Negative Yields Return with a Vengeance - Beware!

A. Second Quarter Global Review

Beginning in the US, share prices moved higher during the quarter, with the S&P 500 setting a new record high. Uncertainty surrounding trade talks did cause some mid-quarter weakness. This weakness was minimized by a dovish Federal Reserve Bank (Fed) and indications of progress concerning the trade talks by the end of the quarter. Overall, economic data was mixed with a positive bias. US gross domestic product (GDP) grew 3.1% in Q1 as expected and well ahead of most major economies in the world. Employment data remained strong, despite slowing in June. The unemployment rate remained stable at a 49-year low of 3.6%, while average hourly earnings climbed 3.1% from a year earlier. The "Trump Economy" continued to motor along, much to the chagrin of his detractors, especially those in the mainstream media!

Despite some of the best economic growth in the world, consumer and business confidence indices weakened, and some survey data pointed to weaker business activity moving forward. The Fed did not cut rates at its June meeting but the "dot plots" they love to follow signaled easier monetary policy ahead. For our non-PhD's, the dot plots reflect what level Fed policymakers think rates should be in the future. The critical point to note is that the leading central bank in the world, within six months, has made a complete 180 degree turn. From hiking rates to a posture of lowering them! For non-PhD's this is what you call a flip-flop! We will return to this topic later in our newsletter.

In terms of the stock market, more cyclical areas of the market, that is, those that are most sensitive to the economic cycle, generally performed strongly. Financials, materials and information technology all generated robust gains. Healthcare remains challenged by potential changes to pricing legislation, and more defensive or less cyclical areas of the market advanced modestly. Energy stocks continued to struggle and were lower during the quarter.

Eurozone

Within the Eurozone equities advanced in Q2 with a sharp drop in May squeezed in between gains in April and June. Top performing sectors included information technology, consumer discretionary and industrials. Sentiment towards trade-exposed areas of the market such as semiconductors and car manufacturers bounced around during the quarter as trade tensions persisted. The lack of further tensions in the trade wars in June helped the market to recover after May's pull-back. The real estate sector continued to struggle.

GDP growth for Q1 in the eurozone was an anemic 0.4% quarter-on-quarter. Annual inflation for June was stable compared to May at 1.2%. European Central Bank President Mario Draghi hinted that further monetary policy easing, such as new bond purchases, which is code for printing money, could be on the way if the eurozone inflation outlook fails to improve. A number of forward-looking surveys painted a mixed picture and did not create much enthusiasm for the future. The Eurozone is mired in economic stagnation driven by their suffocating socialism and deadly demographics. The current trajectory is not positive for long-term economic growth. During the end of the quarter yields on sovereign debt throughout Europe tumbled with over 50% of European government bonds trading with **negative yields!**

United Kingdom

UK shares performed well during the quarter. In particular, areas of the market that generated superior and predictable earnings growth continued to outperform. For example, the technology and consumer goods companies enjoyed another quarter of strong performance. Weakness was more evident in businesses that are more vulnerable to a "Brexit" and political uncertainty.

On June 7th, Theresa May finally resigned as leader of the Conservative Party and as the UK Prime Minister. The Conservative Party began the process of selecting a new leader, who will also become Prime Minister. Hopefully, they will elect a strong leader committed to Brexit and will meet the deadline of October 31, 2019. They must rid themselves of the chains of Brussels and return to being a sovereign and truly democratic nation. Currently there remains some uncertainty as to the path a new leader might take.

All of the uncertainty surrounding Brexit appeared to have a negative impact, particularly on the manufacturing sector. While GDP grew by 0.5% in Q1, the Office for National Statistics (ONS) revealed that the economy shrank by 0.4% in April, primarily due to a sharp fall in car production related to Brexit uncertainty. The ONS also reported widespread weakness across manufacturing, as the boost from the early completion of orders ahead of the UK's original EU departure date (March 29th) faded in April. Manufacturing weakness was also felt in the Purchasing Manager' Index (PMI) for May which slipped below 50, indicating a small contraction.

