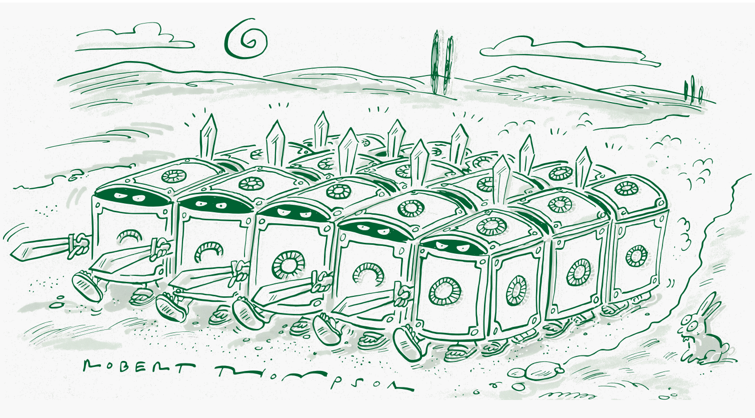
Investment Review

October 2023

15 mins | Investment review



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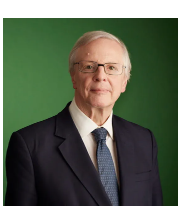
6 October 2023

JONATHAN RUFFER
Chairman



ARTICLES BY JONATHAN

A question recently asked by one of our team, to a potential client of great sophistication and experience in the investment arena, has stuck in my mind.

He asked, “What’s your attitude to the poor performance we’re putting in during 2023?” A good question deserves a good answer, and it got one. Its substance was – when things are tough, two questions need to be satisfactorily answered. The first is: why did it happen? The second is: why are you confident that the portfolio is rightly positioned for effective performance from here? So those are the two questions I shall address in this Investment Review.

We have a big position in the yen, which has dropped this year against all major currencies. The yen has been moving lower for a long while. With currencies, it is always dangerous to try to anticipate a change of direction, even when the fundamentals cry out for it, and our performance has suffered accordingly. We believe the yen is oversold for technical reasons and that, when these dissipate, it is likely to move sharply higher. Moreover, when it does, it is likely to be concertinaed into a brisk uncontrollable move upwards. This happened, to our advantage, in 2008, and we believe that today’s backcloth will cause a repetition of that dynamic. Our confidence comes from the observation that there will be forced sellers of foreign currencies into the yen and, simultaneously, forced buyers of yen, which will combine as a catalyst in turning its direction. If these events occur in the course of a market dislocation, the exchange rate could move as violently as it did in 2008 (up by 50% against sterling in short order).

The compulsion to buy yen will come from two diametrically opposite sources – one domestic, one international. Local demand for yen will come about in the aftermath of Bank of Japan Governor Ueda’s increasing isolation in trying to hold the yields of the government bonds well below the international rate. The most likely way out of this impasse is for the authorities to compel domestic institutions to acquire such bonds at their current (anomalously expensive) prices. To do this, those institutions will have to sell down big holdings of foreign government bonds, denominated, of course, in foreign currencies. Many of those holdings have already been hedged into yen, but much of it will still be held in local currencies, with the conversion into yen telescoped into a short time window.

The international constituency of forced sellers are those foreigners who have borrowed in yen to enjoy a lower interest rate regime than the one in which the assets are purchased. That constituency is more aware of the double advantage of a low interest rate and a steadily diminishing value of their borrowings than they are of the dangers of a currency mismatch which, at the key moment, moves sharply against them.

This investment strategy has almost nothing to do with the fact that the yen, on a purchasing power parity basis, is very cheap. That reason for holding the currency for a capital gain is, by itself, a poor one: in general, weak currencies go on getting weaker. Rather, we are looking for coming dislocations striking at assets or currencies which are wrongly priced. In my experience, it is unusual to find two separate constituencies of forced buyers – to find a single one is enough. It is the strong possibility of an extraordinary upward move in the Japanese currency which provides us with the stamina to withstand the general day-to-day attrition of the yen. If the net result produces merely a satisfactory ultimate return, we will be disappointed.

