Investment update

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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 problem with capitalism

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

We have been silent for the past couple of weeks mainly because anything written down had the shelf life of milk on a summer's day when the fridge has been turned off. But now that we have arrived at the position that deficit reduction (as enunciated through our Discriminating Capital theme) is the new mantra, it is timely to examine the real consequences of what has been set in train.

Not many people realise it, but capitalism dangles by a thread. In order to keep on borrowing and rolling up your debts and interest payments, you need both growth and inflation. It seems strange to say it, but inflation is a necessary element of the edifice of capitalism. Just using some simple mathematics you can show that real growth of about 1.5% is necessary to run a budget deficit of about 5% with borrowing costs of 6%. If inflation turns negative and you continue to borrow, then you are in real trouble and your interest costs as a proportion of total GDP very quickly get out of control.

So this is the problem with capitalism - it is addicted to growth, inflation and the continuation of borrowing into the future as far as the eye can see. Disrupt any of these elements and the whole edifice falls over. And this is what is so dangerous about the future mainly, because all of these elements are at risk:

Growth - The need to rebalance the books at a personal and national level is a threat to growth in the next five years. Unless the magical 1.5% is achieved, on average, there will be serious consequences. In effect, central banks would do best not to touch interest rate policy and even extend quantitative easing to ensure that there isn't an interest rate barrier in the way. Banks would do well to lend and be encouraged to do so.

Inflation - It remains to be seen whether inflation can be sustained in the west. The experience of Japan is that once deflation gets a grip it is difficult to get rid of. The economist Adam Smith said that inflation is, by and large, a currency effect. So with the absence of any kind of domestic pricing power you understand why those in charge may be tempted to allow your currency to decline in order to create some inflation especially if you have a trade deficit.

The continuation of borrowing - Whether it is at a personal or government level, borrowing money (and lending it) is possibly the least fashionable thing to do right now. And yet to keep going, not only does borrowing have to be constant, but more to the point, it is also useful if you never actually pay your interest but instead borrow to pay the interest. The trouble with this idea is that if you keep on doing it (and never have periods of surplus when you pay down debt), then after a time the geometry of mathematics takes over and the amount of earnings you are using each year just to service your debt payments takes off. Catastrophically, this means that, starved of the money to pay your debts, you go bust (or default, as they say).

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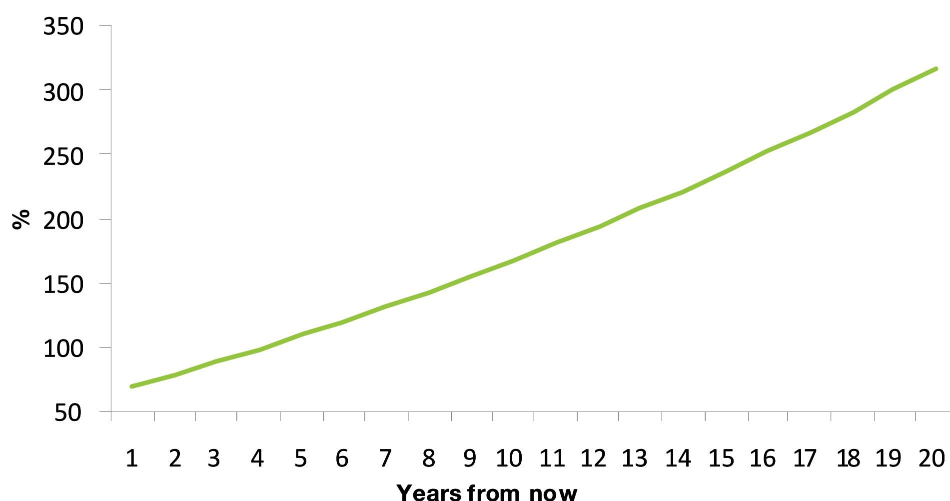
Debt as a percentage of GDP under deflation



Source: OMAM

If you start to think about these three ideas, they amount to the challenges of our age. Growth is going to be hard to come by under the onslaught of deficit reduction, inflation as a permanent phenomenon may be hard to come by and the continuation of borrowing relies on functioning capital markets with investors willing to lend. Capitalism, in that sense, is going to be hard to generate in the form that we have become used to over the past 40 years. And yet it couldn't be more crucial to get it right. Using some simple assumptions it's not difficult to show that if deflation sets in, given our indebted starting point, our debt to GDP ratio very quickly increases rapidly in the coming years, especially if economies continue to habitually borrow 4% of GDP each year at interest rate levels of around 4- 5% (see chart).

The 'solution' is that for interest rates to stay low for a considerable time, bond yields will have to fall and we should expect that there will be competing bouts of currency devaluations in an attempt to generate domestic inflation. Most immediately, the European currencies (including sterling) will bear the brunt of this and eventually the focus will turn to the US dollar. The challenge will be to work out the weakest against other currencies; the emerging markets, commodity currencies, Chinese yuan and even the Japanese yen.

Already we are seeing challenges to western budget deficits in the form of budget cuts. Ireland, Greece, Spain, Portugal and latterly the UK are showing signs of profound choices in social policies in the form of cutting expenditure on education and basic services at the expense of national defence and monetary stability. Social unrest is sure to follow and it remains the challenge of politicians to hold their nerve and sell those choices in the name of long term financial stability. And all the time the aim will be to return capitalism back to its basic needs of a minimum of growth with moderate inflation and prudent borrowing in the public and private sectors.

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