

Jurassic risk

AND THE CHOMPING OF THE TRADITIONAL BALANCED PORTFOLIO

THE DEATH OF INFLATION HAS BEEN GREATLY EXAGGERATED. Its return - perhaps as 1970s-style T-Rex or 2020s genetically-mutated velociraptor - will first scare, then maim, then ruin the traditional balanced portfolios that have served investors well for a generation. Investors need to prepare for a world of greater inflation volatility. And with it a Jurassic risk - bonds and equities falling in tandem.



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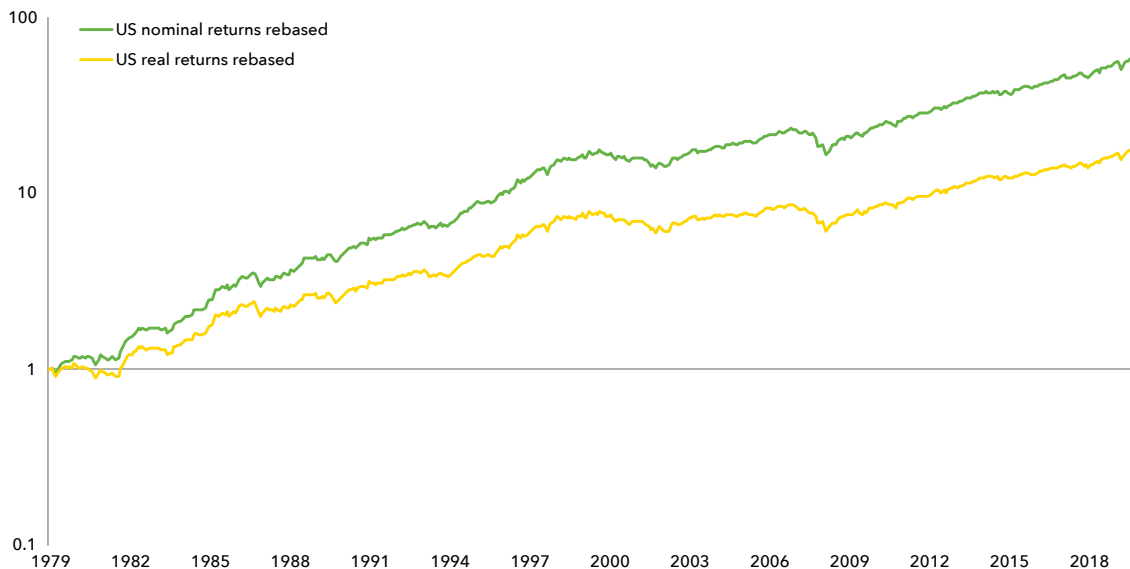
A GREAT FEAR STALKS THE LAND OF ASSET MANAGEMENT

– the return of inflation. And, with it, the death of an investing paradigm: the dominance of a traditional balanced portfolio of 60% equities, 40% bonds. These 60:40 portfolios have been structured to provide a good level of long-term returns, but with a smooth ride. They have been a successful construct, as Figure 1 shows.

Today, with bond yields now so low and inflation fears creeping in, investors are confronting the obvious concern. It is

Figure 1

NOMINAL AND REAL RETURNS FROM A 60:40 PORTFOLIO IN THE US SINCE 1979



summed up well in this quote from Eric Peters of One River Asset Management: “The unprecedented policy response to the pandemic has forced investors to now build portfolios of risk assets without being able to rely on Treasury bonds to materially offset the negative convexity. Consequently, the industry now faces an acute shortage of portfolio diversifiers at a time when it must take ever more risk to achieve its return targets. And the unintended consequences are as profound as they are not yet fully appreciated, let alone understood.”

In short, are bonds still the low-risk, diversifying assets which their historical statistical characteristics suggest they are? And, if you're feeling really jolly, you should re-examine the role of equities too. Shareholders are benefiting from receiving a historically-high proportion of stakeholders' return. What's more, that return to shareholders is being capitalised on very low interest rates.¹ Both of these supports would probably be tested in an era of higher inflation. They will be further tested if, as seems likely, the political economy is tilted towards redistribution of wealth and income (resulting in lower margins).

As we saw in the 1970s, inflation is the beast that will eat your 60:40 portfolio (and eviscerate your risk-parity portfolio too). Anyone running a traditional asset allocation for their clients should rightly fear it. Yet, as Jamie Dannhauser covers later in this year's Review, inflation itself has felt such an unrealistic prospect because of the structural disinflationary forces that have surrounded us for the past 40 years. We can all imagine the terror of facing a T-Rex. But the thought doesn't linger for more than a microsecond because, well, they're extinct. So too, apparently, inflation.

ENTER THE PLAYBOOK

My piece in last year's Ruffer Review was to inflation what the Jurassic Park story was to palaeontology: a hypothesis about why the rebirth of inflation is not just possible, but actually quite likely, and would have some catastrophic results. I argued a financial crisis would precipitate the regime change – and covid-19 gave us that crisis. The policy response to it – the cooperation of monetary and fiscal policy to support nominal demand – has followed the playbook. In fact, the nature of the crisis (“it was no one's fault”) has allowed for a full-throated expression of monetary-financing – the ‘no one left behind’ bailout.

