



#### Dear Partner:

Global fiscal and monetary conditions are highly favorable to our non-operated, farmland investment thesis. By highly favorable, I think it is fair to say, without the risk of being accused of hyperbole – global fiscal and monetary conditions are unhinged.

However, it is not Veripath's job to make moral observations about the machinations of such lofty enterprises as governments and central banks. Veripath's much more prosaic task is to try to separate enough signal from noise to generate a return for our investors. In this vein, it has been said that good investment requires the skill to capture the arbitrage available between perception and reality, and therefore it is critical to know both. Hence all the time spent on global macro conditions by a lowly farmland fund manager.

So bear with me and consider the perception and reality reflected in the following quote: "How did you go bankrupt? Two ways. Gradually, then suddenly." Ernest Hemingway

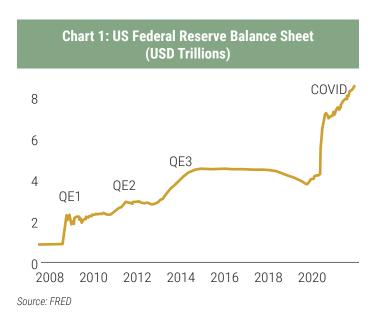
I think that there is something emblematic of our current financial predicament in this snippet of text. With constant fiscal deficits the governments of the developed world have so far been gradually bankrupting themselves. Now by stepping in to somehow fill the economic gap caused by COVID lockdowns and disruptions with printed money, enormous amounts of additional debt have been brought onto already precarious public sector balance sheets.

Central bankers are even openly discussing "helicopter money" and "Modern Monetary Theory" — which stripped of the usual economist obfuscation is, at its most simple level, printing money and sending checks to every person in the country. Granted though this is only different in name from the printing money that has been taking place to bail out the finance, insurance, and real estate sectors since 2001. Helicopter money and MMT were considered strictly taboo topics in the halls of central banks only a few short years ago.

It does bring me to my question: Is everything that has taken place in the last 24 months moving us to the sudden stage of the developed world solvency problems – if not de-jure, then de-facto – via rampant, persistent inflation?

I believe a good starting point for understanding the present is to examine the 1970s. The term that defined that era was "stagflation." Stagflation has once again become a real consideration. Stagflation is that unfortunate condition in which economic growth slows while prices rise (in the 1970s it was caused by the OPEC oil price shock combined with loose monetary and fiscal policy in the US). It may seem like a counter-intuitive combination, but it has happened. Examining the 1970s, we see that there was a bout of stagflation during the second recession of that decade. Inflation reached levels over 12% in 1974 combined with 8% unemployment. This created an economic malaise that was difficult to escape for years.

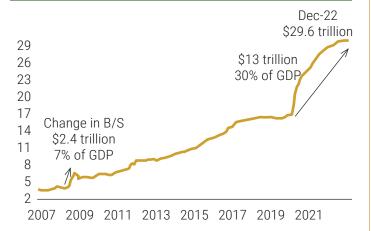
Think of stagflation as the result of an expansionary monetary response to a disrupted real economy. The "flation" portion of the "stagflation" is simply an additional ill to an already grave situation. We believe that what is happening today is not all that different. The response to high unemployment caused by a COVID-19





induced disruption has been a massive increase in government deficits funded virtually entirely with freshly printed money. By way of example, the US Federal Reserve's balance sheet expected to increase by more than QE1, QE2, and QE3 combined – ie this is simply money printing to fund US fiscal deficits. G4 central bank balance sheets are expected to double by end of 2022 to 60% of GDP.





Source: Haver Analytics, IMF, Morgan Stanley forecasts

It has been quipped that history might not repeat but it certainly rhymes. Who can read the following quote from Andrew White recounting the hyperinflation of the French assignat in the eighteenth century and not see some striking similarity to current events?

