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No Time for Complacency!

A. Market Update – First Quarter Review

Equity markets have had a good start to the year, extending last year's performance. The election of Donald Trump as the 45th President of the United Sates, and with him, hopes for substantial tax reform, increased public spending, in the form of infrastructure, along with much needed regulatory reform, has driven the rally in stocks, subsequent to November 8th. Since the election, US business and consumer confidence surveys have shown marked increases in sentiment. These sharp improvements, in business and consumer confidence, have helped underpin not only the US stock market but also the global markets! Just how secure this positive sentiment really is, will depend on whether this improvement in confidence is sustainable, and whether it translates into stronger economic growth, and higher corporate profits. Will there be real change in Washington DC? Draining the swamp of systemic corruption and incompetence, in any government bureaucracy, is very difficult, even with the strongest leadership. This is why we remain very cautious, and continue to focus on the businesses we own, and not politics. This is not a time for complacency!

Despite a good start for the quarter, markets in March took a pause, and this pause has continued into April. This breather is due to both valuations that are far from cheap, and also a wait and see attitude as to whether the new US administration will be able to deliver on its policy agenda. Skepticism has increased, particularly in light of the recent failure to repeal and replace, Obamacare. With the Republican majority in Congress far from united, advancing tax reform and initiating infrastructure spending will take more time than originally thought. This new timeline is not priced into the markets. Through all the political noise, what does seem clear, is that both US consumers and businesses, are significantly more positive about the economic outlook, than they were this time last year, when the US was operating under the economically repressive regime of President Obama.

If there is any "good news" for the global economy, it is that confidence in the economic outlook has spilled over from the US, to many countries around the world. In Europe, business surveys have risen to their highest levels in over five years and consumer confidence has recovered to close to pre-crisis (2008) highs. The improvement in business confidence is widespread across the Eurozone, and European companies are finally starting to show some earnings growth, albeit very small. This has helped European equities to keep up with US equities so far this year, having underperformed last year.

In addition, European elections this year have toed the line with the European Union. The election results in both Austria and the Netherlands showed that despite the growing level of discontent in these countries it has not reached the point of breaking-up the Eurozone, yet! During this quarter, all eyes are fixated on France! Will Le Pen's nationalist anti-EU party be able to duplicate the more populist results of the UK (Brexit vote) and the US? Will France finally reject the calls for the global centralization of power and the undermining of nation states? Will they stop handing over their sovereignty to a cabal of political thugs from Brussels? The polls in France, at this time are very tight, and probably cannot be relied on as being very accurate. As we have learned recently, the only poll that matters is the poll on Election Day, so it looks like we will have to wait until then.

In the UK, Prime Minister Theresa May finally invoked Article 50, beginning the formal process for the UK to leave the European Union. Although this is by far the best decision for the UK, it creates a period of uncertainty for the UK economy. We are monitoring the situation closely, with the anticipation that some great opportunities for investing may emerge, in the midst of uncertainty and potential volatility.

With some signs of improvement in emerging market growth, we have a synchronized upswing in global economic data. Fortunately for emerging markets, there has been a pause in the upward trajectory of the US dollar and bond yields, since the start of this year, and an actual pullback in both since mid-March. This has provided a good environment for emerging market and Asian equity performance, as financial flows out of these countries has slowed, and new money looking for better-priced investment opportunities is re-entering some of the emerging markets.

Looking further afield, Japanese data has been marginally positive, with business surveys indicating expansion and falling unemployment, now down to only 2.8%. However, the strength in the yen so far this year, has weighed on the performance of Japanese equities. More importantly, the demographic profile of Japan is nothing short of disastrous. Like many countries in the world the Japanese citizens have decided not to produce a future in deciding to jettison marriage and procreation. A large part of the reason for yen strength (despite a dismal long-term prognosis) has been the pause in the upward movement of US government bond yields. If the US continues to raise rates (a big if), the yen will come under significant pressure and weaken. Regardless, Japan long-term is committing national suicide and faces a bleak future.