In 2020, the Rubicon of macro policy regimes was definitively crossed. Governments are unlikely to be able to repeat their post-2008 efforts at austerity, particularly while the scarring effects of covid remain evident in unemployment. ‘Balancing the books for the next generation’ is losing its traction to a combination of Modern Monetary Theory and ‘greening the economy for the next generation’.

In short, austerity is out. If fiscal policymakers are able to soften blows for Main Street without any adverse inflationary consequences, they will be expected to play this role in the future. It is no longer just Wall Street that gets the bailouts. This will change the inflationary bias of macro policy for some time: we are now firmly on the road to inflation, and central bankers are lining the road to cheer us on our way.

FROM FIGHTING TO STOKING

Last August, the US Federal Reserve published its monetary policy review. The conclusion in not-so-many words: after a period of below-average inflation, we will let

¹ The stock market is expensively rated. But, if today's interest rates and credit spreads are here to stay, then it is possible to argue the market is fairly valued.

“ Do we have the wit and the wisdom to restore an environment of price stability without impairing economic stability? Should we fail, I fear the distortions and uncertainty generated by inflation itself will greatly extend and exaggerate the sense of malaise and caution... Should we succeed, I believe the stage will have been set for a new long period of prosperity.”

Paul Volcker,
Chairman of the US Federal Reserve, October 1979

inflation overshoot to the upside, to ensure our employment mandate is met. Or, more simply: we will run the economy hot because we don't think inflation is an issue, and we want to get back to full employment.

The Fed, and most other central banks in the developed economies, have come to fear deflation more than inflation. They are more confident in their inflation-fighting capabilities than they are in their deflation-beating ones. They all fear Japan's experience over recent decades.

Beginning in the 1980s, monetary policymakers such as the Fed's Paul Volcker have made strenuous efforts to establish their inflation-fighting credibility. We have now reached the point where policymakers want to establish their inflation-stoking credibility. And they have changed tack just as the political and structural forces are also biasing back to inflation.

As if to illustrate the point, Goldman Sachs are forecasting US GDP growth of 6% in 2021,² while modelling the first interest-rate hike as coming only in 2025.

IS THE FIRST CHOMP ON ITS WAY?

We know the inflationary beast is now on the loose. We just don't know when the predator will strike.

Consider Paul Volcker's experience. He made his inflation-fighting statement of intent in October 1979. It took two years for the markets to begin reflecting the credibility of that intent.

Interest rates first had to rise – from around 9% to around 16% – over this two-year period before they began their multi-decade decline to where they are today. So, even if you had correctly predicted that

Volcker was serious, a long-bond investment wouldn't have started working for two years.

How long will it take to build the inflation-stoking credibility of policymakers in this reverse Volcker manoeuvre? Could it be two years, and further falls in yields, before the Fed's inflation overshooting framework is credible? The answer will depend on two inter-related things. First, political will: whether both the monetary and fiscal authorities have the courage to run the economy hot. Second, the transmission mechanism: what, exactly, will bring inflation about?

POLITICAL WILL IS NEEDED

Volcker's experience shows that, when a regime is deep-rooted, it takes courage and political savvy to pull off a regime change.

Central banks today certainly seem committed to running the economy hot, but the heat is likely to be generated by the fiscal policy in the monetary-fiscal combination. So, if the politics of prudence gets in the way of the political will to reflate economies – as it could in the frugal northern economies in the EU, or with Rishi Sunak's "sacred duty" to balance the books in the UK – then we could end up with more of a stop-start cycle.

This is what has happened in Japan. The fiscally austere Japanese Ministry of Finance is an incredibly powerful bureaucracy, ideologically-wedded to balancing the books. As such, it has a bias to being fiscally tight, even surreptitiously so, when monetary policy has been loose. The result of this bureaucratic reticence is that inflation in Japan has been unable to sustain itself much above 1% for any length of time.

So if politics in the West prevents sustained fiscal cooperation with monetary policy, then it will be hard to raise the level of inflation much. Stop-start stimulus will be the result.

THE TRANSMISSION MECHANISM

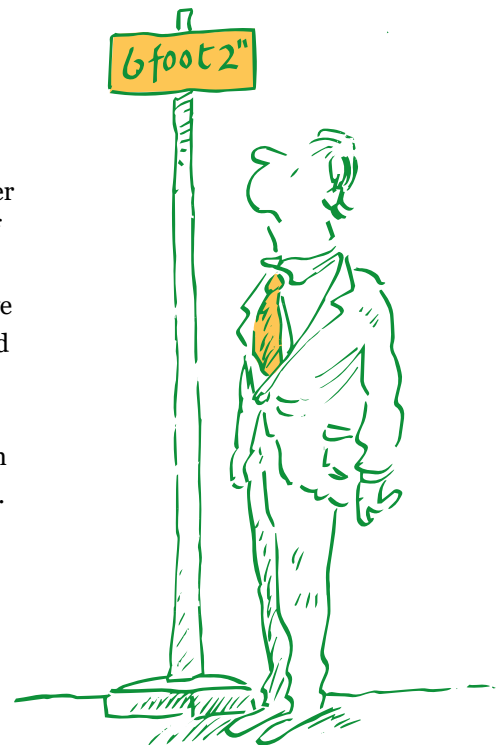
Ever since we started talking about the inflationary endgame at Ruffer, the most common question we've been asked has been: how will inflation be generated? Or, as the investment geeks put it: what is the transmission mechanism?

