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INSIGHT

TRADING SECRETS

Gresham's Law

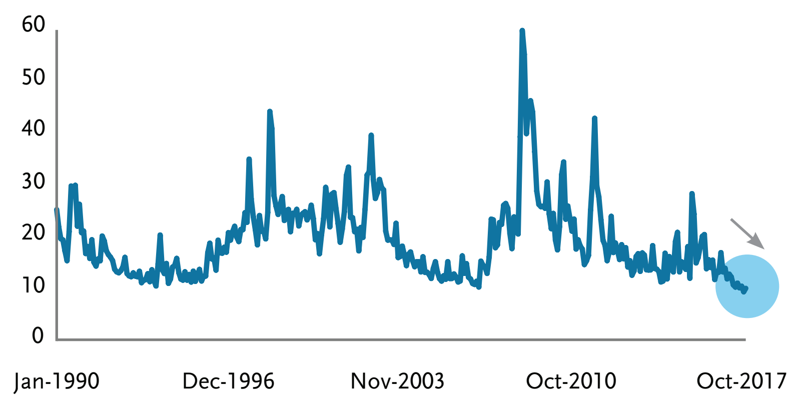
TAD RIVELLE | NOVEMBER 2017

This year's Nobel prize in economics was awarded to Richard Thaler, a pioneer of behavioral economics. But there is a tale told by a lesser known Nobel laureate, Kenneth Arrow. As a World War II weather officer, he was tasked with analyzing the reliability of the army's long-range weather forecasts. His conclusion: statistically speaking, the forecasts weren't worth the paper they were printed on. Captain Arrow sent along his report only to be told, "Yes, the General is well-aware the forecasts are completely unreliable. But, he needs them for planning his military operations."

Okay, maybe you don't actually need a Nobel prize to know that rationality in the decision-making department is often lacking. Case in point: the capital markets. While subtle and ingenious in construction, the capital markets are, nonetheless, driven by the mass action of millions. They are a reflection of ourselves and necessarily express both the summit of our knowledge as well as the pit of our fears, and everything else in-between. And, this brings us to the subject at hand: Gresham's Law. Sir Thomas Gresham was a financier in the time of King Henry VIII and his name is, of course, attached to the principle that "bad money drives out good money." Coin collectors of a certain age are familiar with the near immediate disappearance from circulation of all silver American coins once Congress had mandated the use of base metals beginning with the 1965 vintage. While all coins – silver and copper alike – carried identical legal tender value, it was the silver coins that vanished. Perhaps you are wondering what this has to do with bond investing? Everything!

Consider the state of financial markets as witnessed by metrics of implied volatility:

VIX Index



Source: Bloomberg

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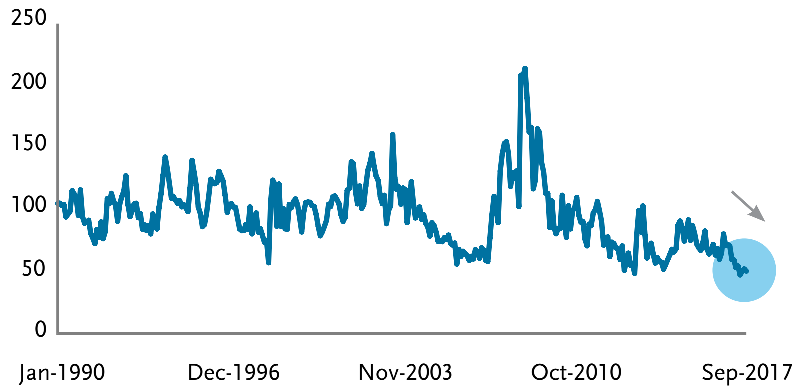
Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing more than $160 billion in U.S. fixed income assets, including approximately $100 billion of U.S. fixed income mutual fund assets under the TCW Funds and MetWest Funds brands. Prior to joining TCW, Tad served as Chief Investment Officer 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.

MOVE Index



Source: Bloomberg

Both indices hover at generational low levels. If markets were "run" today by humanity's better angels of wisdom and rationality, you would have to conclude that Mr. Market has drawn on his collective insight and pronounced the capital markets to be safer now than at any other time in the past quarter-century. That is a stunning conclusion! But if rationality can't explain a 25-year trough in expected risk, then we must necessarily conclude that there must be some other, less rational explanation. How about this: investors are, by and large, famished for yield and willing to underwrite most any risk to get some income. In short, the marginal price setter is "irrationally exuberant", or dare we say it out loud? "Greedy."

