When I was a lad there was a great book about sex called *Men are from Mars, Women are from Venus* which explained why it was all a lot more difficult than it looked. I have always hoped that someone would write a similar book about the financial world, and I have just read one* which gets quite close to the heart of it. Its author uses the Queen's credit-crunch question to the luminaries of the London School of Economics as the pivot: 'Why did nobody see it coming?' Felix Martin, the author, comes up with an interesting answer: the economists, theoreticians at heart, had a framework for understanding the financial world which didn't include money; the bankers and their regulators, practical men all, had a view of money which didn't include macro-economic reality.

Money can take many forms. It has to have two characteristics to play its role: it must represent value, so that things which are not themselves money – goods and services – can change hands. There must also be a wide consensus as to what is effective in transferring value. This is not always a constant – there was not much point in waving a Bank of Scotland banknote at a London taxi driver during the credit crunch.

This makes a key question today difficult to answer: is there too much of it, or too little; if there is too much, then it competes for the limited range of assets which can be acquired: in simple language, inflation. If there's too little, the few buyers can force the terms of trade down when there are many sellers – and that's deflation. There are two schools of thought on this. Some look at the mountain of debt, its fragility, and how it constrains economic growth. They are the deflation men. Others see the increase in asset values since 2009: around twice the size of the US economy – $26.7 trillion. A fair amount of those debts which existed during the credit-crunch have come back from the dead. Both sides can agree on the size of the balance sheet – it's a variation on the 'glass half-empty' attitude: one side of the balance sheet spells deflation, the other spells inflation: both together spell monetary instability.

The rise in asset values, the size of balance sheets, and the sense of lost direction are all symptoms of distortions introduced by the authorities – banks and governments alike – after the credit crunch. The policy of quantitative easing in the United States was a matter of 'desperate times call for desperate measures'. The lowering of interest rates to zero is another major distortion in the free market-place, favouring borrowers over savers. The Fed was gratified that these two initiatives stabilised a market approaching meltdown, and was mystified that these policies have retained their credibility in the cold light of everyday business. Recently, the Fed have come to believe that 'QE' is played out as a policy weapon – it will be interesting to see how important a development this is.

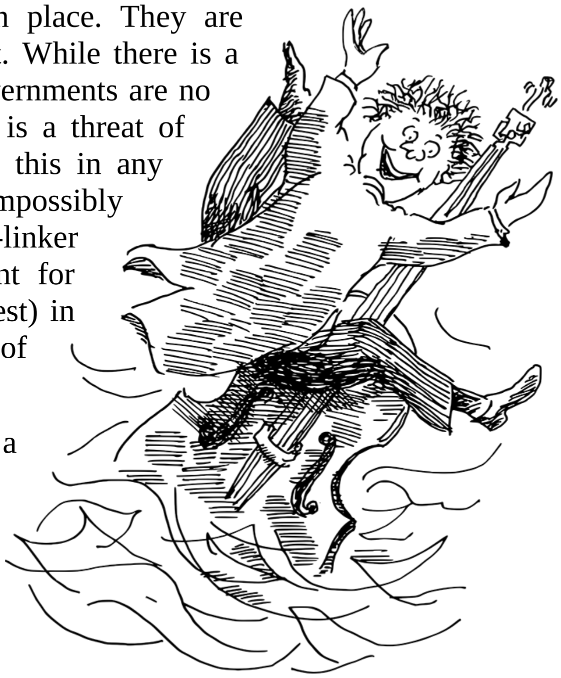
Investors now have to consider the world in a novel way. They have to ask the same questions that they always have – is there a period of prosperity ahead or the opposite? Will (in this case) China grow up or blow up? Will the political troubles in (this time round) Ukraine and Iraq have wider consequences in the markets? Interesting questions all. But what none of us know is whether these questions are dwarfed by the twin distortions of society's rising debts (whether government, corporate or domestic) and the fact that interest rates are far below their natural rate. Conventional wisdom ignores these two distortions or, rather, treats them as though they were part of the normal fabric of economic life. We forget, perhaps we never realised, that much of what has occurred over the past five years is a great surprise.

In this, conventional wisdom is wrong – of that we are sure – but it does not thereby make our view right. We regard outstanding levels of debt as unsustainable. It is worth reminding ourselves as to how high they are. The Swedish Central Bank has recently conducted a debt survey which is comprehensive covering four million individuals, which is more than half the adult population of Sweden. Its deputy governor Cecilia Skingsley paints a picture as bleak as an undertaker's ball. We choose Sweden because the figures there are definitive and there is nothing to suppose they are unrepresentative. In terms of government debt Niall Ferguson says that government indebtedness as a percentage of GDP in America has only been as high as this once before, during World War II, and that was at a time when the private sector's balance sheet was improving sharply, through war wages, and nothing commensurate to spend the money on. We think that these levels of debt are bound – absolutely bound – to default. This certainty is not the same as the belief that it has to happen soon.

In bringing about the distortions, the central authorities have bought time, but the time has not proved to be valuable. Debt levels have plateaued, but not gone down, wage earners have suffered, and those relying on unearned income have been heavily hit. The only group which has prospered in this environment are the small percentage of people who are sufficiently rich not to have to worry about such trivialities as income, and have seen asset prices rise in value. This is politically dangerous. The rise in these values is widely understood to be about the only fundamental which supports the 'animal spirits' essential to fuel a recovering economy, and if people equate this phenomenon with smugness (in the minds of the majority), hubris is never far away. It is a fair assumption that the continuation of this transition period will be marked by a widening of these distortions – rising asset prices, rather than sustained economic growth fuelling widespread economic wellbeing.

Distortions always resolve, and an investor needs to know in what manner it will be resolved. Monetary instability always resolves itself in a new calibration in the relative values of money and assets. If we have defaults, it's less money in circulation, and that's deflation. If currencies are no longer trusted (think of the taxi driver), then you need to give more of it to buy the same journey – and that's inflation. Why are we so insistent that it's inflation which will prevail?

Governments have put their credibility on the line – and that credibility will fall off the perch if confidence in the sustainability of the *status quo* is lost. This is what we mean by default. Confidence will not be lost in all of them simultaneously, just as a loss of confidence in banks in 2008 was a rolling programme. Each one, each time, will see a fall in currency and that leads to a rise in domestic prices. The inhabitants of Argentina don't need to be told this – they have seen it too many relentless times. As in all defaults there will be victims, but they will not be random. The grief will fall heavily on the savers, whose distress takes largely the form of diminution of their spending power, and this poses less systemic risk than borrowers in trouble. If this analysis is correct, regardless of the timing of it, then the absolute centrality of inflation linked government bonds remains in place. They are moving in lock-step with conventional bonds at the moment. While there is a chance that they might be compromised by concerns that governments are no longer sound, the threat only becomes a worry when there is a threat of absolute sovereign default: we do not have to worry about this in any realistic timeframe. There is no denying that they are impossibly expensive on any undistorted view; the deal with the UK long-linker today is that you can lend your money to the government for 54 years and not quite get your money back (including interest) in real terms. But they will do mightily well when the perception of inflation first appears on the scene, and that is still ahead of us.



The easiest way of making money is, in general terms, to spot a rising market, and to continue to hold one's nerve and one's investment. We remain alive to these two very different immediate futures – onwards, and uncertainly upwards, or the appearance of instability consequent on these distortions. It allows us to be agnostic to whether the band plays on, or the ocean sweeps the double bass towards Newfoundland.

Jonathan Ruffer
July 2014

* *Money: The Unauthorised Biography by Felix Martin (Bodley Head, ISBN: 9781847922335)*

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