QE to Queasy

A. Fourth Quarter & Annual Review

The final quarter of 2018 was challenging for equity markets. Investors had to contend with rising US central bank interest rates, an economic slowdown in the Eurozone coupled with decreasing business confidence, weaker Chinese growth and rising geopolitical concerns (including, the saga of Brexit, Italian and French politics and the ongoing trade negotiations between the US and China). These events proved unsettling for investors, many of whom, have been lulled into a sense of complacency by a decade of money printing, record low interest rates, and a massive increase in global debt. On a positive note, precious metals and high quality bonds edged higher, providing refuge and a hedge within investor's portfolios.

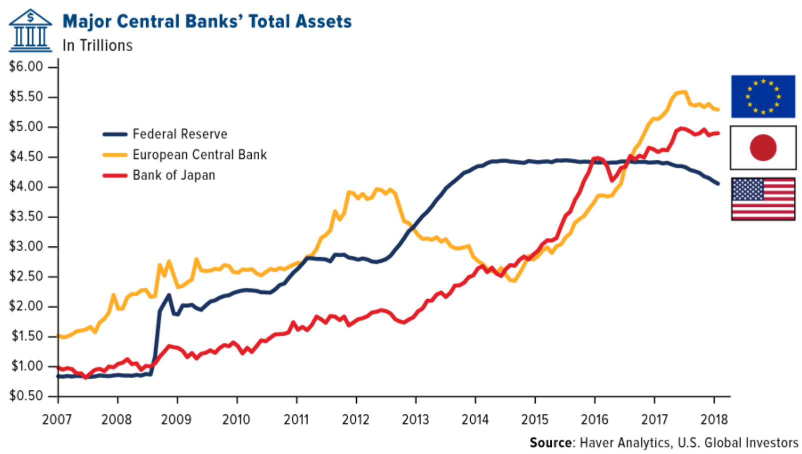
UNITED STATES

The quarter's volatility appeared to accelerate with the Federal Reserve (Fed) chairman Jerome Powell's comment that the US policy rate was "a long way" from neutral, implying that the Fed was going to continue increasing interest rates throughout 2019 and into 2020. It didn't take long for US government bond yields to move higher, pricing in a faster pace of rate rises. Given the decade long addiction to low interest rates and easy money policies, equity investors started to worry about the potentially faster-than-expected pace of rate rises, and equities sold off through October. Interestingly, there was a brief bounce in early November until the US 10-year yields rose above 3.2%! This level of interest rates frightened the equity markets. From the second week of November, equities began to fall with US government bond prices rising (interest rates reversed course and dropped) as investors sought refuge in bonds and precious metals, while selling equities. For investors, it felt like they were getting an advance ride on Canada's Wonderland's newest rollercoaster, expected this summer, called the "Yukon Striker"! It is billed as the "longest, fastest and tallest dive roller coaster in the world"! Rather than a rollercoaster, we were actually experiencing the unsettling move from QE (quantitative easing) to QT (quantitative tightening) and this shift was making the market very queasy! Questions were raised: what happens when rates materially increase and the money supply starts to shrink? Can we unwind a decade of monetary insanity without a significant market correction and slowdown in the global economy?

All of a sudden, many market participants started to worry that the US may be late in its economic cycle and a recession might be just around the corner. Although tax cuts helped boost growth and corporate earnings in 2018, investors became concerned that the fiscal stimulus is losing its momentum and might be out of gas by the time we get to the third quarter of 2019. The US midterm elections in early November were important in determining whether there would be future tax cuts and more business friendly policies. With the Democrats winning the House, the likelihood of further fiscal stimulus, prior to the next US election, is significantly reduced.

In November, under the pressure of weak capital markets, Fed chairman Powell changed his tune a bit, saying interest rates were "just below" the range of estimates that would take us to a neutral level. This shift, while subtle, was quickly interpreted as "dovish", and markets went from expecting 4 - 5 more rate hikes to expecting only one more in 2019! However, Powell's insistence that the Fed continue to reduce the central bank's balance sheet was not altered. This means that the Fed appears to be committed to pulling a substantial portion of the money they printed from

2008 – 2014 out of the global financial system in the next two to three years. We are skeptical that this will be possible, without steering the US and the global economy into a serious recession. Rather, we expect the Fed will be back printing more dollars within the next two years, rather than contracting the money supply and raising rates! Time will tell! Regardless, we need to be prepared either way. The chart below gives you an indication of the massive build up of central bank assets (amount of money printed) over the past decade. Note the leveling off and small drop in 2018. Just that small drop along with increasing interests from the Fed has made the market very queasy.