"The first result of this issue was apparently all that the most sanguine could desire: the treasury was at once greatly relieved; a portion of the public debt was paid; creditors were encouraged; credit revived; ordinary expenses were met, and, a considerable part of this paper money having thus been passed from the government into the hands of the people, trade increased and all difficulties seem to vanish. The anxieties of Necker, the prophecies of Maury and Cazales seemed proven utterly futile. And, indeed, it is quite possible that, if the national authorities had stopped with this issue, few

of the financial evils which afterwards arose would have been severely felt; the four hundred millions of paper money then issued would have simply discharged the function of a similar amount of specie. But soon there came another result: times grew less easy; by the end of September, within five months after the issue of four hundred millions in assignats, the government had spent them and was again in distress. The old remedy immediately and naturally recurred to the minds of men. Throughout the country began a cry for another issue of paper; thoughtful men then began to recall what their fathers had told them about the seductive path of paper-money issues in John Law's time, and to remember the prophecies that they themselves had heard in the debate on the first issue of assignats less than six months before..."

Obviously, Mr White's quote is unlikely to be anyone's idea of humor, but permit me to add the laugh track so to speak. For those of you unfamiliar with the assignat, or for that matter Europe's track record with fiat inflations, France and Germany alone have had 4 noteworthy and complete fiat currency failures (and counting?):

- France 1716: John Law introduced paper money to France in the form of livres. Louis XV required that all taxes be paid in livres. Ostensibly, the currency was backed by coinage. However, the new paper currency was rapidly inflated until nobody wished to hold worthless paper and demanded the coinage. After making it illegal to export any gold or silver, and the failed attempts by the locals to exchange their paper currency for something of actual value, the currency collapsed.
- France 1791: The French government tried fiat currency again called "assignats". By 1795, inflation of assignats was running at approximately 13,000% per annum.
- France 1930s: The French government took over the Bank of France and introduced the paper "franc". It took only 12 years for them to inflate their currency until it lost 99% of its value.

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 Germany: Post-World War I Weimar Germany is one of the most well-known episodes of hyperinflation in history. The Treaty of Versailles imposed heavy reparations on Germany. The German government took the expedient of printing the money to make the repayments. Inflation was so high that it was cost effective to burn marks to heat your home. Here is a brief timeline of the Mark/U.S. dollar exchange rate at 2-year intervals: April 1919: 12 marks, November 1921: 263 marks, December 1923: 4.2 trillion marks.

And yet governments and central bankers keep on trying.

- Global: 1970s
  - GDP: Exogenous shock to the global economy (estimated 10% contraction in GDP) driven by US default on its gold convertibility obligation and OPEC oil embargo to raise real prices
  - Fiscal: Large US fiscal and current account deficits
  - Monetary: Federal reserve responded to indirectly fund government deficits by increasing the money supply (printing money)
  - Result: Decade of high inflation and low growth
    stagflation
- Global: Today
  - GDP: Exogenous shock to the global economy (estimated ~10% contraction in global GDP) driven by COVID
  - Fiscal: G7 governments are running large fiscal deficits (20-30% of GDP in a single year)
  - Monetary: Global central banks responding by directly funding fiscal deficits by increasing the money supply (printing money)
  - Result: TBD

Full marks for determination. Though given the asymmetrical distribution of the benefits to governments (funding) and the costs to taxpayers (inflation) perhaps there is something more premeditated in their dogged Keynesian devotion to nominal GDP growth. The successful rebranding and evolution of Keynesian

economic theory to MMT is a perfect demonstration of the age-old saying "same old wine, new bottle." In a limited defense of Keynes it must be added that he did advocate for the money supply to be increased in periods of economic contraction but then decreased in times of economic growth. It's part two that most governments strangely neglect.

Regardless, you and I do not live in the nominal GDP world inhabited by governments and central banks. We live in the much more demanding "real" GDP world – the one with cash-flow, assets, liabilities, products, customers and all those other bothersome details. But you say, surely we must expand the money supply to stimulate demand and save the economy? Let us reflect on the thoughts of Jean-Baptiste Say on consumption:

"The encouragement of mere consumption is no benefit to commerce because the difficulty lies in supplying the means, not in stimulating the desire for consumption; and production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption."

