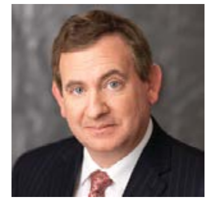
TCW Insight that works for you.™

METWEST

TRADING SECRETS November 2013



Should You Walk Away from a Fed that Prints Money?

Tad Rivelle
Chief Investment Officer – Fixed Income
Portfolio Manager

Activist monetary policies presume that the Fed can control, or at least strongly influence, the rates of interest charged in the financial marketplace. But the laws of economics cannot be conned indefinitely. So, to the extent that the current rate structure – maturity and risk premia – differs from one that would otherwise be established by willing borrowers and lenders, it is an artificial construct. Our $16 trillion economy is replete with opportunities for investors to deploy capital. For that capital to be put to its highest best use, the credit markets need informed and properly incentivized borrowers and lenders to deliberate investment opportunities and to negotiate rates and terms. This, of course, is the process by which the market finds its equilibrium or, if you prefer, its "natural" interest rate. Those who are closest to any given credit transaction are ordinarily the best judge of the merits of that transaction. For this reason, the efficiency and growth-enhancing properties of these capital deployments is maximized to the extent that the individual credit decision is disaggregated from any exogenous criteria.

The converse is that when negotiations become biased by a miasma of zero rates and multi-trillion dollar bond purchases run by a DC-based Board of Experts known as the Fed, bad choices about risk and reward are sure to follow. Indeed, the very point of the Fed's policy regime is to express a judgment that the "natural" rate of interest that the market wishes to establish is "too high." This essentially Keynesian perspective views low rates as "stimulative." Since unemployment is high and inflation low, the no brainer is supposedly to keep financial rates artificially low. The Fed's thinking assumes that magnifying credit creation leads to more consumption and spending which – presto, changeo – takes us to a new and prosperous economic equilibrium. Hmm. While a borrowing binge sounds like a simple and fun way to grow an economy, one would think that five years of zero rates would be enough to prove the efficacy of these policies. Empirically, what we have seen is that even as the Fed has doubled and tripled down on QE, actual GDP growth has remained stubbornly sluggish. Moreover, real wage growth has been at a standstill; the only component of income that has shown any meaningful growth is government transfer payments:

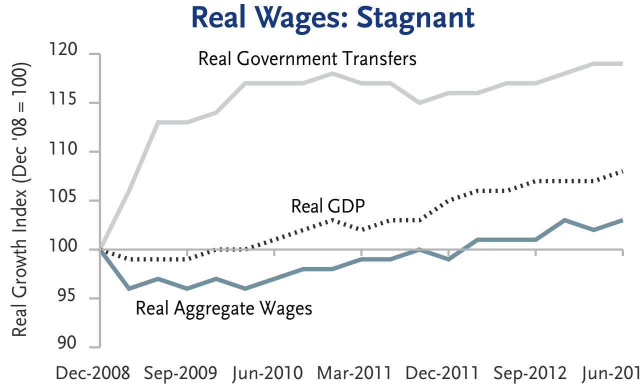
Fed Growth Forecasts

	Fed GDP Forecast[1]	Actual GDP
2010	2.5-3.5%	2.8%
2011	3.4-4.5%	2.0%
2012	3.5-4.8%	2.0%
2013	2.5-2.8%	2.2%[2]

1 Based on economic projections of Federal Reserve Board Members and Federal Reserve Bank Residents (source: Federal Reserve).

2 Annualized, based on reported GDP growth through September 30, 2013 (source: BEA).

Real Wages: Stagnant



Source: BEA, BLS

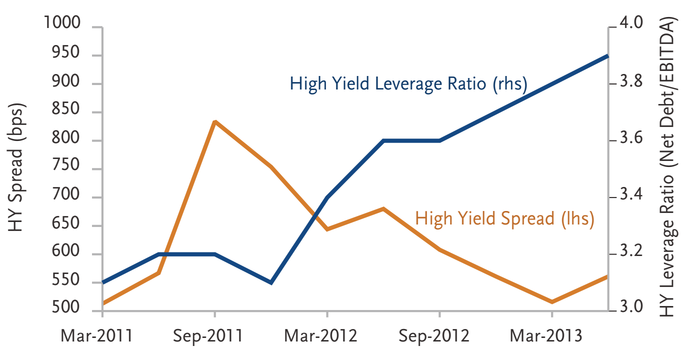
Should You Walk Away from a Fed that Prints Money? (cont'd)

Maybe it's just me, but it is hard to understand the consensus narrative that the economy is getting better when real aggregate wages are stagnant. We'd go a step further: income growth defines a growing economy, just as it would for an individual or a household. In fact, the impression of an improving economy may be something of a phony Potemkin Village: it has been underpinned, not by private sector gains, but rather enabled by Federal government transfers to support consumption. This poses a rather awkward question: if cheap credit isn't moving the economy forward, then what is it doing?

