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TRADING SECRETS

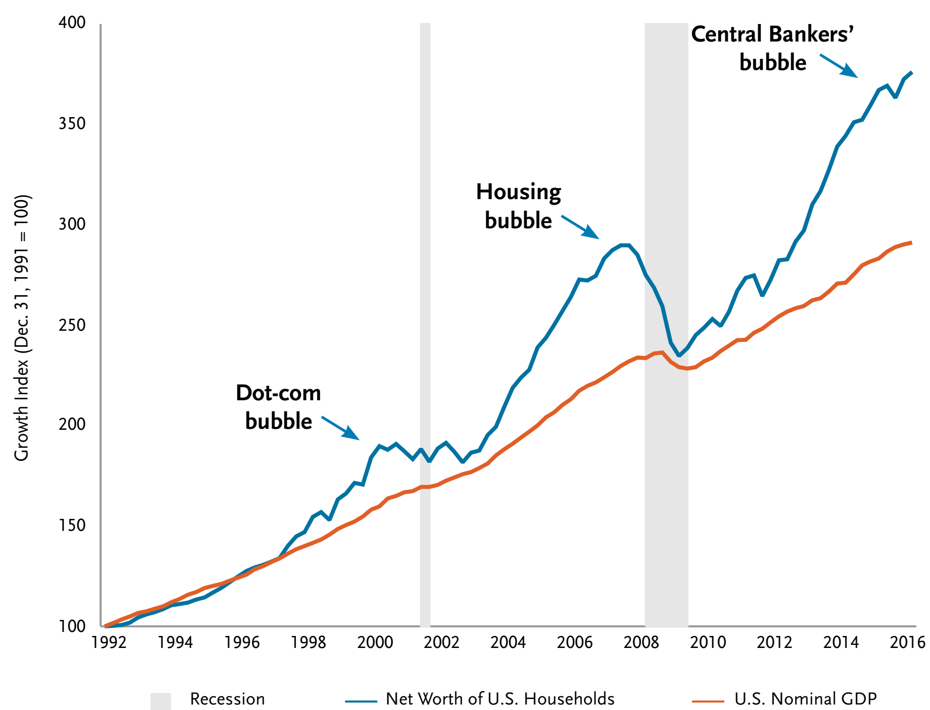
Twilight of the Central Bankers

TAD RIVELLE | SEPTEMBER 2016

While every asset price cycle is different, they all end the same way: in tears. As obvious as this truth is to investors, when the sad end to the credit cycle comes, it always comes as a big surprise to many, including the central bankers who, reliant on their models, confidently tell you that no recession is (ever) in the forecast. But, successful, long-term investing is predicated on not just knowing where the happening parties are during the reflationary parts of the cycle but, even more importantly, knowing when the time has come to leave the dance floor. In our view, that time has already come.

Allow us to properly explain ourselves. Consider the chart below which plots the trajectory of cumulative asset prices (stocks, bonds, real-estate) against that of aggregate income (GDP):

Asset Prices vs. GDP



Source: Bloomberg, TCW

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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.

The chart reveals something rather extraordinary: over the course of the past 25 years, the traditional business cycle has been replaced with an asset price cycle. Rather than let recessions run their painful but necessary course, central bankers move forthwith to dispense the monetary morphine. The Fed's playbook on this is well worn: first, policy rates are lowered. This triggers a daisy-chain of events: low or zero rates promote a reach for yield; the reach for yield lowers capitalization rates across a variety of asset classes which, in turn, spurs a rise in asset prices. Rising asset prices – the so-called wealth effect – "rescues" the economy by rebuilding balance sheets and restoring the animal spirits. And voila! Aggregate demand rises, businesses invest, and a virtuous growth process is launched.

Well, maybe not so much. If it were all so simple, then why is it that after ninety something months of zero or near zero rates, growth is sputtering, the corporate sector is in an earnings recession, and productivity growth is negative?

The explanation is simple: growth is not a simple function of higher asset prices. Growth results when the productive sectors of the economy make themselves more productive by delivering goods more efficiently or by innovating products valued by the marketplace. In short, the vast partnership of labor and capital that is our economy must constantly up its game so as to expand output and, along with it, incomes. The process by which this happens is essentially Schumpeterian: profitable activities expand and bid resources away from the decaying and inefficient. Say what one wants, this has been the wealth engine for centuries.