While growth has been slowly improving across most of the world, inflation has been increasing, even as wage growth has been slowing! This is a very worrisome trend, and puts significant pressure on real wages. Without real wage growth it will be hard to support robust sustained economic growth.

The big question, which no one really knows the answer to is; how many interest rates will we see in the US this year and possibly into next year? At the start of 2017, markets had already moved to price in two rate rises from the US Federal Reserve (the Fed) for this year. However, if the economy continues to heat up and the Fed has to raise rates faster than the three additional interest rate rises that are currently priced between now and the end of 2018, then government bonds will sell off. European government bonds could also come under pressure depending on the actions of the European Central Bank and the outcome of the French election. This is why we continue to be very cautious, and in terms of bond investments, focus on quality (bonds backed by pristine balance sheets) and bonds with a short duration! The downside in bond valuations is higher than the potential upside at this time in the cycle. This does not mean that we believe that interest rates can actually increase much more than 100 basis points plus or minus 50 bps. **The level of debt around the world cannot withstand a major move in rates without bringing on a serious recession/depression in the global economy. We will have more to say on this topic later in the newsletter.**

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Canadian Equity Market

During the first quarter, the Canadian equity market advanced by 1.7% (total rate of return with dividends reinvested was 2.4%), building on the strength of 2016. In the first quarter, the sectors that contributed most significantly to the upward move in the S&P/TSX index, were precious metals (+16%), information technology (+6.9), consumer discretionary (6.5%) utilities (+5.1), industrial (+4.9%) and real estate (+3.4%). The worst performing sector was the health care sector, which dropped by 10.3%, (after falling by over 75% in 2016), reflecting the further erosion of Valeant Pharmaceuticals (we have never invested in Valeant). During the first quarter, the energy sector gave back 6.2% after bouncing back in 2016 from the massive selloff in 2015. The rollercoaster in oil prices over the past two years has led OPEC to agree to some production cuts, in order to increase the price of oil. Time will tell whether there is "honour amongst thieves" and OPEC is successful. Their track record on holding to production cuts is not good, and the ability of the private sector to produce oil at lower and lower prices continues to make OPEC less relevant. For our part, we remain skeptical, with a relatively small weighting in the energy sector. The investments we have made in this sector are integrated oil and gas companies (our largest position is Suncor), with business models and cost structures that can survive and prosper, in a low oil price environment.

One of the top performing sectors in the first quarter of this year after a tough fourth quarter, following the US election was the precious metals sector. During the first quarter, both gold and silver performed strongly advancing by 8.5% and 10.9% respectively. Needless to say, gold and silver equities performed well. Given the ongoing easy money policies that exist around the world, along with increasing geo-political tensions, we maintain substantial weights in the precious metals sector. Our investments in this sector are in the four leading royalty/streaming companies. We believe that both gold and silver are well positioned for substantial gains over the next 3-5 years as the world is forced to deal with the folly of the 40-year debt binge, post the elimination of the "gold standard" in the early 1970s.

Market action during the first quarter and during last 12 months is captured in the following table.

	March 31, 2016	Dec. 31, 2016	March 31, 2017	3 Month	1 Year Return
CAD/USD	$.7698	$0.7448	$0.7507	+.79 %	-2.48 %
Oil WTI (US $)	$33.34	$53.72	$50.60	-5.81 %	+51.77 %
Gold (US $)	$1,237.00	$1,150.90	$1,249.20	+8.50 %	+.99 %
Silver (US $)	$15.44	$16.43	$ 18.22	+10.90 %	+18.00 %
S&P/TSX	13,494	15,288	15,547	+1.70 %	+15.21 %
S&P 500	2,060	2,239	2,363	+5.54 %	+14.71 %
Cdn 10 yr	1.23%	1.72%	1.62%	- 10 bps	+39 bps
US 10 yr	1.78%	2.45%	2.40%	-5 bps	+62 bps

