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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.

Banks for the memory

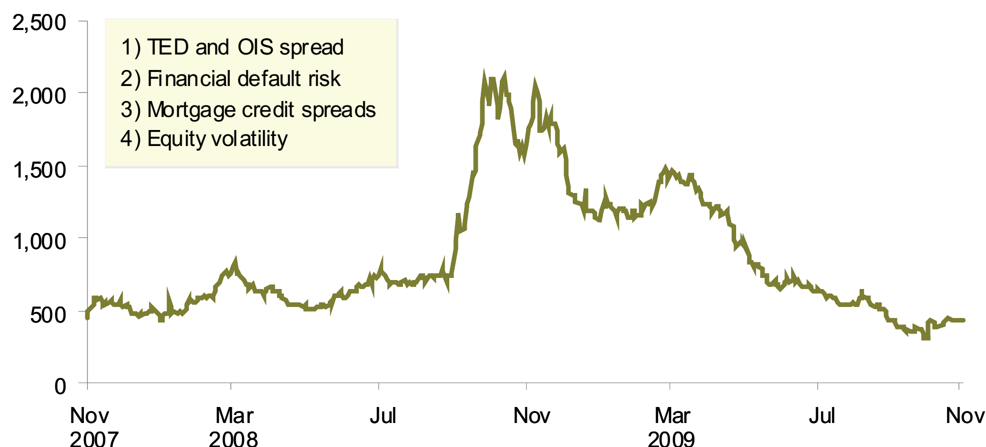
Maintaining a long duration strategy in government bonds

Here's a date to remember – 3rd November 2009. It will probably go down in history as the day that the UK banking system began the process of emerging from a long period of apology. It will also go down as the day when the clock started ticking on the global government bond markets.

Now that Lloyds banking group has announced its long awaited capital restructuring, we can at least breathe a sigh of relief that the end of the beginning has started. Watching the banks wriggle out of the hands of the government is the essence of our 'Sorry' theme: the process of apology and reconciliation by the banks that would signal the birth of a new economic cycle. The use of hybrid capital structures which favour bondholders over equity holders, if things get bad again, reinforces our policy that selected bank bonds hold value in a portfolio context. At the same time it challenges our long duration strategy: if we are poised for an explosion of economic activity, then government bond yields must be ready to burst skywards.

It's true that the banking crisis has been averted. Measures of market stress such as the Libor-Overnight Index Swap (OIS) spread show that the lack of trust in the banking system has abated substantially. Other indicators of the gummed up system like the HSBC Financial Clog Index (an average of stress indicators) also show that on broader measures things are back to where they were a couple of years ago and may even be better than in the period running up to last year's crisis (see chart). The provision of seemingly infinite support from the US Federal Reserve, the Bank of England and the European Central Bank has done much to underpin the banking system. In that sense quantitative easing (QE) has worked. So we can put this one to bed – the banking crisis, per se, is over.

HSBC Financial Clog Index



Source: Bloomberg

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However, all of this is distinct from the needs of the economy. There remains a need to keep the cost of capital down whilst consumers are pulling back from their accumulated debt and when companies are in need of refinancing via the bond markets. Short term interest rates are set to stay low for quite some time in that event. At the same time there should be a continuation and (in the case of the UK) an extension of current QE programmes to help out companies raising money. In that sense steep yield curves in the US, UK and Europe offer some value for investors looking for a refuge from near zero percent cash rates.

Maintaining a long duration (which translates into 'using the yield curve') makes sense going into Q1 2010, but it's becoming an increasingly dangerous game. In these days of ultra-low coupons there is precious little to help you out on the capital side should long dated bonds move by a couple of points in a month. Contrast that with the situation in the late 1980s when base rates were 15% and bonds yielded 13% - there was a handsome cushion to help you out if markets were volatile. Not so these days.

So in an absolute return sense duration strategy is that much more critical these days. As we have said in previous notes, there are significant headwinds against the bond markets in Q1 2010 (not least of which is that inflation will rise in the developed economies due to rebasing effects within the Inflation Index series) but looking through that, unless economies improve dramatically then problems will recur towards the end of Q2 2010, sending government bond yields lower. Tactically, it's right to maintain our long duration strategy for the time being but it is going to require careful management in 2010 as the economic healing process is underway.

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