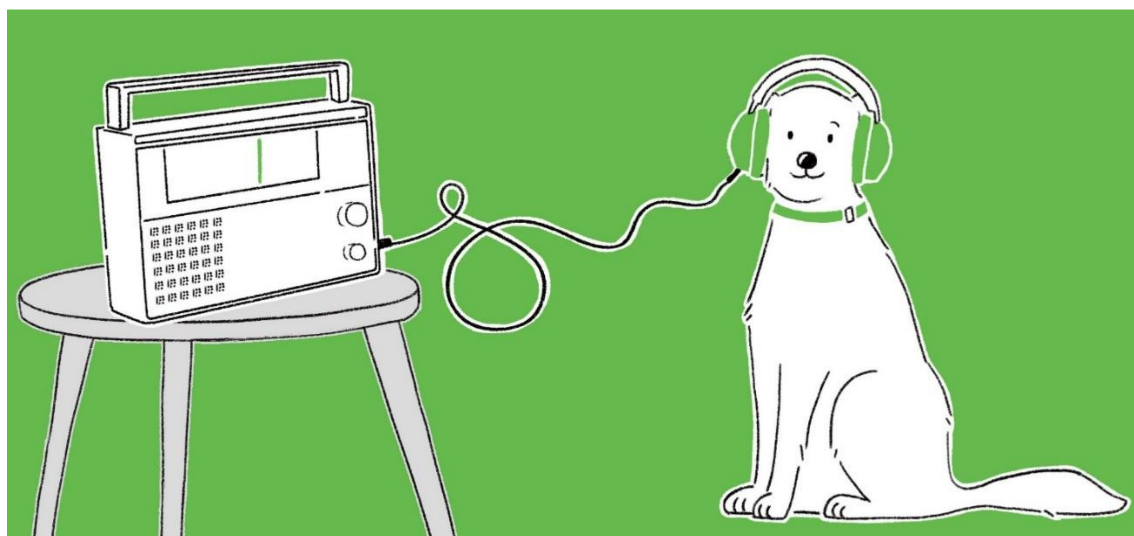
Ruffer Radio

Episode 14 – Ruffer round up – Q2 2022



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Rory McIvor

Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. In today's episode, I'm joined by Investment Director, Duncan MacInnes, who will give us a whistle-stop tour of everything that's been going on in markets over the past quarter.

It's been an interesting one, Duncan, but very pleased to have you on today to give us a bit of an overview.

Duncan MacInnes

I'm pleased to be here, thanks.

Rory

So, Duncan, by way of an overview, what did the major indexes do over the quarter and did anything perform well?

Duncan

In a word, no. Nothing performed well, and that's what's been so remarkable. US stocks had their worst first six months to a year in half a century, the US S&P 500 was down 20%, the tech focus Nasdaq was down 30%, and for years we've been hearing about American exceptionalism because they've all the best companies but their markets were exceptionally bad so far this year. But in contrast, the UK FTSE 100 is only down 1%, but that makes it the best market in the world, so they've struggled and conventional multi-asset portfolios have struggled too, they're down anywhere between 10 and maybe even 20% for the year or 8 to 10% for the quarter.

Rory

Ruffer portfolios were also down a little bit over the quarter and, Duncan, without trying to be too antagonistic, I'm going to put a tricky question to you. Ruffer's raison d'etre is to not lose money. And in fact, lots of people are think – and it's something that has historically been true - when markets fall, Ruffer can actually make money on the other side. So this quarter's performance, what happened there?

Duncan

So we lost a couple of percent this quarter. The problem was that there was nowhere to hide. Unlike the first quarter where derivatives were particularly helpful for the portfolio (that's our unconventional protective toolkit) the problem was that in Q2, those derivatives had become quite expensive after the volatility of the first three months of the year. So we couldn't have quite as much of them as we would have liked, and that's why we went into what we called crouch position earlier in the year and we reduced overall risk, but in hindsight, we should have done more. We came into Q2 with a balanced portfolio but as the quarter progressed, we decided that events had led us to the point where a good outcome, the so-called soft landing, seemed less likely and so towards the end of the quarter, we reduced risky assets significantly but we did that at slightly lower the prices than if we'd done it a bit faster at the start.

