The art of cross-examination in a court of law is essentially the art of asking the right question. The same is true of assessing the economic outlook. Ahead of the credit crunch, one variable stood out above all others as salient: the inexorable rise in the total quantity of debt in the world. There was no need to call the inflexion point when greed would turn to fear – it was enough to know that one day this would happen, and at that time there would be an event, similar in size and type to the eventual outcome of the credit crunch.

That was then, and today's decisive question is a different one – but still related to debt. It is this: can the debt built up over the last two decades be paid down? Our answer is that it cannot. Two years ago that assertion was based on rather less than it is today. The tsunami of liquidity known as quantitative easing (the first barrel, in the spring of 2009 known as QE, and its autumn 2010 successor as QEII), which followed in the aftermath of the credit crunch, has achieved many things. It has stabilised the world economy, which is growing (in the US, anyway) at an above average 4% per annum. Confidence has returned, and investment valuations have normalised. Everything is back to normal, it seems – except for one thing: the absolute level of debt. Quantification of debt is not easy, but there is a useful metric which divides a country's debt by its GDP (the size of the economy). For the US this sat at about 140% a generation or more ago, but rose from 220% in the later 1990s, through 300% in late 2005 to 373% at its peak three years ago. The latest published figure is 357% – effectively unchanged from its highest point. This is the world's problem, and all the prestidigitation of the Federal Reserve has not alleviated it.

Debt can be extinguished either by repayment, which is not happening, or by default, which is the granite path to a depression. There is only one way in between: inflation, with interest rates kept well below that rate of inflation. This is what we are seeing in the UK, where there is already inflation, and what we will see in the United States when it reappears there.

In the meantime, the stockmarkets around the world are rather enjoying themselves, and, rather to our consternation, we have been enjoying a full benefit of this phenomenon. How can we have any sort of bullishness when there is so much danger about?

The way to understand this 'benign' phase of US monetary policy is not only to see that the policy of quantitative easing is massively inflationary but that it is being superimposed on an economic world which has many elements of deflation. We saw how effective this combination was in the 1990s, when China's cheap labour and cheap goods pouring into the West masked policies which were, even then, unequivocally inflationary. While the hot sun of inflation beat down, the land was protected by a deflationary mist. A similar dynamic is at work today. The credit crunch provided massive and instantaneous deflation: the US easing has been burning off this mist.

Thus, the momentum is of increasingly inflationary pressure from the Western authorities which, while it neutralises lingering deflationary conditions, is broadly benign for markets. It will become malignant when it creates overheating. In early 2009 it was a fairly easy decision to climb aboard the donkey of asset appreciation; everywhere and everything was deflationary and was in need of inflationary measures. Investors need to be more selective now than hitherto as to where the money goes: when it comes to equity markets we prefer sclerotic to exotic.

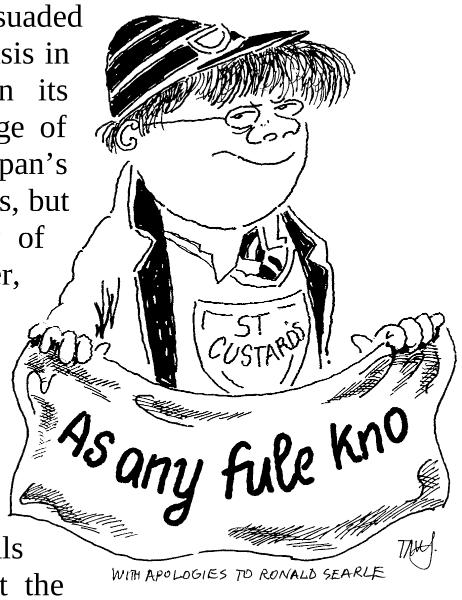
We take it as a certainty that a policy of easy money will continue: take the United Kingdom – retail price inflation nearly 5% and rising, Bank of England interest rates at 0.5%, with a lone soldier on the Monetary Policy Committee, Andrew Sentance, recklessly suggesting that perhaps 0.75% is more like it. But the key to this policy is not what happens in the UK but, rather, events in the United States. There, the Federal Reserve sets a level of interest rates not only for domestic America, but, through the reserve currency status of the dollar, great swathes of the rest of the world as well, particularly emerging markets. China, Brazil and the Far East don't need quantitative easing at all – the mist has already been burnt away, and they manifest the classic signs of overheating in their respective economies. The consensus view in the market place is that while this will no doubt end in tears, it will first create a boom in asset prices. There will, so the thinking goes, be time enough to worry about the problems to follow. We think that investors will be disappointed.

The Far East was on the wrong side of the disinflation trade in the 1990s – six years of boom, and a terrible bust under the baleful eye of the International Monetary Fund in 1997 and 1998. They will have no desire to repeat so recent and painful a memory. Expect to see liquidity constraints at national level, whether they be capital controls (withholding taxes on dividends, anyone?), credit controls or the like. Brazil has raised taxes on foreign bond investors, and Chile has started to intervene to support the peso. Markets hate these sorts of conditions, and those who are invested in the emerging markets simply because that's where future growth will be found, will have to relearn this lesson.

The exact opposite is true for America. High unemployment, and a housing market barely stable at critically low levels, point to the lingering chill of deflation. QEII makes sense for America and most of the West (and, especially, for Japan).

There is a compelling investment opportunity in Japan. As any fule kno, Japan is the poster-child of deflation: there may be summer mists of it in the United States, but there's a blanket fog in Tokyo. Worldwide, a perception of deflation is the only thing which stops the accommodative monetary forces being inflationary, rather than growth-inducing. QEII will, we believe, work for long enough in the US to give an investable window of opportunity – similar measures in Japan could give something considerably more exciting. But will the Japanese authorities ease?

A team from Ruffer has recently returned from Japan and we are persuaded that they will (in fact, they already are doing so). Frustrated by the stasis in the political arena, the Bank of Japan has become explicit in its encouragement of risk-taking behaviour. This has the dual advantage of buoying animal spirits and relieving pressure on the Bank of Japan's independence. It has already launched a policy of purchasing risk assets, but the market was unimpressed by the amount: ¥5 trillion (just shy of £40 billion in real money – one fifth of our own Bank's QE). However, the message our team received is that it may be the first of many moves: it will cause the economy to grow. Thus Japan is the beneficiary of inflation, the opposite of China, which is its victim.



We have also been building a position since the summer in German property stocks. The eurozone's one size fits all monetary policy is the most ill-fitting for Germany that it has been since its inception; the reason for lax policy is clear enough; to keep the indebted peripherals and the European project afloat. But the side effect is inflation at the eurozone core.

I remember complimenting a one-legged ballet dancer on the excellence of a party he had given. 'I've never heard so elegantly expressed', he said, 'so much piffle' *[except he didn't say piffle]*. So, cutting through the piffle, what exactly do we have in mind in the portfolios? Japan remains the top beneficiary of the world for a reflation trade. America and the UK are just fine – for the time being. The outlook for Europe in general is cloudy (with sunny intervals) – too dominated by politics for comfortable investing. And avoid the emerging markets. Christopher Fildes, author of so many of the best one-liners, never got it better than when he defined emerging markets as being those places from which it is difficult to emerge in an emergency. You have been warned!

Jonathan Ruffer
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