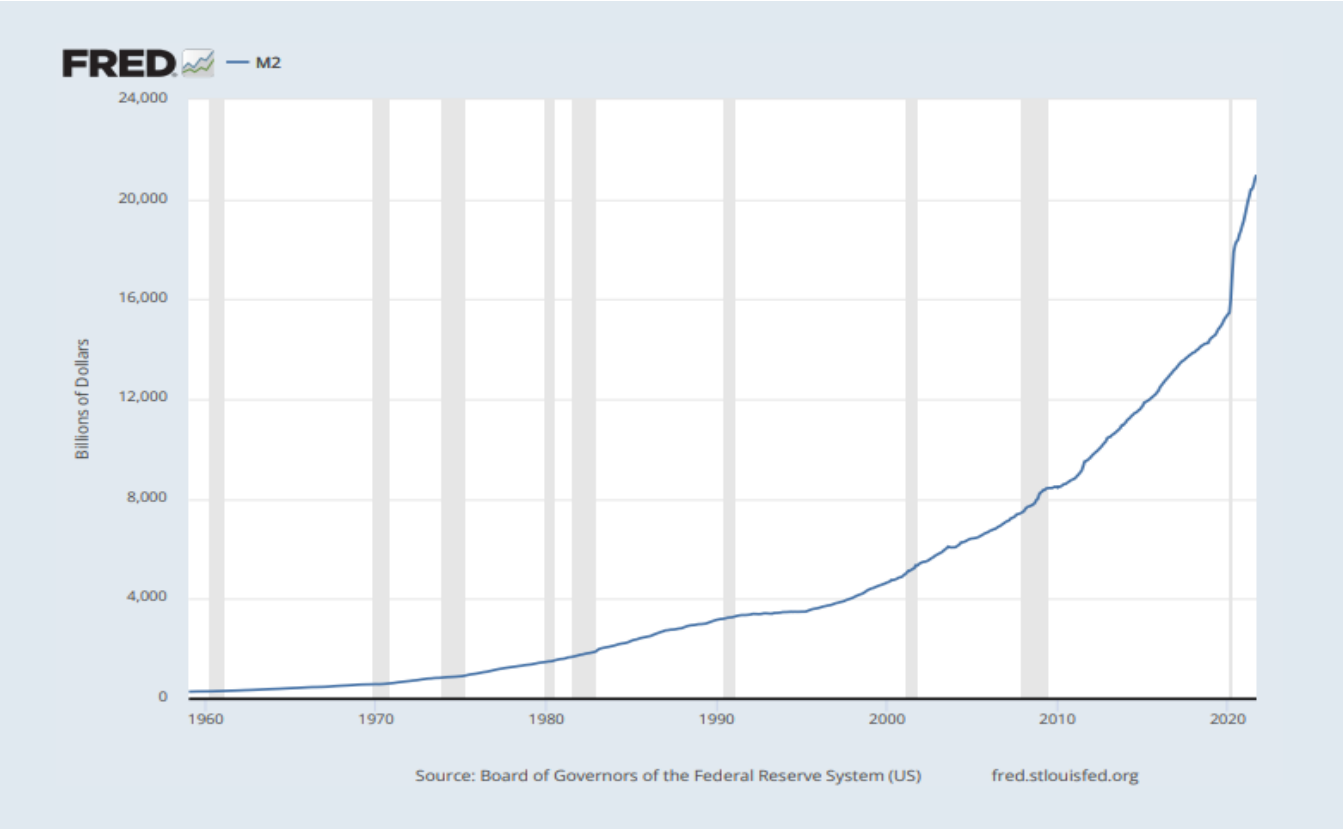
Inflation isn't "Transitory," and interest rates are not going up, so adjust your portfolios accordingly

NOVEMBER 2021

In this note, I share my insights into the current economic backdrop and why we believe farmland is such an attractive investment vehicle in this environment. This is not intended to be investment advice. – Anthony Faiella

We continue to receive confirmations that the inflation we are experiencing is higher and hanging around longer than the central banks claimed it would. It shouldn't be a surprise that this has happened, given that 40% of all US dollars in existence were created in the past 12 months.



All that additional money chasing after the same amount of goods and services would be inflationary enough, but shutting down the entire global economy, sending people money to stay home, then trying to start it up all at once and expecting it to run smoothly has only made the situation even worse. Add aggressive policies to phase out cheap fossil fuels that provide 80% of the world's energy needs when alternative energy isn't yet available at a low cost. It all points to inflation coming in much higher and staying much longer.

