



## SHOW ME THE INCENTIVE AND I'LL SHOW YOU THE OUTCOME – Investing in a World of Financial Repression, Negative Real Rates, Valuation “Challenges” and Inflationary Forces

After seeming to slumber for over 30 years, inflation is waking up and as this is a year-end update forgive us if we inject some philosophical observations about these matters on top of the more prosaic and technical musings such letters inspire.

*“When you want to help people, you tell them the truth. When you want to help yourself, you tell them what they want to hear.”*

– Thomas Sowell

We want to start with a question. Do G7 governments have an incentive to attempt to keep inflation higher for longer and real rates lower for longer?

Negative real rates across a broad spectrum of credit assets are a graphic sign that we inhabit a world of financial repression orchestrated by central banks at the formal/informal behest of sovereign borrowers. In a normally functioning market, lenders do not provide capital to borrowers for negative yields – i.e., they do not pay for the privilege of lending. It goes without saying we are not in a normally functioning market.

There is a silver lining to negative real rates. For the borrower, negative real rates erode the value of the outstanding obligations over time. In effect, protracted periods of negative real rates help the borrower delever. In addition, inflationary monetary policy (monetising fiscal deficits without recourse to borrowing from the capital markets) is a source of funding that takes capital from savers/taxpayers/lenders/pension plans and redistributes it to government. Think of inflation as a reverse redistribution program for government.

The largest borrowers on the planet are sovereign governments which, if they have the desire, can for a period impose such financing conditions on the market. The caveat is that this is possible for a finite period

only. Ultimately, gravity asserts itself even in the financial markets. Central banks can control exchange rates (inflation/purchasing power of the currency) or interest rates. Indefinite control of both is impossible.

### INFLATION/NEGATIVE REAL RATE INCENTIVE #1 – Sovereign Balance Sheets are in Poor Condition.

Stripped of all the elaborate economic jargon, once sovereign debt levels become excessive (or more cynically merely servicing the interest on the debt becomes unmanageable) and access to the private capital markets begins to evaporate, the options fall into four basic categories in some semblance of increasing political palatability:

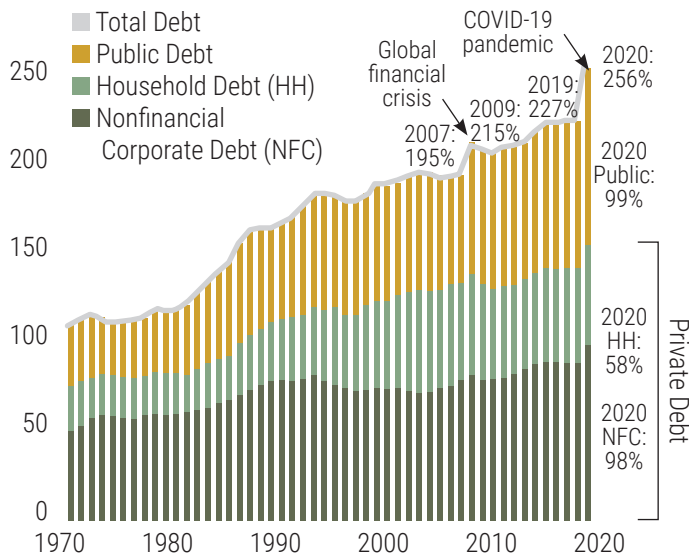
- De jure default – formal debt default and restructuring
- Reduce government costs – reduce entitlements
- Increase government revenue – increase taxes
- De facto default – via inflation

*“At first inflation stimulated production because of the divergence between the internal and external values of the mark, but later it exercised an increasingly disadvantageous influence, disorganizing and limiting production.... It provoked a serious revolution in social classes, a few people accumulating wealth and forming a class of usurpers of national property, whilst millions of individuals were thrown into poverty.”*

– The Economics of Inflation – A Study of Currency Depreciation in Post War Germany

It goes without saying that inflation (with some second order efforts to raise taxes) is invariably chosen as the most expedient plan of action as its causes can usually be obfuscated for some period (often protracted) while lenders/taxpayers suffer the consequences immediately. The other options come with undesirable political consequences at the ballot box and so are usually never even seriously considered.

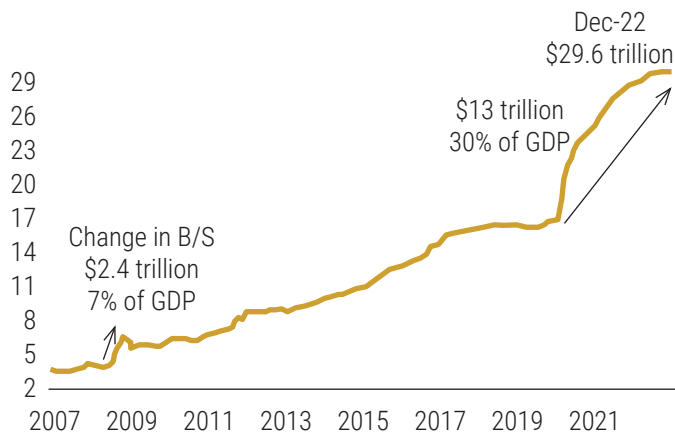
**Chart 1: 1970 – 2020 Global Debt Levels  
(2020 represented the largest increase in 50 years)**



Sources: IMF Global Debt Database and IMF analysis (note – the estimated ratios of global debt to GDP are weighted by each country's GDP in US dollars)

Even with the unprecedented magnitude of the surge highlighted above, this accelerated pace of debt accumulation appears to be set to continue for the foreseeable future:

**Chart 2: G4 Central Bank Balance Sheets – Projection  
(USD Trillion)**



Source: Haver Analytics, IMF, Morgan Stanley forecasts

These increases come on top of already historically unprecedented G7 sovereign and private debt levels. Canada, to its shame, is one of the worst offenders.