Japan

The Japanese market was one of the worst performing within the developed markets. During the second quarter the total return was -2.4%. This was primarily driven by weakness in May. The yen strengthened against other major currencies, driven partly by its perceived safe-haven status at times of geopolitical risk, and partly as a result of changing (lowering) interest rate expectations for the US.

The main development during the quarter was the continued escalation of trade issues, notably the announcement in May of sharp increases in US tariffs on imports from China. These higher tariffs are expected to have a greater impact on volumes, with repercussions throughout global supply chains and thereby impacting many Japanese companies.

Economic data was mixed, with the largest positive surprise seen in Japan's growth rate for Q1 2019. Data indicated that real GDP growth was expanding at an annual rate of 2.1%, far ahead of consensus. Although the domestic economy remains very weak, it does appear in the short term that Japan will avoid a recession, but not by much! The Bank of Japan left its aggressive monetary policy unchanged during the quarter continuing to hold rates as low as possible, including negative yields, and adding more yen to the money supply. As we have stated before, Japan is headed for a significant economic and social collapse.

Asia (ex-Japan)

Asia ex Japan shares posted modest losses in the second quarter as markets in the region recorded mixed performances. Trade tensions, economic risks and global monetary policy were the key factors holding back the markets. In particular, the US-China trade war escalated in May after the US raised tariffs on US$200 billion worth of Chinese imports and added Chinese telecommunications group Huawei to a trade blacklist. China countered with retaliatory tariffs on US goods. Both

countries subsequently agreed to a truce and will resume trade negotiations following a meeting between their leaders in June, at the G20 Summit in Japan. In our view, trade talks will not be easily resolved! Therefore, don't hold your breath while you are waiting.

Indian stocks posted slim gains as Prime Minister Modi's Bharatiya Janata Party was re-elected with a stronger mandate. Separately, the central bank cut its benchmark interest rate twice to spur economic growth. India continues to tantalize investors by holding out much promise. Unfortunately, it's social, moral and ethical challenges are greater than many of its perceived opportunities. Our investment exposure will continue to come from multinational corporations operating in the country.

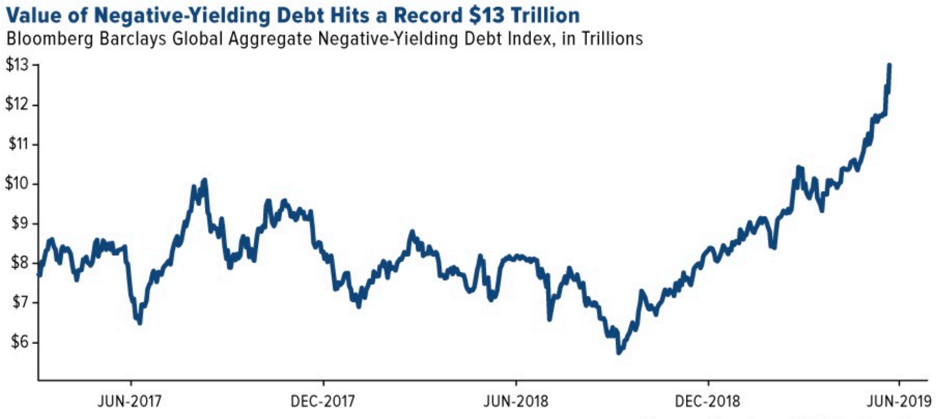
Global Bonds

It was a positive quarter for fixed income markets with both riskier bonds and government bonds making gains. Broadly, this reflected expectations that central banks would keep monetary policy loose, including the possibility of US rate cuts! At their respective meetings in mid-June, comments from the Fed and ECB confirmed the growing dovishness among policymakers, with both clearing the way for further policy measures if needed.

