Investment update

2 July 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.

There's a smell in the kitchen

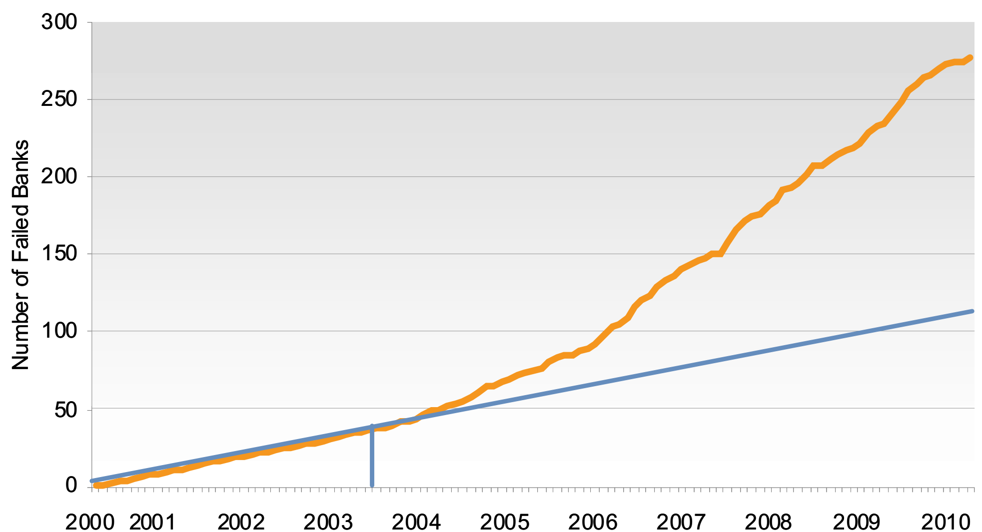
Long duration in the US, avoiding US and peripheral European bank debt

In my house in London there's a smell in the kitchen. It isn't permanent, but comes in waves and at uncertain times. The very unpredictability of it makes us slightly nervous and edgy a lot of the time. We suspect something has died somewhere and we are reaping the aftermath.

Predictably, I'm going to stretch this analogy to breaking point; whilst we have been preoccupied with Europe these past few months, there has been the whiff of a problem wafting across the Atlantic, which has been periodically troubling. We suspect something may have died whilst we weren't looking. More to the point, has anybody noticed that, as of 25 June, 86 banks have closed their doors this year, according to the FDIC? This is a faster rate than in the terrible year of 2009. In fact, if this continued at the current pace, there would be 178 bank failures this year, compared to 140 last year.

To be fair, there is always someone going under in the US banking system. The Darwinian nature of the markets wouldn't be working properly otherwise. But there was a long period of time (between June 2004 and January 2008) when there were just three failures. Chart 1 shows what happens when you plot a trend line through the data. The pace has clearly picked up considerably since 2008 and it is accelerating again today.

Chart 1: Cumulative US bank failures since 2000



Source: Bloomberg

This would be bad enough if it wasn't for the fact that there are hidden items rotting away in the European banking system too. Spain stands out in this respect and the full horrors of recent times are yet to be discovered. The thought that the ECB might not renew its 440 billion facility to the banking system should send shivers through the markets in the coming months. Finally, and belatedly, the markets might get the idea that we are not looking for a

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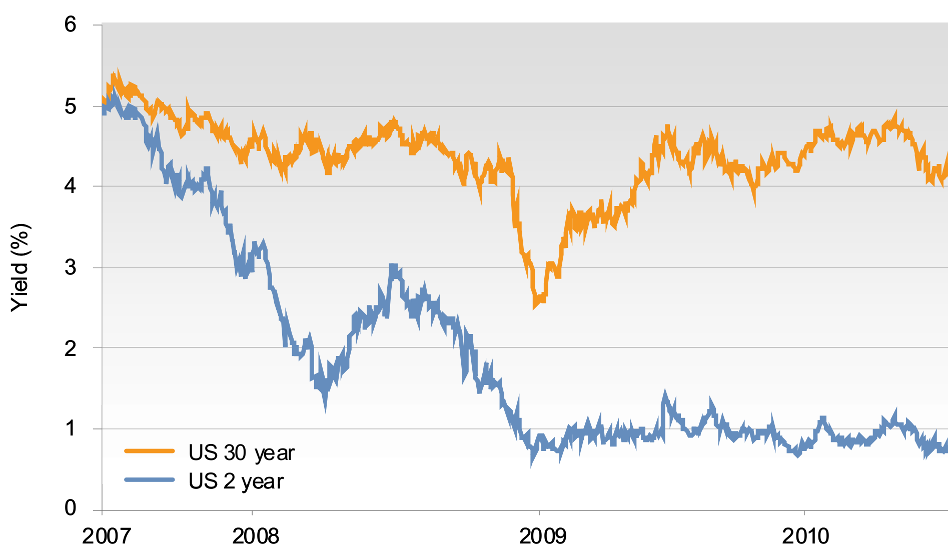
magic bullet or an event that will solve this crisis; instead what we are witnessing is a process that might take years to act out. During this time we can expect benchmark government bond yields to be driven down to extraordinarily low (Japanese-style) levels.

Short-term interest rates have reacted – they are now lower than at the height of the first banking crisis (see chart 2). What hasn't happened during the process, and arguably needs to, is that long-term interest rates have barely moved. Leaving aside the fact that the US needs to reduce its budget deficit radically (along European lines), either by market manipulation or natural forces, long-term interest rates need to fall in the US to help out the economy going forward, otherwise the current whiff of bank failures will turn into a unbearable odour and everyone will want to exit the kitchen but in something of a disorderly manner.

Chart 2: US bond yields since 2007



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