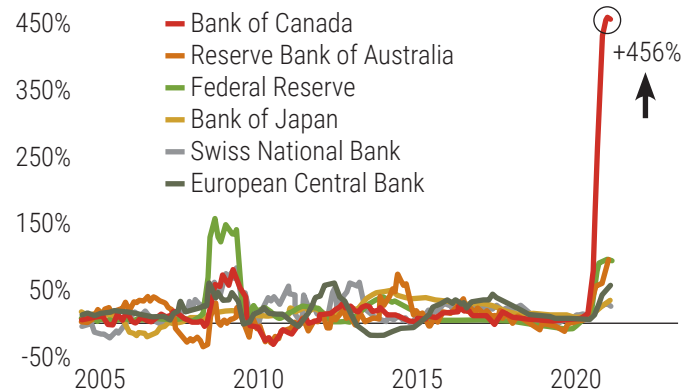
**Chart 3: Debt to GDP (%)**

	Debt as % of GDP	Govt debt as % of GDP	Private debt as % of
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	37.9	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	128.5	56.7	71.8
India	122.9	68.1	54.8
Argentina	108.4	86.1	22.3
Indonesia	70.3	30.1	40.2
Average	235.96	75.24	160.72

Source: Icecap Asset Management, IIF

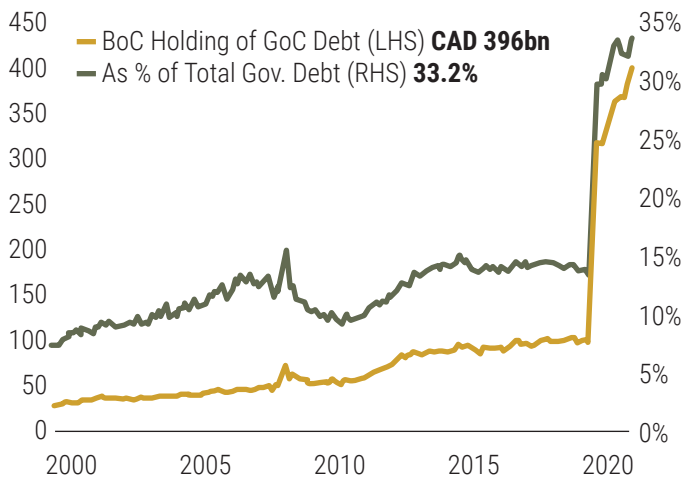
*“I do not think it is an exaggeration to say history is largely a history of inflation, usually inflations engineered by governments for the gain of governments.” – Friedrich von Hayek*

**Chart 4: Central Bank Balance Sheets Assets to Nominal GDP (YoY Growth)**



Source: Bloomberg, Crescat Capital

**Chart 5: Government of Canada Debt held by Bank of Canada**

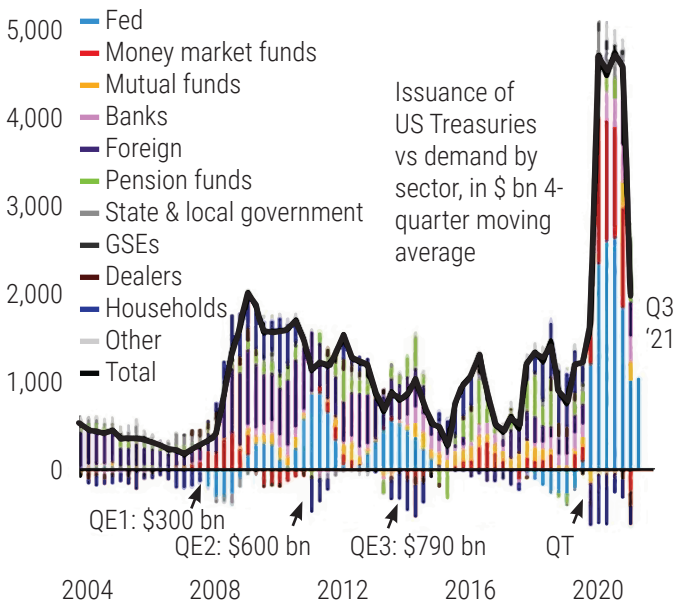


Source: Bloomberg

Canadians are now in an economy where the Bank of Canada is the marginal buyer of all Government of Canada debt via the printing press – i.e. Canada is now a direct monetisation economy with no observable inclination to stop on the part of the government.

...However, so is the US...

