TCW

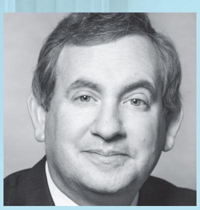
Manager of the TCW and MetWest Fund Families

INSIGHT

TRADING SECRETS

Hey! They’re Raising the Price of the Free Lunch

TAD RIVELLE | MARCH 2015



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

Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing some $130 billion in fixed income assets, including over $80 billion of mutual fund assets under the TCW and MetWest Funds brand. 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 UCLA Anderson.

Fed policy has fostered the delusion that cheap money is a free lunch. Such thinking results from conflating the financial cost of loanable funds with the economic cost of real capital resources. Money and credit are mere claims on resources– they are not resources in and of themselves. Hence, while a QE program expands the supply of loanable funds, it does nothing to increase the availability of capital resources, i.e., steel, energy, brains, and patents. No matter how big the printing press or well-educated the printer, sustainable growth cannot be secured by artificially minting monetary claims. Worse, QE and zero rate policies mask price signals that would otherwise inform investors and borrowers how to deploy their resources. After six years, such policies have impaired the recovery and exacerbated wealth disparities.

Central banks conjure money into existence so as to effectuate adjustments to the price and availability of credit. The ostensible purpose is explained in terms of rejuvenating animal spirits, manufacturing aggregate demand, and raising asset prices so as to produce a “wealth effect.” Yet, as there are no shortcuts to true wealth, whatever benefits monetary stimulus can deliver are not lasting. Wealth and incomes grow when labor and capital are adapted into more competent combinations. Such improvements are a result of individual households and businesses seeking to better their prospects by working, saving, and risk-taking. For this process to work effectively, proper incentives must exist within the context of good price signals. Greece isn’t going to become prosperous through helicopter drops of money. That said, monetary policy does have its uses, primarily as a crisis management tool. When financial markets self-immolated in 2008, the intervention of a lender of last resort was wise and essential. But the expertise to put down a house fire isn’t the same as that used to build a construction business.

When zero rates were first introduced in December 2008, the NASDAQ hovered around 1500; as of this writing, it is approaching 5000. That’s a lot of wealth effect for a pretty muted recovery. Might it be that artificial credit prices and the asset price inflation they have engendered have interfered with the proper allocation of true credit resources? Wealth effects don’t happen in a vacuum. Rather, a wealth effect, more or less by design, will necessarily have a disparate impact on households and businesses depending upon whether they are part of the wealth economy or whether they belong to the income economy. Households in "super zips" have seen their property values soar while many middle income neighborhoods have languished. Owners of stocks and bonds have prospered while bank deposit rates have been nullified. Consequently, the credit worthiness of the wealth economy has become steadily more attractive in the eyes of prospective lenders even as the credit worthiness of the income economy has been held in check. The result? A self-reinforcing misallocation of capital that has impaired growth.

Say a borrower from a super-zip is looking to improve his home by adding a swimming pool. While the addition will enhance his property value, a swimming pool is not a unit of productive capital. The swimming pool does not deliver any goods or services to the marketplace. Indeed, the homeowner will actually have to divert a portion of his income from other uses so as to maintain the pool. While the pool may be desirable to own, it is a financial liability on the homeowner's balance sheet, or would be if he kept a balance sheet. Be that as it may, any number of bankers would happily supply low cost, 50 LTV financing to enable the consumption of the new swimming pool.

Meanwhile, the Main Street businesses populating the income economy live in a world of sluggish wage and income growth. When such businesses seek to borrow, they encounter loan terms with onerous covenants that render expansion untenable. It is all too easy to miss the connection between excesses of "swimming pool" credit formation on the one hand, and a dearth of income generating loan origination on the other. But capital resources are scarce and an expanded supply of loanable funds doesn't mean that everyone gets expanded access to the underlying resources. Hence, when the Fed – or any other central bank– disables the price mechanism for allocating a scarce resource, the inevitable result is that the rationing process must take on a new modality of allocation. Instead of borrowers bidding for capital, credit allocation becomes predicated on terms and conditions. Therefore, capital is preferentially allocated to those with artificially inflated balance sheets rather than those who can most productively employ the capital. The economic landscape becomes simultaneously less equal and less efficient.

Fed policy is now at a cross-roads. Life needs to be improved on Main Street and many voices counsel against raising rates fearing the pain it will cause. The unstated assumption, of course, is that artificiality in the pricing of credit is a "remedy" to the malady of poor wage growth and low labor force participation rates. Intriguingly, former Fed chairmen, including Alan Greenspan, have cogently argued that salvation cannot be found by travelling down the low road of the credit printing press, but rather up along an avenue of capital deepening. More and better capital has traditionally bolstered the competitiveness of businesses while creating new and better paying forms of employment. Those who have a proper grasp of our monetary system's strengths and weaknesses recognize that even as the benefits of zero rates have petered out, its ill effects in the form of mal-investments and poor credit choices grow by the day.

Rates have to normalize so as to properly rebalance the underlying economic costs of capital with financial market pricing. A zero rate structure doesn't deepen the capital base nor does it enhance the effectiveness of capital. If the Fed carries through on its stated intention to lift-off the zero bound, higher rates will begin a process of crowding out marginal lending and initiate a long delayed "clean up" of capital misallocations. Precisely because such a process is painful, the incentives to defer normalization have been powerful. On the other hand, a decision to delay a rate rise simply means the can is being kicked down the road. Unfortunately, no one can ever say in advance how far the can might be kicked before it just goes over a cliff. In that event, the reality of a world of scarce capital will collide with the fantasy of the monetary free lunch. Either way, the price of our "free lunch" is going up and whether that news is delivered by the FOMC or by a market de-leveraging event will matter little to the investor caught short-changed at the lunch counter. ■