

## Investment update

01 August 2011



**Stewart Cowley, Head of Fixed Income and manager of the Old Mutual Global Strategic 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.

# The God of Compound Interest

The debts of the G5 national governments are forming into the fourth wave of the credit crunch. Slowly but surely, the implacable force of compounding is turning interest payments into a significant public expense

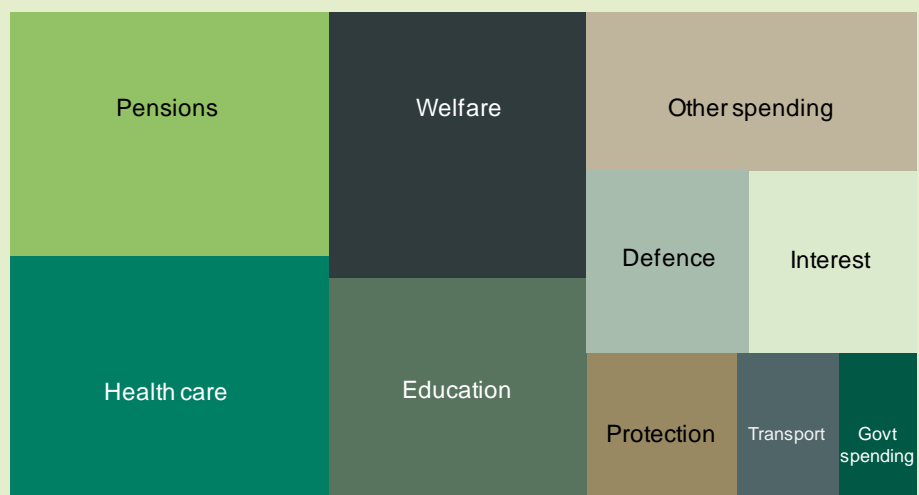
### Long the government bond markets

There's an awful lot of political point scoring being made out of it, but most of the arguments about budget deficits are really the realisation that, very soon, the God of Compound Interest will soon be smiting the best laid plans of even mighty nations like the United States of America. Compound interest is a benign mathematical effect when you are a saver; the interest you earn over years itself earns interest and so on increasing your wealth in an ever rising geometrical progression. If you were to graph it against time it would progress gently for a while then all of a sudden the numbers take on a life of their own and the line begins to rise rapidly.

This is a nice effect when you are a saver but as a borrower it has the reverse effect. After a time of continued borrowing, you need to borrow to pay your interest, the compounding effect means you become rapidly impoverished if not insolvent. Mathematics determines the outcome, but the decisions are made through politics.

If you were to lay out the problem for the UK, for instance, alongside all other central and local government expenditure (see the first table) then many people would be surprised that the UK currently pays some £44bn a year in interest costs. Over the course of this parliament (until 2015) interest payments are set to eclipse defence spending and exceed more than half of the education budget, whilst pension payments start to edge out both

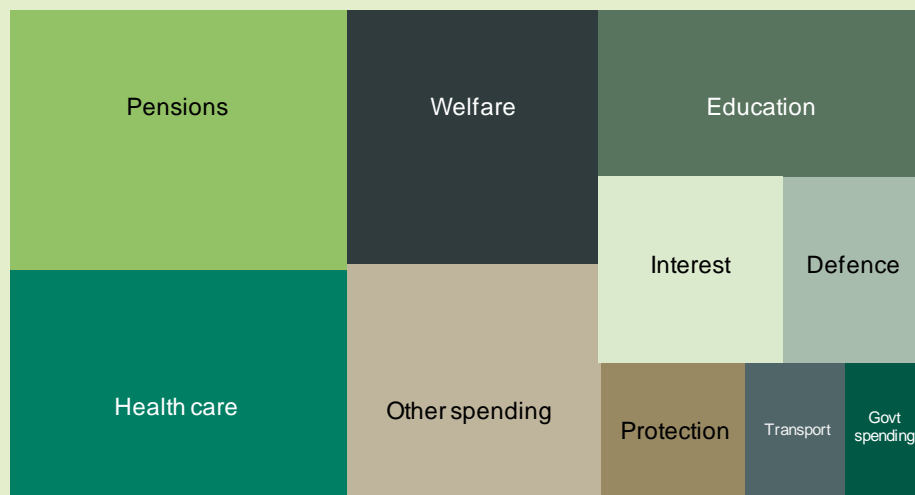
**Table 1: UK Central Government Spending 2011**



Source: OMAM

healthcare and welfare payments as the biggest single item in the national budget (see the second table). In absolute terms, by 2015 interest rate payments will have risen to over £62bn a year. The interest paid by the UK is rapidly becoming a major budget expenditure, ranking alongside good and worthy causes that benefit society.

