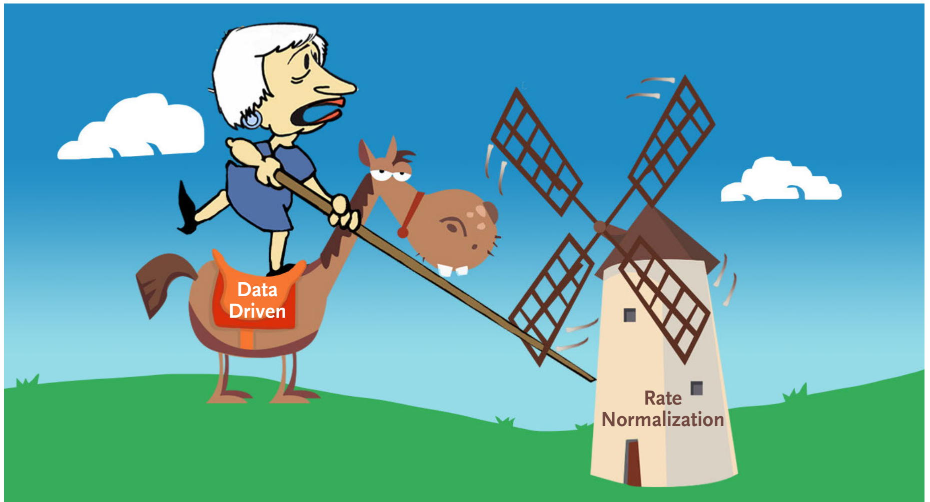
TCW

INSIGHT

TRADING SECRETS

The Fed's Quixotic Journey

TAD RIVELLE | JUNE 2017



"History has not dealt kindly with the aftermath of protracted periods of low risk premiums."

– ALAN GREENSPAN, AUGUST 26, 2005

"Prices are important not because money is considered paramount but because prices are a fast and effective conveyor of information through a vast society in which fragmented knowledge must be coordinated."

– THOMAS SOWELL

The global financial crisis is so nine years ago, and still the central banks can't seem to find a way to "normalize" policy. Measures that had been introduced as emergency responses have morphed into permanent fixtures without which, we are told, growth would become impossible. And, so, not only do the balance sheets of the world's central banks continue their relentless expansion, *the rate of expansion has actually accelerated* to a rate of *$2 trillion per year*, i.e., more than the GDP of Italy (see following exhibit). Since the 2008 meltdown, the technocrats have "minted" a collective $10 trillion worth of new balance sheet in a failed attempt to achieve "escape velocity." Yet, what these extraordinary measures have failed to achieve in terms of wages and incomes, they have more than "made up" for in terms of leverage and asset prices.

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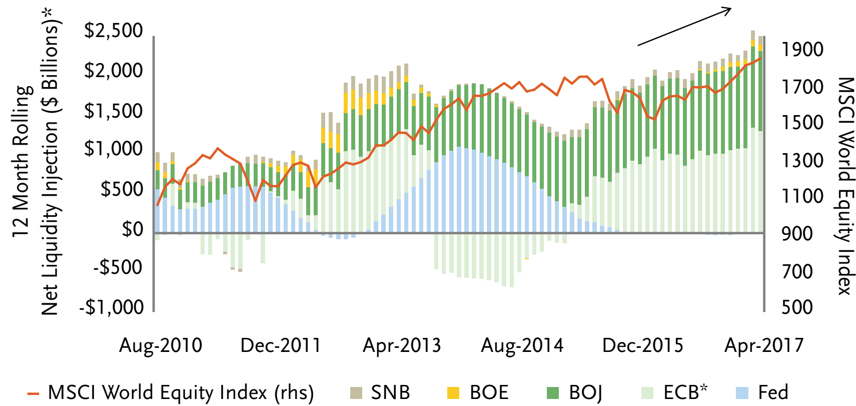
Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing more than $160 billion in U.S. fixed income assets, including approximately $100 billion of U.S. fixed income mutual fund assets under the TCW Funds and MetWest Funds brands. Prior to joining TCW, Tad served as Chief Investment Officer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

