

Investment  
update

21 October 2011


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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.

*Reducing duration and buying inflation protection*

## Capitalism in Crisis

### Capitalism is not working, and it won't work until we deal realistically with our enormous public deficits

The sight of protestors outside St Paul's cathedral here in London serves as a reminder that there are parts of our societies that aren't going to take the financial crisis lying down or if they are it's going to be in a tent outside a prominent land mark. The "jazz hands" signs of approval used at the organizing meetings may look somewhat tame by comparison with the more direct and incendiary approach taken by the Italians and Greeks over the recent weeks, but it shouldn't be taken as a sign that there won't be more direct action in the future.



But listening to some of the rhetoric outside of St Paul's on Monday it occurred to me that one of the "inherent contradictions in capitalism" is that it has been behaving like socialism. The engine of capitalist growth has, through the tax system, increasingly redistributed wealth into society in the form of government jobs and services. The problem is not so much that capitalism is evil per se it's just that it's stopped working for the greater good and people don't like it. You get the sense that if we got any growth or job creation social discontent would abate pretty quickly and people would go shopping again.

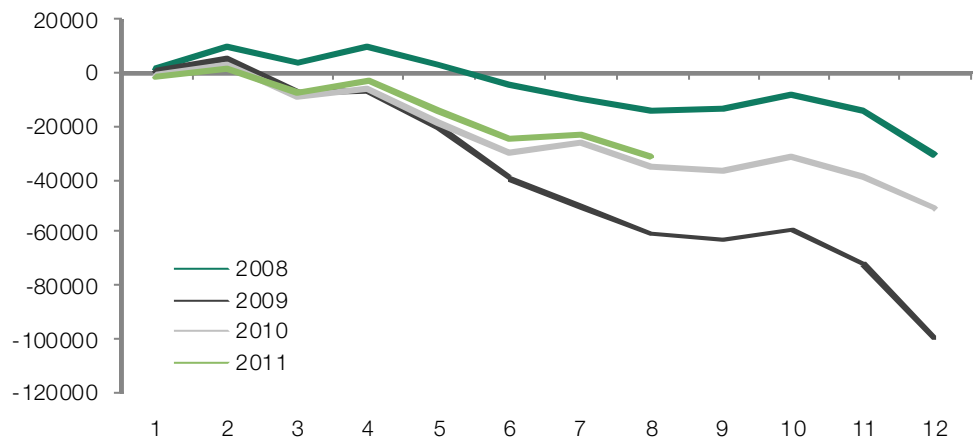
In the meantime, you have to start thinking that there is more trouble to come on this score. Here in the UK, one by one, attempts to tame our budget deficit have been repelled either by circumstance or political capitulation. Normally the markets would have punished us for that and yet they haven't. You can only believe that we have been spared the attention of the markets because what is happening in Europe has only served to deflect attention away from us.

The extent of what we are getting away with is best illustrated by comparison. If you look at the progress on spending in Spain, for instance, you can see a marked improvement in their deficit position compared to 2009 and 2010. Cuts have occurred in a meaningful sense. Compared to the same data for the UK and you will see 2009 and 2010 are almost identical (the last throes of the previous Labour administration) and, so far, in 2011 there is no real evidence for significant improvement. Like the US we are heading towards another year of Deficit/GDP ratio of 8 - 10%. This is made all the more extraordinary by the fact that long-term

bond yields are close to their all time lows and in real terms offer decidedly negative yields. Inflation in the UK hit 5.2% last month whilst long-term gilt yields are under 3.5% This is odd.

Clearly, the well-intentioned and good natured protests seen here in the UK and the Occupy Wall Street movement in the US (a look at Goldman Sachs' results would probably garner the answer "You can have it - be our guest...") may yet be a precursor to a more European response to the crisis which will test what little resolve politicians appear to have to tackle society's overspend. We may yet witness the UK coalition abandon all attempts to tackle the deficit whilst in the US the on-coming presidential campaign will not be a time to ask the voting public to take any form of pain. Some might like to call this "Plan B" but to the markets it will merely be the abandonment of Plan A.

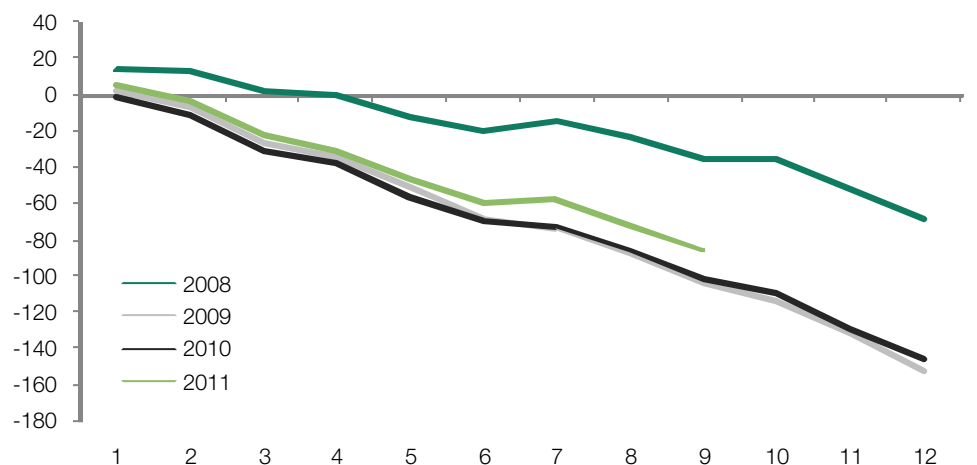
**Figure 1: Spanish budget deficit YTD by year (euro millions)**



Source: Finance Ministry of Spain/Bloomberg. Budget deficit net monthly level YTD.

Should the political establishment try to spend their way out of popular unrest the effects could be profound; sterling and the US dollar would decline and government bond yields would be sent materially higher. Inflation being, as Adam Smith said, a currency effect would be sent higher and the expected decline of the basic stuff of life anticipated by the Bank of England would not materialize. All of this would be made doubly true if Europe can put a long-term plan on the table that carries sovereign and banking solvency beyond two-monthly deadlines. The stakes are very high.

**Figure 2: UK budget deficit YTD by year (£ billions)**



Source: UK Office for National Statistics/Bloomberg. Public sector net cash requirement (net borrowing) ex financial interventions.

With western bond yields priced close to perfection the risks in government bond markets are, according to a number of metrics, skewed at this time; there isn't much down side for yields but there is a lot of potential upside. For this reason we have radically reduced our duration from over 8 to close to zero, bought put options on government bond futures (funded by the sale of call options in a so-called "costless collar") and taken out inflation protection using index-linked government bonds in the US and UK. We are not exactly calling the absolute turn in the markets but, at this time, a low risk duration policy is more appropriate than a high risk one.

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