Investment update

22 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.

Wishful thinking

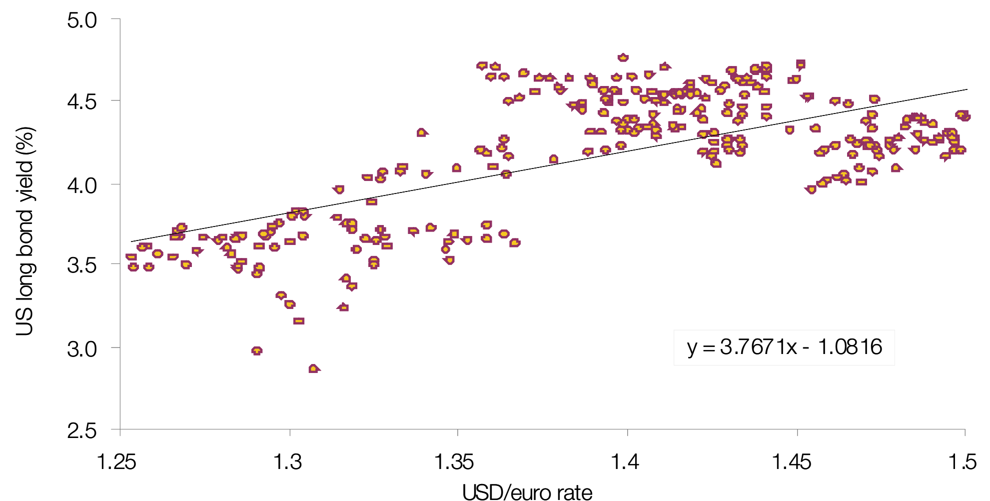
Long conventional government bonds, underweight the US dollar

Human beings have a tendency to see only what they want to see, which is why dictatorships aren't the best idea we've ever had and equally why companies are best managed by a group rather than a single person banging a large, leathery drum sitting at the end of the office floor: you need checks and balances. In the same vein, the worst thing you can do is 'hope' rather than invest. 'Hoping' things work out for you when you know that you are in the wrong place doesn't make for a very restful or happy life.

So at times like this, when you seem to be getting one half of the equation right only to see it cancelled out by the other side, you have to enter a period of deep introspection and wonder whether you are in the 'hope' phase rather than the 'investing' phase. Take for instance the current bond/currency conundrum, which is a perfect example of two elements of return (currency movements and bond price movements) going in opposite directions. To get any traction in terms of a consistently rising portfolio value you have to be on the right side of both elements.

This hasn't been as easy as it sounds in the past few months as old relationships have broken down. There's been a simple rule that has worked for a long time: long the US dollar and long the bond markets or short the US dollar and short the bond markets. You can illustrate this by correlating the euro/US dollar rate against the US 30 year long bond yield. In times of distress, the US dollar has strengthened and yields have fallen (long the US dollar, long the bond markets) and vice versa. This is the so-called 'flight to quality' trade on one side or the 'risk trade' on the other.

Chart 1: Euro/US dollar rate vs long bond yield



Source: Bloomberg

As you can see from chart 1, the relationship isn't strict; a linear line can be drawn through it but there is a fair amount of scatter and noise that exists around it. For instance, if the current yield on the long bond is 'right' then the euro/US dollar rate should be over $1.5

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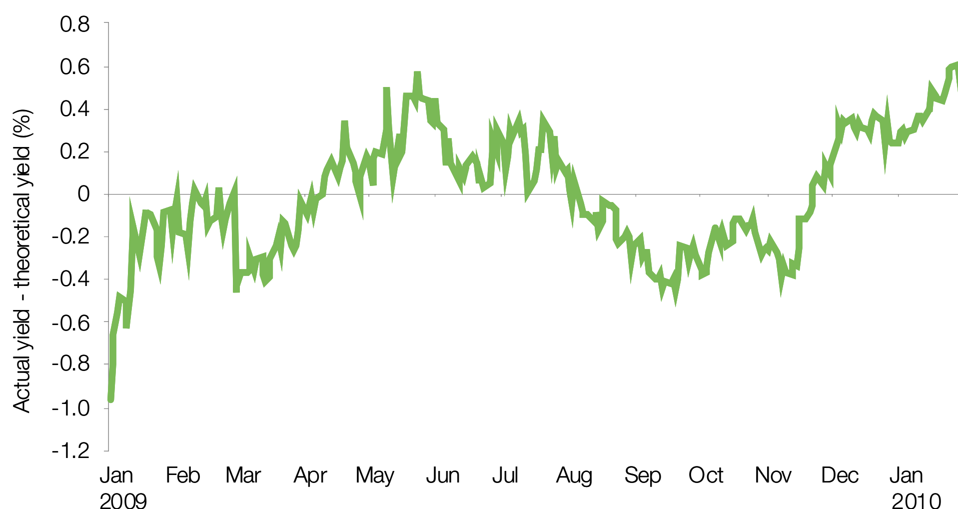
according to the correlation, whereas it is $1.36 currently. To correct this, the US dollar would have to fall by $0.14 or 10% against the euro. You understand now why, if it weren't for Greece undermining the credibility of the euro, the US currency would be on the 'at risk' register, or, more to the point, why it is vulnerable to good news coming out of the European Monetary Union states going forwards.

Now let's turn the situation upside down and imagine the euro is 'right' at its current value of $1.36. It's easy to calculate the resulting long bond yield. Here I'm going to dignify the process by describing it as a 'model' and if you compare it to where the actual yield of the US long bond is today you can show that the US long bond should be close to 4%, or about 0.6% lower than it is today (see chart 2) which is the equivalent of a 11.5% price rise if it corrects back to the recent relationship.

Chart 2: US long bond model



Source: Bloomberg

Life is rarely as simple as linear models of financial relationships. But if we were to get back to what has worked in the past, then we would have to throw away the old rules for a while and implement the 'short the US dollar, long the bond markets' position to re-establish our equilibrium. You can argue back to fundamentals from here to justify it (the need for lower bond yields to keep the cost of borrowing down and the loss of the dollar's 'safe haven' status because of excessive government borrowing) but either way, the current situation looks anomalous and far from mere wishful thinking.

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