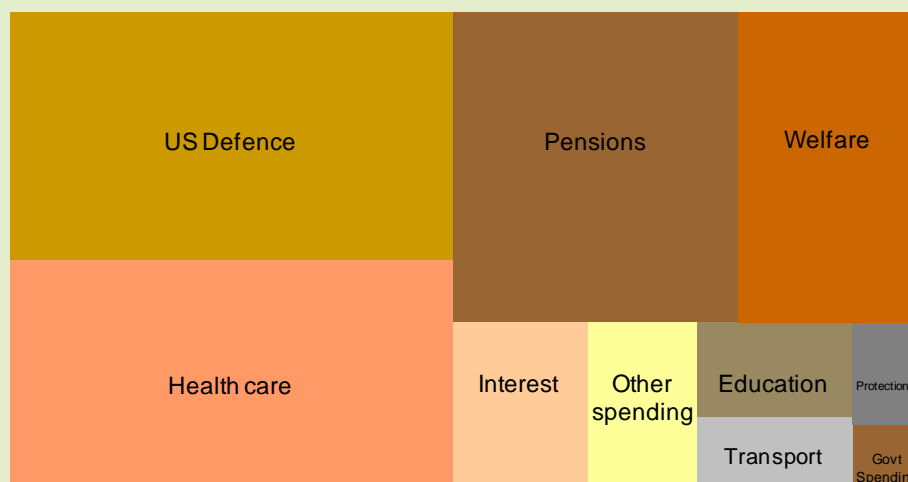
**Table 2: UK Central Government Spending 2015**



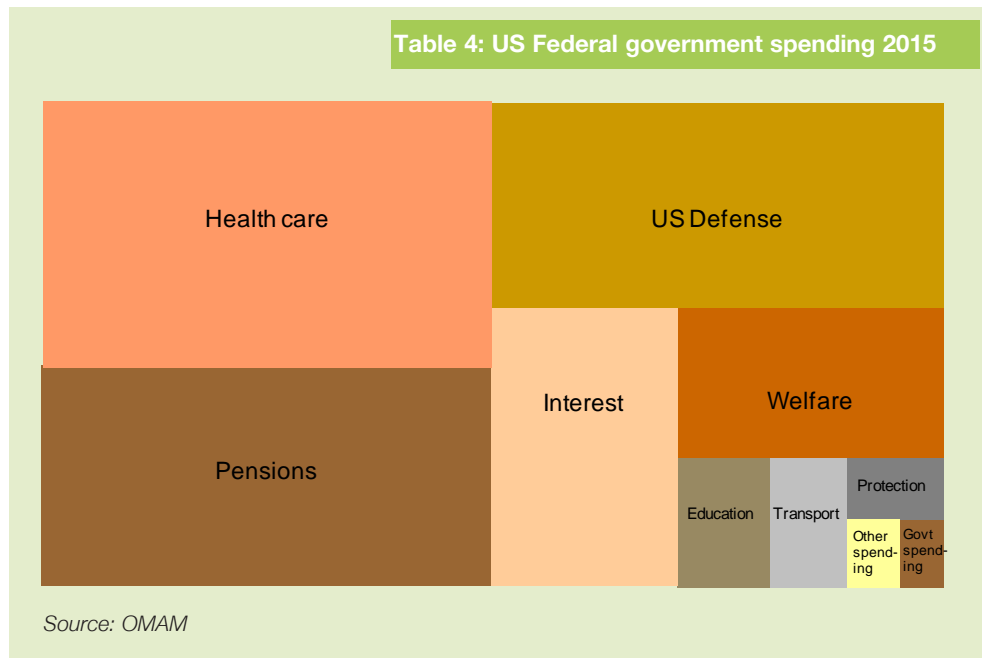
Source: OMAM

If you do the same exercise for the United States it frames the current budget deficit debate in terms that remove some of the ideology and places what is at stake in context. At this time, Federal spending is dominated by defence (see the third table). Interest rate payments are greater than Federal-level education spending. Roll the situation forwards to 2015 and, at current estimates, health care becomes the single largest item of US Federal expenditure whilst the combined value of health care and pensions takes up over half the budget, nudging defence into third place (see the fourth table).

