We wrote a rather downbeat review in April, in which we said that the timing and order of the various cross currents in the world were making our investment strategy uncertain, and concluded that 2010 was a year to be 'got through'. In fact, the first quarter had gone well, and while the second quarter just finished has given back some of this gain, the overall position after six months remains satisfactory.

The biggest practical problem facing us at the moment is the use of currencies in protecting the portfolio from loss. Our philosophy is to strive for protection by investing in a wide range of assets which will protect, and be protected by each other. For many years this has worked well, and is still working well – but the increasing importance of liquidity provided by central banks means that there is a non-plussing correlation of all asset prices: up when the quantitatives are eased: down when they are reversed. If bonds, equities, commodities and real estate all go down simultaneously, what's the fun of finding that you lost money in each of them? In this world, currencies have become the only effective way to achieve true diversity. But currencies are not very obedient to the fundamentals and this feline quality means that even a correct analysis of the situation does not ensure a satisfactory result. In the event, the gains (so far) in 2010 have largely been achieved through a bold move into the dollar.

There's another danger with currencies. Our glory is in having no benchmarks – but a base currency is an implicit benchmark – stray too far from sterling (or other base currency), and the risks increase. This put us in a difficult position in Japan, where we have (correctly) identified that a weak stockmarket will be accompanied by a strong yen, and *vice versa*. The obvious way to protect our largish positions in Japanese equities would be to keep the yen unhedged – but a big dollop of dollars, and a big dollop of yen would have meant, for sterling investors, the risk of being too much away from sterling as a general election and a harsh budget approached. In the event we broke the wrong way arithmetically – the stockmarket did go down, the yen did go up, and we suffered in the former with no benefit from the latter. This need for currencies as an asset class is a temporary phenomenon, lasting only as long as the dominance of central bank intervention in the investment mix. When this dominance fades, we will be able once again to remember the adage: if you have a view on currencies, have a little sleep and hope that, when you wake up, you'll have got over it. In the meantime, it will provide a specious excuse for any future underperformance.

The current weakness in the stockmarket is generally attributed to fears of a 'double-dip' recession – there is, however, little hard evidence of this, although leading indicators in both America and China would be consistent with a slowdown. For what it is worth, we incline to the view that the adrenalin afforded by extra liquidity will keep things bowling along for a while, and evidence of this should reassure markets. Nevertheless, it is worth taking a step backwards and reminding ourselves of the fact that the economic world is the instrument of a massive real-time experiment to see what happens when you pump extraordinary amounts of money into the system to neutralise the deflationary effects of the credit crunch. Eighteen months ago nobody knew whether this would turn world economic growth around. We now know that it did. Nobody knew whether the bond markets would tolerate such an injection of liquidity. They have done.

So far so good. Where are today's uncertainties? Nobody knows whether this tolerance will continue for long enough to allow economies to recover their internal strength, so that the indebtedness they have created can be repaid. Those who speak the most authoritatively on such things are the economists, who not only failed to see it coming, but are so unblushing that one might almost imagine the dislocation didn't occur, and the credit-rating agencies, who combined an equal lack of understanding with an egregious dose of conflicted interest. That's as sensible as putting Messrs Pétain and Quisling in charge of the inauguration of the United Nations.

Despite this bankruptcy of understanding there is a sharp conflict of thought as to whether belt-tightening or continued assistance is the better way to treat the economy. Cynics might think that it largely depends on the election cycle, with Obama's call for further easing playing into the mid-term elections in the US, and Britain setting off on a budget-cutting cliff-hanger (the only way is down) having established an uneasy political consensus following the May elections.

The theory behind this debate is reminiscent of the conundrum in the 1930s – balance the books and bring on a depression, or print the money and blow up sound money. Or, in today's language, deflation or inflation? The two are very nearly the same thing. Imagine driving down a straight road when a tyre bursts. The car lurches to the left, and if the driver does nothing the car ends up in the (deflationary) ditch on the left hand side. More likely than not, the driver will desperately pull on the steering wheel to avoid this and then, of course, the danger is the right hand ditch of inflation. We have always said that for America the iconic mistake of the twentieth century was the depression (just as for the British it was the Battle of the Somme). Back to the analogy of the runaway car, the odds on left-leaning mistakes or right-leaning ones are not evenly balanced. There is an overwhelming dynamic away from the 'do-nothing' deflation, towards the soothingly-delayed consequences of monetary compromise.

We are – and have been for over a year – inflationists, but the travails of Europe and Japan – followed probably by China – will put this resolution to the strain. We believe though, that the worse the deflationary forces the more the policy response is towards monetary compromise. This is seen in the situation after Greece's crisis: the contagion quickly threatened Portugal and Spain, so after a perfunctory show of firmness, the ECB produced a reserve 'shock and awe' cheque-book package of €750 billion. The more the deflationary lurch, the harder the steering wheel is turned.

We are increasingly excited about Japan in this context. The central bank has a good understanding of the need for financial easing – and, unlike the west, their shot is still in the locker. The onset of inflation is massively effective in rebalancing the comparative advantage away from the saver towards the borrower – provided, and here's the rub – citizens don't see it coming. Fifteen years of Japanese deflation or near-deflation means that nobody there has any inkling of how easy it is to inflate if the authorities are prepared to compromise on currency. They are as nervous as a 愛くるしいふわふわした子猫* about pulling the trigger – it will take a crisis for them to act. What form might the crisis take? Exactly the sort of deflationary forces which abound everywhere, and which doubly afflict the Japanese economy. How will we recognise the moment – we won't, of course, but if the yen strengthens to $¥85 – then hold on to your hats. Intervention will weaken the yen, steepen the yield curve, strengthen price expectations – and the equity market could be absolutely remarkable in its upward parabola. You heard it here first.

Although this may appear to be a second downbeat investment review, it should be an encouragement to readers. We are more than halfway through – probably – this period where the fundamentals of economic forces are willed into quiescence by politicians and bankers. We have taken our positions for the ultimate resolution of this tension – and it will be terrific for all of us if we are vindicated!

Jonathan Ruffer
July 2010

** little fluffy kitten*