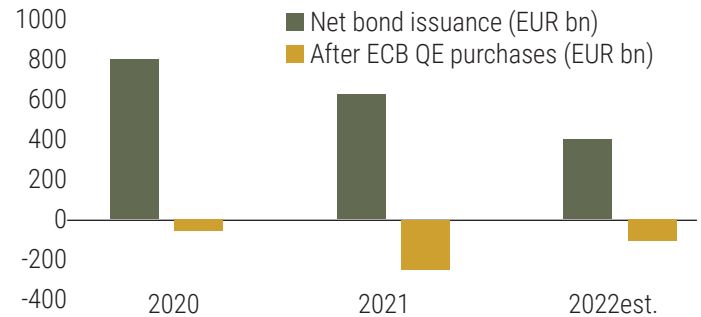
**Chart 6: Federal Reserve Funding of US Deficit**



Sources: Haver, IIF

...and so is the EU...

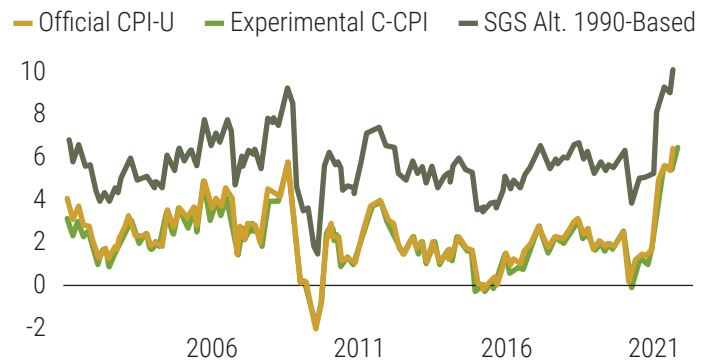
**Chart 7: ECB Funding of EU Deficits (>100%)**



Source: ECB

I believe the monetisation of these ongoing massive fiscal deficits will prove to be highly inflationary. In fact, using previous CPI calculation methodologies (which do not use dubious hedonic adjustments, owner equivalent rents etc.) inflation is well over 10% and climbing.

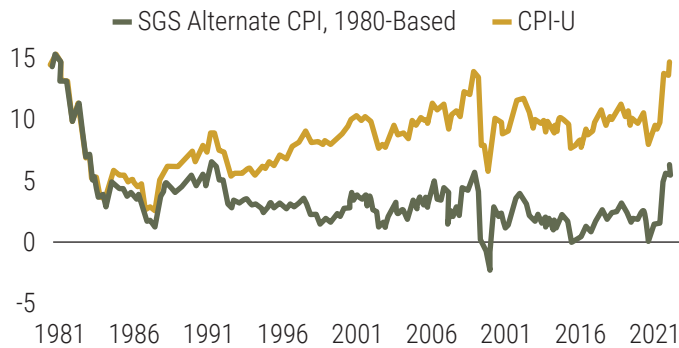
**Chart 8: US Inflation (Using CPI calculation methodology which was employed prior to 1990)**



Source: Shadowstats

*“It is no crime to be ignorant of economics, which is, after all, a specialized discipline and one that most people consider to be a ‘dismal science.’ But it is totally irresponsible to have a loud and vociferous opinion on economic subjects while remaining in this state of ignorance.” – Murray Rothbard*

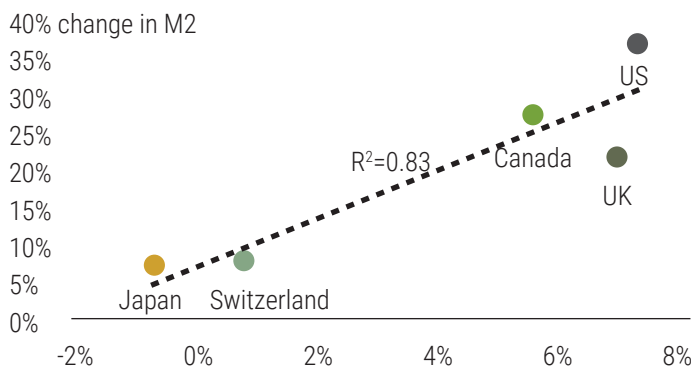
**Chart 9: US inflation (Using CPI calculation methodology which was employed prior to 1980)**



Source: Shadowstats

The Canadian government, and to be fair many others, is arguing it has no policy “tools” to deal with inflation as it’s a global phenomenon driven by supply chain disruptions (which certainly is a contributor) and a base line comparison issue from the COVID drop and bounce back (also certainly a contributor) but even some simple analysis shows this is disingenuous at its core. The primary cause is the fatal combination of massive increases in fiscal deficits funded via money supply growth (the printing press).

**Chart 10: Inflation vs. Money Supply Growth (Dec 2019 – oct 2021)**



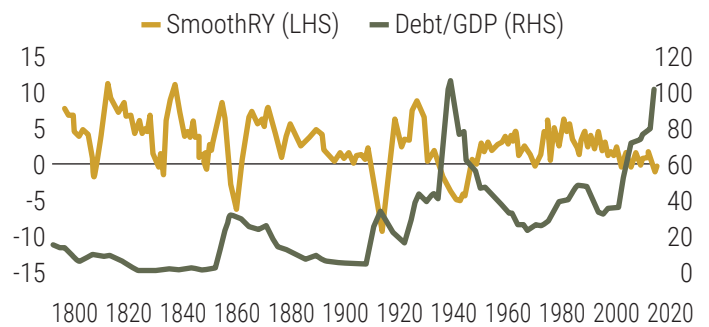
Source: Bloomberg

*“Socialism in general has a record of failure so blatant that only an intellectual could ignore or evade it.” – Thomas Sowell*

*“If socialists understood economics, they wouldn’t be socialist.” – Friedrich von Hayek*

Deutsche Bank’s research shows that real yields consistently move deeply negative when sovereign debt suddenly spikes.