The global capital markets have proven adept at transmitting newly created credit from one region to the next and from this asset class to that. Hence, the central banking "stimulus" programs have had a deep and very widespread scope of impact. Rates are set negative here, driving a reach for yield there. Corporate debt removed from circulation in Europe supports narrow risk premia in the U.S. But, to what end? Without a sustainable rise in GDP and incomes to match this global levitation in asset prices and leverage, the central bankers are only ensuring that when the inevitable cycle denouement comes, the down trade will be omnipresent.

Central Banks Are Adding Stimulus At The Highest Rate For This Cycle

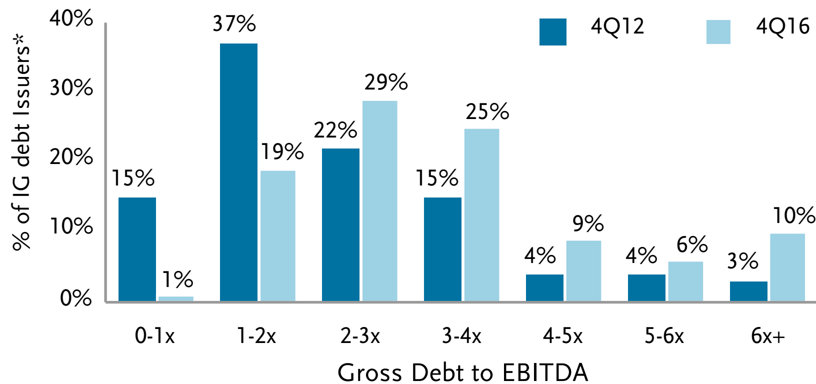


Source: National Central Banks, Bloomberg, TCW.
*ECB injections include gross LTRO and TLTRO balances.

All the while, the Fed doth protest that it will surely "normalize" rates over time, yet never seems to find just the right combination of unemployment, inflation, and asset prices that would justify a credible march towards "normalization." The reason for this is as simple as it is portentous: after having acclimated the global economy to an artificially low rate and risk premia environment, "normalization" is no longer possible without a severe retrenchment in asset prices.

So, if the Fed can just hold off raising rates and the rest of the central banks keep stimulating, is the risk-on trade safe indefinitely? That does seem to be the consensus logic. Yet, alas, if this cycle doesn't end badly, it will be the first one in the history of financial capitalism that hasn't. Cycles don't just live on because central banks can temporarily evade the market's self-correcting impulses, just as breaking the thermometer doesn't cool the oven. This cycle's grand experiment in centralized rate suppression has taught investors to "just look the other way" rather than attending to those late cycle signs that warn of impending risk. If you are willing, we'll have you look at just these six signs:

1. **Low rates have incentivized managements to "arbitrage" their earnings yield against the low cost of the borrow through such re-leveraging activities as share repurchases. As a result, corporate leverage has grown, even as profit growth has sputtered. The median U.S. investment grade company now sports three units of (gross) debt per unit of EBITDA, a level that traditionally has strained the very definition of what constitutes investment grade.**



Source: JP Morgan, TCW
*Weighted by amount of debt outstanding.

