

Investment
update

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Stewart joined OMAM in June 2009 from Newton Investment Management where he held a similar role and managed the Newton International Bond Fund and BNY Mellon Global Bond Funds, both rated AAA by Standard & Poor's. He has more than 20 years' experience of global fixed income markets, having begun his career in 1987 as a broker before subsequently switching to fund management.

Increasing inflation protection, investing in corporate bonds

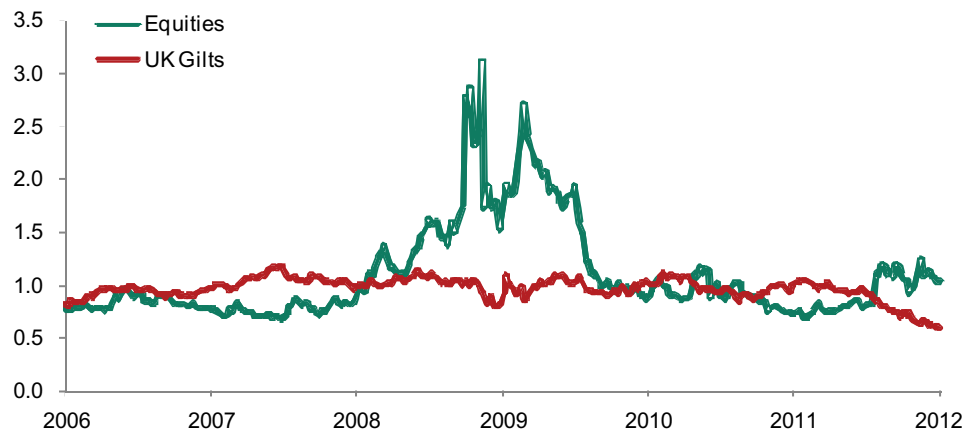
The price isn't right

Government bonds depend on central bank life-lines while the relative value of corporates is attractive

If 2011 was about economics 2012 will be about valuation and pricing. And by valuation I mean all asset classes; government bonds, corporate bonds, inflation-linked bonds, equities and currencies.

"Isn't it always?" you ask. Well, yes, but last year was characterized by short-termism, market manipulation and an increase in volatility that saw investors making extraordinary portfolio movements (the kind of things you expect over months) in a day. Also investors bought things at prices that were unthinkable (like accepting negative returns on government bonds) just so they could hide their money away from a banking system that at times appeared to be crumbling in front of our eyes. As a result, prices have, on a number of measures, gotten out of line.

Figure 1: Risk adjusted yields in UK equity and gilt markets



Source: Bloomberg.

By now we know the economics. We even know the issues that face us. Governments (well some of them) are embracing the experiment that is deficit reduction. It's easy to show that even a feather-light decrease in pressure on the government spending accelerator causes GDP rates to fall. So what is to come is a low growth environment, which no electorate will like, and as a consequence, central banks that won't touch official interest rates for years to come. At the same time, we are seeing price pressures that – in our view – are pushing up the basic costs of life faster than what is reported in official Consumer Price Index numbers.

And then there is the thorny issue of the West's place in history. We continue to run up debt whilst the major developing economies are adding to their bank accounts. It's the big grey wrinkly thing in the room that we have been deflected from due to the goings-on in Europe. Our currencies should decline relative to theirs over time and the tensions are rising for them, the Chinese in particular, to allow this to happen.

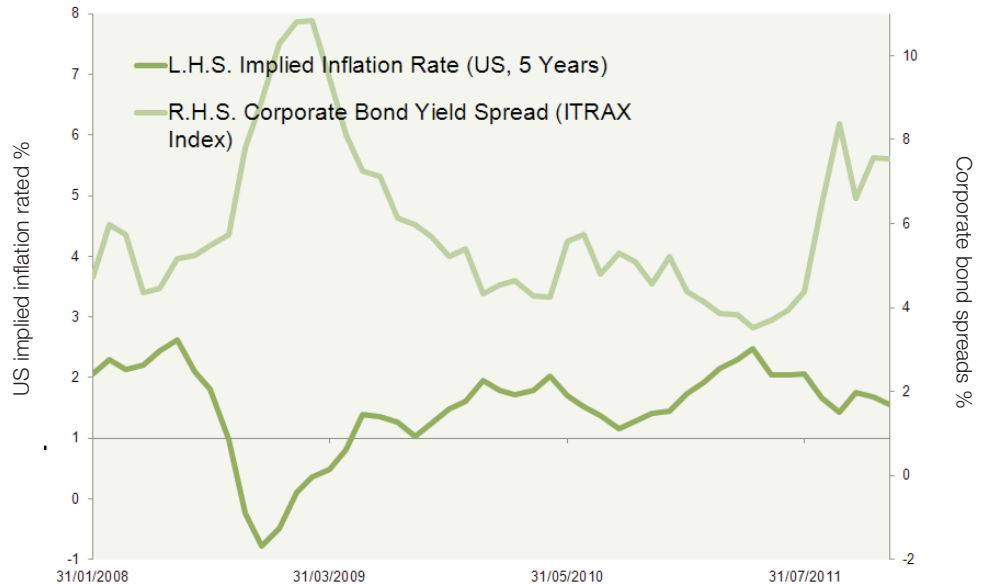
We also know that pretty much everywhere you look the government bond markets are rigged. Operation Twist in the US, quantitative easing in the UK and Japan and the recycling

