Critical Insights

Part 3: Economic Policy

DGC Asset Management Limited is a UK-based project developer and consultancy. This series of reports is intended to provide investors with an insight into developing trends in the underlying fundamentals that shape the global economy and investing landscape. Our goal is to drive better decision making for those considering long-term investment strategies.

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Foreword

Moving into part 3 of the Critical Insights series, we now take a look at the economic and geo-political trends that are shaping the global economy, and influencing financial markets. Having already revealed in parts 1 and 2 how evolving global demographics and shifting patterns in consumption are shaping a new global supply chain, we now turn our attention to the impact of economic and wider political policy for investors today.

We have already noted in this series that the deterioration of the demographic profile in industrialised nations is shaping economic policy. Now we add to the mix untenable levels of national debt and a growing fear of deflation in key markets such as Europe. It is little wonder then that interest rates have slipped into negative territory, turning the safe haven of cash into a costly, depreciating asset. Furthermore, talk continues of further attempts at stimulus from central bankers keen to use any measure possible to stave off a recession, or worse, a sustained depression. These measures, so far at least, have proven at best ineffective, and at worst a major contributor to the worst financial apocalypse since the great depression.

Perhaps the biggest influence on the performance of investment portfolios allocated mostly to traditional financial markets however, is the growing geo-political storm threatening to spread chaos and instability throughout global markets. From a proxy war between Russia and the US in the Middle East, to a possible exit of the EU by Great Britain – the Brexit. Not since the cold war era has geo-politics had such an impact on financial markets.

Read on to gain insight into the what, where, why, who and how of global these mega-trends from the point of view of today's investor.

> *"I put forward a pretty general theory that financial markets are intrinsically unstable. That we really have a false picture when we think about markets tending towards equilibrium."*

George Soros

Quantitative Easing & Asset Purchasing

Policymakers first failed attempt at economic stimulus...

Quantitative Easing & asset purchasing was the first attempt by central banks to stimulate economies post 2008. In short, QE generally involves a central bank creating new money out of thin air, and loaning it to itself or other banks. This new 'credit' is then used to buy purchase assets from banks, primarily government bonds and other securities, and to encourage interbank lending.

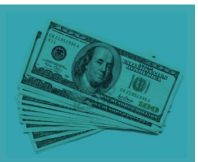
QE is supposed to have a stimulating effect on the economy by increasing the money supply and in turn lowering interest rates. This, in turn, is designed to encourage banks to lend to businesses and individuals who then use this debt to invest and consume goods and services, thus creating jobs and expanding the economy. Debt fuelled inflation 101.

Japanese policymakers were the first to use QE back in 2001. This was followed by a string of failed QE programmes in major economies in 2008, starting with the United States. The Federal Reserve has since purchased $3.7 trillion in bonds, and the United Kingdom has printed £375 billion ($550 billion) in 'new' money. This was followed by a €60 billion per month asset purchase program by the European Central Bank in 2015, funded entirely by printing cash. This has so far extended to €1.2 Trillion in 2016.

As a result of these measures, economic growth across Europe remains stagnant at 0.1%. In the United States the Federal Reserve balance sheet has doubled from $2.825 trillion to $4.482 trillion. In the United Kingdom, debt to GDP ratio has doubled from 44.5% in 2007, to 88.6% on 2015. Overall, one cannot call these packages a success. At best they have marginally delayed the inevitable.

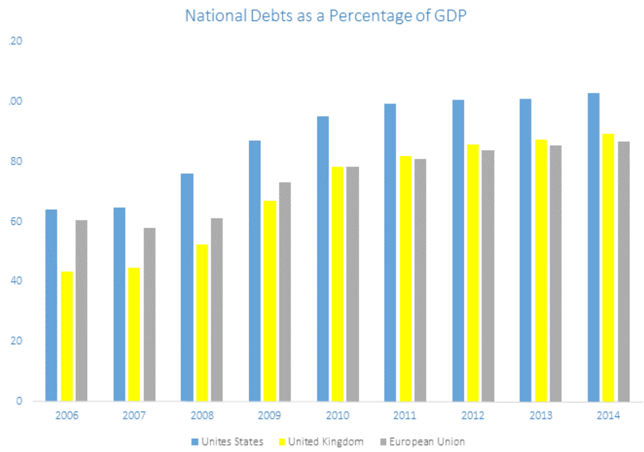
It remains the case that the World's biggest and most influential economies are unable to overcome the headwinds of an ageing population, low birth rates, mounting debt, and an increasingly uncertain geo-political outlook. This now combines with a massive bubble in stock and bond markets to create a very bleak economic outlook indeed.