EUROPE

In the "socialist utopia" known as Europe, business surveys weakened throughout 2018. During the fourth quarter of 2018, business sentiment reached levels that historically have been consistent with a recessionary economy. It is an understatement to say that political tensions are running high throughout Europe, especially Western Europe. This factor alone is enough to rattle businesses and lead to a sharp drop in business sentiment.

Think for a moment about the uprisings in France that have continued into 2019 and have no end in sight. The French people have begun to push back on the globalist policies of President Macron and the myriad of leaders before him that have devastated their standard of living. High income taxes, damaging and useless carbon taxes, excessive regulations and unchecked immigration policies have ravaged living conditions in France's largest cities and strained the public purse.

Unfortunately, these same policies are being pursued by most of the European countries. These policies are leading to the stripping away of personal liberties and the redistribution of wealth from the productive class to the idle class. When politicians focus on wealth distribution and not wealth production, they will always be left with very little to "distribute"! In any event, this is not a good environment for economic growth! On top of all this, the European Central Bank (ECB) says it will also end its quantitative easing program in December! Great timing! We suspect that the ECB is living in an alternative universe and extricating themselves from low interest rates and money printing will be virtually impossible without taking down the European house of cards starting with their insolvent banks! Has anyone heard of Deutsche Bank? It is the world's largest landfill of derivatives! Be glad you didn't buy this bank twelve years ago when it was trading on the US market at $146 per share. Today it is trading at $8 per share, and given its toxic and incomprehensible balance sheet that means it's still $8.00 per share overvalued! Europeans should feel a wee bit queasy!

Even Germany's economy, plagued by many of the challenges facing France and the rest of Europe, is slowing as export markets weaken (particularly China). Germany faces massively higher social program expenditures as Germans selfishly refuse to form families and produce a future. Allowing millions of migrants into their country that have no interest in being "Germans" or working as Germans will only exacerbate their challenges. The only institution that continues to grow in Germany and throughout Europe is the State. As the State grows, personal liberties and freedoms contract along with wealth creation. Social unrest is brewing and inevitable at some point. Caution is warranted!

UNITED KINGDOM

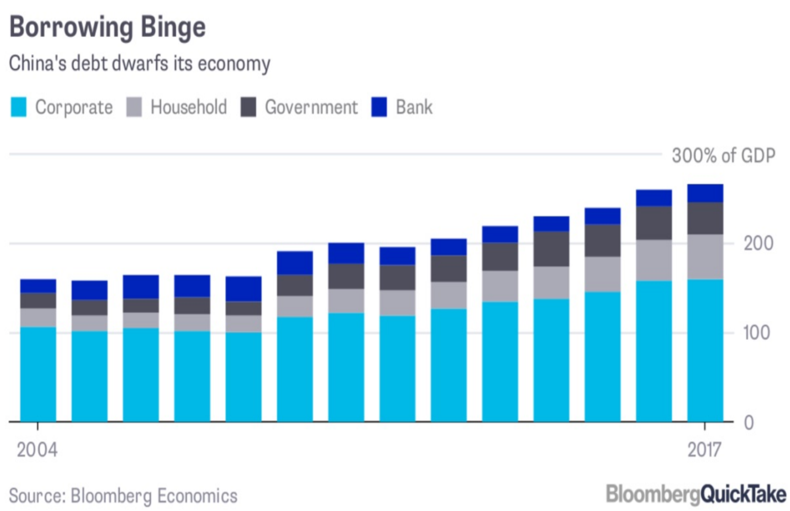
In the UK, the economy has been doing quite well, with wage growth accelerating at the fastest pace since the financial crisis. On the other hand, the ongoing uncertainty surrounding the Brexit negotiations has weighed on business and consumer confidence. This has been seen in house prices, and in the number of real estate transactions, which have dropped. Against this backdrop, the Bank of England has maintained rates at 0.75%, which is very low and accommodative, while the political theatre around Brexit continues. We are not worried about Brexit over the medium to longer-term. In our view, the UK would be better off taking back power and control over their laws and decrease the burdensome regulations from the dictatorial (unelected) and corrupt power elite in Brussels! Western Europe is dying (socially, morally and economically) and although the UK has massive challenges, being tethered to a corpse is hardly a good idea. Benjamin Franklin's famous quote comes to mind; "Those who would give up essential Liberty, to purchase a little temporary Safety, deserve neither Liberty nor Safety."

