Investment update

8 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.

That's a bit steep…

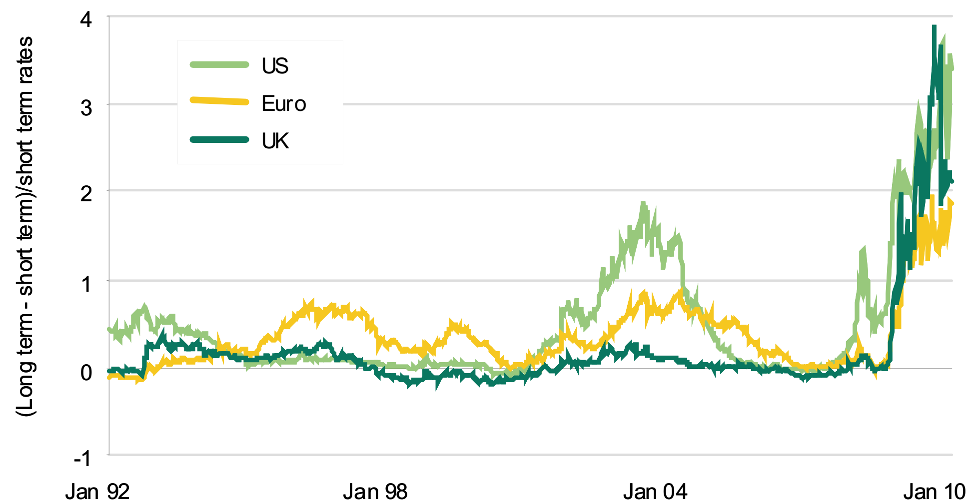
Long conventional European government bonds

We've had a lot of information in the recent past. Greece and Spain have proposed massive budget deficit reduction programmes, President Obama has proposed to create a million jobs and maintain trillion dollar deficits for the foreseeable future and our own Bank of England has 'paused' the quantitative easing programme that has pumped £200 billion into the UK economy. It's all a bit bewildering if you don't know what all of these groups are actually trying to achieve.

In their own way they are all acts of desperation. Spain and Greece are seeking to persuade the capital markets that they are in control of their borrowing and they shouldn't be criticised. If successful, they will be keeping their costs of borrowing down. President Obama is emphasising the problems of the economy in the hope that borrowing costs will be driven down by natural forces. Meanwhile, the Bank of England has paused a policy that has caused all kinds of consternation, and is also hopeful that natural forces will drive down the cost of borrowing. Are you getting the idea here?

Some of that isn't terribly logical but that's sort of where we are. The reality is that the difference between long term and short term interest rates (the steepness of the yield curve) is incredibly high and needs to come down, otherwise the cost of borrowing for governments and corporations will stay high. There is a way of illustrating this using the ratio of the yield curve steepness to short term interest rates; (long term - short term)/short term interest rates.

Yeild curve steepness in the west



Source: Bloomberg

If you perform this comparison you will see that, because short term interest rates have rarely been this low, yield curve steepness has never been higher in the developed nations. What this is mathematically and subliminally saying is "take your money out of the bank and invest it in bonds and you'll earn more".

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The reason for this opportunity is that clearly there are a lot of concerns about budget deficits in the west. Our ‘discriminating capital’ theme crystallises this into the idea that those who have money (China, Japan et al) are going to be more discriminating with their money in the future – they aren’t going to finance our debt-fuelled existence. Hence long term bond yields are relatively high compared to cash rates in an attempt to tempt them (and others) to buy.

There is another way of looking at this; markets don’t like governments allocating nations’ resources. Government intervention (in the shape of the budget deficit) is at all-time highs by all kinds of measures and many in the markets don’t think that this is the most efficient way to run things, because governments, by their very nature, are inefficient. And don’t forget, governments have no money. Governments redirect money in the economy through taxation (or the now ubiquitous ‘levy’) which for the past 25 years has increasingly been the job of the markets. Clearly, the markets don’t like the idea that the largest distributor of resources is at the same time the least good at it and want compensating through higher yields.

There is a way to correct this situation; governments have to return to their previous low intervention status. The way to do this most effectively is to reduce expenditure (and not to raise taxes). You understand why one by one the budget deficit shoes are falling in Europe: Ireland, then Spain and then Greece have had to take corrective action. It is only a matter of time before the same message is broken to the UK electorate; a tricky message to send if you are trying to get elected in May this year.

If, in the next few months, the right things are said and done, European bond yields (including gilts) will fall in the first half of 2010. Things appear to be going the right way in Europe, sending German bond yields to all-time lows. In the meantime, we are giving the UK the benefit of the doubt and are staying long gilts. But if our administration fails to keep the confidence of the markets, gilts and sterling will have to go no matter how steep the yield curve is at the time.

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