Everyone can understand the argument that inflation is the more palatable form of default for an indebted government. But most struggle to foresee how inflation could actually be generated, given the structural headwinds to inflation and the dominance of monetary policy in the macro policy mix.

"It's one thing wanting inflation; I want to be 6 foot 2 inches tall" was the retort. "It's another getting it; I'm 5 foot, 8 inches".

Of course, inflation can always be generated in a fiat-money system if there is the political will to do so. The issue is how it can be generated in a healthy fashion. As Nick Carn of Carn Macro Advisors puts it, if your home central heating breaks down, it's not particularly reassuring when the heating engineer arrives with a jerrycan of petrol and a flaming rag and says, "Don't worry, we can get this place warmed up in no time."

The transmission mechanism matters when it comes to policymaking. Yet the language here is unhelpful: it conjures up mechanical images of inputs and outputs, which can be controlled



“ Japan’s deflation problem is real and serious; but, in my view, political constraints, rather than a lack of policy instruments, explain why its deflation has persisted for as long as it has. Thus, I do not view the Japanese experience as evidence against the general conclusion that US policymakers have the tools they need to prevent, and, if necessary, to cure a deflationary recession in the United States.”

Ben Bernanke, November 2002

by the operators. This leads to a focus on conventional explanations for inflation – for example, the monetarist view that changes in the quantity, velocity, or, even, impulse of money supply cause inflation.

What history shows is that inflation is often a collective behavioural phenomenon – with all the non-linear dynamics that implies. If we think of it in this way, we may be drawn to the lesser-discussed fiscal theory of inflation. This holds that a loss of confidence in a government’s ability to service and repay its debt results in a repudiation of

the country’s bonds and an inflation caused by currency weakness. A confidence crisis like this occurs suddenly, rather than in a predictable, mechanistic manner. Think tipping points.

Takeaway: the causal explanation of inflation may not be obvious until after the event, so it’s not helpful to tie an investment strategy to a transmission mechanism. It’s an investor’s conviction on the inevitability of the outcome that matters most.

MEET THE FOUR

And yet it is worth considering what sort of inflationary beast will eat the 60:40 portfolio. Should we fear the Raanessaw? Will we be Fed to the repressor? What about the 1970s T-Rex? Or could it be a new genetically-mutated velociraptor for the 2020s?

First beast

THE RAANESSAW

What's a Raanessaw? It's a reverse Wassenaar, obviously. So what's a Wassenaar?

In 1982, Europe's Volcker moment came with the Wassenaar Agreement.³ Named after the quiet suburb of The Hague where it was signed, it was a ground-breaking agreement between employers' organisations and labour unions. A consensus had emerged in the early 1980s that, to sustain employment, the burden of taming rampant inflation should be shared by employers and the employed. Unions needed to stop demanding ever-greater wage rises, and employers needed to respond by employing more people again. As it set the tone for later social pacts elsewhere in Europe, the agreement has been credited with ending the wage-price spiral of the 1970s.

Today, with income inequality a hot political issue, and shareholder capitalism seemingly giving ground to stakeholder capitalism, is it possible we could see the same consensus emerge, just in reverse? This would involve governments, major industries and organised labour working together to increase wages and bonuses.

In 2013, Prime Minister Shinzō Abe of Japan attempted to instigate exactly this as part of Abenomics. He wanted the link between corporate profitability and wages restored so that the stimulus didn't just get

'stuck' in higher corporate profits and the financial system. Although nominal wages in Japan did rise, real wage growth has been muted. Japan's deflationary mindset has made it very difficult to start a wage-price spiral with enough oomph to reach the 2% inflation target.

While the rest of the world doesn't yet suffer the same deflationary mindset as Japan, I still think it would be hard to kickstart a wage-price spiral in the West. The unions have far less influence now than they did in the 1970s. Governments may push minimum wages higher but are not inclined to impose themselves more broadly in wage-setting. And, while companies may lean-in to the idea of stakeholder capitalism by paying employees more, they won't unilaterally create a spiral which undermines their profit margins.

So the Raanessaw doesn't seem like an imminent inflationary threat.

Second beast

FED THE REPRESSOR

The US ended the Second World War with debt running at nearly 120% of GDP, while the UK's ratio stood at 250%. By the early 1970s, the US debt-to-GDP ratio had fallen to around 25% and the UK's was down below 50%. How was this achieved?

A lot of the heavy lifting was done by repressing the interest rate paid on government debt to a rate below the level of

inflation. For example, the rate of interest on US long bonds was fixed at 2.5% in June 1941 and remained at that level until the Treasury-Fed Accord in February 1951. Inflation, meanwhile, averaged 5.9% over that period.⁴ As a result, real interest rates were deeply negative, which meant nominal GDP grew faster than nominal debt, thereby reducing the debt-to-GDP ratio to more manageable levels.

One of the attractive things about this period is that the government's deficit, having been enormous during the war, fell back to near balance in the years after it. As a result, US gross debt levels flatlined.