$3.7 Trillion
Bond purchases by Federal Reserve since 2008



£375 Billion
Total 'new' money printed by HM Government in the UK

€1.2 Trillion
Money printed by European Central Bank in 2015



Source: Eurostat and World Bank

Interest Rates

The value of cash is shrinking fast, and asset values are in a horrendous bubble…

Post QE, the next, and perhaps last measure designed to stimulate growth is the reduction of interest rates into negative territory.

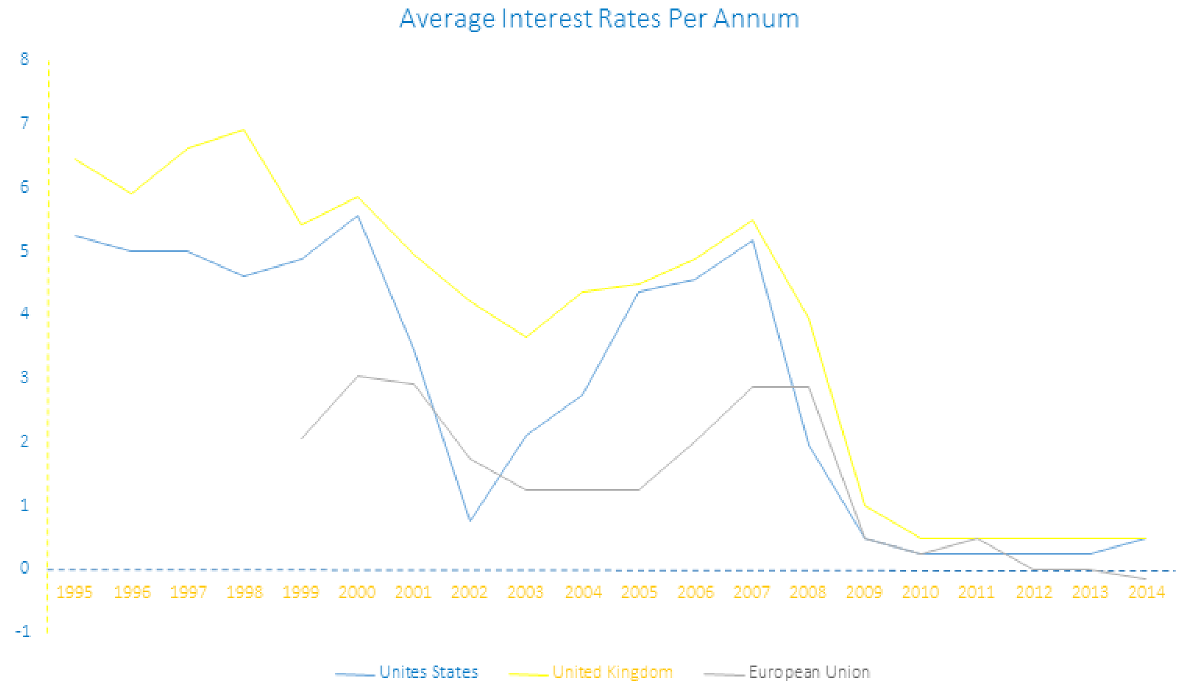
The issue of negative interest rates is not simply one of poor returns to cash in the bank. As central banks shift rates below zero, effectively charging customers to deposit cash, the impact for investors and the economy is significant and widespread. As bankers now try this new, deeper economic measure to try and stimulate their economies, the impacts could be far reaching – even catastrophic. Many commentators feel that this measure is, in and of itself, a precursor to an apocalyptic economic crash, to be followed by a deep financial depression.