Inflation is precisely what central banks have consistently preached that they've wanted for a properly functioning economy, except the inflation we are seeing feels like it is much higher than the official numbers we're told. The official CPI (Consumer Price Index) has been modified over the years to adjust for the prices of things that go up too much and includes a sprinkling of made-up numbers for other pricey expenditures such as housing. Add it all up, and it has become a fictitious number. Some estimate the actual inflation number using the methodology used in the 1980s would be over 10%, much higher than the most recent print of 6.2% year-over-year increase posted in the US. That increase in inflation marked the most significant inflation surge in more than 30 years. Regardless of what number you choose to believe, it is evident that inflation is high, yet central banks are still not looking to raise rates until "sometime next year." The US Federal Reserve recently announced they would scale back on their $120 billion of conjured up money....er, QE, used to buy assets each month. One-third of that total has been used to purchase mortgage bonds, even as housing prices rise double digits and hit new highs. Does the US housing market need $40 billion/month in bond purchases (in addition to the zero-interest-rate) by the Fed to support it?

The reality is that there is too much liquidity in the market, and the Fed has been removing it from the overnight market through Reverse Repo's, so don't read too much into this tapering of QE. The Federal Reserve supposedly has a dual mandate that includes "price stability" and "maximum employment." It's difficult to see how the 6.2% CPI can be viewed as "price stability." Last month saw the third consecutive month of record numbers of people quitting their jobs and the fourth record in the previous six months. With job openings near historical highs and quit rates at record highs, it sure sounds like maximum employment, so why the delay in raising rates?

This year the Federal Reserve has added $1.3 trillion to its balance sheet and held rates at 0% while inflation has risen to a 31 year high of 6.2%. They have fostered a speculative and reckless environment that's given us NFTs (non-fungible tokens, which is a digital asset bought online and often using cryptocurrencies.....enough said) and meme stocks (stocks that go up because of hype on social media with no underlying fundamental reasons). Along the way, US stock markets trade at all-time highs, new and used car prices are at all-time highs, home prices hit all-time highs, cryptocurrencies trade to new highs and even Pokémon card prices are skyrocketing; because....well, why not?

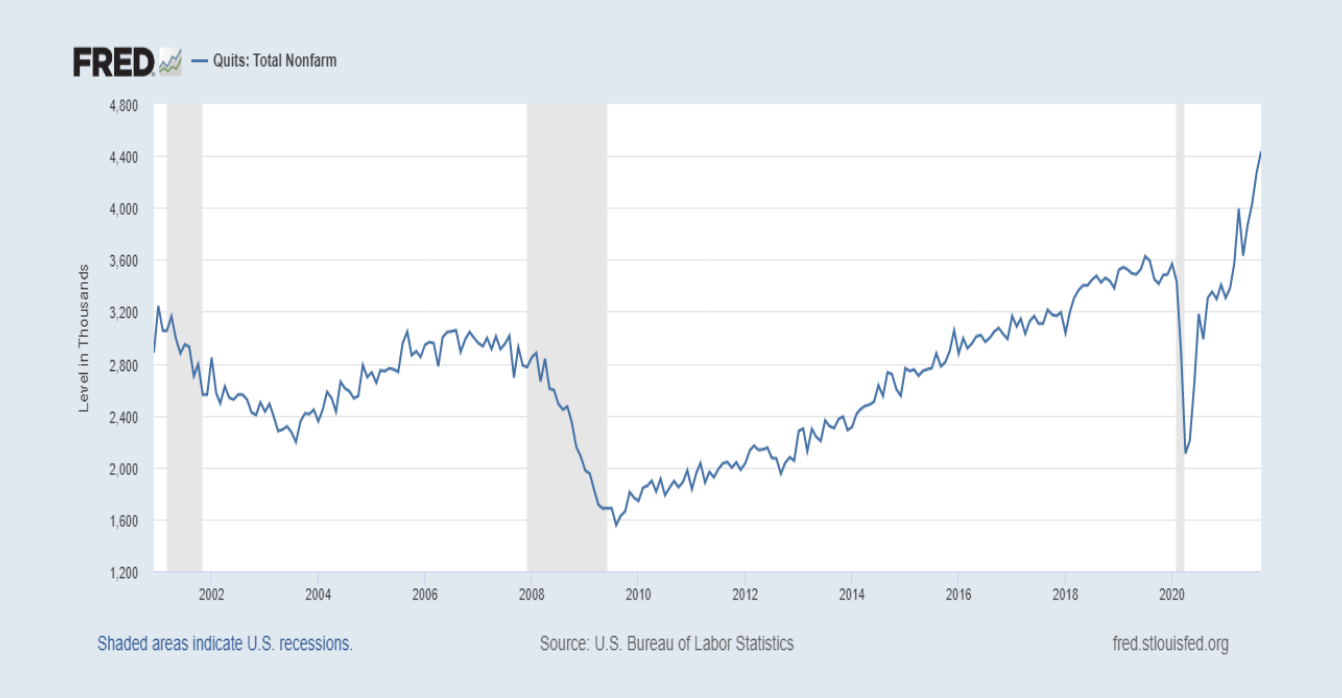
But it's still too soon to raise rates? Maybe there is something else going on?

