INVESTMENT REVIEW

The art of oversimplification is an essential tool in conveying the essential narrative of world events. In the headline 'Up Yours, Delors', The Sun newspaper did not perhaps capture the nuance of detail in his views about European Federalism, but it did tell the reader all he needed to know. Wouldn't it be marvellous if, today, it were possible to find three words which capture the future of the euro, the ambivalent strength of the Chinese economy, the fate of Spain and Italy, and perhaps Britain's tally of medals in the coming Olympics?

This investment report, the fourth that I write as Chairman of Ruffer LLP, and the last as Chief Executive, is an attempt to give such an insight by reducing the narrative to its barest essentials.

The conclusion: a battle on the one hand between the forces of deleverage and uncertainty, which keep the risk of recession (or worse) one misstep away, and, on the other, the response of governments and central banks to combat this force with virtually nil interest rates, and massive injections of cash. If you look only at the recently revived patient, up and about, it is easy to believe that the outlook is rosy. If you look only at the oxygen mask still lying on the stretcher behind him, it is just as easy to see the centralised action as no more than the knobkerrie which flogs the dead horse. The volatility in the stock markets reflects this polarity. We have no insights as to the shocks ahead for the economy, or the pattern of growth forged out of the availability of easy and cheap credit. It makes us shy of trying to be too cleverly right. We can, however, claim victory in one significant skirmish – a correct identification that banking shares would have a powerful bull run. The announcement by Mario Draghi in early December that the ECB would provide unlimited lending at a three year term (long-term refinancing operation or 'LTRO') was a significant one. Coming after various ineffective or non-credible European policy initiatives in 2011, it was easy to put too small a weight on this policy initiative too. But it had the characteristic of Greenspan's initiative in 1999 to counteract the possibility of mayhem in the computer world at the turn of the millennium ('Y2K'). Designed as 'foam on the runway' in the event of severe dislocation, when there turned out to be none, the money formed the basis of the last months of the dot-com boom. So in 2011: LTRO was there to protect Greek default spiralling out of control – there was no death-spiral, and this time it was the banks which led the stock market up.

It has helped us get off to a good start in 2012, but the climax of the battle – government reflation, combating a deflationary economy – makes for uncertainty in investment strategies. The course of the battle is unclear – the timing of its resolution particularly so. Deflation, if the economic slump proves the stronger force? Inflation, if the reflation turns out to compromise the value of respective currencies? I have in the past likened money to a car driving along a cliff road with precipitous falls to left and right – the left being deflation, and the right hand side a descent into inflation. The credit crunch was a tyre blowing out on the car which lurches sickeningly towards the left. The driver is bound to respond by turning the wheel hard to the right. Too little, and over the deflationary cliff edge – too much and it's into an inflationary crisis: surely it's a 50:50 call?

Our insight is that it's not a 50:50 call at all – although both precipices beckon. The best way of explaining this is to tell – re-tell – a story which occurred at the end of the eighteenth century in the North East of England. The leading Banker, Jonathan Backhouse, proprietor of Backhouse's bank in Darlington, had a cordial hatred of the Duke of Cleveland, who lived at Raby Castle – an enmity which was warmly reciprocated. It was the days when conversations took the form of 'Fi, Sir' and 'Damme!', and one day the two of them got to arguing about which one was richer. The Duke owned a sizeable chunk of the county, and had the mineral rights to enough coal to keep a couple of navies going for a century. Mr Backhouse had only his bank – but he had brains too: he challenged the Duke to a competition where they would sit at a table in a public house and, in turn, tear up £5 notes. The first to stop would clearly be the poorer of the two. The Duke of Cleveland ignominiously proved the silver medallist in this pissing contest. He never realised that when he tore up a £5 note, he was £5 poorer (though he was immensely wealthy): every time Mr Backhouse tore up a £5 note of Backhouse's bank, he was tearing up a piece of paper, suffering only the inconvenience of having to print another one. The moral: in a straight fight between finity (however big) and infinity, the latter will always prevail.

This story goes to the essential core of today's battle. The economy, however much it shrinks, is a finite thing. The 2008 shock vaporised economic growth, and world GDP shrunk by an eye-watering percentage – but it was still a finite amount. The governments' response of quantitative easing, LTRO, TARP, Japanese hula-hula, is essentially infinite. No resources are commandeered – they are electronic entries on bureaucrats' spreadsheets. It is true that governments are somewhat schizophrenic in their response to the conflicting forces at work. There is a visceral feeling in the political arena that austerity is necessary – both to keep the AAA government ratings, and as a punishment for past excesses. This deeply deflationary sentiment is not to be underestimated – but politics (after elections), is a very different matter to government. The key is not to look at the deflationary forces, many and powerful though they are, but that the central authorities have the will to combat it. We believe that any weakness in economic activity, or threatened default will be met with an infinity of firepower, albeit fired in finite quantities. The United States, with their reserve currency resting on paper, have been doing it for a decade, and most developed countries have a political backcloth which makes such interventions easy to implement; although the European authorities took time to understand how to undermine the contractual cross-commitment to their fellow members.

If this analysis is correct, we can await the melancholy accident off the right-hand cliff of inflation. It is one thing to know what will happen ('we're all doomed'); it is quite another to have any sense of when it will happen. For one thing there is not nearly enough historical evidence to know when one can say that a currency compromise is beginning, well under way or out of control. Even if one could, the value of a paper currency is a matter of confidence, not of objective evaluation. If many are afraid of deflation, the loss of confidence through inflation will take correspondingly longer: interestingly, the obverse of this can be seen in 2008, when the commodity inflation (oil at $147!) of the spring of that year, a belated reflection of the 2006/2007 boom, masked the galloping deflation which was engulfing the world.

The moral of this is that we view the 'timing' element in the investment mix in an almost diametrically opposite way to the consensus view, that market timing is everything. To our way of thinking it would be the key to investment if it could be done (Caruso said that *il Trovatore* was an easy opera to perform provided you had the four best singers in the world). But like most performances of *il Trovatore*, it is not possible – so the moral is to make timing as irrelevant as one possibly can. Our inflation-linked bonds did enormously well last year, but many other things didn't. We sold some US index-linkers at a high price, but have suffered the (not very great) falls in value of the remainder – it has, however, coincided with a good time in other holdings. The ice-breaker edges forward, the dogs bark, and the caravan moves on . . . to a new Chief Executive!

Jonathan Ruffer
March 2012