INVESTMENT REVIEW

An embarrassing dog puddle has appeared on the carpet of Ruffer performance – and, as Warren Buffet once said, 'it doesn't help to observe that it was only a medium-sized dog which did it'. We haven't lost money for clients (or only a little), but in 2012 we haven't really made any either, despite the indices being up (by some 4% this year in the UK and European markets, currency adjusted and the US market by rather more).

There is always a temptation to ignore these things, and hope that clients won't notice – excepting those that actually tread in it. I think it is a temptation worth resisting, but it is the future which concerns us, not the immediate past. There is a big tipping point ahead: a game changer, every bit as big as the 2008 credit crunch. We do not know when it is coming, although we do know (we think) what the nature of it will be.

Why are we so confident that we have identified it? The answer is that it is easy – just as easy as earlier ones were. Ask the right questions, and the answers are obvious.

Question	*Answer*
Would the bear market of the 1970s end?	Yes (1982)
Question	*Answer*
Would the TMT bubble end?	Yes (2000)
Question	*Answer*
Would fear replace greed in the helter-skelter of borrowing?	Yes (2008)

Today's question has more words in it but it is just as stark–

Question	*Answer*
Can the value of currencies survive the systematic injection of newly created money on its present scale?	No! (TBC)

A look back on the performance of Ruffer since we started in 1994 shows that there seems to be a regular cycle of three distinct phases which repeat over the years. The first phase, when a tipping point has become apparent, has always been good for Ruffer. The preparatory investment strategy has seen us through, and we have made good money when others have lost it. Hurrah, caps in air! The second is the recovery phase, one from which we have customarily benefitted, usually through a mixture of having kept both our powder and our nerve. The third phase has proved, in retrospect, often to have been a dog puddle. As the markets continue to make progress, we are discouraged both by market levels, and, more importantly, we get more concerned by the dangers ahead which appear increasingly menacing. The clever chaps, no doubt, will continue to ride the tiger and jump off it just as it enters the bus terminal. We always tend to part company three bus stops too soon: we don't aim to do this but that is what keeps happening. And so it seems this time. In 1999, our inability to make money in TMT was regarded as almost a miracle – an impossibility. In 2006/07, we called it our 'tractor on motorway' moment as we ploughed on with yen and Swiss francs awaiting their repayments by distressed borrowers; come the 'credit crunch', a decision vindicated. Now, we have no idea of when the crisis of paper money will come, as it depends on the collective human response: the certainty is that it will occur at some point.

We therefore hold investments on the basis of how they will perform in an environment quite different from today, and we have identified two dangers which need to be guarded against. The first and, arguably the most worrisome, is that the price of cash (no income on bank deposits) is distorted: you are robbed if you hold cash. That drives savers into investments which have cash-like qualities. The result is that the safer and surer an investment is, the more it will reflect (by overvaluation) the distortion of cash on deposit. When that distortion reverses, the capital value of these safe investments will decline as they re-price for the new normal. This actually happened in Britain in 1936: the 1937 Stock Exchange Yearbook eloquently shows the extreme overvaluation in the good, rather than the bad, investment opportunities. And such was the overvaluation that it was the one and only opportunity to invest in the UK stock market and not get your money back in real terms for 50 years. We need to be careful!

The other great risk that investors face at the moment is to assess what will happen when the stimulus of monetary liquidity grinds to a halt. Market forces will forbid governments from continuing this policy. The dynamic is clear. It is extraordinarily difficult for governments to retrench – the fine promises made by David Cameron two years ago have been resolutely pursued: but they have achieved barely 20% of their target, and further retrenchment looks difficult to achieve. The shrill statements from the Chairman of the Federal Reserve, Dr Bernanke, and the open-ended promise to reflate take the United States' financial system into Bulgarian territory.

