Ruffer Radio

Episode 16

First published at ruffer.co.uk/rufferradio, January 2023

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. Chinese New Year 2023 is the Year of the Rabbit. But for investors, it will be the year of a similarly jittery character, the central banker. Chances are by now you've read or heard lots of reflections on 2022 and plenty of predictions for this year. But rather than speculate or pontificate on the many moving parts of the market machine, investment manager Fiona Ker joins me to explain why and how now more than ever central bankers hold investors fortunes in their hands. Fiona, thanks very much for joining.

Fiona Ker

Nice to see you, Rory.

Rory

So to renege on my promise immediately and before getting into the central bank conundrum, how did the Ruffer portfolio fare in 2022?

Fiona

Well, Ruffer delivered positive returns in 2022 which was pleasing in a year where the traditional 60/40 portfolio of equities and bonds fell nearly 17% and had its worst year since 1931. So not particularly surprisingly, in that context, it wasn't equities, or bonds that drove positive returns at Ruffer, but the unconventional protections. So, by holding financial contracts known as derivatives, we were able to benefit from the rising interest rate environment that led to falling asset prices.

Rory

And it's this rising interest rate environment that we're going to focus on. So rather than taking the panoramic view of investment markets, let's hone in a little bit on central banks. And firstly, Fiona, why is it that central banks matter so much for investors?

Fiona

Central banks are so important because essentially, they manage the supply or the availability of money itself. And they do this in very simplistic terms by setting the level of interest rates, essentially, the price of money. So, what's the point? What are they trying to achieve? Well, if we look at the Federal Reserve, the Fed for short, they have two objectives, which they set out to achieve. The first is maximum employment, ensuring people have work. And the second is to achieve low and stable inflation. Now, if we very quickly characterise the economy as the child and the Fed as the parent, it's the parent's job to calm the child when they're overexcited and to gee them up when they're down in the dumps. And the Fed does this by: raising interest rates to cool the economy and slow things down; and cutting interest rates to provide a boost.

Rory

And we generally talk about the Fed synonymously with central bank policy because we're in dollar-centric financial universe. Fi, we've witnessed one of the fastest and steepest hiking cycles in the history of financial markets. So where does that leave us today?

Fiona

Well, firstly, start with a disclaimer that we can't really talk about central banks and monetary policy without talking about inflation, because they are intrinsically linked. Now, I'm sure everyone listening will know that we came into 2022 with inflation already elevated. The initial expectation was that this was a transitory phenomenon to do with the covid and inflation would self-regulate back to normal levels, most central bank's target 2% to define normal. The Fed eventually acknowledged that immaculate disinflation didn't appear to be on the cards, and they signalled in early 2022, that they would need to take action on interest rates to dampen inflation. So, their first-rate hike was implemented in March 2022 when interest rates in the US were at 0.25%. And at the end of 2022, interest rates were at 4.5%. So, that was the fastest pace of interest rate increases since the 1980s.

Rory

Now, clearly, monetary policy is nuanced and complex, but what are the simple choices facing central bankers today?

Fiona

So, the Fed are in an extremely unenviable position, I would say. They have this target to keep inflation at 2%, which they are currently feeling on that objective by a factor of about three. And the remedy to this is to keep monetary conditions tight. So that is interest rates need to remain higher for longer. However, the likely outcome of that policy is that the economy will slow will head into recession, and that will cause unemployment to rise going directly against the Fed's other objective of maintaining maximum employment, so they're really in a bit of a pickle. And prioritising getting inflation under control will slow the economy which runs a very high rate risk of causing people to lose their jobs.

Rory

Fi, what's the market expecting of central bank policy?

Fiona

What's really interesting, actually, the bond market is very much calling the Fed's bluff. So, the Fed has guided that interest rates will peak around 5% this year, and will remain at that level throughout 2023. However, if you look at the bond market, there's an expectation that the Fed is going to capitulate, and they see interest rates falling by about 0.75% by the end of this year.

Rory

And part of what the Fed do is to signal their intentions in order to outline the potential path for interest rates and their policy. What could change that would mean that Federal Reserve Chair Jerome Powell alters the direction of travel?

Fiona

So, the rosy case, the best case would be that inflation continues to fall precipitously towards 2%. And the Fed therefore decides interest rates don't need to be so high anymore. However, research shows that throughout historical periods where inflation is breached 8%, which we saw in the US last year, the median time to return to inflation below 3%, is ten years. And the range of that study had six years to 16 years. So, there's maybe a bit of wishful thinking going on that we're going to see inflation back to normal levels by the end of this year. The alternative that could cause Jerome Powell to alter the course for policy is that something would have to break. So that would be a financial crisis of some kind, that causes the Fed to step in to support the economy with lower interest rates. And to state the obvious that is unlikely to be good news for markets. So, we're coming back to what you said at the start, Rory, markets are going to be very dependent on the action taken by the Fed this year. But in particular, there will be a lot riding on what they choose to do, should we enter a recession.