The post-war context was perfect for financial repression. The necessary reconstruction created demand, and supply was still impacted by the war. Background inflation remained elevated while interest rates were controlled. It is difficult to say, therefore, that financial repression drove inflation; rather, financial repression was effective because inflation was already the mood music.

A similar repression has taken place since 2008. Real US overnight interest rates have been negative for most of the past 12 years. Although interest rates beyond the overnight rate have not been formally fixed as they were in the 1940s, they have been heavily managed through a combination of quantitative easing and forward guidance by the Fed. This has stimulated asset price inflation, but not consumer price inflation.

In our current environment, interest rate repression alone is not enough to stimulate higher consumer prices. So, if we're imagining how the future might be more inflationary, the post-war period is only part of the story. When most people think about inflation, they tend to think about the 1970s. Does this period hold the key?

Box 1

NEGATIVE INTEREST RATES

Financial repression since 2008 has been a support – rather than a threat – to the traditional 60:40 portfolio. In fact, were the Fed to push harder by experimenting with negative nominal interest rates, then the 60:40 portfolio would continue to thrive.

As I argued in last year's Review, I don't believe negative nominal interest rates will be seriously attempted in the US unless fiscal policy abandons monetary policy in the stimulus mix. This now looks a lot less likely in a post-covid world.

Why? Because the baton of policy stimulus has passed to fiscal policy (with accommodation from monetary policy). This baton pass is needed to drive demand directly, rather than hoping that asset markets will transmit monetary stimulus to the real economy through higher asset prices.

Third beast

THE 1970S T-REX

The inflationary cycle of the 1970s is largely associated with the supply-side shock from oil prices allied to the labour market frictions of high union power. Fiscal largesse, blind to actual output gaps, provided the fuel of excess demand.

Lesser appreciated is that, in the US, this cycle had its origins in the 1960s. President Lyndon Johnson's government overestimated the amount of slack in the economy – and sought to utilise it. Beginning with the Kennedy-Johnson tax cuts in 1964, the US began stimulating growth with fiscal policy while pressuring the Fed to keep monetary policy loose. The result was a series of inflationary waves in the 1960s which were amplified by the events of the 1970s.

There are some parallels with today. Take the supply side, the capacity of the economy to produce goods and services. This has undoubtedly been damaged by the covid crisis. Unusually, in the West it has been the dominant service sector which has been hardest hit (think, hotels and restaurants that will struggle to reopen). The crisis has also reminded business leaders that there are benefits in having some redundancy (think, holding a little more just-in-case inventory). Covid-19 compounds two other structural supply side shocks that are covered by my colleague Alexander Chartres elsewhere in this Review: supply chains shifting as US-China relations deteriorate; and the attempt to price in some of the cost of environmental, social, and governance externalities into the costs of business.

Collectively, these shocks will act against the structural disinflationary trends that have prevailed in recent decades. But will they make the Western economies inflation-

prone, 1970s- style? It's unlikely; the oil shocks were very extreme cost-push events. That said, we need to consider the emerging macro context. If these supply-side changes are allied to macro policy, which assumes both an unchanged disinflationary backdrop and a greater degree of slack in the economy than actually exists, then we could have the set-up for a very similar policy mistake to that made in the 1960s. Stick a high voltage across a copper wire and it will get hot; stick the same voltage across a thinner wire and it will get hotter.

The US Federal Reserve, for example, has been explicit in its view that monetary policy should remain accommodative until unemployment is back to, or below, the low levels of 2019. The Fed assumes inflation will not be an issue between now and then, because it wasn't previously. So much so, in fact, that it has adjusted its monetary policy framework to include the idea of inflation make-up, or inflation overshooting – the Fed will allow inflation to remain higher for a period to compensate for a past period in which it ran lower than the 2% target.

And fiscal policy is now active alongside monetary policy. This is direct stimulation of demand. It does not rely on transmission via the financial markets, as it has since 2008. Stimulus via monetary policy alone has tended to get trapped in financial markets – with share buybacks and financial engineering, rather than new factories and higher real wages. Monetary-fiscal coordination is stimulus via Main Street, not Wall Street. It stimulates consumer price inflation rather than asset price inflation.

Adding it all up... we have demand stimulus (which is more directly inflationary) hitting a post-covid economy (which is structurally more inflationary

biased). That combined with policymakers who will both cheer inflation on and who have promised to let the economy run hotter for longer. All against a backdrop of financial markets that have wired themselves to the proposition that low interest rates are here to stay.

Fourth beast

A NEW, GENETICALLY-MUTATED VELOCIRAPTOR

While the 1960s and 1970s provide the textbook roadmap for inflation in the developed economies, we need to think more creatively about what unique genetic mutations the next inflation might have. One avenue that interests me is the idea of a run on fiat currencies.

In developed economies, we are used to relative stability in foreign-currency exchange markets because of the credibility of the institutions that manage the economy. This means most people haven't spent a lot of time asking themselves, "what is money?" or "is my money safe?"

That has started changing in the post-2008 world of extremely low, sometimes negative, interest rates. Faced with a safe pathway to retirement that is torturously slow, savers have been forced to take substantially more risk to find return. For some, particularly the young, this has incubated a 'speculate to accumulate' mentality. And one of the popular speculations has been on digital currencies.

