

TRADING SECRETS

No Stagnation Without Representation

TAD RIVELLE | JANUARY 2017

“In the department of economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause – it is seen. The others unfold in succession – they are not seen.”

– FREDERIC BASTIAT

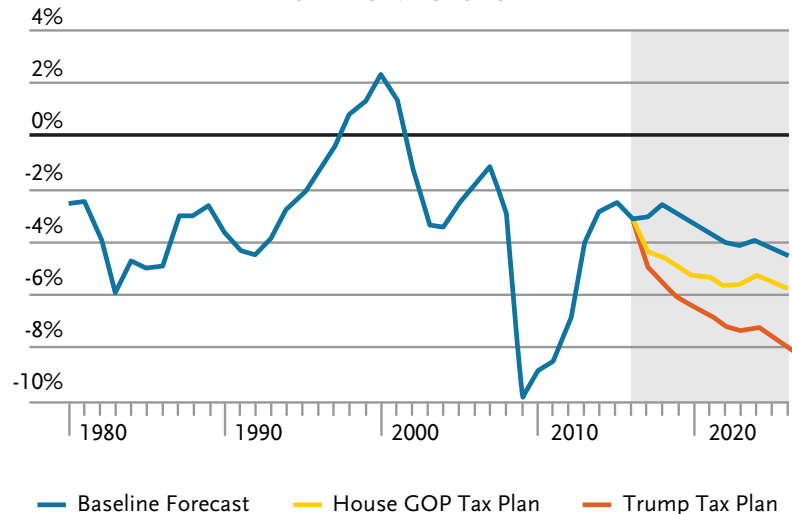
**Tad Rivelle**

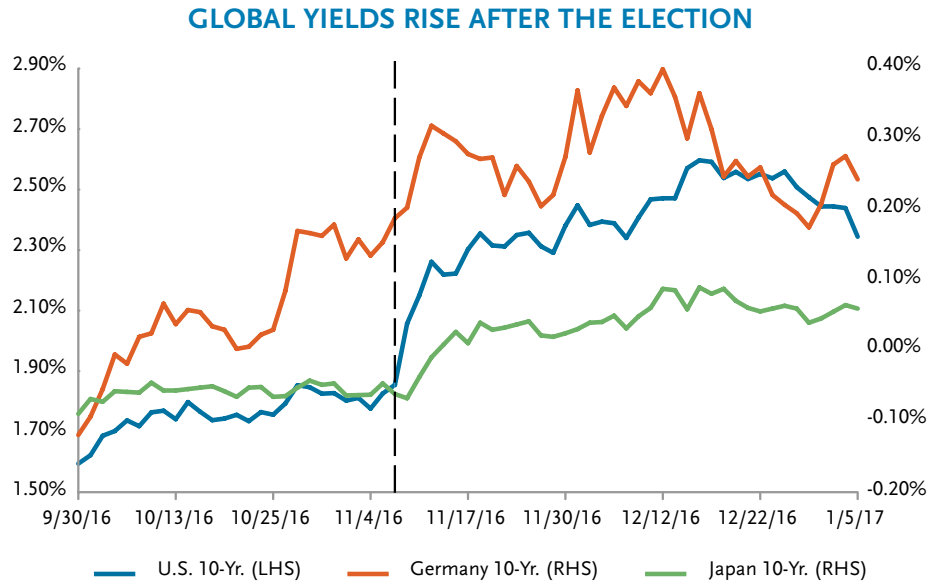
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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing more than \$150 billion in U.S. fixed income assets, including over \$90 billion of U.S. fixed income mutual fund assets under the TCW Funds and MetWest Funds brands. Prior to joining 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.

