I have asked Henry Maxey to write this quarter's review. It is not that I'm growing cabbages in Spalato; (classicists will recognise this as a reference to Diocletian). It is because I think that he has identified the cross-currents which will control the direction of the markets over the coming year. It is summed up in the French expression 'reculer pour mieux sauter': three elements of deflation which preface an inflation. He sets them out clearly below, and it seemed better to hear its articulation direct from the Maxey's mouth.

Jonathan Ruffer

Three arrows of deflation

Central banks are printing money. Don't we know it. Robert Peston's been banging on about it for years. Nevertheless it is easy to forget the scale of these central bank actions, particularly now that Japan has joined the party. Between the US Federal Reserve and the Bank of Japan, the creation of electronic money amounts to about $1.7 trillion per year, the equivalent of Australia's annual GDP. So it might seem a little strange then that the one sure-fire protection for investors against this abuse of fiat currency, gold, hit the lowest level in 34 months last month, heading for the worst quarterly slump in at least nine decades and down circa 30% from its high. Inflation and market-implied inflation expectations too have been falling sharply, while yields on bonds have been rising. Even commodities and emerging markets, perceived safe havens from the debt problems and financial repression in the west, have fallen sharply.

For investors, this dashboard of global market indicators is pretty confusing. How do you reconcile one of the greatest central bank reflations in history with market action like that? My answer to the conundrum involves the interaction and unintended consequences of three independent players – Japan, the US and China.

The story begins in Japan. The political and monetary regime change which followed the Japanese election in December last year, is the single most important change for global financial markets since Mario Draghi's 'whatever it takes' speech in summer last year. It is significant not just for Japanese markets but also for global capital flows, ie the wiring together of the world's capital markets. Investors, however, have been slow to appreciate its significance.

The initial objective of Japanese policy was to weaken the yen. The Japanese were clever about it, spotting that in today's quantitative easing (QE) world, many macro investors and currency traders forecast currency movements according to their prospective view of the growth of the monetary base in one country relative to that in another. So, by pledging to double the monetary base (the narrowest definition of money, which increases when central banks enact quantitative easing) the Bank of Japan managed to engineer a massive, foreign investor driven currency depreciation under the guise of domestic monetary stimulus. However, by front loading the effect of future QE into weakening the currency, the first impact on the world was disinflationary because a weaker yen exports deflation from Japan to the rest of the world by making Japanese goods and services cheaper. This disinflationary impact was then exacerbated by the behaviour of Japanese domestic banks. After the central bank announced its QE plan in April, the commercial banks immediately started selling bonds aggressively causing a violent rise in yields and interest rate volatility. In reflationary terms, this was the equivalent of stepping on the clutch just as you rev the engine: a lot of noise but not much traction. Finally, the removal of the yen as the world's default 'hard currency' rotated the dollar into the position of the world's 'least soft' currency, supported by a narrative of prospective energy independence (the shale gas story) and economic recovery. A stronger dollar has the effect of sucking liquidity out of emerging markets most of which have explicit or implicit dollar ties. Declining liquidity in emerging markets has revealed their individual structural weaknesses while also reducing their demand for, and hence the price of, commodities.

Standing back then, we can see the perverse impact of Japan's entry into the global reflationary game. While a weak yen helps a Japanese domestic reflation, the initial global effect of its money printing has been disinflationary. It has also changed the nature of global capital flows. Emerging markets have been the biggest losers and the US and Japan the biggest winners of this change.

This takes us to the US where Ben Bernanke has a policy challenge. He and the Federal Reserve are haunted by two financial stability demons, 1994 and 2004, and *the* economic stability devil, 1937. In 1994, the US Federal Reserve raised interest rates aggressively and unexpectedly, ie they introduced rate rises and rate volatility simultaneously, and brought upon themselves a bond market blow-up. Between 2004 and 2006 they raised rates in line with market expectations 17 times by 0.25%, ie they raised rates predictably and without volatility, resulting in moral hazard, excessive risk taking and eventually in 2008 a credit crisis. In 1937 they tightened monetary policy too soon, killing the post-depression recovery in its tracks. So Bernanke wants to avoid financial instability, ie asset price bubbles, without tightening policy so much that he kills the nascent US economic recovery.

His attempt at an answer to this puzzle is, I believe, what is now known as the tapering debate; this is the discussion about when and how the Fed will end quantitative easing. By introducing the concept of tapering to the market, Bernanke hoped to introduce volatility to interest rate markets but without significant impact on the level of interest rates themselves. Like the dodgy rock band which doesn't understand the sensitivity and feedback loops of its sound system, Bernanke tapped the microphone and the amplifiers blew up. Long term real rates rose by 1%. The first live gig didn't go so well.

Why were bond markets so sensitive? First, because market participants didn't expect tapering to happen so soon and hadn't yet disassociated it from rate rises. Secondly, the intermediation capacity of the financial sector has been significantly reduced. Because of balance sheet concerns and regulatory pressure, banks are less able to take on big inventory positions to buffer flows even when prices look attractive. At the same time, the size of global fixed income markets has grown from circa $40 trillion to $100 trillion over the last ten years. This means that fixed income flows and pricing increasingly resemble a boat with water in the hull, a slight tilt and there is very little to stop the vessel lurching from one side to the other. The final factor is an interest rate hedging dynamic in which the need to hedge interest rate risk by selling bonds increases as interest rates rise. In other words, selling begets selling. The net effect is an extreme over-amplification of marginal changes in US monetary policy just as the disinflationary impact of Japanese policy is at its zenith.

And then the cherry on the bottom of this upside down cake: China's attempt to rein in its out of control credit system by letting interbank interest rates rise sharply. Politically motivated and slightly alarming – it is part of what has been called a 'rectification campaign' – this is not a decision made with any care for its immediate impact on the wider global economy. It is a domestically focused decision by a new Chinese regime which is looking to bring power from the provinces back to Beijing as part of a ten year plan. At best, it is a disinflationary force because it will slow Chinese economic growth; at worst it could precipitate China's long feared financial crisis.

What does this all add up to? A three-way disinflationary impulse in an otherwise powerfully reflationary world. Of course, the disruption caused by this impulse has been brutal and could result in something significant breaking, eg the collapse of a financial institution, an emerging market blow-up, or a sovereign crisis. If it doesn't, and Japanese capital starts to flow out of Japan, then I would expect global reflationary forces to begin reasserting themselves over the coming months.

Henry Maxey
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