The second quarter has seen a strong application of Nanny's Nivea cream to the grazed knees of the investment community – and all the stock phrases have reappeared, ('a corner has been turned,' 'we have seen the worst', and my favourite analogy, drawn from the fairground merry-go-round, 'bumping off the bottom'). It is not that we disagree; we side with those who truthfully say that they haven't a clue whether the stockmarket lows of March 2009 will turn out to be the final ones.

This is what we think is going on. The destruction of the financial system in 2008 led irresistibly to negative consequences in the real economy – lack of consumer demand, fractured world trade and an almost complete cessation of borrowing opportunities in the corporate sector, auguring badly for the medium-term economic outlook. A wide range of radical – not to say revolutionary – incentives were applied to the financial system by central banks. The Fed's defibrillator was activated, but the equity markets at the beginning of the year felt that it might be too late; perhaps the entire world system was irreparably broken. These extreme fears have proved to be unfounded. Oiled by the TARPs, the TALFs, the Quantitative Easing and the PPIP, the fly-wheels of industry have restarted, and with the new CEO of the Royal Bank of Scotland's pay now edging towards the £10 million mark, the Titfield Thunderbolt is back in business. The optimists check their timetables to see when the economic locomotive will reach its furthest destination, the bears wonder how good an idea it was to power the train with a large dose of plutonium. The picture is confused, but economic conditions are showing signs of stabilising, and the threat of a bank failure bringing down the financial system seems much less probable.

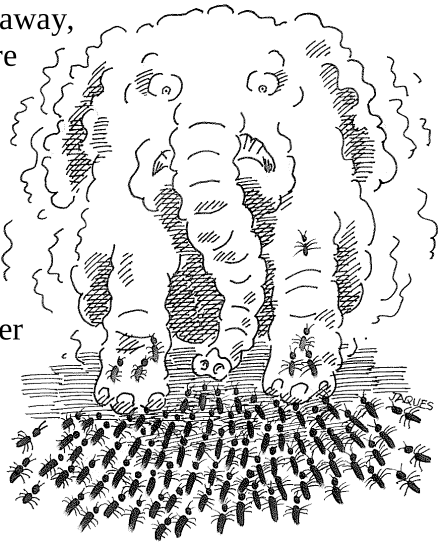
The easier part of the Fed's work is done. By making credit abundantly available to the banks, the derivative markets recovered, dragging the 'cash' market (ie, the stockmarket and other asset prices) up in sympathy. From the Fed's point of view this initiative had one big advantage, and two disadvantages. The 'plus' was that it could be done in the shadows, without being easily visible, and crucially without increasing the size of the Fed's balance sheet, which the vigilantes have identified as primary evidence of money-printing by the authorities. The bad news is that the injection of credit into the system has to be done through the banking system. This has ensured that their second quarter's profitability has been enormous – not perhaps the signal to give the world. Moreover, the bankers can be relied upon to create further bubbles to extend their profitability – they have had years of practice at it. The old apparatchiks continued unchanged in a post-perestroika world: capitalists are no different from communists in this regard.

If the Fed is to continue its easing, it must find another conduit, and that is proving to be a straight purchase of assets in the market place. This change of emphasis focuses attention much more directly on the Fed's balance sheet, which expanded alarmingly last year from $800 billion (of which $600 billion was cash equivalent) to over $2 trillion – this exercise will probably take it to over $4 trillion. The danger is that the vigilantes ambush the US political system and force a discontinuance of the Quantitative Easing by the authorities. Then the comprehensive nature of the deflationary forces will be laid bare. The citizens of Ireland know how terrible its dead hand can feel: the combination of competing with Britain's weak £ and suffering the indignity of an overseas central bank (the ECB) setting the rules for circumstances independent of Ireland itself means that inflation is now running at -4%: in other words harsh deflation. Make no mistake; the Fed is doing the right thing by printing money to avoid this elemental force of deflation. The gallows of inflation may well be tomorrow's theme – but another day, another opportunity, and the Fed is underwriting today's survival.

