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A Coming Winter of Discontent

In investing, as in life, timing can be everything. The cycles of the capital markets are as immutable as are the seasons of the year. Those who commit risk capital while the cycle is enjoying its “risk on” spring will prosper; those who avoided risk taking during the spring would be well-advised not to do so as the autumn chill approaches. Shockingly, as critically important as it is to take the measure of the cycle, there is precious little insight offered in terms of understanding what drives the financial and economic cycles. Worse, the explanatory narratives put forward often suffer from a “pretense of knowledge” as if the institutions charged with managing our collective economic destiny have some special knowledge that permits them to “really know.” Alas, the ability of our institutions to forecast, much less control, the cycle has been exceedingly poor. Need proof? Inspect the pronouncements of our high priests and priestesses of finance at the Fed. In June 2008 – three months before the failure of Lehman and take-over of Fannie Mae and Freddie Mac – the Fed expressed its concern over rising inflation and reiterated its expectation that growth would continue. Our point isn’t to lambast the Fed – who like the U.S. government, Wall Street, and the media – failed to perceive the severity of the financial fragility that had built during the housing bubble. Rather, our purpose is to remind that the traditional ways of understanding and measuring the cycle are nearly useless and investors need to examine the cycle in a new, or at least different way.

Traditionally, there have been two basic narratives that have been used to “explain” the cycle. Indeed, there was a time when economics textbooks were replete with descriptions of the inventory cycle. Recessions happened, so we were to understand, because businesses became infused with an excess of “animal spirits.” Overexpansion begot an unwanted build in inventory forcing the shuttering of production until inventory was worked down to a manageable level at which point normal growth would be restored. Now, does that sound like any business cycle you’ve seen in the last thirty years? Alternatively, some claim that the imbalance comes not from business, but from the consumer. He gets exuberant, goes on a shopping spree, spurs inflation, forcing the Fed to pull the “punchbowl.” Once removed and consumer spirits dampened, the cycle concludes. Well, does this sound like 2008? Was inflation such a menace that the Fed pre-emptively raised rates to flatten growth? Was inflation the cause of the de-leveraging and downturn of 2000-02, 1998, 1994, or 1990?

So if the usual suspects have little to do with the demise of the cycle, then investors ought to look elsewhere if they are to more properly gauge the durability of the cycle. A study of the de-leveragings of the past quarter-century provides the necessary guidance: simply put, we have lived for some time now in an integrated global economy mirrored by a globalized financial system. For all intents and purposes, this has meant that the credit cycle and the business cycle have become almost one and the same. Provided that the capital markets are willing and able to extend the frontiers of credit that one extra step, so long as one more marginal loan can go to that one more marginal borrower, we maintain growth. But, once the high water mark in credit

Trading Secrets

A Coming Winter of Discontent (cont'd)

is reached, a de-leveraging inexorably builds momentum (either gradually over several quarters or within the context of a market “crisis,” when it happens over days or weeks), and an economic downturn is underway. No longer does the economic dog wag the financial markets; rather, the dog is the credit markets and the “Main Street” economy the tail!

The implications for the investor, then, are clear. “Main Street” economic indicators are *derivative* from the financial markets. Car sales, purchasing manager surveys, employment data, housing market activity, asset prices – within a given cycle all these economic variables are highly dependent upon the willingness of the capital markets to engage in the lending activity that fuels a re-leveraging economy. The notion that high asset prices and a low level of unemployment inoculates the economy from economic downturns is belied by history. Did such a peak in stock and real-estate prices prevent the cataclysm of 2008? Did the sub 5% unemployment of early 2008 mean that the virtuous jobs-income-jobs cycle had firmly and forever established itself? Obviously not.

The ramifications for investors in the current cycle are clear. If you want to understand how “old” the cycle is, i.e., how risky a commitment to risk based assets might be, then it is critical that you judge the quality and durability of underwriting standards in the capital markets. A “recovery” that is predicated on the continued production of loans, too many of which will ultimately “go bad”, is no recovery at all. Rather it is a condition that supports current period economic activity at the expense of a future write-down in loan and asset valuations. Hence, the narrative that assures us that all is well, or at least better, because of the cyclical improvement in car sales, asset prices, and (maybe) the labor market is only half true. Yes, conditions appear better but the “house of recovery” is increasingly being built out of credit straw rather than brick and, consequently will not withstand the gales of the tighter credit to come. Whether these tighter conditions come “naturally” via a capital market self-realization of the excesses in the credit markets, or by the Fed’s need to raise rates in response to the risk or reality of higher inflation, the result will be a de-leveraging and possibly recession. With the ratio of asset prices to incomes nearly back to peak 2007 levels, and given the rapid erosion in debt underwriting standards, we at TCW Fixed Income view the cycle as sufficiently aged so as to counsel caution. For this reason we have steadily reduced our exposure to rates and to risk taking in credit with the expectation that an environment of higher rates, wider risk premia, and higher volatility lies ahead.

Regretfully, a hot summer day does not preclude but only precedes the onset of an inevitable winter in the credit markets.

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