Investment update

17 March 2010

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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 second mouse

Maintaining allocations to commodity currencies and emerging market debt and currencies; looking to re-establish Japanese yen position

There is one of those wonderful pithy phrases that goes around the financial markets: "the early bird catches the worm, but the second mouse gets the cheese", the implication being that the first mouse will have triggered the trap. This can be applied to how you take risks - it's best to be the second mouse.

The attraction of the emerging markets in the minds of investors is overwhelming and you just start to think that, in rodent terms, some people might be the first mice. But it's easy to rationalise why investors are so drawn to emerging markets - both debt and equities. Let's do a standard calculation on the potential returns from equities and bonds in the developed and developing world. If you follow it through using market rates and consensus expectations of growth, inflation and dividends then you end up with single digit returns (see table 1). Given our expectations for declining bond yields in the west, the difference between the total returns of equities and bonds is really not worth talking about.

Table 1

Developed World	Expected real GDP growth	= Real earnings growth	+ Expected dividend yield	= Expected real return	– Real bond yield	= Implied equity risk premium	Expected inflation	Expected nominal equity return
US	3.0	3.0	2.4	5.4	0.2	5.2	1.5	6.9
Japan	1.9	1.9	1.8	3.7	1.5	2.2	-1.1	2.6
UK	1.2	1.2	4.8	6.0	-0.6	6.6	2.7	8.7
Europe ex UK	1.2	1.2	5.2	6.4	-0.9	7.4	1.7	8.1

Source: Bloomberg

Now let's do the same calculation for the developing world and you begin to see that in all cases the expected nominal equity return is somewhat higher than in the developed world (see table 2).

Table 2

Developed World	Expected real GDP growth	= Real earnings growth	+ Expected dividend yield	= Expected real return	– Real bond yield	= Implied equity risk premium	Expected inflation	Expected nominal equity return
China	9.6	9.6	2.4	12.0	-1.2	13.2	3.2	15.2
Hong Kong	4.0	4.0	4.0	8.0	-1.6	9.6	2.3	10.2
South Korea	5.0	5.0	1.9	6.9	0.7	6.3	3.0	9.9
Singapore	5.5	5.5	1.9	7.4	2.0	5.5	1.7	9.1
India	5.6	5.6	1.5	7.1	1.3	5.8	4.9	12.0
South Africa	2.9	2.1	4.0	6.9	1.1	5.8	6.1	13.0
Brazil	5.1	5.1	4.5	9.6	7.2	2.5	4.6	14.2

Source: Bloomberg

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This type of analysis reveals a couple of things:

- As long as interest rates stay low in the west, investors will seek a home away from near-zero interest rate policies and increasingly divert money to the developing nations
- The emerging market thesis is built upon high expected real GDP rates, a generous dividend policy and inflation that is higher than in the developed nations
- Any disruption to the above will bring the whole edifice down

Clearly, by virtue of negative real interest rates alone, there is room for policy tightening in China and Hong Kong, which can be achieved by a combination of interest rate increases, lending restrictions and currency appreciation. Given the noises that the Chinese authorities have been making recently, it's pretty clear they are preparing for a shift in policy through adjusting their currency arrangements. They could announce this at any time. Interestingly, as a proxy currency, the yen could benefit from the Chinese yuan rising against a basket of currencies. Recently, we have taken short-term profits on the yen as it was one of the strongest currencies in the world during the European debt debacle. However, as that worry fades for the moment, we should look to re-establish a long yen position in the coming weeks.

More to the point, in the free-floating currency emerging (and commodity currency) nations, their very success may prove to be their downfall. You only have to look at the currency appreciation of some of these nations to see that the flow of money from the developed nations will cause trouble one day. A rising currency will choke off inflation, cool GDP and cause expected equity returns to converge towards those of the developed world. In the process the thrill will be gone for the emerging markets, with dramatic effects in the opposite direction.

The weakness of currencies such as the US dollar and the euro is not good for the developing nations as it will exaggerate and exacerbate the flow of money in a self-reinforcing feedback loop. As things stand, because of our dire budget deficit positions, we should expect this process to extend over the next few years, setting the scene for developing/developed nation bond convergence and emerging market currency appreciation. This can be useful in a portfolio context, but we should understand that in reality we are dealing with the next bubble. And, at risk of mixing my metaphors, this time there will be a case for being the first mouse; the first mouse out of the trap.

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