Taking back
control?

STAGE ONE, We say nothing is going to happen.

STAGE TWO, We say something may be going to happen but we should do nothing about it.

STAGE THREE, We say that maybe we should do something about it but there's nothing we can do.

STAGE FOUR, We say maybe there was something we could have done but it's…too late now."

A VICTORY FOR DEMOCRACY, YES PRIME MINISTER, 1986

DEMISE OF THE DEFLATION MACHINE

When Anthony Jay and Jonathan Lynn scripted their masterpiece, *Yes, Minister,* in the late 1970s, the world was on the cusp of radical change. The 'Deflation Machine' was being born. Deng Xiaoping, having outmanoeuvred Mao Zedong's preferred successor, began the process of reforming China's moribund economy. In the West, liberal, free-market ideals were gaining traction, ideals that underpinned the subsequent regime of rapid, disinflationary global growth.

JAMIE DANNHAUSER

Economist

But this regime – propelled by economically desirable, yet politically intolerable, hyper-financialised supply chains – contained the seeds of its own demise. Its inherent contradictions were as much economic – higher inequality within economies was needed to reduce inequality between them – as they were political: a multilateral liberal world order required political power to be drained from national governments and their respective electorates.

A global financial crisis and pandemic-induced economic heart attack later, this regime is in its dying days. No one knows exactly what will follow, but the broad outline of the prospective paradigm is becoming clear. At its core will be 'strategic rivalry' between the US and China, respectively the fading and rising hegemonic powers of the twenty-first century.[1] Domestically, politics will become less internationalist, tolerant and laissez-faire and more nationalist, parochial and interventionist. 'Who are we?' and 'what share of the pie will we get?' are the questions that will dominate political discourse during the phase ahead of us, just as maximising growth of the national pie took centre stage in the one we are just leaving.

Our destination is a regime hostile to stable, non-inflationary growth. Globally, inflation is likely to be higher and more volatile. Inflation risk, an absent adversary throughout the careers of most investors today, will need to be priced once again. If a lack of inflation risk is the defining characteristic of today's financial markets, its return will have profound consequences for prospective asset returns and cross-asset dynamics.

> "'Who are we?' and 'what share of the pie will we get?' are the questions that will dominate political discourse during the phase ahead of us."

1 Mearsheimer (2021), The Inevitable Rivalry: America, China and the Tragedy of Great Power Politics

INFLATION RISK – THE ABSENT ADVERSARY

Where we are heading was the focus of my article in last year's Ruffer Review. Its central premise was that the demise of the existing strong growth/low inflation regime started long before the pandemic. The events of the past two years are best viewed as accelerants of malign shifts in the global economy's structural underpinnings. The pandemic matters not because it changes where we might end up (or why) but because it provides clarity on when we might arrive.

But left unsaid was what the journey might look like. Constructing a portfolio solely with the destination in mind without an eye on the potholes in the road is foolhardy. Somewhat counter-intuitively, the journey is more uncertain than the destination. The core argument is, paradoxically, that the return of inflation risk might first lead us into a deflationary ditch – a painful outcome for any portfolio positioned solely for an inflationary future.

The logic is as follows: moderate inflation and depressed nominal risk-free interest rates are perceived as permanent features of the economic landscape and have become hardwired into investor behaviour.[2] Allocations to risky and illiquid assets have responded accordingly, driven higher by the combination of low volatility and non-existent returns on 'safe' assets. This shift in portfolio structure has accelerated dramatically as nominal risk-free interest rates have fallen to zero.[3]

If, or more likely when, central banks start to respond to persistent inflation by pushing short-term interest rates closer to historic norms, the reversal of these flows into illiquid corners of the market will occur in a non-linear and disruptive fashion. The withdrawal of policy stimulus is likely to include an end to large scale asset purchases (and later active balance sheet shrinkage), the closure of emergency liquidity facilities and explicit guidance about a higher (conditional) path for policy interest rates.

This will expose the illusory and ephemeral nature of liquidity in the post-2008 financial ecosystem, what our CIO Henry Maxey has dubbed its 'avalanche prone nature'. If it is right that flows, rather than fundamentals, anchor asset prices in our financial system sanitised by quantitative easing (QE), the drawdown in risky assets could be dramatic.

