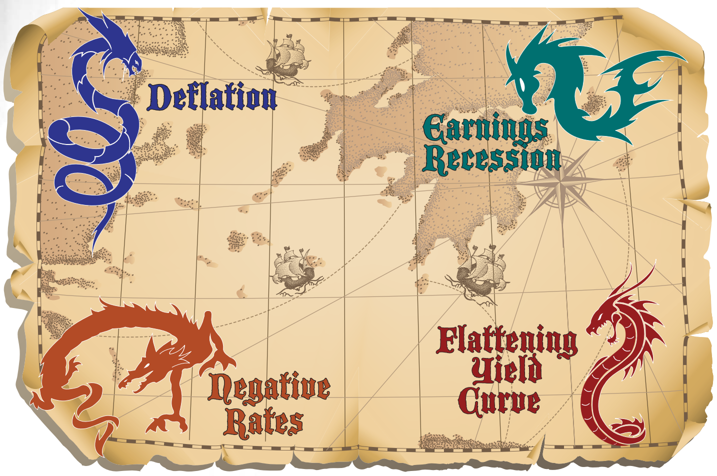
INSIGHT

TRADING SECRETS

Here Be Dragons

TAD RIVELLE | JULY 2016



Capital markets are information engines. When functioning properly, they reflect what investors know – or think they know – about the future. Future expectations are for all to see, discounted in today's financial prices. Obviously, this doesn't mean that capital markets are always "right," for the future comes as it will, caring not a whit whether it was the one we ordered up or not.

For the first time in recorded history, financial interest rates have gone negative. To say this makes no sense is almost tautological. Nobody pays to have their Amazon delivery delayed or their Uber pickup deferred. Consumption now is always prioritized over consumption later, which is why interest rates have been positive for centuries. Is there some set of future expectations that could possibly justify negative yielding debt?

Government Bond Yields

Country	1-Year	2-Year	5-Year	10-Year	30-Year
Switzerland	-1.02	-1.01	-1.02	-0.63	-0.14
Japan	-0.35	-0.35	-0.35	-0.27	0.11
Germany	-0.63	-0.70	-0.62	-0.17	0.38
Netherlands	-0.62	-0.62	-0.49	0.02	0.48
Denmark		-0.55	-0.36	0.05	0.47
Finland	-0.64	-0.63	-0.50	0.09	0.52
Austria	-0.59	-0.59	-0.47	0.11	0.80
France	-0.58	-0.60	-0.42	0.12	0.88
Sweden		-0.64	-0.30	0.15	
Belgium	-0.59	-0.62	-0.50	0.17	1.00
Ireland		-0.39		0.45	1.19
Spain	-0.20	-0.11	0.24	1.16	2.20
Italy	-0.19	-0.06	0.29	1.20	2.21
United States	0.49	0.65	1.02	1.43	2.14

As of 7/11/16; Source: Bloomberg

Tad Rivelle
Group Managing Director
Chief Investment Officer–Fixed Income
Co-Director Fixed Income

Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing more than $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.

Were an investor to accept that negative yields actually reflect future expectations, then the sovereign debt market must be calling for a '30s style price deflation! Go long canned green peas and head for the hills! Yet, is there not a fly in the ointment of this analysis? Stocks hitting record highs obviously do not reflect deflation expectations. Nor do investment grade corporate bonds yielding 2 ¾%. The risk markets violently disagree with the sovereign debt markets. Yet, how can it be that government bond yields are pathologically low while risk assets are priced atrociously high?

The Occam's razor answer is this: the ECB, the BOJ, and yes the Fed too have blocked the capital markets from expressing their "unbiased" future expectations. Rather than let the capital markets reveal investor expectations, the central banks have imposed a pricing regime that reflects what the academics believe to be "better" outcomes.

This is scary. If negative rates are merely the latest in a long line of artifices the central banks have resorted to so as to make the risk carry trade profitable, then look out below! For once the central banks let go of the till (or have it pulled from their hands), this whole financially engineered dynamic goes careening into reverse.

Without active suppression by the central banks, the bond market will call off-sides on negative yields, and sovereign rates will surely "normalize" back to positive rates. But higher government rates will also force cap rates higher everywhere: in stocks, in real-estate, and in the real world where businesses calculate a demanded return in exchange for a capital allocation.

