Investment update

4 May 2010

Stewart Cowley, Head of Fixed Income and manager of the Old Mutual Global Strategic Bond Fund, Old Mutual Dynamic Bond Fund and the Old Mutual Global 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.

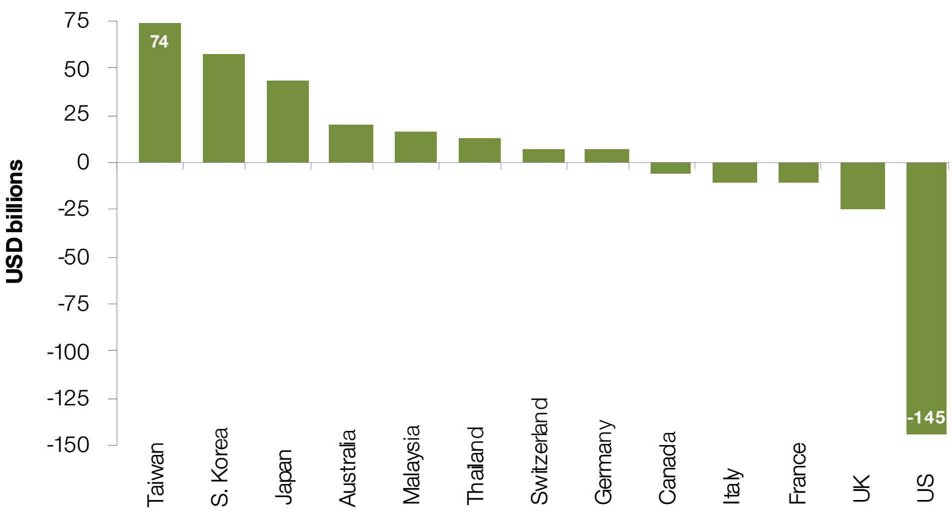
I'm still dancing

Strategically long conventional western government bonds whilst owning the Japanese yen and commodity currencies

Although it might seem something of a stretch, the fact that the Greek government has finally gone running into the arms of the European Union to secure funding is part of a pattern that is likely to be repeated in a number of western nations to varying degrees. The 'New age of austerity' or 'The party's over' if you like, defines a time when deficit reduction is the main mantra of the US and European governments. To be blunt, those with money (the Middle East, Far East and China) simply aren't going to continue funding our lavish lifestyles fuelled by debt. There are better things to do with your life and money.

That's not to say that there isn't a mutual dependency occurring here; we may be the main consumer of other people's money, but at the same time we buy their goods with it. You can sort of see the tension that is arising in the chart, which shows the trade position of various nations with China. To the left we have those nations that are net exporters to China, whilst on the right we have the net importers. If there was ever an illustration that defined our future destiny then it's this chart, because the nations on the right tend to be the ones that have big budget and current account deficits that fuel global consumerism. Coincidentally, they are ones that also have to reduce those deficits in the near future with all the social and economic consequences that follow; high unemployment, low growth and low inflation.

Country trade position with China



Source: Bloomberg

By reducing generalised borrowing growth will be restrained, which in turn will lead to a general cooling of the global economy. In that case, it's difficult to see the US Federal Reserve, the Bank of England or the European Central Bank raising interest rates in the near future on that basis alone.

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More to the point, the mutual dependency culture of the Far East/China and the west points to global, rather than just western, trouble. The expansion of China, which so many people expect to be the saviour of the situation, has, by and large, been led by investment rather than by domestic consumption. Until the Chinese consumer comes online and replaces its western counterpart, there will be a risk that what was a virtuous circle of exporting to the west and lending back the profits turns into a vicious one and what looked like an emerging market economic miracle ends up looking like nothing more than an illusion. It shouldn't come as a surprise for instance that last month China posted its first trade deficit since April 2004, mainly because western consumers stopped consuming. Clearly the emergence of China as the dominant economic force of the century isn't going to be a straight line.

It's certainly true that China has plenty money in its bank account (about $2.5 trillion in March this year) to smooth the economic cycle over the coming years, but the culture of dependency on western consumerism means that they may well need it. However in general, you can see who the winners and losers are going to be in the future; the winners will be countries such as Taiwan, South Korea, Japan and Australia, while the losers will be Italy, France, the UK and the US. Simplistically, this will have profound effects on currencies and interest rates. Currencies such as the yen, Australian dollar and South Korean won will rise against the euro, sterling and the US dollar whilst, at the same time, to keep the party going when credit is being withdrawn, the west will need low interest rates and low bond yields as long as consumers suffer from the twin onslaughts of debt repayment and deficit reduction. Any sign that dampened growth expectations in the west are spreading globally will put a halt to the current one-way trade that is putting upward pressure on emerging market assets and currencies. But whilst the music is still playing we are still dancing and if you have ever seen OMAM's fixed income team dance you'll know that isn't an altogether pretty sight.

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