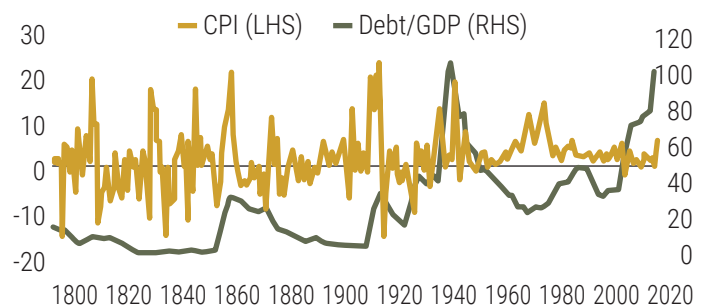
**Chart 11: Smoothed 10yr Real Yields (using 5yr rolling average of CPI) and the Debt-to-GDP Ratio**



Source: Deutsche Bank

In addition, Deutsche Bank’s research shows that CPI invariably spikes when sovereign debt spikes – in fact in each of the previous debt events spot inflation reached 20% or higher.

**Chart 12: US CPI Inflation and the Debt-to-GDP**



Source: Deutsche Bank

To the average person inflation is a pernicious and destructive force but to heavily indebted sovereign borrowers, negative real rates driven by high inflation are a marvellous opportunity to reverse the overspending

mistakes of the past and discretely de-lever their balance sheets. Negative real and even negative nominal rates are endemic across the global credit markets.

**Chart 13: Global Central Bank Policy Rates**

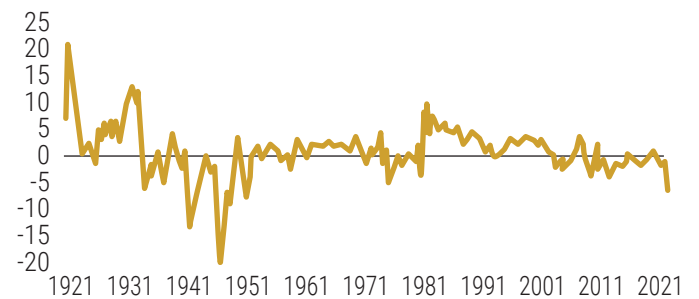
Country	Rate	Central Bank Rate (Today)	CPI YoY	Real Central Bank Rate	Last Move	Last Move Date
Switzerland	Target Rate	-0.75%	0.9%	-1.7%	Cut	Jan-15
Denmark	Deposit Rate	-0.60%	1.8%	-2.4%	Hike	Mar-20
Eurozone	Deposit Rate	-0.50%	3.0%	-3.5%	Cut	Sep-19
Japan	Policy Rate Bal	-0.10%	-0.3%	0.2%	Cut	Jan-16
Norway	Deposit Rate	0.00%	3.4%	-3.4%	Cut	May-20
Sweden	Repo Rate	0.00%	2.1%	-2.1%	Hike	Dec-19
Poland	Repo Rate	0.10%	5.5%	-5.4%	Cut	May-20
Australia	Cash Rate	0.10%	3.8%	-3.7%	Cut	Nov-20
UK	Bank Rate	0.10%	3.2%	-3.1%	Cut	Mar-20
US	Fed Funds	0.13%	5.3%	-5.2%	Cut	Mar-20
New Zealand	Cash Rate	0.25%	3.3%	-3.1%	Cut	Mar-20
Canada	Overnight	0.25%	4.1%	-3.9%	Cut	Mar-20
Thailand	Policy Rate	0.50%	0.0%	0.5%	Cut	May-20
South Korea	Repo Rate	0.75%	2.6%	-1.9%	Hike	Aug-21
Czech Republic	Repo Rate	0.75%	4.1%	-3.4%	Hike	Aug-21
Hong Kong	Base Rate	0.86%	1.6%	-0.7%	Cut	Mar-20
Peru	Policy Rate	1.00%	5.0%	-4.0%	Hike	Sep-21
Saudi Arabia	Reverse Repo	1.00%	0.3%	0.7%	Cut	Mar-20
Taiwan	Discount Rate	1.13%	2.4%	-1.2%	Cut	Mar-20
Chile	Base Rate	1.50%	4.8%	-3.3%	Hike	Aug-21
Colombia	Repo Rate	1.75%	4.4%	-2.7%	Cut	Sep-20
Malaysia	Policy Rate	1.75%	2.2%	-0.5%	Cut	Jul-20
Philippines	Key Policy Rate	2.00%	4.9%	-2.9%	Cut	Nov-20
South Africa	Repo Rate	3.50%	4.9%	-1.4%	Cut	Jul-20
Indonesia	Repo Rate	3.50%	1.6%	1.9%	Cut	Feb-21
China	Loan Prime Rate	3.85%	0.8%	3.1%	Cut	Apr-20
India	Repo Rate	4.00%	5.3%	-1.3%	Cut	May-20
Mexico	Overnight Rate	4.50%	5.6%	-1.1%	Hike	Aug-21
Brazil	Target Rate	6.25%	9.7%	-3.4%	Hike	Sep-21
Russia	Key Policy Rate	6.75%	6.7%	0.1%	Hike	Sep-21
Turkey	Repo Rate	19.00%	19.3%	-0.3%	Hike	Mar-21
Argentina	Benchmark Rate	38.00%	51.4%	-13.4%	Hike	Nov-20

Source: Compound, CharlieBilello

In practice, there is virtually no place to escape this financial repression – long term, short term, real or nominal.

