

Critical Insights

Part 5: Inflation vs Deflation vs Stagflation

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

For those readers joining us anew, the Critical Insight report series, authored by the senior management team at DGC Asset Management Limited, was created with one purpose in mind; to examine and dissect the push/pull levers that influence the performance of financial markets and investment portfolios in this new-normal 21st century global economy.

Our aim from the start has been to nurture the collective intelligence of the investing community, and facilitate better capital decision-making that is based on a full rounded knowledge of the modern day environment.

Having now reached the fifth edition of the series, we have so far looked into a number of significant developing trends in the fundamentals that continue to drive and shape current and future growth. We have seen how pressure from a changing demographic, economic, geopolitical, social, fiscal, and ecological environment have created a new-normal global economy. As such, we have thus learned how we, as investors, can no longer rely on traditional markets, assets and strategies to provide sufficient consistent growth and income so as to protect the value of accrued wealth, and to provide for a comfortable (and increasingly expensive) retirement. We have learned how we must in fact look further afield, shift our focus, and develop new strategies that harness and leverage new growth fundamentals so as not to be left behind.

It is here where we pick up in part 5. We begin to examine the current economic climate; one that is largely manipulated by monetary and fiscal policy, and increasingly influenced by geopolitics. We start today with an insight into inflation. We look at the major influencers of value growth, from aforementioned policy decisions designed to float a potentially deflationary economy in the West, to the socio-economic factors driving rapid expansion in emerging economies. We look at how the dynamics of demographics we pointed out in Part 1 of this series are advancing emerging market economies whilst weighing down long-term growth prospects elsewhere. We now aim to weigh to this combination of inflationary and deflationary pressures, and seek to find some answers as to how this might play out in the global economy.

“ *No central banker would disagree with the proposition that inflation is primarily a monetary phenomenon. Not one of them will disagree that every inflation has been accompanied by a rapid increase in the quantity of money and every deflation by a decline in the quantity of money.* ”



Milton Friedman
(Nobel Prize Winning Economist)

Inflation vs Deflation

Whilst advanced economies falter, emerging markets continue to grow...

Today there is a battle going on right in front of us. It is a battle for economic growth, for rising prices, and for stability, and it is being fought by policy makers in almost all advanced economies.

In Part 1 of this series we looked at the global demographic profile. How social and medical evolution has led to an ageing population in advanced economies, and how mass urbanisation combined with higher birth and mortality rates, along with a swift shift in consumption patterns in emerging markets, is driving rapid but unstable economic growth.

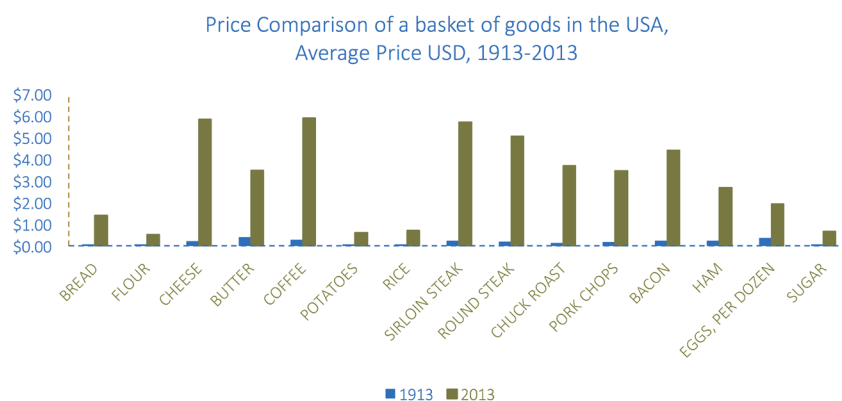
Back in Part 3 we looked at the monetary policy that has been rolled out in advanced economies post-2008 as efforts to stimulate economic growth, keep prices steadily rising and thus stave off another – potentially much worse – global financial catastrophe remain at the forefront of our collective minds. Of course, we saw how low and negative interest rates, and trillions of dollars in new money has had little effect other than to drive up massive bubbles in financial markets that are due to pop at any moment, and to see masses of public debt pile up into what many economists believe are now insurmountable piles. Furthermore, we have seen how more recent attempts at currency devaluation have led to nothing more than a race to the bottom, as one country after another joins in the party of ever-more aggressive interest rate manipulation.

