Investment update

14 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

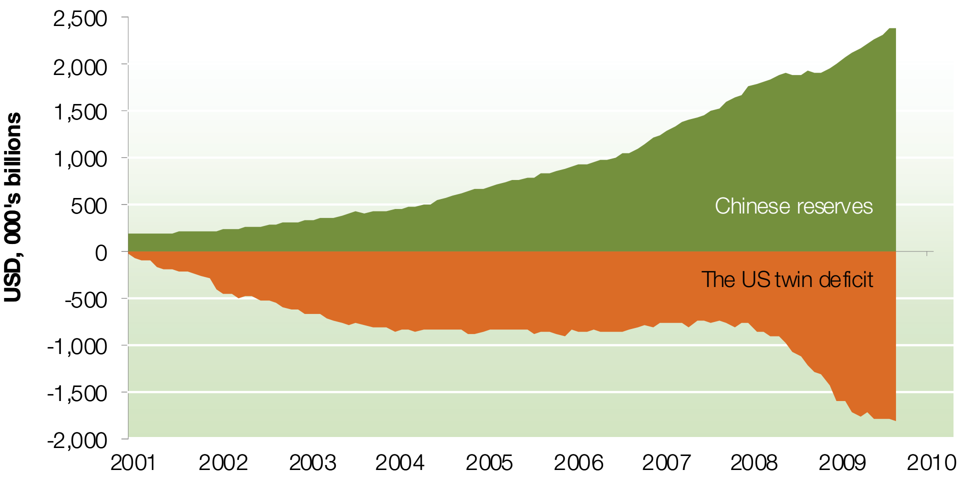
Stewart joined OMAM in June 2009 from Newton Investment Management where he held a similar role and managed the Newton International Bond Fund and BNY Mellon Global Bond Funds, both rated AAA by Standard & Poor's. He has more than 20 years' experience of global fixed income markets, having begun his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

'Chinese Water Torture'

Beginning the process of rebuilding euro positions

The drip, drip, drip of bad news is enough to make your average bond manager reach for something stronger than water. But it has become apparent that whilst we have been concentrating on protests on the streets of Madrid and Athens, we have been happily ignoring the bigger problem in the world. Whilst the hair shirt of austerity is being worn around Europe, President Obama has quietly pondered whether the US should award itself another $200 billion of other people's money to keep things going in the US. If you add in the current account deficit this takes the annual bill to keep the US going to over $2 trillion a year.

The US and Chinese financial relationship



Source: Bloomberg

For too long there have been those who have looked to the Chinese to keep on feeding money back to the west in order to maintain our consumerist lifestyles. However, even China has 'only' $2.4 trillion in its bank account, which is the sort of money we could fritter away in about a year. The Chinese simply don't have enough money and what's more they may need it themselves going forward.

Besides, Chinese reserves aren't a sign of strength as some would have it, but instead are actually a sign of the weakness of the global financial system. Clearly there is a tremendous imbalance in the world if one very large economy is living on an overdraft whilst the other has an equal but opposite bulging bank account. If you wanted to see the main challenge the world faces in the next decade you wouldn't have to look any further than the one shown here - the amount of money China has compared to the amount of money the US needs each year. The only other times that this kind of imbalance has persisted have been in the 1920s in the US and in the 1980s in Japan. We shouldn't have to spell out what the aftermath of those occasions meant for the global economy.

It has long been a fetish of western capitalism to come up with ever more ingenious ways of harnessing the potential that China presents. The great disservice that the success of China has presented to the west is the possibility of fulfilling that avaricious dream. The success of China has allowed excess money to be recycled back to the west, which in turn has fed our habitual budget deficits. Some people call this Keynesian economics, which is to

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

misunderstand what John Maynard Keynes was talking about when he said it was OK to borrow 3 to 4% of your GDP from time to time in order to smooth out your economic cycle. The point is that it is supposed to be occasional, not habitual.

Of course, in the case of China, sustaining western growth helps fulfill the Chinese agenda. Expected growth leads to investment which leads to more growth and more investment. In that sense, the Chinese economy, as it is currently configured, is specifically designed to fulfill the expectations of the past and hope they will be repeated in the future. In fact if you look at the composition of Chinese GDP, about 30% is created by investment whilst a paltry 5% is what we would call retail sales.

In the process of sponsoring Chinese investment at any cost, there have clearly been some reckless practices in the Chinese banking system. Nobody can grow broad money supply at 21% per year without some mistakes happening. In fact if you really want to know the magnitude of lending that is happening, less than a decade ago the total amount of loans being extended in China was about $150 billion a year. Today that figure is $1.4 trillion. So bad debts are undoubtedly building up in the Chinese banking system, but since many bad debts are taken 'off balance sheet' as the accountants say ('hidden', to you and me) they barely show up in the official statistics. In that sense, going forward, we shouldn't be surprised to find that, at some point in the future, the Chinese banking system looks less solid than we currently imagine. In fact it may well resemble the US and European banking systems of today.

So, if we were looking for the next big problem, leaving aside our preoccupation with the budget deficit reductions in Europe, we wouldn't do too much better than the combined budget deficit and current account problem of the United States and what it is doing to China. The rebalancing of the global economy to correct the disparity between spending and saving between two great economic powers in the world will undoubtedly involve a breaking of the US dollar/yuan peg and a violent or gradual rebalancing of that relationship. The question is 'when', not 'if'.

Already the Chinese have stepped in to stop the decline in the euro, belatedly acknowledging that a rising dollar is bad for its main customer, the US. Simultaneously, dark rumblings have done the rounds that the revaluation of the yuan will occur sometime in June. In reality, the Chinese could drop it on us at any time so we are now on red alert for that to happen. A change in the US dollar/yuan rate can be achieved in a number of different ways but it isn't just a bilateral event. For instance, what happens to other currencies with respect to the US dollar? The last time this event occurred (between 2006 and 2008) the US dollar lost ground on a trade-weighted basis against the major currencies of the world. So a specific change in one currency relationship resulted in a generalised fall for the dollar against a basket of currencies (which most surely was the point of the exercise in the first place).

Now that some stability and sizing of the issues for Europe have been established, maybe even the unloved euro can gain some ground on the dollar. On that basis and because the risks of a Chinese statement are rising, we are cautiously beginning the process of rebuilding our euro positions at the expense of the dollar.