Irrespective of the merits of these digital assets, their emergence has led a generation of young people (and quite a few older ones too) to consider some of the existential questions about money. Even if it is simply to justify a speculation, they have had to consider characteristics such as: fiat money's potentially unlimited supply; how much money is being 'printed' to bail out the latest victim(s); how inflation typically eats away at money's purchasing power; how a real asset like gold can – and did – act as a monetary anchor; and how new technology offers the potential of 'money over IP'.



Large numbers of people outside finance are interested in what money is and, more importantly, what its failings are. They are also getting equipped with tech tools that allow them to move out of fiat and into alternatives such as gold or bitcoin. The website of the mobile bank Revolut yells out: “Go from cash to crypto, in seconds.”

In the nineteenth century, once people got the hang of the signals that indicated banks might be in trouble, they would seek to withdraw their bank deposits on the back of the rumour, rather than waiting for the facts. The banking panic run of 1893 was a spectacular example of this learned ‘panic early’ behaviour.⁵

So the psychological tinder of confidence in fiat money is drying, and the technology providing alternatives is becoming available to everyone. This greases the wheels of another route to inflation: a sharp fall in and run on the currency, something we normally only associate with emerging market economies. As with fiscally-driven inflation, this too would have tipping point characteristics.

Could this happen today? Potentially, yes, but I doubt the tinder is dry enough yet. I think further development is needed on three axes –

- A sharp pick-up in actual inflation, which central banks seek to look through.
- Sustained use of fiscal policy and continued academic endorsement for it.⁶
- A further acceptance of, and widening access to, digital assets (the things depositors would run to) by institutional investors, regulators, and commentators.

All of these feel like very live dynamics for the next 12 months.

DRAWING ON THE FOUR BEASTS

Box 2 shows an example sequence of events from here, drawing on the thoughts set out so far.

The key point to take away is that it is inflation volatility, not necessarily sustained higher inflation, which ignites the psychological tinder. We might only need 1960s inflation volatility to get 1970s inflation rates.

This would give us a kind of inflation unexpected by the conventional analysis. It is one which favours the intuition of our Chairman, Jonathan Ruffer: the transmission mechanism is something to marvel at in hindsight, rather than seeking to time with foresight.

By putting the focus on inflation volatility, this also accommodates the possibility that the still-powerful disinflationary forces in the world will continue to make sustained inflation hard to come by.

FIRST FRIGHT, THEN MAIMING, THEN DEATH

Investors’ generic fear for portfolios today is that bond prices can’t rise much more and so they won’t be a good hedge in portfolios. This is overly simplistic.

First, it ignores the possibility of negative nominal interest rates, something we see as unlikely but not impossible. More important, it ignores the key question: what drives the bond-equity correlation, and what conditions will turn it positive again? Put simply: when will bonds stop providing an offset to equities in a portfolio?

On the Jurassic theme, true to Hollywood form, it seems most likely that we get some inflation frights before the final demise of the 60:40 portfolio. By inflation fright, I mean inflation volatility, which

⁵ federalreservehistory.org/essays/banking-panics-of-the-gilded-age

⁶ For a recent example of such an endorsement, see this piece by prominent US economists: brookings.edu/wp-content/uploads/2020/11/furman-summers-fiscal-reconsideration-discussion-draft.pdf

Box 2

AN EXAMPLE SEQUENCE OF EVENTS

Dramatic covid policy stimulus into supply side shocks gives us an initial burst of inflation and growth in the second and third quarters of 2021.

1

This negative fiscal impulse quickly takes the heat out of the economy. Inflation and growth fall sharply again at the end of 2021 or early in 2022, and the secular stagnation headlines reappear: 'Inflation only transitory.'

3

The overall effect is much higher inflation and growth volatility, which central bank policy prevents from being priced into much steeper yield curves.

5

Inflation in that economy moves decisively higher, justifying the pre-emptive move by depositors and investors. Perhaps, more interesting, what happens if – given today's technologies – society itself is able to function better with higher levels of inflation than it has in the past? Would this make over-indebted governments more tolerant of inflation? The losers would be the older generation of savers and pensioners. But perhaps this too is more tolerated because this is also the generation which has accumulated the wealth.

7

2

Central banks are willing to look through this and, if required, stop long-term interest rates from rising too much. Fiscal policymakers, feeling the need to appear prudent, use it as an opportunity to reduce some of the fiscal stimulus.

4

Fiscal policymakers are compelled to return to stimulus, which they now feel is an effective tool alongside accommodative monetary policy. Central banks continue to signal their approval. Chatter around Modern Monetary Theory grows louder.

6

Suddenly, on the back of another wave of stimulus and a pick-up in inflation, there is run on a major G7 currency. Domestic depositors and investors seek to escape the financial repression of low rates and resurgent inflation.

8

Seeing this, depositors in other G7 countries, are primed for exactly the same behaviour in their own currencies. The pattern becomes contagious.

implies inflation rising sharply, scaring people, and then disappearing back into the undergrowth. The conditions for starting this in 2021 are perfect thanks to the vaccine-led reopening of the world economy, supported by enormous monetary and fiscal stimulus. No doubt, as soon as it looks like the world is reflating, policymakers will seek to remove their extraordinary fiscal support measures. This will quickly puncture any inflationary exuberance – and down inflation will go again.

