Investment update

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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.

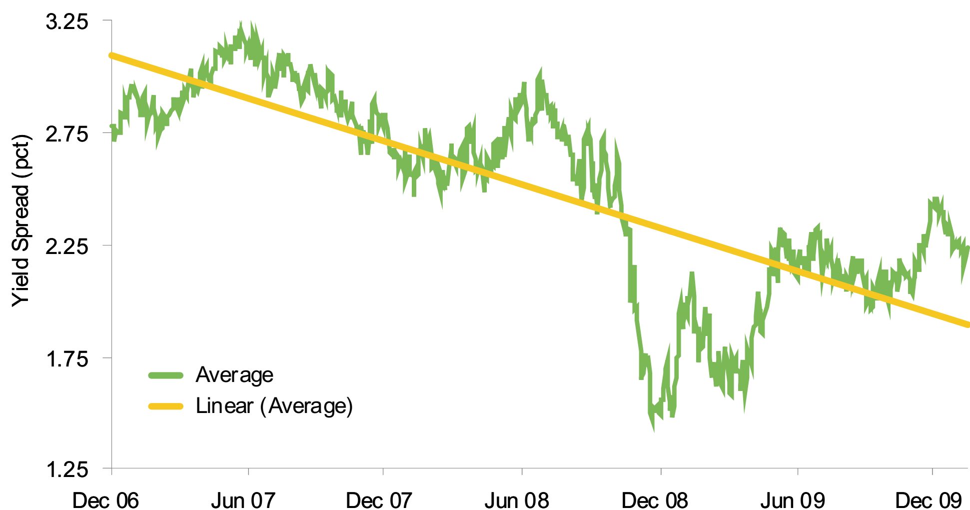
The urge to converge

Strategically long conventional bonds

It was with some relief this week that Germany and Europe announced that they would stand behind Greece and support the weaker members of the European Union. The euro and sterling rallied (for a while), risk assets did well and some light at the end of the six week tunnel began to shine. Still, no matter the short-term sticking plasters that have been placed over the markets it doesn't really change the fundamental problem; the west needs lower borrowing rates to sustain it through a difficult few years to come.

Forgetting tactics for a moment, there appears to be a fundamental urge at play here; the urge of western bond yields to converge towards Japanese levels of borrowing costs. You can illustrate that by looking at the average ten year maturity yield spread in the west compared to Japan. Western bond yields have been, over the past couple of years, in the process of tending towards Japanese levels. There have been excesses and interruptions but if we wanted a road map for the possible, this is a fair illustration. Western bond yields could drop by another 1% in the coming year or so if you follow the convergence argument.

Average western bond yield spreads compared to Japan



Source: Bloomberg

Fundamentally, you can understand why this might happen. Inflation is set to roll over in the coming months and growth is set to turn downwards by mid-year. There is even some evidence that there could be a secondary wave of problems to come in the US banking system that will remind us all of the headwinds against the western economic system still labouring under the aftermath of a decade of debt-fuelled hedonism. Put crudely, after you throw a party you have to clear up and we are in the phase of clearing up before our parents get home.

Against this cosy convergence is the problem of debt issuance. It's going to be harder and harder to fund western budget deficits at lower and lower yields (rewards) if investors get the idea that yields are about to rise any time in the near future. As bond mathematics says, as yields rise, prices fall and nobody is going to want to be on the wrong side of a sudden loss

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of confidence that sends bond yields spiraling higher and prices lower. The capital losses will be tangible. In that sense it's right that the markets turn up the heat on Greece, Spain, Italy the UK and eventually, the US, to start reducing those budget deficits through expenditure cuts.

As we have said in previous notes, strategically, you want to be long the western bond markets to capture the yield decline but we may have to be a bit cute along the way and manage your portfolio duration to protect yourself from periodic yield increases that can damage its capital value. It's going to be tough to time those moves but that's the job. At the same time, we shouldn't be deflected from the main strategic prize; the convergence of western and Japanese bond yields.

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