The central banker's model of growth not only ignores these creative/destructive forces – it is antithetical to them. Consider: what does a boom in asset prices actually foster? Higher asset prices literally means that your economy has "more" assets. If you double the value of all homes in the nation, then you have "twice" as much real-estate. But twice the real-estate means there is twice the real-estate to lend against. Effectively, higher asset prices is the Fed's mechanism for expanding the system-wide pool of loanable collateral. More collateral means that more credit can be created. Of course, in the short-run, more credit creation feels like an economic recovery, which is why monetary expediency has so many cheerleaders.

But buying growth today with credit that needs to be repaid tomorrow is not a free lunch! Artificially "stimulated" credit creation means marginal or even unprofitable enterprises are being fed when they should actually be starved. Further, the low rate induced asset price inflation preferentially directs credit to those who are already asset rich. Those whose assets have inflated now possess more collateral, making them more credit-worthy in the eyes of the lender. This results in all sorts of distortions that serve to further impair efficiency. Fortune 500 companies get to borrow cheap so as to repurchase shares even as small businesses are starved for capital; affluent homeowners get favorable access to loans to build swimming pools while renters suffer impoverishment by the resulting housing price inflation.

Indeed, the longer term consequences of policies that fixate on credit growth lead to a general, system-wide expansion of leverage ratios. Meanwhile, this credit inflation disempowers the market based mechanisms that would otherwise allocate resources to their highest, best uses. The result? ***Leverage goes up faster than the income available to service it.*** As such, the credit-fuelled expansion inevitably comes to a bad end. We've lived this story before: indeed, while every cycle is distinctly different, they all end up suffering from the same central banker induced maladies. Consider the similarities in terms of where we are today versus where we were in 2007:

	9/30/2007	**6/30/2016**
Unemployment Rate	4.7%	4.9%
Core CPI (YoY change)	2.1%	2.3%
Household Net Worth as % of Disposable Income	642%	640%*
S&P 500 Cyclically Adjusted P/E Ratio	26.7	25.9
Average U.S. Apartment Cap Rate	6.2%	5.5%
Average U.S. Office Cap Rate	6.5%	6.5%
IG Non-Financial Corporations		
Gross Leverage	2.1	2.9
Net Leverage	1.9	2.4
Interest Coverage Ratio	8.3	8.3
U.S. Federal Debt Held by the Public as % of GDP	35%	76%
Fed Funds Target Rate	5.25%	0.50%
Federal Reserve Balance Sheet	$890 Billion	$4.5 Trillion

* Data available as of March 31, 2016.

It's back to the future – again. Leverage has returned, most notably in the corporate sector where debt metrics have not just round-tripped but indeed are now in excess of the levels experienced before the Great Recession.

And while the Fed clings to the fiction that it is "data dependent," its response function – cowering in the face of every market "tantrum" – reveals monetary policy to be what it really is: a put on financial prices. But can the Fed, Canute-like, hold back the future tides of de-leveraging? No, though we expect that they, like their comrades in arms at the ECB and BOJ, will keep trying. Indeed, negative rates can be best understood as merely the latest attempt to forestall the failures of policies past. But, is anyone helped by establishing negative "hurdle" rates to incentivize "investment?" If a commitment of capital requires a negative opportunity cost, then whatever activity that might be launched will assuredly be productivity destroying. Negative rates have all the economic "logic" of destroying the village so as to rebuild it. It is monetary madness and while it might hold back the flood for a time, it fairly well guarantees that when the flood comes, it will be worse than it would otherwise.

Face it: the central banking Emperors have no clothes. But, might the Fed come up with new artifices to prop up the towers of leverage they have built? They might, though it would be folly. Yet, underestimating folly is, I suppose, a folly of its own. The Fed could continue to use its printing press to falsify capital market signals, but to what end? When a central bank buys an asset with an electronically printed dollar, a "something for nothing" trade has taken place. Unless everything we understand about economics is plain wrong, the Fed cannot go on blithely adding printing press dollars to the system and expect no ill effects. ***Essentially, inflationist monetary policies cannot be the answer to the problems caused by inflationist monetary policy.***

And this is precisely our point: when the supposed "solutions" to the Fed's dilemma are merely new "problems," you know you are approaching the cycle's end. Our counsel remains as it has been: avoid those assets that will be broken in the coming de-leveraging while keeping a "steady as she goes" attitude towards the future purchase of those assets that will merely bend when the flood comes. ■

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