Short-term real rates are negative:

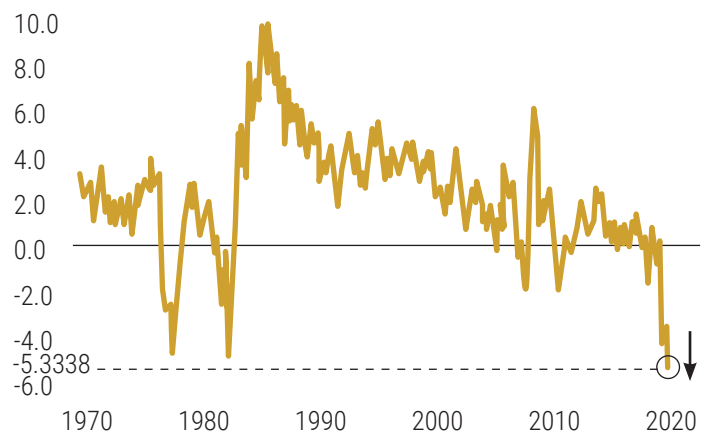
**Chart 14: Real Fed Funds Rate**



Source: Deutsche Bank (using 3m T-Bill yield before July 1954)

Long-term real rates are negative:

**Chart 15: US 10-Year Real Yield (10-year nominal yield minus CPI YoY (%))**

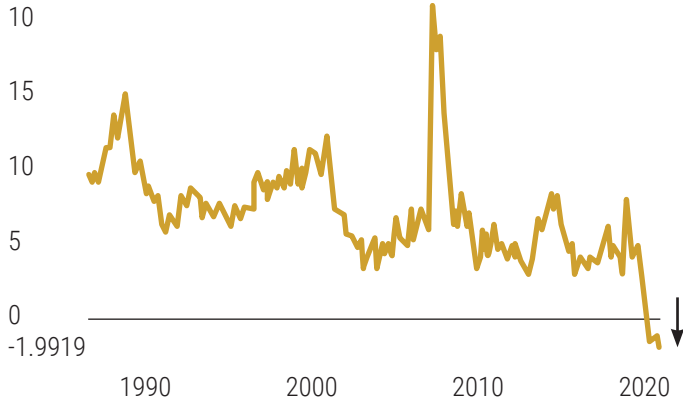


Source: Bloomberg, Crescat Capital

*“The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics.” – Thomas Sowell*

Junk-bond real rates are negative:

**Chart 16: Junk Bonds Real Yield – US corporate High Yield (Yield to worst minus CPI YoY (%))**



Source: Bloomberg, Crescat Capital

Even nominal bond rates are negative in parts of the market:

**Chart 17: Negative Nominal Yielding Bonds (market total (\$ trillions))**



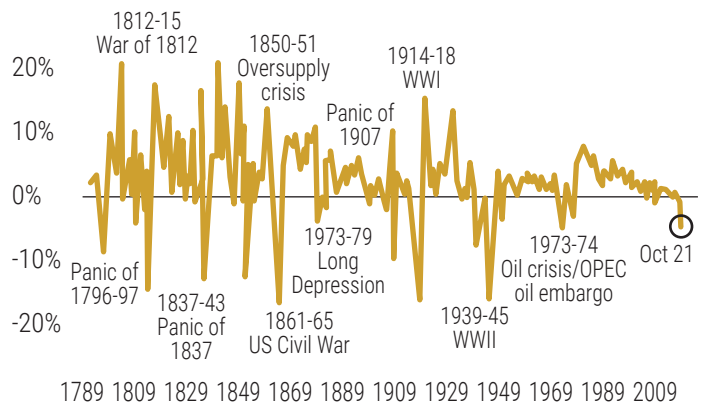
Source: FT

The global credit markets, rather than providing risk free return are providing return free risk and given their tenuous balance sheets, sovereign borrowers are certain to attempt to extend these favorable borrowing conditions via their fiscal and monetary powers. This

will mean an extension and perhaps even an increase in the unfriendly nature of conditions for the holders of cash and bonds. Sovereign borrowers have little choice (as they perceive their choices) and in fact are obviously incentivised to do so.

**INFLATION/NEGATIVE REAL RATE INCENTIVE #2 – Persistent Sovereign Fiscal Deficits and Historically High Asset Valuations Are Unlikely to Support Higher Nominal or Real Rates.**

**Chart 18: 200-Year History of US Real Interest Rates (10-year real interest rate = treasury yield – CPI YoY %)**



Sources: Bank of America Global Investment Strategy, Global Financial Data

G7 fiscal and monetary policy is the most accommodative since the 1950s – both the short and long end of the nominal and the real yield curves are low or negative. According to Jim Reid of Deutsche Bank, real yields have been lower during other periods of rapid debt accumulation, “However, that was with 20% inflation.”