THE FINANCIAL MARKET TAIL WAGS THE REAL ECONOMY DOG

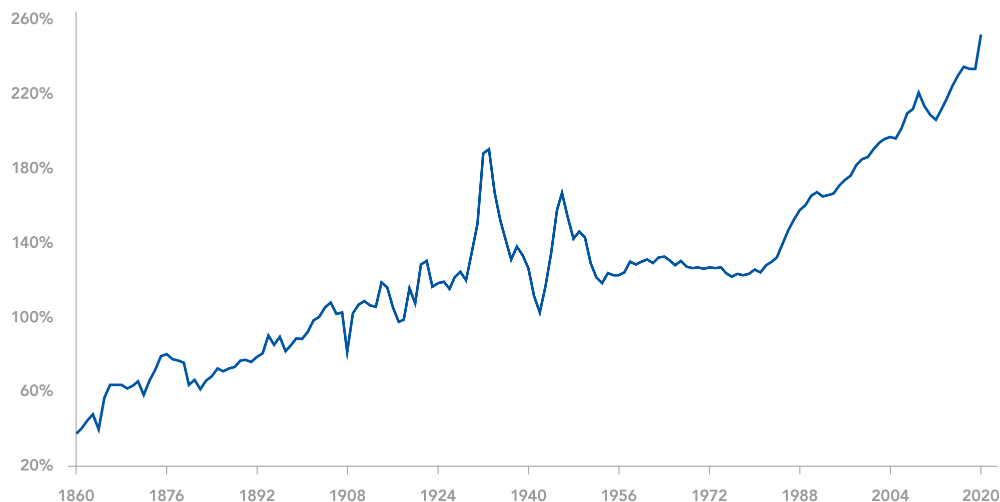
What the real economy needs today (higher interest rates) is something financial markets can't stomach. But if the financial ecosystem has become so intolerant of policy 'normalisation', isn't there a fundamental paradox, given the financialised and debt-laden nature of the economic system? (Figure 1)

The emergence of genuine inflationary dangers are anticipated to produce a policy response that, by triggering financial disruption, snuffs out the very thing that worried investors (and central bankers) in the first place. This would seem to confirm the belief that anchors today's financial markets – the belief that the global economic system is inherently disinflationary.[4]

This view is appealing and widely held, especially in the policymaking community. But it is likely to be wrong, for it ignores some crucial factors: politics and the social

2 Cole (2017), Volatility and the alchemy of risk, Artemis Capital
3 Lian & Ma (2018), Low interest rates and investor behaviour: a behavioural perspective, Federal Reserve Bank of Boston
4 Borio & Disyatat (2014), Low interest rates and secular stagnation: is debt a missing link?, VoxEU

Figure 1
US domestic non-financial sector debt, 1860-2020



Source: Federal Reserve Board, Census Bureau, Ruffer calculations

forces that shape the economic paradigm.

Financial conditions dance to the tune of central bankers. The more policymakers argue inflation will subside quickly and painlessly, the less likely it is to evolve that way. Why? Because perceptions of prospective inflationary dangers shape the message central bankers transmit into financial markets. If central bankers signal that they don't believe much policy tightening will be needed, financial conditions will respond accordingly by barely tightening at all. The growth impulse from loose credit standards will remain considerable, and flows into illiquid corners of the financial ecosystem will remain substantial. At the core of this dynamic sits the reaction function.

THE PARADOX OF DEBT-INDUCED INFLATION

When economists talk of the reaction function, they have in mind something mechanistic – a simple rule that links economic outcomes to policy decisions. Uncertainty is purely economic (eg how far unemployment is from its non-inflationary steady state level). Yet, neither central bankers nor fiscal policymakers operate in a political vacuum. The reaction function is as much a description of how policymakers react to economic conditions, as it is a window into the political and social forces that constrain their behaviour. The 'run it hot' strategy formally adopted by the US Federal Reserve (the Fed) in 2020 is as much a reaction to the post 2008 political aftershock as it is an exercise in intellectual housekeeping.

> “A global financial crisis and pandemic-induced economic heart attack later, this regime is in its dying days.”

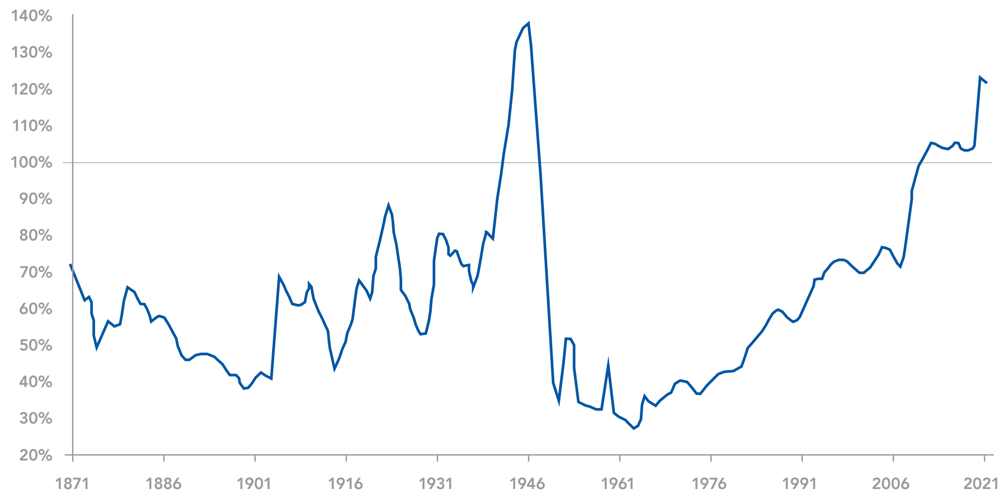
For many, the idea that we are entering a new regime of high inflation, given excessive private and public sector debts, is outlandish. Surely debt overhangs are deflationary.