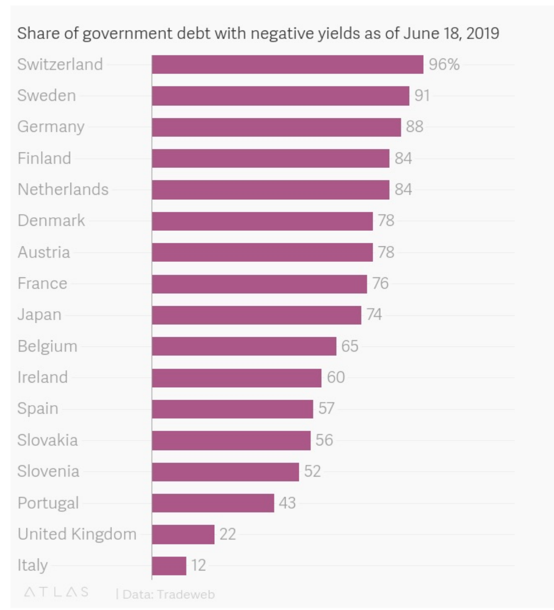
Government bond yields fell markedly as prices rose. The 10-year US Treasury yield was over 40 basis points (bps) lower during the quarter and the 10-year German Bund yield over 25 bps lower at -0.33%. There was a pronounced move in the Spanish 10-year yield, which fell 65 bps to just above 0.40% as the April general election removed political uncertainty. Corporate bond markets overall delivered positive total returns and outperformed government bonds as investors scoured the market for higher yields bidding up the prices of corporate bonds in the face negative yields.

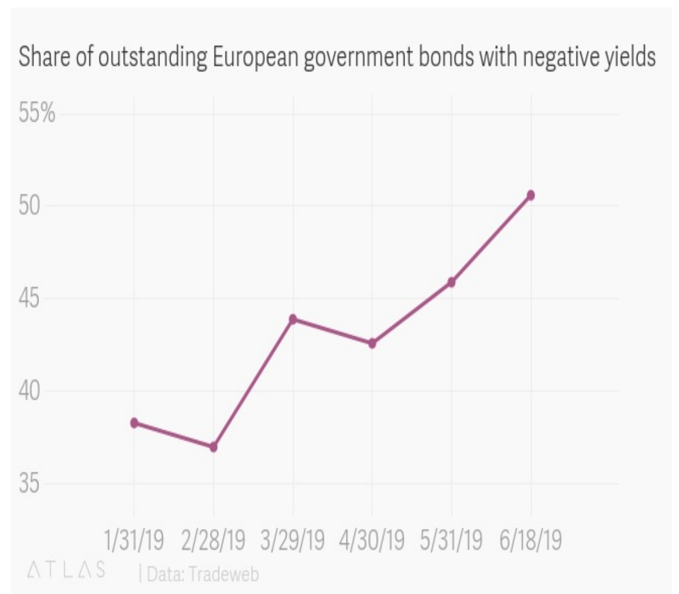
B. Negative Yields Return with a Vengeance – Central Banks to the Rescue?

Believe it or not, at the end of June, there were approximately $13 trillion USD of investment grade corporate and government bonds trading with negative yields. These bonds were predominately European and Japanese, according to Barclays data. That's the largest amount since the middle of 2016 when the UK voted to leave the European Union and the Bank of England restarted its bond-buying program, known as quantitative easing (QE), in response.



Today, half of all European government bonds have a negative yield, with the total amount outstanding at €4.4 trillion ($5 trillion USD), compared to €3.3 trillion at the end of January, according to data from Tradeweb. At the end of May, 20% of European investment-grade corporate debt had negative yields. The two next charts provide readers with a breakdown of the negative yielding bonds and by country (left) and in aggregate year-to-date (right).





