Riveted on the Fundamentals

A. Fourth Quarter Global Review

Wow, what a difference twelve months makes! While 2018 was the first year since the financial crisis to see equity markets drop in value, 2019 finished with one of the best advances in stock market prices in the last 25 years! As you might recollect, the mood a year ago was quite bleak. First, there was angst that the trade talks between the US and China, as well as other regions in the world, would lead to a sharp drop in economic activity. Second, the Federal Reserve (Fed) had begun its long anticipated reversal of easy monetary policies put in place during the financial crisis in 2008-2009! Interest rates were actually being boosted for the first time in ten years. On top of rising interest rates the Fed had started to pull some of that printed dollars out of the economy for the first time since the financial crisis! Lastly, there was a high degree of skepticism concerning the sustainability of global growth.

Fast forward twelve months and the sentiment has completely flipped! Currently, there is a great deal of optimism concerning global trade talks. The US has renegotiated trade deals with Canada and Mexico, they have signed new deals with South Korea and Japan. They are also working on finetuning trading arrangements with Europe and plans on working with the UK when Brexit takes place. Most importantly, trade talks with China are now on to phase two with the signing of the phase one deal on January 15th. The world's attention is now moving to the next phase of negotiations. All the hype about the negative impact of trade talks and tariffs was exactly that… hype! Second, the Fed completely reversed policy and began lowering interest rates and printing more money, much to the joy of the capital markets! So much for financial discipline! As we have told our clients for the past 10 years central bankers have backed themselves into a corner and extricating themselves will be virtually impossible without a serious recession! Debt levels in the world are so high it will be impossible to shrink the money supply and raise rates without negative economic repercussions. Third, economic growth, while weak has stayed ahead of expectations. Most of the "outperformance" is actually coming from the US and driven by President Trump's policies, much to the chagrin of the global elites who despise him!

In terms of the numbers, the U.S. equity market as measured by the Dow Jones Industrial Average was up 22.3% in 2019. While this fell short of the +54% in 1933 (during the Great Depression), or the +53% of 1954 (during the 1951-1966 bull market), but it was an amazing year for US stocks. The S&P 500 was up 28.9% in 2019, just a smidgeon below its +29.6% of 2013 and above its large returns of 2003 and 2009 (+26% and +23%, respectively). The robust equity market performance of 2019 came after a ~6% decline in stocks in 2018. To help put 2019 performance into context, stocks are presently about 10% higher than they were from their highs in 2018.

Every sector in the U.S. stock market ended the year positively, with technology growing 49% (led by semiconductors and hardware) and telecom & media advancing +31%. Financials (+29%) were a standout and surprised the pundits who predicted that declining interest rates would hurt their performance. Many of the mega-bank stocks advanced over 40% during 2019. Even the worst performing sector, energy, still managed a +8% gain, and health care, last year's leader was the "second worst" at +19%.

Eurozone

Eurozone equities advanced strongly during the final quarter of the year, with the region's MSCI EMU index returning 5.1%. Stocks were buoyed by better economic data from Germany as well as the phase one trade deal between the US and China. Gains were led by sectors that are largely economically sensitive, with top performing sectors being information technology, consumer discretionary and materials. By contrast, more defensive sectors like the communication services and consumer staples sectors registered negative returns, while utilities were also weak. In the consumer staples sector, global powerhouse Unilever warned that its 2019 sales growth would be slightly below its previous forecast. In the car sector, Fiat Chrysler and PSA Peugeot signed an agreement to merge in a €40 billion deal making them the fourth largest automaker in the world. France's luxury goods group LVMH bought US jeweler Tiffany & Co for $16.6 billion, making it the largest luxury goods acquisition ever!