We don’t think so. In fact, unsustainable debt burdens (in the sense of being unmanageable at historically normal levels of interest rates) are necessary for the coming regime change.

The long tail of vulnerable borrowers, including many governments (Figure 2), has fundamentally reshaped how policymakers react to economic shocks. Our debt-heavy, hyper-financialised economy can cope with neither another financial shock nor a material rise in (real) interest rates. Central bankers internalised this long ago. Our political system, meanwhile, is in no shape to accommodate more economic hardship on Main Street. A bout of (unexpected) inflation may now be the only politically acceptable route out of the rabbit hole down which two decades of loose monetary policy and credit excesses have taken us.

Figure 2

Advanced economies’ government debt to GDP ratio, %



Source: IMF (to 1970), OECD (1970-2000), IMF WEO (from 2001)

KNOWN DESTINATION, UNCERTAIN JOURNEY...

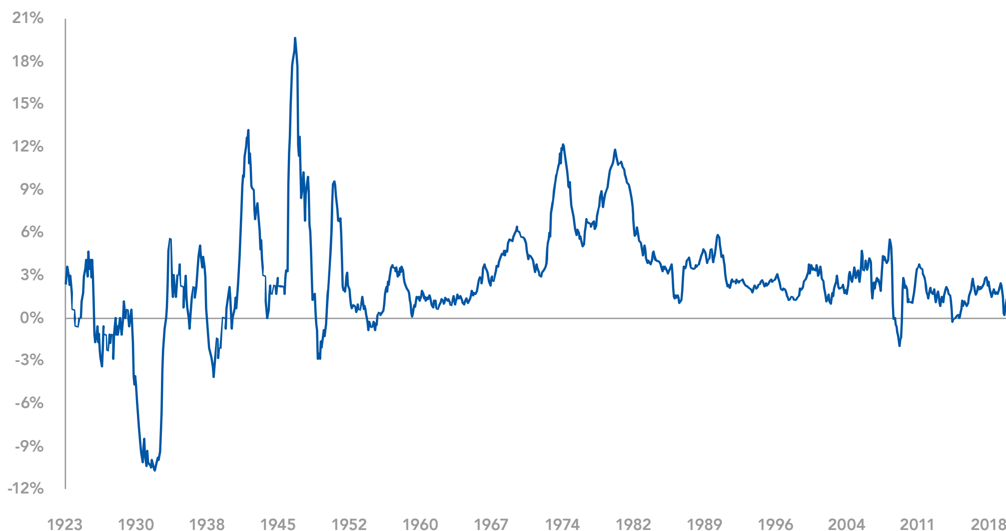
This is the view from 30,000 feet. But in the present, prospects for global growth remain decent. The US economy is strengthening, emerging economies are catching up with their vaccine rollouts and China's property-led slowdown probably reached its nadir at the end of 2021. So, for now, the threats to Main Street are contained.

We remain convinced that a phase of more persistent and malign inflationary pressures has begun, but the possible paths ahead remain unclear. One involves a direct route to our inflationary destination; the other meanders first, through financial disruption and (apparent) deflationary dangers. We have, therefore, built a portfolio robust to both 'left-tail' and 'right-tail' outcomes.

A market comprising richly priced assets – justified by structurally low risk-free discount rates – is fragile. In the next one or two years, it may unravel because either 'left tail' threats to earnings, liquidity-fuelled markets and the economy materialise; or 'right tail' dangers to the nominal risk-free discount rate become a reality.

One could imagine a scenario in which inflation does dissipate. Demand may be weakened by a rapidly fading fiscal impulse; or bottlenecks may resolve themselves more quickly than anticipated; or maybe a highly transmissible vaccine-resistant variant forces the global economy back into lockdown. We know how policy would evolve in these scenarios – and how portfolios ought to be constructed, but these outcomes appear unlikely. If inflation in advanced economies persists above the 2% parapet, possibly starting to rise again in the latter part of 2022 (after a mechanistic drop in the middle of the year) central banks will have to decide between two unpalatable courses of action. Do they stick with their

Figure 3
US headline CPI inflation rate, 12m % change



Source: US Bureau of Labor Statistics

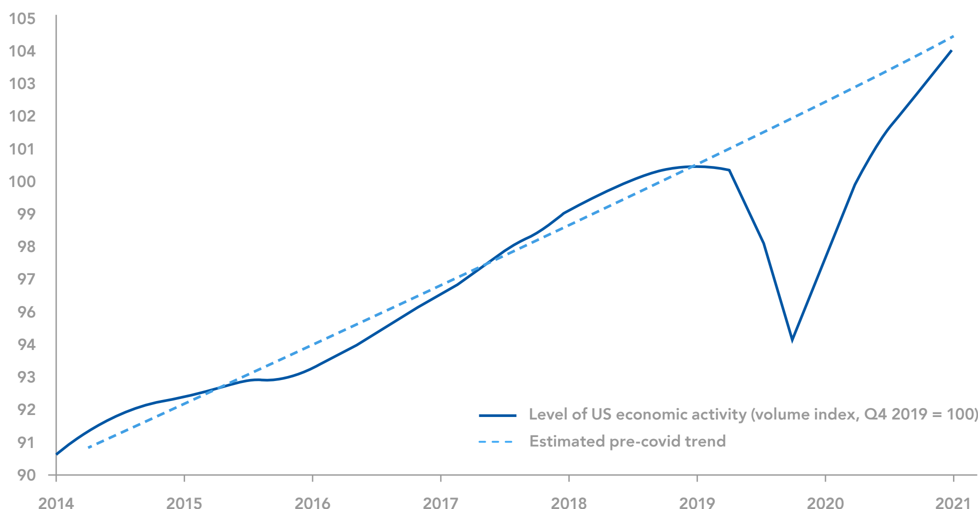
> "We remain convinced that a phase of more persistent and malign inflationary pressures has begun, but the possible paths ahead remain unclear."

