Investment update

11 January 2010

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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.

Drove me Chevy to the levy but the levy was dry …

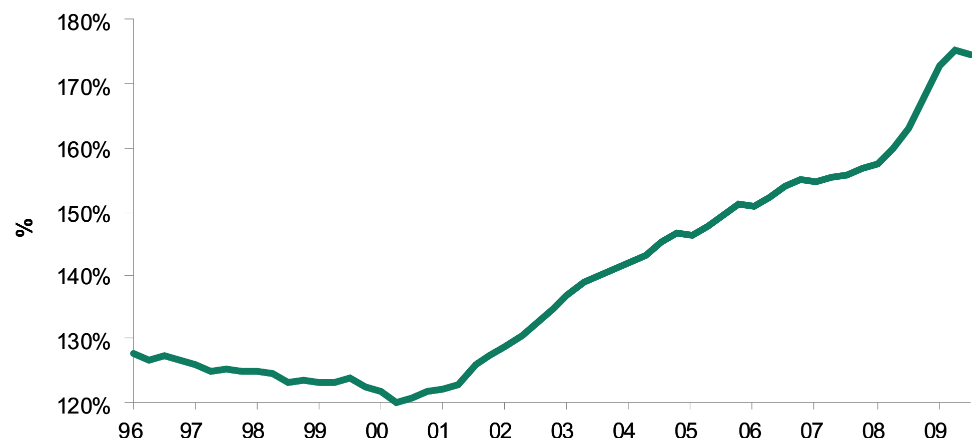
Long duration in the US

It was interesting to watch over the Christmas period how many times the word 'levy' cropped up in the commentary of those proposing future policy. Amongst the innovations was a 'levy' of £15 on top of fixed penalties for UK drivers who commit an offence. Another was a generational 'levy' on those people over a certain age in the UK, who are clearly to blame for the mess we are in, so that the young won't have to pay for it in the future. 'Levy' is, of course, merely a synonym for 'tax'.

Our unwillingness to face up to exactly what the tax increase/public expenditure reduction combination we will actually need in the future has been quite remarkable. No politician wants to be the one to break it to the electorate (least of all in the UK in the run up to a General Election) and no trade body wants to admit to it for fear of frightening away scarce consumers. Hence you can understand why we would use nice neutral words like 'levy' instead of 'tax' to mask the harsh reality.

At least our own Chancellor of the Exchequer, Alistair Darling, has injected some reality by announcing that the 50% rate of income tax isn't a passing phase, but will last for the entirety of the next parliament, should there be another Labour administration in the UK. You get the sense though that, both here and in the US, we are being drip fed the bad news rather than it being announced in one go. And as Bill Gross of PIMCO pointed out very recently, if nothing is done then the risks are rising of a sovereign debt crisis in the US and UK. Incidentally, this is a conclusion we came to in our article *'Basket Case'* (October 2009).

Chart 1: US consumer, mortgage and public debt outstanding as a % of nominal GDP



Source: Bloomberg

Where we part company with Bill is maybe timing. Certainly the pressure to take radical action is mounting (compare the Irish public sector pay cuts of 5-8% just before Christmas), but the sheer scale of it may be giving pause to many in public office in the US and UK. For instance, it's easy to add up the total consumer, mortgage and public debt in the US and compare it with income (nominal GDP) at a national level. Charts such as the first one abound in various forms, but whatever the numerical value, they all show the same thing;

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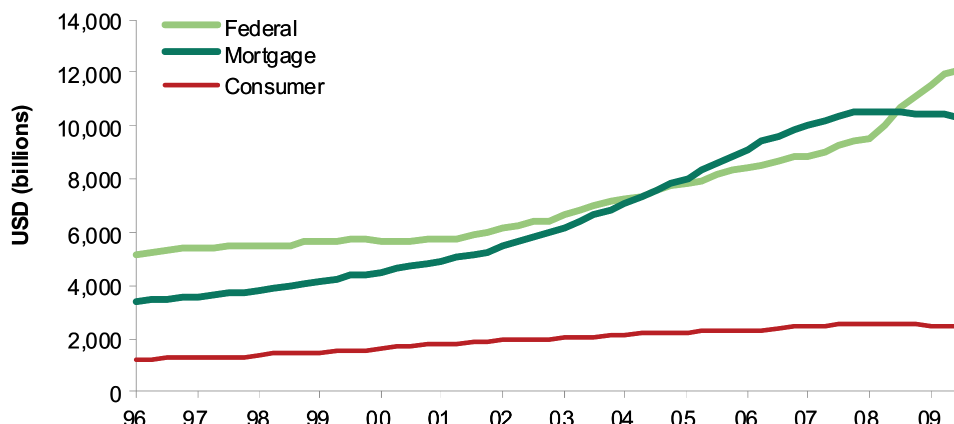
national indebtedness is at an all-time high and needs to fall, which is a prescription for multi-year austerity.

Chart 2: US consumer, mortgage and federal debt outstanding



Source: Bloomberg

What is more illuminating is to deconstruct this into its component parts (see chart 2). This shows that Federal expenditure increases have replaced mortgage and consumer credit pay-downs. This is why the axe has to fall on central government expenditure in a way that is most unpalatable to politicians; nobody likes to announce bad news.

In the case of the US, let's not get the idea that nothing is being done about this. Admittedly President Obama's healthcare bill is set to raise expenditure nationally, but at the local level cuts are already beginning to happen. Witness the behaviour of Californian Governor Arnold Schwarzenegger who, in July 2009, achieved an agreement that diverted money from municipalities, cut school, welfare and public health programmes and forced earlier tax payments in order to fill his $24 billion budget hole. In New Jersey, Governor Christopher Christie is preparing for a 25% reduction in the public budget. In economies that are being propped up by incentives (the 'Chevy' in our title refers to 'Cash for Clunkers' and other schemes), imposing another 'levy' on consumption looks like the wrong way to go; the axe falls squarely on expenditure to balance the books.

In the UK we are strapped to our own political cycle, which is most unhelpful and puts our bond markets and currency at particular risk (here we agree with Bill Gross). But on either side of the Atlantic the last thing we need at this time is higher bond yields, or interest rates, because of a loss of confidence in government housekeeping. A debt crisis of that sort would send the general cost of borrowing spiraling higher for companies (corporate bond yields would be pushed higher because of the narrowness of current spreads) and in turn precipitate a slump that would turn all those comparisons with the Great Depression into reality. What we actually need are low interest rates and lower long term borrowing costs; this is reason enough not to lose faith in the idea that bond yields can decline in the first half of 2010.

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