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US Equity Market & Fixed Income

Turning our attention briefly to the U.S., the S&P 500 Index gained 5.5% during the first quarter after a strong year-end rally in 2016. As we discussed in our 2016 year-end update a big change came with the election of Donald Trump in November. Trump's strong pro-business policies and promised tax cuts have helped change market sentiment and increase the level of optimism amongst business people. Only time will tell whether he will be able to implement all the changes that he has proposed and the market reaction is justified. It is turning out to be a real battle! Trump inherited a US economy weakened by 8 years of economic collectivism and a doubling of the national debt. He also inherited a global geo-political environment weakened by the Obama globalist policy agenda that rewarded rogue nations at the expense of America's traditional friends and allies. This has led to heightened political instability in the world at the present time. This uncertainty should provide us with some wonderful buying opportunities if we are not complacent, but opportunistic!

During the first quarter the price of bonds actually bounced back a wee bit, with yields on both the 10-year government bond in Canada and the US easing (down 10 bps in Canada and 5 bps in the US). Year over year yields continued to climb, putting downward pressure on the values of bonds. When it comes to ROCKLINC, our investors are largely sheltered from the volatility in bond values, since we continue to invest in quality bonds with a short duration! As we stated in our last report, **"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 quality bonds for two reasons. First, they help dampen volatility in client portfolios. 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."**

Canada – Another Liberal Budget – Back to the 70s

The Federal government in Canada is back spending money like the proverbial "drunken sailor". Although this comes as no surprise, one has to marvel at the stupidity of human beings to constantly repeat the mistakes of the past, thinking a better outcome will emerge! In March the Federal Liberal Government released their second budget. It was a typical Liberal budget. Spend more than you have, promise more goodies, to those who do not deserve them, under the guise of "social justice" and stick your neck into more people's lives, as you strip away more personal freedom and dignity. The red ink alone over the next 5-6 years will add well over $127 billion to our national debt. Is there anyone who believes this money will be wisely allocated? While the budget talked of innovation, skills development, community development and "gender-related" issues, the reality is that the government is already too involved in all these areas and in some cases should not be involved in them at all! More government involvement only leads to further intrusion into the lives of hard working Canadians. This involvement is undermining our long-term productivity and has fed the collapse in the standard of living in Canada (just ask how a newly married two income professional couple are going to buy a home in a urban area in Canada, let alone a "normal" couple). Of particular concern is the government's

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all out attack on the traditional faith based family and on Canadian's free speech, both are bedrocks to a free and democratic society, and without them we head straight for a more authoritarian future. The truth is we no longer have free speech in Canada (have you been to a university recently, or have you heard of Islamophobia?) and the traditional family is an anomaly, despite being the most important social institution in society.

But let's not forget to take a moment to thank President Trump. Given the substantial tax cut Trump is promising for Americans, the Trudeau regime was forced to postpone some of their "wealth distributing" tax increases in their latest budget. When greater clarity on tax policy south of the border emerges we can expect the liberals to increase taxes. I hope my prediction, on this topic is proven wrong!

B. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate, across all our accounts, they were up 3.1% during the first quarter of 2017 and up 11.4% during the last 12 months (period ending March 31, 2017). Our average annual compound rate of growth over the past 3 years is clocking in at approximately 8%. These returns are after all fees. These returns are based on an asset mix of approximately 65% invested in equities with the remainder invested in short-term deposit accounts, bonds and preferred shares. This mix has varied over the past three years but in general we have averaged approximately 60-65% invested in equities. Throughout 2016 and into 2017 we have experienced record levels of new investments from both existing clients and new clients. This new cash, which we are slowly and strategically deploying weighs down our overall performance in an upward moving market, but does not impact 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 dig into our numbers, we find that our basket of equities actually increased by 4.3% during the first quarter, and by over 17% during the past 12 months. Our equities have been compounding by approximately 13% per year, over the past 3 and 5 years. Given the conservative nature of our portfolios, we are pleased with our progress, but never satisfied. We are cognizant that our investors are more interested in future returns, rather than looking out the rear view mirror at past results! We are working hard, to ferret out unique opportunities for your investment portfolios.

