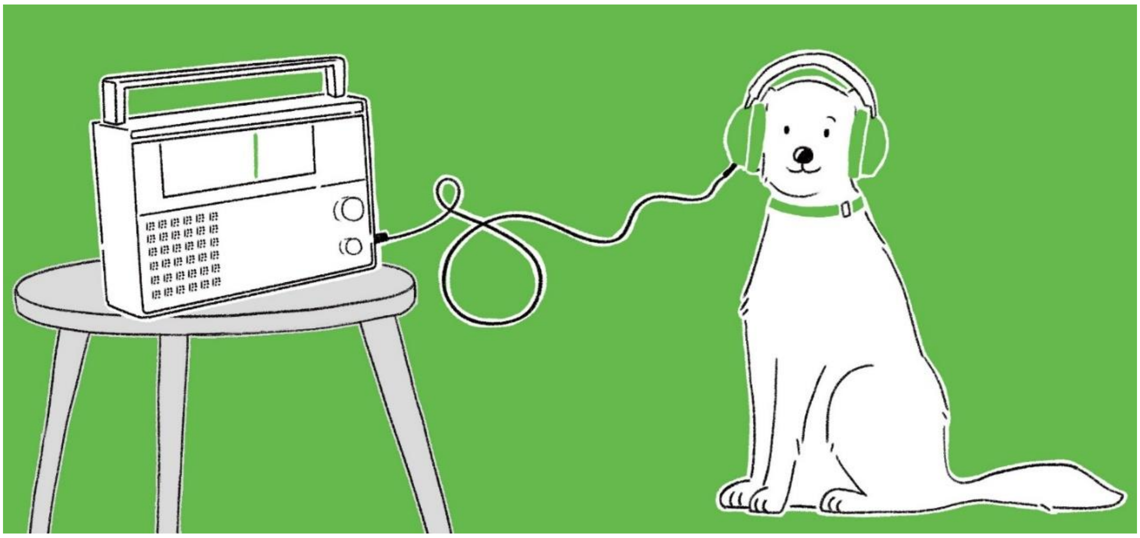
Ruffer Radio

Episode 17 – Something always breaks



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Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. When central banks began hiking interest rates, their objective was simple: quell inflation and restore price stability. And in so doing, try not to break anything: either the economy or financial markets. But hiking cycles throughout the ages share a common trait: something always breaks, and so it ever was. Today, I'm joined by Investment Director, Jos North, to review the trials and tribulations of the first quarter of 2023, to look at what has broken and what might be still to break, and importantly, how the Ruffer portfolio is navigating a new flavour of financial crisis. Has the investment universe fundamentally changed?

Jos North, Investment Director

Arguably, not. We've just had a bit of a delay to where we were and where we thought we were going. Heading into the quarter, you mentioned the central bank interest rate rises last year, we had about 450 basis points of interest rate rises in the US. So, heading into the quarter, we were looking out for that moment when those interest rate rises would start to impact the real economy. We thought, and in hindsight, the market thought that that would come quite quickly as we headed into 2023, and it's turned out to be not exactly the case. And this has been for a couple of reasons. The first one, China reopening at the back end of 2022. The Chinese economy reopened, abandoned the zero covid policy. And then, the second one was stimulus from the Bank of Japan. And what that's essentially done is it's pushed out that moment where something broke and we saw that in March. So, when you look at Q1 as a whole, we're actually pretty much back to where we were at the beginning of the first quarter. We're expecting to see the impact of the central bank interest rate rises start to play out quite soon.

Rory

Bizarrely, Jos, equities have done pretty well then across the course of the first quarter.

Jos

They have. Well, almost all the gains happened at the beginning of the first quarter.

Rory

Okay, so in January and February equities flew on the back of China reopening, Japan coming in with more stimulus, and then March was really when the moment of impact happened?

Jos

Exactly. What we saw is, if we take the high point for equity markets for the quarter, that was in early February, global equities in sterling were up around over 8%. They finished the quarter up just over 4% so that there's been a significant pullback through the latter half of February and into March.

Rory

Jos, the market dynamics that came into play then in March and are very much in play now, they are dynamics that are supportive of Ruffer's core investment thinking. These are things - particularly with respect to liquidity - that Ruffer have been speaking about and writing about certainly for a year, if not, a little bit longer. So why then, Jos, has the Ruffer portfolio maybe not held up as well as some people, some clients and investors might have expected?