The IFO business climate indicator, which measures confidence among German executives, improved to 96.3 in December from 95.1 in November. The eurozone composite purchasing managers' index was unchanged at 50.6 in December, a level that indicates weak growth. (50 is the level that separates expansion from contraction. The survey is based on responses from companies in the manufacturing and services sectors). Annual inflation was 1.0% in November, up from 0.7% in October but still well below the European Central Bank's (ECB) target of close to 2%. This means that the ECB will continue its easy money policies in an effort to avoid deflation in the Eurozone. Former IMF chief, Christine Lagarde, took over as president of the ECB on November 1. Given her poor track record at the IMF we expected her to continue the misguided policies of her predecessors and central bankers in general! She did not disappoint, in her first major speech she urged governments to boost public investment in order to increase domestic demand in Europe. This is simply code for more government spending and greater levels of government debt. Investors need to be cautious! Lagarde's policies can only lead to a quickening in the erosion of the purchasing power of fiat currencies and the heightened need for investors to seek assets that will help hedge them against inflation and its confiscatory impact on wealth.

United Kingdom

National politics drove UK capital markets following a landslide general election victory by Boris Johnson and his incumbent Conservative Party in December. The new government is set to use its majority to rescue the UK from the corrupt and bureaucratic EU by January 31, 2020. UK equities performed well, especially domestically focused businesses that benefited from the reduction in political uncertainty. This trend was further reflected in a very strong performance by small and mid-cap shares and a sharp recovery in sterling from the lows in the summer.

Latest GDP figures confirmed the UK economy avoided entering a technical recession in the third quarter after contracting in the previous quarter. GDP growth was 0.4% quarter-on-quarter in the third quarter compared to -0.2% in the second quarter. Overall, the data suggests that the economy is coping with the uncertainty from Brexit, despite the outrageous claims from the political left that Brexit would irreparably damage the UK economy. Wise people discount such rubbish! More widely, many economically sensitive areas of the market outperformed, in line with the trend across global markets amid a return of risk appetite. However, the oil & gas sector was the notable exception and performed poorly during the fourth quarter, despite an increase in crude oil prices. HSBC (which has a large exposure to Hong Kong and China) performed poorly as sentiment was negatively impacted by a combination of factors, including social unrest in Hong

Kong, lower US interest rates and various company specific factors. We pray that the brave citizens of Hong Kong will continue to stand against the totalitarian polices of China and that their personal and economic liberties will not be curtailed by the repressive regime of Xi Jinping. It is shameful that our Prime Minster refuses to openly support the heroic freedom fighters in Hong Kong, but not a surprise given his admiration for Communist regimes and his pedigree. The apple clearly did not fall very far from the tree!

Japan

The Japanese market rose in each month of the quarter to record a total return of 8.6%, but underperformed other major markets in December. Across the quarter as a whole, the yen weakened slightly against the US dollar but generally remained in a range which is comfortable for both the US and Japan. Sentiment towards Japanese equities fluctuated in line with geopolitical tensions but was ultimately helped by signs of easing relations between the US and China and expectations for the signing of a phase one trade agreement. Foreigners remained net buyers of Japanese equities for most of the quarter.

The most recent quarterly reporting season for Japanese companies ended in November and was largely in line with expectations. Japan's economic data continued to show a significant divergence between the strength in service sectors and the weakness in manufacturing. There were also signs that the long running trend towards an ever tighter labour market had finally reached its natural limit. The main economic event for the quarter was the consumption tax increase on October 1st. Prior to the tax there was some frontloading of demand which led to a subsequent downturn that was greater than consensus expectations, even when allowance is made for the devastating typhoon which hit central Japan in the same month. In response, the government announced a special budget, with a particular focus on reconstruction. Investors have generally responded positively to this planned fiscal stimulus, while the Bank of Japan governor, Mr. Kuroda, welcomed the change in emphasis away from monetary policy alone. The Bank of Japan made no changes to their interest rates this quarter but continued to print yen each month in order to maintain negative interest rates on government bonds under 5 years.

Given the massive debt levels in Japan (the worst in the industrial world) coupled with their massive unfunded pension obligations only made worse by a declining population this is a country to be very concerned about looking forward. None of the domestic, or internal economics of this country are sustainable! Having said that, the can kicking into the future has not yet impacted markets at this time. But as long-term investors we want to be way ahead of this slow motion train wreck and refuse to invest in or be exposed materially to the yen as a currency or domestically focused Japanese companies.