run-it-hot strategy out of concern for financial stability and a broad and inclusive labour market recovery? Or do they revert to a more traditional policy approach, getting 'ahead of the curve', but running the risk of a policy-induced recession and the accompanying political fallout?

In the first of these scenarios, we could enter the high and volatile inflation regime in one fell swoop. Higher inflation would become ingrained in wage and price setting behaviour, fundamentally compromising the inflation-targeting regime. Initially, this scenario might provide succour to financial markets, buoyed by depressed real risk-free interest rates and strong (nominal) earnings growth. But conditions would eventually sour, as real resource constraints create a more 'stagflationary' feel of slower growth and stubborn inflation –in caricature, a more prolonged post-covid-19 bull market but at the expense of a more violent repricing, when inflation risk stares Mr Market in the face.

In the second, central bankers engineer a very different – higher and steeper – path for real risk-free interest rates. These moves might ensure a soft landing, with asset prices deflating just enough to restrain emergent inflationary momentum, without a recession. But history suggests such an outcome is highly improbable. Policy tightening cycles almost always end in recessions. Given how rapidly inflation accelerated in 2021, and how close to full employment some economies are (notably the US, Figure 4), this won't be a gentle tap on the brake. This might just reveal how avalanche-prone asset markets really are.

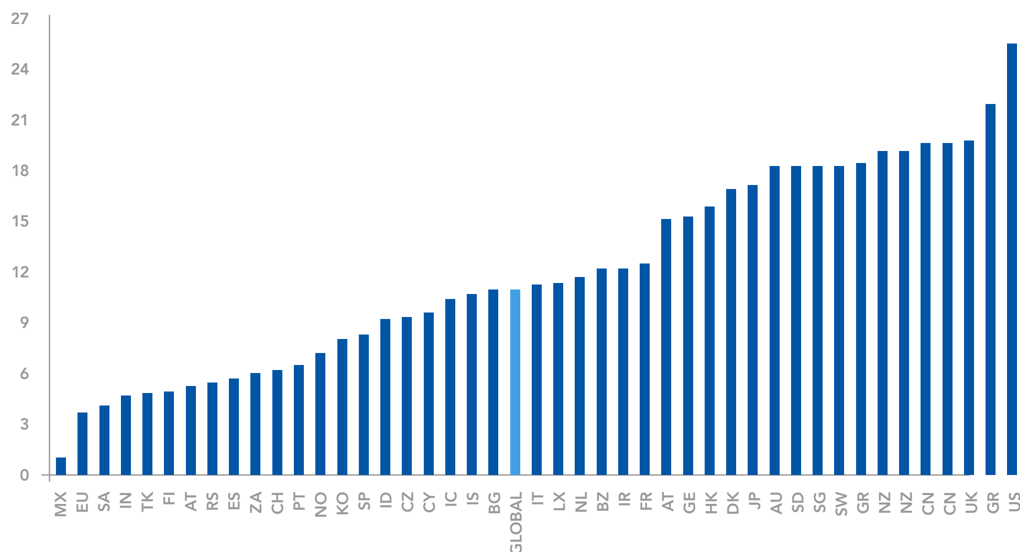
Figure 4
Aggregate US economic activity



Source: Philadelphia Fed GDPlus, Ruffer calcuations

Figure 5

Discretionary fiscal stimulus by country in 2020-2021, % of GDP



Source: IMF Fiscal Monitor Database, data as at 31 October 2021

TRAPPED DOWN THE MONETARY RABBIT HOLE?

It is tempting, but in our view wrong, to believe if we are diverted down the path of financial disruption by aggressive central bank tightening in 2022 and 2023, we will not arrive at our inflationary destination but instead at the 'secular stagnation' status quo ante. As the argument goes, deliberate policy action and the disappearance of pandemic-related bottlenecks will quash inflationary momentum, revealing the economic system's true technology-driven disinflationary tendencies.

Parking the question of how disinflationary information and communications technology (ICT) advances will be in the next few years – a less clear cut position than many think – there are then three reasons to be sceptical that the 'financial disruption' scenario really leads us to a different destination.

The first is nothing more than an observation of how far down the rabbit hole policymakers find themselves: despite a massive pandemic-induced spike in inflation and the fastest rebound out of recession in post war history, to date we have seen only a paltry reduction in policy stimulus, itself the most aggressive and wide-ranging stimulus programme in peacetime history (Figure 5).

