If the fundamentals for oil continue to improve for the rest of the year, and into 2017, along with the prospects for other basic commodities, including precious metals, this will bode well for the overall Canadian stock market, and also for the Canadian dollar. After a large drop in our dollar in 2015, (due to the significant pullback in energy prices) our dollar has been trading in a fairly tight range (after getting pummeled in January). We expect our dollar to stay in the 75 – 80 cent range for the remainder of the year. As we have communicated to our investors before, our focus when it comes to equities is to invest in the best businesses possible at the most attractive prices. Since the businesses we invest in are largely focused on North America and Western Europe, currency moves tend to wash out over time. The reality is most of our equity exposure is in US dollars, which remains the strongest currency in the world despite all the problems south of the border! Some of the market action during the last quarter and year over year is captured in the following table.

	Sept. 30, 2015	June 30, 2016	Sept. 30, 2016	3 Month	1 Year Return
CAD/USD	$.7502	$0.7742	$0.7624	-1.52%	+1.63%
Oil WTI (US $)	$45.48	$48.33	$48.24	-.19%	+6.07%
Gold (US $)	$1,115	$1,320.75	$1322.50	+. 13%	+18.61%
Silver (US $)	$14.54	$18.71	$19.15	+2.35%	+31.71%
S&P/TSX	13,307	14,065	14,725	+4.69%	+10.66%
S&P 500	1,920	2,099	2,168	3.29%	12.9%
Cdn 10 yr	1.45%	1.06%	0.95%	- 11 bps	- 50bps
US 10 yr	2.06%	1.47%	1.60%	+13 bps	- 46 bps

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Turning our attention briefly to the U.S., the S&P 500 Index gained 3.2% over the past quarter and is up by approximately 13% over the past 12 months. Despite a slowly expanding labour market and a strong housing market fed by historically low interest rates, the U.S. market continues to be choppy with economic growth very anemic. Despite the lackluster nature of the U.S economy it is still marginally better than the insipid economies of Europe and Japan. From an investment perspective, companies continue to struggle, which is seen in their lack of ability to grow total profits. As we have pointed out previously, too many firms are still resorting to massive share repurchases to make their earning per share look more attractive, often funding these repurchases with cheap debt. Unfortunately this means that many firms are not investing for the long-term, which will truncate their future growth and leave them with weaker balance sheets. We do not expect to see any major change in this behaviour, and are working hard to avoid companies with low growth prospects, and a preoccupation to simply buy back more and more of their stock, at inflated prices.

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 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 in some cases 30 years), and not receiving any interest payments? We cannot, and can assure you that we will not be purchasing any negatively yielding bonds in your portfolios! Although European equity indexes performed better in the third quarter most are still negative over the first three quarters of the year.

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 continued to decrease during the third quarter, given the weak state of the Canadian economy, while yields in the US moved up slightly. Over the past 12 months yields are down in both the US and Canada and this has helped to increase the value of bonds in our portfolio. 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 normal 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! It is wise to heed the advice of Baron Rothschild when he stated "the time to buy stocks is when there's blood on the streets

B. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate, across all our accounts, they increased by 10% and 13% respectively, over the first nine months of 2016 and year over year. Our average annual compound rate of growth over the past 3 years has now risen to over 10%. These returns are after all fees have been deducted. It is important to note these numbers

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are based on an asset mix of approximately 64% invested in equities with the remainder invested in short-term deposit accounts, bonds and preferred shares. This mix has obviously varied over the past three years but in general we have averaged about 60-65% invested in equities. During the first nine months of the year we experienced record levels of new investments from both existing clients and new clients and this new cash, which we are slowly and strategically deploying has weighed down our overall performance. This does not impact any of our existing investors since all our clients have their own personalized segregated accounts! The performance we are discussing is our aggregate performance across all our accounts. Each client's portfolio is unique and performance will vary based on your risk tolerances and specific asset allocation.

When we delve into our numbers in more detail we find that our basket of equities actually increased by 20% and 26% respectively over the past 9 months (year-to-date) and 12 months. The annual rate of return for our equity holdings over the past 3 years is approximately 17 percent. Given the conservative nature of our portfolios, and the overall mediocre stock market performance, we are pleased with our progress, but always looking for more. We know that our investors are 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 six best performing sectors in our portfolios and their percentage change (January 1, 2016 – September 30, 2016) are:

1. Precious Metals +77%
2. Infrastructure +27%
3. Real Estate +29%
4. Water/Industrial +14%
5. Consumer Staple +5%
6. Manufacturing +5%

So far this year, none of the sectors we use to categorize our investments were negative year to date (first nine months).

