TCW

INSIGHT

TRADING SECRETS

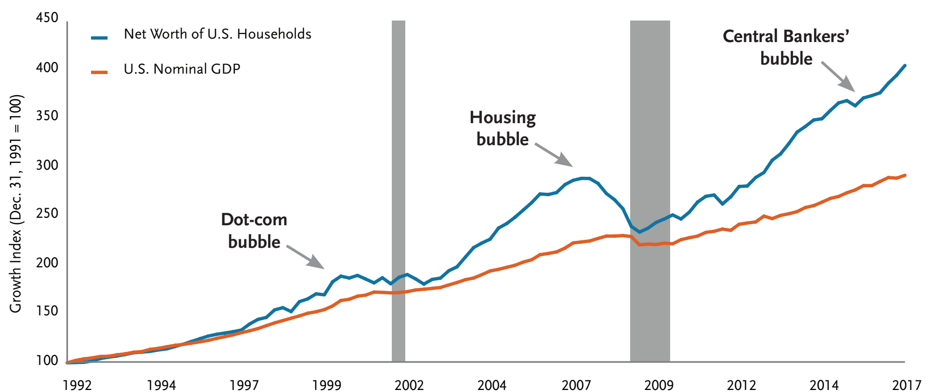
When Failing to Prepare is Preparing to Fail

TAD RIVELLE | APRIL 2018

A financial asset is nothing more nor less than a claim on future cash flows. So, when asset prices motor ahead of incomes or profits, it means fundamental valuations have deteriorated. Let the fundamentals erode long enough and far enough, and financial instability is ensured. How could it be otherwise? Asset prices are the sum total of stocks, bonds, and real-estate. When asset prices are high relative to GDP, chances are good that you'll encounter some combination of stretched P/Es, outsized ratios of real estate prices to household incomes or rents, and bond yields that are too low or credit spreads too narrow.

Since asset prices and incomes must, over sufficiently long periods of time, follow an interlocked trajectory, an episode of asset price inflation will invariably sow the seeds of its own destruction. In this cycle, the de-coupling of asset prices and GDP has been extraordinary and is largely attributable to the central banks' collective flood of cheap credit. Rather than allow asset prices to find their natural, market determined levels, the Fed, et. al. have harnessed extreme monetary "stimulus" in the service of a bull market in risk assets. Artificially low rates have driven present values to lofty levels fostering belief in the almighty central banker.

Wealth Economy Has Decoupled From Income Economy



Source: Bloomberg, TCW

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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing nearly $170 billion in fixed income assets, including over $100 billion of 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.

But trees don't grow to the sky. The Fed is, at long last, tip-toeing its way to a rate normalization. And a world made by low discount rates can be unmade by higher discount rates. Meanwhile, capital that has piled into risk asset classes is growing increasingly wary that underlying fundamentals do not validate the bull market in "everything." The misnomer all along has been that while prosperity naturally lifts asset prices, elevated asset prices alone do not create prosperity.

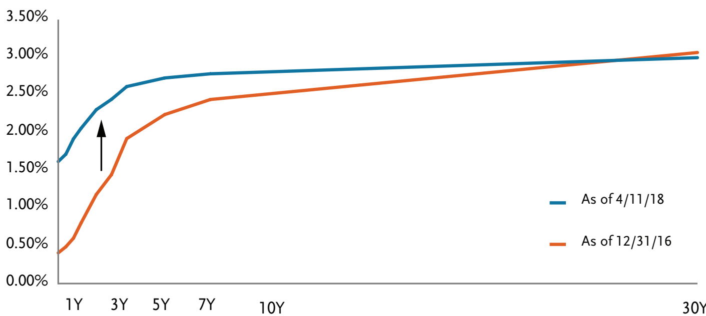
That said, the Fed is out of reasons/excuses to further delay raising rates: fiscal policy has dramatically upshifted, the labor market is "beyond" full employment, growth is on steadier grounds, and deflation remains a no show.

What are the probable next chapters to be written? We can see two:

1. **The Fed lifts short rates and long maturity rates rise in tandem.** In this event, discount rates rise out the curve leading to a correction in asset prices. Rising 10-year Treasury rates would set up a "collision" between riskless yields on the one hand and equity dividend yields and commercial real-estate cap rates on the other. History augurs against "immaculate" rate increases.

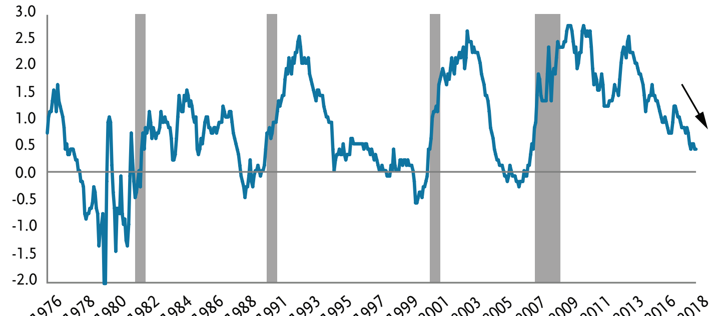
2. **The Fed lifts short rates but long rates stay "anchored," causing the yield curve to flatten.** In that event, term premia evaporate as long rates and short rates converge. This is a distinctly bad outcome for virtually all financial intermediaries as the very basis of banking, insurance, mortgage REITs, etc. lies in using short-term funding to finance long-term lending. As term premia skinny, so do net interest margins (NIMs). At some point, rationally managed enterprises understand that shrunken NIMs requires some form of de-risking, often in the form of a balance sheet de-leveraging. The result? Credit becomes both less available and more expensive.