Even under the pre-covid-19 run-it-hot strategy, when inflation risks were far less threatening, the Fed felt the need to shrink its balance sheet (by $20-40 billion per month) and lift the Federal Funds Rate to 2.5% as the US economy approached full employment. Returning even to these policy settings is likely to take years, not months.

But if this policy stance won't be reached any time soon, two issues naturally arise. On the one hand, one might challenge the plausibility of the 'financial disruption'

scenario itself. If this is all the Fed can muster, will financial conditions really tighten sufficiently to avoid the first scenario, namely a swift transition to a regime of ingrained high and volatile inflation?

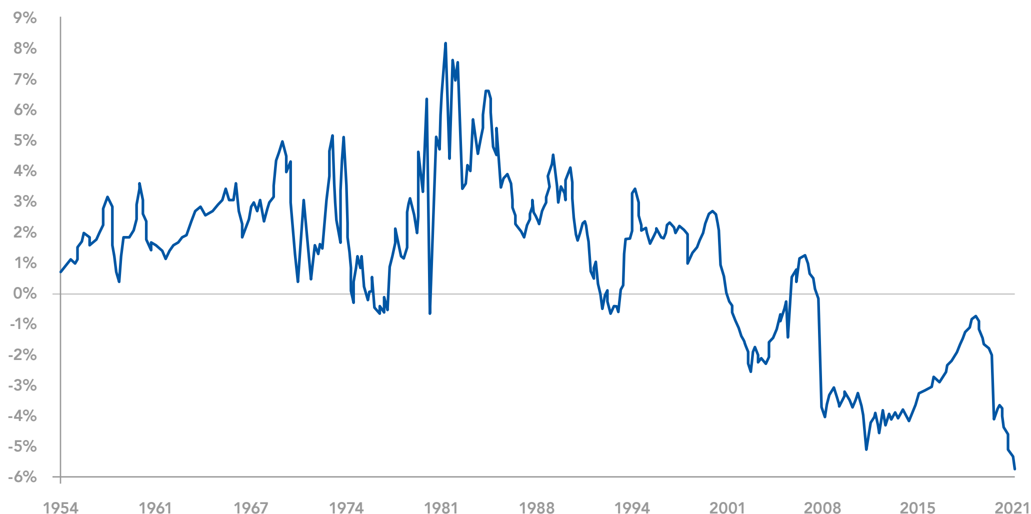
On the other, if the financial ecosystem has become so addicted to cheap money that even this sedate pace of monetary withdrawal triggers financial disruption, then far less of the cumulative stimulus injected into the system will get removed post-pandemic than was the case after the 2008/2009 crisis. So, when they fret about the looming damage to Main Street, central bankers will find their armoury even more depleted than was the case in early 2020. Whether made explicit or not, 'helicopter money' will then be the only tool available. At which point the notion of central bank independence, upon which the dying regime rests so heavily, will become a charade.

THE 'DONUT EFFECT' AND OTHER POST-PANDEMIC SHIFTS

The second reason to question whether the 'financial disruption' scenario really ends in the deflationary ditch relates to the economic legacy of the pandemic. People are buying different things in different ways, working in different places, using different modes of transport and living in different locations. As the virus becomes endemic, some of these behavioural changes will reverse, but many will not.

Much commentary has focused on the shift in spending towards goods and away from high contact consumer services but of all the changed behaviours wrought by the pandemic this is the one most likely to normalise, as the health threat subsides. Will Western society really eat at home more and dine out less frequently over the medium to long term?

Figure 6
US real risk-free short-maturity interest rate, %



Source: US Federal Reserve, Conference Board, NY Fed, University of Michigan, 12m constant maturity US Treasury yield less survey-based estimate of one-year ahead inflation rate

> “Whichever behavioural shifts dominate in the pandemic’s wake, economies will need to reallocate resources on a meaningful scale.”

Far less has been written about the long-term consequences of the move to hybrid work, a shift with profound implications for existing locational patterns of spending and activity. The hollowing out of dense urban centres, dubbed the ‘donut effect’, could mean wrenching changes to where workers, physical capital, and real estate (so-called ‘factors of production’) need to be located.[5]

Whichever behavioural shifts dominate in the pandemic’s wake, economies will need to reallocate resources on a meaningful scale (a slow and socially disruptive process) to match changed preferences and patterns of spending (a much quicker adjustment). The resulting supply side disruption will make calibrating any future policy response to financially driven economic weakness that much trickier.