As long as the market keeps going up, should we worry about the increasing prevalence of negative yields? In 2016 Jeff Nielson writing for Sprott Money penned a thought provoking article entitled, “Negative Interest Rates: The Tax on Capital”. Although I have significantly edited and added to the article I want to reference Jeff’s article and number of his insights on this crucial topic.

First it is important to realize that there is no such thing as a “negative interest rate”. By definition, an “interest rate” is a positive number. It is the price we pay in exchange for the use of capital. Therefore the phrase “negative interest rate” is a non sequitur. It is a deceptive expression used to conceal what is really happening, and that is the theft of capital. If we were to go directly to the bottom line we should view negative interest rates as a tax on capital!

Second, a negative interest rate is not the natural and logical progression from low and zero interest rates. The moment we reached “0% interest” we completely left behind any semblance of legitimacy and integrity within our monetary system. If there is no “time value of money” your money is unethical because it cannot act as a store of value even over the shortest period of time. The question to ask is, why is this happening? As we have explained before, global debt levels are so far past the point of repayment, they cannot even be serviced unless we eliminate interest rates! Think about that for a moment and let that point really sink in.

Behind all of this is the ongoing growth in debt. Our global economy is totally addicted to deficits, debt increases and governments that cannot stop promising more and more services, to decadent populations without the tax base to pay for them! You can tell that the treadmill is running close to full speed when interest rates go to zero and below!

So how do governments respond to this crisis? Wanton indifference! Just keep spending and promising, have your central banks keep lowering interest rates and when there is a shortfall, print more money and monetize the debt! What do you do when debts are so high that even a 1-2% interest rate is too costly for the economy to support the debt? Take the rates down to zero and just keep going! How else can you stimulate a debt laden economy in the midst of a debt crisis? According to the wizards of finance pile on more debt, get rid of interest rates and print more money!

Let's take a few moments to go a little deeper. What does it mean when a central bank, such as the Fed starts to churn out "free money" (QE – Quantitative Easing) into the economy? In the best case the currency will lose value slowly, and in the worst case, it will become worthless! Just think for a moment, any "good" which is produced at zero cost, and in very large quantities, like our fiat currencies (currencies with no collateral behind them), must decrease in value as more is "printed". But a well taught adolescent, without a PhD in economics and finance, can logically reason that distributing free money that can be used to purchase real goods and services, that are limited in supply at any one moment, will eventually undermine the integrity of the monetary system! It will lead to a misallocation of resources and create inflation. You don't have to look too far back in history to see numerous examples of this folly. Today we see elements of this stupidity in countries such as Argentina, Turkey, Venezuela and Zimbabwe. But just because the erosion of purchasing power is taking place at a slower pace in Canada don't be lulled into complacency. Large swings can, have and will take place in the major trading currencies of the world, especially given the current voodoo economics being practiced by the world's major central banks.

Third, and related to the first two points, using free money as a form of economic stimulus has the obvious effect of causing asset bubbles throughout the economy. The reckless impact of causing asset bubbles, whether it's in real estate or financial assets, outweighs any long-term "stimulating" benefit to the economy. Asset bubbles are not sustainable and often favour a small part of the population at the expense of those that are not invested in the bubble. This, as we have witnessed recently, can lead to significant wealth disparities. When the bubble bursts everyone is hurt and permanent wealth is lost because the artificially low rates have caused market participants to misallocate and waste limited capital while the bubble expanded.

Just ask yourself the question, if 0% interest rates and now negative interest rates were a prudent way to stimulate our economies, why haven't we used this strategy in the past? Because it has been universally accepted, throughout our economic history, that the financial perils of a reckless policy of free money grossly outweighs any economic benefits. A "0% interest rate" doesn't work as a policy of stimulus and it has never worked. In fact, since 1990 we have a country that has tried to create wealth and stimulate its economy with zero and negative interest rates and it failed! That country is Japan! So why are all the major trading economies of the world now copying Japan and heading down the broad road of easy money when the narrow and less travelled road of hard money and financial prudence is the only solution to our monetary woes? I think you know the answer!