But what does all this mean for those of us that rely, in part, on an inflationary economy in order to generate positive investment returns? Are we in for inflation, or deflation? And what about stagflation?

In order to answer that question, we must look at the finer details. With such a complex, globalised economy, it is no longer possible to simply park capital 'in the markets' and expect to ride the wave of voracious growth. Whilst the baby boomer generation may have had that luxury, the same rule cannot be applied today. Investors now must be more globally aware, strategic in approach, and open minded in their asset allocation.

Our thoughts are that, whilst current monetary and fiscal stimuli have at best helped to stave off a massive global recession, they have in no way created an environment of stable, consistent or sustainable growth. From almost any angle it looks very much like policymakers have used all the tools at their disposal, and as the impact of these measures splutters and dies, what happens next is very much an unknown. When one also considers the growing influence of geopolitics on the global economy – regional wars, US elections, Brexit – it is difficult to imagine a bright future for financial markets, or the investors clinging loyally to them. It is perceivable, however, that we may see the value of some assets rise in line with increased demand from 5 billion new, hungry consumers.

Value growth will continue apace where demand for specific goods and services continues to outweigh supply. This inflation will form the basis of positive returns to well-allocated investment portfolios, and whilst traditional markets limp along through the next period of extreme volatility, those investors that are well-diversified will be best-positioned to benefit.



The Current State of Play

Deflation is already taking hold in some markets...

Looking at the major advanced economies of the US, UK and Europe, the published rate of inflation is low. In fact, in some countries deflation has already taken hold.

Some of the most aggressive monetary policy has come out of the European Central Bank (ECB). Policymakers there are desperately seeking to prop up failing economies and avoid a regional and global crisis. As such, trillions of Euros in quantitative easing and asset purchasing programs has been rolled out, and interest rates have been depressed to below zero. However, inflation in the region continues to scrape by at just 0.33%, and in some countries included in the group, price contraction is already occurring.

All of Greece, Estonia, Poland, Slovakia, Slovenia, and Spain are seeing in 2016 with below zero inflation numbers. Prices are falling, and neither new money nor negative rates have helped. Does this make European financial markets an attractive prospect for today's investor? Unlikely.

The UK economy – the fifth largest in the World – fares little better. Flaccid inflation numbers mirror those of Europe, and both QE and low rates have again done nothing more than to create precarious bubbles in financial markets, accompanied by hundreds of billions in additional debt. Should we look to UK markets as a sustainable long-term growth prospect? Probably not.

The US economy has problems all of its own. Whilst the published rate of inflation is higher than in European counterparts, it still hovers way below

1.37%

US CPI Inflation January 2016

0.30%

UK CPI Inflation January 2016

0.33%

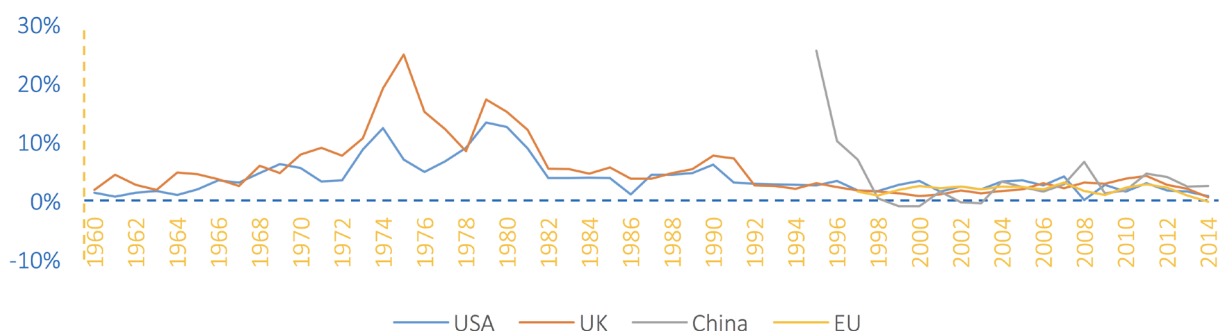
Europe CPI Inflation January 2016

1.5% in 2016. The biggest problem however, is a \$20+ trillion debt pile that is becoming increasingly difficult to service.

So, with the inherent relationship between inflation and economic growth, the prospects for a prosperous period in advanced economies is becoming less likely almost daily. In the short term, weak demand for products and services continues to drag on growth, whilst a shrinking workforce and ageing population in these regions indicate that long-term prospects do not fare much better.