How unfortunate and convenient that the politicians and their Keynesian advisors have been obsessed with the wrong part of the economy for decades – absolute nominal GDP growth – versus real per capita GDP growth. Unlimited, deficit-driven consumption is only possible, granted sometimes for an intoxicatingly long period of time, via the illusion of wealth created by an ever-expanding fiat currency. It does not, however, create long lasting prosperity, as ultimately becomes apparent.

Just how bad are our problems? Difficult to quantify in the limited space available here, so permit me to fall back on another quote, this time from the venerable Ludvig von Mises. Though 70 years old, it seems almost purpose written for today.

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should



come sooner as a result of the voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."

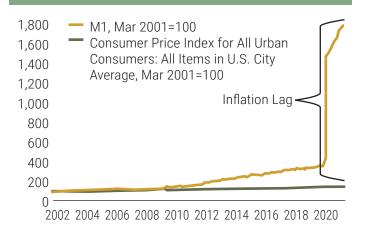
Many will argue Mises is wrong. I doubt he will be, although as he states, the speed at which this will take place remains to be seen.

### THE INFLATION LAG

It is a common question: why, if the money supply has been growing rapidly for the last 2 decades, have we not seen inflation? Ignoring for a moment the issue of the accuracy of government inflation statistics, in his book, "The Dying of Money," Jens Parssons discussed the concept of the "inflation lag." The idea is simple; the money supply often can increase significantly over an extended period-of-time before inflation becomes apparent. We have experienced approximately 35 years of benign general price inflation, coupled with massive monetary base expansion, such that a large inflation gap has accumulated. When inflation begins to accelerate, it may be commensurately massive and lengthy as the gap is closed.

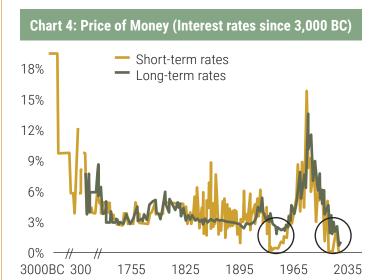
Framing this money supply linked inflation issue in a different but perhaps more visceral way – should the

Chart 3: M1 money supply versus CPI since 2001 global financial crisis.



Source: Federal Reserve of St Louis

price of money be at 5,000 year lows given the perilous condition of the developed worlds balance sheet?



Source: Bank of America Global Research, BOE, Horner and Sylla "A History of Interest Rates"

### **JUST HOW COMMON IS EXTREME INFLATION?**

Extreme inflation (let's say annual inflation rates >20% pa) is much more common than you think:

Chart 5: Periods of Banking Crisis, Default and Inflation by Country

	Since independence or 1800			Since 1800*		
	Share of years in a banking crisis	Share of years in default or resce- duling	of de-	Share of years in which inflation exceed- ed 20%	Share of years in which inflation exceed- ed 40%	Num- ber of hyperin- flation years
Austria	2	17	7	21	12	2
Belgium	7			10	7	
Denmark	7			2	1	
Finland	9			6	3	
Germany	6	13	8	10	4	2
Greece	4	51	5	13	5	4
Hungary	7	31	7	16	4	2
Italy	9	3	1	11	6	



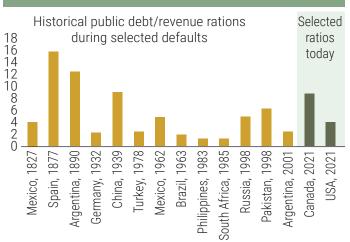
Netherlands	2	6	1	1		
Norway	16			5	2	
Poland	6	33	3	28	17	2
Portugal	2	11	6	10	4	
Spain	8	24	13	4	1	
Sweden	5			2		
United Kingdom	9			2		

Source: Reinhart and Rogoff (2009)

## WHO IS IN WORSE SHAPE – CANADA IN 2021 OR ARGENTINA IN 2001?

If the ratio public debt to revenue is a reliable indicator of sovereign default risk which nation is in worse shape – Canada in 2021 or Argentina 2001?