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of money by the European Central Bank are all forms of artificial stabiliser. On a number of metrics (such as comparisons with credit default swaps or inflation) government bonds are valueless. But this is unlikely to be reflected in Treasury or gilt prices unless central banks change policy radically – or the vast swathe of issuance coming in 2012 overwhelms the markets.

If short-term interest rate policy isn't going anywhere and government bond markets are effectively manipulated, it makes the case to look for opportunity elsewhere. First of all let's look at the bond/equity relationship (see Figure 1). It's not right to compare bond and equity dividend yields directly because they have fundamentally different risk characteristics. But if you allow for the difference you will see something profound has happened in 2011. Prior to 2008 equity yields were lower than those on government bonds. Then the credit crunch hit and there was a strange moment when risk-adjusted equity yields traded well above government bond yields. In 2009 equities rallied and the old relationship was restored. But recently, due to QE and irrational buying, government bond yields – on a risk-adjusted basis – have been driven back below equity yields, and by a decent margin.

Figure 2: Implied US inflation and corporate bond spreads



Source: Bloomberg.

This relates to circumstances in the UK but it is also true in the US, continental Europe and Japan. Remember – this isn't an indicator of the absolute direction of markets but of how out of kilter the relative valuations have become. This is reinforced by trailing price/earnings relationships that are well below historical norms. There is no getting out of it – equities look good compared to government bonds. If investors begin to shun government bonds in favour of equities it is quite conceivable that faced with the mountain redemptions (and consequent new issuance) due from governments globally in coming months and years, central banks will end up taking on board significant amounts of the coming supply. Otherwise, one slip on the supply/demand balance and even the global central banks may not be able to stop government bond yields rising in 2012. In this sense the risks in the government bond markets appear to be skewed; the best you can hope for is the running yield and the worst is an unquantifiable loss.

Now if we turn to relationships in the bond markets, we sort of know that government bonds

offer negative real yields or yields that are less than or close to their insurance (CDS) costs which means they offer little real investment value unless you want to buy duration risk. This leaves you looking at alternatives like corporate and inflation-linked bonds. If you look at yield spreads (in this case the middle of the credit spectrum) and implied inflation rates in the index-linked market (see *Figure 2*), you'll find that inflation assumptions are low and corporate bond yield spreads have widened. The relationship isn't as extreme as in 2008 when there were notions of the world entering into a deflationary depression with wide scale corporate failures, but still the troubles of 2011 have left markets in a state of shock which would seem to ignore some of the fundamental dynamics of our world.

There are currency movements that can and should occur over the coming years – the decline of sterling against the renminbi, for example – that will challenge the 2-3% inflation assumptions priced into the index-linked markets. For instance, has anybody noticed that the oil price rose 20% in 2011? It is up 45% since mid-2010. At the same time, here in the UK, we have the 2012 Olympics which, by the experience of other countries, pushes up inflation in the host nation. The Bank of England has little or no chance of hitting its 2% inflation target this year.

At the same time, we know companies are cash rich and some even trumpet they have more cash in their bank account than they have debt outstanding. Given that many good companies in unfashionable sectors are producing results above their domestic economic performance it's too narrow-minded just to concentrate on the inevitable default of Greece to define investment policy in the future. All corporate bonds got lumped in together in 2011 when episodes of risk aversion ebbed and flowed but now, as the dust settles, we are left with a market that offers value to investors prepared to buy and hold over a couple of years – and with the nerve to ignore some of the inevitable volatility to come.

There are a lot of "known knowns", as they say, now. We pretty much know Greece will default (it's in the interest of a broad church of interests). We also know that the European banks are funded for three years by the ECB to the tune of Euro450bn. We also know the US Federal Reserve aren't going to increase interest rates before 2013 and that they will recycle hundreds of billions of maturing debt into the long end of the government bond markets to halt any major rise in yields. We also know that the political establishment are going to leave the budget deficit to the next president. One further point – looking back in history, it has been the habit of the Federal Reserve in an election year to over-insure the good things that are going on the economy. Meanwhile, the Bank of England and Bank of Japan are going to continue their policies of QE.

Looking at currencies, the markets have never been so negative on the euro relative to the US dollar, which creates room for buyers if there is any kind of resolution in the eurozone. Western currencies, as we have said, are overvalued relative to the east.

If you add it all up, you understand why investors should be preparing to shun government bonds, buy risk assets (equities and corporate bonds), buy inflation protection and decrease safe haven currencies like the US dollar and Japanese yen.

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