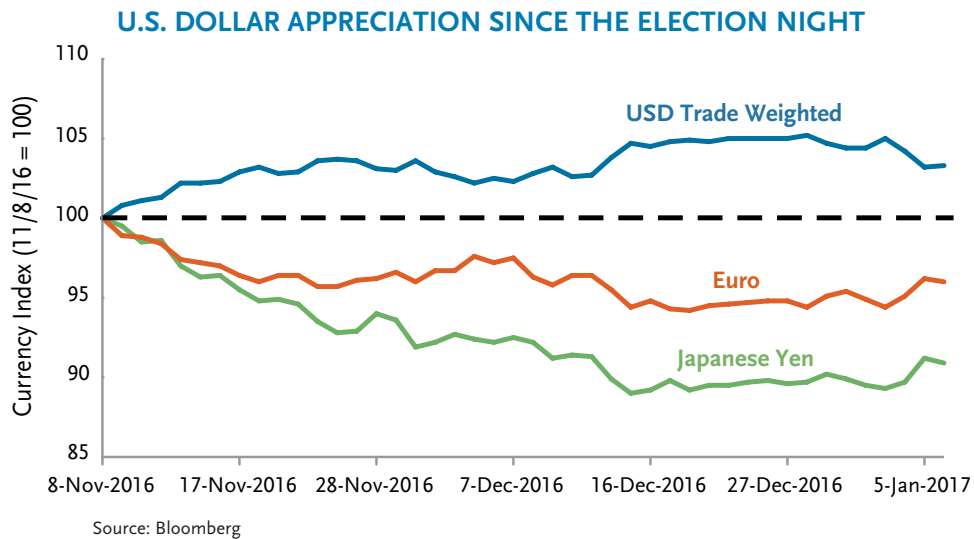
Over the course of this asset price cycle, central banks have held the rate markets in thrall. Until now. Low for longer just slammed head-on into November’s altered political realities. While the detailed content of Trumponomics has yet to be revealed, the broad outlines are apparent: comprehensive tax cuts, regulatory roll-back, and, more speculatively, an infrastructure program. The rate market’s “first draft” reaction to a Fed that has had its low rate car keys taken away and a Federal government about to massively balloon its borrowing requirements has been predictable: higher Treasury rates.

TOTAL FEDERAL DEFICITS/SURPLUS AS A PERCENTAGE OF GDP



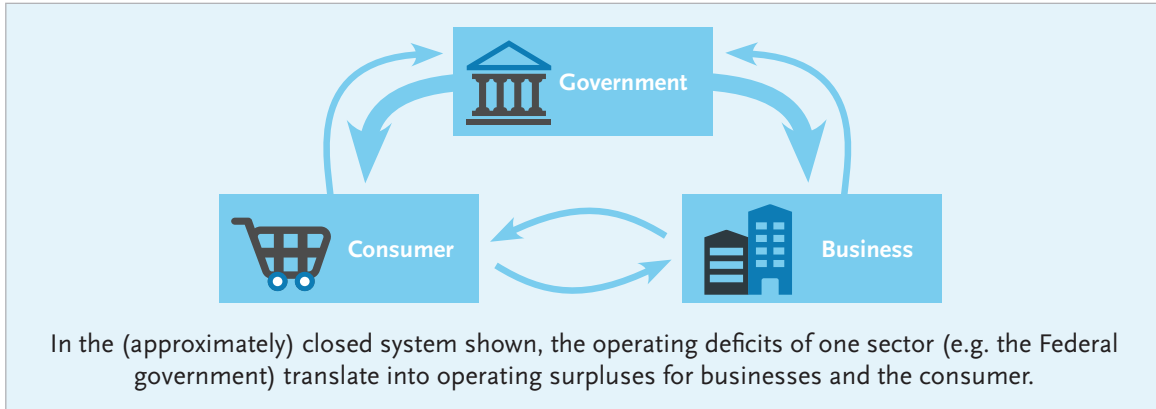


Higher rates have, in turn, made dollar assets look more attractive, promoting a sharp rise in the dollar's exchange value:



So, are markets telling us that with the new year we augur in a new era of prosperity? Or, does the financial baggage carried along from the past six or seven Christmases mean that investors must still navigate an aging credit cycle, fraught with all manner of late-cycle risks? Put differently, is it really feasible for fiscal policy to restart the cycle “anew” given years and years of financial excess?