Chart 6: Total Debt (Federal) versus Total Government Revenues



Source: SG Cross Asset Research, Reinhart and Rogoff 2009, Veripath analysis

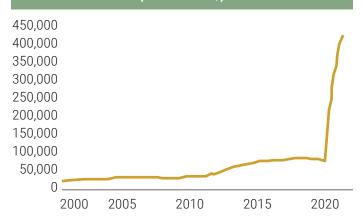
It seems to me that there is a sense of complacency bordering on smugness in Canada about prevailing debt levels. With a slight of hand that a circus conjurer could admire — Canadian governments at all levels and of all stripes are keen to roll out NET debt statistics and gloat about how Canada compares to all its reckless compatriots. Maybe, but Canada's total debt numbers paint a far, far less benign picture. In fact, there is only one nation with a worse debt situation than Canada — Japan. A nation that is into its third lost

decade for economic growth and has elevated money printing and economic stagnation to an art form.

Chart 7: Debt to GDP (%)						
	Debt as % of GDP	Govt debt as % of GDP	Private debt as % of GDP			
Japan	444.7	237.1	207.6			
Canada	356.1	89.9	266.2			
France	351.4	98.4	253			
US	318.7	106.9	211.8			
UK	310.8	86.8	224			
Italy	301.6	135.5	166.2			
South Korea	283.7	<b>37</b> .9	245			
China	258.4	50.6	207.8			
Australia	236.9	41.4	195.5			
Germany	215.8	61.7	154.1			
Russia	211.4	14.6	196.8			
Turkey	200.1	30.2	170			
Mexico	170.1	35.4	134.7			
Brazil	157.5	87	70.5			
South Africa	a 128.5	56.7	71.8			
India	122.9	68.1	54.8			
Argentina	108.4	86.1	<b>2</b> 2.3			
Indonesia	<b>70</b> .3	30.1	40.2			
Average	235.96	75.24	160.72			

Source: Icecap Asset Management, IIF (note figures include debt of governments, households and non-financial corporations at end of 2020 Q3

Chart 8: BOC Holdings of Government of Canada Bonds (Million CAD\$)



Source: Bank of Canada

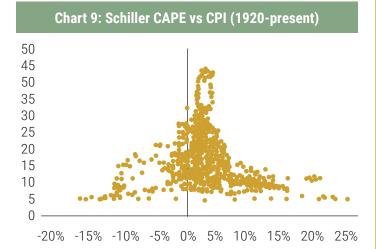
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## THE MYTH OF THE PUBLIC MARKET EQUITY INFLATION HEDGE

There is a persistent myth I would like to address – the belief in public equities as inflation hedges under all conditions. The reason for its persistence, after being disproven time and time again is a subject for another day – *cui bono* anyone? Price earnings ratios tend to be highest during periods of low, predictable inflation: From the chart below Shiller's CAPE ratio averaged:

- ~16 when inflation was less than 1%.
- ~13 when inflation was higher than 4%.
- ~20 when inflation was between 1% and 4%



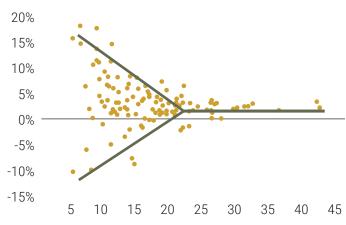
Source: RIAPRO

Chart 10: Average PE Ratio by Range of Inflation:						
		ALL PERIODS (1900-2019)		EXCL. LATE 1900S (1900-1994)		
CPI RANGE		AVG	AVG	AVG	AVG	
BEG	END	CPI	P/E	CPI	P/E	
less than	0.00%	-3.8%	14	-4.0%	14	
0.00%	0.99%	0.5%	18	0.6%	16	
1.00%	1.99%	1.5%	19	1.4%	16	
2.00%	2.99%	2.5%	23	2.6%	16	
3.00%	3.99%	3.3%	19	3.3%	16	
4.00%	4.99%	4.3%	16	4.3%	16	