Rory

And Duncan, you did touch on it a little just as you began speaking, but just to quantify for listeners, how big is the damage that we've seen across asset markets?

Duncan

I think it's getting to be pretty remarkable. So to try and scale it, I think we're talking about perhaps 50 trillion US dollars, with a 't', of wealth distraction across stocks, bonds, crypto, and the more opaque assets like private equity and venture capital, and that is undoubtedly a big enough number that it will start to have ripples out into real world behaviour and the risks of things like forced liquidations start to come to the fore. Now in terms of market action, we've been saying for a few years that investors will not be able to rely on conventional protections. In the covid crash in March 2020, it was the Ruffer portfolio's unconventional protections derivatives effectively which saved the day when most conventional assets misfired. This time around, it's the same sort of playbook and traditional safe havens have just not worked. The Yen has been a disaster. Gold has declined even though there's a war. Inflation-linked bonds have not worked at all, even though there's inflation and we'll come back to that, and the ultimate safe haven of US government bonds haven't just not worked, they've actually been the centre of the problem.

Rory

Markets are moving at such a rapid pace at the moment and we're learning more about the trajectory of the inflationary journey, with everyday that goes past. So Duncan, what do we know at the end of this quarter that we didn't know at the beginning?

Duncan

So as always, it's good to go to Charlie Munger or Warren Buffett for a clever quote about investing. And Charlie Munger once said that if you're not confused about what's going on, you

just don't understand it, and I really think that sums up where we are today. We came into this year saying that it was path-dependent and it depended on how serious central bankers were about tackling inflation and tightening financial conditions, and six months on, it's pretty clear that they are serious. They've started to raise rates, they've promised to do a lot more between now and yearend, the Bank of England I think still take interest rates to 3% by the end of the year, the Fed [Federal Reserve] to 3.25. We're only at one and a bit today, so that's a long way. But I think an appropriate metaphor for all this is that it's a little bit like going on a diet. It's very easy to talk about it, to plan for it, to maybe buy a recipe book about it, but it is actually rather difficult to get up at five in the morning, go to the gym, eat healthily, and do it day after day until it works. But right now, central bankers are actually impressing me with their resolve. Jerome Powell in the US is saying that it's going to act like [Paul] Volker in the 80s and raise interest rates to squeeze inflation out the system. But ultimately, we doubt that he has the political capital to do this, but for now, the multivariate experiment of raising interest rates and conducting quantitative tightening at the same time is underway. We know that markets don't like it. We've experienced that in the first six months of the year. But we are yet to experience the biting point for the economy or for inflation.

Rory

The consensus view now is pretty bearish across markets, so it's almost surprising that things haven't actually gone further. But I'm sensing, Duncan, from the way that you're talking about things that you do think that things could go further and in fact, there may be shoes which are yet to drop?

Duncan

Yeah. I think from a market perspective, we've seen valuations come down because prices have fallen, but that assumes that earnings stay the same. Now, earnings estimates still are quite optimistic to us. We would expect that if we have a recession that global earnings will fall by 10 to 15% but currently forecast so the earnings will grow by 8 or 9%, and to us that just seems too optimistic given the current outlook and uncertainty.

Rory

What's the timeframe for that, Duncan?

Duncan

That's over the next 12 months. So, that's one reason why we've not been rushing to buy the dip because I think people are only just starting to realise what is happening. Private market valuations need to adjust. For example, Klarna which was just in the press at the weekend with evaluation down 90% from its high, although they do tend to react with a lag of 12 to 18 months. And I think we need to wait for this to all play out over a little bit more time and just to drill down a bit further, profit margins are at all-time highs and they're forecast to go to higher highs. Now how likely does that seem when debt service costs are going up, labour costs are going up, input costs such as energy are going up? You need an awful lot of pricing power as a business to pass that on and retain higher profit margins.

