

Will There Be A Shift From Financial Assets To Hard Assets?

In November 2011 I was in Orlando for meetings at CNL Financial Group, and in Atlanta for meetings with Wells Real Estate Funds, Inc. Obviously a lot of the discussion had to do with the future trends in the global economy. For what it's worth, these are my thoughts about where we're heading.

Since the first quarter of last year I've expressed my concern about risk assets (particularly equities). In a joint article with Professor Phil Romero (U of O Business School) in June 2011 we warned that another financial crisis might be just over the horizon – and sure enough it manifested itself as the sovereign debt crisis in the Eurozone. I still think we are heading in the direction of a relative shift out of financial assets toward real assets. I also think that the global inflationary trend is upward. And I still maintain that the financial asset bubble is only moving around from one set of balance sheets to another – from tech company balance sheets, to real estate owners' balance sheets, to government and central bank balance sheets. Deflating the capitalist debt bubble will take time – and it will be painful! Let me explain through the analogy of taking off a band-aid. The West has elected to deal with the pain by slowly pulling off the band-aid trying to avoid the sharp sting of ripping it off fast. But slowly peeling it off will still hurt, not as bad as ripping it off, and it will hurt for longer. It will be a slow and lingering pain.

This asset bubble floating around – fueled by unsustainable debt creation – has been manifesting in *financial assets*. "Financial assets" are assets that derive their value from a contractual claim, like stocks, bonds, loans, bank deposits, and mortgages. *Real assets* (also known as hard assets) on the other hand are physical, identifiable and tangible assets like gold, land, equipment, patents, and commodities. Like most things in life the classification of economic assets in the real world is blurred. For instance, is a residential house a real asset or a financial asset? There are those that claim it has elements of both. It is a real and tangible thing with a value derived from the demand for shelter. However, the value of real estate is also very much dependent on the paper/debt markets. Think about it – what would residential real estate be worth if not for the existence of a 30-year fixed mortgage?

Without getting too technical, since the debt bubble has manifested itself primarily in financial assets, investment activity may shift more and more to real assets. I really believe there is merit to this argument. This dovetails well with the expectation that the global inflationary trend is upward. This upward trend will boost the shift to real assets, which perform better during inflationary periods. The West has been trying to make their economies more competitive through currency devaluation. Central banks, like the Federal Reserve, have intervened by "printing" unprecedented amounts of money. The money supply of the United States has been increased significantly. The devaluation trend of the dollar leads to higher commodity prices since commodities are priced in dollars. Given the global supply and demand imbalances one can expect that

commodity prices generally will rise, of course, there will be volatility and differentiation. As Mihir Worah points out, the emerging market economies were exporters of disinflation to developed economies during the great moderation of the 90's. This trend is turning around. Commodities trade on global markets, and to the extent that emerging markets are going through a particularly commodity and energy intensive phase of growth, their consumption will affect what you and I pay for our goods. The inflationary pressure from commodities will be even higher within emerging markets, since commodities are such a large part of their consumption basket. As these economies face their own inflationary pressures they may find that they cannot continue to couple their currencies to the US dollar and to combat inflation they need to let their currencies appreciate. This inflation will be exported to us (because now it will cost us more to buy their stuff).

Remember, I am not making the argument that hyper inflation is in our future, but I see a trend toward *increased/higher inflation*. This trend supports my thesis of a shift toward real assets.

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