INVESTMENT REVIEW

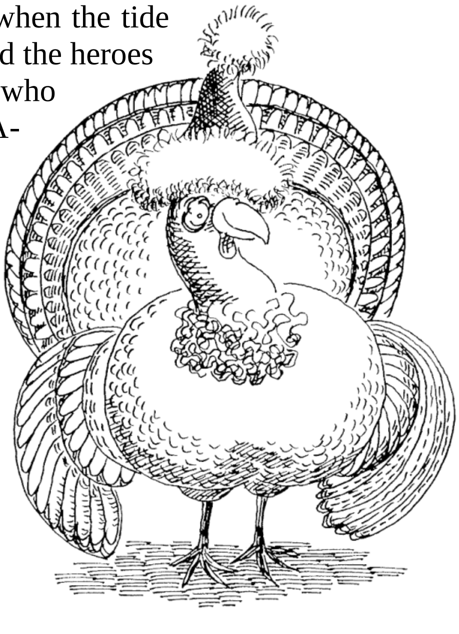
Some years ago I introduced our readership to the Swedish economist Knut Wicksell. My general view on economists is that if they were half as clever and twice as sensible, they would be four times more useful, and one of the few pleasures from the rolling economic crisis is that the central bankers, economists and politicians appear collectively to be housed in an imperial nudist colony. Not a pretty sight to be sure, but one that warms the cockles of the heart.

In our last review, I wrote that it was almost 'impossible to call' the coming events – that remains true, but it is abundantly plain where we will end up. In this context, the fog of the journey is perhaps less important than the destination: high road or low road, we are on the way to high inflation with low – eye-wateringly low – interest rates. It's the insight of Knut Wicksell, over a century ago, who articulated its determining principles.

Wicksell was the man who observed that there is an interest-rate level which keeps borrowers and lenders in balance. Tilt interest rates up; the savers love it, the borrowers hate it: and of course, *vice versa*. He went on to observe that if interest rates are kept constantly below the happy medium – which he described as the natural rate of interest – it started to change the way a society behaves. Many savers become discouraged, and become either spenders or investors, depending on their temperament. Indeed it might be unclear which dynamic it is – those who bought a surprisingly large house 20 years ago might well have been motivated by the cachet of it, but they now boast about their excellent investment which has turned out well. So it is that the tenor of a society can be changed. According to Wicksell, this process has a momentum that cannot be checked, and if interest rates stay too low indefinitely, asset prices will rise to infinity. This *reductio* was intended to highlight the unreality of such a world. He described it as a fictitious futuristic concept; in a world where currencies were based on gold, it must have indeed seemed mythical.

If you wait long enough at a bus-stop for a sea-horse, no doubt eventually one turns up. Wicksell's myth is our reality. As I write this, the retail price index in the UK is 5.2% and Bank Rate is 0.5%. Can there be any credibility for the Bank of England's policy makers (whose mandate is to hold inflation at below 2%) in having such a low interest rate? Not only have they achieved it, but the lone soldier who recklessly believed they should be put up to ¾% was regarded as a man of radical bravery! He has now retired.

When turkeys vote for Christmas, it's worth looking for distortions. And you didn't have to look far – the fragility of the financial system. It was Warren Buffett who noted that when the tide goes out, you get to see who has been swimming in the nude (step forward the heroes of my first paragraph!). The light-touch regulators, the stress-testers who passed as fit any bank that could lift an eyelid, the subsidies, the AAA-rated no hopers, the traders who wish from the bottom of their hearts that their rogue trades had worked – all combine to make the world unsure of where stability is to be found. There is far too much debt in the world, debt which should in an ideal world be serviced and eventually repaid. We know in our hearts that much will not be repayable – this intuition will become horribly apparent quickly if the payments of interest are anything other than near-zero. (On a different note, here's a Victorian riddle: what's the difference between a model woman and a woman model? One is a bare possibility, the other a naked fact. Boom-boom!) Contrast the aftermath of the savings and loan banking crisis in 1992 America with today's.



Then the Chairman of the Federal Reserve lowered interest rates to 3%, and invited the war-weary banks with their shot-to-pieces balance sheets to borrow from the US government at this rate of interest, and re-invest it in three year US government debt at 4.5%. Even the stupid ones could see that 4.5% is more than 3%, and since the counterparty was the same, there was no third-party risk. It worked, and the current Fed Chairman, Ben Bernanke is trying hard to do the same today. Interest rates are effectively free, but if you are outside the charmed circle, you may find yourself paying 0.25% (lousy European banks are currently finding they're having to pay 0.35%, they're so risky). If they invest in three year, US government paper, they get 0.38%. Even on ten year paper (which is far from riskless: ten years is a long time) they only get 1.7%. The latest Federal Reserve lifeline is another distortion on a distortion – Operation Twist is designed to 'flatten the yield curve'. You have to be as clever as an economist to understand why this will help.

But one thing is clear. Interest rates are welded to a near-zero rate. The central banks simply cannot put interest rates up, almost whatever happens to inflation. It is a gaping hole above the waterline, which could sink the ship if rates are raised to combat inflation. It leaves us all defenceless.

There seems no violent inflationary storm about to break upon us. There are, however, plenty of places from which inflation could break loose. And if Wicksell is right (which he is), the fact that it's over the horizon is no reason to discount its inevitability. High inflation, low interest rates are a disaster for the saver (ie our client base) – and, in addition, in the UK we live in a world where nominal gains are taxed, notwithstanding that they are sometimes illusory if money loses value through inflation. Inflation-linked government bonds (of surviving nations) are designed for exactly this economic climate. It is not a high inflation rate which makes them thrive – it is the differential between inflation and interest rates. They have the capacity to become enormously valuable – like Titanic lifeboats – in a world where the ordinary saver despairs of keeping his nest egg safe. We have a great deal of your assets in them because we are approaching what I've described before as an airless valley which we have to pass through. Every investor suffers when interest rates are held below the rate of inflation; money on deposit guarantees a loss of capital in real terms, and it requires a risk-taking policy (along with many other people) even to hold steady in real terms year-on-year. This is unlike the 2008 credit crunch, where grief was optional – loud the bangs, and bright the flashes, but there were trenches to hide in.

Are we feeling relaxed about these big inflation-linked positions? Absolutely not. The key to an untroubled investment performance is to be diversified in investments – always coveting being not wrong, and leaving being right to others. This is a unique asset class, apart from gold, which makes a tempting mistress, but an unsatisfactory wife. The absolute key to ultimate safety, in our view, is the presence of these bonds. In the meantime, they are subject to the vagaries of an investment consensus which is quite unaware of anything other than the fact that they are already unprecedentedly expensive. They are indeed expensive, travelling in the same charabanc as their conventional fixed-interest government securities, which are in a bubble every bit as dangerous as the dot-com stocks used to be – more so, actually, because they are at the very centre of the financial system. We've done our best to lay off the specific risk to this asset-class, and time will tell if we're right or not.

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