OLD MUTUAL ASSET MANAGERS

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For professional investors only

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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.

I'm still dancing…

Reducing investment grade credit, switching into government bonds

Finance is part reality and part illusion. Markets are not economies but sometimes they behave in line with economies. And to illustrate this, it looks like there are many things happening right now, but actually there is only one thing.

For instance, stock markets have been rallying, credit spreads have been contracting, government bond yields have been rising and investors have fled the safe-haven US dollar for other currencies. Meanwhile, some commentators have, in true Galbrathian fashion, announced a confident return to normality to engender confidence in the population and turn the early signs of stabilisation into a full-blown recovery. All these variables look impressively independent and yet they are linked by a continuous thread of logic: they are simply related to money finding a home.

What money is hiding from is near-zero interest rates. Purely because of the mathematics of bonds you have, over the past six months, been able to buy pretty much anything in the credit arena with the knowledge that, as long as the company is around to honour its interest payments and return the principal amount at maturity, then you are on to a winner. The flood of money into corporate bonds has been truly astonishing; $11bn went into US corporate bond mutual funds just in the week ended 5 August. Outright sales or lack of demand for government bonds has sent their yields on an upward track.

Taking their cue from the weight of money going into bonds, equities have rallied and with the sense that 'risk is back' the US dollar has lost some of its defensive usefulness and declined. Not wishing to be left out of being 'the first to call the turn' opportunistic commentators have dug deep into the atrocious data coming out of the US, UK and Europe to put it together and make a story out of it. And all because money has flowed into corporate bonds because of the mathematics. It makes you want to put your head in your hands and emit a low moan. The only practical thing you can do is switch out of some of your carefully nurtured investment grade debt that now has yield spreads lower than they were in August last year when the blow-out started.

And for those who want to try and convince investors that all of the risks in the global system have dissipated because of 'a slowing of the rate of decline' in the west, they are looking in the wrong place. In the BRIC nations (Brazil, Russia, India and China) money supply has recently been rising at an alarming rate. More to the point borrowed money has been used to create debt-fuelled consumerism. The Chinese alone have borrowed almost exactly the same amount of money as the US in the past five years (around $1.4trillion), which is staggering given the naivety of the system. But more to the point, the slowdown in the west has had effects even on the BRIC nations and it is astonishing how fast Non-Performing Loans (defaults to you and me) and bankruptcies are rising (see chart overleaf for an example). This is the next problem waiting to happen.

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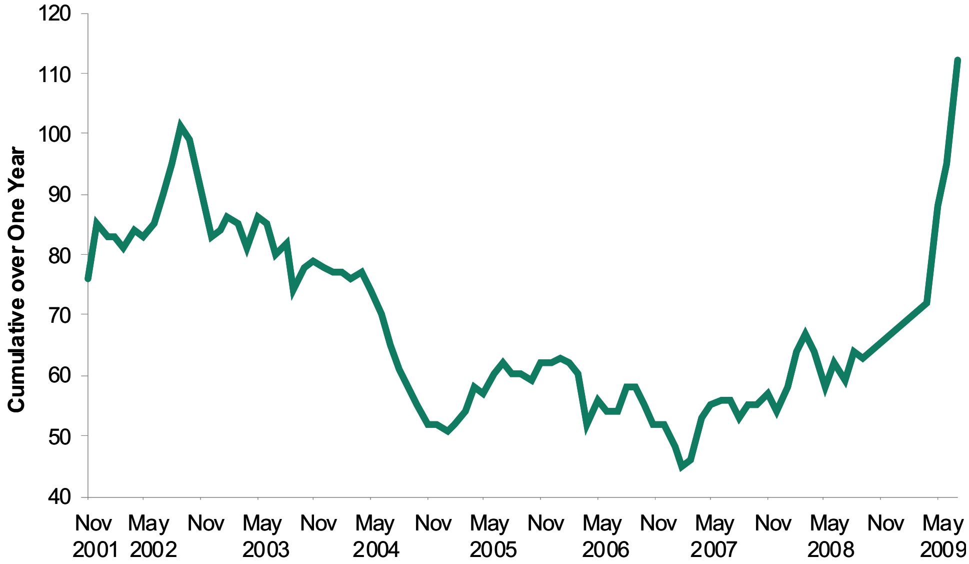
Please see important information overleaf

Bankruptcies in Brazil (San Paulo region)



Source: Bloomberg

Any rapid expansion of credit always ends in tears. Just like our own system, nobody knows what will eventually tip over the BRIC nations' debt-fuelled consumer expansion. It may not even happen for several years or it could happen tomorrow but the signs are ominous. So while the party lasts – I'm still dancing. When the music stops we can only hope our remaining banks are not too exposed to BRIC consumers that suddenly evaporate. Meantime, if the only engine of growth that so many are pinning their hopes on also disappears, government bond yields will be sent spiraling down once again.

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