Jos

So, I think if you step back, the majority of the quarter we've not had conditions consistent with our liquidation thesis, the thesis that we've written about and started positioning the portfolios for from the middle of last year. How so? Well, I mentioned those two events, China reopening and stimulus from the Japanese central bank. Essentially, they were net liquidity injections into financial markets. So, along with the economic impact of that China reopening, what you had was the People's Bank of China stimulate after two and a half years of 'zero covid' and the lockdown economy of China. The Chinese authorities have been pretty focused on making this a success, so, it's a whole of government effort. And so, you've had stimulus from China, stimulus from the Bank of Japan, and actually, conditions which have been the opposite of our liquidation thesis.

Rory

And on that, Jos, a difficult task but one I'm sure you're up to, could you define 'liquidation thesis?' Or what is the core of the liquidation thesis in two or three sentences?

Jos

Very simply, it is liquidity being drained from financial markets. So, it's excess cash, excess money in financial markets, finding a home thereby boosting asset prices. Very simply, it's that process being withdrawn either by raising the cost of money, so higher interest rates, or asset sales from central banks. So, in the US, it's quantitative tightening so unwinding the asset purchases in the post-pandemic era through direct sales of those asset prices. This is all reducing liquidity in financial markets.

Rory

And that's the big concern, and that's what you think, Jos, could be monumentally painful for investors. But I just want to stick with Ruffer's performance for the first quarter, what was it that hurt performance over the course of January and February?

Jos

So, we have in the portfolio an allocation to protective strategies. They take the form of derivatives, so protection on equity indices as well as protection from higher corporate borrowing costs. These protective assets have a cost, and in a quarter where equity markets on aggregate were positive but particularly in those first two months of the year, that cost of protection is a large reason why the portfolio is slightly underwater for the quarter.

Rory

And in March, they presumably started moving in the other direction?

Jos

Exactly. So, the performance for the strategy in March particularly around some of the stresses to do with Silicon Valley Bank and then Credit Suisse, the performance for the portfolio in March was doing exactly what we would hope it to do.

Rory

Jos, it took more than five minutes for us to mention Silicon Valley Bank, but let's hone in then on the US banking sector. So, with interest rates north of 4%, why aren't more investors fleeing asset markets? Why hasn't the liquidation thesis, maybe been or played out more quickly than some people are expecting. At a 4% risk-free rate - you can even get 5% with some banks - why aren't all investors moving to this safe yield?

Jos

There's certainly some form of inertia there where it takes time for the impact of these higher rates to filter out through the system, and that's been one of the unusual things of this tightening cycle. It's happened incredibly quickly. If you go back a year, interest rates had only just got off the floor, and here we are today and the base rate in the US is 5%, so it's happened incredibly quickly. So, you would expect there to be a bit of time before these higher interest rates to feed through. Now, when you look at asset markets and that question of why aren't investors taking money out of asset markets, well, one of the phenomena that we've seen is that you haven't been able to get that into that same interest rate on deposit. We're talking about around central bank's raising interest rates to levels of four or five. Well, the ordinary investor if they were to pull money from their equity portfolio or their fixed income portfolio, would not be able to achieve that interest rate on cash. And so, that's one of the reasons. Now, you can observe this in prior tightening cycles. Banks are very slow to raise interest rates. Ultimately, they want to get the benefit of the repricing of their loans before they reprice their deposits, essentially, to protect their margin. They benefit from higher interest rates on loans and then the lower interest rates on deposits that they pay out to their depositors. But this does create a tension and it's one of the reasons for some of the issues in the banking system over the past month. Essentially, what we're now seeing is that moment where depositors wake up to the higher interest rates available and pulling money from the banking system and depositing it in money market funds.

Rory

Jos, I'm going to move from one sort of commercial and investment banking realm to another realm of banking, the realm of central bankers. Central bankers are the only game in town. And over the course of the last six months, we've been waxing lyrical about how they have a fundamentally important decision to make. That decision now looks extremely difficult. It looks very difficult for central bankers to get this right. What's your view on what that choice is that they face, and how likely are they to succeed in their objectives?