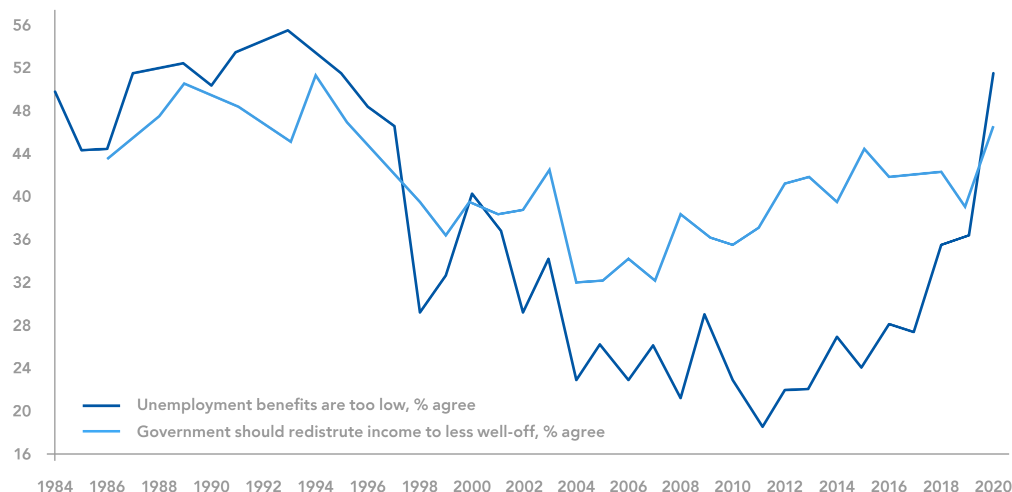
Parallels with the recession of 1970 and the subsequent policy blunder will be obvious to those familiar with their economic history. Misjudging the ingrained nature of the late 1960s inflation, the related supply side degradation, and the de-anchoring of inflation expectations, the Fed refilled the punchbowl aggressively in 1970, lowering the Federal Funds Rate by over 400 basis points in real terms. Inflation fell back in the aftermath of the downturn, but not far enough. It remained stuck above 3%, until the rapid acceleration in prices in late 1973.[6]

THE RETURN OF THE BIG STATE

The third reason is the most convincing to us. Traumatised by the experience of 2008/2009, the political elite will no longer tolerate economic suffering on Main Street. The way policymakers respond to economic disturbances has changed. This change partly reflects a political response to shifting voter beliefs (Figure 7), partly an intellectual climate more supportive of aggressive and proactive stimulus, in particular fiscal support, and partly more limited policy space. Policy stimulus is now bolder, better co-ordinated, more all-encompassing and, most importantly, more rapid.

5 Ramani & Bloom (2021), The donut effect of COVID-19 on cities, NBER Working Paper No. 28876
6 FRED, St Louis Federal Reserve, Bureau of Labor Statistics

Figure 7
The UK public's attitudes to major economic policy questions



Source: British Social Attitudes, bsa.natcen.ac.uk

If there was any remaining doubt that the reaction function has changed dramatically since the 2008/2009 crisis, the pandemic has removed it. What better example of this than the violent downturn, then rebound, in asset markets in spring 2020 amidst the most catastrophic economic collapse in recorded history. The economic and epidemiological news was dire, but the promise of unlimited policy support validated investors' prior beliefs about the 'policy put' that stood behind financial markets. The next time financial markets put the frighteners on central bankers, those gambling in the casino might be even more confident that the required support will be forthcoming.

This hints at a deeper change in the dynamics of the economic system. Policy interventions in the years after the Lehman collapse focused on Wall Street, not Main Street. They were unsuccessful in lifting inflation, but as we look ahead, expectations of what policymakers are prepared to do and what they can achieve have shifted. The pandemic has revealed that sizeable and broad-based support for Main Street is now the default position.

As firms and households are now discovering, support for Main Street can lift inflation, where stimulus aimed at Wall Street cannot. Whether this is true in an econometric sense is neither here nor there. What matters is the perception that

> “Inflation risk, an absent adversary throughout the careers of most investors today, will need to be priced once again.”

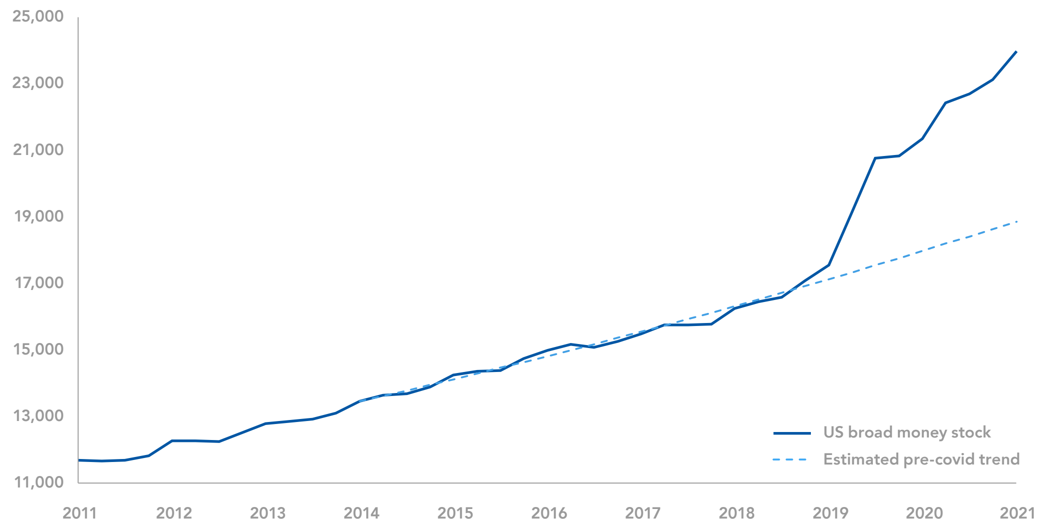
governments have now found a way to drive up inflation in the aftermath of a recession.