Central banks have been actively suppressing nominal yields to support the massive supply of sovereign debt issuance. In doing so, they have created a pervasive negative real yield environment. Combined with debt levels that are at historically high levels, global mone-

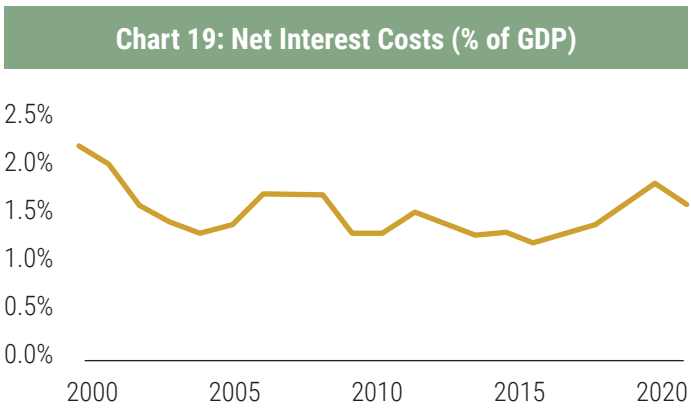
*“How did you go bankrupt?” Two ways. Gradually, then suddenly.” – Ernest Hemingway*

tary authorities seem to be arriving at their Hobson’s choice moment.

- Choice 1 – Stop financial repression = fiscal deficits may not be fundable and asset valuations may drop.
- Choice 2 – Continue financial repression = inflation rises but sovereigns de-lever.

Remembering that incentives drive outcomes – what path do you think will be followed?

Just how tenuous is the G7 sovereign funding position? The G7 has effectively never been this indebted and at such low nominal as well as real interest rates. In the past two years the United States has borrowed approximately \$6 trillion. Despite such a large increase in debt, the federal government’s net interest payments have remained below 2% of GDP – a trend that has persisted since 2001 on the back of low interest rates.



Sources: Peter G Peterson Foundation, CBO

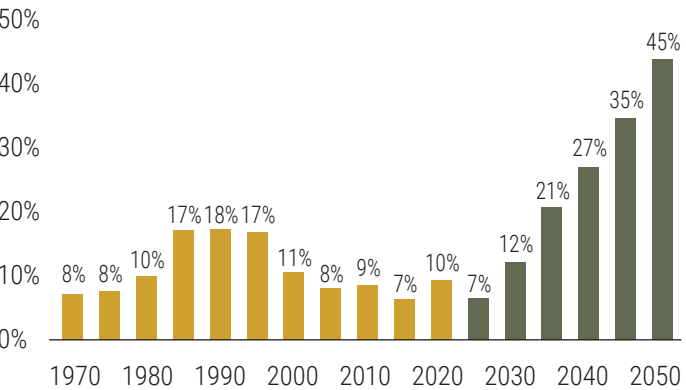
However, according to the Congressional Budget Office (CBO) if short-term rates rose to 2.4% in 2031 and long-term rates to 3.5%, interest costs for the federal government would double – from 1.5% of GDP in 2021 to 2.7% of GDP in 2031. Looking out over the next 30

*“Blessed are the young for they shall inherit the national debt.” – Herbert Hoover*

*“The life of the inflation in its ripening stage was a paradox which had its own unmistakable characteristics. One was the great wealth, at least of those favored by the boom. Many great fortunes sprang up overnight... Side by side with the wealth were the pockets of poverty. Greater numbers of people remained on the outside of the easy money, looking in but not able to enter. The crime rate soared.”*  
– Jens Parsson – Dying of Money

years, the total of US net interest payments is projected to be more than \$60 trillion.

**Chart 20: Net Interest Cost (projected to 2050 as a percent of federal revenue)**



Source: Peter G Peterson Foundation, CBO, (excluding any federal funding of 2050 Net Zero targets)

According to the CBO’s long-term outlook, by 2051, interest payments will take up nearly half of all US federal revenues and measure close to 9% of GDP. This is a pattern repeated throughout the G7. Such trajectories are not sustainable.

Turning the page to asset prices, just how tenuous are they? Bond yields are at historic nominal and real lows which needs no further explanation. At the same time, equity valuations by many metrics are also at historically elevated levels.



*“The way to crush the bourgeoisie is to grind them between the millstones of taxation and inflation” – Vladimir Lenin*

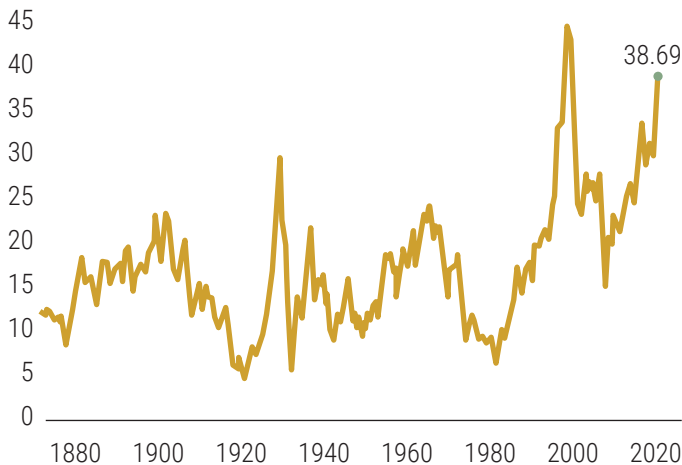
**Chart 21: S&P 500 Valuation Metric Current Percentile Relative to History**