For 60:40 portfolios, the first of three phases will be fright. Inflation volatility rises. Bond prices no longer trend higher, but they do remain negatively correlated with equities. In this phase, bond prices are likely to fall as nominal growth and expected

inflation rise (and vice versa). Equities are likely to do the reverse. So bonds remain an offset, but bond prices are probably beginning to trend downwards. The 60:40 portfolio has both dampened return and dampened volatility.

The second phase will be maiming. This moment comes when the bond-equity correlation switches back to being positive. The purpose of bonds in a portfolio is lost.

Phase three will be death. The deadly chomp arrives when inflation drives interest rates higher and this causes a de-rating of equities (investors are willing to pay less for the same level of future earnings). Bond and equity prices, being positively correlated, both trend lower together.

Figure 2
THE US BOND-EQUITY CORRELATION SINCE 1902

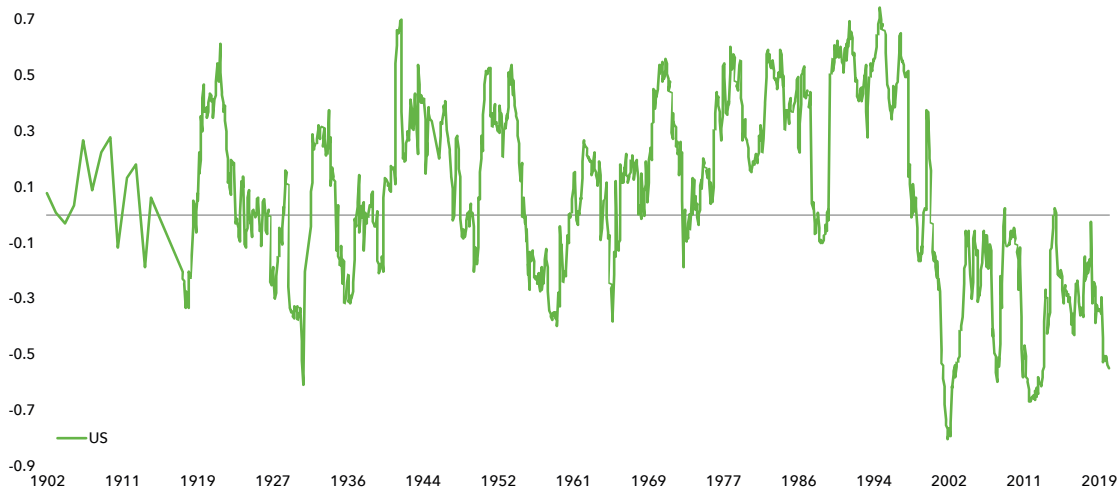
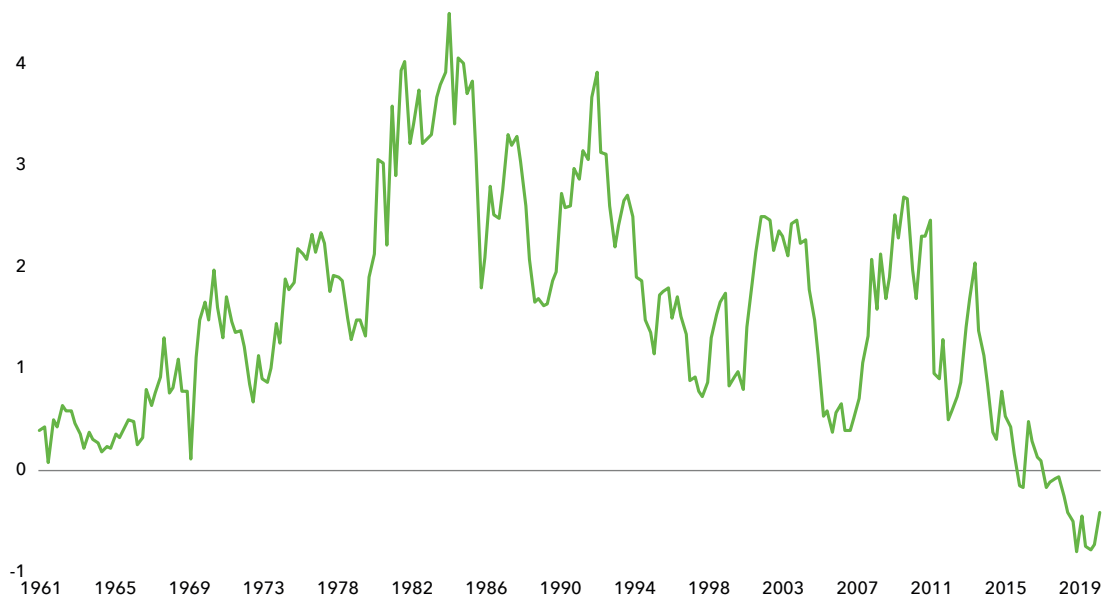


Figure 3
TERM PREMIA - ACMTP10 INDEX



THE BOND-EQUITY CORRELATION

The negative correlation between bond prices and equity prices has been a key driver of the success of 60:40 portfolios. With bond prices rising as equities are falling, portfolios enjoy a smoother journey. Yet, as Figure 2 illustrates, the bond-equity correlation shows different patterns over time.