During the first quarter of 2017 the best performing sectors, (top 6) in our portfolios and their percentage changes were:

1. Technology +9.3%
2. Precious Metals +8.7%
3. Healthcare +8.4%
4. Manufacturing +7.5%
5. Consumer Staples +6.6%
6. Infrastructure +6.1%

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We had two sectors that performed negatively during the quarter they were:

1. Agriculture - 2.7%
2. Energy -7.0%

Our agricultural holdings were negatively impacted by Agrium, which dropped by 5% during the quarter, but within our agricultural holdings offset by Input Capital and John Deere. Any further weakness in the price of Agrium will provide us with an opportunity to add to our position across client accounts. We remain bullish, on the long-term prospects for Agrium and the agricultural sector in general. The energy sector rebounded significantly in 2016, but gave back some of that rebound during the first quarter, with the price of a barrel of oil decreasing by approximately 5%. We maintain a small weight in the oil and gas sector. Our main positions are Suncor, BP and Exxon. All three positions decreased on average by 7%. The world today is awash in oil and gas and there is no shortage of new finds. For these reasons and others, we are not bullish on the long-term price of energy and prefer to invest in energy infrastructure businesses, such as Enbridge and TransCanada, along with businesses operating in the renewable energy sector, such as Brookfield Renewable and TransAlta Renewable.

Overall, we are off to a solid start in 2017, despite a great deal of background noise coming from around the world! However, it is not a time for complacency!

C. Company Update - PepsiCo

We continue to look for new opportunities and companies we believe are uniquely positioned, to take advantage of irreversible long-term secular changes. Over the past 26 years (long before the formation of ROCKLINC) I have owned directly and indirectly (in client portfolios), The Coca-Cola Company. While Coca-Cola remains a powerful business with one of the world's leading brands we recently sold our position in Coca-Cola and replaced it with PepsiCo Inc. While PepsiCo is similar to Coca-Cola in offering some of the world's leading beverages it is much more than a beverages or soft drink company.

PepsiCo has interests in the manufacturing, marketing, and distribution of grain-based snack foods, beverages, and other products. Today's PepsiCo was formed in 1965 with the merger of the Pepsi-Cola Company and Frito-Lay, Inc. Since then, it has expanded from its namesake product Pepsi to a broader range of food and beverage brands, the largest of which have included an acquisition of Tropicana Products in 1998, and the Quaker Oats Company in 2001, which added the Gatorade brand to its portfolio. Many are surprised when they learn that PepsiCo has an array of leading brands in their food and beverage business with a portfolio that includes 22 brands that each generates more than $1 billion in estimated annual retail sales. The picture at the top of the next page captures some of their most significant brands.

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From an investment perspective there are three primary reasons why we have invested in the company and included it as a long-term position in our consumer staples sector allocation.

The first reason is the company's attractive valuation. Although the company is not cheap, it is much more attractive than its competitive rivals and other high quality investment alternatives. Compared to Coca-Cola, on a free cash flow yield and present value calculation, PepsiCo trades at a 20-25% discount. There is also room for PepsiCo to increase its dividend and repurchase stock, over the next few years, which should buttress the share price of the stock.

The second reason for investing in PepsiCo is its organic growth rate. Despite PepsiCo trading at a discount to Coca-Cola the company (its main brands) has been growing at a much faster rate! Overall, PepsiCo has been growing sales of their core products between 2-4% over the past few years despite weakness in the carbonated soft drink market. Companies like Coca-Cola have been having a tougher time given their concentration in carbonated soft drinks. What is of particular interest is that PepsiCo in both the salty snack market, where they are the world leader, and in the sports drinks market, are doing exceptionally well. Both of these market segments are expected to grow more than 3-4% per year for the foreseeable future. Being in the right market segments at the right time should help PepsiCo continue to outpace its competitors over the next 3-5 years.

