

22 July 2009

For professional investors only

Stewart Cowley, Head of Fixed Income and manager of the Old Mutual Global Strategic Bond Fund and the Old Mutual Dynamic Bond Fund

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.

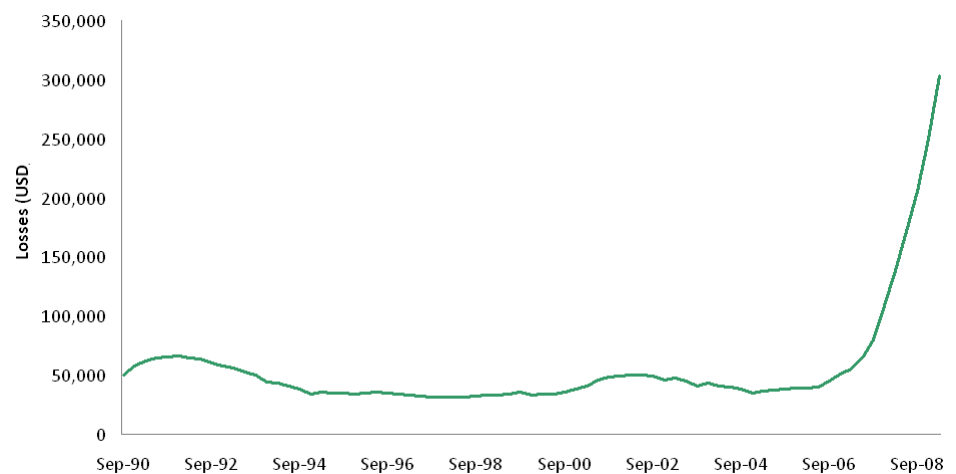
Delay and pray

Increasing US government bond duration

It was interesting watching US Federal Reserve Chairman Ben Bernanke giving his dry mouthed testimony to the Congressional Banking Committee recently, reassuring the members that, when the time came, the Fed had all the tools at its disposal to increase interest rates. Thought leaders in the US clearly have finally realised that it's alright to have a policy but it's best to announce your exit strategy long before you need it. But what was striking was that there was no mention as to how the Fed would lower interest rates going forwards.

The rise in US Treasury yields in the past six months can't have helped the cause of those hoping for a quick recovery. Coupled with rocketing delinquency rates the potential losses in US banks are mounting once again. Given the signal that CIT would not be helped out by the government and the fact that over 50 small US banks have failed this year already we should only expect more problems before the year is out.

Chart 1: Estimated mortgage delinquencies



Source: Bloomberg 1 June 1990 - 30 June 2009

The scale of the potential losses sitting inside US banks is truly impressive. The fact is that delinquency rates¹ are now only as high as they were during the last real estate crisis in the early 1990s. The problem now is that the size of the mortgage market is just that much bigger: something like five times larger.

An idea of the kind of losses that are mounting in the mortgage market can be had by simply multiplying the delinquency rate by the size of the market (chart 1). Until recently the increased size of the market counted for very little because loan delinquencies fell to astonishingly low levels, creating the illusion that there was a stable \$50bn at risk at any one time. But all that has changed recently and the rapid rise in delinquency rates now means that there is an astonishing \$300bn of potential losses sitting within the mortgage markets and it only looks like it's going to get worse as unemployment rises.

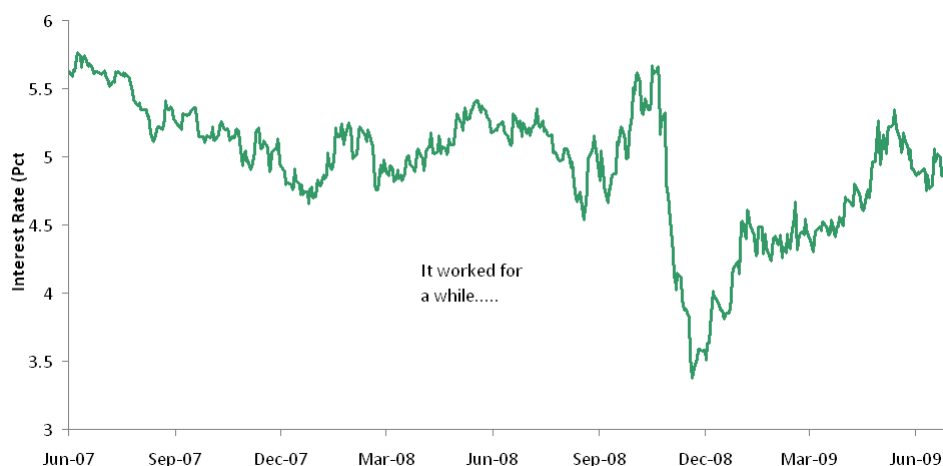
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Contact details

+44 (0)20 7332 7500
www.omam.co.uk

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Chart 2: US 30 year mortgage rate since 2007



Source: Bloomberg 2 July 07 - 22 July 09

Even Mr. Bernanke admitted that unemployment would stay well above the natural full employment level for the next few years even after the economy had reached a new lower plateau.

The trouble with the default and delinquency rates on mortgages is that they more than likely underestimate the problem. The new policy of 'extend and pretend', the process of forgiving a few months' interest payments to companies and individuals masks what would naturally have been a much higher default rate under more normal business conditions. In reality 'extend and pretend' has been replaced by 'delay and pray'.

With mortgage rates back to where they were nearly two years ago (chart 2) the tentative policy of quantitative easing announced last December has been a demonstrable failure. When chided for the extent of the Fed's intervention in the money supply through asset purchases, Bernanke replied that the Fed now had proportionally less US Treasuries on its books than it did a couple of years ago. This can only mean that they should have plenty of fire power going forwards to start buying US Treasuries to pull down mortgage rates in order to counteract a secondary round of small and medium sized bank failures in the second half of 2009.

¹Delinquency is the failure to meet a financial obligation when payment is due. Delinquency rates are measured as a percentage of end period loans.

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