In our research on the bond-equity correlation, we have identified three main factors behind the shift in correlation from positive to negative since 1997: the spectre of deflationary busts; the central banking paradigm in a low-growth world; and the counter-cyclical need for high-quality, risk-free collateral in modern financial markets. The second of those, on the central bank paradigm, has been shaped by a fear of repeating the experience of Japan: very low or negative inflation is a terrible thing, so monetary policy is biased towards avoiding busts rather than

worrying pre-emptively about booms. On the need for collateral, this simply means that, when asset prices fall, the demand for collateral rises (usually as margin in derivatives exposures) and therefore demand for 'risk free' government bonds also rises.

The existence of this negative correlation, and the expectation that it would remain in place, has shaped the bond markets. The term premium – the extra yield you get as compensation for the uncertainty that comes with lending for longer periods – has progressively fallen. This premium is now considered to be negative, as Figure 3 shows. Paying a premium, rather than receiving one, for owning longer-duration bonds can only be logical if the following holds: the drawbacks of uncertainty must be more than outweighed by the benefits to the portfolio's risk-return character that come from owning the long bonds.

This introduces a reflexive dynamic into bond yields. Disinflation has both caused yields to fall and the bond-equity correlation to turn negative. In turn, this caused the term premium to become a term discount, because of the added attractiveness of bonds in a portfolio. This has been a double-headed force for bonds; the trend has been self-reinforcing and will be hard to break.

Higher inflation volatility is unlikely to be enough to break this trend, especially when the Fed is expected to look through any initial move above its 2% inflation target. What will be required is a belief that the underlying level of inflation has risen sufficiently and sustainably, so that central bankers once again begin to fear inflation more than deflation. This might involve a sustained move upwards in the inflationary trend (as in the US 1960s example) or a sudden jump to a much higher level of inflation (say, accompanying a currency crisis).

When the double-headed trend for bonds does reverse, it will work just as powerfully in the opposite direction. Bond prices will both trend lower and be positively correlated with equities. At this point, bonds will be about as useful to portfolios as a chocolate teapot is to tea at the Ritz. The 60:40 portfolio is better off being a 60:0 portfolio.

WHAT ABOUT EQUITIES?

If it takes a sustained shift in the level of inflation to break the negative bond-equity correlation, then the accompanying rise in nominal interest rates may also cause a de-rating of equity markets. This is the Jurassic risk – equity and bond prices fall together.

The most damaging phase for investors is likely to come after the reversal of the bond-equity correlation, when inflation moves sustainably above the Fed's target.



Figure 4 comes from Gerard Minack at Minack Advisors. It shows the level of inflation (measured by core CPI) against the multiples investors place on equity earnings in the US. For equities, the best level of inflation is around 2%. If inflation were to rise above 4%, then there is a high probability that the equity market would de-rate. Given the high starting multiple (the orange dot), this could be a very painful process.

Jonathan Ruffer calls this environment the 'airless valley'. Both equities and bonds would be trending lower and their prices would be positively correlated. The 0:0 portfolio (cash) would outperform traditional 60:40 portfolios. When it comes, this environment will destroy wealth on a level not seen in a generation.⁷

After decades of investing in financial markets for wealth creation, wealth preservation will be the priority.

Figure 4 US EQUITY TRAILING PRICE-EARNINGS RATIO (PE) AND CORE INFLATION

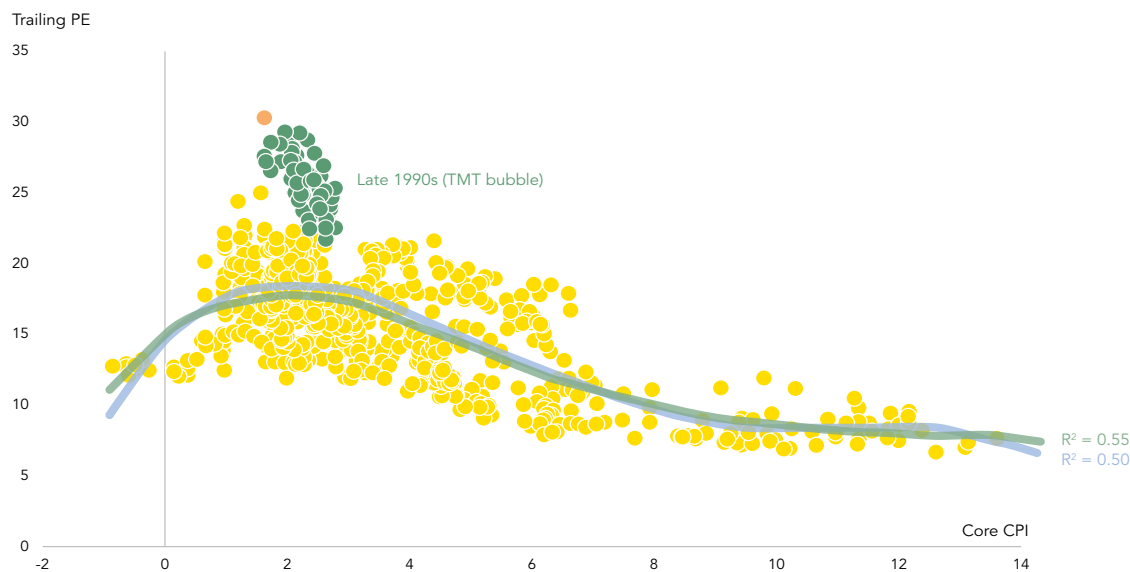


Figure 4: Minack Advisers. Operational earnings from 1988, monthly data from 1955. This chart shows two lines of best fit. R^2 at 0.55 excludes the TMT bubble.

