In the 1920s, King George V summoned his wife over to see an impressionist picture: ‘Come here, Mary,’ he exclaimed, ‘this one’ll make you laugh!’ We live in a post post-modern world, and art is now as formless as the smile on a Cheshire cat. The financial world today has something of the same quality. Just as the ordinary man cannot tell the difference between the splosh of a five year old and the splash of a Frank Auerbach, so he can’t make head nor tail of what looks like the collective madness of the central authorities. Yet, just as there is order in the contemporary art market, so there is in the financial markets: the man who knows what he likes, and buys it, is in a dangerous position.

It is worth reminding ourselves of how alien today’s financial ‘certainties’ really are. Interest rates are at unprecedentedly low rates everywhere. Rates were never as low as they are today, even in a world where the scarcity of the metal ensured that there would never be a currency glut. Now interest rates are zero in money which can be created electronically – who would be at the expense of a printing press? Governments have taken advantage, of course, and debt ratios are at wartime levels – and yet none of them go bust, even the Nell Gwynnes of the borrowing world are dressed in white. Something very odd is going on.

The experts are reasonably relaxed. Provided this new issuance is not monetised, they aver, then it is not inflationary. Do they know what monetisation is? Well, they did when the use to which Governments put it was tentative, but now they direct it at anything which will create traction, the experts are not so sure. Certainly, a policy which began on bended knee to Nancy Pelosi in the House of Representatives in 2008 has extended in quantum and flexibility of use far beyond what was thought to be safe. Today the US Federal Reserve provides $85 billion per month for asset purchases – and (at last a predictable reaction to an economic phenomenon) the price of assets is going up.

It would be a mistake to imagine that any of the commentators or protagonists (including, alas, ourselves) have a clear idea as to what is going on. For one thing, it is far from obvious what effect egregious policy mistakes – if such they are – will have on the body politic. It is rather as if a doctor, confronted with a surgery of difficult patients, hands out the pills which happen to be in his dispensary, and since the patients have neither turned green nor died, has gained confidence and is now distributing them in larger quantities.

It should be a great relief to know that the economists were, almost to a man, wrong about the possibility of the credit crunch of 2008, failing to see that if a society continued to borrow, borrow, borrow, the result would be financial dislocation. It means that we can safely ignore them this time round, and turn back to first principles.

There is a very great inherent stability in the way that human beings interact and policy errors imposed by authorities on their long-suffering people can persist for long periods of time without crisis. How else to explain the failed experiment of communism, which broke down in the late 1980s, decades after its moral and economic bankruptcy was apparent to all? (Its demise, of course, came as a great surprise to the experts.)

This means that even if the coordinated issuance of currency is but another example of the mistake that it always has been in the past, there is no certainty or necessary presumption that it will be revealed as such in a short timeframe. The very fact that all major currency blocs are engaged in it, makes its early demise less likely. If a single country pursues such a reckless policy, the markets will be quick to punish it. The whole point of the euro was to ensure that the currency bloc was bigger than the markets, which would ensure freedom from the threat of attack; the euro bloc can therefore bully speculators into inaction. This was the revelation of 1992: Britain was forced to devalue by the attacks from George Soros and others, but when those same speculators turned their attention to France, Germany stood alongside her, and France prevailed. Everything that has followed in Europe has been based on that insight.

The creation of government debt has been effective in buying time. It is, however, no solution unless there is a major and sustained pick-up in world growth. Alas, there has been precious little growth in the western world since 2008 – hardly a surprise given the distortions and dislocations of the previous boom. The time which has been bought has therefore not yet provided a solution. Four years on, there is a ray of light on the growth front: the United States has a real possibility of modestly sustainable growth this year, and the Bank of Japan is providing an alternative to the Federal Reserve in producing the necessary liquidity. (This was written before Abe’s announcement on 4 April, which is breathtaking in its audacity of scale).

It is likely that at some point the inherent fragility of the system will break down, unless we achieve a spontaneous, prolonged and widespread economic recovery. While we wait for this, there are ground rules to observe.

The liquidity benefits asset prices, especially, as now, investors have got over their losses of five years ago, and their trepidation that the world is out of control.

The gains available to investors mask the fact that it is impossible to obtain a worthwhile yield on safe investments. The lack of yield on cash is a distortion which means that safety can no longer be found in conventionally defined 'safe assets' or 'safe havens', and cash itself is dangerous to hold in these inherently inflationary conditions. Without a refuge, and safety closed off to prudent investors, there seems little choice but to strive for capital gain – which has been broadly available. Thus we are all chivvied towards reckless behaviour at a time when the macro-economic climate cries out for carefulness in the management of assets.

This is the world which investors are faced with today, and which the rest of this review addresses.

We have stated again and again that the most likely outcome is global inflation, which, if accompanied by continuing low interest rates will provide the only possible escape route for debt-plagued economies. This is why we hold inflation-linked government bonds, in considerably greater size than gold, which was the place to be in similar circumstances in the 1970s. Gold itself acts as the safety net since the force playing on the world's economies is deflationary – the inflationary issuance of liquidity being a counterweight to it. If the deflation wins, then gold has what inflation-linked does not have – a protection against widespread government default. Thus the bonds protect against a semi-catastrophe; gold against its elder brother.

We have introduced a new element into the portfolios, which could play out well against a variety of backcloths. There is an assumption that interest rates will remain at rock bottom for the foreseeable future. Common sense suggests that this will not be the case (experts may disagree), and there are reasons why this could happen sooner rather than later. This development would not be good for equities, and protection seems desirable.

What are those reasons? One is the ever-present possibility of a loss of confidence in central bank action by holders of deposits: they already have to tolerate no interest, the possible default of the bank in which their money is deposited, and now, following Cyprus, the theft of the capital itself. Who is to say that this nest-egg will remain supine in the hen-house? We are seeing asset price inflation as money leaves deposits for investment; if it were spent instead, then inflation could lift quickly and central banks would have to raise interest rates to acknowledge the threat.

The opposite reason – a sunny outlook for the US economy could also lead to the same result. We have therefore used instruments which would take advantage of such a move in the US and Japan.

These protective assets allow us to have rather more money invested in equities than we might otherwise have; the obvious areas to avoid currently are the conventional 'gilt-edged' equity markets. For this reason we have been gently reducing our holdings of steady, high-yielding staples in the equity list, since they have enough royal blood to attract the attention of Madame la Guillotine.

The most striking part of the portfolio has been our big weighting in Japanese equities. These have done well for us, particularly as we had originally hedged the yen back into the base currency. Is there more to go? The cynics of Japan have recent history on their side but if Abe's three arrows of change are anything like analogous to the policies of Japanese Finance Minister Korekiyo Takahashi in 1931, then the optimists, like us, will have more rising sun to enjoy.

For the first time in a fair while, we are more confident that the portfolios have a balance which will protect us from the many and unsettlingly unknowable dangers to savings. The distortion in the price of money means that all conventionally safe investments are the wrong price, so if this does turn out to be the case, the balance will be an achievement.

I want to finish this review on a personal note. It is a year since I became Chairman of Ruffer LLP, and my intention was to split my time equally between Ruffer LLP and the project to revive Auckland Castle in County Durham. Notwithstanding a recent article by me in the Spectator magazine, where more to my surprise than anyone's, the editing made it seem as though I had left Ruffer, I am actually in London rather more than in Auckland; the Castle opens to the public six days a week from 1 May, the first time properly since the Civil War – see *www.aucklandcastle.org* if you want an insight into what I have been up to! Meanwhile the hard work continues for me and my colleagues at Ruffer LLP, protecting your wealth in this post post modern world.

Jonathan Ruffer
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