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INSIGHT

TRADING SECRETS

The Fed's Clock Just Struck Thirteen

TAD RIVELLE | APRIL 2016

"Two and two are four."

"Sometimes, Winston. Sometimes they are five. Sometimes they are three. Sometimes they are all of them at once. You must try harder. It is not easy to become sane."

– George Orwell, 1984



Tad Rivelle

Group Managing Director
Chief Investment Officer—Fixed Income
Co-Director Fixed Income

Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing over \$150 billion in U.S. fixed income assets, including over \$90 billion of U.S. fixed income mutual fund assets under the TCW Funds and MetWest Funds brands. Prior to joining TCW, Tad served as Chief Investment Officer for MetWest, an independent institutional investment manager that he cofounded. The MetWest investment team has been recognized for a number of performance related awards, including Morningstar's Fixed Income Manager of the Year. Mr. Rivelle was also the co-director of fixed income at Hotchkis & Wiley and a portfolio manager at PIMCO. Tad holds a BS in Physics from Yale University, an MS in Applied Mathematics from University of Southern California, and an MBA from the UCLA Anderson School of Management.

Few who assume power ever do so with the intention of relinquishing it. So long as the Fed maintains the fiction that without monetary "stimulus," the U.S. economy is doomed to recession, depression, deflation, or maybe to all three at once, the Fed legitimizes its role as de facto global central planner for interest rates.

After eight plus years of ZIRP, the Fed took its first baby step towards rate "normalization" in December. Rather than accept that capital markets will need to – sooner or later – re-price themselves to "normal," the Fed's response to Q1's equity and credit market volatility was cringe worthy. January's clear guidance that rates would be heading higher was replaced with Yellen's March statement that from now on the Fed's guidance would be market dependent. Sorry, but that is not "guidance" – it is all but a confession that the Fed, having missed its off-ramp to raise rates for this cycle, no longer knows whether rates should go up, down, or sideways. The Fed has painted itself into a corner, and knows it.

What are its policy options? Through door #1 lies the wrecked remains of the bridge to "normalization." The "dream" of riding off into an eventual sunset of 3%+ short

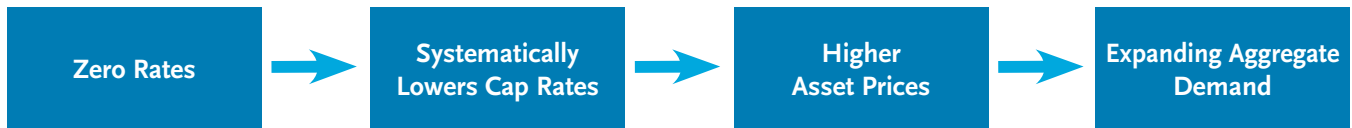
rates is dead. That path won't be followed because it can't be followed. Higher rates in the U.S. would further strengthen the dollar, curtail corporate profits, flatten or invert the yield curve, thereby causing a recession. That leaves door #2: hope and pray. In other words, don't raise rates, at least not now, raising the specter that when this cycle finally gives up the ghost, it does so with the Fed out of ammo. The Fed full well understands that the legacy of its eight years of asset price inflation has not been prosperity but rather an economic no-man's land embodied by an apathetic "recovery." The Fed sold us a bottle of monetary Dr. Good but never did get around to mentioning price. But economics inherently is about balancing costs with benefits; it is not about the procurement of free lunches. Indeed, if zero rates delivered only benefits, then I suppose all of us in the asset management industry ought to call it a day and just let the central bankers give credit away, abolish capital charges, and exhort the borrowers of the world that they have nothing to lose but their chains.

But we know better: all things economic have a price because they have opportunity cost. To use a resource in a certain way at a certain time precludes its use in another way at another time.

Facts are indeed stubborn and while an economic good can be priced at zero that does not mean that its cost is zero. And, when prices are misaligned with costs, resources are sure to be squandered and growth will suffer.

When the Fed decided to misalign rates with economic reality by pivoting to the zero bound, it did so with the expectation that a reach for yield would ensue and would, in turn, suppress capitalization rates across such diverse markets as real-estate, stocks, and bonds. The tautological result would be a bull market in risk followed by (or so the Fed thought) a rejuvenation in animal spirits and a virtuous cycle of spending, credit creation, and output expansion:

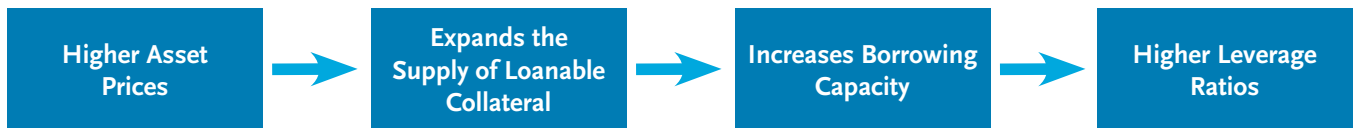
The Fed's Playbook: ZIRP as "Free Lunch"