Once the avalanche has been triggered, and the policy response is forthcoming, the experience of the past two years should condition how investors expect inflation to behave in its wake. Will they remember the sluggish drawn-out recovery from 2008/2009 or the rapid, inflationary rebound from the pandemic, still fresh in their minds? Behavioural economists gave us the answer long ago.

This abrupt turn in policy – from monetary constriction to curb above-target inflation towards money-financed fiscal expansion to contain the fallout from financial distress – will take place when inflation is above target and much of the liquidity injected into private sector balance sheets is still untapped (Figure 8).

Figure 8

Estimated US excess liquidity created during the covid-19 pandemic, $bn



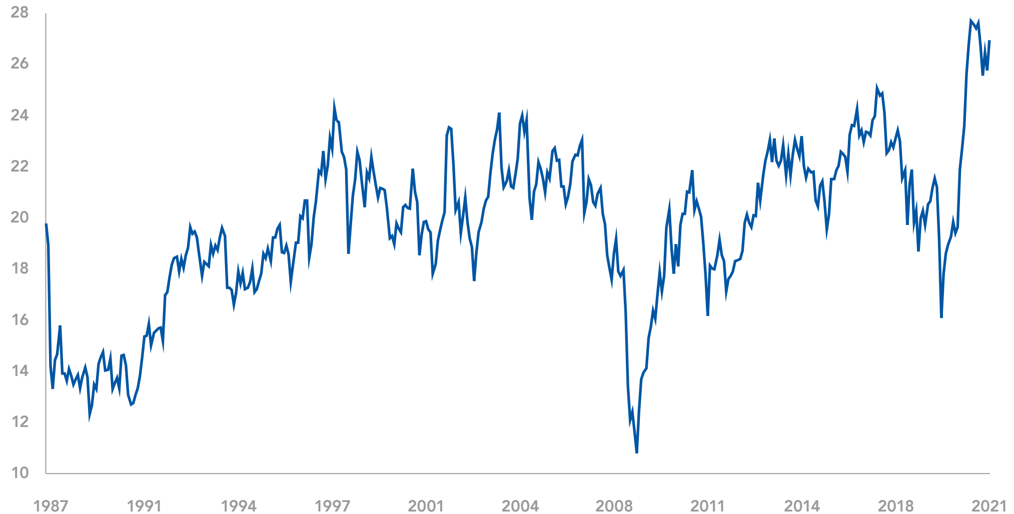
Source: Federal Reserve Board flow of funds accounts, Ruffer calculations

NOT A REPEAT OF THE 1970S, BUT DON'T LET IT FOOL YOU…

Financial disruption will be part of the transition to a new inflationary regime, not a harbinger of deflation. That seems paradoxical but it is not. Avalanche-prone markets are highly exposed to the coming central bank tightening cycle, even if it is a limited one. So too is our hyper-financialised economy, still at risk from an abrupt tightening of financial conditions. But because the political elite cannot afford another economic shock, lest the populist threat becomes a reality, they will react swiftly and aggressively at the first sign of trouble. Unbeknown to them, though, the economic system is not what it used to be. They are still fighting yesterday's war, warding off the deflationary bogeyman, when his inflationary nemesis hides in the shadows.

It is important to stress the coming phase of high and volatile inflation need not look like the 1970s and probably won't. It often feels as if there are only two plausible outcomes from here: either the current inflation surge will dissipate rapidly, returning the economy to its pre-pandemic 'secular stagnation'; or the economy will morph into a ghastly replay of the mid-1970s. In practice, neither trajectory looks all that likely from here.

Figure 9
Price-earnings ratio of median US-listed companies



Source: FactSet, 2,500 firms by market capitalisation, trailing earnings

> “The more policymakers argue inflation will subside quickly and painlessly, the less likely it is to evolve that way.”

The supply side tailwinds that have held down inflation for so long are much diminished, if not reversing. Politics is febrile. The economic system has become more inflation prone. But it is also radically different from the unanchored, sclerotic system so stressed by the 1973 OPEC oil embargo.

There are three principal reasons why. First, the labour market is more flexible and unions less dominant, reducing the risk of powerful ‘second round effects’ (into wages) from an initial spike in prices. Second, goods sectors comprise a much smaller share of national output. Since goods prices tend to be more flexible than service sector prices, economies more dependent on goods activity are also more prone to bursts of high and volatile inflation. Third, digital technologies mean product markets are more flexible and competitive, reducing the oligopolistic

tendencies of the business sector.