Asia (ex-Japan)

Asia ex-Japan equities delivered a strong return in the fourth quarter, supported by easing geopolitical risk as the US and China reached their phase one trade deal. US dollar weakness also provided support for returns, since many of their currencies are tied to the US dollar making their exports more competitive. Against this backdrop China, South Korea and Taiwan all outperformed. In Taiwan, a strong performance from the technology sector lifted returns, as earnings expectations were revised upwards following solid third quarter sales. In South Korea, the central bank cut interest rates by 25bps to 1.25%. Pakistan was the best-performing market, led higher by banking stocks while Thailand recorded a negative return and was the weakest market as third quarter GDP growth remained sluggish. The Philippines and Malaysia finished in positive territory but lagged the index. India underperformed, negatively impacted by higher crude oil prices, rising fiscal pressure and concerns over slowing growth. Hong Kong posted a solid gain but lagged the wider index. Returns were held back by the intense political struggle going on in that country as they push back against the overreaching tentacles coming at them from communist China.

Global Bonds

Expectations of a phase one US-China trade deal, along with better economic data supported an increase in the risk sentiment during the fourth quarter. Government bond yields rose (prices fell) and corporate bonds outperformed. The US 10-year yield rose from 1.66% to 1.92%, while the two-year yield dropped from 1.62% to 1.57%, steepening the yield curve as investors took a more optimistic view on the economy. Economic data saw some improvement, relative to expectations, over the period. The German 10-year yield increased (but remained negative) from -0.57% to -0.19%, while France's rose from -0.27% to 0.12%. The Italian 10-year yield rose from 0.82% to 1.41%, as political risk increased. Spain's 10-year increased from 0.15% to 0.47%. The UK 10-year yield rose from 0.49% to 0.82% amid an important election victory for the incumbent Conservative party and optimism that Brexit would finally take place in January. Corporate bonds performed well and turned in a strong year. High yield outperformed, but US investment grade debt was also a strong performer relative to government bonds. Emerging market bonds also saw solid returns during the year as yields across most countries decreased during the year. While yields are off their bottoms reached in the middle of 2019 they remain at or very close to historical lows and in parts of Europe and Japan yields are still negative! Rates this low should cause us caution since they reflect high stress levels and substantial central bank involvement in the global debt markets.

B. North American Equity Market Statistics

During the fourth quarter the Canadian equity market, S&P/TSX increased by 3.2%, and year over year increased by 22.9%, including dividends. Although the return in 2019 was strong the S&P/TSX index has lagged most of the world's major stock markets over the past 10 years. Despite this underperformance, ROCKLINC has successfully generated 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 fourth quarter our basket of Canadian companies outperformed the index by approximately 4.1% and over the last twelve months we were ahead of the Canadian index by approximately 14.2%! Our overweight in the gold and silver royalty companies, along with our infrastructure holdings and technology stocks added significant value during the quarter and over the past year. 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. Despite these very strong numbers our focus remains on the long run and on economic fundamentals.

In terms of the S&P/TSX, the sectors ranked from best performing sectors to the worst in the fourth quarter were: Information Technology (+10.7%), Materials (+7.4%), Energy (+5.9%), Industrials (+4.8%), Utilities (+.9%), Financials (+.2%), Telecom Services (-.2), Consumer Discretionary (-2.8%), Real Estate (-3.4%), Consumer Staples (-4.2%) and Healthcare/Cannabis (-6.0%).

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

	Dec. 31, 2018	Sept. 30, 2019	Dec. 31, 2019	3 Month	1 Year Return
CAD/USD	$.7365	$0.7553	$0.7698	1.9%	4.5%
Oil WTI (US $)	$45.41	$54.09	$61.21	13.2%	34.8%
Gold (US $)	$1,281.30	$1,465.70	$1,518.20	3.6%	18.5 %
Silver (US $)	$15.51	$16.90	$17.87	5.7%	15.2%
S&P/TSX	14,322	16,659	17,063	2.4%	19.1%
S&P 500	2,507	2,976	3,231	8.6%	28.9 %
Cdn 10 yr.	1.96%	1.37%	1.70%	+33 bps	-26 bps
US 10 yr.	2.68%	1.67%	1.92%	+25 bps	-76 bps

Source: Bloomberg

The Canadian dollar continued to trade in a normal trading range over the past three and twelve-month periods, increasing by 4.5% 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. For example, over the past twelve months our US based companies while performing exceptionally well were held back by 4.5% due to the appreciation of the Canadian dollar against the USD. 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 in your portfolio.

