Ruffer Radio

Episode 20 – Survival at five?

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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. A new year is an opportunity for all of us to look back on the past twelve months and to look forward to and around the corner of the year ahead. And this year, perhaps more than any other in Ruffer's history, this has also been a period for introspection to really analyse the thinking behind the portfolio and how and why things played out differently to what we expected. And no one is better placed to do just that than Matt Smith, a core fund manager here at Ruffer, who I am delighted to be joined by today. Matt, thanks very much for joining.

Matt Smith, Fund Manager

Hi Rory, thanks for having me on the pod.

Rory McIvor

What questions, Matt, are important for investors to be asking themselves looking ahead to 2024?

Matt Smith

Well, I think to navigate 2024 successfully, there's just one question that investors have to ask themselves. Can the economy and the market survive with interest rates at 5%? Our answer is an emphatic no. What's the evidence for that? Well, I think it's best summarized in a single sentence. Only the government is a borrower at 5%. Let's just unpack that a bit. Last year saw falling bank lending, one of the lowest levels of corporate bond issuance since the global financial crisis in 2008, and the lowest level of mortgage activity since the .com bubble burst in 2000. So neither households nor companies find it attractive to borrow and invest when interest rates are at 5%.

The US government, by contrast, which doesn't really have to worry about what rate of interest it pays, borrowed more money last year than at almost any time since the second World War. If you are, for example, an individual looking to take out a mortgage to buy a house, your ability to do so has declined dramatically as mortgage rates have risen from 2% to 6%. So for your purchasing power to be restored, you either need mortgage rates to come down or you need house prices to fall. And that's my simple summary of the world as we sit here today. Either interest rates need to come down or asset prices do.

Rory McIvor

So, Matt, that's a summation of the outlook for 2024. But let's just briefly reflect on what happened in 2023. What was the story for the year?

Matt Smith

Yeah, well, for full disclosure, I would have said exactly the same thing. At the start of 2023, what actually happened was that interest rates rose and so did asset prices. That's historically very unusual, and it was driven by three things. Firstly, at the start of 2023, asset prices were already quite low after a material sell-off bear market in 2022. And people were very bearishly positioned, thanks to worries back then about a winter gas crisis and runaway inflation in Europe, and an unending interest rates hiking cycle from the Fed in the US.

As time passed and gas prices and inflation started to fall sharply, in turn leading to fewer rate hike expectations, everyone became a lot more bullish and asset prices rose, defying rising interest rates. Secondly, the already mentioned big boost in government spending, as it happens, alongside a big injection of money into the system by the US central bank after the collapse of Silicon Valley bank in March, helped keep the economy strong again, even as interest rates rose. And finally, it's more of a technical point. The way the US government funded itself, issuing lots of short dated bonds and therefore competing for capital with investors cash allocations instead of issuing lots of longer dated bonds which compete for space investors financial market portfolios, meant that the fiscal spending didn't crowd out any financial market assets. So interest rates rose and asset prices rose despite that.

Rory McIvor

So you were positioned, Matt, for two potential outcomes, neither of which happened. That would suggest that, a year in review, you got it wrong.

Matt Smith

Yeah, we got last year wrong, or more charitably, we were early in our view. That's not great, but it's also not unusual. We're often early. Historically, it has been an indicator of stress building in the financial system. And after all, successful investing is only about getting it right 51% of the time.

Rory McIvor

Matt, can I stop you on that? What do you mean?

Matt Smith

What do you mean? Being right more often than you're wrong is a matter of small margins, is all you need to generate an enduring investment track record over time. The thing is, on the rougher tin it states, we aim to avoid losing money if we are wrong. So we focus much more on the 49% than on the 51. Last year was the worst performance in our history. Driven, I think, by an unappealing setup at the beginning of last year. Absolutely. But also an overconfidence that we would be right about the events of 2023 and a failure to prepare the portfolio for an outcome where neither of our expectations materialized as you said. I can only apologize for those mistakes and the performance it's led to.

Unneeded protection protecting against a market decline that didn't happen accounted for almost all of the loss in 2023. Now it's easy to poke fun at that. Why are you overcomplicating things with these derivatives? Can't you just do it simply like you used to? The short answer is that we've been constructing portfolios in this way, using derivatives for over half of our 30 year history, reflecting the changed market environment post 2008 credit crisis. And these instruments have been absolutely invaluable. Take two recent examples, March 2020 and calendar year 2022. In both periods, almost all conventional assets went down and almost all conventional investors lost money. By contrast, were able to deliver decently positive returns in both periods, with almost all the positive contributions coming from derivative positions. We've got a proven expertise with these securities and they are a vital part of the toolkit.

And more fundamentally, we're absolutely comfortable with losing money on protections that aren't needed. We'd much rather it was that way around than being unprotected against market declines. But unequivocally, we want to make sure that doesn't result in an overall negative return at the portfolio level. So versus last year, we have a strong desire to make sure that the portfolio carries positively rather than declining if nothing happens. And that's been a big focus of our asset allocation.

Rory McIvor

And by carries positively, you just mean makes money, or makes a little bit of money whilst you wait.

Matt Smith

Absolutely earns its keep.

Rory McIvor

What's different about today Matt?