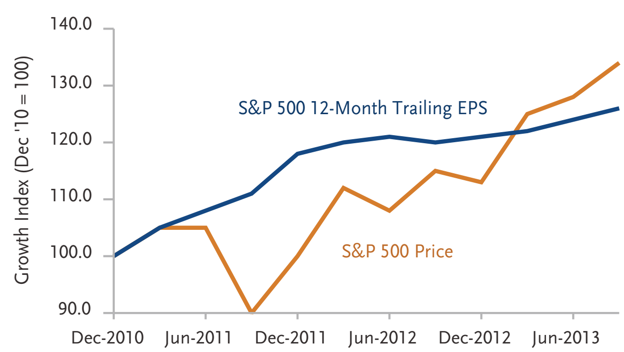
One of the obvious realities of abundant credit creation is that the newly created obligations have to find "homes." The result? An ongoing transformation of business and household balance sheets in the direction of higher leverage. Thus far, financially repressive policies have shown themselves to be far more effective in terms of expanding the liability side of the balance sheet (by adding debt claims) than in expanding the asset side. This means that our collective stock of capital must support ever more debt claims. This, naturally, lowers the margin for error and adds fragility to the business cycle. The longer this dynamic is accommodated, the more risk for the economy and for the financial markets.

A second reality of financial repression is that the hurdle rate of return on capital projects is lowered. Cheap credit means more projects appear to pencil out, including those whose fundamental merits are questionable. Further, capital held in the form of zero rate bank deposits or money market funds becomes progressively more restless. Negative real returns on cash – the moral equivalent of a wealth tax – drives flows into high yield bonds, emerging market debt, real-estate, stocks, anything that has a reasonable prospect of earning a yield above nothing at all. In short, the Fed's zero rate policy is "arbitraging" prospective returns on capital out of existence. This, of course, is accomplished by sending asset prices higher:

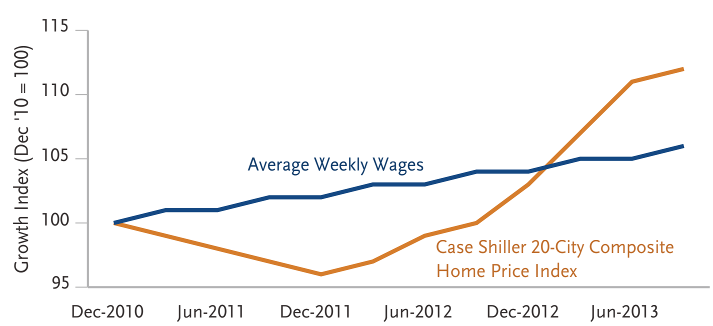
Asset Prices Decouple from Their Fundamentals



Source: JPMorgan, BofA Merrill Lynch



Source: Bloomberg



Source: BLS, Bloomberg

When high yield bond prices climb even as leverage ratios deteriorate, when home prices appreciate but wages do not, and when stocks are up but profit growth is flat, what we have is a generalized decoupling of asset prices from their fundamentals. Too much money is chasing too few assets, pure and simple. Artificially low rates deliver artificially high asset prices, accentuating financial fragility. Of course, it is always possible that the fundamentals could catch up and therefore "prove" the higher asset prices, but that would require healthy economic growth. Is this likely?

To our way of thinking, no. Artificially low rates do not assist growth. Bad pricing in the credit markets franchises economic inefficiency. No market clears at "zero" and financial repression is re-arranging incentives. Artificially high home prices benefit the "house rich" but correspondingly "impoverish" renters who see their rents pushed higher and their required down payment on starter homes enlarged. As such, Fed policies are unnaturally redistributing wealth. Homeowners are incented to "invest" in swimming pools, not in productive capital. The availability of cheap credit also means that adding leverage to an existing asset is more lucrative than starting a new business. Making money the "easy way" by financial arbitrage is encouraged at the expense of entrepreneurship. Nay, low rates are not the cure to the malaise: they are the malaise.

Thus far, financial markets have understood the folly in fighting the Fed. "Risk on" has been the market's mantra. However, the May/June "taper tantrum" should serve as a warning: the Fed attempted a "controlled burn" and soon found itself in the midst of a conflagration. This suggests that a lot of dry timber has been building. Possibly, the Fed can continue to "con" the credit markets into still more mal-investments, in the vain pursuit of a recovery that can never come until rates are allowed to normalize and the market can properly and efficiently take back its proper role. Meanwhile, investors live with a witch's brew of low growth, rising leverage, and artificially elevated asset prices. These conditions cannot be sustained indefinitely, and so they will end. Either the markets or the Fed itself will come to accept that financial repression is a "box canyon" whose only escape is by climbing out through higher rates and wider spreads on risk assets. Staying "risk on" requires the investor to underwrite the exacerbating risks inherent in an economy that is being given bad signals and is accumulating a menagerie of mispriced assets and bad loans. Yes, you should walk away from a Fed that prints money.

METWEST IS A WHOLLY-OWNED SUBSIDIARY OF THE TCW GROUP, INC.

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | www.tcw.com