Valuation	
Metric	Current percentile ranking (relative to history)
S&P 500 forward P/E	█
S&P 500 trailing P/E	█
S&P 500 5-year normalized P/E	█
S&P 500 price/book value ratio	█
S&P 500 price/cash flow	█
S&P 500 dividend yield	█
Shiller's CAPE (cyclically-adjusted P/E)	█
Rule of 20	█
Equity risk premium (10-year Treasury yield)	█
Equity risk premium (Baa corporate bond yield)	█
Fed Model	█
Tobin's Q	█
Market cap/GDP	█

Source: Charles Schwab, Leuthold Group

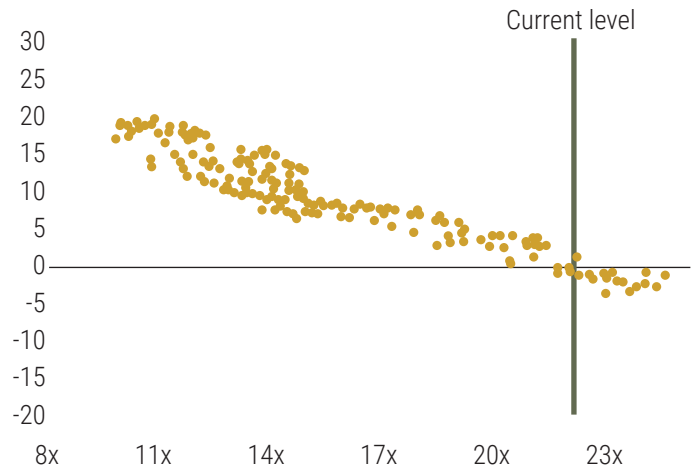
Schiller CAPE is one of the metrics with the most extreme reading. Something to bear in mind as its predictive utility has been quite good.

**Chart 22: Schiller CAPE**



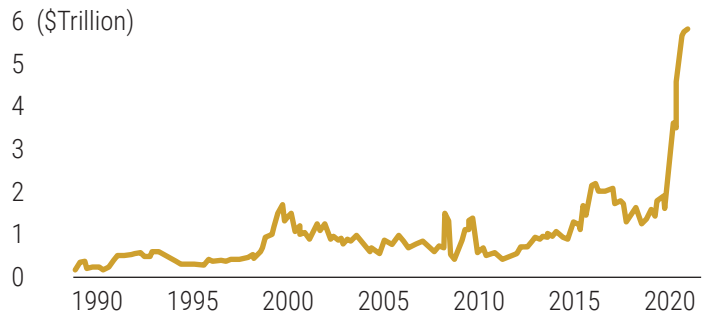
Source: Robert Schiller

**Chart 23: S&P Forward P/E Ratios and Subsequent 10-year Returns (total annualised returns in percent)**



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

**Chart 24: Total Enterprise Value of Firms with EBIT less than Interest Expense: (“Zombie” companies as coined by Seth Klarman are companies which cannot pay interest without cheap debt)**



Source: Kallash Concepts

**INFLATION/NEGATIVE REAL RATE INCENTIVE #3 – Use Inflation to Fund 2050 Net Zero?**

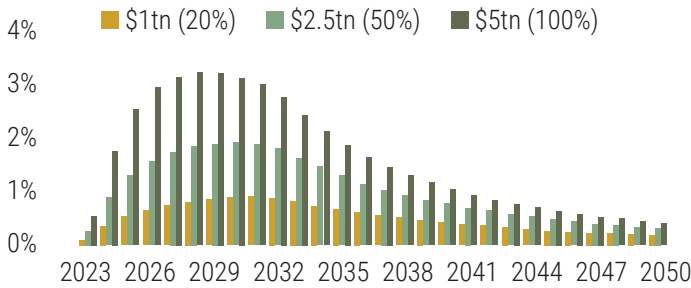
Below you will find some selected excerpts from the recent, influential report of Bank of America – “*Tran-swar-ming*” World”. The report is a detailed analysis of the expected costs to reach 2050 Net Zero – along with a light-hearted real time translation tool. The synopsis of the report is that the 2050 Net Zero targets will require a minimum (emphasis mine) of \$150 trillion in capital – approximately 2 times current global

GDP. Our expectation is this estimate will prove highly optimistic given the complex and unprecedented nature of the undertaking.

**Q: What is the economic impact of net zero?**

**A:** Elevated net zero funding could be inflationary, but the impact looks manageable at **1% to 3% per annum** depending on central bank monetization rates, particularly if government spending is targeted and contributes to accelerate the rate of global GDP growth. The IEA also has a productive outlook for their net zero scenario, where the change in the annual growth rate of **GDP accelerates by somewhere between 0.3% and 0.5%** on a sustained basis over the next 10 years as a result of a shift to a green economy. (Emphasis mine)

**Chart 25: Increase in Inflation Relative to Baseline Assuming Various Levels of Cost Monetization**



Source: Bank of America, Haver, assumes \$500 billion of spending in 2021 increasing by \$500 billion every year until reaching \$5 trillion in 2030 for **perpetuity** (emphasis mine)

**Translation** – This is an explicit recognition that Net Zero 2050 is expected to be funded in a highly inflationary manner. While Bank of America forecasts that 2050 Net Zero expenditures will generate up to 0.5% nominal GDP growth, if funded by 50% monetization (which is reasonable given the direct taxation challenge), they are also expected to generate approximately 2% annual inflation for the next decade (i.e. in addition to the already elevated inflation rates that are unfolding). Net Zero targets will therefore create modest GDP growth but material inflation growth over the next decade – i.e. they are forecast to reduce real GDP which intuitively makes sense as it will involve

the stranding and early retirement of US\$ trillions in legacy capital.