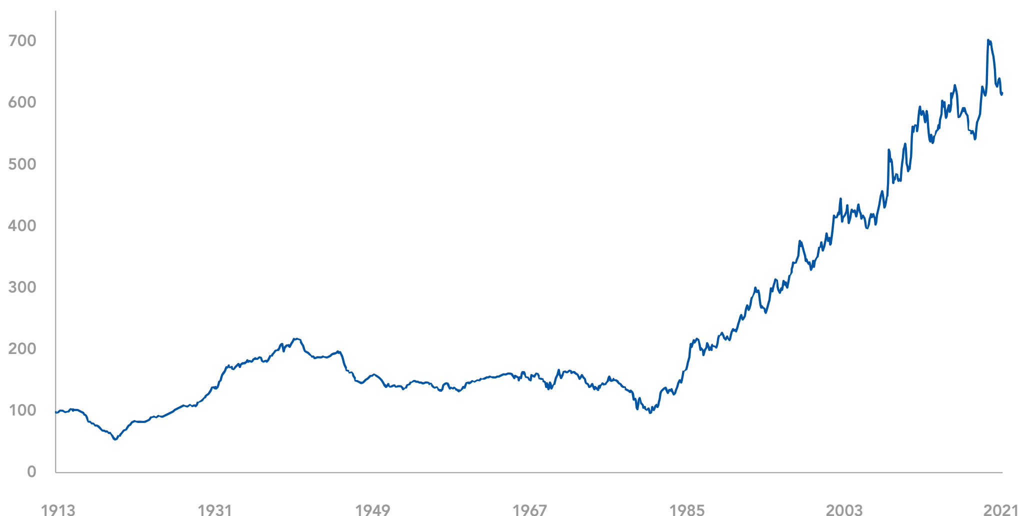
The oil shock made the 1970s inflationary episode far worse than it might have been. Geopolitical shocks of this magnitude may be ahead of us, but there is no objective reason to believe so.

The destination towards which we are journeying is unlikely to match what we saw in the mid-1970s, either in scale or speed. And there is no guarantee that we will see a continuous ratcheting up of inflation, as happened from the late 1960s. We are as worried about inflation volatility as we are about a higher average level of inflation, but neither of these judgements should offer investors comfort because the starting point is more extreme in two critical ways.

First, the financial ecosystem has become primed for a world without inflation risk. Risk-free interest rates, the anchor of today's fiat system, are at multi-century lows.[7] Richly priced risky assets (Figure 9) are justified, primarily, on the basis that these depressed risk-free interest rates will endure. Similarly, mean-variance investing (via balanced '60-40' portfolios) dominates today's investment landscape, because government bonds are seen as a low volatility 'safe asset' that protects portfolios during equity market drawdowns.

How much longer can investors expect these characteristics to survive if inflation risk returns? Before the 1990s, bond and equity returns were positively correlated, bond

Figure 10
US real US Treasury bond return index, 1913-2021



7 Schmelzing (2020), Eight centuries of global real interest rates, R-G and the 'suprasecular' decline, 1311-2018, Bank of England Working Paper No. 845

Source: GFD, Refinitiv, BLS, Ruffer calculations

return volatility was structurally higher and inflation-adjusted returns were, on average, non-existent (Figure 10). And there was a good reason for bonds to have these attributes: even those issued by high-quality sovereigns were historically 'risky', not because of frequent formal defaults by governments but because investors had to weather inflationary disasters surprisingly often.

The second consideration is overtly political. The 1970s is today remembered as a period of political turmoil in the West. This was as much a consequence of the decade's economic disruption as it was a cause. At its beginning, wealth and income inequality were as low as they had ever been in recorded history. Meanwhile, the experience of most adults at the time was one of rapid gains in living standards after the hardships and sadness of World War II. Major economic and financial crises had been avoided for 25 years. Life was immeasurably better in 1970 than it had been in 1945.

By contrast, at the dawn of the 2020s, the backdrop is very different. The average household's real income has been stagnant (or worse) for over a decade in most Western societies – and since the 1980s in the case of the US. Wealth and income inequality are both much higher than five decades ago. There is a deep sense of resentment within Western societies that the elite has stolen power, identity and community away from the people.[8] The 'somewheres' have found their voice once again, electing populist leaders (Donald Trump, most obviously), but more importantly forcing the locus of political debate to shift away from liberal centrism to interventionist populism.[9]

Finally, in the geopolitical arena, a second Cold War is underway, with far more serious ramifications for the global economic system than the Russia-US conflict of the mid-twentieth century.

We are not building a portfolio with the expectation that average inflation, or its peak, will match that seen five decades ago. We are troubled by something historically far more mundane, of which most investors today have no experience. In the transition to this new regime, there is much we are still uncertain about. Crucially, how far will central bankers go to contain inflationary pressures? The answer to that question will determine what the scenery looks like on the way.

“There is a deep sense of resentment within Western societies that the elite has stolen power, identity and community away from the people.”

8 Goodwin & Eatwell (2018), National populism: the revolt against liberal democracy; or Mair (2013), Ruling the void: the hollowing out of Western democracy

9 Goodhart (2017), The road to somewhere: the populist revolt and the future of politics