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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.

Monte Carlo or bust

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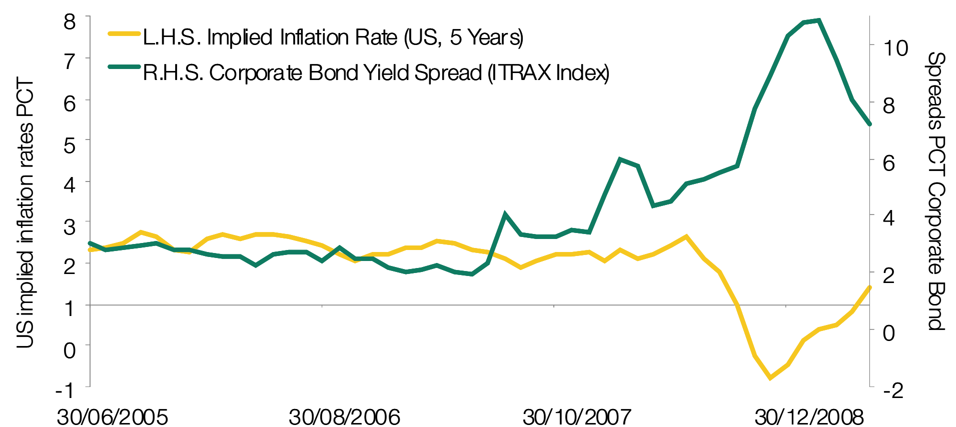
If anything the past six months have been about resolving the tension between a corporate sector that appeared to be bust and the abyss of Japanese-style deflation visiting itself upon the West. Since the end of the year corporate bond spreads across the board have converged towards government bonds whilst the implied inflation rates within inflation-linked bonds have gone from predicting outright deflation to allowing for a small positive number in the coming years (see chart 1 for illustration in the US). At the same time government bond yields have risen markedly. On the face of it you would have thought the whole thing was fixed. Nothing could be further from the truth.

Chart 1: Implied US inflation rates and corporate bond spreads



Source: Bloomberg

The sight of US and UK banks returning money to their respective governments has added to the atmosphere of reconstruction but those of you who thought that business as usual would be resumed in short order should think again. Much of the debt-fuelled consumption of the past decade has been propelled by what is euphemistically called 'financial innovation' which used vast computing power and high-level mathematic techniques, such as Monte Carlo simulations, to justify the structures being sold to investors. What has become clear is that a technique that started in the nuclear physics labs around the world should really have stayed there: even the thousands of simulations involved didn't include the one where a whole lot of people chose NOT to pay their mortgages simultaneously. Risk and business managers are having to think again about how they value debt as they survey the rubble of their balance sheets as a result. Nobody is going to be doing a lot of wholesale lending in the future. Debt-fuelled consumerism is bust.

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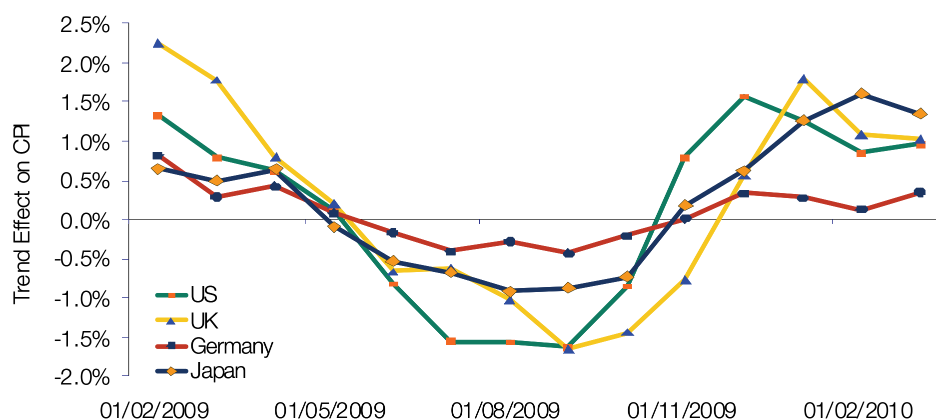
Besides, the rise in government bond yields that has accompanied the apparent relief in the markets isn't so much a testament to the healing process as you might think. More likely it could become a threat to sustained recovery if bond yields continue to rise. For instance, in the US the economically sensitive long-dated bond yield is up nearly 2% since the beginning of the year. Also as the year goes forward there will be some uncomfortable inflation news in all major economies (see chart 2) mainly because of rebasing effects: a year ago the decline in the oil price caused inflation indices to tip over, creating a low base to start from and some unflattering year on year effects as a consequence. What has been a deflationary drag of about 1.5% turns into an inflationary push of about 1.5% in late 2009.

Chart 2: Inflation rebasing effects



Source: Bloomberg

Any further reaction to bad news on the prices front that pushes bond yields higher may have to be faced with more aggressive official action to put a lid on borrowing costs that would otherwise choke off the nascent recovery. As the year goes on the US Federal Reserve may have to follow the Bank of England lead and engage in true quantitative easing rather than just talking about it.

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