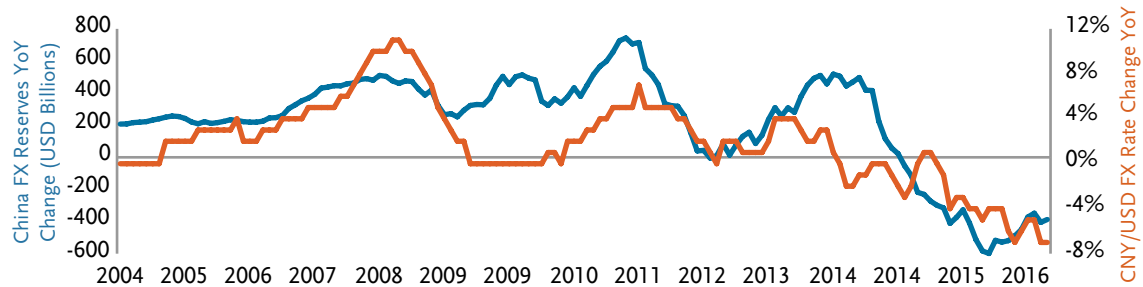
Well before tipping our hand, let's acknowledge that cutting taxes and whittling down the regulatory state should lift productivity and enhance growth – over the long term. “Long-term” in this case likely means well after this current cycle has sung its swan song. But, there will be near-term benefits. If we think of the domestic economy as having three parts, i.e., government, business, and the consumer, then, almost tautologically, the operating “deficits” of one become the combined “surpluses” of the others (see figure on following page). If government goes further into deficit, consumers and businesses see the benefit in the form of higher incomes and profitability. But, these are the most immediate and visible effects of the changing policy regime.



Yet, the lowering of the Federal take from the economy is hardly costless and will have lagged consequences. Furthermore, the lagged consequences of today's pending policy changes have already been at least partially discounted by forward looking markets into higher Treasury rates and a stronger dollar. And, even lagged consequences will, in turn, have their own lagged consequences. Consider:

1. **Higher Treasury rates.** Interest rates powerfully impact asset prices and the general economy. Notably: (1) rising capitalization rates pressure asset prices; (2) the already overgeared U.S. investment grade sector may find itself hard pressed to “maintain rating” as borrowing costs elevate; (3) higher home mortgage rates further stretch home affordability, potentially derailing one of the brighter spots in the U.S. economy; (4) a wider rate differential between the U.S. and Europe and between the U.S. and Japan may exacerbate an on-going flight of capital from overseas, placing upward pressure on euro and yen denominated rates.
2. **Stronger dollar.** The dollar holds a unique position in the global economy, and a rapidly rising dollar exchange rate has historically caused something, somewhere in the global economy to “break.” Those in the EM that have borrowed in dollars face the reality of a liability stream that has become more expensive to repay. Meanwhile, the second largest economy on the planet, China, has informally pegged the yuan to the dollar. A stronger dollar generally means a stronger yuan; a stronger yuan means a less competitive export sector for an economy whose “mother’s milk” is trade.
3. **China economy.** Many believe the China economy to be well managed and with \$3 Trillion in FX reserves, who really wants to argue the point? Yet, large nations have a way of “exporting” their troubles, in the manner that was attributed (in the 1960s) to then U.S. Treasury Secretary John Connally when he quipped that the “dollar was our currency, but your problem.” Suppose China finds that its domestic growth continues to slow. What are its choices? China can “unpeg” the yuan and allow it to depreciate, so as to maintain Chinese export competitiveness. That’s good news for China, but might be a disaster for weaker links in the EM that are unable to adjust to a lower yuan. Or, China might sell-off some of its stockpile of Treasuries so as to finance domestic consumption at a time when its exports are weak. The likely ceteris parabis result would be higher dollar interest rates and, you guessed it, a still stronger dollar. Yep, the yuan is their currency, but it could be your problem.

