

INVESTMENT REVIEW

One Man's View Of A Mania

This bull market has some of the characteristics of Rasputin - shoot him, poison him, stab him, but he just rolls his eyes and keeps on going. In the last quarter of 1997, there was a devastating collapse of confidence in the economies of the Far East. Marc Faber said of it, "Never has there been such a total economic breakdown and massive destruction of wealth as occurred against all expectations in Asia in the last six months." World stock markets responded by dropping by about 2%. This quarter, just ended, has seen no such shocks, and the world index, expressed in sterling, has risen by nearly 13%.

At times like this, a roadmap is helpful. The first point to make is that against a background of reducing inflation, buoyant consumer demand is fuelling both stock and bond prices. Against classic yardsticks, (dividend yield, earnings multiple and premium to net asset value replacement costs) equity valuations are unsustainable, unless earnings and assets grow at ten times the current rate of inflation for the foreseeable future.

This overvaluation, while extreme even by previous excesses, is a usual characteristic in the early stages of a deflationary cycle. These deflationary forces have been a constant theme of our investment reviews over the quarters: the Asian collapse testifies that the pressures are increasing. Governments are responding by adopting as accommodative a stance as they dare. Interest rates and taxes are down, and easy money has been allowed into the system. In inflationary times, central action such as this would be disastrous: a Lawson boom writ large. This time, it provides an effective counterweight to deflation: hence the Goldilocks' economy - not too hot and not too cold, and near-universal plaudits for the policymakers. Unfortunately, a by-product of this policy leads to distortions in other parts of the system. Corporations have embraced with admirable alacrity the advantages of replacing equity with debt when the latter appears cheap. While the consumer spends and the economy remains buoyant, this enhances equity returns. This adds to the fuel of rising asset values, which are as popular as mother and apple pie, while it lasts. The problem comes when the values move in the opposite direction. Then the unforgiving nature of debt becomes apparent, and small changes in growth make big changes to market valuations. Matheson Investments have estimated that a drop in corporate profitability from 8½% to 8% should knock one third off the value of Wall Street! (Presumably if corporate profitability is assumed to edge up to 9%, then Wall Street can go up by a similar amount.) The point is that a rise in the value of bonds and equities is mutually inconsistent in the long term - both can rise on the increase in liquidity, but ultimately the economic consequences of the underlying economic conditions and the governments' response to them, will determine their relative attractiveness. What we do believe is that any significant setback on Wall Street is likely itself to be a fundamental factor in reducing consumer demand, so that the one factor which can unequivocally offset the lack of confidence engendered by the deflationary forces will go into reverse.

What is to be done about it? The first is to recognise that, to the extent that one rides the tiger, then one must be aware of the risks one is taking. For a majority of one's money, therefore, it is important to have as loose a correlation with market levels as possible. In our view, the fixed interest market is indubitably the best way of doing this, because any increase in deflationary forces, *ipso facto*, will benefit this asset class. The second is to concentrate on growth stocks. In a deteriorating economy, there is a real question of "first catch your growth", but however hard it may be to find in quantity, it will always be there, and it justifies a high rating. Meanwhile, eccentric as it may seem to be picnicking among the mountain rocks when the beach looks so inviting, if the tide turns, a number of beachcombers will have more than wet feet.

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