Rory

And it wouldn't be like Ruffer not to dig in a little bit more into the inflationary story, so we'll perhaps come onto that in a few minutes' time. But just on earnings, Duncan, I'd be interested to know what you're hearing from management and from companies at the coalface in this?

Duncan

So as with everything, the devil is in the detail, and I sort of think the plural of anecdote is data. Now, we don't own any of these companies but I think stories are instructive. There's always winners and losers in any economic environment, but hearing from easyJet that they're struggling to get staff, so what are they doing, they're removing seats from planes so that they can fly the planes with fewer cabin crew. The CEO of Marriott Hotels perhaps counterintuitively has said that the summer numbers looked extraordinary, people are desperate to go back on holiday, business travel is back at 90% of the pre-pandemic levels and so from their perspective, it's all coming roaring back. In contrast, Winnebago, who make those big camper van RV things, they enjoyed a vintage period during covid as everyone explored their wanderlust in a safe environment, but they're finding it very difficult today because they sell a large expensive discretionary item in a cost-of-living crisis, and let's be honest, those things probably get about five miles per gallon.

Rory

Yeah, I mean, that is extraordinary and you're right to say that the conflicting signals make it very difficult for investors to get a read on things, indeed the crouch position feels like a sensible one at the moment. So one of the major detractors from Ruffer's portfolio performance over the past quarter was the index-linked gilts. Now, those linkers have fallen a long way, but overall, the portfolio performance remains robust and these are a sizeable position within the portfolio. So could you just elaborate a little bit on how you've managed to maintain robust performance amidst a large proportion of the portfolio suffering in the way that it has?

Duncan

The carnage in elongated inflation like gilts just should not be understated. Take the 2073 index-linked bond which is about a 2% position in most portfolios - its down 55% from it's high in November. We've called these assets the crown jewels of the portfolio because it's our conviction that they will provide the best protection against the world of financial repression and that's an environment we think we'll be in for an extended period of time. That remains the case but the sensitivity of those bonds to rising interest rates, that we have warned about, has now been felt. Thankfully, we had hedged a lot of the interest rate risk here and therefore we didn't feel the full pain of that fall, we had an offsetting option on the other side, but it is humbling that something that we prized for so long has performed so poorly. But it also does say something about the effectiveness of our hedging and of the way that we put the portfolio together, we have constructed portfolios around these crown jewels but despite their lacklustre performance over seven months, the overall portfolio performance during that time is positive. So I think this episode illustrates a very important distinction that we have been labouring, that is worth re-emphasising, that investing for inflation and investing for inflation volatility, which is what we are doing, are not of the same thing and conflating the two can be quite costly. We think that Mr Market will make it very difficult for us to own these bonds, we'll have to crawl through fire for the gift of redemption that they will offer us in the future. But from here, inflation-linked bonds are back to prices last seen before Brexit, and yet in our assessment, the

likelihood of the eventual inflationary denouement is much greater, you know, we were seeing it every day at the moment. So we believe that they're particularly asymmetric and attractive and we've been buying.

Rory

Duncan, you've warned on the dangers of a wage/price spiral and that's really when inflation begins to bite, and I know that sounds silly because with inflation in double digits across lots of measures at the moment, it really does feel like we're at biting point. But in the event of a wage/price spiral, inflation presumably has further to go?

Duncan

Yeah. So, the traditional definition of inflation, or one traditional definition, is too much money chasing too few goods. And that's certainly what we experienced in the last couple of years. There was lots of money printed in response to covid, there was accumulated lockdown savings, and they were chasing goods that were materially disrupted because of supply chains and so on. But one way that Jonathan Ruffer has framed inflation is that it's a psychological phenomenon. Once people expect that prices will be higher tomorrow, then they spend their money today, and that turbocharges demand then only goes to reinforce the inflationary dynamics. My observation would be that I think that might be starting to happen, price rises are becoming more normalised in society in a way that I've not seen before in my lifetime.