Jos

So, the choice is between monetary stability, read inflation, versus financial stability, financial markets. Because what's become plain in the last month is that the interest rate required to slow inflation and to slow the economy is much higher than the interest rate with which financial markets can take. So, you have this tension now where central banks are going to have to prioritise one over the other. And we kind of saw this earlier on in the quarter. Essentially, coming into the year, yeah, central banks are keen to avoid repeating the something-always-breaks cycle. So, they had telegraphed a slowdown in-- when I say central banks, what I'm referring to here is the Federal Reserve, but other global central banks will follow-- they had telegraphed to slow down in the pace of their interest rate rises from 75 basis points in October down to 50 basis points, down to 25 basis points. And the expectation was that they would like to pause to acknowledge that monetary policy works in lags and that there had been this extraordinary tightening cycle over the course of 2022. However, the very process of telegraphing that slow down and then pause, and then those dynamics which we spoke about earlier in the conversation around China reopening and liquidity coming from the Bank of Japan, essentially supported growth and supported inflation. And then, we've seen inflation start to rise again from the low level of 10% in the UK, and 6% in the US And this is consistent with history. One of the lessons from the 1960s that you'll hear Jerome Powell talk about is not to ease policy too soon, but one of the lessons from that period is that you really have to ring inflation out of the system in order to avoid it coming back when the cycle turns again. So, we had that tiny pick up again in inflation, central banks telegraphed that they're going to raise interest rates again, and further, Jerome Powell, in front of Congress in early March, opened the door to an increase in the pace of those interest rate rises. And then, we had the break moment, then we had Silicon Valley Bank, then we had Signature Bank, then we had Credit Suisse. So, we are now at that moment where things are breaking, financial stability is at risk, and that's coming at a time when inflation is picking up again from those levels that I spoke about, ten and six. So, this is the choice, if they were just to focus on the financial stability part of their mandate, then they would be pausing here because banking stresses will inevitably lead to slower credit growth, slower economic growth, but it might come with a lag. If they were to look on the inflation side, there's no way they should be putting interest rate rises here. They should be hiking more and more aggressively. So, that's the tension, and which way they go will set the tone for the rest of the year.

Rory

The signalling of the Federal Reserve versus the action that they take is fascinating. It's sort of like there are three frogs on a log and one of the frogs decides to jump into the water, how many frogs are left on the log? Well, the answer is three because they haven't actually made the leap. They have signalled a leap; they've made that decision but they haven't actually done anything yet. So, the decision is yet to come. Now, maybe on a more optimistic note, Jos, because it's been rather dreary so far, not our conversation that's obviously been a thrill, but where in the Ruffer portfolio could positive returns be made, potentially even returns above that which you might get on cash?

Jos

A core part of the Ruffer portfolio remains inflation-linked bonds in the UK and in the US. And if you think about that dilemma central banks are facing, if they favour financial stability over monetary stability at a time when inflation is at high single digits, that's going to support these inflation-linked bonds because we likely start to see the repricing of inflation expectations. If one of the largest tightening cycles since 1980 hasn't been able to slow inflation and central banks are stopping that tightening cycle, you would expect a higher inflation expectations to become embedded, and that supports these inflation-linked bonds.

Rory

And you've got a decent allocation to commodities as well?

Jos

We do. That's the same theme played slightly differently. Commodities, it's one of the parts of the portfolio where we've added to this quarter. There's been a pullback in a whole range of commodities and we've taken advantage of what we think will be a long-term allocation after a decent repricing.

Rory

What are the big risks, Jos, facing the Ruffer portfolio, not only in this quarter but over the course of the next 12 months? Because if we look at the previous 12 months, it's been choppy financial markets, Ruffer's sort of been pretty steady and that's been great, but what are the big threats to capital that the portfolio is protecting against?

Jos

So, one of the big threats to the portfolio is in the assets which we think represent the part of the portfolio that is protecting from those big threats to capital, to investors' capital, and that's higher inflation through these inflation-linked bonds. Now, the very fact that we're protecting from that inflation risk with these instruments means that that's probably the part of the portfolio that's most vulnerable. So, what do I mean by that? If we were to see significantly higher real yields, that would impact the portfolio. But we think that the risk of higher real yields now is much lower especially after the events of March than it was at any point in the last 18 months.

