Investment update

1 September 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 urge to converge

Markets may be chaotic, but through it we see the re-emergence of the trend of government bond yields converging to the lowest common denominator. For many, unfortunately, the real yield will be negative

Emerging from a Borneo rain forest, thankfully unhindered by mobile phone access for a week, it was an interesting jolt back into reality to switch on the television and see the apoplectic anchorman of CNN loosening his tie to the cry of "THE MARKETS ARE IN MELTDOWN!!!!!" By the look of him, it was him who needed a week or two in quiet contemplation of nature because nature can teach you a thing or two about how systems work and how they can become chaotically unstable.

It may seem fanciful, but whilst idly feeding chocolate biscuits to Doctor fish (those things that nibble your feet in department stores these days) in an oxbow lake, I noticed that all went well for a while; the fish swarmed around the confectionary and took turns in an orderly manner to take a chunk. The activity became more frantic as the supply of biscuit declined until there came a moment when the game sped up to such a velocity that the fish would literally explode out of the water in their scrabble to get the remaining crumbs.

These bursts of chaos are similar to what happens in markets. As the game speeds up, the market reaches a point of instability and exhibits extreme and chaotic behaviour. Effectively, this is what is happening right now. We have a financial system that is running out of the supply of the commodity it feeds off, ideas, and it is increasingly displaying chaotic behaviour. August was just an example of it and not the last one we are going to witness.

That's not to say that there isn't an orderly response occurring as a consequence of chaotic behaviour; the volatility in thought and stock markets is pushing western government bond yields closer and closer to Japanese levels by natural forces. The urge to converge, which had progressed for 15 years before being put on hold temporarily by thoughts of economic support from central banks, is back on the agenda again (see Chart 1).

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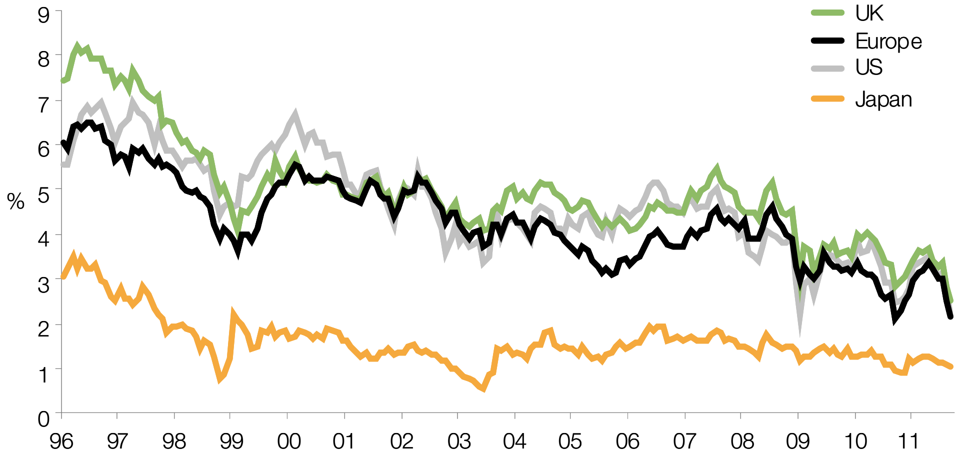
Chart 1: Global nominal 10 year bond yields



Source: Bloomberg.

Part of this change in thinking is a function of the fact that we now realize there is no magic wand that can be waived by the US Federal Reserve (Fed) or the European Central Bank (ECB) to solve our deeply entrenched financial problems. The best that anyone could come up with of late (including the bug-eyed CNN anchor) was that the Fed should engage in another round of Quantitative Easing (QE). If that's all we have left then this really is a system running into the sand.

For what it's worth, the US (and even the UK) could engage in another round of QE and this time they would do it the right way by purchasing long-dated bonds to set benchmark rates low enough to keep the cost of capital down for consumers and corporations. For the US, the timing of it would most likely be in November so as not to interfere with a Presidential election year in 2012, but the effectiveness will be questionable and, no doubt, will continue to increase the basic costs of living that so much loose money has already done much to fuel. It's a sad indictment but it's all we have left – inflation and low nominal bond yields.

So the prospect going forward is that investors in western government bonds are going to have to accept negative real interest rates for a considerable time, which is a horrible prospect given that there are still considerable funding pressures and ideas of deficit reduction are in many cases just that, ideas. There is precious little evidence that spending cuts are being implemented in any meaningful way. The risks surrounding a collapse in even those notional moves, because of popular revolt at spending cuts, remains extremely high. At the same time, using historical inflation rates, it may surprise readers to see that we have real long-term bond yields in the west that are now more negative than those in Japan (see Chart 2). That is how much of a mess we are in. Notice, by the way, that the most outstandingly awful investment in the world is UK gilts.

Arguably, these negative real yields are economically necessary as part of the healing process for societies that are now embracing the idea of deficit reduction with as much zeal as they did government expenditure in the past. But as an investor, they are a bad deal and only serve to erode the real wealth of a generation that spent a lifetime building it up. Philosophically, this is right: wealth artificially created by financial engineering should be destroyed by financial engineering as part of the rebalancing of the system.

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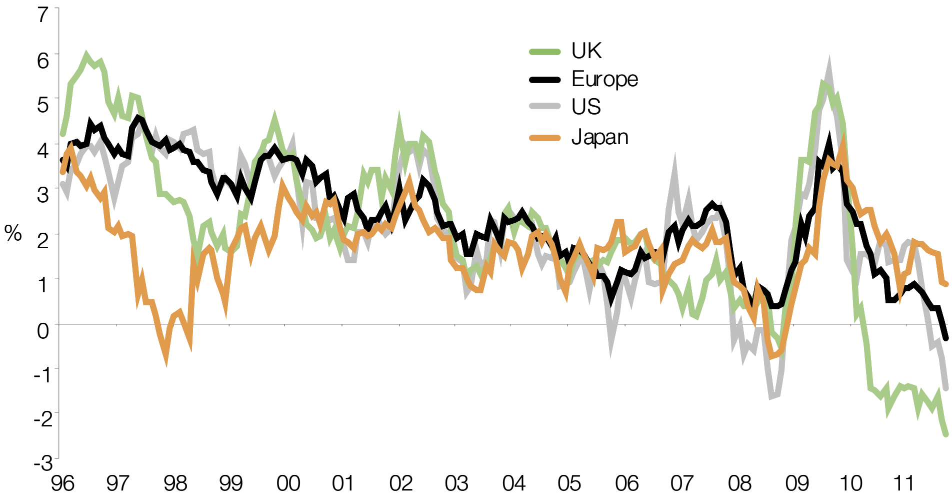
Chart 2: Global real 10 year bond yields



Source: Bloomberg.

In trying to ameliorate the process, performing asset/liability matching (when your major liability is inflation) should push investors into corporate bonds that have yields in excess of foreseeable inflation rates and, if the company survives, will give you your money back on a fixed date (equities offer good dividend yields but have no fixed maturity date). That's not to say that from time to time there won't be bouts of volatility going forwards in high yield bonds – there undoubtedly will – but correctly applied they may just help tone down the ravages of inflation and the volatility of a financial system that has run out of ideas, is increasingly prone to periods of chaos and offers few real alternatives.

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