Rory

What do you mean by that?

Duncan

So, for the last 10 or 15 years, the price of cinema tickets or going out for dinner has been pretty much constant. Now, they are higher. They're materially higher than before covid. And most people are fine with that. Taxis, pubs, restaurants, holidays, airfares, people appreciate that many of these businesses really struggle during covid, they're facing their own cost pressures of supply chains and labour and energy, and people think that they're entitled to try and make up for lost time and make money whilst the sun is shining. Similarly, I think people are pretty sympathetic to workers demanding higher wages in the current economy. I mean, that seems to be everyone except from the governor of the Bank of England who isn't very happy about it. But if those workers get those wage rises, then that's more fuel for that inflationary fire. But as I said earlier, it's inflation volatility that's important to us, we don't think we're on a direct train to some inflationary bonfire, there will be ebbs and flows to this journey. And fascinatingly, in the last week or so, you don't need to believe me anymore, Christine Lagarde, in a panel, said that she doesn't think we're going back to an era of low inflation and I think that should have been front page news around the world.

Rory

Yeah, it feels almost confessional. So, Duncan, what should be looking out for over the summer months? Is it just earnings or are there other clues to be revealed in the course of the coming weeks?

Duncan

Well, as I said that we're in crouch mode and I think that's because we're waiting for a few paradoxes or dichotomies in the market to be resolved, and I think they probably will be in a few months' time. One is that consumer confidence is at record lows due to cost of living. CEO confidence has fallen dramatically over the last five or six months. And yet, if you look at the hard data, things like household net worth, consumers have never been so well-off, they've never had more savings. Those two situations are unlikely to co-exist for long. Zooming out of it, I view that policymakers are walking a tight rope towards what they hope will be a soft landing on the other side. That's the dream scenario where they tame inflation without doing too much harm to the economy or the market. But I think that will take a remarkable combination of luck and skill, and frankly, I think their luck has probably run out because on the one side of the tight rope, if they raise rates too much and taking financial conditions too much, the economy will end up in recession. Or on the other side of the tight rope, if they do not enough to stem inflationary momentum, then I think they risk of the inflationary spiral, which we are arguably already in, becoming quite disorderly.

Rory

And at risk of being labelled pontificators, let's maybe move on, Duncan, to a little bit of an outlook for the rest of the year - more specifically, perhaps just for Q3. How would you summarise your outlook?

Duncan

In our opinion, you pay or appoint an investment manager to assess the economic or market landscape and the opportunities they see and then make a decision about how much risk to take. And we just do not think the current environment is a good one to be risking our client's capital. So we have the portfolio in crouch mode, as I said, we have avoided most of the slings and arrows of the vicissitudes of the market but we have still taken a bit of a bruising. But I think the next few months we'll see it as a period to survive. There's so much uncertainty around war, around Central Bank policy, inflation, the consequences are raising interest rates and corporate earnings as we discussed, and this is all happening at the same time as the tide of easy money that has washed over the global economy in the last decade is finally receding and it is our strong suspicion, to come back to Warren Buffett, that when the tide goes out, some people will be found swimming naked. And as our Chief Investment Officer, Henry Maxey, said in his recent piece, winter is coming, to quote Game of Thrones, for liquidity, it's coming for narcissism, it's coming for crypto, it's coming for retail punting, and it's definitely coming for businesses that depend on any of these things. Now, I'm not as eloquent as Henry, but my take on it would be that there are times that you want to own a 'get rich' portfolio and there are times that you want to own a 'stay rich' portfolio, and this is definitely the latter.

Rory

Crouch mode is the word of the day. Duncan, thank you so much for your time.

Duncan

Thank you.

Rory

And thank you for listening.

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