THE DRAMA UNFOLDS

The dramatic events of 2020 have tipped us into a new, more-inflationary, regime. The demise of the 60:40 portfolio may not be imminent; the full drama may take years to play out. Rather than using the time to escape, I suspect most investors will just extend their stay in traditional balanced portfolios.

As with the visitors at Jurassic Park who know the velociraptors have broken loose, but who can't emotionally connect with the danger until they see stampeding crowds, it will take some portfolio bloodshed to cause panic. Perhaps we had a glimpse of the future in March 2020 when traditional portfolio diversification failed.

Regulation focused on protecting investors (using, for example, backward-looking risk measures that present bonds as

low risk) will inadvertently make it even harder for investors to avoid the Jurassic catastrophe. "Rest assured, ma'am, the security cordon is impenetrable. There's absolutely no way for the dinosaurs to get out..."

It will take bravery, imagination, and an uncomfortable portfolio journey to get through the drama.

In the scenes immediately ahead of us, inflation volatility will rise in 2021 as economies reopen. Some of the inflation prints this year could be startling, elevated by the recovery and the low base for year-on-year comparisons. It is unlikely that high levels of inflation will be sustained. In the new macro policy regime, fiscal policy is the accelerator and monetary policy will (eventually) be the brake. So it is the fiscal impulse – positive or negative – that will be



“ I believe inflation, when it emerges in earnest, will be a tipping-point phenomenon...”

the primary driver of inflation and growth, while central banks (initially at least) will look through inflation overshooting their targets.

Having played second fiddle to monetary policy for the past 40 years, fiscal policymakers are out of practice. Hence, we can probably expect the sort of stop-go driving of an old Land Rover going off-road, where the driver is scared both of driving too fast and of stalling the vehicle in a muddy ditch. This is the bumpy journey towards a policy regime which looks more like Modern Monetary Theory or helicopter money – the explicit and enduring coordination of monetary and fiscal policy.

As inflation volatility rises, we will discover how inflation-prone economies are. This will be the first test of structural disinflationary forces clashing against more recent supply side shocks.

If the structural disinflationary forces still dominate, then inflation volatility will remain high while the underlying level of inflation will rise only slowly. In this scenario, I think it is currencies that become brittle – there is a higher likelihood of

an eventual ‘jump to inflation’ via a run on the currency.

If, on the other hand, the economy is more inflation-prone than expected, we are more likely to see the underlying level of inflation rise steadily as inflation volatility persists. Here, the level of inflation rises through 2% inflation targets and keeps rising above 4%. This could also happen quite quickly, and currency weakness may well be a part of this story too, just not the abrupt weakness of a currency crisis. This would look more like the 1960s-1970s playbook.

Of course, different economies will have different characteristics, and may have wildly different experiences. In particular, the US, with the dollar as the world’s reserve currency, will matter enormously to what happens globally.

THE CONFIDENCE GAME

I believe inflation, when it emerges in earnest, will be a tipping-point phenomenon – of the genetically-mutated variety – rather than a more linear input-output mechanical phenomenon. Policymakers will be focused on labour markets and

output gaps, not on the growing fragility of confidence in fiat money.

They see the firefighter of their policy as sitting in the Arctic: the conditions are cold and icy (even if some supply-side pressures are warming the landscape a little). To worry about wildfires in this context seems perverse.

Thanks to Volcker, policymakers also have a prevailing confidence that inflation can be controlled if it does end up burning a little too brightly.

From this, a paradox emerges. Policymakers may observe an objective truth that the inflationary potential of the system is low at a given point in time.

Yet the inflation volatility they encourage and tolerate – shaped by their confidence in that objective truth – may alter the subjective beliefs of the spectating public. Armed with partial truths and partial information, and powered by social media, the collective action of the public may reveal the greater truth about money and inflation: it is a confidence game.

What happens if enough of the crowd start to believe that sharp bursts of inflation (even if not sustained) are proof of the

authorities' efforts to undermine the value of their savings? It matters not whether this is actually the correct assessment. If the crowd takes a tech-enabled exit to other perceived stores of value, in that very instant the objective truth will have changed.⁸ The firefighter will have teleported from the Arctic to the African savannah, and – whoosh – we have inflation.

In physics, this is would be called a phase transition: certain properties of the medium change, often discontinuously, as a result of a change in external conditions.

THE CHALLENGE BEFORE US

It is our job at Ruffer to create portfolios for clients that are resilient to the different pathways to the inflationary endgame but that don't rely on precision timing.

Our approach thrived in the Spielberg drama of 2020. We are prepared for the sequels, and to dodge the chomps coming for the 60:40 portfolios. ●

8 I doubt this drying of the psychological tinder will be picked up by survey measures of inflation expectations. I believe it is the confidence in the expectation that matters, rather than the expectation itself; this is unlikely to be captured in the surveys.

