Investment update

8 July 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.

Don't bank on it...

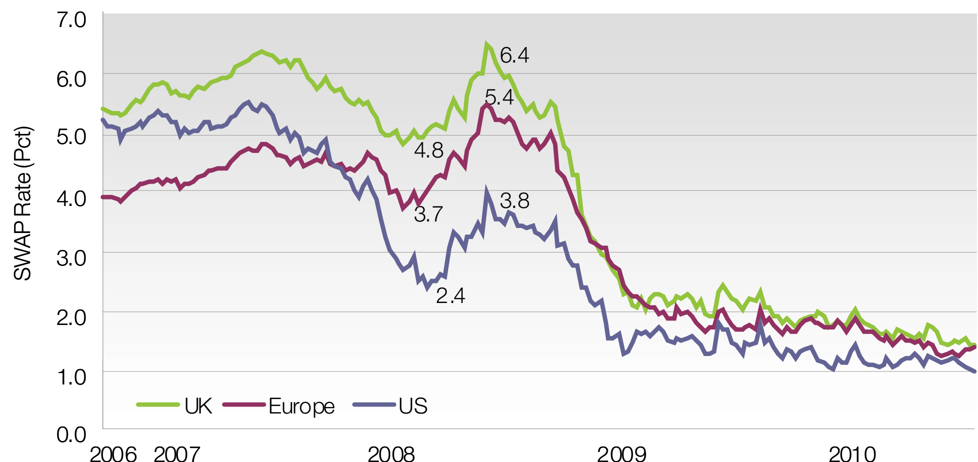
Selectively increasing corporate bond holdings

Whatever the process is that we are currently going through, it seems to be fairly well advanced. For instance, we know that:

- governments have no money
- banks have money but won't lend it
- the Chinese don't have enough money to fill the gap

In fact, you could argue that even the market thinks that the problem has been pretty much defined and that the banking crisis per se is all but over (except in Spain). If the kind of borrowing rates used by the banks are anything to go by, the risks associated with a systemic collapse in the western banking system are all but over (see chart 1). Two year swap rates (which equate to commercial borrowing rates over the next two years) have fallen to a low and stable level of around 1.5% in the west, a symbol of the fact that things have settled down to a rather uneasy equilibrium and level of acceptance.

Chart 1: 2 year SWAP rates in the US, UK and Europe



Source: Bloomberg

It would be easy to cite other examples of the attenuation of the banking crisis; the decline in broad money supply, the collapse in lending secured on property and so forth all point to one thing - frivolous capitalism based on infinite lending has disappeared from our societies (see chart 2). Needless to say, this isn't quite the situation in the so-called emerging nations. They appear, in a number of notable instances, to be repeating our past mistakes - borrowing money to buy real estate and living off the revalued proceeds. You can understand why, to us, some of these 'economic miracles' merely look like the next problem waiting to happen.

But the decline in borrowing rates for banks, as symbolised by two year swaps, also says something else; maybe the market doesn't see the banking system to be the threat that it once was because the banks are now set on a course of balance sheet reconstruction that will turn them into the rather dull institutions that they used to be. Faced with this idea and accepting that companies need money to function, where will the next source of funds come from to finance future economic activity?

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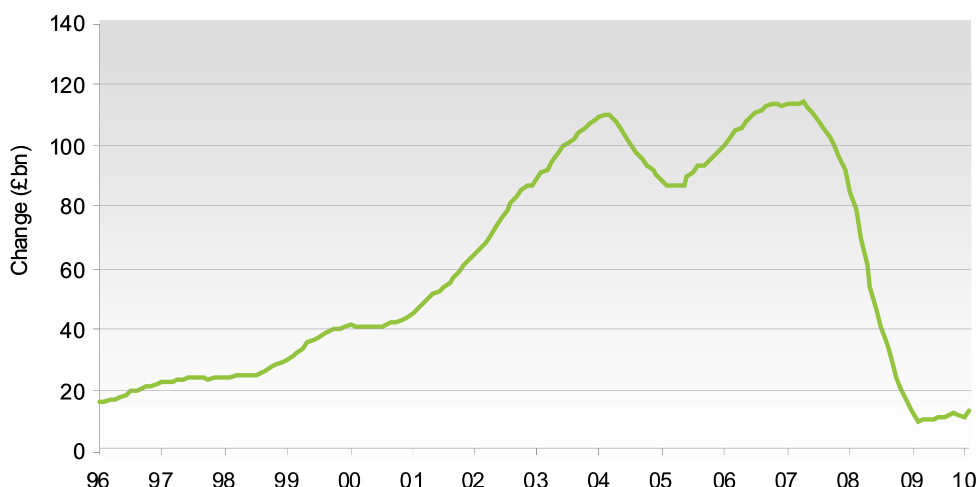
Chart 2: UK annual change in secured lending



Source: Bloomberg

It doesn't seem too fanciful to suggest that 'companies are the new banks'; cash on balance sheets and borrowing power in the markets is being used to finance customers and suppliers, thereby disintermediating the banking system whilst it goes through its multi-year reversion to the mean. From the evidence of our own experience we can say that this idea is gathering pace, since asset managers and corporate treasury departments are increasingly being approached directly with private placements of debt and equity on a scale unseen prior to the start of the credit crunch. At the same time we have noticed a number of companies removing cash from their balance sheets and replacing it with debt, thus monetising themselves such that if things go wrong it is the bond holders who will shoulder the burden, rather than the equity owners and the management. Credit risk is thus being transferred out of the banking sector and into the hands of ordinary people via bond holders and investors in funds.

This raises a number of problems; if corporations are the new banks, are they really equipped with the skills to perform that function and are bond holders being compensated adequately for the coming risks? Like all good ideas, you can trust the financial markets to take the idea of 'companies as banks' and push it to an extreme such that when financial instability turns up next it won't be in banks, but in companies that you would never have expected to be in such a position. This raises the uncomfortable idea that you cannot look at, say, a traditional industrial company, from the point of view of their primary product alone but, instead, you need to take into account the totality of their business.

The blurring of the difference between 'product' and 'financial engineering' is making us more discriminating about the kind of credits we are buying for our portfolios as it could well be the beginning of the next big problem. What does a company sector classification in a portfolio really mean? Is that really a supermarket? Don't bank on it!

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