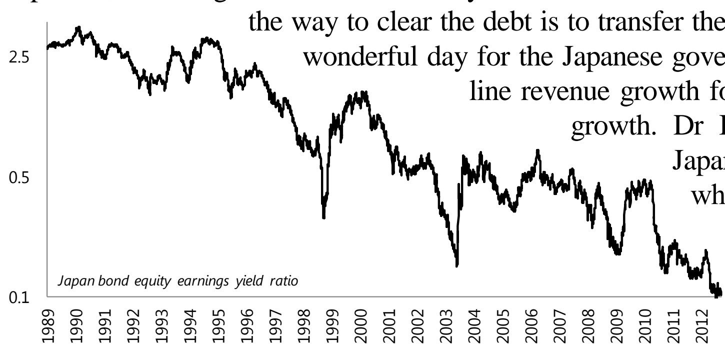
It feels as though Dr Bernanke has crossed a Rubicon in his attempts to reflate the economy, but there have been so many in the last five years, none of which have brought the curtain down on the world as we know it, that most commentators accept the open-handshake and wide-eyed honesty which accompanies the whispered message of 'trust me'. To be fair, Dr Bernanke announced 10 years ago what he had in mind, and it earned him the sobriquet 'helicopter Ben'–

> *'The US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost. By increasing the number of US dollars in circulation, or even by credibly threatening to do so, the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.'*

Now he's doing it. Previously he waited for a new bout of economic weakness and evidence of deflationary pressure: now he's moved when the economy is off the ropes, and lest anyone doubt this change of policy, he has manifested his intention that the Fed will target job growth – this means that the Fed would be indifferent as to how much of that growth was inflation. On the face of it, the Bank of England's mandate – to target 2% inflation, would preclude such a policy here. But last year, with inflation running at 5.2%, base rates were held at 0.5%. In the pirates' club Long John Silver meets Cap'n Hook.

The markets, the inflation rate, the experts and the populace remain quiescent – but sooner or later that will change – and suddenly. High inflation will follow – but not the hyper-inflation that the doomsters (who, as a group, are the guys who are looking in the right direction) hope for. These anxious commentators, who describe themselves as 'in despair' but are shot through with a never-ending hope of disaster, have gone for the *reductio ad absurdum*: if you cross the road in Bond Street, and keep going, you might end up falling off the White Cliffs of Dover! No! The point of inflation coupled with interest rates below that rate of inflation is to transfer wealth quickly and effectively from the saver to the battleground of the borrower. This has a social purpose: it is a transfer from an older generation to a younger one: it is the dynamic which was seen in the 1970s and 1980s, and reversed, to the advantage of the elderly, over the next 20 years. The pendulum, both investment and political, is swinging back.

Our job is to protect people in a world where protections are being comprehensively and deliberately removed. It is not enough to see it coming: we need also to have the wisdom to know what is likely to represent a safe haven – bearing in mind that safe havens are all entering this new and frightening overvalued phase, because the attack on savers has already started. That is probably the right way to look at the lack of yield on deposit. We are taking refuge in inflation-linked bonds and gold, of course: but we remain attracted by Japanese equities, which have, up until now, stood out like a bad deed on Armistice Day. Japan is one of the few countries which will be the outright beneficiary of inflation, since the perils of deflation have been an intermittent reality in that country. Although heavily indebted, the owners of the debt are exclusively Japanese, and the government bonds they own are conventional, and not inflation-linked. Remember the argument above: the way to clear the debt is to transfer the asset wealth from the saver to the borrower: this will be a wonderful day for the Japanese government – and for Japanese corporations, who will see top-line revenue growth for the first time coming through inflation as well as actual growth. Dr Bernanke would be proud of them. The argument that Japanese shares are cheap is true, but all investors know that what's cheap tends to get cheaper. Nevertheless, at a time of change, this is a real protection. And, boy, are they cheap! Look at the chart, which represents a single snapshot of how cheap or expensive Japanese shares are compared with their government bonds. Equities are expensive when the chart is high, and opposite when it is low. The chart starts with a ping at the top of the Japanese equity bubble. The bloop is… well, the bloop is now.



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Source: Thomson Datastream

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