Oil continues to be very volatile and held hostage to geo-political events. Over the past year oil was up by 34.8% after a very negative 2018. Oil stocks advanced but were still held back by the overall negative sentiment directed at the oil and gas industry especially in Canada. Fortunately for our investors, our exposure to the oil and gas sector remains very low! Commodities in general are very volatile and lack predictability making them poor long-term investments. To add further pain, in Canada we have the added complexity of having political leaders who are more interested in sabotaging the resource sector (especially the oil and gas sectors), rather than leaving it alone to prosper and create significant wealth for all Canadians.

During the fourth quarter, interest rates actually edged up, although they are still down year over year. **We do not expect interest rates to increase materially in 2020! At this point the market is currently factoring in flat rates as far as the eye can see. With all the global debt it will be very difficult for the global economy to sustain interest rate hikes!**

Low interest rates, coupled with fears of a global slowdown, continued to propel the price of precious metals and gold jumped to its highest level in six years (gold as measured in Canadian dollars is now over $2,000 per oz. which is an all-time high). Year over year gold is now up over 18%. Our expectation is that this is just the beginning for gold and its lagging counterpart silver. With interest rates approaching zero and, in many geographic regions, negative, coupled with record amounts of money printing globally, it's a safe bet that monetary substitutes, like gold and silver, will experience substantial upside in the years ahead. The bottom line is that currencies, whether US dollars, pounds or yen are based on nothing more than trust. Precious metals have a 5000 year history as money and represent a dependable store of labour and real value. Trust is not required to hold gold and silver because they have no counterparty risk and are not another person's liability.

With governments around the world coupled with their central banks destroying trust in the financial system with their profligacy, it's not difficult to understand why investors should maintain a portion of their portfolios invested in the precious metals.

C. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, with a 70% equities and 30% short-term bonds mix, they advanced by 3.8% during the fourth quarter and 22.4% during the last 12 months (period ending December 31, 2019).

More importantly, our average annual compound rate of return over the past 3 and 5 years is clocking in at approximately 9.6% and 8.5%, 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 67% 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 5.1% during the fourth quarter and by approximately 31.3% during the past 12 months. Our equities have been compounding by approximately 11.8% per year over the past 5 years. We like to point out the significant difference in performance between Canadian and US equities. Over the past five years, our Canadian equities have been compounding at 9.9% per year, while our US equities have been growing at 15.1% 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 fourth quarter and throughout 2019, our focus never changes and we continue to focus on the economic fundamentals! This means that we **first,** selectively add companies as our research team ferrets out 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 and when focused on the playing field.

D. Company Update – ThermoFisher SCIENTIFIC

Although not fully immune to the effects of a recession, the healthcare industry has a relatively inelastic demand (lower sensitivity to economic growth) that helps it weather through tough times and enjoy periods of robust growth. As more money continues to channel into this space, investing in healthcare can be both a profitable yet challenging endeavour. On the one hand, growth in the healthcare sector is being propelled by many long-term secular growth trends, such as the aging population, increasing chronic disease and new therapeutic advancements. On the other hand, growth has been tempered by increasing regulatory uncertainty, cost reduction pressures and rising government budget deficits. In this game of tug-of-war, it can be treacherous to find yourself invested in a healthcare company that is in the wrong growth area at the wrong time. With all of these challenges to navigate, it is prudent to carefully invest in companies that can benefit both from secular growth trends, while circumventing or limiting exposure to negative tail risk that can quickly pop up from various political pressures.

