OLD MUTUAL ASSET MANAGERS

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For professional investors only

Stewart Cowley, Head of Fixed Income

Stewart Cowley 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. Stewart 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.

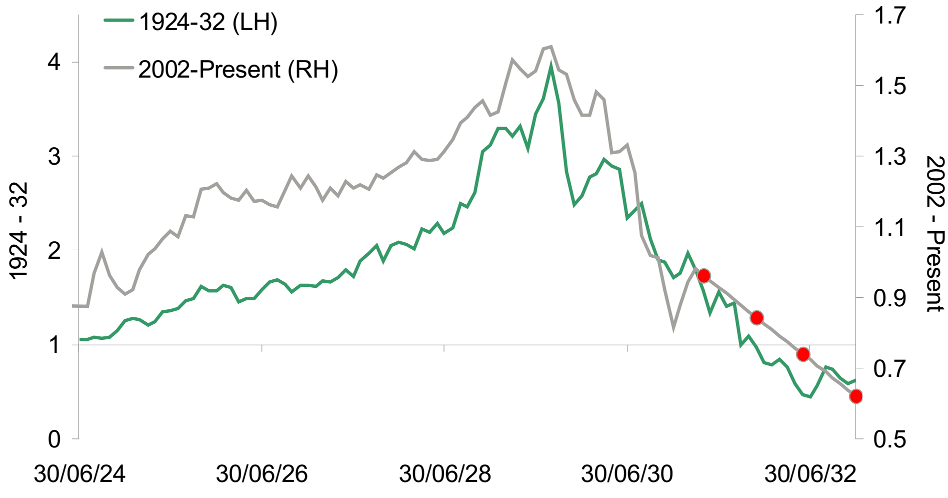
1929 and all that

Increasing duration in the government bond portion of the portfolio

Although we are now half way through 2009 it would be easy to become confused by one or two short term market movements: bonds are down, stocks are up, the US dollar has stabilised and credit yields are now relatively closer to their government bond equivalents. You would be forgiven for thinking that the nastiness of 2008 is over and we can resume 'normal exuberance'. Sadly, this is more like a pause than signs of the beginning of the end.

Personally I have never understood statements like "the market is tired" or "the economy is in need of a rest" as there is no particular evidence for physical attributes being necessary for organised collective behaviour: it does not follow that investors one day grow 'tired' of their wealth increasing or that an economy would choose to stop consuming because of 'fatigue'. Similarly, I have some reservations about the mechanistic notions of the relationships like interest rates and the stock market. For instance, there is plenty of evidence that money was tight in the years preceding the 1929 stock market peak in the same way that monetary policy has been said to be 'too loose' in the run up to the top of the current crash-ette. You can't have it both ways: simplistic explanations are just that – simplistic.

Chart 1: The Dow Jones, then and now



Source: Bloomberg

No, it is the psychological willingness to speculate, blindly and with the full suspension of disbelief, that causes bubbles and it is the sudden appearance of reality that causes spectacular reversals, not 'tiredness'. That all bubbles will come to an end is not to be doubted and when they do the selling destroys the illusion of ever-increasing values. The

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rush to unload whatever commodity it is that is involved in the bubble becomes disorganised and chaotic and the speculative orgy ends. We do not know why the speculative binge ended between 1928 and 1929 in the same way that we may never know why it ended in 2000 or 2008 for that matter. But it did, and it has, for the time being.

To get an idea of where we are in the current process of speculative deflation we charted the era up to and beyond the peak of the US stock market in 1929. In a few short years before 1929 the value of the Dow Jones quadrupled. In the following years it fell 84%, peak to trough. Using a similar timescale, place upon it the same experience since 2002 when values 'only' doubled in a relatively short period of time. My old geometry teacher taught me how to fool people with graphs so I won't be so dishonest as to try and trick you and say merely that the illustration is only by way of a comparison but nonetheless a useful one as to what could happen if history repeats itself.

But you get the idea: if we are to make comparisons with 1929, the ripples will spread out for another five years at the very least (don't forget what got America out of the Great Depression was the Second World War and not a natural economic recovery), mainly because the propensity to speculate has been crushed and the means to do it (cheap and available money) has been removed. For fun, we extrapolated where we should get to, by modern standards, before the current bear market reaches a bottom for stocks (see the four dots on the graph which represent the extrapolation). It looks like we are at least a couple of years away from a bottom and 3,000 points off the market (36%).

So until the fantasy created by easy money can be rekindled in the minds of speculators and the means to propel the dream-like state (new, undamaged money) can be found, markets will, at best, vibrate in a range which will create a lot of work for fund managers. Meanwhile, to stop another bout of stock market weakness the US Federal Reserve, the European Central Bank and the Bank of England will need to keep interest rates low and ensure that borrowing costs in the bond markets stay capped. Quantitative easing could yet return in the second half of 2009.

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