The month of September produced one of the best of equity market rallies. It coincided with poor, or even – one might say – sinister news from the real world, with consumer confidence in decline, house prices rolling over and debt levels disconcertingly high. For sure, companies are largely doing pretty well, but a robust economy and good corporate profitability was a surprise only at the beginning of the year, and the third-quarter figures from corporations have yet to be released. So why the rally?

The answer is clear enough: the words in the latest Federal Reserve announcement, *'and is prepared to provide additional accommodation if needed'*. This provided the signal that it is prepared for another round of quantitative easing. Connoisseurs of the mixed metaphor will know that we have provided a quiverful in our oft-repeated prediction of a series of deflationary shocks in the economy, each leading to the same resultant policy of Central Bank easing. Eventually ordinary citizens will lose confidence in their respective currencies, a dismay which will cause them to spend it – on a party, on the house repairs needed to be done for a bit, an investment – and the increased velocity of circulation will bring about the very inflation he has feared. Indeed the Deputy Governor of the Bank of England, Charles Bean, has commended exactly this course of action to hard-pressed savers! You really couldn't make it up.

But we are going to look at quite a different aspect of this policy, that of encouraging the consumer (and the borrower) at the expense of the saver. A quick glance at a recent bank statement will set the scene. This appeared on a deposit statement of a client with slightly over £2.1 million in it–

Up to £2,500	0%
£2,500-£5,000	0%
£5,000-£25,000	0%
Above £25,000	0%

While this example might be an extreme example of customer care (rumour has it that one institution is changing its name to the 'lessening bank') it highlights a frightening development for savers: it is no longer possible to keep your money safe. The choice of a 'riskless' option in the form of an instant access account is now certain to lose money in real terms. With inflation currently running at about 4% in the UK, this is death by slow drowning.

The consumer is, of course, plagued by a series of insect bites: the car driver faces parking and speeding fines, householders are impotent in the face of council taxes ('we're from local government and we're here to help you'), and face utility bills that can't be utilised for anything – so a tax from the relationship manager at the local bank feels like just another of these things. There is within it, however, a great danger – most people who received so recently a risk-free return of 5% nominal on their deposit accounts will not easily stand for a return of nearly nothing, or nothing at all. Some will take Mr Bean's advice, and be savers no longer. Others will judge that it will be better to accept a bit of risk and find an investment which gives the requisite yield. Those who have already taken that route have found to their pleasure that there is a brighter side to risk; they have received a reward! Government bonds, or even better, first class corporate bonds with names like Tesco, have given not only the running yield which substituted for the lack of deposit interest, but they have also made a decent capital gain as well. 'Safe' money has rarely been so imaginatively invested: buy-to-let back on the menu, high yielding 'safe' equities (we confess to liking these at Ruffer). But it is a distortion. By putting a false value on riskless assets the slightly risky, and the somewhat risky investments take their cue from that distortion. The easiest way to see this is in the price of the shortest index-linked stock, the Treasury 2.5% 2011. It is priced to give a real (inflation adjusted) return of minus 2.5%. Why would anyone want to own that? The answer, of course, is that with inflation running at more than 4%, the proceeds in cash will lose rather more (in real terms) than the loss of the index-linked gilt. The distortion in the price of the 2011 vintage is felt throughout the universe of index-linked stocks. The Treasury 1.25% 2017, not due to mature for over seven years, now gives no return at all. (Actually, a very small loss, in real terms to that maturity date.) This thought is reinforced by the Government's quiet withdrawal of index-linked National Savings certificates some months ago.

Investors who look for safety first have to consider whether the capital is safe. Their failure to do so ahead of the credit crunch meant that everybody is now aware of the danger on this front. Consequently, there is a great attraction in the undoubtedly secure asset, but a second mistake is easily made; for an investment to be safe it must be both secure, and bought at a sensible price. There is no doubt that a government bond in Germany is safe in the sense that it will repay bondholders their contractual due, but with stocks on a three year maturity yielding less than 1% and the twenty-five year maturities yielding less than 3%, there is quite a possibility in the meantime of a substantial capital loss if circumstances change, regardless of the absolute security of the underlying investment.