Everyday, progress is made towards new scientific developments and discoveries, which leads to life-changing diagnostic methods and therapeutic treatments. One company that is helping to empower these scientific advancements is ThermoFisher Scientific. ThermoFisher Scientific is the world's largest maker of scientific and laboratory equipment. As a trusted partner to many of the world's leading pharmaceutical, biotechnology and laboratory organizations, ThermoFisher offers highly specialized tools, equipment, solutions and services across a diverse number of markets, such as bioscience, genetics, food and safety, toxicology, anatomical pathology, diagnostics, microbiology, structural analysis and bio-production. This helps diversify the company across a broad range of areas within healthcare.

ThermoFisher leverages a "razor and blade" business model by offering an extensive selection of science and medical capital equipment ("razor") and complementary consumable products ("blade") to generate high recurring revenue. Approximately 25% of the business is instrumentation and equipment, while the remaining 75% consists of after-market products, such as consumables, chemicals and services. As the gold standard in the industry, ThermoFisher Scientific is widely known for developing industry-leading analytical systems and equipment that are used by scientists and researchers across the world's leading laboratories and research facilities, including the 2017 Nobel Prize winners in Chemistry. The company supplements its base of systems and capital equipment by offering an abundant number of consumable products that need to be replenished on a regular basis, such as instruments, cell cultures, diagnostic test kits and reagents used in medical and biological research, drug and vaccine discovery and genomic research. The company offers an e-commerce platform of >1.5M products where customers can conveniently buy all in one place. This recurring revenue stream enables the company to have a fairly stable and predictable business in the midst of growing market segments.

Many of the leading pharmaceutical, bioscience and biotechnology companies partner with ThermoFisher Scientific because it is a manufacturing powerhouse of >5,000 R&D scientists that have contributed to issuing >7,500 patents globally within the past 5 years. It has significant manufacturing capabilities and distribution presence across many geographies. This enables the company to benefit from economies of scale in purchasing, laboratory operations, purchasing, inventory and product development. Due to its significant size and scale, ThermoFisher Scientific is a "one-stop shop" that its customers can reliably trust. As one of the leading contract development and manufacturing organizations (CDMO), ThermoFisher Scientific provides end-to-end development, manufacture and clinical trials of small and large pharmaceuticals. This enables customers to take a drug from formulation development all the way to commercial production. By having such a depth and breadth of offering that covers across many areas of health and pharmaceutical care, the company has a diversified revenue base that is less susceptible to significant downswings from a specific market.

ThermoFisher Scientific (TMO) 5 Year Share Performance

With a strong capital position, ThermoFisher Scientific is well positioned to grow organically through investments in research and development (>$1 billion/year) and innovative areas such as precision medicine, which is an emerging medical model that offers specialized diagnosis and treatment according to a patient's individual molecular and clinical make-up. The company also has the financial strength to make strategic acquisitions to bolster its product offering or enter into new areas of growth. With so many different options to invest in the healthcare market, we believe that ThermoFisher Scientific is a wonderful investment with significant upside as the company continues to reinvest its growing free cash flow stream! Over the past five years the company has grown its revenue and net income at approximately 14% and 16% per year respectively. The market has rewarded shareholders of the company with the price of its shares climbing from $130.00 to over $336 over the past five years (see graph above from Yahoo Finance).

G. Moving Forward – Staying Focused on Fundamentals

Our focus has not changed. We continue to keep our eyes riveted on the fundamentals of the businesses we invest in, within the context of the global economy. **We will do our best to take advantage of sharp moves in the market!** As investors, volatility and turbulence are our friends and we will use them to your advantage. During the last quarter we began to let our non-equity allocations start to increase for the first time since we started Rocklinc back in 2010! The fundamentals of the market are telling us to be more cautious.

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. Over the past year we have added several new companies to our mix including Abitibi Royalties, Algonquin Power, Northland Power, Pan American Silver and ThermoFisher Scientific. During the same period we eliminated one significant position, Oracle, along several smaller positions. Our most significant asset allocation change during 2019 was our increased weighting to the precious metals sector primarily through the streaming and royalty companies. Given the global monetary recklessness we are engulfed in, we view this allocation as a strategic hedge to protect the overall value of 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. Our highlighted company this quarter ThermoFisher Scientific 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! We expect our cash allocation to increase slowly during 2020!

6. Remain optimistic and opportunistic without being gullible 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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