A STARTER FOR YEN

September 2023: The Bank of Japan has been marching to a different beat to other central banks. While the Federal Reserve, ECB and Bank of England hurried to ramp up rates in a battle against inflation, a deflationary mist lingered over Japan. Until now...

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INVESTMENT REVIEW

July 2023: Our defensive positioning in anticipation of a liquidation event has hurt portfolio performance so far this year. In his latest quarterly review, Jonathan Ruffer recalls similar testing periods before past market crises and explains why we think the liquidation event has only been postponed, not cancelled.

READ

INVESTMENT REVIEW

April 2023: Portfolios have been alert to the dangers of a liquidity crisis for some time. Now that it has arrived, our task is to analyse how events are likely to play out. Certainly, it doesn’t appear to be a repeat of 2008. It isn’t quite like 1929 either. Reaching for either of those investor playbooks would be a mistake. But, as Jonathan Ruffer notes in his latest quarterly review, past circumstances can be instructive.

READ

> “We’ve seen this all before, and we know how it ends, but that doesn’t mean the journey won’t be bumpy along the way.

The other impediment to an effective performance in the first three quarters of 2023 has been a breakdown in the relative movements of asset classes. An important tenet of our portfolio construction has always been the juxtaposition of offsetting assets. So far this year, they haven’t obliged; cast iron relationships have proved unreliable, and as a result the portfolio has looked imperfectly balanced.

One extended example, which has cost the portfolio heavily, will suffice. We began the year believing, as we have done for some time, that long-duration fixed interest assets would very probably be a bad place to invest. In the event, that call was correct. Representative investments of this asset class are US Treasury bonds maturing in the late 2040s, and the UK gilt equivalent, where maturities stretch out to over 50 years. In the ordinary way, our view can be factored into the portfolios very simply – we don’t own any of them. Unfortunately, one of the key assets that we do own (the UK index-linked bond), in what we see as a vital protection against future inflation, is a first cousin of the conventional UK gilt. We own it because of its second, valuable characteristic, of giving protection against rising prices. But it is still a bond, whose return will be at least partly determined by the price of conventional bonds. To repeat, the index-linked prices are determined by two things: their unparalleled protection against inflation, and their consanguinity with conventional bonds, which are themselves likely to be dismayed by that very inflation proving to be a long-term problem.

Rather than regretfully avoiding the index-linked because of this connection to conventional bonds, our natural response is to take an offsetting position in another set of assets which offer a mirror image of long-dated conventionals. Thus we can retain in the portfolio the desirable component of the bonds (their inflation protection) whilst neutralising their weakness (the interest rate linkage). To our mind this argued for a continuation of investing against the equity of highly rated growth companies in the stock market, which had worked so well in 2022. The officious bystander might point out that an investment against the Teslas of this world is scarcely a mirror image of a long-dated conventional bond, but what is counter-intuitive is not necessarily wrong. Rising interest rates play havoc with the discounted valuations of future earnings, and the present valuation of growth stocks is heavily dependent on the contribution of those future earnings. The earnings of a company growing at a slowly fading 15% a year will have a net present value of x if discounted at 3%, but only 0.3x if discounted at 5%. Same company, same outlook, same stock – but applying the change in long-term bond yields should price it lower by 70%. That repricing is what hasn’t happened for technology stocks this year, and as a result the portfolio’s vulnerability to rising interest rates hasn’t been offset.

This shows why we are confident in our current positioning. At the heart of our investment strategy is the belief that 2023 has seen fundamental truths – with their gravitational pulls on valuations – momentarily overwhelmed by market forces. These forces can, in the short term, be very much stronger than a mere ‘gravitational pull’, but in the long term gravity always beats a good party.

Thus far, we have done no more than hold out justifications for continuing to hold what hasn’t worked. We need, I think, to show cogent reasons that, far from the world being a safer place economically and politically today, it is in fact more dangerous. It should be clear from the first part of this review that, if the markets prove hostile to investors, the positions held will not merely be defensive (although they will), their shield will become a sword.

