

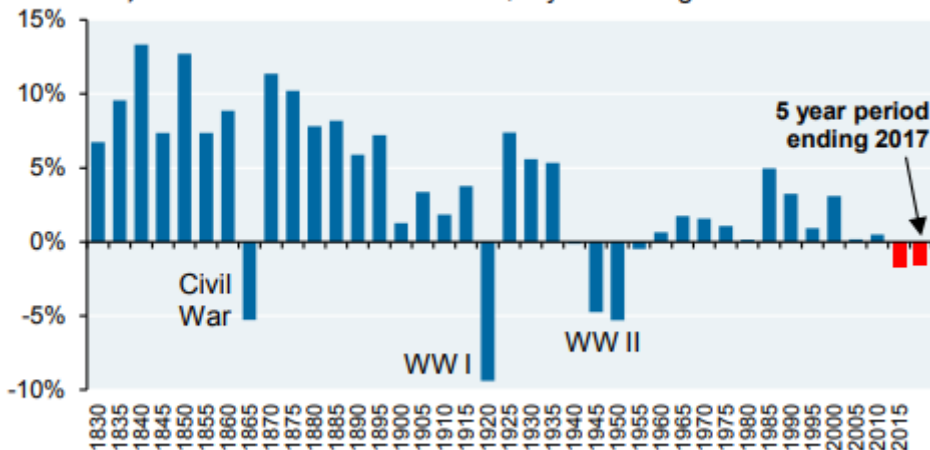
The Coming Age of Real Assets

What do these four periods have in common?

- 1861-1865
- 1916-1920
- 1941-1950
- 2010-2018

On close inspection, the first three eras are periods of major U.S. military conflicts (The Civil War, World War I, and World War II), but you may be wondering why we included the recent, post financial crisis era. The reason is that these four instances are periods of excessive monetary stimulus. The chart below, recently published by JP Morgan Asset Management, illustrates average real yields in 5-year periods since 1830.

Lowest real yields on cash since 1830, other than during wartime, T-bill/Funds rate less inflation, 5-year average



Source: FRB, Robert Shiller, GFD, BLS, JPMAM. December 31, 2017.

As shown, historical periods of negative real yields (market interest rates below the rate of inflation) developed out of the dire need to fund deficit-spending associated with the massive cost of those wars.

In stark contrast with those major events, that is not what is happening today. The current period is a remarkable anomaly as it stems not from war but from years of financial chicanery and monetary policy experimentation. This period is something altogether different and will certainly have consequences that many fail to anticipate.

We have been frequent critics of the Federal Reserve (Fed) and the other major central banks for all their various forms of so-called sound central banking policies. The manufactured stimulus resulting from interest rate manipulation and money printing aimed at forcing stock prices higher has wide ranging effects. Some are easily noticeable in the short term and other distortions and consequences will only be observable over longer periods of time. This article discusses one such distortion that presents an investment opportunity in the making.

As discussed in [Wicksell's Elegant Model](#), when the market rate of interest is held below the natural rate of interest (a proxy for economic growth) as has been the case since the financial crisis, capital tends to get misallocated on a vast scale. Companies and investors that can borrow at ultra-low cost are more incentivized to re-invest in *existing* assets. They do not need or want to take on the risk and time demands of deploying capital into new long-term projects. This is even truer today as executive compensation packages, laden with stock options, reward such behavior.

The result is a price boom in existing financial assets such as stocks and bonds. Because capital is largely directed to financial assets, commerce increasingly shuns investment in new property, plant and equipment and gravitates toward takeover bids for existing competitors, share buybacks and larger dividends.

Financial asset transactions, however, do not lead to an expansion of the capital stock. They are only a transfer in the ownership of assets which primarily results in a net increase of total debt. Economic growth during such environments has little organic sponsorship. Instead, the growth realized is largely, superficially fueled by debt and, as a result, temporary.