CHINA

In China, growth has slowed significantly and this is very important for the global economy. In fact, China has been the primary driver of growth for the global economy since 2008. Despite only accounting for 15% of global GDP, China accounts for 25-30% of global GDP growth! Part of this weakness is attributable to the drop in global exports given the softer global economy and trade friction, but there is also clear weakness coming from within China. For example, Chinese imports have collapsed, from 37% year-on-year growth in January to only 3% in November! In December, China's Manufacturing PMI came in below 50, signaling a contraction in their manufacturing sector! Until recently, a contraction in their manufacturing sector was unthinkable, and even if it did occur they would never admit it! Following a clampdown on lending from the shadow banking sector, Chinese money supply growth has also slowed and this has resulted in a slowdown in the pace of retail sales growth and industrial production.

Consider the following, Chinese borrowing rose 14 percent in 2017, ballooning to 266 percent of gross domestic product, from 162 percent in 2008. That growth outpaced the U.K. and U.S. in the decade before the financial crisis. Acknowledging this large run up in debt led the Chinese government to attempt a de-risking campaign, but this has created some real pain. Once-rare corporate debt defaults ran at a record pace in 2018, and China's huge conglomerates have been reined in following debt-fueled acquisition sprees. The government is also targeting spending cuts in its budget, and has introduced sweeping rules to tackle shadow banking, which is a $10 trillion network of unregulated lending and risky investment products.

There's also been a focus on curbing loans to bloated state-owned enterprises, a task that President Xi termed "the priority of priorities." (More than half of China's debt is held by state and private corporations.) The upshot is that the cycle of expanding credit that began in 2004 has ended, according to S&P Global Ratings. Even so, the government remains willing to change its strategy when the economy is threatened: A brewing trade war with the U.S., coinciding with those moves to curb leverage and shadow banking, began to make it harder for companies to get funding in 2018. That prompted the authorities to introduce monetary-easing measures, such as freeing up banks to make more loans to smaller businesses. But how long can China simply crank up its debt and print more money in order to keep this economy growing? The chart below shows the massive runup in debt over the past fourteen years. Given what really happens in China, the numbers are probably far worse.



To put it bluntly, China is a country fueled by junk debt and one of the biggest risks to the global financial system today, cleaning up this mess will not be painless! To make matters worse, China along with all the East Asian countries (including Japan, South and North Korea, Taiwan and Mongolia) are in the midst of the most significant natural population decline in the history of the world. The birth dearth, the rapidly falling childbearing population, urbanization and lack of family formation, defined as Biblical marriage, has put the most rapidly growing countries of the past three decades into social, economic and moral freefall. Cutting interest rates coupled with more deficit spending and printing more money is simply not going to continue working or ameliorate the declining demand that will inevitably set in as populations age and then crumble.