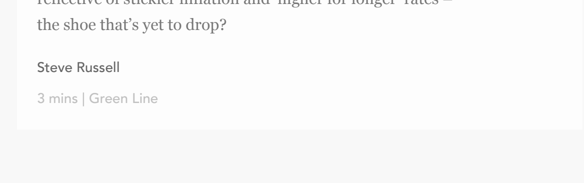
It is our firm conviction that inflation is in an inexorable up-cycle. We do not put timings on it, but two factors will prove more powerful at stoking rising prices than the single force pulling the other way – the impact of central bank tightening. The first is the increased balkanisation of economic activity – the extraordinary growth of China, funded by two decades of free American money, gave the developed world a holiday from inflation. That has ended. The middle-aged investor class were the unambiguous beneficiaries, the younger workforce the opposite.

This inequality has led to the second key driver of inflation: a reversing of the Marxian battle between capital and labour, something that always happens at extreme points, typically reached every half century or so. The bottoming of interest rates in late 2021 was the nadir of labour, and the onset of strikes by organised labour will be a feature for the next couple of decades, and probably longer. I am involved in County Durham, and the position there – a low pay economy – is that a working family struggling to escape poverty has to compete with a double digit rise in state handouts for the unemployed, the increasing cadre of elderly protected by the upward-only pension ratchet, and the price of staple goods rising more sharply than wages, which have shown three decades of real decline. Just released is the average year-on-year wage increases: 7.8%. That’s not enough when the worker has the wind in his face – but it’s considerably too much for a healthy economy and a 2% inflation rate. Wherever one looks for the old certainties, one sees liquescence. Some is old behaviour, newly spotlighted; more is a failure of leadership, where nothing surprises, since no virtue is expected.

In summary, the world has more than a tinge of aurora borealis. It is a dystopian world where everyone is a victim, the central authorities in the West buy off every dissatisfaction with money they haven’t got, and a new order awaits its time, still to come. If you know where to look, there are eternal truths that are observable by eternal pieces of evidence. In the field, it is rheumatism in the knee which heralds the change from father to son; in the West, it’s the day that the cost of paying the interest on a nation’s borrowings overtakes the (sharply rising) defence budget. Just as with the yen, we’ve seen this all before, and we know how it ends, but that doesn’t mean the journey won’t be bumpy along the way. ●

#bear market, #inflation

OUR THINKING



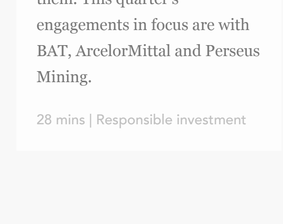
18 October 2023

IT'S A VERY, VERY MAD WORLD

October 2023: Some extraordinary dynamics have emerged in markets in 2023. None more startling than the breakdown of the typical relationship between bond yields and equity valuations – especially mega-cap tech stocks. So far, it’s been bond investors who have endured the pain of rising real yields. But is an equity market repricing – reflective of stickier inflation and ‘higher for longer’ rates – the shoe that’s yet to drop?

Steve Russell

3 mins | Green Line

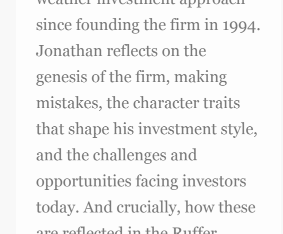


11 October 2023

RESPONSIBLE INVESTMENT REPORT

We outline some of the difficulties of engaging when it comes to commodity investments and explain our efforts to find ways around them. This quarter's engagements in focus are with BAT, ArcelorMittal and Perseus Mining.

28 mins | Responsible investment



9 October 2023

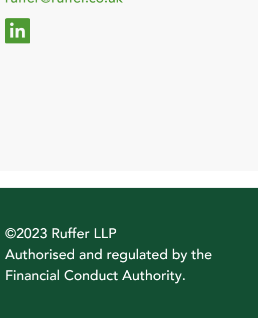
RUFFER RADIO: FROM THE CHAIRMAN

July 2023: In this quarter’s episode of Ruffer Radio, Chairman Jonathan Ruffer shares his perspectives on the evolution of Ruffer’s all-weather investment approach since founding the firm in 1994. Jonathan reflects on the genesis of the firm, making mistakes, the character traits that shape his investment style, and the challenges and opportunities facing investors today. And crucially, how these are reflected in the Ruffer portfolio.

Jonathan Ruffer, Rory McIvor

30mins | Ruffer Radio

OUR THINKING



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