Has 30 years of free money fixed Japan's economy? No. Thirty years of free money has destroyed one of the world's strongest economies post World War II. Look at what near-zero, 0%, and now negative rates have reaped in our own economies: massive real estate bubbles all over the Western world coupled with a massive bond bubble and many would argue, overvalued stocks.

Observe the reasoning of the central bankers and the foolish short-term driven politicians. If a 0% interest rate "stimulates" our economies, then moving to negative rates will provide even more "stimulus". It is the logic of a child with no discipline and no sense of the long-term implications.

Two factors are completely ignored in this puerile reasoning. First, a 0% interest rate does not stimulate an economy, it destroys an economy, as just explained. The positive "interest" paid to savers which is supposed to (partially) protect us from the rapacious "inflation" of the central bankers is removed. Our savings are stolen – at the full rate of inflation. Remember long-term inflation is caused by adding too much money to the money supply and not holding back governments and their central bankers by tying money growth to a collateral standard such as gold.

Negative interest rates go well beyond even this level of theft. Negative interest rates actually ***tax capital***. How do you "stimulate" an economy by taxing capital? Anyone with even an ounce of economic savvy would immediately realize that you don't stimulate an economy with a tax – any tax.

Taxing capital is arguably the most-destructive form of taxation devised. It is even more destructive than taxing income because without the investment of capital you cannot grow an economy nor produce any income streams to tax!

Rather than taxing capital we should be doing is the exact opposite. First, savers should once again be paid by their bank, in exchange for bestowing the bank with the privilege of using their capital. Lenders would once again be paid by borrowers in exchange for the use of their capital. Putting a cost or price on capital forces a proper use of capital and directs it to the areas of highest economic return and accountability.

Secondly, the bankers and the politicians should put an end to the central banker's game of theft-by-inflation: taxing (and pocketing) our wealth via the monetary fraud of their excessive money-printing. Legitimate interest rates foster sustainable economic growth and development. The obvious sanity and justice of positive interest rates is fully supported by economic fundamentals. The monetary alchemy imposed upon us by unprincipled central banks, and rubber-stamped by puppet politicians is the ultimate in financial vice.

Central banks to the rescue? No! Central banks around the world are feeding debt addicted economies giving them more and more flexibility to keep running massive deficits, to ignore the mounting levels of debt and for their respective government to promise more and more goodies that simply cannot be paid for with real money. Central banks are aiding and abetting an ultimate collapse in the global economy, they are not our friends, they are our foes. We must be vigilant as we increasingly invest our hard-earned capital into an unsustainable economic environment. Negative interest rates provide us with clear evidence that all is not well. They are a powerful barometer that point us to an insalubrious global economy.

C. North American Equity Market Statistics

During the second quarter the Canadian equity market, S&P/TSX increased by 1.7%, and year over year increased by .65%, without factoring in dividends. The S&P/TSX has been one of the worst performing equity markets in the developed world over the past 10 years. Despite this underperformance, ROCKLINC has managed to generate returns over the past year and for longer periods that have stayed ahead of the overall Canadian 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 second quarter our basket of Canadian companies outperformed the index by approximately 2% and over the last twelve months we were ahead of the Canadian index by almost 7%. Our overweight in the gold and silver royalty companies, along with

our infrastructure holdings and technology stocks added value during the quarter. Our underweight in banks, energy and all things cannabis helped us avoid some of the weaker sectors in the S&P/TSX during the quarter.

In terms of the S&P/TSX, the sectors ranked from best performing sectors to the worst in the second quarter were: Information Technology (+14.2%), Materials (+5%), Industrials (+4.7%), Utilities (+4.2%), Consumer Discretionary (+4.1%), Financials (+2.4%), Consumer Staples (+1.4%), Telecom Services (-1.3%), Real Estate (-2.6%), Energy (-3.9%) and Health Care (-9.4%).