Clearly the precious metals sector is on fire after 4 years of "misery". The beautiful thing about misery, when it comes to the stock market, is that it usually creates wonderful buying opportunities, and indeed this is the situation! During the first nine months of the year returns in the precious metals sector have been spectacular. Currently our largest holding within this sector is the world's leading gold, silver and oil royalty company, Franco-Nevada, which increased by 45% during the first nine months of the year. Our best performing precious metals business over this time frame was Royal Gold, which increased by almost 117%! Our other two major positions in the precious metals sector, Silver Wheaton and Sandstorm Gold increased 106% and 84% respectively during the first three quarters of the year.

Our exposure to this sector (across all our ROCKLINC clients) is approximately 10% or 16% of our equity exposure. We see no need to reduce our exposure given the massive challenges facing the global economy. As we stated in our last quarterly update, "the three largest

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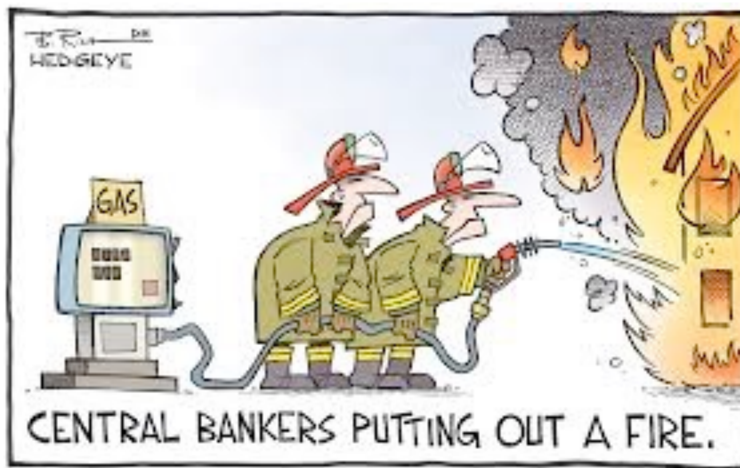
financial challenges are; first, the massive and unsustainable levels of debt (which we have discussed many times with our investors), second, the low level of interest rates, which continue to drop as the world fears the specter of deflation. Third, the addiction to money printing that continues at 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." The best investment in this environment is an investment that can protect your purchasing power, and has minimal counterparty risk. For us this means gold and silver! We believe, that given the global financial conditions we find ourselves in today, gold and silver must form a meaningful portion of every investor's portfolio! As we have discussed in previous updates, we have chosen to invest in the bankers to the gold and silver miners, known as the royalty and streaming companies.

After years of pursuing low interest rate policies, central banks have maneuvered themselves into a lose-lose situation. Whether they continue the current policies or attempt to end the low interest rate regime there is no way to avoid the imbedded risk in the global financial system. The last two "straws" for us were first, the imposition of negative interest rates, and second, the large scale purchase of stocks and corporate bonds, on the part of a number of the world's most influential and important central banks. Both of these policies border on insanity and make it crystal clear to us that the world's central banks are out of control and do not know how to extricate themselves from the mess they have created. Pouring more gas on the fire they started is not a viable plan!



The idea of pumping increasing levels of "counterfeit money/printed money" into the economy, whether by giving money away to debtors by not charging interest, or propping up the worlds financial markets by buying stocks and bonds, is recklessness and folly on steroids. These policies will never create a single cent of lasting wealth! Both of these policies are pure theft and are distributive schemes to strip wealth from savers and the middleclass while turning the masses into serfs of the State. How can savers accumulate capital when their capital cannot earn interest, or worse is reduced by a tax (negative

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interest rate)? How can investors prudently buy stocks when stock prices are elevated and pumped up by central banks using printed money to buy record levels of stocks and ETF's?

We have no choice but to work as hard as possible, to 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. Moving Forward – "Batten down the Hatches"

At the time of writing this report shares of Deutsche Bank (Germany's largest bank) have been hammered. There are serious concerns that the German lender will need to raise capital to pay a USD $14 billion fine from the US Department of Justice, to settle probes over toxic mortgages it packaged, leading up to the financial crisis in 2008. The reality is that this potential fine is a drop in the bucket, when compared to the bank's bad loans (especially from the weak European countries such as Greece, Spain, Portugal etc.), their overleveraged balance sheet, and their massive derivatives position. Earlier this year, it was reported that Deutsche Bank had a derivatives portfolio valued well in excess of USD $50 trillion! That is around 15 times the GDP of the German economy! Anyone who believes that you can correctly value all these derivatives, probably works for a central bank, and believes in unicorns!