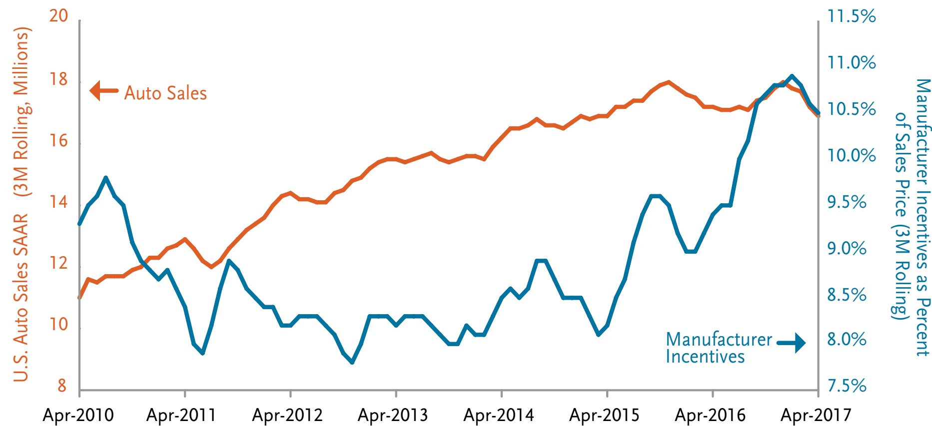
2. **High yield bonds provide thin compensation against the risk of default. Imputing a historically low annual loss adjustment assumption, the median high yield bond provides only marginal yield premium relative to a BBB investment grade bond. We don't see the value in extending multiple turns of leverage for an extra 20 bps of yield.**

Quoted Yield for the High Yield Corporate Index	5.50%
2017 Expected Moody's Default Rate	3%
Assumed Recovery Rate	40%
Implied Loss Rate (next 12 months)	1.80%
Loss Adjusted High Yield Bond Rate	**3.70%**
Quoted Yield for BBB-Rated Corporate Bonds	**3.50%**
High Yield "Premium"	**= Only +20 bps!**

Source: Barclays, TCW
*As of May 23, 2017

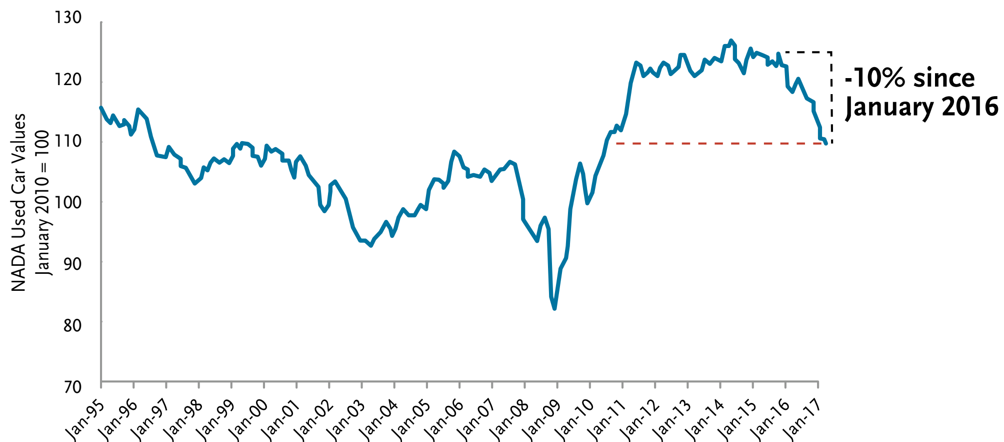
3. **The bellwether auto industry has passed its cyclical peak. Auto sales are falling from their plateau even in the face of a cycle peak in manufacturers' incentive payments that now foot to over 10% of the typical new car purchase price. Meanwhile, the used car market demonstrates signs of "saturation," eating away at the pricing power of the seller in both the new and used car markets.**

