Investment update

23 September 2011

Stewart Cowley, Head of Fixed Income and manager of the Old Mutual Global Strategic 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.

Twist and Shout

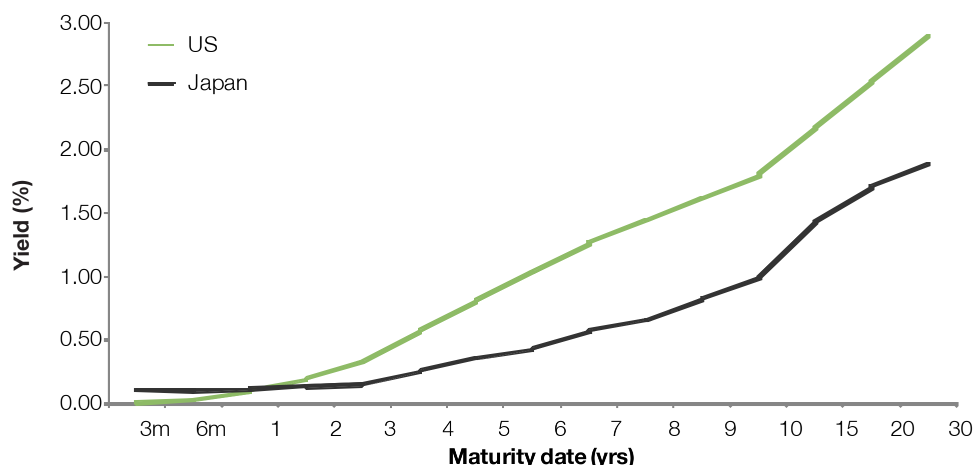
Operation Twist is achieving its aim of lowering yields. But as the West turns Japanese, the scope for absolute declines is limited

Reluctantly long the US Treasury and Bund markets, underweight the euro for the time being

The US Federal Reserve has finally set about undoing the damage they did at almost exactly this time last year. If you remember back, the implementation of the second Quantitative Easing program (QE2) was handled so badly it actually sent bond yields up. The Fed chose to buy short-dated bonds, boosting the money supply and in the process spooking the markets with the perception that they were creating monetary-inspired inflation. Thirty year bond yields rose from 3.5% to 4.25% between August 2010 and February 2011.

"Operation Twist" simply seeks to undo that damage through selling short-dated bonds and buying longer-dated US Treasury bonds as well as mortgage debt. This has the twin effect of lowering benchmark borrowing costs as well as funding the housing market. It's not a bad idea and is arguably needed when unemployment is persistently high, short-term interest rates are set to remain unchanged until 2013 and the spectre of deficit reduction is looming. It is the latest in a series of increasingly desperate acts.

Figure 1: US and Japanese Yield Curve Comparison



Source: Bloomberg

The $400bn the Fed is going to throw at this policy (combined with shouting about it a lot) is meant to keep yields low or indeed send them materially lower. The benchmark for how this process can go is Japan. A look at the comparative yield curves would say that in the target maturity range (above 6 years) there is "only" some 0.8% to go before this happens. Given the speed at which markets are moving this could happen in a matter of days at which point the global bond market rally is effectively over.

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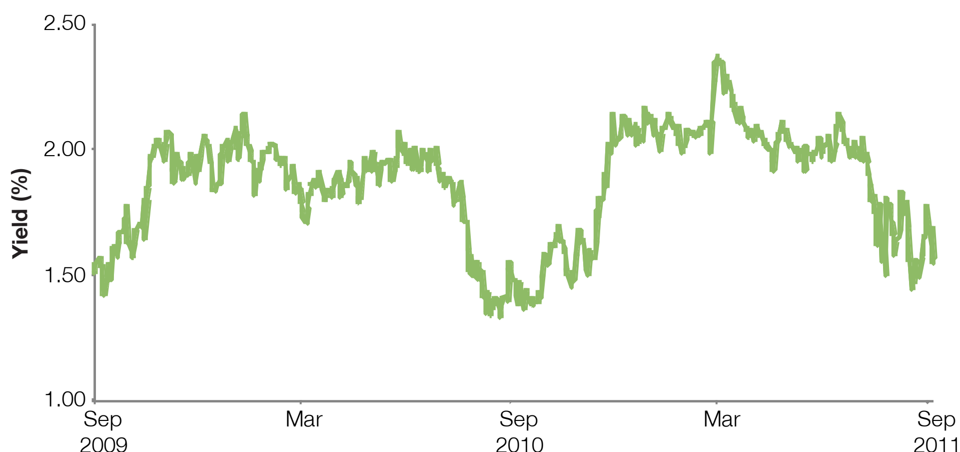
We've also tried to look at this from the point of view of comparing the shape of the yield curve with the creditworthiness of the US and Japanese bond markets, using values from the credit default swap market. Again this picks up the rapid convergence process seen in nominal yields, but it also illustrates that we are approaching the all-time lows of the relationship. In effect, on this measure there is only some 0.2% to go before the process is over.

Either way you look at it, this is a bond rally that is in its last throes. For that reason we are scaling back on our duration positions in the US as the market continues to rally.

Figure 2: US vs Japan Convergence Index



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