The world is awash in debt, and interest rates are the lowest in hundreds or even thousands of years. The concept of "growing our way out of this debt" was always a fallacy to explain why the debt levels weren't a problem. Except now, it is apparent that we can't grow economies fast enough to pay back that debt or even outpace the growth in debt. The only solutions involve a hard default, where the debt is not repaid (that would be messy and hasn't gone over well in the past), or a soft default, where the debt is inflated away with debased or less valuable money. If you choose the second option, you're beginning to think like a central banker. There is precedent for the extreme debt levels facing much of the world, and it was the period following WWII. The US Government had very high debt levels following the war and dealt with it by letting inflation run hot while lowering interest rates. With the "reported inflation" running in the 4-6% range across Canada and the US, the 10-year government bonds yielding approx. 1.5%, it seems the plan is to inflate away once again the extreme debt levels facing governments, corporates, and consumers (here in Canada). That would mean we are currently experiencing negative real rates in the order of (-2%) - (-4%), assuming you believe the CPI is even close to the actual inflation. The US was running with negative double-digit real rates in the years immediately following the war to put that into perspective. The playbook calls for inflation to erode debt and make it more manageable. The negative real rates are effectively stealing money from the savers and giving it to the borrowers. Think Robinhood, but in reverse. Bizarro Robinhood. Also, removing liquidity and raising interest rates will result in a Willie Coyote moment that will leave asset prices with no support and just a puff of smoke at the bottom of your screen. That asset price deflation would be even more disastrous for the economy.

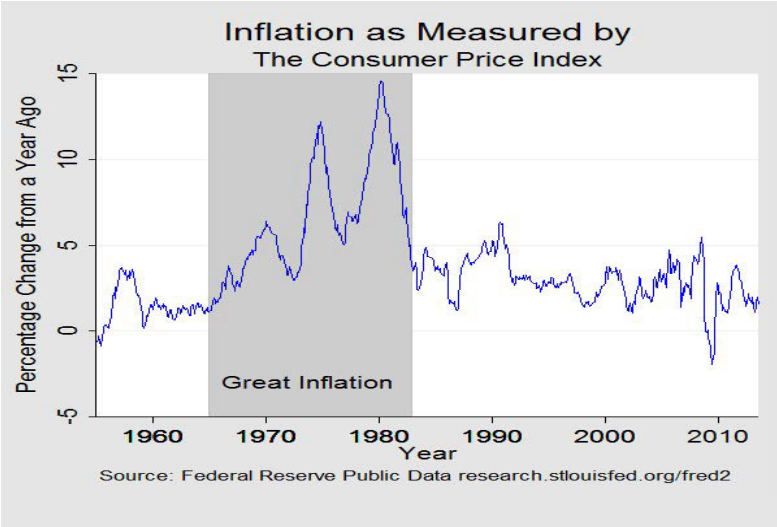
That was my very long-winded way of saying any increase in interest rates would make current debt levels unsustainable, and high inflation is precisely what central banks are trying to achieve.

Once you understand the environment we are in; you can begin to assess the positioning of your portfolio. High inflation and low rates are the game plan and letting asset prices run higher is part of the "wealth effect" they think they are achieving. Except by now, it should be evident that we have a speculative frenzy in almost all asset classes that make the tech bubble look like a walk in the park. A recent FT article noted that in the UK, customers opened 7.1M investing accounts in the first 12 months of the pandemic (on a population base of 67.2M), while in the US, more than 30M new accounts were started in the same period (on a population base of 330M). That means more than 10% of the adult population are newly minted "investors." That should give us some sense of the sophistication levels driving asset prices today and why we have meme stocks and NFTs. Before this past week's move, the market capitalization of Dogecoin, a cryptocurrency that was created as a joke, was greater than that of Barrick Gold, which generates $3.4B of free cash flow. If you owned all the Dogecoin outstanding, you would own nothing. If you owned all of Barrick, you would have an income of $3.4B each year, yet "investors" preferred Dogecoin. This is "tulip-bulb mania" type stuff, except it's everywhere and on a global scale.

You don't suppose all this rampant speculation and paper gains resulting from printed money has anything to do with the sudden surge in people quitting their jobs, do you?