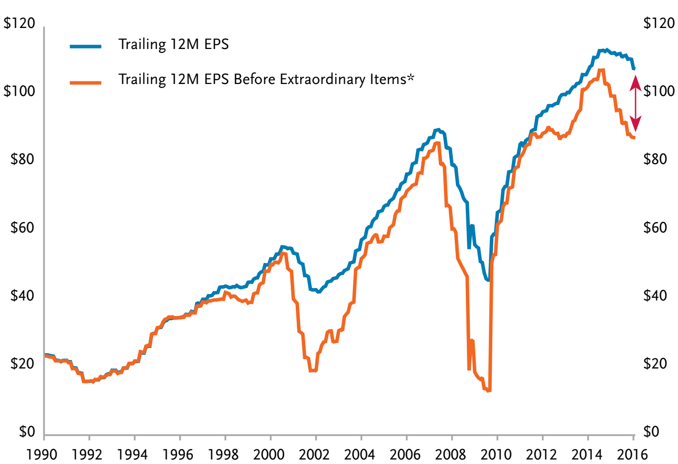
In the mind of the central banker, the capital markets must be stopped dead in their tracks whenever they threaten a "tantrum." But, in so doing, capital markets are prevented from telling us what true market clearing levels are. And, without good information, coordination loses its effectiveness, leading to low growth and soggy productivity. Low growth – the consequence of inefficient resource use – then becomes the recurring justification for still more central bank rate suppression. The paradigm is not one of self-correction but of doubling down. Keep doubling down and rather than having a series of corrections, you might just end up with a crash.

Monetary central planning has not led to the uncorking of the champagne bottles. Instead, it has engineered a condition of overvalued asset prices now propped up by the absurdity of negative rates.

The Fed, et al. are riding the tiger of a great global carry trade. Some have called this the "new normal." But it is anything but normal and it is also inherently unstable. How unstable?

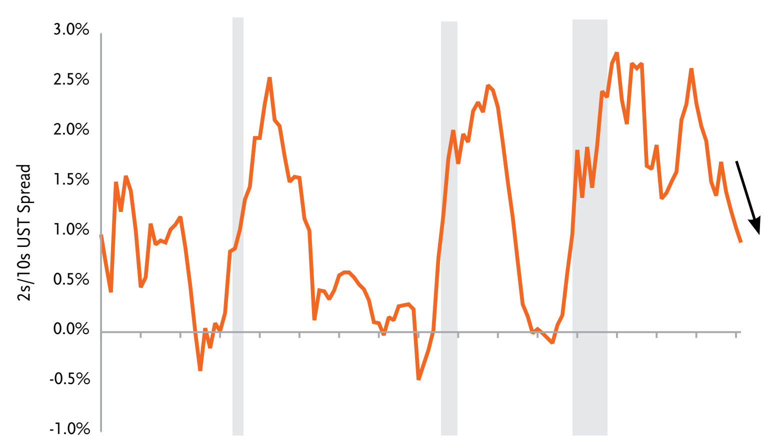
While no one can say for certain, two metrics that have had a dispositive record of forecasting recession are (1) declining corporate profits and (2) progressively flatter yield curves. We have both:

The Gap in GAAP Earnings



Source: Bloomberg, TCW
* Basic EPS before Extraordinary Items excludes the effects of discontinued operations, accounting standard changes, and natural disasters. Includes the effects of other one-time gains/losses. Uses weighted average shares excluding the effects of convertibles.

Flattening Treasury Curves Precede Recessions



Source: Bloomberg

There is really no mystery as to why these metrics matter. Lower profits force managements to defend their margins by curtailing business investment and by throttling back on hiring. The widening chasm between the "adjusted" earnings that companies report versus what their GAAP calculated earnings would be is yet another red flag. And, of course, flatter yield curves compress net interest margins making leverage less profitable. Less leverage means balance sheets shrink which forces a rationing of credit and a tightening of lending standards. The writing is on the wall.

Our central bankers took the till away from the markets years ago, confident that their policies would chart a course to El Dorado. Instead, they have sailed us off the map, into places that financial markets have never been, and should never be. ■

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup