INVESTMENT REVIEW

~ A WINTER'S TALE ~

Man now has a sufficient grasp of the elements to be able to change the character of the seasons, and the economic cycle. The first of these is regarded with increasing alarm. Changing weather patterns, such as milder winters, are a source of universal anxiety – even for those who are doubtful as to the causes of global warming.

There is no such alarm in the financial world, yet the same thing has happened; what is more, its architects intended that it should be so. Everybody can see that summers of prosperity are more enjoyable than winters of recession, and the dynamic has been: 'so let's get rid of recessions!'. Nobody is foolhardy enough to say that lower heating bills and fewer frozen pipes are a good reason for abolishing winter – and yet, economically speaking, this is precisely what the Fed has done. The ambitious theme of this investment review is that the Federal Reserve has had the will and the resource to influence the very shape of the economic landscape, and has used this power so comprehensively that it has interfered with the rhythms of the world's economy.

Its dynamic was a simple one. From the late 1980s, whenever the economy looked like slowing down, the Fed simply lowered interest rates and made money freely available. At the time of the LTCM crisis in 1998, a long period of prosperity was approaching exhaustion, and a recession was on the way. The result of the Fed initiative was not only to sustain economic demand, but to set off a stockmarket (TMT) boom, which itself encouraged further economic activity. But when that boom turned to bust the economic world was faced with *two* summers' worth of detritus, and the likelihood of a deep recession. The Greenspan trick was repeated, and, lo, there was no deep recession; instead a housing boom which itself turned into a housing bubble. When this bubble burst in 2007, the world was looking at the stabilisation of the detritus of *three* summers – the original one following from the 1990s' prosperity, the aftermath of the stockmarket bubble in the early years of the century, and the excesses which reached their crescendo in 2006/2007 in the leverage boom based on the housing market. We were thereby faced, not with a recession (appropriate in the 1990s) or a deep recession (appropriate in the early years of this century) but a full-blown depression. And when the US administration butterfingered the Lehman crisis in October 2008, it was upon us.

Unsurprisingly, the Fed responded to this crisis in the only way it knew how – lower interest rates and a massive injection of liquidity. Slowly, hesitantly, sluggishly, the ship of state picked up – overwhelmed at first by the awfulness of the trade crisis which followed hard on the heels of the financial dislocation. It seemed a forlorn hope that the depression could be avoided, but it has happened; for the third time, the winter season has been delayed while, this time, the balance sheets of sovereign nations take the strain. But one day, perhaps soon, perhaps not, this new pillar of support will prove inadequate and then what will happen? The pattern looks unmistakeable. It starts, 'no recession now, but a deep recession later.' Then it becomes, 'no deep recession now, but a depression later.' After 2008 it becomes, 'no depression now but…' and it seems clear that the dynamic is going to be something like, 'and then there will be a complete wipe-out'. But this is emphatically not the case. This is the moment for writing in green ink and in block capitals, *NOT SO*.

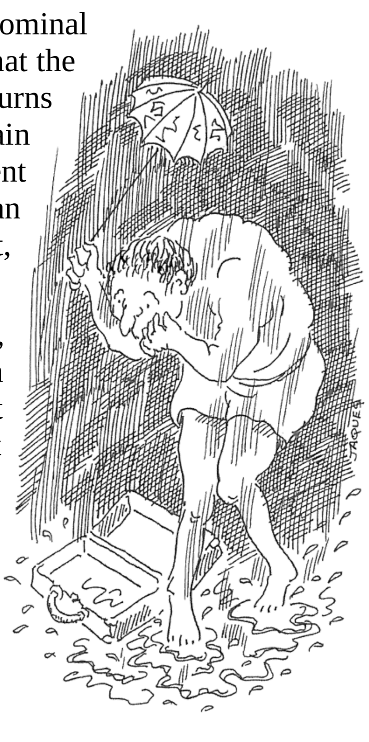
This may seem amazing, but it is the case. The central bank dog has twice barked and made the position more and more unstable – how can the hair of this dog put us on course for a cure? Before we rejoice in the introduction of a new stability into the world financial system, it is worth pointing out the frighteningly unsatisfactory feature of it: it is the money of the savers which is going to plug the destabilising gap between the accumulated debts and their lack of collateral. We are all about to become a lot poorer.

To understand the background to this, one has to revisit the Victorian debate as to the nature of consumption in an economic system. Can you consume what you haven't got? In the world of moral absolutes, morality and common sense came together in declaring that only accumulated wealth could be consumed. This raised the tricky question as to where borrowings fitted into all this; a bicycle bought with borrowed money was every bit as much a bicycle as one bought from savings. Did the motivation matter – whether the bicycle was to be used for a paper round, or for the pleasure of butterfly-catching? The traditionalists took an absolutist line, standing alongside their theologian-brothers who were at the time defending the Bible against Professors Darwin and Huxley. But they chose their positions badly. Just as the Bible was a lot less brittle in accommodating darwinism than its defenders feared, so it turned out that the economy could handle a great deal of money borrowed for frivolity and pleasure. In defending the wrong battle line, the traditionalists not only got the theory wrong, but the practicalities, too: in the 1930s, the policy of balancing the books made things worse, whereas Maynard Keynes' suggestion that governments who borrowed money would give a helpful jolt to an economy, turned out to be spot-on.

For the last sixty years the idea has been discredited that you can't create something out of nothing (an argument attested to by both King Lear and common sense: an unusual alliance): because borrowings have had the power to increase asset values, and have done so comprehensively, it has been assumed thereby that wealth also has increased. The powerful lesson to be drawn from the leverage boom of the last ten years is that borrowing on the basis of an increase in asset value alone is not, in the long-term, a sound proposition. The extra value in the stockmarket bubble created borrowing-capacity, but when the bubble burst the borrowings secured on this virtual wealth were left beached. Its replacement by the housing boom provided an alternative support – for a while – but by 2007 it was seen to be no more real than its predecessor.

We have now moved into a new third stage. Bank loans in the private sector have been replaced by government borrowings – which create deficits. Any problem in these will be felt through the currencies of sovereign governments – stand by for this next default!

Earlier generations would be amazed at the utter naivety of our financial generation to imagine that a paper currency could possibly – could <u>possibly</u> be a substitute for wealth. Property, land, claims on profitable enterprises, even tulips, yes! But paper currencies? Surely the 1825 Colombia Loan (money lent, ammunition bought, ammunition fired off, end of loan) proved that? Like all sophisticated societies we have to learn the obvious lessons last. When currency values buckle, a third chimera of wealth will fade as inflation causes monetary spending power to decline. Nevertheless, providentially, this inflation has within it the seeds of hope. Provided interest rates are held below the rate of inflation (helped along by taxes charged on nominal returns rather than on an inflation-adjusted basis), then savers will find that the value of their wealth goes inexorably down, year after year. Riskless returns that are negative were enjoyed – if that is the right word – in Britain between 1975 and the early 1980s. Savers and those on fixed retirement incomes became poorer and poorer with each successive year. This was an effective transfer of wealth from those who had it, to those who didn't, either through poverty or debt.



Today, the man with £1 million of debt, and an asset worth, say, £500,000 is not only insolvent, he is also a threat to the stability of an economy. If money halves in value, he may well be able to sell the asset for £1 million in devalued currency. If he has paid only a small amount of interest in the meantime, then it is the creditor, the man with the savings, who is repaid in devalued money, and he has had no proper post-tax reward for his pains. This is the cure which is unfolding upon us – but for the saver it is more of a curse than a cure. This practical and immediate danger is very hard to guard against, and extremely irritating to live through. That is why your portfolio looks as it does at the moment.

Jonathan Ruffer, January 2010