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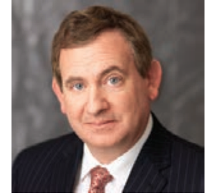
TRADING SECRETS April 2014



Tad Rivelle
Chief Investment Officer – Fixed Income
Portfolio Manager

Understanding the Boom and the Bust

It isn't what you earn – it is what you keep that matters in investing. While systematically underwriting too little risk may mean that you do not earn all that you might, underwriting too much towards the end of a business cycle can be disastrous. With this in mind, it becomes obvious that timing an investment strategy may be the most important single decision an investor needs to get right. But how is one to know where you are in the cycle?

Our collective experience from the last cycle tells us where not to look for the answer. Don't bother yourself with poring over the minutes of the latest FOMC meetings. No one at the Fed saw the cataclysm of 2008 coming. Nor did the Fed see the demise of the cycle before that (2001-02), or the brutal deleveraging of 1998. Indeed, the track record of our policymakers-in-chief in so far as alerting investors to the danger signs of a late stage business cycle have been dismal. As an investor you would have been similarly disappointed by our experts in government, on Wall Street, or in the media. I'm afraid that all that stands between you and a major capital drawdown is your personal independent judgment and, of course, that of your investment manager. And where should one go to get some schooling on the business cycle? For entertainment if nothing else, check out the conventional wisdom you'd find in most any textbook.

You might read that the business cycle happens because manufacturers get exuberant over their prospects and end up producing a lot of inventory that can't be sold. Businesses are obliged to "clear" the excess and this they do by shuttering factories and laying off their assembly-line workers. Now, seriously, does this sound like any cycle we've experienced in the past 30 years? It does not. So, perhaps you read on and find an alternative explanation: the whole economy gets infused with an excess of "animal spirits" and consumers collectively demand too much from producers, bidding up prices. Inflation rises to unacceptably high levels and the Fed is forced to "pull the punchbowl." Well, sorry, that doesn't sound like any cycle we've seen in decades, either. The global financial crisis unfolded while U.S. inflation remained perfectly benign.

So, shall we give up on understanding the cycle? Not so fast. There is, we believe, a working explanation for the cycle which conforms to the reality we've witnessed in recent periods. It is this: **the American economy is now so thoroughly "financialized" that the business cycle and the credit cycle have essentially become one and the same**. So long as credit markets are willing and able to extend new credit, GDP grows; once the credit markets go the other way and initiate a de-leveraging process, economic growth falls into the tank.

The credit creation tail wags the economic dog, and the dogma that counsels you to focus on the real economy is, ironically, out of touch with reality. Labor markets may be slack, conventional inflation benign, but these are not the metrics that count, so don't spend your time counting them! Rather, assess the credit markets. Will investors continue to expand the frontiers of credit creation? Once the credit tide has reached its high water mark, it must, by definition, recede. Those businesses and associated claims on those businesses that have been built on solid foundations will weather the ebb tide, those build on sand will suffer a different fate.

Ah, but you say the Fed can't possibly let rates go up or stand by as credit conditions tighten. Nay, not with labor slack and inflation nil. Indeed, the Board of Governors might just decide to hold its collective breath and keep rates at zero until growth blooms, or hell freezes over. Many do believe this, or some variant of the almighty Fed narrative. A central banking atlas holding up the structure of asset prices and providing free loans…sounds too good to be true. Well, the Fed is mighty, but not almighty. But, sorry, artificially high asset prices (houses too pricy for their renters, stocks too pricy for their earnings, and bonds too pricy for their risk of loss) never survive their inevitable rendezvous with reality. Alas, economics is derived from the human condition and until and unless folly can be banished from the human condition, neither the credit cycle nor the asset price structure it supports nor the business cycle that is co-terminus with the credit cycle can be willed away. So, what can the individual, or the institutional investor do about this?

Individually, assess where you think we are in the cycle. Notice how under the Fed's leverage driven economic growth model, that a late stage condition is signaled by, among other things, an unsettling rise in volatility. Call it the postman always rings twice effect. In 1999, that volatility was manifested by watching your favorite stock get thrashed after missing its earnings by a measly penny. Irrational behavior? Not at all. The capital in the equity markets "knew" that valuations were stretched and that missed earnings meant that the corporate growth model in question was exhausted. Remember the Thai banking crisis of 1997, the prelude to the stomach turning swoon in the emerging markets in 1998? And no one needs reminding of the mortgage "early payment defaults", hedge fund failures, and collapse of Bear Stearns that were the prelude to the last great de-leveraging cycle. With this as context, consider well whether the 2013 "taper tantrum" was just a disembodied episode of volatility or one of these recurring warning shots across the bow. While no one can be sure until after it no longer matters, recognize that all Bernanke had to say was "Boo" before practically bringing the whole house down.

Further, consider the basic DNA of a credit cycle. First, lenders get burnt by the bad loans made in the previous cycle. They vow never again, like a drunk after his last hangover. So early stage underwriting is disciplined. Borrowers are forced to prove their creditworthiness beyond any reasonable doubt and to further consent to restrictive covenants. But time goes on and credit amnesia sets in. Zero rate cash gets restless and finds its way into bond funds and the managers of said funds have to do something with their newfound riches. Whether you have too much time on your hands or too much money, something bad eventually is going to happen. Marginal borrowers are courted and so marginal loans get made. And while it is never apparent while the party is roaring, the neighbors have already called the cops. The punchbowl is getting emptied, distress is getting manufactured and no, the solution is not to refill the punchbowl. Loans that ultimately can't be repaid, won't be. And simply creating more and worse loans to repay the bad loans already made is a solution that only a politician, or a central banker, could come up with.

As scholars of the credit cycle (the core of our team has invested together for nearly a quarter-century), our assessment is that the punchbowl is looking pretty drained. An examination of all-in yield levels, an assessment of the skinny risk premia in bonds, and a general unease with lofty asset valuations counsels us to maintain a high quality of underwriting. Yes, less risk means less yield, but it also means more peace of mind. Are we too early to leave the party? Well, good investors are like professional party goers: they arrive on time but leave early, and let others swill the last dregs left in the punchbowl.

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