5.00%	5.99%	5.5%	15	5.5%	15
6.00%	6.99%	7.3%	13	7.3%	13
10.00%	and more	13.7%	8	13.7%	8

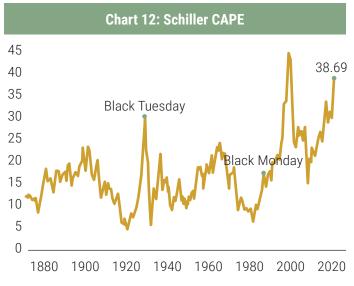
Source: Crestmont Research Copyright 2004-2020

## Chart 11: Scatter Plot: PE Ratio and Inflation (1900-2019)



Source: Crestmont Research Copyright 2004-2020

From the charts above, the faith in public equities as effective inflation hedges will have serious consequences if the medium to long term conditions remain inflationary or worse stagflationary. Just how serious could those consequences be?

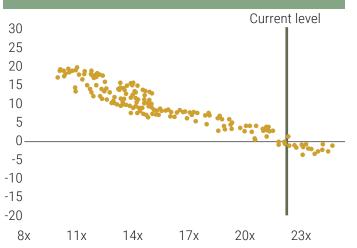


Source: Robert Schiller



Historically, the highest average CAPE (~22 times) occurred when inflation fell between 5%-6%. CAPE is currently over 35 and assuming this relationship holds, this implies a risk of the S&P 500 falling more than 30%. Clearly investors are forecasting that current elevated inflation levels are transitory as is being suggested. This assumption appears to be wrong. Even ignoring the inflation backdrop, P/E ratios at current levels would not bode well for future returns.

## Chart 13: S&P forward P/E ratios and subsequent 10year returns (total annualised returns in %)



Source: IBES, Refinitiv Datastream, S&P, JP Morgan Asset Management, Financial Times

## **CONCLUSION:**

The lessons of financial history, inflation and outright sovereign defaults is that there is nothing new under the sun and that no one learns their lessons. More prosaically, as distilled by Niall Ferguson, author of "The Ascent of Money," the following is a useful roadmap:

**Q**: What do governments not do with massive debt burdens?

- × Slash expenditure on entitlements
- Reduce marginal tax rates on income and corporate profits to stimulate growth
- Raise taxes on consumption to reduce deficits
- Grow their way out without defaulting or depreciating their currencies

**Q**: What do governments usually do with massive debt burdens?

- ✓ Oblige central bank and commercial banks to hold government debt
- ✓ Restrict overseas investment by firms and citizens
- ✓ Default on commitments to politically weak groups and foreign creditors
- ✓ Condemn bond investors to negative real interest rates

In the near-term, the developed economies will continue to experience the clash of strong inflationary forces against the liquidation of decades of malinvestments playing out across many asset classes. Therefore, I continue to believe that capital preservation should be given the highest priority, with an allocation to investments with returns linked to markets with generally favorable demographics, high savings, and trade surpluses that can be expected to continue going forward (e.g. emerging economies and Asia in particular), and ideally a positive return profile in the event of stagflation.



#300, 4954 Richard Rd SW, Calgary, AB T3E 6L1 www.veripathpartners.com

# **About Veripath**

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Sources: Canadian farmland data-FCC, CPI-Statistics Canada, SP500-10yr Bonds-Macrotrends, FTSE REIT-Nareit, Veripath analytics, St Louis Federal Reserve, Statistics Canada, Macrotrends, Hancock Agricultural, real rates = CAD 10 year bonds – CPI, Series runs to 2019