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.

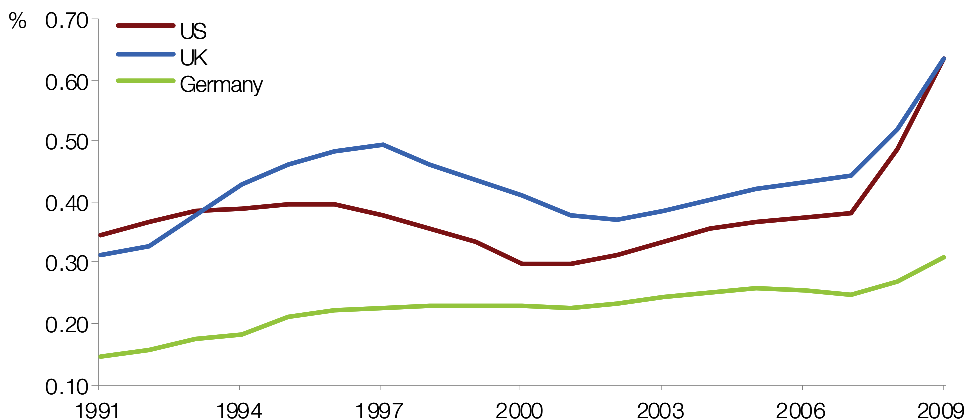
Basket case

Reducing US dollar exposure gradually, positive on the euro

Possibly the worst kept secret in the currency markets was broken as an exclusive in *The Independent* newspaper this week: some people are planning to pay for oil in euros, which would signal the demise of the US dollar. In reality this has been going on for a number of years now and is linked to the idea that in the coming years a single currency regime (akin to euro) will be created in the Middle East. In the meantime, middle eastern organisations have been diversifying their reserves away from the US dollar, buying euros and other currencies, as an insurance policy against the secular decline of a once great reserve currency. If you would like to read more about this secret then pick up a copy of Gulf News whenever you are in the region – there's usually a piece about it.

The case for a basket of currencies to replace the individual Middle Eastern currencies (does anybody remember the ECU by the way?) has been made over and over again and the last time I heard about it, the main stumbling block to implementation was that nobody could agree what the picture on the notes should be. Things are pretty advanced, you could say. If that's the case, then if we are all going to be lumped in together, which of the western currencies is going suffer the most? This is the essence of our 'discriminating capital' theme - in the future, those with bulging bank accounts will think twice about handing money to those who have the biggest debts.

Chart 1: Government debt as a proportion of GDP



Source: Bloomberg

If we look at who has the soundest finances of the debtor nations then we should get an idea of who is going to achieve most favoured status. An easy way to do this is to compare how much a country earns per person with how much that country is borrowing per person. It's just good housekeeping to think this way - if your debts are rising as a proportion of your income then you are going to be in trouble one day. The results are pretty shocking.

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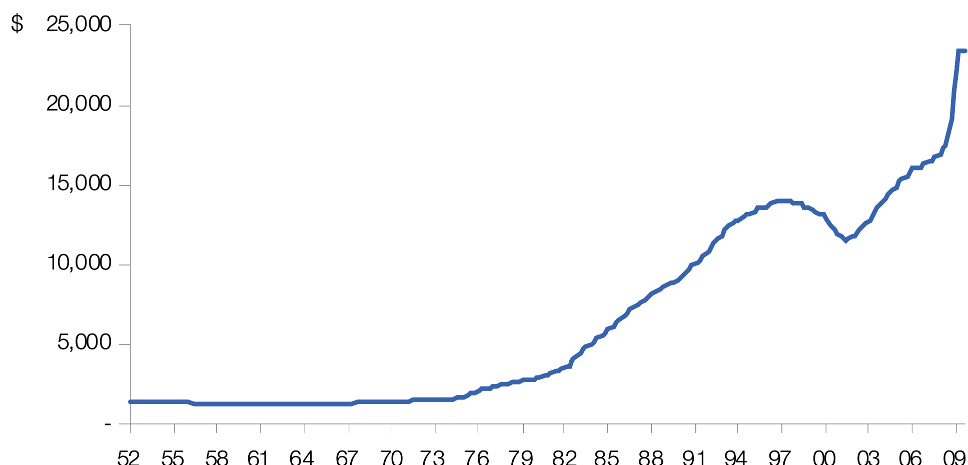
Chart 2: US federal debt per person



Source: Bloomberg

The accelerating deterioration in the debt to GDP ratio in the UK and US is all you need to know about the real consequences of the credit crunch. A combination of increasing outstanding government debt (created to prop up the banking system) and declining GDP has had a disastrous effect on our good housekeeping ratio. By a startling coincidence both the US and UK now have debt mountains that are over 60% of nominal GDP. Contrast this with the case of Germany and the comparison becomes even more stark. Thanks to the strictures of entry into monetary union, the hair shirt that European countries wore in the run up to the creation of the euro meant that their debts haven't exploded during the last nine years, giving them extra fire power should they need it going forward. Germany's debt to GDP ratio now stands at half that of the UK and US.

Ratios are one thing, but to put this into context it's possible to work out how much can be allocated to each citizen of a country. In the US, for instance, the years when President Kennedy controlled the debt to a few thousand dollars per citizen were followed by a rapid increase in the 1980s under Presidents Reagan and Bush Sr, only to be halted when President Clinton was paying down the national debt. The steepest rise in the amount that each citizen owed was down to President Bush Jr and now each and every American owes close to $25,000. Don't forget this is only as seen through the prism of the Federal debt. The total outstanding public debt is closer to $12 trillion and each citizen owes some $39,000. Before any UK readers start feeling smug, your bill is about $23,000 each.

The astonishing thing about the current situation is that there has been the mad coincidence of a rapid rise in the amount of debt outstanding and a collapse in bond yields (i.e. financing costs). Interest payments are quite manageable in both the US and the UK at current levels of bond yields. The trouble comes if markets 'normalise' back to bond yields in the 4-5% range. At that time, unless a serious amount of debt repayment has occurred, annual debt costs will balloon. At today's level of debt the US would need about $800 billion (6% of GDP) just to meet its interest payments each year. The UK probably wouldn't be much better off.

Two things have got to happen: the total debt has to be reduced in the US and UK (which means increased taxes and reduced expenditure), whilst bond yields have to be kept low to keep financing costs low. Think about that sentence for a moment - there's a lot of politics

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in there. And then there's the currency angle. It's difficult to see, unless there is a rapid change of behaviour, why discriminating owners of capital would have much faith in currencies that dangle by such fragile mathematics. The US dollar may currently enjoy 'safe haven' status in the psychology of investors, but that isn't going to last long unless radical action is taken soon. Sterling won't be far behind in those circumstances.

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