Matt Smith

I think it's a very different setup to a year ago. The three factors that confounded us last year and enabled asset prices to go up even as interest rates did have waned or gone into reverse. So taking them in turn again last year, everyone was bearish and bearishly positioned. Everyone is now bullish and positioned accordingly, expecting a rising market and a soft landing in the economy. The big boost from government spending that was in large part a hangover from covid spending is now a mild negative. And finally, the US treasury is near the limit of how much it can fund itself just using short dated bills. So very importantly, and this has been true really, since the late summer of last year, the ability of the market to defy higher interest rates is significantly reduced.

And we've seen the portfolio balance has been much better since that time. At the same time, following the declines of last year, the prices of the assets that we like are much cheaper and the punch of the protection we use in the portfolio is now much higher. Finally, it's worth remembering that the passage of time matters a lot when it comes to interest rates. It's a bit like holding your breath underwater and we've been near 5% interest rates for coming up to a year now. This has left the economy, but in particular financial markets, in what we think is a fragile state. So at the current moment in time, the portfolio setup for those three reasons looks pretty outstanding. The factors that confounded usual dynamics between interest rates and asset prices have gone into reverse or waned.

The prices of the assets that we like have come down a lot. The protection that we think we're going to need is much more powerful. And importantly, we've been at these high interest rate levels for a long time now. So let's go back to that original framing. Either interest rates need to come down or asset prices do. What do we got in the portfolio to reflect that on the interest rates come downside, which could absolutely be the way it folds. We've got our structural holding of inflation linked bonds, which really reflect the long held view that when push comes to shove, central banks won't tighten sufficiently to deal with inflation. We've got the Yen, which really behaves like a bond, and our gold exposure, which is an inflation protection, but also enjoys falling interest rates.

Rory McIvor

Matt, when you describe the yen as behaving like a bond, just what exactly do you mean by that?

Matt Smith

So the Japanese have for a number of years now fixed their interest rates across the yield curve at or near zero. As a result, when, in particular, US and European or UK interest rates rise, the differential, the interest rate differential between Japan and those other countries worsens in favour of the countries whose interest rates are rising. And that is solved by the Yen going down. So last year, us interest rates went up a lot. That's no secret. And that drove the Yen down because they didn't hike interest rates. We think that they're moving towards doing so. And we think that us interest rates are coming down. So that differential is narrowing, and that should lead to a strong performance for the Yen, as Jonathan Ruffer wrote about over the summer last year.

Rory McIvor

And actually, Matt, bond yields have come down quite significantly in the fourth quarter in the US, and we began to see a little bit of a rally in the yen. Is that right? I mean, how far can it go? Is the yen a real money making position?

Matt Smith

I like the Yen because it's a two headed investment. In the first instance, exactly how you state falling interest rates in the US or rising interest rates in Japan can, on their own drive the value of the yen up. Secondly, the Japanese are big investors abroad, particularly in US credit markets. Now, we think that US credit markets are one of the most overpriced areas of any asset market. And anything less than perfection in 2024 is probably going to see corporate bonds end the year less valuable relative to government bonds than they are at the moment. If there is a liquidity panic of any kind, we think that investors who have gone into corporate bonds really as in

preference to holding government bonds, will head back to cash or just to plain old government bonds.

For the Japanese, that likely means that they'll repatriate those dollars that they currently own, they'll sell the bonds, turn those dollars back into yen and invest it in the increasingly, and that is a relative term, attractive domestic Japanese market. So the yen can work if interest rates come down, or if interest rates go up in Japan, and it can work in the event of a particularly credit market shock in asset markets. So that kind of two headedness is something that's always appealing to us, that's why it really sits in both buckets. So again, if interest rates come down, we've got the inflation link bonds in the portfolio, the Yen and the gold exposure. If it is actually that asset prices would end up going down, then we have got equity protection, ie p. E. Protection against an explicit decline in equity markets.

Alongside credit protection, those are instruments that appreciate in value as what is currently price for perfection. Corporate bonds deteriorate in value. We're combining that with a modestly higher weight in equities last year, with a focus on what we think is a sweet spot of, to be honest, quite boring, but out of favour, c. Cheap bond like stocks, healthcare and some of the UK consumer staples, things like that. So let's summarize it all back. Last year saw interest rates and asset prices go up. Very unusual, but it was extremely painful for the portfolio and for our clients. This year we think we could well see the reverse. Falling interest rates and declining asset prices. That would be an environment in which the portfolio would thrive.

Now the key is to make sure that it doesn't go down if we're wrong about that. But to us, the setup today is absolutely what we'd want.

Rory McIvor

Matt, just in that environment. And as a final thought, lots of investors remain invested in the so called 60/40 portfolio. If we do get a fall interest rates and as you say, asset prices, so equity markets coming down, 60/40 investors, they might be okay, might they?

Matt Smith

I think at the current moment in time, it's not a bad place to be. And the Ruffer portfolio is not wildly different. We have more of a bias to the front end of the bond market and a pretty low equity weight, but bonds will work if the economy slows and if asset prices fall. We think absent some specialist scenarios, but the equity decline could significantly outweigh the bond performance and ultimately the 60/40 portfolio is not a buy and hold investment at this point. We've talked for a long time about a regime shift inflation. We've framed it as inflation volatility. What does that really look like? I think you can summarize it as a shift from a 2% ceiling on inflation in the period running up to covid is now a 2% floor on inflation.

That doesn't sound like much, but that is a regime shift and that has radical implications for portfolio construction and most specifically for bond valuations. We're going to find out in 2024 just how hard that 2% floor is.

Rory McIvor

Matt, thank you very much for joining.

Matt Smith

Pleasure. Thanks Rory.

Rory McIvor

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