Far from worrying about inflation, the consensus is unconvinced that the Fed can do enough to stave off this Irish-style deflation. Our belief is that they absolutely can – because they are in a position to create money faster than the economic downturn can destroy it. A silly, but possibly true, story can illustrate it. At the beginning of the nineteenth century there were two grandees in County Durham – one was rich and stupid (His Grace the Duke of Cleveland) and the other was rich and clever (William Backhouse of Backhouse's Bank, Darlington). One day they had a schoolboy spat as to which one was the richer. William Backhouse challenged the Duke to a competition: they would sit opposite one another in a pub, and tear up £5 notes. When His Grace tore up a £5 note, he was £5 poorer: when Mr Backhouse did so, it was at the trouble and expense of printing another one. So it is today. It doesn't really matter how rich the Duke is, or how deep the write-offs are: the Darlington banker and the Central Banks can always match it – and more – so long as there are trees to provide the paper. This is what the Chairman of the Federal Reserve, 'Backhouse' Bernanke wrote in 2002: *'What has this got to do with monetary policy? Like gold, US dollars have value only to the extent that they are strictly limited in supply. But the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost. By increasing the number of US dollars in circulation, or even by credibly threatening to do so, the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.'** These much quoted words reflect his intention. This is his moment. There is as much chance of him changing his mind or losing his nerve as Maggie Thatcher joining the Liberal Democrats. Only the political machinery can thwart him, and just as Mervyn King had to abandon his strong £ policy last year when the economy slumped, so the political opponents of Quantitative Easing will be swept aside by the deflationary forces which will quickly turn Celtic in their ferocity. Inflation/deflation? This is the burning question for investors at the moment. We believe that it is nearly a certainty that we are headed for inflation, although we accept that this view could look horribly wrong – not for long, maybe, but our discomfiture could be great.

Let us emphasise again that, in terms of the economic situation we are out-and-out deflationists. Every pressure is for prices to go down, as economic activity withers away, companies default. The inflation we fear can be seen as simply one more default – the default of the currency. In a corporation, though, it is binary – a company is either alive or dead. With currencies there is an infinity of gradations from absolute loss (Weimar Germany), destabilising loss of value (Britain in the 1970s) to the rumbling problems of gradual but persistent erosion which were the pattern for most countries in the latter half of the twentieth century.

What then will be the transmission mechanism of this inflation? Peter Warburton here has argued powerfully that the financial alarms of last year could easily upset the fragile supply-chains which, in this 'just in time' world have little resilience to rupture. Even a mild inventory re-stocking would lay this problem bare, and a widespread series of one-off 'special' price increases could aggregate into general inflation.



But the real place to look is in the psychology of the world's citizenry. The widespread ridicule of Gordon Brown's initiative to 'invest' the UK out of recession is a short step from a realisation that the cornucopia of money which he prints to pay for this investment is equally ridiculous. A £20 note, so devalued, is likely worth less – invert that idea, and the cost of a £20 item is likely to go up in this circumstance: inflation! In the circumstances, it would not be the Bank of England or Goldman Sachs' strategists who call this inflection point: it will be the Sun newspaper, whose front page will show a picture of a £50 note, with the banner headline beneath: BOGPAPER! If people fear inflation, they act in ways which bring it about – the danger of inflation comes from the activities not of the rogue elephant, but the power of an army of ants. Psychology is apt to change quite suddenly – the financial world saw it when everybody became fearful of bank deposits in a matter of days in that dark month of September 2008. The same could be true of paper currencies. Crowd behaviour is impossible to observe, but of immense power. It could bring about inflation very quickly. We think it will not necessarily come soon, but that when it does come, it will come quickly: not a chip-pan fire of bubbles, smoke, blue smoke and fire, but the sudden burst of petrol catching alight. This could be quite disconcerting.

Jonathan Ruffer
July 2009

** Governor Ben Bernanke, 21.11.02 'Deflation: Making sure 'it' doesn't happen here' before the National Economists Club, Washington DC*

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