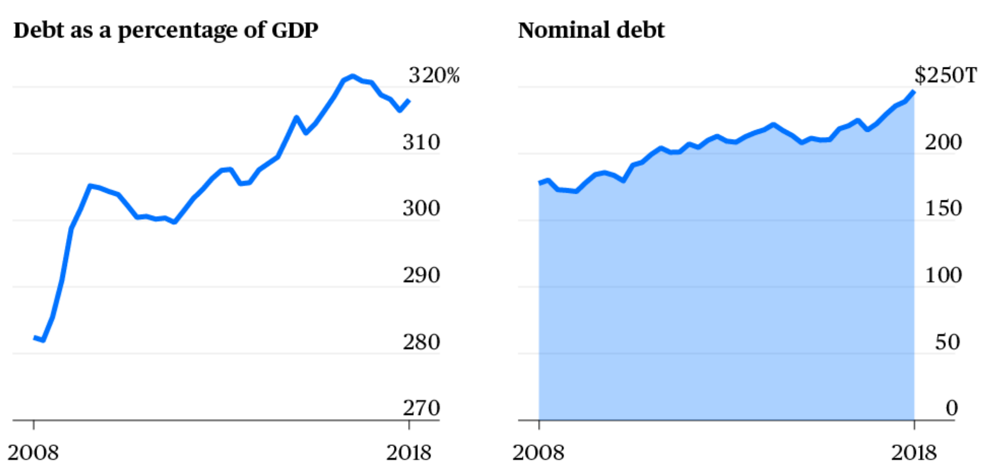
CREDIT MARKETS

Turning our attention briefly to the credit/debt markets. Overall, they struggled during the quarter. Non-financial corporate debt-to-GDP has risen to the highest level in over 70 years and the credit quality of the US investment grade index has deteriorated. Since liquidity is lower than it was before the financial crisis, a wave of corporate debt downgrades could put further stress on credit markets. There are also concerns about the covenant quality in the leveraged loan market along with the subprime debt in the auto loan market. Given this backdrop, fixed income investors need to be selective and buy only high quality issues supported by both cash flow and hard assets. We are keeping a close eye on the credit markets given their uncanny ability to signal fundamental changes taking place in the broader capital markets.

ENERGY

The oil price plunged in the fourth quarter as rising supply, led by US shale production, caught up with demand. Fears around the outlook for global growth and hence demand for oil have also weighed on the price. Falling oil prices create both winners and losers. Oil producers will be hurt and business investment in the energy sector will fall. However, oil consumers—both households and many businesses—will benefit from lower energy costs, providing some positive news to at least some sectors in the economy. Fortunately, at Rocklinc, our exposure to direct oil and gas investments has been negligible. Where we have invested, primarily Suncor and BP, we have actually made money because these firms are integrated oil companies and are better suited to withstand low oil and gas prices.

Overall, the risks are probably higher now than they have been at any point since the financial crisis in 2008-2009. Moving from QE to QT in the face of unprecedented debt levels can only lead to heightened volatility in the markets. For value investors, heightened volatility can and will provide us with greater investment opportunities if we are disciplined! The chart below (from Bloomberg) gives you a sense of the massive build up of debt that continues unabated! Prudent investors would call this a debt addiction!



B. North American Equity Market Statistics

During the fourth quarter the Canadian equity market, S&P/TSX (Total Return – dividends reinvested) decreased by 10.1% and year-to-date dropped by 8.9%. The S&P/TSX has been one of the worst performing equity markets in the developed world over the past 10 years. Despite the underperformance of the broad basket of Canadian equities, ROCKLINC has managed to generate returns over the past year and for longer periods that have stayed ahead of the overall market index. We have managed to do this by avoiding many of the weaker performing stocks and minimizing our exposure to some of the underperforming sectors. During the fourth quarter our basket of Canadian companies outperformed the index with our underweighting in "health care stocks", otherwise known as "cannabis" and our lower than index weighting in energy and the banks. Our overweight in the gold and silver royalty companies added substantial value during the quarter, rising on average by 21%!

In terms of the S&P/TSX, the sectors ranked from best performing sectors to the worst in the third quarter were: Consumer Staples (+5.4%), Telecom(+.8%), Materials (+.4%), Utilities (-2.6%), Real Estate (-7.8%), Information Technology (-10.4%), Financials (-12.3%), Consumer Discretionary (-12.3%), Industrial (-13.7%), Energy (-18.2%, Healthcare (-35.4%).

Pertinent market action during the fourth quarter of 2018 and during the last 12 months is captured in the following table.

	Dec. 31, 2017	**Sept.30, 2018**	**Dec. 31, 2018**	**3 Month**	**1 Year Return**
CAD/USD	$.7971	$0.7744	$0.7365	-4.89%	-7.60%
Oil WTI (US $)	$60.42	$73.56	$45.41	-38.3%	-24.8%
Gold (US $)	$1,296.50	$1,188.38	$1,281.30	+7.82%	-1.17%
Silver (US $)	$16.86	$14.61	$15.51	+6.16%	-8.0%
S&P/TSX	16,209	16,073	14,322	-10.89%	-11.64%
S&P 500	2,674	2,914	2,507	-13.97%	-6.25%
Cdn 10 yr	2.04%	2.43%	1.96%	-47 bps	-8 bps
US 10 yr	2.40%	3.06%	2.68%	-38 bps	+28 bps