U.S. Car Sales Have Been Artificially Supported By Manufacturers' Incentives



Source: Bloomberg, TrueCar, TCW

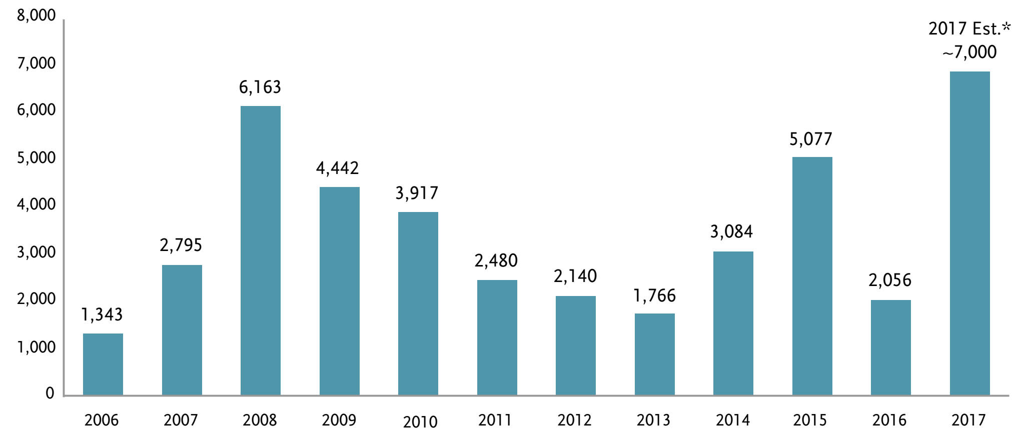
Used Car Values Have Fallen Precipitously



Source: J.D. Power Valuation Services

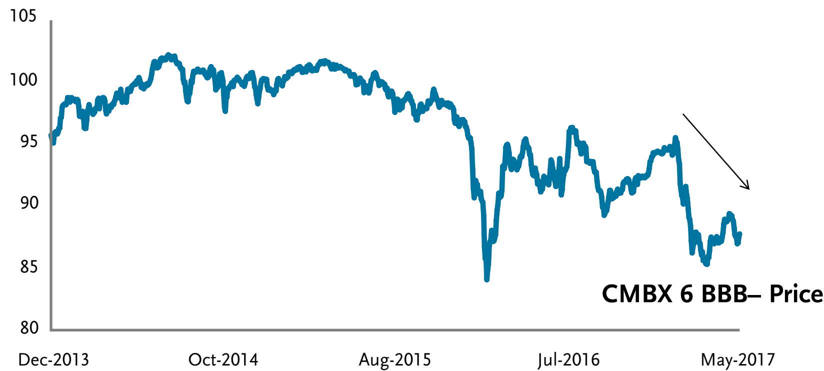
4. **Retail employs more people in the U.S. than does manufacturing, accounting for some 11% of the workforce. Unless you live in a cave, you know that both restructuring and distress are coming to a store near you. The number of retail outlets expected to close in 2017 will exceed that of 2008. Meanwhile, as retail comprises some 30% of the commercial real-estate (CRE) market, don't expect CRE valuations to survive unscathed.**

Retail Store Closings



* Estimated based on actual YTD closings through April 2017 and historical annual closing trends.
Source: Credit Suisse, TCW

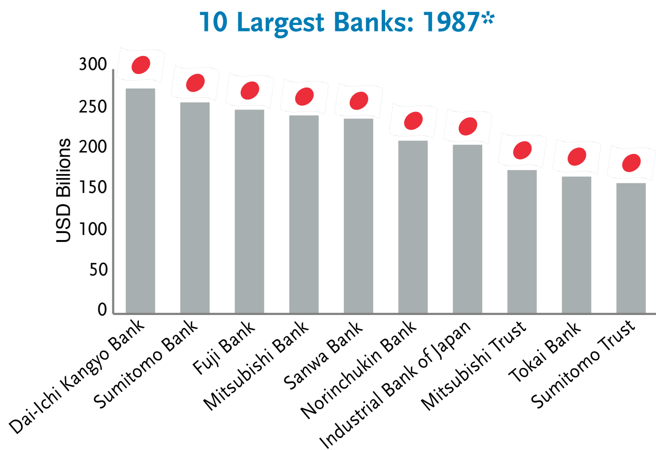
A Falling Price for the 2012 Vintage CRE Debt Index Reflects Expectations for Rising Losses



