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INSIGHT

TRADING SECRETS

Volatility is Volatile, So Expect the Unexpected

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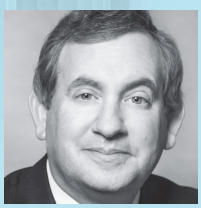

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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing over $130 billion in U.S. fixed income assets, including over $80 billion of U.S. fixed income mutual fund assets under the TCW Fund and MetWest Fund brands. Prior to joining TCW, Tad 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.

Before we developed a modern understanding of chemical processes, the notion that there might be some way to cook base metals and turn them into gold must have sounded plausible. Now we know better. Sure, the ingredients can always be made more esoteric, the cooking more complex: still, you can never obtain any gold from the pot, unless you already had put some in. Nature's conservation laws inform us that regardless of the skill of the chemist, elements cannot be created nor destroyed, merely re-arranged. Finance has conservation "laws" as well, though our central bankers theorize that their power to "optimally" steer short-term rates is a 21st century philosopher's stone. Given that asset markets have long since learned to do as the Fed says rather than as the fundamentals do, the credibility of Fed policy now dictates its durability. So, are the Fed's actions credible? Can we investors rely on the skill of the Governors to see around corners and guide the economy and capital markets into the next Great Moderation?

Call us Thomas on this one. If there were but a single lesson to be learned from the last bull market it is this: extended periods of low volatility eventually self-immolate. This empirical observation is grounded in simple common sense. Volatility is an inherent feature of capital markets because volatility is life. Circumstances fluctuate, prospects for one industry rise as another falls, the business cycle matures, leverage grows. When capital markets are doing their job, they are properly reflecting reality by appropriately pricing risk and opportunity. Markets are information engines and what they have to say matters. Prices are not supposed to be arbitrary constructs. Just as a high stock price tells a management team to keep doing more of the same and then some,

a stock price falling into the tank triggers self-reflection and hopefully self-correction. Higher asset prices are not "better" than low asset prices and the "best" asset price is the one that appropriately reflects what investors think and believe based upon the information they have available to them. Thus, if capital markets are to "mean" anything, or to "be" anything other than a souped up casino, market pricing must reflect the fundamentals and, when found to deviate from said fundamentals, must necessarily re-price. To believe otherwise would be tantamount to saying that the asset markets are not, in fact, signaling devices but rather just random number generators. If that were indeed so, then, to paraphrase Simon and Garfunkel, analysis would not be worthwhile.

Since the financial crisis, markets have co-habited with a central banking partner that expects trust but that does not trust. Rather than hear what capital markets have to say about rates, risk premia, and volatility, the Fed has preferred to "optimally" guide the capital markets to the "right" result. Problem is, the whole reason we have markets in the first place is because no one knows what the "right" price for capital assets is supposed to be. Markets are the means by which we collectively discover where prices should be, so that accurate signals get sent, and properly informed decisions can be made. Since 2009, the Fed's actions are very much at odds with this view of finance.

The Fed's thinking goes more this way: the 2008-09 economy suffered a shock to aggregate demand causing asset prices to fall, unemployment to rise, and the economy to fall well below its potential output. If rates were kept down, asset prices would rally causing a wealth effect, contributing towards a renewal in aggregate demand. Ergo, low rates are "better" than higher rates, higher asset prices are "better" than lower, and volatility can be managed out of the system by the Fed's very own masterful forward looking guidance on rates. While the Fed's intentions are laudable, history and logic argue that the volatility you suppress today isn't destroyed but merely re-arranged in time. In short, a Fed that denies the capital markets the freedom to adjust interest rates and risk premia in accord with ever changing fundamentals, is preventing the capital markets from producing the information needed by the entirety of the economy. Rather than let the mirror reflect that which is, the Fed distorts the mirror to reflect the prices that it believes are "better."

Investors are being led down the primrose path. In denying markets their freedom of expression, the chasm between that which is real and that which is priced into the markets gets wider with time. But unless the Fed intends to build a new kind of capital market, maybe one that never knows a bear market in risk, the day must surely come when capital market prices are unshackled from the Fed's guidance and re-anchor themselves in the fundamentals. As the latter and the former have already substantially diverged, investors should expect that such an adjustment will be neither smooth nor very much fun. Volatility suppression is a policy that has always failed. Like a caged tiger, volatility will spring forth, angrier and hungrier than before it was confined.

Perhaps the Fed understands its can't have your cake and eat it conundrum: if rates are going to be renormalized say back towards its current guidance of 3.25% by 2017, then the longer it waits, the faster rates have to be raised. Less volatility in short rates today would necessarily mean more volatility tomorrow. Or, perhaps the Fed "gets" the notion that inflated asset prices and suppressed yields are subject to the law of unintended consequences. Just what will happen to the balance sheets of millions of companies and individuals after a rate re-normalization now that they have spent years "filling up" on low rate long duration assets? Or, who says that low rates have not helped form asset price bubbles? Does a doubling in Shenzhen stock prices over the past six months sound like a move based on fundamentals?

Face it: a gulf between asset prices and their fundamentals cannot be reconciled absent an elevation in volatility. Hence, investment strategies whose success is predicated on picking up yield by "selling" volatility in the form of incremental credit or prepayment risk are headed for a reckoning. Relatively modest sacrifices in yield today can be thought of as buying rate and risk insurance for the inevitable. One of the legacies of this cycle will be that using extraordinary monetary policy to abolish volatility will prove as futile to the central bankers as were the attempts to transmute lead into precious metals to the alchemists. ■

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