In my last investment review, I made disparaging remarks about central bankers, likening them to Babylonian necromancers, an affectionate testimony to the authority of their pronouncements.

It would be a mistake to assume that if they are wrong, they are unimportant – that phenomenon is true of fund managers, but it's not true of those who have power to change the landscape through their actions. No use despising hanging Judge Jeffreys for his incomplete grasp of the maxim, *res ipsa loquitur*[*]: it may give you something ironic to think about on the way to the scaffold, but he will have the last word. We need to be aware of both what they are likely to do – that can be deduced from the presumptions they make – and what the consequences of those actions are likely to be if they act on those presumptions. Maynard Keynes said that investment was like a beauty parade where you needed to choose not the girl you thought was prettiest, but the one whom the majority of other investors would favour. Today, it's the central banks that get to make that judgement, and tiptoeing into their minds is no bed of tulips.

Central bankers have been shaped by the credit crunch crisis of 2008. The policies adopted from March 2009 onwards have stabilised the situation, an unexpected and pleasant surprise as much to themselves as to others, but they have done no more than that: economies all over the world face deeply deflationary headwinds. The Federal Reserve has come to be aware, too, that the steps they have taken in quantitative easing have had more effect in driving asset prices higher than stimulating the economy, and can also see that of all the factors which are acting favourably in the economic fundamentals, the buoyancy of asset prices is the single most important factor.

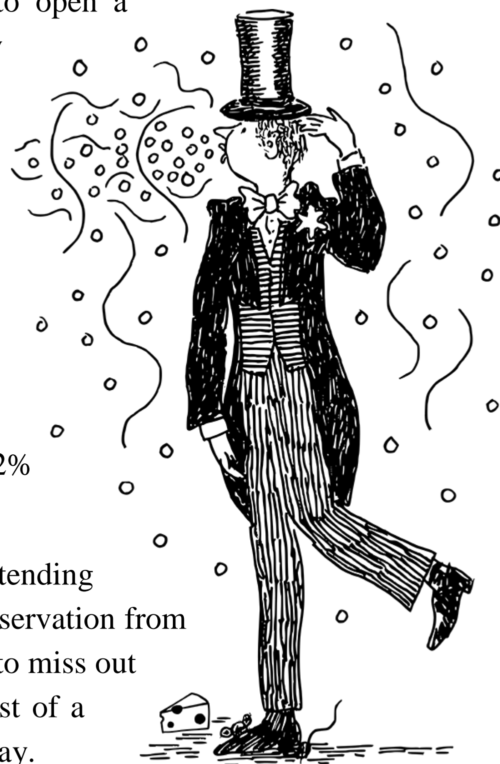
They worry that this rise in asset prices is both a good thing (a primary stimulant to an anaemic economy) and a bad thing (a catalyst for a new 'bubble' in asset prices: bubbles burst, and the burst is always both dislocative and deflationary). Alan Greenspan famously didn't choose to burst the housing bubble, and he speaks for the consensus of central bankers when he says that only a very few call a bubble-condition correctly; their timing is too haphazard to count. Having listed[†] the overwhelming numbers of clever-clogs who failed to spot what was going on in September 2008, he continued, 'What I'm trying to get at here is that implied in a lot of the stuff *[he really does talk like this]* that's being written now is that there were people who got it right. And the answer is yes, that is factually accurate. But you would not have made money off their predictions in the past. I know these people.' *(Editor's note: no-one in Ruffer LLP has ever met Alan Greenspan.)*

Now all this would be good knockabout schoolboy stuff, except that the Fed experiments are carried out with live ammunition, and the fallout from this can be more significant than the 'fundamentals'. Indeed the Fed's activities with the live weaponry, haphazard as it may be, **is** the fundamental. That is why investors need to know how the Fed is thinking. An interesting piece from David Zervos at Jefferies LLC puts the possibilities well, and quotes Larry Summers (big cheese player: runner up to replacing Ben Bernanke as Chairman of the Fed). Mr Zervos posits 'that there are three possibilities for central bank response'.

The first is the 'traditional' response, and speaks with a heavy German accent. Sound money and price stability is the key – it sank America in the 1930s, and is doing the same in Europe today. To be traditional is to be a depressive.

The second is the 'non-traditional' response – interest rates down to nothing, and then a variety of monetarily expensive initiatives to get the economy going, and to encourage a bit of inflation. The announcement which Janet Yellen made on 19 March 2014 by instalments, was an expression of this 'second possibility'. Old hands at my investment reviews will know that next to the toothpaste tube and the alarm clock at home sits the Stock Exchange Yearbook for 1937 which is the prize exhibit in setting out what happens to asset prices in a non-traditional response world. (They go up, and then they go down.) If Mr Greenspan is right, 95% of investors miss the phenomenon, and 5% are wrong by 14 years. Asked in 2010 about those who warned that housing prices would crash, he responded[‡], 'Right. For example, Shiller was saying that since 1996'. Someone once said that the trouble with bubbles is they make a fool of everyone – either now, or later.

Perhaps the most interesting part of David Zervos' article is that Larry Summers articulates a third policy – one which we as a house fear (a terrible outcome) and yearn for (we're invested for it). In this response, the Fed not only involves monetary policy (quantitative easing and other balance sheet manoeuvres), but fiscal policy as well. Fiscal policy acts directly whereas monetary policy does not. Money in the consumer's pocket is more powerful than consumers 'feeling' richer from the increase in their portfolios – only a minority of consumers have assets anyway, and the enormously rich, who are the prime beneficiaries of monetary expansion, are inclined to sit on their hands when it comes to stimulating economic growth. Monetary policy gets the tiger of inflation to open a sleepy eye; the fiscal policy puts the tiger in your tank (how many of us are old enough to remember this old Esso Petroleum advert? ...happy days!)



It is interesting that he expresses this response in the language of the economist, Knut Wicksell, who sees interest rates as having a 'natural' level – where borrowers and lenders meet. Mr Summers thinks that the right level is minus 2% – that is to say, savers need to be taxed in real terms to achieve equilibrium. He means, of course minus 2% in real terms, but it is striking to imagine what that means for index-linked stocks – on a minus 2% yield, the long bond would be trading at triple the current price.

What are we doing? Of the two types of foolishness, we favour tending towards being foolish now, rather than later. I was struck at the observation from a beady and seasoned investor (as we describe all our clients) that to miss out on a bubble was an unacceptable opportunity cost. Well it's a cost of a sort, but the mouse that went cheeseless was the mouse that got away.

Jonathan Ruffer
April 2014

[*] *'The thing speaks for itself'*
[†] *In an interview with Justin Fox, Harvard Business Review, January 2014*
[‡] *New York Times, 15 October 2013, quoted ibid*

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