Source: Markit, TCW

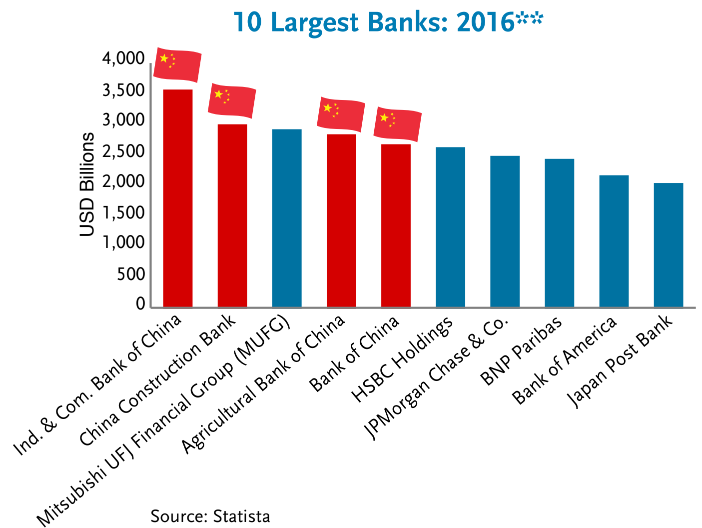
5. **10 largest banks: then and now. Laying claim to having the biggest banks might seem to be a source of national pride. It isn't. Your banking system gets to be the biggest by originating more loans than "everyone" else. At the height of the Japanese equity/real-estate bubble, its banks towered over the competition. Today, four of the five largest banks in the world are the Chinese state banks. History doesn't repeat, but perhaps it rhymes.**

10 Largest Banks: 1987*



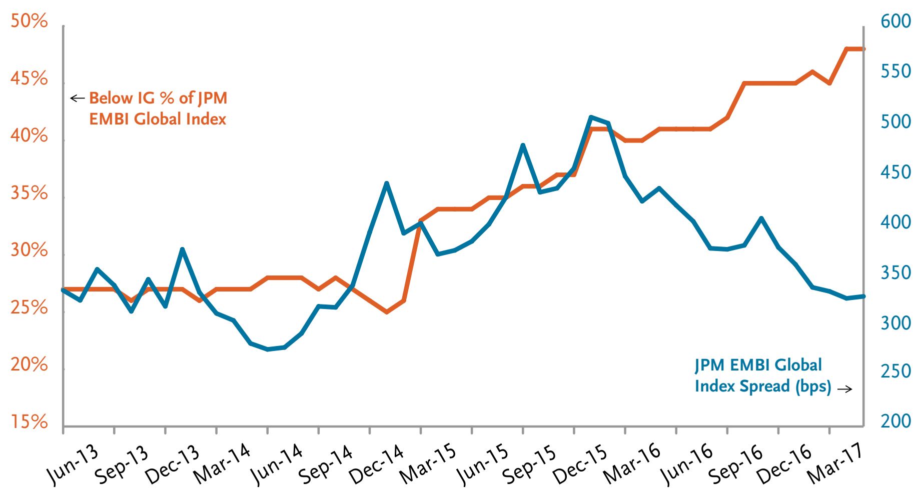
Source: LA Times, American Banker
*Largest 10 banks in the world by deposits

10 Largest Banks: 2016**



Source: Statista
**Largest 10 banks in the world by assests

6. **Spreads on Emerging Market sovereign and quasi-sovereign debt have remediated to mid-2013 levels, despite the fact that the percent of below investment grade bonds in this universe approaches 50%, a level nearly double of what it was in 2013.**



Source: JP Morgan, TCW

Conclusion: Times were when central banking was an honest profession. Asset prices are not meant to be arbitrary quantities that are to be steered or targeted by central bankers. The signs of late cycle excess continue to spread, but faith abides in central banking "stimulus". We all do well to remember that when markets lose focus on the fundamentals, there is danger at the door.

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