Pertinent market action during the second quarter of 2019 and during the last 12 months is captured in the following table.

	June 30, 2018	March 31, 2019	June 30, 2019	3 Month	1 Year Return
CAD/USD	$.7630	$0.7490	$0.7637	+1.96 %	+.1%
Oil WTI (US $)	$74.13	$60.14	$58.47	-2.8%	-21.1%
Gold (US $)	$1,250.45	$1,292.12	$1,413.70	+9.41%	+13.1 %
Silver (US $)	$16.06	$15.40	$15.34	-.4%	-4.5%
S&P/TSX	16,277	16,102	16,382	+1.7%	+.65%
S&P 500	2,718	2,834	2,942	+3.8%	+8.2 %
Cdn 10 yr.	2.17%	1.62%	1.47%	-15 bps	-70 bps
US 10 yr.	2.85%	2.41%	2.01%	-40 bps	-84 bps

Source: Bloomberg

The Canadian dollar continued to trade in a fairly tight range over the past three- and twelve-month periods, increasing by .1% against the USD over the past year. Currency moves will impact the performance of your investments in the short-term but tend to cancel out over longer periods of time. The best way to mitigate currency risk is to buy strong and growing businesses that generate revenue in numerous currencies and as a result, create a natural currency hedge for you.

Although oil had a spectacular first quarter rising by over 32% it dropped by 2.8% in the second quarter and is still down significantly year over year (-21%). This is a reminder of the volatility that can occur in any sector, especially commodities. In Canada, we have the added complexity of having many of our political leaders who are more interested in sabotaging this important industry, than leaving it alone to grow and create significant wealth.

The area that caught most market participants by surprise was the continued sharp drop in bond yields during the second quarter and also year over year. Over the past twelve months the yields on Canada and US 10-year sovereign debt dropped 70 and 84 bps points respectively. The pundits were all predicting increasing rates as the Fed started the arduous task of normalizing rates about 24 months ago. **But as we have discussed many times; interest rates are hostage to the outlandish levels of global debt. In our view, it will be impossible for central bankers to normalize ethical interest rates, without a full-blown economic depression.** This should be a major concern for all investors interested in protecting their capital.

We do not expect interest rates to increase in 2019 or 2020! In fact, the market is currently factoring in several interest rate cuts between now and the end of this year.

The drop in interest rates, coupled with fears of a global slowdown ignited the price of gold to its highest level in six years. Year over year gold is now up over 13%. Our expectation is that this is just the beginning for gold and its lagging counterpart silver. With interest rates approaching zero and, in many instances, negative, coupled with record amounts of money printing globally it's a safe bet that monetary substitutes, like gold and silver, will witness substantial upside in the years ahead.

D. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, that hold on average, 70% equities and 30% short-term bonds, they advanced by 2.4% during the second quarter, 13% year-to-date, and 10.4% during the last 12 months (period ending June 30, 2019).

More importantly, our average annual compound rate of return over the past 3 and 5 years is clocking in at approximately 7.5% and 7.2%, respectively. Returns are after all fees, and are based on an asset mix of approximately 70% 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. Please note that the performance we are disclosing 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 increased by 3.3% during the second quarter, 18.4% year to date and by approximately 14.5% during the past 12 months. Our equities have been compounding by approximately 11.1% 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 8.2% per year, while our US equities have been growing at 15.9% per year! This points to both the greater investment opportunities outside Canada and the strong US stock market. We continue to allocate capital into global businesses and glean the benefit of global growth and diversification in our portfolios.

Although the markets have been very positive in the second quarter our focus never changes. We continue to **first,** selectively add companies as we research new opportunities. **Second**, prune underperforming businesses. **Third**, take advantage of market swings and add to our outstanding companies at better prices! Whether the markets are woozy or exuberant, there are always opportunities we can seize, when prepared!