Money Message

Part of the reason financial engineering and speculation has taken precedence over real capital investment is that investors lack a sound basis for making long-term investment and project decisions. **Exchange rates and interest rates are a reflection of money as a store of value and therefore a vital conduit of information.** When policymakers tamper with either or both, they distort that flow of information, thus handicapping investors in their ability to properly assess the current and future value of goods and services. Under those circumstances, few business managers are willing to take on the risk of investing in new plant and equipment especially after adjusting for the probability of failure. The easiest solution to that problem is to borrow heavily at low interest rates and reinvest in assets offering an existing stream of income. This produces a reasonable return on investment with much better visibility. �

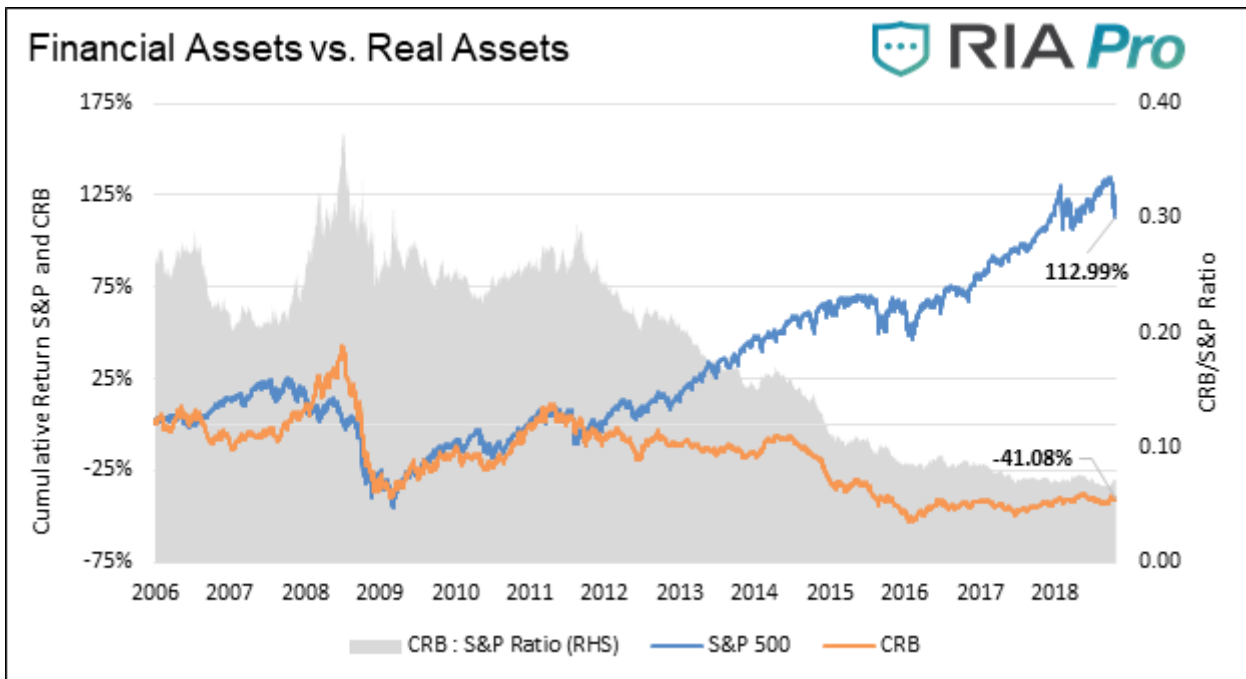
One of the more compelling charts we have seen in the last year is the long-term relationship between the S&P 500 and the Goldman Sachs Commodities Index (GSCI). No chart better illustrates the distortion of uses of capital as described above. The following chart highlights the divergence between financial assets, using the S&P 500 as a proxy, which have exploded in price and real assets such as those found in the commodities complex.