Lastly, PepsiCo has an amazing line up of brands within growing market segments. Consider a couple of interesting statistics in terms of PepsiCo's market presence. The company has a global market share of 35% in salty snacks, 60% of the US potato chip market, 70% of the tortilla and tostada market share globally, 25% of the global soft drink market (Coca-Cola is at 34%), 77% of the US sports drinks market and 29% of global sports drinks market, 10% of global bottled water (Aquafina) and 7% of the global juice market. These are wonderful market share positions to grow over the next few years!

One last point of interest is that PepsiCo would make an excellent acquisition target. It is not a secret that the number of global brands companies are shrinking as consolidation continues around the world. One potential suitor is Kraft-Heinz. They continue to be on the prowl to buy up more leading global brands companies and have been rumoured to be looking at a potential merger with PepsiCo. Time will tell! PepsiCo is an example of a high

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quality business that we want to have exposure to in our client portfolios over the next few years.

D. Moving Forward – Tightening Interest Rates?

The Federal Reserve has finally initiated the fifteenth tightening cycle since 1945[i], after the some of the most lax monetary policies in human history! It is important to point out that in 80% of the prior fourteen episodes, recessions followed, with business contractions taking place in eleven of the fourteen tightening periods. "What is notable today is that the economy is in the 93rd month of this expansion, a length of time that is well beyond periods in prior expansions where soft landings occurred (1968, 1984 and 1995)."[ii] This means that the economy is extremely vulnerable to a shock, which could lead to recession. It is interesting to note that regardless of whether there was an associated recession, during the past interest rate tightening periods, the last ten cycles of tightening all triggered financial crises. **It is not a time to be complacent.**

We must move forward with caution in the current environment, despite increased optimism in many areas of the global economy. Optimism is wonderful, but it can be misplaced at times!

Four important considerations that exist today that were not present in past cycles, and that could magnify the current restraining actions of the Federal Reserve:

1. The Fed has initiated a tightening cycle at a time when the overall economy is still very weak with growth in nominal GDP lower than in any of the prior fourteen cases when tightening occurred.

2. Business, government and personal balance sheets are laden down with record amounts of debt. This means that even small changes in interest rates will likely have a whopping impact on investment, spending, and savings decisions within the economy. If debtors are now at the end of the rope, in terms of their ability to service their debts, what happens when rates climb materially?

3. The aging demographics within virtually all the industrialized countries are unprecedented. The underfunding of pensions and other social programs is at a record level and the demands that are being placed on governments from an aging population, that are short of savings, are simply not payable, without a substantial restructuring of obligations. Restructuring is a code word for economic pain!

4. The addiction to free/easy money has never been so entrenched in the economy. Getting off this addiction will not be easy. Whatever is free is generally squandered. This is certainly the case with money in the hands of politicians and a decadent populace. Over the past 8 years there has been very little motivation to invest wisely and consider the opportunity costs of spending versus long-term saving. This has resulted in substantial malinvestments around the world. It will not be different this time! We will have to experience payback, for wasting precious resources, and living beyond our means!

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E. Moving Forward – ROCKLINC Investment Portfolios

As we have explained many times, the market is manic-depressive, as investors we must always be prepared to take full advantage of volatility, or significant price swings. Our basic strategy, which has not changed, continues to be summarized in the following six points!

1. Diversify across asset classes, sectors and geographic regions.
2. Invest in businesses with strong balance sheets, 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.
6. Stay optimistic and opportunistic without being naive to the risks all around us. **It is not a time to be complacent and buy some gold!**

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

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[i] Hoisington Investment Management, Quarterly Review and Outlook (First Quarter 2017).
[ii] Ibid.