As economic growth – and contraction – typically plays out in financial markets, it is time for investors to look further afield to other asset classes for which demand is growing, supply limited, and the prospects for sustainable long-term value growth more realistic.

Inflation Levels, 1960-2014



Shifting Value Growth

With markets at risk, value growth has shifted into alternative asset classes ...

There is a perpetual debate as to the true mechanism of inflation. One school of thought believes that price growth occurs as demand for goods and services outweighs supply. In this model buyers compete with each other and drive up prices. In addition to this, when the value of a currency decreases, the relative price of goods and services increases as each unit of currency is able to purchase less. Using this model as a framework, we are able to identify assets that might provide a solid base for long-term wealth preservation, income generation, and portfolio growth. So, with all this in mind, we are now looking for assets that will remain in high demand, and for which supply is limited. With our existing knowledge of the 21st century growth dynamic, this job becomes somewhat easier.

Taking into account the source of today's economic growth; predominantly emerging markets, and what is driving it; mass urbanisation and social and industrial evolution, we should look at the goods and services these new consumers demand, and seek to own part of that expanding supply chain.

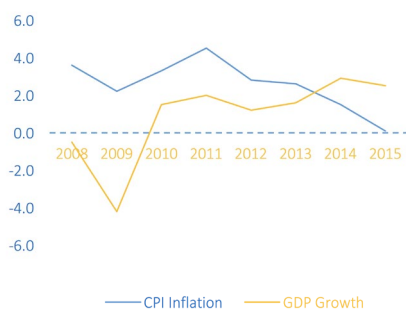
Where populations migrate to urban areas, growth is greatest in the consumption of food and energy. As noted in part one of the report series; one of the first major evolutions as families become wealthier is that of the household diet. Furthermore, urban populations consume far more energy than rural counterparts, and so owners of the assets that form the foundation of these supply chains are likely to experience the kind of consistent, long-term growth

that has historically been reserved for the financial markets of now advanced yet failing economies of the West.

Another part of our asset identification model is the concept of flight to safety. Where markets are volatile, sluggish and inconsistent, investors seek out alternative assets that retain value throughout every economic cycle in order to hedge their portfolios. This is witnessed in the increasing allocation to real assets in institutional investment portfolios of the last decade. Holding of infrastructure, energy assets and natural resources such as farmland and timberlands have increased exponentially. This adds further weight to the investment case for real assets, but we must look at assets that investors would consider to be safe to own in the long term.

Finally, we must take into account that, as an economy weakens, so too does the value of its currency. This makes goods, services and assets denominated in those currencies more attractive to buyers holding more valuable money. So we should also focus, at least in part, on assets in these advanced yet failing economies that offer a higher level of risk mitigation than assets located in emerging markets. Less political risk exposure, more secure property rights, a better commercial and legal environment, a better-developed supply chain infrastructure and operational expertise, and the opportunity to supply into growing economies, creating revenue in a more valuable currency.

CPI Inflation vs GDP Growth (UK)



CPI Inflation vs GDP Growth (USA)



CPI Inflation vs GDP Growth (EU)



Summary

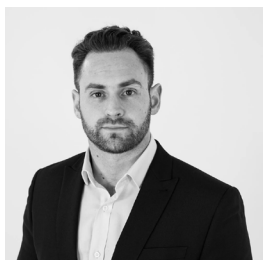
New thinking is required for a new landscape...

Using inflation as an indicator for value growth, we can see that despite a marginal turnaround in GDP growth within advanced economies such as the UK, US and Europe, the value of goods and services are falling, and so the long-term positive correlation between economic growth and prices has been torn apart. New thinking is now required.

This adds considerable weight to the concept that traditional markets and investment strategies – which rely in part on value growth to generate returns – can no longer be relied upon, and new markets, assets and strategies must be considered in order to protect and grow wealth in the long term. Those investors that cling to old thinking and methodology will surely be left behind, and those who gain exposure to expanding supply chains and in-demand assets will prosper.

In the next part of this series we will investigate how traditional markets have performed. We look at the new risk premia that results from increasingly volatile geopolitics and monetary policy has skewed real value, and we weigh up the idea that this increased level of risks detracts for the value of returns in these markets, forcing investors to look elsewhere.

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.