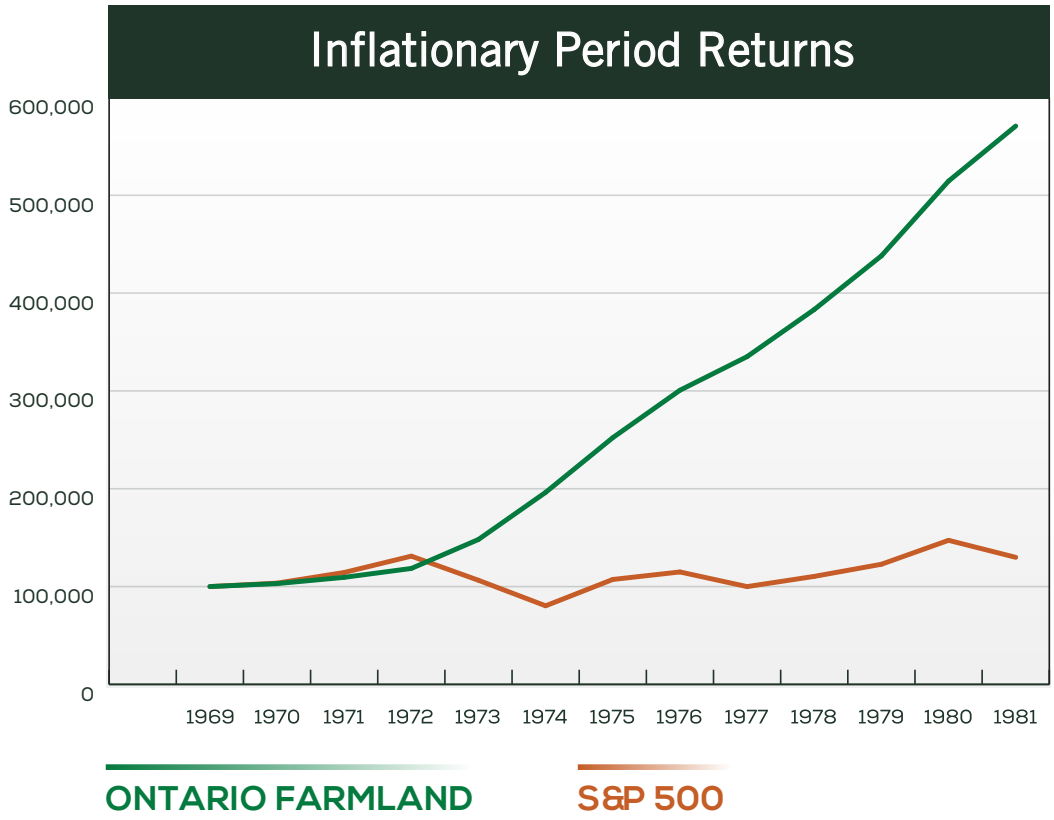
This environment should probably concern investors since very little is based on fundamentals, and almost all of it has been fueled by excessive liquidity and 0% interest rates. So, it might be a good time to assess if your portfolio is positioned for an extended period of inflation and invested in good underlying fundamentals.



We believe investors should be looking to add more real assets to their portfolios. The trick is owning productive assets that act as a hedge against inflation and an investment with a real scarcity value. Historically, farmland has proven to be possibly the best investment to own during periods of inflation.

But not all farmland is equal. As the world wrestles with a changing climate and many of the best farming regions struggle with water issues, Ontario is fortunate to have the largest freshwater source in the world.

The great lakes not only provide ample fresh water for the region, but they also ensure we get regular precipitation throughout the year, while other regions are now regularly dealing with longer, drier summers and water sources that are drying out. The great lakes also ensure warmer temperatures and protect the area from earlier frosts, giving us a longer growing season.



Maybe it's time to look at your portfolio and think about the rationale of paying higher and higher valuations for assets that, in some cases, don't have earnings or produce anything (NFTs and cryptocurrencies). Maybe it's time to think about wealth as owning assets that make something valuable. Measure your wealth by the productivity of the assets you own and the scarcity value of those assets. Given farmers own more than 98% of farmland, its value is determined by its fundamentals. Farmers pay prices that allow them to operate the farm profitably, not on the expectation that someone else will come along and speculate on it. Ongoing innovation in technology and biology should continue to drive productivity and efficiencies, making the farmland more valuable. While this drunken currency orgy may be causing prices of all assets to go higher, it's worth ensuring you own something tangible for the inevitable time when the world finally sobers up. That's when you will be glad you own something that indeed generates wealth and not something that appreciated based on speculation with free money.

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