

## Investment update

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**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.

# Investment outlook

Stewart Cowley, manager of the Old Mutual Global Strategic Bond Fund, reviews the sovereign deficits in Europe and their impact on currency and bond investments.

## What is your view on the situation in Greece?

Clearly it is an extremely serious situation and I have been surprised by the domino effect it has caused across Europe. One of our investment themes has been what we call 'discriminating capital', which looks at how the west could not afford such budget deficits, and that the people with money would not fund them for ever. We thought the problem would arise in the United States leading to weakness in the US dollar, and we were surprised that it showed up in Greece and led to weakness in the euro, but this is a serious situation with ramifications across Europe.

Although this concerns Greece, it is also about Germany. The vast majority of German GDP comes through exporting rather than domestic consumption, so a decline in the euro is good news. Flight to quality in terms of German bunds as well means that the real cost of capital will fall. So there is negative contagion and a spreading of the problem across Europe, but also there is also positive contagion through lower interest rates, or lower cost of capital. This is a form of quantitative easing which is what we've been arguing for, and bond yields can finally fall.

## How will the UK government pay off its debt?

If you look at the UK situation, it's pretty clear that expenditure stayed high but tax revenues have fallen away and that gap means that we've just got to reduce expenditure. You can play around with income taxes and VAT as much as you like but the reality is that £90bn has to come off that budget deficit each year.

This administration has to make tough choices, and that can bring real social pain. There are regions in the UK where 60-70% of local GDP is sponsored by government expenditure, and that is just not sustainable. Effectively we need to re-privatise GDP, and this will be an especially painful transition if financial services are not to contribute to GDP in the same way they have done in the past.

## For mid 2010, are you expecting deflation or inflation?

There is no particular inflationary push underlying things in western economies, and so by the second half of this year those relatively high inflation rates of round about 3-4% should decline back to around 1-2% again. So we could end up with negative real interest rates if nominal bond yields fall below inflation.

## What are your views on major currencies at the moment?

I've always been a big proponent of the euro and felt that we needed the euro as a single trading block to match the Americans and the rising Far East, and I'm disappointed that the euro has been kicked off course right now, effectively by deception. But maybe this could strengthen the euro long term because it means people will have to fall in line with financial regulations and over time the euro should recover.

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If our politicians do not do the right things in the UK in terms of deficit reduction, then sterling itself is a currency 'at risk' and will go the way of other European currencies. And by a process of elimination, there will be only two reserve currencies in the world, the dollar and the yen.

### Are you continuing your high exposure to government bonds?

Yes, for the time being, but selectively. We have argued for some time now that western bond yields should converge down towards Japanese style bond yields. I think inflation will fall away in the second half of this year which will allow this to happen and, either by market manipulation or natural forces, bond yields have got to come down. However my real worry about government bond markets is the unfunded liabilities of unknown size that need to be funded in future. These will start to kick in because of the demographic changes due in the second half of the next decade or so. So we have to address deficit reduction as these unfunded liabilities approach, and they will entail high government expenditure. If we don't contain deficits then bond yields will rise, but for the time being they should decline.

### Are you still keen on financials?

Greece is really just one of a whole series of financial reconstructions in governments and in the banking system which must happen. The reconstructive phase in the banking system in the UK is well in place and I think it's going in the right direction. I still think there's a problem in the US banking system: it shouldn't have escaped notice that Fannie Mae had to borrow another \$10bn from the US Treasury, for instance. There could be more problems in the European banking system, but in the UK we are making progress. So we are still fans of financials, but selectively so.

### How do you see bond markets over the next twelve months?

Well declining bond yields are not a problem for bond managers, because as yields fall prices rise. So we're currently long duration. There are selected parts of the corporate bond markets - financials, ideas-based companies - that can do well in this situation. In terms of currencies, we have no euros right now, but we've got lots of dollars and yen in our fund. It is quite a bond-friendly environment in some respects, and a currency-friendly environment if you pick the winners, so in a total return context you can make returns for people, especially compared to cash and possibly to other asset classes.

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#### Old Mutual Asset Managers (UK) Limited

2 Lambeth Hill  
London, EC4P 4WR, UK

[www.omam.co.uk](http://www.omam.co.uk)

+44 (0)20 7332 7500



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