Rory

Fi, can central bankers get it right and by get it right, I mean, support the economy, avoid chaos in the financial markets, and ensure that all stakeholders across markets and the economy remain in a healthy position throughout the year?

Fiona

It's not impossible. But there's not been a great hit rate in terms of cooling down the economy once things have got hot. This is what you described already as the soft-landing scenario that's been referred to lots through 2022. So, the optimal outcome of the Fed, tightening financial conditions just enough to slow the economy and quell inflation, but not so much as to pass into a severe recession. So, on this measure, looking back to the 1960s, there have been nine cycles of increasing interest rates. And if we were to be generous, we would say three of those ended in soft landings, if you were being less generous, only one - either way, they're not great odds and I wouldn't be betting the house on it.

Rory

So, what's the read across to markets?

Fiona

So, the bond market is telling us to expect a recession and to expect the Federal Reserve to cut interest rates this year. Meanwhile, equity markets are telling you that companies will grow earnings in spite of a potential recession and rising costs. And the fact is that company margins are at all-time highs. So, markets, as a whole are going to be extremely dependent on what action is taken by the Fed and I would go as far as to say, are hanging their hats on the Federal Reserve cutting interest rates at some point through this year. Now, we at Ruffer, we can't be sure whether that will happen or not. But where we do find conviction is in the view that interest rates are not going back to zero. We're not going back to that era of free money that has defined the previous decade. So, when we think ahead through 2023 and beyond, we envisage a period of continued volatility in markets, as companies and economies have to digest this higher interest rate environment. So, one way in which that might manifest itself is as we begin to see companies refinancing and having to pay higher interest rates to borrow. I think that through 2023, we'll see the cracks appearing as the impact of the policy tightening that took place in 2022 comes into effect.

Rory

Last year, the sell-off in asset markets was relatively orderly and bar cryptocurrency and profitless tech, we didn't really see a chaotic capitulation. And clearly then from what you're saying, Fi, is that that might not remain the case going forward. Consensus has merged around entry into a new investment regime and a new world order. A new investment order is something that Ruffer has been discussing certainly for the past two or three years. But when I look across at what other investors are doing and flows in markets, it seems that portfolios haven't really changed that much, certainly not changing to reflect that potential sea-change in the investment environment. What are investors missing?

Fiona

Yeah, it's a really good question, Rory. And I echo your thoughts that we have seen a prevailing narrative of a new regime and a recession coming, and people seem to be cottoned on to the idea that the future might look a bit different from the past. But it's absolutely critical, as you say, what are people doing about it? That's the question that investors should be asking. It's the distinction between what you see and what you do that really matters in a portfolio. And I think that's something that Ruffer is very consistent at doing and has done throughout our history is to reflect our outlook in the portfolio. And so yes, there might be lots of people saying that there's going to be a recession, for example, but they will still own stocks and bonds. So to quickly recap on what our thesis is regarding that future, we think inflation is going to be volatile for longer and structurally higher than it has been in previous decades. What that might look like, would be instead of an average inflation rate of 2%, and a range between one and three and a half, it might average 3 - 5% and the range could be 0% to 10%. And that's a huge change for markets to digest, it's likely to be extremely disruptive, leading to volatility, lower valuations and investors demanding a higher return for the risk they take.

Rory

That sounds like a hostile environment for almost all assets. So how have you positioned the portfolio?

Fiona

Well, one thing I would say is that volatility isn't always bad. It can mean movements in both directions. So there is an opportunity set there as well. We're reflecting our outlook in the portfolio with a historically low equity weight of only 12%. We think equity markets are really running on optimism here, pinning hopes on that narrow strip of the soft landing that we discussed. So, the best-case scenario is inflation is self-depleting. The Federal Reserve cuts interest rates, and the economy staggers through without a recession. And our conviction in that outcome is reflected in that equity weight of 12%. Secondly, we continue to hold protection against runaway inflation in the form of gold and inflation-linked bonds. And lastly, we have portfolio protection via derivatives. So that's the unconventional protections that offered us positive returns through 2022 when markets were volatile, and we think they'll continue to be crucial to the portfolio in 2023.

Rory

Fiona, it sounds like we have some monetary policy mayhem ahead, but I'm sure it will be all fun and games. Thanks very much for joining today.

Fiona

Thanks, Rory.

Rory

And thank you for listening. You can subscribe to Ruffer Radio on the App Store, Spotify or wherever you get your podcasts.

Past performance is not a guide to future performance. The views expressed in this podcast are the views of Ruffer LLP. They do not constitute as investment research or advice and may be subject to change. Ruffer LLP is authorised and regulated by the Financial Conduct Authority in the UK and is registered as an investment advisor with the US Securities Exchange Commission, the SEC. Registration with the SEC does not imply a certain level of skill or training. © Ruffer LLP 2023