Rory

It's something, Jos, that our CIO, Henry Maxey, has spoken about a lot. But the market makes it really uncomfortable to hold the assets during a crisis that you absolutely want to own on the other side, so it kind of feels like we're a bit in that stage now. Now, Jos, one of the hats that you wear at Ruffer is to look after the UK institutional business, how have your clients and your investors fared over the course of the last year? What lessons are you seeing? And how are you responding from a manager's point of view?

Jos

So, one of the core components to any UK institutional business in the past decades has been corporate defined-benefit schemes, corporate defined-benefit pension schemes. And we had a significant investor base of these DB schemes.

Rory

'Had' past tense?

Jos

'Had' past tense. And Jonathan actually references this in his investment review. Clearly, DB schemes were the epicentre of the LDI issues last September, October. And essentially, many of our DB schemes are now in a position, despite the LDI issues, to essentially reach buyout. So, issues from LDI, but actually these schemes are in a much better position so there's less need for Ruffer going forward.

Rory

That's interesting. And really in their time of need in the maelstrom of the LDI crisis, Ruffer was able to return capital, and that was the key point at that point. It wasn't return on capital, it was return of capital. So, Ruffer did its job really then.

Jos

Yeah, and we think of this as the 2008 moment for Ruffer's institutional business. So, you remember that leading up to 2008, we were still a predominantly private client, individual investor firm. Our institutional business grew post 2008 on the back of that strong performance and the role that we could play in the portfolio, but these clients hadn't themselves experienced the real benefit of the Ruffer strategy. And for corporate defined-benefit pension schemes, that happened in 2022, where diversification failed and Ruffer was able to provide that, that capital preservation, diversification and liquidity. From a business perspective, clearly, we're still focusing on our UK institutional client base and we think there are some significant read across as to how we performed in 2022 at the strategy level and also the role that we can play for other segments of the UK institutional client base. And predominantly, that's defined-contribution pension schemes. So, those are the pension schemes, Rory, that you and I have, not those defined benefit pension schemes for the older generations, and also another area of our business which is local government pension schemes. So, for defined contribution, the focus in this segment for the past decade has been the growth phase of the life cycle because the investor who has defined contribution tend to be younger, they're growing, they're still taking more risk, but that's now switching towards pre-retirement, so that period in the run-up to retirement. And the asset allocation in this part of the life cycle has essentially been a sophisticated version of life cycling, so the older you get, the more de-risking you do and you go to fixed income to achieve that de-risking. Now, 2022 was that return of inflation risk and we all know what happened to fixed income markets and strategies that have de-risked through fixed income. Their performance was pretty shocking, to be honest. So, we think there's a real opportunity for Ruffer whether it's focused on capital preservation and diversification to play a role within defined contribution schemes at that part of the life cycle. And it's pretty similar for local governments as well, they've had an asset allocation that had diversification from equities but they've done so with bonds, credit, property, infrastructure, duration-linked assets. And again, in this more volatile and inflationary world, that diversification fails. So, we think there's another opportunity for Ruffer's part of that new forms of diversification that are going to be essential going forward.

Rory

Interesting. And then, Jos, just to bring it out bigger picture, how's the portfolio shaping up? What do you currently own that you definitely want to be owning? Is there anything in the portfolio at the moment that you're adding to, anything like that?

Jos

We think the portfolio is in pretty good shape for the world where we ultimately think we're ending up. The big question heading into this year, as we've discussed, was at what level of interest rates bond yields, real bond yields, would be required to slow the economy and start to impact financial markets? I think we've had that moment. For us, that de-risks that core element of the portfolio in those inflation-linked bonds. So, we think from here, they offer an asymmetric return profile. The upside could be significant and we're probably in the sort of zone of limited downside. Commodities will be important. And again, this is to pick up on the comment you made referencing Henry Maxey, our CIO, in the way that the market makes it as uncomfortable as possible to own and hold the assets that you need for the next cycle, and we think commodities will be another important element to it. Ultimately, we don't think equities are out of the woods yet. The market's behaving a little bit as if it was, hence, the positive quarter for equities. And we think that's significantly under-pricing the recession risk which we think we're heading into for the back end of the year. So, equity weight is low and likely to remain so with protection in place for falling equity markets return opportunities available by those inflation-linked bonds and commodities.

Rory

Something always breaks, Jos, but crucially, we have to be curiously indifferent to the timing of exactly when and that very much sounds like how the portfolio is shaped up. Jos, thanks so much for joining. And thank you for listening.