**Table 3: US Federal government spending 2011**



Source: OMAM



But interest payments in 2015 will be much larger as a proportion of the whole and greater than the welfare budget. In absolute terms the US will be paying just under \$500bn in interest rate payments alone (up from \$306bn for calendar 2011).

One way or the other for the UK and the US, controlling interest payments is absolutely the top priority for the political establishment. You COULD increase taxes but as J. K. Galbraith pointed out in his seminal text on the stock market crash of 1929, amongst the contributory factors to the Great Depression was that the wealthy stopped spending. If taxation deters those with some disposable income left from spending, we are left with the socially unpalatable spectacle of trying to control deficits by reducing expenditure. But this is to misunderstand the gravity of the situation because if a country is running a budget deficit at all then the total stock of debt is still rising and the proportion of total expenditure drained off for interest payments must also continue to rise. The pace may slow but eventually the God of Compound Interest will once more take hold.

Clearly, the intervention of the rating agencies has changed the game for the likes of the US. If there is any premium (as logically there ought to be) for the loss of the AAA-status on US debt, the interest burden increases even beyond what the God of Compound Interest would otherwise dictate. Incidentally, the US is not unique in this sense - it is the same for the UK. But as we have seen, even meagre reductions in government expenditure significantly reduce economic growth, which in the UK has fallen to levels usually associated with statistical noise. The transfer of jobs from the private sector to the public sector over the past few decades in the US and UK means that any attempts to tone down public spending sends unemployment up. The US is almost certain to see a 10%-plus unemployment rate going forwards if Republicans have their way on deficit reduction.

Whether it is in the US, UK or Continental Europe, attempts to reduce budget deficits are not per se policies that promote growth and yet they are now the main issue for all governments in order to ward off the effects of compound interest. Notice we don't say "solve the problem" because without balanced budgets we are merely slowing the pace of the car crash down.

For those who argue that we should continue to spend our way out of the current situation there is some logic; does it really matter whether you have a car crash at 80mph or 100mph? The effect is, near as damn it, the same and, at least for a while, the general public (i.e. voters) will be spared the high unemployment rates that will inevitably ensue with the deficit reduction approach. But either way, in the coming years it is almost inevitable that the US and UK will lose their AAA-rated position in the government bond markets. We had this penciled in for 2012/13 but events are now moving at a pace we hadn't foreseen. Also, without government-inspired growth it is highly likely that government bond yields will decline to very low levels before they rise again.

In effect, this is the fourth wave of the problems coming out of the Credit Crunch of 2008. First it was consumers, then banks. The peripheral European sovereigns and the US states followed. It is now moving to the largest economic entities on earth, the G5 national governments. Germany is a partial exception, whilst Japan has a postal savings bank and external assets that can be used to self-fund their problems for the time being. But clearly, this is an issue that is going to rumble on over many years with investors receiving sub-inflation compensation effectively reducing the real value of an entire generation's savings. You could argue that this is merely pay-back time; wealth that was artificially created by financial engineering is being destroyed by the rebalancing of the global economy. But how we got here is not going to concern the God of Compound Interest.

---

**Old Mutual Asset Managers (UK) Limited**

2 Lambeth Hill  
London, EC4P 4WR, UK

[www.omam.co.uk](http://www.omam.co.uk)

+44 (0)20 7332 7500



---

**Important information:** Past performance is no guarantee of future results. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested. OMAM has no house market view and opinions expressed are the views of individual fund manager(s) as at the time of writing. These views may no longer be current and may have already been acted upon. Any underlying research or analysis has been procured by OMAM for its own purposes and may have been acted on by OMAM or an associate for its or their own purposes. OMAM is the appointed investment adviser for Old Mutual Fund Manager's in-house OEIC funds. Old Mutual Asset Managers is the trading name of Old Mutual Asset Managers (UK) Limited and Old Mutual Fund Managers Limited. Old Mutual Fund Managers Limited, 2 Lambeth Hill, London EC4V 4AD. Authorised and regulated by the Financial Services Authority. A member of the IMA. Old Mutual Asset Managers (UK) Limited, 2 Lambeth Hill, London EC4P 4WR. Authorised and regulated by the Financial Services Authority. Telephone calls may be recorded for security purposes and to improve customer service. U5783/05/11