Investment update

3 June 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.

"Hello dollar, well hello dollar, it's so nice to have you back where you belong...?"

Currently, overweight the US dollar, underweight the euro - looking for a re-entry point.

Without wishing to sound like too much of a fan of Barbara Streisand, it's tempting to welcome the resurgence of the dollar to its preeminent position in the global financial system. Sadly, the dollar is being used not for what it IS, but for what it ISN'T - the euro.

We don't have to rehearse here why the euro is sliding against just about every currency in the world but suffice to say that the $1 trillion bailout of the European Union, and the transfer of core central European country creditworthiness to those who don't deserve it, has undermined the credibility of a currency that at one time looked a likely replacement for the dollar as the reserve currency of the world. But those who might have been harbouring any form of schadenfreude for the decline of the euro should think again. The fall in the euro has the very practical implication that the dollar rises, and the last thing America needs right now is an overly strong currency.

The point couldn't have been hammered home more starkly last week. Whilst more hysterical, wrist-flapping market commentators were calling for parity between the dollar and the euro, both US and European officials tried to halt the slide through dark rumours of 'market intervention'. The reality is that sovereign states are just too small to control the capital markets (they simply don't have enough money) whilst at the same time, the market has never been so short the euro. Any implied reversal would be enough for those who simply leap on established trends and exaggerate them to react accordingly and buy the euro once more.

The reason that is important to halt this money making opportunity is simple; America can't afford it. It shouldn't have passed anybody by that US inflation is decisively on the slide (see chart). Any further appreciation of the dollar will only serve to exaggerate the deflationary trend that is in place. As we pointed out recently, the one thing that capitalism REALLY doesn't like is deflation. It has the effect of increasing the real value of debts, which is something that an economy that is $1.4 trillion in hock to the rest of the world, per annum, can ill afford.

On the same day it was announced, much as we have been discussing, that foreclosure and delinquency rates in the US housing market are on the rise again. A rising dollar isn't good for the economy, which is on a tentative growth path - if the US is priced out of the global export markets then unemployment will rise again. For pessimists, there are already signs of this. Double dip recession won't be far away and a secondary wave of banking problems will be hard to avoid.

On the flip side, a sliding euro isn't so bad for Europe. German GDP is very dependent on exports and a declining currency helps German exporters. In that sense, the US would do well to collude with Europe in order to halt the slide in the dollar/euro relationship. And here

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US CPI Core YoY

Source: Bloomberg

is the important point: without some form of concerted effort to stop the currency recalibration, what was a localised European problem will become a global problem. The new deficit strictures being imposed on peripheral European economies are, to all intents and purposes, a political union within Europe; the lenders of last resort now call the shots, transcending national borders and political systems.

In a portfolio context, we have recently modified our euro position and reduced it to a minimum. But no matter the currency base of our funds, we aren't closing our minds to the fact that the current crisis and its resolution will, one day, actually strengthen European Monetary Union because it will bring about greater transparency, accountability and discipline among all the nations involved. With it will come the resurgence of the euro if the political landscape is stabilised. Without it we will see further weakness in the euro.

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