We have been instructing our investors for the past six years to stay clear of most leveraged financials, particularly European banks and life insurance companies. Because of our views on this subject, we were very interested in the comments made by former macro hedge fund manager Raoul Pal, whom we highly respect.

Raoul Pal recently pointed out that Deutsche Bank could be a "canary in a coal mine" signaling a much bigger problem in the European banking system. "It's one of the canaries in the coal mine telling something really bad is going on in the European banks overall." In a presentation he gave on Real Vision in February, Pal said the European banks were "the black swan nobody was looking at," referring to a hard-to-predict event. It's something he's been warning about for almost two years.

Across the board, European bank stocks have gotten trounced this year. For example, Deutsche Bank has collapsed more than 50% this year. Credit Suisse has plummeted more than 40%, while UBS has fallen 31%. Royal Bank of Scotland has fallen 48% and Barclays has slumped more than 33%. Shares of Spanish banks Banco Popular and Bankia have also been pounded. And I could go on!

In an interview with Yahoo Finance (September 27, 2016), Raoul Pal highlighted five key issues that are creating storm clouds in the European banking system that we need to watch carefully, because if systemic problems emerge in Europe, they will create challenges for banks around the world. Canada will not be immune!

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1. Overall the European banks are still a mess. The European Central Bank has been trying to tackle the issue of non-performing loans (NPLs). The ECB has taken a massive amount of low quality collateral off the banks' balance sheets, especially from banks in Greece and Cyprus. Unfortunately, the banking system is still not functioning properly, because there are too many bad loans, and the banks don't have enough capital to write them down/off. Will banks get bailed out, or will banks bail-in their depositors?

2. The yield curve continues to get flatter, and yields are turning negative, due to the interest rate policies of central banks. This is dreadful for the banking business, since banks borrow at the short end of the yield curve, and lend at the long end. When the yield curve is flat, interest rates spreads are too small and banks can't make money. The low interest rate policies are undermining the viability and profitability of banks, around the world.

3. Regulations have been getting tighter. In addition to massive new collateral requirements, driven by the Basel III agreement, the European Union established rules designed to prevent taxpayer bailouts. Technically Germany is not supposed to bail out Deutsche Bank. If it does, the fear is that Greece, Italy or Cyprus might insist that their bank bail-ins were inappropriate, if those rules don't apply to Germany. This would put enormous stress on an already stressed out EU.

4. LIBOR (the London interbank offered rate) has become a worrying story for the banking system. Libor, a measure of banks' borrowing costs, has continued to climb higher, making it more difficult to manage the current level of borrowing. The reason LIBOR is increasing is that the banks do not trust each other, due to increasing systemic risk.

5. Many foreign companies and banks have, since the crisis, been borrowing in US dollars to invest in projects outside of the US. The Bank of International Settlements pegs these borrowings at approximately USD $10 trillion. US dollars were at one point seen as cheap and stable. But as the US dollar has been moving higher it is making it more challenging for banks and companies to pay back those loans in weakened currencies relative to the US dollar. If the US Federal Reserve actually increases interest rates in the near future, the US dollar could appreciate even more, exacerbating this problem.

As Raoul Paul says, "It's not yet a big storm, but the clouds are everywhere," and that is why we believe it is prudent to batten down the hatches! Many of our older clients will be familiar with this expression. For our younger clients this expression is a nautical term from the early 19th century. When a ship was about to enter rough seas, the captain would order the crew to batten down the hatches. The crew would close all the hatches (doors) on the ship's decks and use lengths of batten (rods) to secure the hatches in the closed position. This would help to ensure the protection of the ship! In our case, we are battening down your portfolios, to protect them from any potential storm that might arise quickly!

Despite the challenges, we press on looking for wonderful long-term opportunities. We continue to invest in strong companies, operating in solid long-term industries. During the

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second and third quarter we selectively began adding to several new positions, that we will discuss in more detail in our yearend report.

If the market gets manic-depressive, we are prepared to take full advantage of the volatility! Our basic strategy, which has not changed, 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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