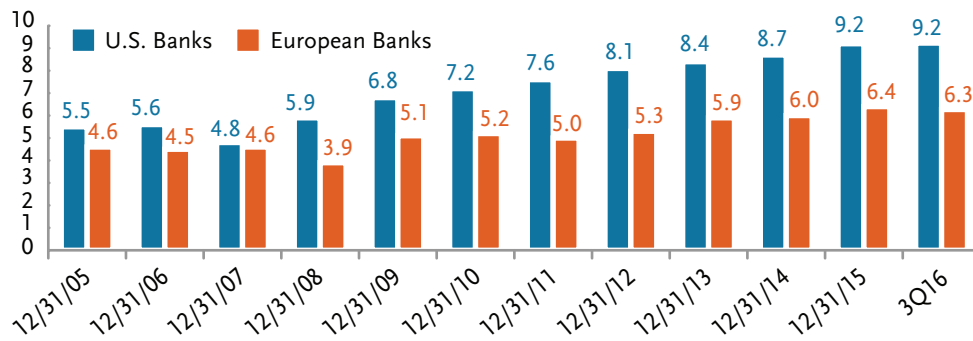
CHINA'S SUPPORT OF THE RMB REFLECTED IN DECLINING FX RESERVE BALANCE



Source: Bloomberg

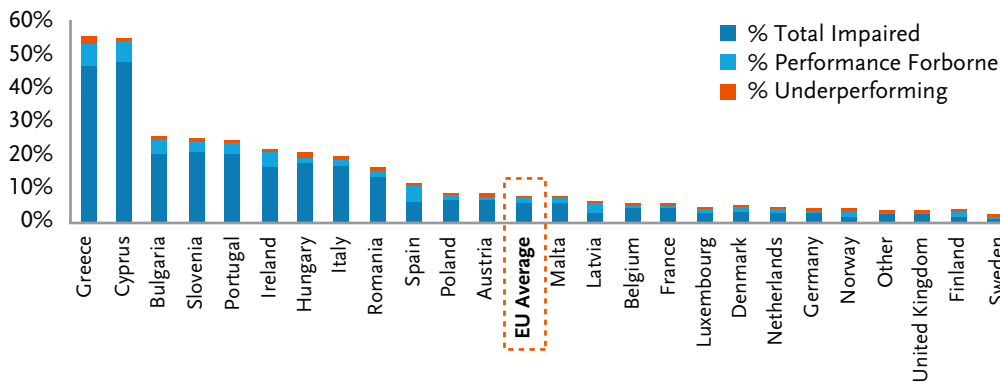
4. **Undercapitalized continental European banks.** Unlike the U.S., Europe barely recapitalized its banks after the 2008 crisis. Worse, with a negative rate environment and a slow growing economy, the European banks are accreting new capital at a snail's pace. Some say that so long as the national governments have the back of the European money center banks that perhaps low capital ratios are irrelevant. Yet, let's not forget that those who are not credit-worthy, don't get credit. Inadequate capital levels raise the specter that European banks remain vulnerable to a "liquidity" crisis when times get tough. And, bereft of U.S. depository gathering facilities, the only way a European bank can get its hands on U.S. dollars is wholesale, likely via the capital markets. The ECB may be a European bank's best friend in a crisis but that might be thin consolation if the bank is shut-out of the capital markets and in desperate need of dollars. And with problem loans running at an EU average of 20%, you don't even have to be a bond guy to foresee trouble ahead.

U.S. VS. EUROPEAN TANGIBLE COMMON EQUITY RATIOS (%)



Source: SNL Financial

TOTAL PROBLEM LOAN RATIO, BY COUNTRY



Source: Deutsche Bank

So, in our estimation the investment climate for risk assets after the election looks a lot like the environment before the election: risky. And while there are many valid reasons to cheer a change in tax policy, saving the U.S. and global economy from its past excesses is not one of them. Stay cautious, my friend. ■

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