So, the age old tension that presents itself is this: there are those investors, the "value tribe", that resists the general lowering in underwriting standards that comes with the aging cycle. The value guys believe that their principal is always precious and is best "wagered" when the return/risk profile is asymmetrically biased in favor of the investor. The "momentum tribe", in contrast, tends towards a belief that your capital must be kept working, otherwise "yield" is "needlessly" sacrificed.

Does it not stand to reason that, late in the asset price cycle, that the "momentum" money drives out the "value" money? Yes! Capital that lowers its hurdle rate of return and adapts itself to loose underwriting criteria will necessarily bid up asset prices to levels that become inconsistent with the criteria applied by the more discriminating pools of capital. The "clad" underwriting drives out the "silver."

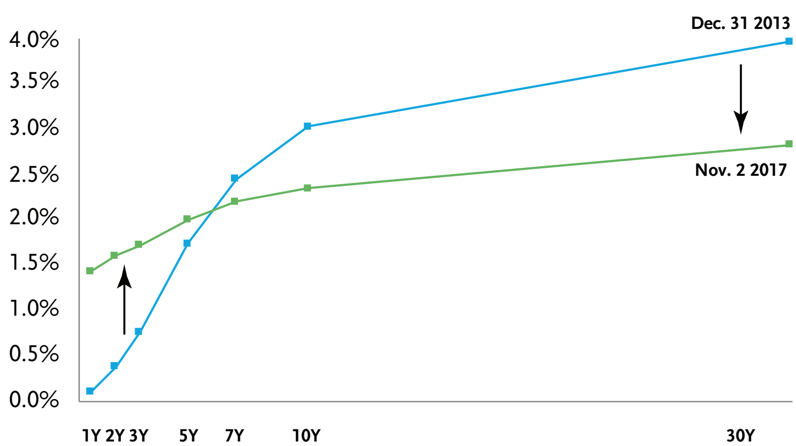
Now, admittedly, a win is a win, and momentum has been the winning trade. Whether intrepid or fool-hardy, "risk on" has won the year 2017. But do trees ever grow to the skies? Did Minsky not elucidate how extended periods of low volatility have the effect of masking financial pathologies, allowing them to metastasize throughout the system? Indeed! While the central bankers dream of a never-never land where wise scholars can direct the flow of irrational humans, the real world that the rest of us inhabit is decidedly messier.

How so? Long periods of low volatility often mean that some traders and fund managers become less concerned with closely scrutinizing what they own. Credit analysis is hard, and in an environment where prices become inelastic to the "fundamentals," some conclude that the work involved in analyzing bonds is a case of the juice not being worth the squeeze. Low volatility environments remove incentives to trade, thereby degrading the quality of price information. Meanwhile, the low rate / high asset price environment removes the impetus for corporate frame breaking changes, and so low productivity businesses are "allowed" to just muddle along, restraining the Shumpeterian forces necessary for growth. In short, fundamental problems are systemically ignored by the collective. So, if you happen to see an emperor strolling about, happy and stark naked, you just shrug and move on.

But the worm will turn. It always turns. The collective gets jolted out of its slumber and suddenly realizes that capital is surrounded on all sides by clear and present dangers. The torrent of capital that flooded in under the FOMO banner may well become the most formidable ebb tide!

Before concluding one of our typical (i.e., informative and cheery) discussions, it's worth a brief reminder that markets "vote" in the short-run and "weigh" over the long-run. Equities, real-estate, and bonds with "hair" have all voted, and we know how that has turned out. Meanwhile, we may not have heard enough from one of the most reliably smart guys in the financial markets. He seems to do a pretty good job of "weighing" and has one of the better (though far from perfect!) track records of forecasting recessions. Never heard of him? Oh, yes you have: he's the yield curve, of course:

U.S. Treasury Yield Curve



Source: Bloomberg

Stocks roar to new highs. Tax cuts advance in Congress, I think. Consumer confidence revs while unemployment plumbs its lowest levels in decades. Yet, the yield curve just doesn't seem to be buying it. Perhaps he has lost his mojo. On the other hand, even if he has misplaced his crystal ball, a flattening yield curve does more than just signal that growth and inflation prospects are viewed skeptically. A flatter curve squeezes the term premium out of the equation for virtually all financial intermediaries. Less term premium means less net interest margin (NIM). Less NIM dis-incentivizes credit formation. Indeed, should term premia continue its vanishing act, we might find that it was the yield curve that helped put the "de" back into "de-leveraging." Proceed with caution!

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