GSCI (TR) / S&P 500 ratio: shares expensive, commodities cheap



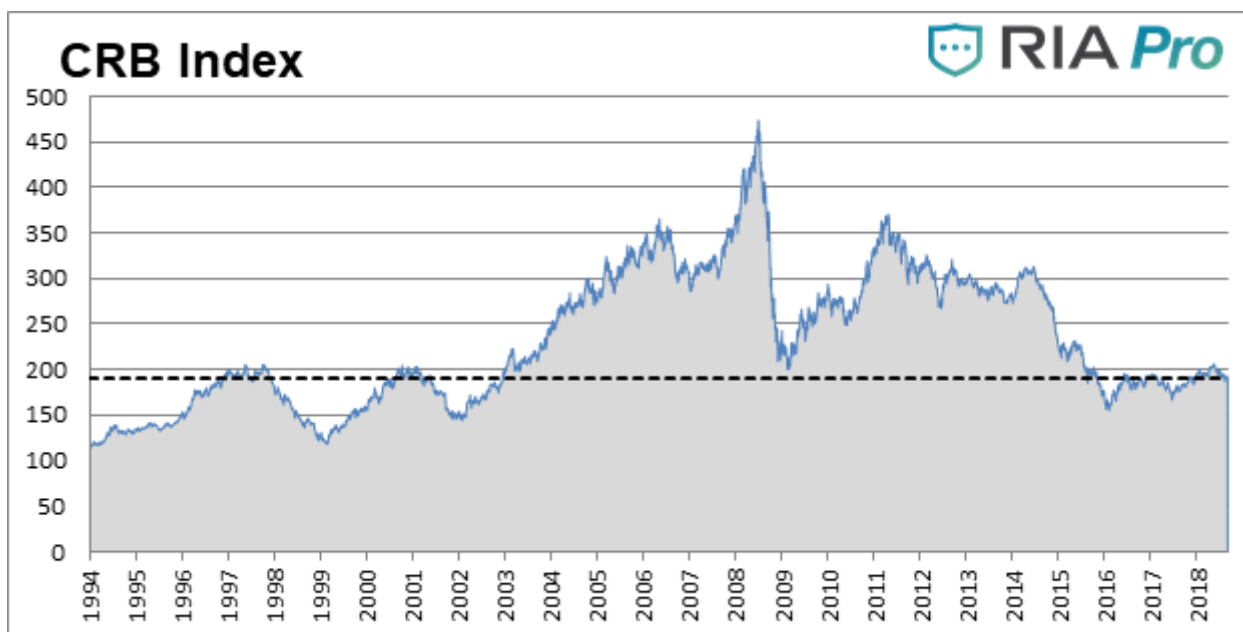
Sources: Professor Dr. Torsten Dennin, Lynkeus Capital, Incrementum AG

To offer a more detailed perspective, the next chart highlights the contrast in price returns between the S&P 500 and the Commodities Research Bureau (CRB) commodities index along with the ratio between the two gauges.



If the negative real interest rate regime of the post-crisis era has indeed obscured the pricing mechanism of money and reinforced the preference for financial assets, it should also be

negatively reflected in real assets. Using the CRB index as a proxy as shown below, we notice that commodity prices are at levels seen over 20 years ago.



Despite negative real rates and rising marginal costs of production, two factors that have historically supported commodity prices, they continue to remain under pressure. Additionally, while China's appetite for raw materials has diminished somewhat, plans for the massive One-Belt, One-Road (OBOR), the new silk road, continue to advance as do the commodity requirements for that project.

Opportunities in Commodities

If as we suspect, the low interest rate environment has been an important dynamic in financial asset price inflation, then normalizing interest rates may also bring gradual normalization of investor preferences.

Such an adjustment could be an impetus towards more investment in durable cash flow projects and less in speculative financial assets. Over time this would be disruptive to stock prices and beneficial for commodities.

From a value perspective, commodities are relatively cheap as an asset class and some specific components in particular have been depressed for quite some time. Since 2017, sugar is down -35%, coffee is down -45% and natural gas is down -28%.

Taking a longer view, since 2014 corn and soybeans are down -11% and -28% respectively while lean hogs are down -44% and sugar is down -22%. Last we checked, the global population is not shrinking and the likelihood that demand for these basic necessities will fall seems low.

Add to the equation the supply restraints of harvesting or mining resulting from environmental disruptions and this out of favor asset class could begin to surprise to the upside. In a world where everyone seems inclined to pay top dollar for the latest fad, these staples of global society certainly warrant close monitoring.

Summary

Low interest rates have disrupted the normal functioning transmission mechanism of the price of money and prudent decision-making has been obscured as a result of these extensive price controls. This has led investors, corporate managers and entrepreneurs to take evasive actions, avoid risks, and lever up cheap money to go for the sure thing. The irony is that although this produces favorable short-term results, it impairs the intermediate and long-run growth potential of the economy.

Given the slow and methodical process promised by the Fed, any normalization may take time. Then again, if concerns around inflation begin to emerge, the normalization of interest rates may be forced to accelerate. Commodities have been a big underperformer since 2011 as investors shunned real assets over financially engineered options. Although the turn may not be here quite yet, the commodity sector stands to eventually benefit and is one place with a lot of options to look for value.

Those who see that the last 10-years of experimental stimulus has been on par with, or arguably exceeded, policies historically reserved for major wars gain a unique and valuable perspective of the current monetary mirage. The demise of those policies, as they are bound to unravel, will reveal a multitude of investment opportunities left behind in the ill-advised euphoria of anti-capitalism.