**Q: How much will it cost?**

**A:** The energy transition to a net zero greenhouse gas (GHG) economy by **2050 will be a very expensive exercise**, (emphasis mine) estimated by the IEA at \$150tn of total investment, over a period of 30 years. At \$5tn p.a, the IEA see it costing as much as the entire US tax base every year for 30 years. BNEF has a higher estimate that the total investment needed for energy supply and infrastructure could be as high as \$173tn through 2050, or up to \$5.8tn annually, which is nearly three times the amount invested on an annual basis today.

**Translation** – This cannot be funded by from tax revenues, certainly not without a taxpayer revolt. Inflation is the most expedient way forward.

**Q: Who will pay for it and how?**

**A:** A combination of corporate bond issuance, commercial bank balance sheet capacity, government debt, and carbon taxes will likely be required to achieve full decarbonization. It will be very challenging to boost funding resources to the \$5tn a year required to get to net zero emissions, ...Decarbonisation bill of \$5tn a year is equivalent to 25% of current global tax revenues (\$20tn); assuming that global tax revenue grows at the 10y average over the next 30 years and a progressive spending path, the decarbonization bill would amount to 15% of global tax revenues by 2030, meaning accommodating climate action finance likely required far beyond fiscal budgets.

**Translation** – The taxpayer will pay for all of it, through the redistribution effects of inflation and taxes.

*“The problem isn’t that Johnny can’t read. The problem isn’t even that Johnny can’t think. The problem is that Johnny doesn’t know what thinking is; he confuses it with feeling.”*  
– Thomas Sowell

*“There are two ways to be fooled. One is to believe what isn’t true; the other is to refuse to believe what is true.” – Soren Kirkegaard*

**INFLATION AND THE AGRICULTURAL SECTOR**

How might current and forecasted real rate/inflation conditions effect the agriculture sector? Inflation tends to manifest quickly in the agriculture complex. The two major transmission mechanisms being 1) fuel and fertilizer input pricing combined with the 2) the inelastic demand curve for food.

Following the recent run-ups in agriculture commodity prices, the long-term price trend in the agriculture space seems to indicate sustained upward pressure is possible and that agriculture commodity prices may have entered a cyclical bull market. This would make sense given demand growth and inflation expectations.

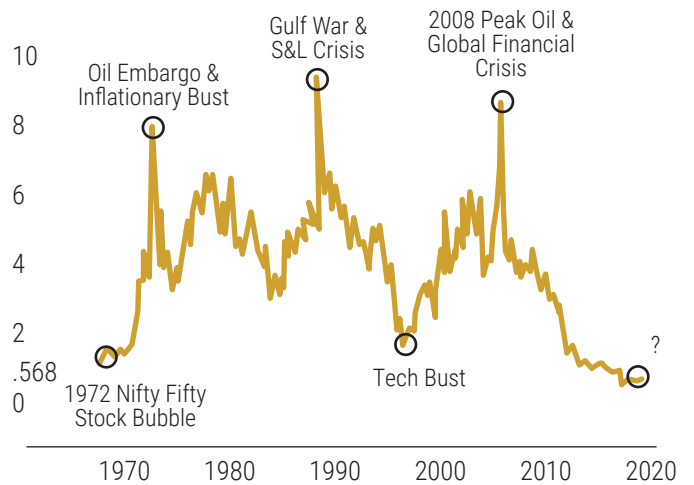
**Chart 26: Agricultural Commodity Price Trend – \$DBA ETF**



Source: Bloomberg, Crescat Capital

Rotation out of long duration, inflation sensitive assets may provide an additional impetus to agriculture commodity returns. While commodity prices have moved materially in the last 24 months, commodities are still historically undervalued in relation to other asset classes such as public equities:

**Chart 27: Commodities to Equity Ratio: S&P GSCI Index / S&P 500 Index**



Source: Bloomberg, Crescat Capital

*“An age of loose money not only destroys savings; it corrodes character.” – Theodore Dalrymple*

To conclude this update, we believe a reasonable working hypothesis is that the economic incentives for sovereign borrowers to attempt to continue financial repression via negative real rates and inflation will trump the need for sound economic policies for the foreseeable future.

Despite the destructive outcome this is bound to unleash, if history is a guide, when government finds this is the last option, there is typically no hesitation to attempt to use it.

In practice, if you think of inflation as a source of funding when all others have been exhausted, then you will clearly see the path forward. So, while central banks and governments may make superficial, highly publicized attempts to appear to be dealing with the problem, these will at most be made with a view to keep the repression to a politically tolerable level to extend the benefits for as long as possible. Expect there to be an attempt to boil the frog slowly in the inflationary water so to speak.



# About Veripath

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