## Investment update

11 January 2010

**Stewart Cowley, Head of Fixed Income and manager of the Old Mutual Global Strategic Bond Fund and the Old Mutual Dynamic 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.

# Death of a Salesman

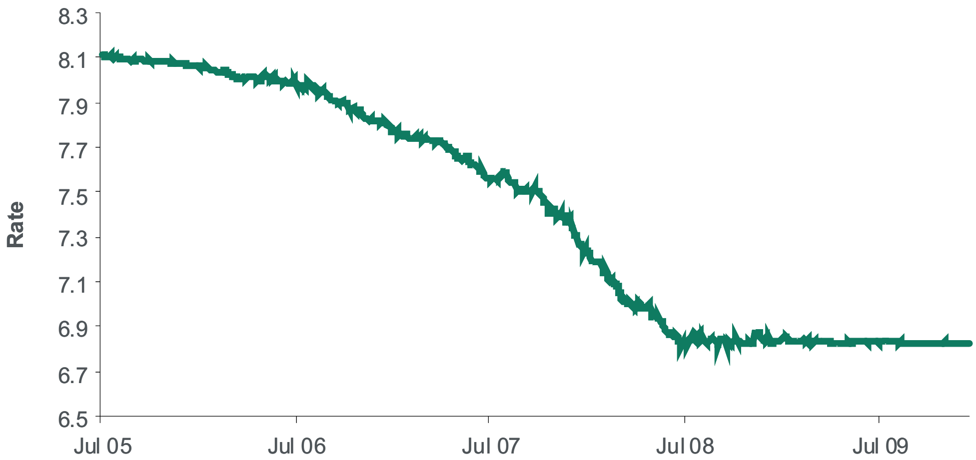
## Long the euro

Trading foreign exchange has changed a lot in the last 25 years. Back then you used pick up a big black thing on your desk, call a salesman named Vince and say things like "Million cable – what's the offer?" and his response would be along the lines of "Four-eight mate, on the dog and bone, whatcha wanna do?" A paper ticket would then be written which would be handed to your tame Bob Cratchet-like person in the corner, usually called Tony, and after wiping your brow at the effort of it all you'd go to lunch, your work for the week being completed.

Things are very different now; foreign exchange deals are passed to a dealer electronically who then dumps them into an electronic trading hub where they are filled automatically - after which you go to lunch, your work for the week being completed. There isn't any need for any human intervention in this process. Depending on how successful he was, Vince is now either working at PC World or whiling away his days on the golf course.

Electronic trading has undoubtedly contributed to the ease and number of people playing the currency markets but hasn't really detracted from the idea that, fundamentally, currencies are driven by the really big ideas in the world. Everything else is just volatility around the super trends. One of the big issues to resolve in 2010 and beyond is the relationship between the Chinese renminbi (yuan) and western currencies. Over the Christmas period the Chinese unwillingness to let their currency appreciate, in the face of mounting international pressures, hardened. Take the words of China's Premier Wen Jiabao; "*We will not yield to any pressure of any form forcing us to appreciate. As I have told my foreign friends, on one hand, you are asking for the renminbi to appreciate, and on the other hand, you are taking all kinds of protectionist measures,*" he said.

**The Chinese renminbi against the US dollar**




*Source: Bloomberg*

The reality is that the US dollar/renminbi rate has been locked in the kind of stable trading range that Vince would have turned blue at the sight of; there is no opportunity to trade if there is no movement (see chart). All the signs are that China will perpetuate this situation for as long as its national interests allow. A unilateral movement of the yuan upwards would hurt



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the Chinese domestic economy at a time when they could do without it, and that just isn't in the 30 year plan. Sanctions and threats will be waved in the faces of the Chinese, which will be as much about being 'seen to be doing something' than any real action, but the net effect will be an unholy stand-off between the Chinese and the rest of the world.

If the US dollar declines, taking with it the yuan, then the European economy (and others) would be crushed and China will be able to flood the world with cheap (deflationary) goods. International relations between the US, Europe, Japan and the BRIC nations would be strained to their limit as American self-interest would be pursued to the cost of the rest of the world. We can only hope the Obama administration doesn't take this course of action. Certainly it's absolutely clear that countries are not going to sit idly by and allow the US dollar to decline without comment. The new Japanese finance minister, in his first day in office, made that abundantly clear. He immediately called for a weaker yen, saying he would work closely with the Bank of Japan to steer the currency toward an "appropriate" level of around 95 yen to the US dollar.

It's much more likely that there will be a currency stand-off this year which actually dampens currency volatility throughout the world to relatively narrow ranges. As we have stated before, the US dollar and UK sterling are 'at risk' currencies as the issues surrounding their budget deficits gather pace. But the idea that the US dollar could decline without the sanction of the Chinese just doesn't seem likely, given the intransigent statements coming out of Beijing. Currency volatility is therefore likely to stay low between the US dollar and its main trading partners, especially the euro, as they try and maintain their relative advantages.

If you think this through for a moment you come to an extraordinary conclusion; the biggest export from China to the world is currency stability. Without it, given the concerns surrounding the US budget position and the desire to inflate it away through currency appreciation, the US dollar would surely have been considerably lower than it is today. Of course, 'lower than expected currency volatility' isn't the same as no currency movements at all, and a good insurance policy against a sudden decline in the US dollar would be the euro, regardless of any concerns about Greece and Spain. No doubt the tensions will rise and fall between the US and China in 2010, but in the meantime a generalised dampening in one area of the financial system usually means a rise in volatility somewhere else - look out for equities, bonds and commodities to swing around this year.



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