Having already rolled out hugely significant economic measures in order to try and kick start the global economy out of a state of permanent stagflation, or worse, recession, policymakers are using perhaps their last desperate measure in their battle for growth.

The main motivations behind dropping interest rates to below zero are:

- It is hoped that lower rates result in a weaker currency. This, it is hoped, will lead to an increase in exports.
- Lower interest rates are supposed to incentivise businesses and consumers to borrow more, invest more, and spend more.
- Lower rates push up asset prices by negative correlation. The hope is that higher asset prices (bonds, equities, property and other assets) boost confidence and spending.

As noted above, there is rather a lot of hope involved. When economic policy is based on hope, then I think we can all agree that, when this fails, there is very little left to do but weather the ensuing storm. With that in mind investors must think hard and fast about where to place capital today.



Source: World Developement Bank

Interest Rates

The reality is that none of these things are likely to come to fruition, and the situation may well in fact prove disastrous. Currency devaluation only works when the value of other currencies is maintained. In actual fact more regions are introducing negative rates, and so a race to the bottom is taking place with no real net benefit to anyone.

Whilst rates are lower, private lending has not really increased. The lower rates simply mean it is less profitable for banks to lend. This, combined with stricter underwriting criteria and balance sheet requirements post 2008 have resulted in almost zero net benefit.

In terms of encouraging spending, negative rates have had the opposite effect. Savers are not spending, they are moving their cash into hard assets such as gold, land and other tangible items.

One area where lower rates have arguably had some influence is higher asset values. However, there is now an enormous bubble in bond markets and the stock market which are both due for a significant correction. Not good news.

Furthermore, as we noted in parts 1 and 2 of this series, the global economy faces deeper long term challenges that will likely see a permanency of low growth in developed markets regardless of exogenous stimulus packages. An ageing population, low birth rates, and advances in technology are rapidly shrinking the workforce, severely impacting growth prospects. Whilst an older population also draws on its economy for much longer, creating a far larger obligation for the state in the long term. No amount of rate reduction or QE can solve these issues.

So negative rates have turned out to be a damp squib. Apart from contributing to a tremendously precarious financial bubble that is now set to burst. Government bonds are so expensive they are trading at negative rates, and stock markets are trading at pre-crisis highs despite poor underlying fundamentals. At some point there will be a massive correction, and whilst no-one can predict precisely when it will happen, the time is fast approaching. In fact, at the time of writing this report, it may already have begun.

Geo-Politics

The influence of geopolitics on global markets has never been so pronounced…

The world we live in today is far more interconnected that at any time in the past. Globalisation is an unstoppable phenomenon, and this interconnectivity results in a susceptibility of investors to global market conditions – both economic and geopolitical. The old adage goes that if the US sneezes then Canada catches a cold, now if one of the major world economies sneezes, we all get the sniffles.

This brave new world is a nexus of rising geopolitical tensions and shifting socio-political trends. Influence has shifted from long-serving global superpowers, and rapidly evolving social trends have created an increasingly unstable political environment on a global scale. These factors combine to threaten the global supply chain, and influence financial markets in a way never before seen.

This new level of political risk is impacting visibility in global markets, making forecasting near impossible. As a result, companies are changing the way they do business, and investors are increasingly wary of investing in asset markets with a connection to less stable regions. That is, in fact, almost all markets to some degree.

Geopolitical events can now easily be linked to economic and financial market performance. Middle East tensions drive a migrant crisis and terrorist attacks in Europe and the US. Migration and terrorism is the biggest influencer on European politics today, and also heavily influences US foreign and domestic security policy. As a result, previously comfortable sectors of society feel increasingly vulnerable and less financially secure.

Now, as diplomacy fails, other measures are increasingly deployed. With growing inequality and injustice driving social unrest around the world, we see sanctions, protectionism, aggressive regulation, border disputes and armed conflict, and a rise in anti-establishment sentiment, protests, violent demonstration and terrorist activity. All of these can deliver a direct economic cost that is changing the business and investment landscape. It is certainly true that a 21st century investor cannot rely on 20th century thinking and methodology.