Source: Bloomberg

Let me reiterate what I stated in our last quarterly update concerning the precious metals. Without making any predictions as to the exact value of gold and silver it is fair to say that precious metals are quite inexpensive (based on physical demand, supply and production costs) and are well positioned to advance looking forward. Given the record levels of consumer, corporate and government debt, and the increasing trade concerns and political tensions around the world, precious metals should be bid higher this year, after edging higher in the fourth quarter of 2018. We continue to own the world's leading royalty and streaming companies in the precious metals space. As I stated in our September 2018 report, "If the markets do the "wild thing" on the downside, these companies should do the "wild thing" on the upside!" That statement turned out to be very prescient. As we noted earlier, our four royalty and streaming companies Franco-Nevada, Royal Gold, Wheaton Precious Metals and Sandstorm Gold on average increased by 21% in the fourth quarter, with Sandstorm leading the way at over 31%! Each one of these companies continue to generate record performance and we are looking to even better rates of return over the next 1-3 years relative to the broader markets.

The table above, continues to point to the reality of increasing interest rates, year over year. The key question is: what level of interest rates will start to weigh meaningfully on economic activity? During the fourth quarter, the price of quality bonds reversed course and increased in value, with yields on both the 10-year government bonds in Canada and the US by 47 and 38 basis points, respectively. Year over year yields are still up but well off their recent highs. This has put significant downward pressure on the value of bonds over the past few years. When it comes to ROCKLINC, our investors are largely sheltered from the volatility in bond values, since we keep investing in quality bonds with very short durations!

We continue to watch the central banks closely, as discussed in the first portion of this newsletter, to see how aggressively they will act. For the time being, we will only invest in short-term (less than 4 years, with most under 2 years) quality bonds for three 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 markets sell off, and we need some cash to take advantage of cheap equity prices! Third, as bonds mature, we are able to roll them over into bonds offering higher yields. **The bottom line is that the level of debt around the world cannot withstand a major move in rates, without creating a serious recession/depression in the global economy. As a result, we do not expect interest rates to increase during the first half of 2019.**

C. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate across all our accounts, they were down 2.9% during the fourth quarter of 2018 and down 0.6% during the last 12 months (period ending December 31, 2018). Despite these small negative returns we were able to substantially outperform the relevant indexes with the US equity market dropping by 6% and the Canadian market dropping closer to 10% during 2018.

More importantly, our average annual compound rate of return over the past 3 and 5 years is clocking in at approximately 6.1% and 6.6% respectively. Returns are after all fees, and are based on an asset mix of approximately 68% invested in equities, with the remainder invested in short-term deposit accounts, bonds and preferred shares. This asset mix has varied over the past five years but in general we have averaged approximately 65% invested in equities. Currently we are running at 68.1% in equities, at the end of the fourth quarter. Please note that 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 tolerance and your specific asset allocation.

When we dig further into our numbers, we find that our basket of equities decreased by 4% during the fourth quarter, and by approximately 1.4% during the past 12 months. Our equities have been compounding by approximately 10.4% per year over the past 5 years. It is interesting to point out that there has been a significant difference in performance between Canadian and US equities. Over the past five years, our Canadian equities have been compounding at 7.7% per year, while our US equities have been growing at 14.6% per year! This points to both the greater investment opportunities outside Canada and the red hot US market. We will continue to allocate capital into global businesses and glean the benefit of global growth and diversification in your portfolios. Given the conservative nature of your portfolios, we are pleased with our progress, but are working hard to grow your portfolios even faster in the years ahead.

For the time being, as long as the market is volatile, our focus is on first, selectively adding new companies we come across as new opportunities. Second, pruning underperforming businesses and third, taking full advantage of market swings that provide us with the opportunity to buy one of our exceptional companies at the best price! Queasy markets tend to provide us with more of these opportunities!

While 2018 was filled with plenty of excitement and riveting headlines we suspect 2019 will be more of the same! As a result, we will continue to be vigilant in protecting your capital. One company that we have been able to carefully add to during the recent downturn is Apple Inc.

