Investment update

8 June 2010

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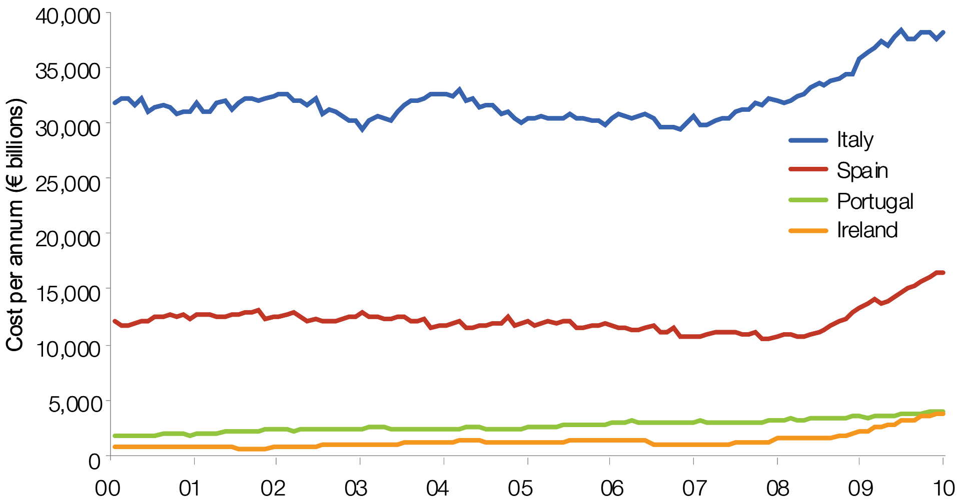
Stewart joined OMAM in June 2009 from Newton Investment Management where he held a similar role and managed the Newton International Bond Fund and BNY Mellon Global Bond Funds, both rated AAA by Standard & Poor's. He has more than 20 years' experience of global fixed income markets, having begun his career in 1987 as a broker before subsequently switching to fund management.

The Italian job

Owning the Japanese yen

Whilst we have all been preoccupied by The Greek Tragedy, we have somewhat missed the point. Greece is a tiny country with massive ratios but, in reality, it shouldn't challenge the integrity of something as mighty as the euro. It's good to put things into perspective from time to time, and if you were thinking about the ability to pay your debts and the interest on them, you would be hard pressed to look further than a simple idea of how much money you were actually paying each year. Simply multiplying the average coupon of a country by its outstanding nominal amount of debt can give you a sense of this (see chart 1).

Chart 1: European interest payments



Source: Bloomberg

In actual money terms, countries such as Spain, Portugal and Ireland are but nothing compared to the gargantuan needs of Italy. Each year Italians need to pay out (or borrow) over 35 billion just to meet their interest payments. And yet Italy has a debt to GDP ratio of 118% (second only to Greece's 125%) and is much bigger in actual size. For instance, Italy has a bond market as big as that of Germany. We seem to have lost our sense of proportion as to where the real problem lies in Europe.

So the elephant in the room is not Greece or Spain or for that matter Portugal, but Italy. You don't need to "blow the bloody doors off" but clearly the borrowing job of Italy is much more a threat to monetary union than Greece. Maybe that's why they have attempted to preempt criticism by signing off a budget that will reduce spending by 13 billion in 2011 and bring the deficit down to 3.8% of GDP.

The saving grace of Italy is that it is much less dependent on foreign investors than many other nations. But this rapid rise in annual interest costs is characteristic of many nations in the west (including the UK). However, it pales into insignificance compared to what is happening in the US (see chart 2). The combination of a declining tax take and a rising amount of borrowing means that the annual interest costs of the US are now increasing at a

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geometric rate. In that sense, the only thing saving the dollar is the weakness of the euro, not the virtues of the dollar per se.

Chart 2: US annual interest costs

Source: Bloomberg

So if you are borrowing over $150 billion a year just to keep up with your interest payments, whilst, at the same time, the Obama administration is calling not for austerity and restraint but instead for another supplementary stimulus of $200 billion, you have to wonder how long the markets will continue to treat the dollar as a traditional safe haven currency.

It is obvious that in the next year or so Greece will have to default on its debts. We can only hope that the markets don't turn to the more obvious target of Italy in an attempt to blow the European experiment apart. But if, at the same time, the cloak of respectability is lifted from US finances, then you have to wonder what could become the 'safe haven' currency of the world. Sterling and the commodity currencies are too small to accommodate international investors so, starved of any other alternative, the last resort may be the Japanese yen. For thematic reasons and risk management reasons we'll be hanging on to some yen going forward.

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