Investment update

23 November 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.

Reducing duration

The illusion of material equivalence

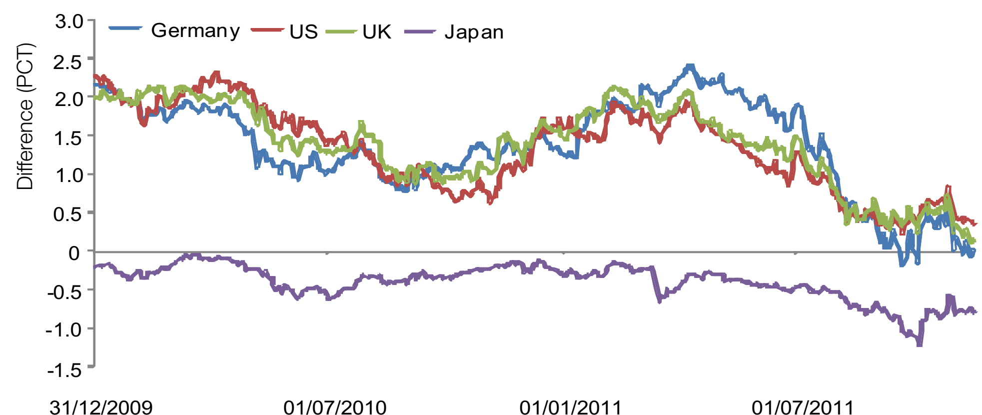
We have lived on debt, debt and more debt. We have all been complicit, governments, banks, producers, retailers, consumers. Now we have to pay it back

My laptop finally came to the end of its useful life on Friday. We've been together for four years. But the accumulation of viruses, a full registry and programs that take up gigabytes of memory have filled its brain to overflowing. I finally fell into the arms of Apple, much to the delight of my daughters.

But the whole process set me to thinking about our time together. I bought my laptop from savings; money in the bank. Another Stewart Cowley, in a parallel universe, would have bought it with credit. At the end of four years, we both would have a virus riddled collection of useless plastic and semiconductors, but I would have cash in the bank plus interest earned, whilst my quantum mechanical doppleganger would have debt plus the interest paid. In the meantime, we would have looked the same to the outside world - we would have maintained the Illusion of Material Equivalence. Except, we weren't equal. At the end of it all, I would have savings and my alter ego would be now be enslaved by debt; the gap between us would actually have widened.

The Illusion of Material Equivalence is an idea writ large in our society. It is an idea promoted by governments (that everybody can be equal all of the time), facilitated by finance (through the provision of credit), serviced by the producers of products, gobbled up by consumers and bailed out by Central Banks when it goes wrong. It is, in essence, the origin of the problem that we have at this time; that the lack of widespread wage growth has been inoculated against by the widespread use of debt. Depending upon where you are in that chain of events, you will either blame governments, bankers, creators of goods with built-in obsolescence or the naivety of consumers who don't know their limits. In reality, everybody was in on it all at once - it was a monumental failure of imagination or, more generously, proof that you cannot be in a system and observe it at the same time.

Figure 1: Government bonds minus insurance cost



Source: Bloomberg

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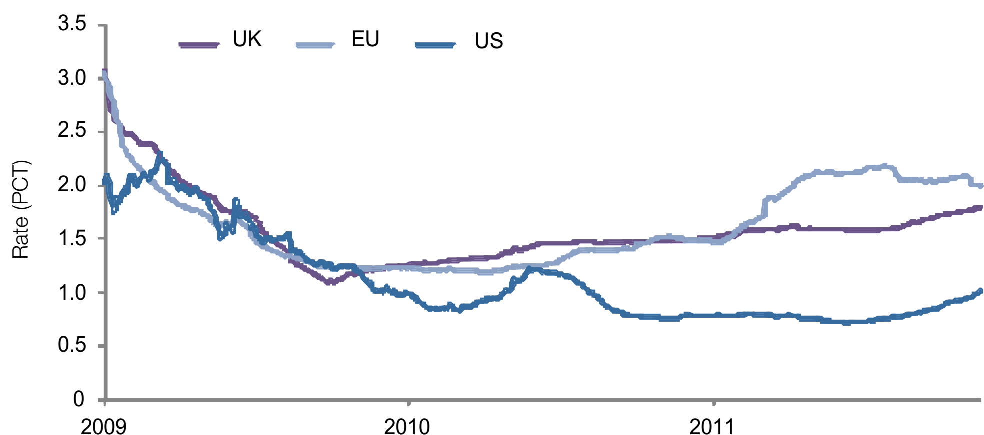
The debts we built up are everywhere; they are in government expenditure, in the salaries of our teachers, nurses and doctors, in our houses, in the redundant consumer goods that clutter up our houses and even in the degrees of young people who were persuaded that university was for them when they would have been better off in work whilst taking vocational qualifications. In the coming years we are going to have to rebalance that equation and it's not clear that many people understand how intense the pressure is going to be, both in the public and private sectors. We are going to be faced by a vanishing system of funding.

For instance, in the next two years, 2012 and 2013, $3.6 trillion of US government debt will mature and need to be refinanced. This is before the near $2.2 trillion expected deficits, suggesting a total funding requirement over the next 24 months, for the federal government alone, totalling $5.8 trillion. Eurozone governments will need to refund maturing government debt to near $2.3 trillion over the same period, before starting on their deficits.

Meanwhile, bank balance sheets have hardly declined in size yet and their maturity profile means they are also facing bumper years of funding needs. In the top 23 banks in Europe for instance, this amounts to some $1 trillion in 2012 and 2013. If the process of balance sheet reduction is to occur, then asset sales will surely follow and with it an intensifying reluctance to lend.

The competition for funds between the private and the public sectors is about to heat up in a volcanic way. It will last during 2012 and 2013, adding to the confusion as Europe struggles with its identity and the US struggles with trying to find a new president in the face of a mounting economic crisis. If I was over at Apple designing it, I would probably call it Credit Crunch 2.0.

Figure 2: Twelve month LIBOR rates



Source: Bloomberg

In the face of everybody trying to reduce debts at the same time and competing for essential funding, there is a delicate balance at play here. Unemployment (and with it social unrest) will become a permanent feature of our lives for some time to come. This would argue for low interest rate and bond yields. Certainly, official interest rates are going nowhere - it is unimaginable that a western central bank will be in the position to raise base lending rates for many years to come. But looking at a number of valuation metrics, there is very little leeway

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for money market interest rates or bond yields to fall too much further from here. Head of the German Finance Agency, Carl Heinz Daube, has called this the German "luxury problem". Investors love their bonds, but they are just too expensive: bond yields are too low to be credible in the long-term.

If you were an economist you would argue that low growth, high inflation and high unemployment warranted negative real yields. But going forwards, it seems more likely that the focus will be on the competition for funds which (given the numbers involved) could increase bond yields and borrowing costs. Bank deposit rates are already rising in an attempt to attract funds as an alternative to the punitive rates sought from the senior bank debt market (see illustration).

We have all been mesmerized by a year that has successively thrown at us Australian floods, New Zealand earthquakes, a Japanese tsunami, the Arab Spring, a series of eurozone debt crises, downgrade of the US credit rating, the over-throw of European governments and a global economic slowdown which has propelled bond yields to close to record lows. If we continue to cling to the illusion of material equivalence, we will see our lives as always looking towards the next upgrade, or constantly on "shuffle". But we should not be too complacent that this course is constant. Funding pressures in 2012/13 could yet reverse the gains made in 2011.

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