D. Company Update – Apple Inc.

Very few companies have shaken up the consumer product industry like Apple. Since the introduction of the first Macintosh in 1984, the company was prepared to take the road less travelled, in order to differentiate itself and build one of the greatest businesses in the world. Over the years, Apple has reinvented itself several times in order to maintain its leadership position. Today the company had created a virtual ecosystem of products and services that boasted revenues of over $265 billion in fiscal 2018. Apple has developed an ecosystem of inter-related software and services that centres around its massive install base of 2 billion iOS devices. This ecosystem allows consumers to seamlessly share, transfer and view data and content between devices, such as the iPhone, iPad, MacBook, Apple Watch, Apple TV, HomePod and iPod Touch. Through this install base of products, Apple has created multiple revenue sources by offering services, such as Apple Music, AppleCare, ApplePay, the App Store and iCloud.

In 2018, the App Store celebrated its 10-year anniversary with the highest revenue and earnings in Apple's history. From Christmas Eve to New Year's Eve of 2018, consumers spent $1.22B on Apple's App store and over $322 million on 2019 New Year's Day alone. There are over 2 million apps available for consumers to download on the App Store. Apple generates revenue from the App Store by receiving a percentage of the money paid for each app purchase.

Apple has also built businesses that have a recurring business model, such as Apple Music, Apple Pay and iCloud storage. Apple Music is a subscription-based model that enables users to listen to a wide collection of music without any advertisements. In May of 2018, Apple CEO Tim Cook announced that the Apple Music streaming service had reached 50M paid and trial subscribers. Apple Pay is another recurring revenue business that allows users to make in-store purchases using their iPhone. Mobile payments are increasingly becoming the preferred method to make in-store purchases and are now accepted by approximately 60% of U.S. retailers. When users develop and create more data, storage becomes an increasing need. Apple has built a recurring revenue business by offering its iCloud data storage option that stores consumer's data in the public cloud. As data needs increase, Apple offers iCloud data storage plans that are charged on a monthly basis. With storage needs continuing to increase, Apple's fees continue to grow!

The iPhone has been one of the best-selling consumer products in the world. It is continually expanding into new geographies with strong consumer satisfaction and loyalty. Recently, Apple's management noted that it will no longer report unit sales of iPhones. This caused many analysts to grow cautious concerning the future growth of iPhone sales. Despite this fear, iPhone revenues have soared and broken company records. Although there is much market noise regarding iPhone growth, we are less pessimistic about the long-term trajectory of the iPhone story and believe growth will continue, albeit at a much slower rate. As the product life cycle runs its course, and existing consumers update their phones, Apple will continue to innovate and new buyers will enter the market. Most importantly, as shareholders, cash will continue to flow in to the company!

Recently, there has been much pessimistic market sentiment regarding Apple's near-term growth prospects due to concerns of deceleration in China and slower product demand. This has caused the stock to correct by over 30% from its 52-week high. It was not too long ago that Apple crossed the trillion-dollar market value line and became the world's most valuable company. How quickly "Mr. Market" forgets! Although this may pose some concern in the near term, we believe that these concerns are cyclical in nature and primarily driven by market sentiment. Apple has many sources of revenue that it can leverage to fuel the momentum of what is really a free cash flow generating machine! Apple is currently attractively valued with a free cash flow yield of 9%, a price to earnings ratio under 13 and a price to sales ratio under 3. It also has one of the strongest balance sheets in the world with over $150 billion in net cash. As "Mr. Market" continues to wallow in Apple pessimism, we will continue to capitalize on this weakness and gingerly add to our positions, hoping that this current bout of pessimism continues!

E. Moving Forward

Our goal is to keep our eyes fixed on the fundamentals of the businesses we are investing in, on your behalf. **We will do our best to take advantage of any moves in the market, which might be larger and more violent than what we have been accustomed to recently.** As investors, volatility and turbulence are our friends and we will use them to your advantage. The investment team at Rocklinc is working hard to make sure our existing companies are performing as expected, and searching for new companies that we can add to your portfolios.

Our basic strategy, continues to be summarized in the following six points!

1. Diversify across asset classes, sectors and geographic regions. At the current time we are focusing on eight sectors. These are infrastructure, financial, technology, manufacturing, precious metals, healthcare, agriculture and water.

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

3. Invest in firms that produce essential products and services, in growing industries, with long-term secular growth trends well established. Apple Inc. which we highlighted in this newsletter, is an excellent example.

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

5. Maintain liquidity in our portfolios, in order to take advantage of significant moves in the stock market. Cash is not trash when the markets get crazy!

6. Stay optimistic and opportunistic without being naive to the risks all around us. **Investing in turbulent times can be rewarding, with the right investment philosophy and prudent execution.**

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

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