The net result of geopolitics on financial markets and assets? Sharp price fluctuations in commodity markets. Food, raw materials, oil and other energy assets, many of which are produced in the World's least stable regions. Economic sanctions causing wild swings in the supply and demand dynamic for goods and services, as well as impacted the growth potential of the affected countries and an overall depression in international trade.

Moving through 2016 it is likely that the biggest influencers on the global economy will be United States economic policy, security (or otherwise) in the Middle East, the UK referendum on EU membership, and the economic outlook for China. Political decisions, therefore, will certainly impact financial markets in a major way. Investors in turn will continue to allocate capital to safe haven assets in order to mitigate this new risk premia.

Summary

The beginning of the end for financial markets…

Trillions of dollars of phantom cash held in mountains of debt by central banks (and ultimately the taxpayer), interest rates below zero, a massive bubble in stock and bond markets, and a geopolitical landscape that is impacting the performance of both the global supply chain and financial markets. 2016 and beyond is likely to be a tough time for investors. Investors, that is, who hold majority exposures to stocks, bonds and cash. For those that view today's landscape through a 21st century lens and allocate capital elsewhere as appropriate, there could be solid gains ahead as value shifts into hard assets.

In Part 4 of the Critical Insight reports series we will start to examine the precise symptoms that play out in financial markets, and in investment portfolios, resulting from the fundamentals we have covered in this and preceding reports in the series. We see the phenomenon of inflation and deflation both happening at the same time as value and demand shifts in an unbalanced supply chain and global economy. We also see the impact on financial markets, as rapidly inflating bubbles threaten to burst, and volatility becomes the watchword for investors navigating markets.

Author Biographies

David Garner – Chief Executive Officer

With a background in real estate, finance and investment, David launched DGC Asset Management Limited in 2009 alongside Wendy Brittain as DGC Business Consulting Ltd; DGC was established to provide institutional investors, family offices and HNW Individuals with access to credible asset class and risk analysis within the real-asset space, focussing primarily on natural resource properties including farms and timberlands.

David has collaborated as an Advisor on investment projects within the distressed-residential and agricultural market segments with servicing Asset Managers and Family Offices through Europe. In 2009 he led a consortium of Investors investing in a structured sale-and-leaseback of a number of farm properties in the United Kingdom which has delivered annualised returns of more than 12% since inception. In 2010 David sourced and managed a multi-client investment into two farming estates in Western Australia. These assets were held and operated for two years before being profitably disposed of in November 2012 delivering a net return after fees and local taxes of 18%.

In 2011 – post financial crisis – David led a collective of US Mortgage Bankers and Real Estate Developers in developing the Secure Income Strategy™; a real estate investment project based on the acquisition and management of single family homes in the United States. This project has since attracted over USD $28 million from US and international investors, and has grown to include over 420 individual properties in five States. The SiS project has also executed a number of profitable exits; delivering liquidated annualised returns of between 18% and 65% for investors.

David is a passionate exponent of sustainable agriculture as an alternative asset class, and has developed an investment strategy and approach designed to deliver the most attractive blend of risk and reward in this growing and exciting space. Vaccinium is an extension of David's passion for agriculture, and he believes well-managed, well-located productive farmland will be one of the safest and most profitable asset classes for two generations.

Charlie Kermer - Director of Funding and Research

Charlie began his career working with BNY analytics, a quantitative asset manager belonging to The Bank of New York Mellon, where he held responsibility for business development and conducting deep market research and analysis which was used to advise central banks and institutional investors in strategic asset allocation.

His next step was to join American Express in the Credit Risk Team where he conducted thorough credit risk analysis and consulted some of the world's largest corporations on their risk profiles and advised on strategies to reduce their exposure.

After years of conducting market research and analysis and gaining a well informed view of world markets, Charlie opted to move into the investment sector in a capital raising capacity, with a focus on hard assets. Charlie used his analytical ability to build structured property portfolios in Central London for UHNW investors and institutions across the globe.

Since joining DGC, Charlie has advised on and managed real estate and agri-business transactions equating to $45 million across North America, The United Kingdom, South America and Australasia. Charlie has built a wealth of experience working with a variety of HNW individuals and Institutions, from project creation and due diligence stage all the way through to fund raising and execution.

DGC Asset Management