Investment update

3 February 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.

Televisions don't go up in price …

Long conventional government bonds

For six weeks now I've been trying to buy a television, the new 32" 7-series LED Samsung, wafer thin and rather beautiful. My local PC World in Fulham has a display model and each week I dutifully walk in and ask if they have any in stock. "Next week", I am repeatedly told by the predatory salespeople. Last week I tried one more time. "Next week, but if you buy today we guarantee that it will be the same price when it is delivered." "It's not going to go up in price," I replied. "It might - that's our Price Promise," said the hopeful looking salesman. "Televisions don't go up in price," I replied. His eyes fell to the floor and I instantly felt bad. It was an unnecessary crushing of someone just trying to do their job.

But the whole frustrating situation made me think about a range of things, the first of which was "where is the stock?" There was a time when you could walk into any large-scale retail outlet and get whatever you wanted whenever you wanted it, but those days have gone. Now 'just in time' inventory management has been replaced by 'just after the time you want it' inventory management and the reason is pretty simple: if you have inventory you have to borrow money to finance it. If the banks aren't extending credit as a facility then retailers can't carry stock, ergo customers might not be able to get what they want when they want it. Also, it means we are heading into erratic inventory cycles that some will parade as growth or the emergence from recession from time to time. Don't believe it, it's just that PC World have run out of 32" 7-series LED televisions again and have ordered some more. Something else that struck me was "why do I assume that things go down in price?" The product cycle undoubtedly contains the idea that 'the new model costs the same as the old model at the beginning of its life'. As time goes by new technology means that the new model is replaced and the old model plummets in price. The new model appears at an elevated price and the cycle goes around again. LCD televisions are being thrown at consumers at a third of the price they were even three years ago. Coincidentally, new LED televisions are the same price as LCD televisions were three years ago. And so the cycle of abuse goes on.

But here in the UK, sterling has declined in the past two years and we run a trade deficit so why are goods still so cheap? It is because we are experiencing a kind of imperceptible deflation that is not recognised in prices alone. We now get more functionality per pound than three years ago and if you include the time value of money, you would have to knock something like 10% off the price. Despite this functional deflation there are clearly people who believe that there is outright inflation coming in this country, which in turn is leading them to seek protection.

For instance, since November 2008 the inflation rate implied by a 5 year maturity index-linked bond has risen from -1% to +2.5% (see chart). In historical terms 2.5% isn't very high, but the swing and direction is telling. As index-linked bond prices rise, yields fall. So over the same time period the real yield on the same security has fallen from over +4% to -0.3%. Dwell on that for a moment - this is a bond in which you are guaranteed to lose money unless inflation turns out to be over 2.5%. What's more, if real yields were to normalise along with conventional gilts because, say, an exit strategy from quantitative easing had been implemented, then investors would lose 15% on this supposedly safe, boring, short-dated government bond investment. Equities might do that, but not government bonds, supposedly.

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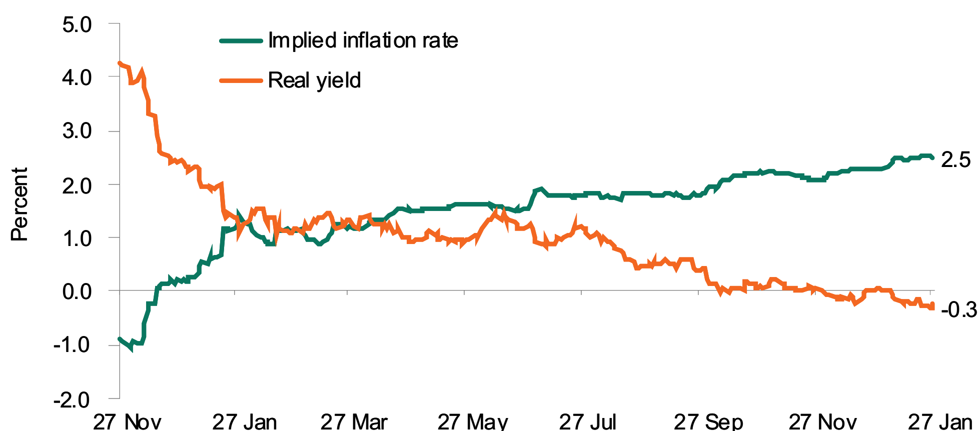
Real yields and implied inflation rates in the UK



Source: Bloomberg

Adam Smith said that inflation is a currency effect. You could interpret the rise in implied inflation rates as being a reflection of the idea that there is a group of people out there who think that there is a sterling crisis on the way. If we are importing, for example televisions, my assumption that they don't go up in price is going to be severely challenged in the years to come.

On the other side, maybe that negative real yield is telling us a different story. The economic situation is so bad (with tax rises and government expenditure cuts) that to keep things going requires negative real interest rates. To reflect this deflationary scenario, conventional yields will have to fall, leading inflation-linked bonds to severely underperform conventional gilts.

So in reality, there is only one way that index-linked gilts offer investors anything other than a relative loss going forward: if inflation soars. If, like some people, you are one of those who believe that the UK is 'the next Greece' then you could be right. Otherwise, these 'safe' government bonds are nothing more than a source of guaranteed disappointment. Back in November 2009 in our note *The Vibrating Monetarist* we saw why, as rebasing effects came through, there would be heightened fears of inflation at the beginning of 2010 and made a case for owning inflation-linked bonds. That moment has passed and we don't own them any more as, by the middle of 2010, we expect inflation to be declining again. On that basis, I think I'll wait a while before I buy that television.

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