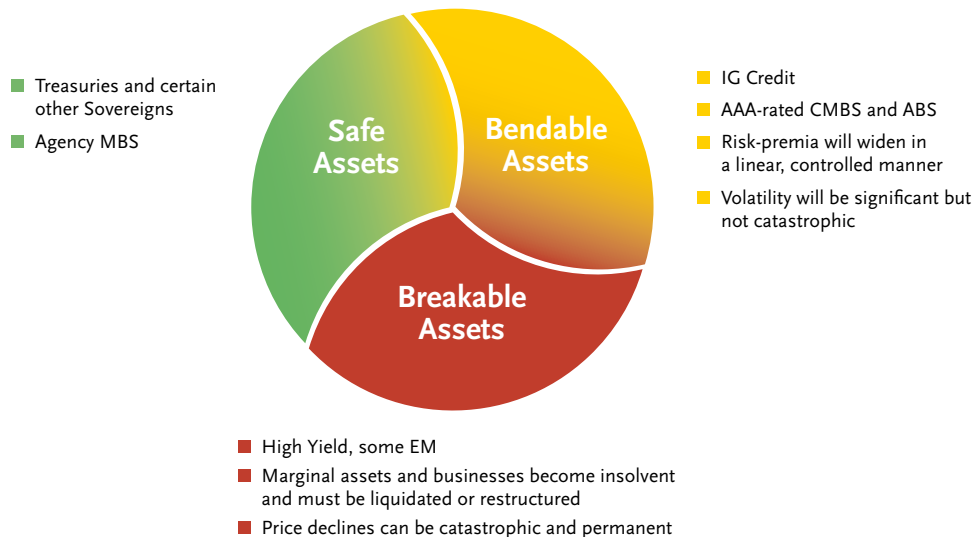
The Fed must have thought that its monetary innovations would shock and awe us into a state of rapid growth. Alas, growth is a complex process that happens one business and one innovation at a time. The attempt to socially engineer growth from the top down by "falsifying" rates and asset prices was bound to fail, and so it has. Did anyone at the Fed ask the question of what the consequences of an artificial expansion in asset prices really meant?

Apparently not. Quite obviously, inflating asset values tautologically expands the system-wide supply of collateral. Higher real estate prices means there is more real-estate to borrow against. With more stuff to leverage, more leverage will be added to the stuff. Of course, had the leverage been used to direct resources efficiently, the happy result would be that boom the Fed promised was coming our way. Instead, we are saddled with the leverage created by an artificial bull market, hence without the proportionate increase in incomes needed to service all that newly created leverage:

The Delayed and "Hidden" Costs of ZIRP



Eventually, too little income servicing too much debt can have but a single result. As fixed income investors, how are we to prepare ourselves for the inevitable? We can start by recognizing that late in the asset cycle bonds naturally organize themselves into three distinct cohorts: the Safe, the Breakable, and the Bendable:





Safe assets, as the name implies, includes Treasuries, agency MBS, Bunds, and Japanese Government Bonds (JGBs). No one is going to feather their nest in style with Safe assets, but they can be counted upon to damp down volatility when the de-leveraging storm hits shore. After it does, selling such “anchor to windward” assets in favor of higher yielding opportunities is de rigueur for the active manager.

Meanwhile, active management would have little meaning unless it further recognized the inevitable presence of Breakable assets in every cycle. Last time around, subprime mortgages and high yield debt created as a result of such absurdly overleveraged transactions as the 2007 TXU buyout constituted the Breakable cohort. This time around, assets have already broken in the energy and commodities complex and, in time, the breakage will spread to new territories in the high yield and emerging market landscape. Needless to say, active investors need to avoid the Breakable until they actually break. To do otherwise is to invite writedowns and principal losses into your portfolio.

Finally, there are the Bendable assets: your investment grade corporates, your top of the capital structure AAA-rated CMBS and ABS. These assets have the wherewithal to survive a de-leveraging cycle but will most certainly suffer marking-to-market volatility as the weather turns inclement. The Bendable, by definition, will survive the cycle and should be bought in a disciplined, dollar-cost averaged manner.

So, while the Fed cannot direct the movement of the clouds, the rest of us earthlings can prepare for the incoming squall. This means taking counsel from this investor's playbook: buy Bendable into weakness, sell Safe into strength, and avoid the Breakable until the break. ■

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