It does not often happen that the cost of money is so distorted that it changes the whole basis of market valuation, but it did happen in Britain in 1935/1936. Interest rates were so low that the Government was able to issue a 1% Treasury stock, maturing in 1942 – what price did that fall to in the 're-armament' inflation of 1937 which reached 6%? Equities bought in late 1936 (taken as a whole) did not get back to the purchase price in real terms until 1985 – the longest period of nil returns for equities there has ever been in Britain.

How do we tackle this issue? The answer is with difficulty, since the distortions mean that the price of just about everything of investable quality is like shopping for bargain antiques in Bond Street. There are two ways of finding true safety. The first is to find stable assets which will inevitably be expensive on their conventionally assessed value, but which nevertheless have virtues which are currently underestimated. Pre-eminent in this category is the inflation linked government bond market and, in particular, the UK index-linked. Two years ago, nobody would ever have imagined that some of these stocks could be priced for a guaranteed loss in real terms. The circumstances which we have already described show that this is now so. The distortions which are explicitly observable in the short-dated stocks will run on through the longer-dated issues as well: real yields will become negative, driving index-linked prices higher. Since our primary view is that there will be a period when inflation will be much higher than interest rates, this distortion will be much magnified, and so index-linked stocks provide not only directionally the right place to be, but the chance of a massive re-rating as the distortion becomes more pronounced. On the other hand, conventional bond markets are dangerous almost in their entirety. The best opportunities will be at the junk end of the market, where stock-specific dangers are perhaps less than perceived. But the inflationary developments will be a body blow to the valuation of conventional issues, and the certainty of a nominal return, so much valued at the moment, will not be translated into confidence in a similar real return.

The second thought is to find assets which look more dangerous than they in fact are. High yielding large-cap companies perhaps fall into this category, but it is a well-worn theme, and is arguably more dangerous than it seems. The Will Sutton factor is largely ignored. (Will Sutton was the American bank robber who, when caught, was asked why he did it. 'Because that's where the money is', he replied.) We live in a world where governments have desperately weak balance sheets, largely as a result of the bailouts to avert the consequences of the credit crunch. Foremost among the winners from this has been the corporate sector – so it will not be a surprise to see, for instance, the drugs companies' tax rates go up, the integrated oil companies having to drill more safely, the corporate rules changed against the telecommunications companies in India. Each of these seems like a one-off hazard, but collectively they form a pattern. Nevertheless, the dividend yields are attractive, they are sufficiently risky to avoid somewhat the distortions of riskless money, and if (a big IF) their profitability can be maintained and enhanced, the dividends could provide an alternative inflation-linked return.

Another such area is Japan. The Bank of Japan is under terrific pressure to respond to the deflationary pressures within the system, and we believe it is only a question of time before the current regime in the Bank of Japan is either removed, or of its own volition provides a stimulus beyond simply currency intervention to the embattled Japanese consumer. If this happens in decisive style, we think the yen will be forced sharply lower, and the stock market sharply higher. This is truly one of the few markets which is cheap in almost any environment. We feel like the schoolboy with sixpence in his hand, and finding that the sweet shop has knocked 50% off all their stock. Which is it to be? The rum butterballs of financials, or the sherbert dip of exporters? This has the capacity to be a really exciting market.

In short, the distortion which has arisen within the markets drives a stake in the whole concept of keeping clients' money safe: there is now a tax on safety. The need is therefore to think carefully about the juxtaposition of assets to keep the portfolios safe despite this impost; we are determined not to try to be clever in what we do. Long observation shows that clever fund managers lose their clients' money rather more quickly than stupid ones!

Jonathan Ruffer
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