One company that we have owned in client portfolios dates back to 2011 when it was spun out of ITT Corp. It is a wonderful example of a company that you can buy, hold and watch your value increase!

E. Company Update - xylem

Xylem Inc (NYSE: XYL) is a pureplay water technology company that is a leader in solving complex water challenges. Water is an essential resource that plays a fundamental role in the economy. It is used across many industry applications, such as mineral processing, pharmaceutical development, energy production and semiconductor manufacturing. Water also plays a critical role in daily human functioning. Cities rely on their water distribution system to deliver water; however, these systems can fail and result in significant financial costs and inefficiency. For example, aging water infrastructure often results in structural deterioration that leads to unwanted loss of treated water. According to the American Water Works Association, there are over 200,000 water main breaks per year in the US which impacts up to 2 trillion gallons of treated drinking water. Water systems can also fail when systems are unable to handle excess capacity. For instance, cities with combined sewage and storm water systems can overflow when there is heavy rainfall and cause untreated sewage and storm-water to flow into lakes and streams.

To address these issues, the water industry is adopting smart water technology that incorporates intelligent systems, software and networks into water infrastructure assets. Smart water technology can be used to continuously collect and monitor data in real-time. This data can be analyzed to provide operators with actionable insights to assess water infrastructure conditions, prevent problems and address issues in real time.

The Company

One of the companies we believe is a leader in smart water technology is Xylem, Inc. The company designs and manufactures highly engineered water infrastructure, applications and technologies. Approximately 50% of the company's revenue comes from the utility industry, while the remaining revenue comes from industrial (35%), commercial (10%) and residential (5%) customers. Xylem's products are used across the entire water cycle from energy efficient water pumps used in water intake and transport, to filtration, analytical and disinfection technology used in testing and treating water and wastewater. The company also develops industry specific applications for various industries such as the oil and gas, food and beverage, mining, agriculture and life sciences.

Over the past 5 years, Xylem, Inc has made strategic acquisitions to develop a portfolio of smart water technology that is used to predict equipment failure, reduce energy usage, identify the location of leaking pipes and other damage. In January 2018, Xylem, Inc acquired a Canadian based company called Pure Technologies, which previously traded on the Toronto Stock Exchange. Pure Technologies developed leading leak detection and condition assessment solutions for water distribution networks. It also developed smart infrastructure assessment and diagnostic solutions used to monitor and detect leaks from pipes buried underground. We believe this acquisition helps strengthen Xylem's portfolio of diagnostic and analytical solutions for water and wastewater networks.

As the water industry continues to face challenges, we expect Xylem's expertise in smart water technology to become increasingly valuable and vital to customer's operations. Xylem has developed a strong reputation in developing highly engineered and specialized solutions that distinguishes the company as a leader in the water industry. With a large install base and greater software offering, Xylem is well positioned to generate steady recurring revenue from replacement parts, software subscription and maintenance services. This has all contributed to Xylem's growth story and translated into strong financial results. For instance, from 2013-2018, Xylem free cashflow increased

12.0% per annum, while adjusted operating margins expanded 190 bps to 13.7%. During this same period, investors were rewarded with a compounding share price of 19% per annum! With a Debt to Equity ratio of <1, we believe that Xylem's astute management team has room to continue making prudent capital allocation decisions and invest in high return investments and acquisitions to generate higher shareholder return over the long-term.

G. Moving Forward

Our goal is to keep our eyes fixed on the fundamentals of the businesses we are investing in, within the context of the global economy. **We will do our best to take advantage of any moves in the market, which might be larger and more intense 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, or better and searching for new companies that we can add to your portfolios.

Our basic strategy has not changed and 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 nine sectors. These are agriculture, consumer staples, financial, healthcare, infrastructure, manufacturing, precious metals, technology 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. **Xylem Inc.** which we highlighted earlier 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 become irrational!

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.

Worth.Investing.

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