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INSIGHT

TRADING SECRETS

Has the Fed Missed the Zero Rate Exit Ramp?

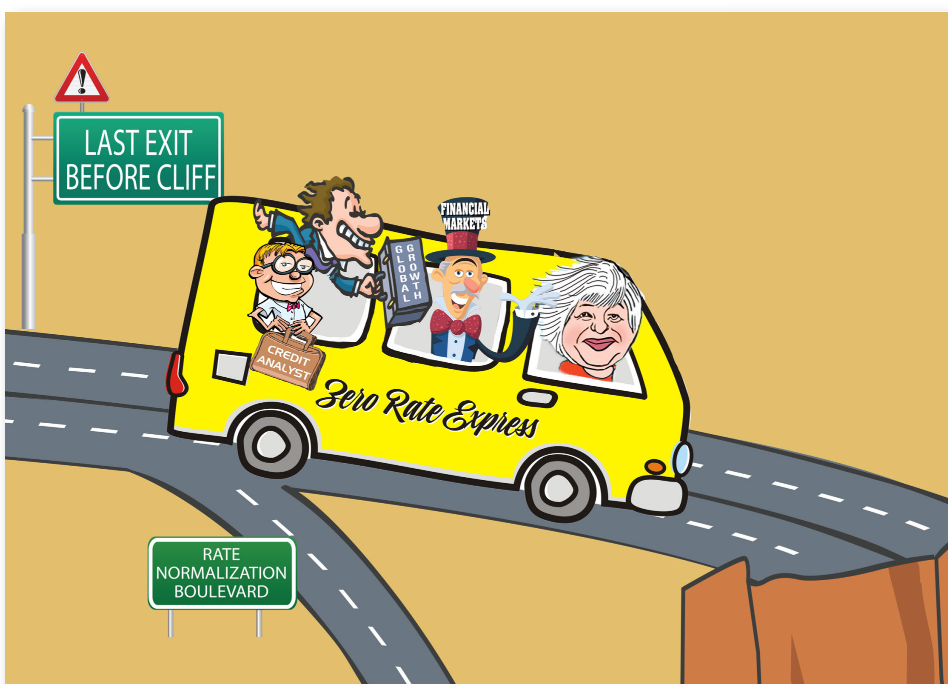
TAD RIVELLE | AUGUST 2015

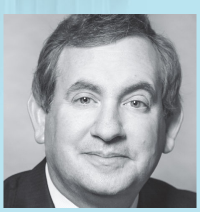
Tantalus was eternally doomed to stand in a pool of cool water beneath a fruit tree. Whenever he reached for the fruit, the wind would blow the branches out of his reach; if he kneeled to drink, the water would drain away.

After years of extreme policy, the Fed's twin goals of faster growth and 2% inflation remain tantalizingly out of reach. But are the Governors ready to look past the commodity bust, a strengthening dollar, and a near meltdown in Chinese stocks, and "tighten" policy for the first time in nine years?

The Fed has talked the talk of "exit strategies" for years. The bank once upon a time asserted that the "trigger" would be 6.5% unemployment. That "trigger" became a "threshold" which became a "dashboard" and then merely an assurance that the Fed would be "data dependent." And the Fed now agonizes over whether a rise in rates of ¼ of 1% in September might need to be taken off the table. Is the recovery so tenuous that even a "technical" move off the zero bound might place it in jeopardy?

If so, then why continue a policy regime whose "fruit" reeks with the rotten odor of deflation? Rather than acknowledge that the policy might actually be wrong, apologists for the Fed insist that punk growth and quasi-deflation require – you





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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing $140 billion in U.S. fixed income assets, including over $85 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 UCLA Anderson.

guessed it – still lower for longer. Yet, if prosperity were truly a function of adding leverage and cheapening credit, shouldn't the recovery be brimming with animal spirits by now? Ah, but we are told that this time is different. The financial system suffered a "coronary" and home prices tanked nationally for the first time since the 1930s. Or, we have "secular stagnation" – everyone just got suddenly old in 2008 and Silicon Valley ran out of innovative ideas. Yet, have not home prices rebounded and stocks attained record highs? And do we not see vast valuations being applied to tech businesses on the presumption that their frame breaking business models will yield a cornucopia of productivity gains and wealth creation? Face it: if zero rates were going to do their magic, seven years is a more than adequate window of time to be shocked and awed by its power.

Well, as the old saw goes, you're either part of the solution or you're part of the problem. Could it be that low rates not only can't cure but are actually the cause of our serial misses on GDP and inflation? Well this sounds like heresy: after all, aren't lower rates "better" than higher rates?

They are not! Interest rates are prices and like all prices they have a job to do: to ensure that scarce resources go to where they do the most economic good. When market clearing prices are permitted to emerge from the soup of borrower/lender preferences, the expected result should be an information rich allocation of capital. When the market's mechanism is overridden, because the central banker "knows better", locally known information pertaining to producer efficiency and buyer urgency is lost. Suboptimal credit pricing begets suboptimal resource use which retards growth. Zero rates, far from being stimulative, poison the tree. Consider the far reaching and unintended consequences of ZIRP:

1. Legacy borrowers receive financial relief enabling inefficient enterprises to outlive their usefulness. New trees can't grow where there is dead wood, as Japan learned with its zombie companies.

2. Cheap loanable funds that fail to reflect the true economic cost of using a resource misdirect economic activity. Every real resource has a range of uses, from the sublime to the ridiculous. Sublime users are supposed to go to market and outbid the ridiculous users so that resources go to those who place the highest value on them.

3. Abnormally low rates and risk premia have fostered a "reach for yield" which has distorted judgment of relative risk and reward. An excess of capital flows into energy, commodities, high yield, and emerging markets are emblematic of such resource misallocations.

4. "Trashing cash" has spurred real-estate prices. Those with expensive homes have seen their "collateral package" enlarged enabling them to borrow more and on better terms when facing their local banker. No surprise, then, that higher home prices encourage more investment in swimming pools and, tautologically, less in say expanding payrolls at small and medium enterprises.

This list could go on. The Fed, we are sure, is full of good intentions and technical competence. That said, financial markets excel at resource allocation in a way that central direction never can. Price information is invisible until a market mechanism "reveals" it. And information is the key to getting the right resources to the right places at the right times. Policies of financial accommodation outlived their usefulness years ago. Resources have been misallocated, capital misdirected, and so cleaning up the mess created by ZIRP will be costly.

Regretfully, we can see only two options ahead for the Fed, and neither one of them is good. It can throw away the playbook and accept that a real rate normalization will happen eventually, no matter what. In that event, the Fed can use September as the starting point for taking us back home to a world of normal market clearing short rates. Lifting rates over time to even 2% would mean that real short rates would be just barely positive. Of course, the likely result of tightening to 2% would be recession.

Then why do it? Because the second option is potentially worse. Allowing rates to remain artificially low keeps asset prices artificially high. Effectively, the Fed keeps "riding the brakes" and calling it progress. The conundrum is that expanding leverage in a slow growth economy eventually fails – often dramatically.

Sooner or later, the inevitable de-leveraging will come, catalyzing a bear market for risk assets. We counsel investors to remain mindful of the asset price cycle and skeptical of the claim that risk-centric strategies will be – or can be – forever sponsored by the Fed. ■