U.S. Treasury Yield Curve



Source: Bloomberg

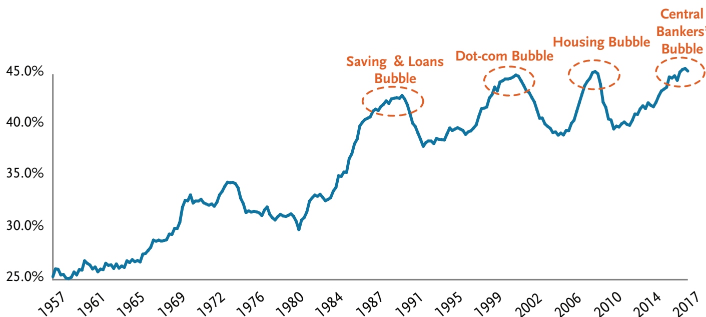
2s-10s Treasury Spread



Source: Bloomberg

Barring some unforeseen zig back to a "Goldilocks" market, monetary policy has entered its late stage. Those years of cheap money that sent enterprise multiples skyward have left a credit binge in its wake. Excesses in leverage are increasingly visible in wide swathes of the economy, perhaps no more so than in the corporate sector:

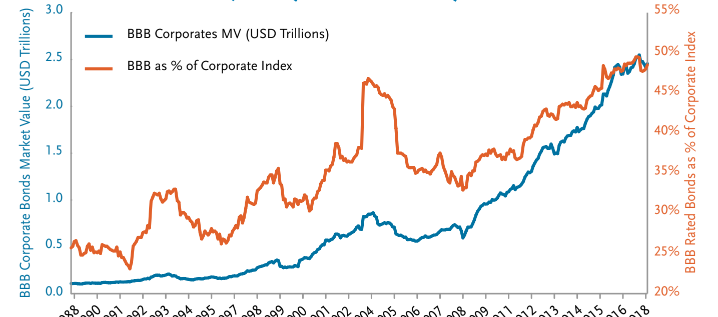
Corporate Debt as % of GDP*



Source: Federal Reserve, TCW.

* Debt securities and loans of nonfinancial corporate businesses as a percentage of U.S. nominal GDP, quarterly.

IG Credit Quality Has Steadily Deteriorated



Source: Barclays, TCW

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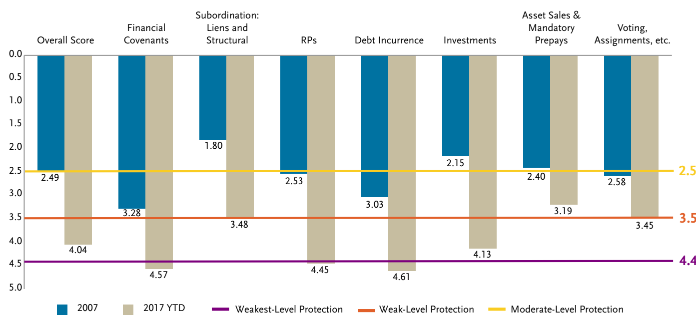
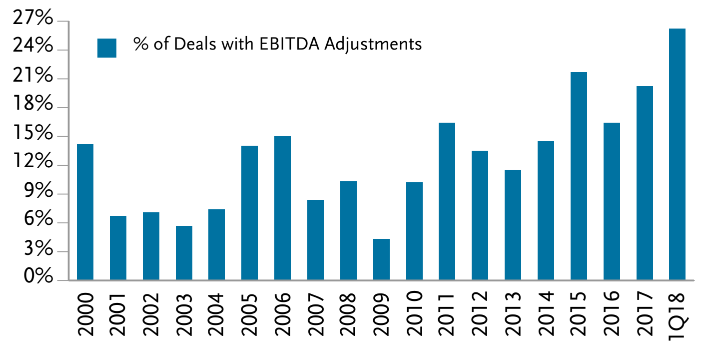
A further confirmation of a late stage credit cycle is the enthusiastic embrace of financial engineering. Good investors do not believe in alchemy and when deal sponsors resort to "off-color" tactics to justify their deals, it is an acknowledgement that traditional metrics *do not* support the transaction. The tactics of financial engineering are many but we'd draw your attention to two of the more prominent, i.e. covenant lite high yield debt issuance and EBITDA "add-backs." Simply put, covenant lite issuance enables the equity sponsor to dilute (or eviscerate) the contractual rights of the debt holder. Optionality that belonged to the bond holder is signed away to management meaning that the assets of the business may never be available to protect the interests of the bondholder, even if the company became financially distressed. In the case of EBITDA "add-backs," management justifies a debt issuance not by its "inadequate" GAAP earnings but rather by using a higher EBITDA equal to its GAAP earnings plus an "add-back." While there can be situations where a pro-forma number may be "better" than a GAAP number, the proliferation in the use of add-backs probably tells you all you need to know before you invest in today's high yield market.

Underwriting Covenants: Uniformly Worse Than 2007



Source: Moody's
As of September 30, 2017.

EBITDA Addbacks Are at Multi-Decade Highs



Source: S&P Global Market Intelligence

When the investment cycle is young or mid-stage, "risk-on" strategies swim with the tide. Portfolios with higher "ex-ante" yields generate higher "ex-post" returns. Late in the cycle, this relationship reverses and rather than yield being the condition precedent to gains, it becomes a leading indicator of principal impairments. The time to prepare for adverse outcomes is always before the bear market. Those who do not heed the signs of danger will learn, first hand, why in investing, "Failing to prepare is preparing to fail." ■

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