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Financial Repression: The Endgame

Presentation for:
LAEDC's Annual Economic Forecast

February 19, 2014

"The one single thought that sustains me is that the fundamentals are good."

Presented by:

Tad Rivelle
Chief Investment Officer–Fixed Income
Group Managing Director

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Three Models of Private Sector De-Leveraging

- **Laissez-Faire Response: Borrower/Lender Share the Losses**
  - Banks (and subprime borrowers) pay
  - But insufficient capital to absorb the losses

(Fall 2008)

- **Statist/Keynesian Response: Government Spending "Artificially" Lifts Incomes**
  - Taxpayer pays
  - Tea Party rebellion (2010)

(2009-2010)

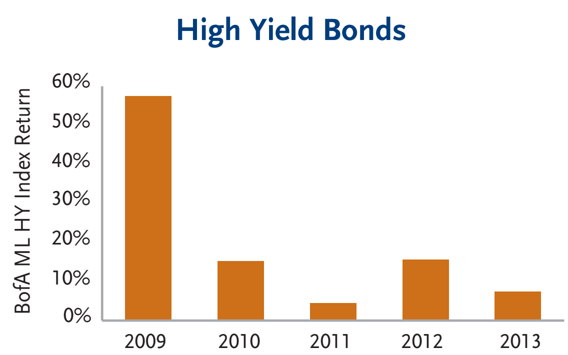
- **Monetary Response: Print Money**
  - Saver pays via negative real rates
  - Depreciated dollars buy less food, gas, but service debt "at par"

(2011 ⟶)

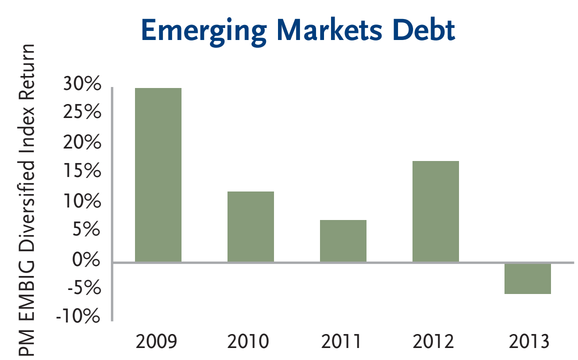
Saver Pay Model: The Essence of Financial Repression

- Saver Pay Model sponsored the "risk on" trade
  - Those without risk appetites lose purchasing power
  - Cumulative real loss for holding cash 2009-2013 approximates 10%
  - Nominal GDP growth policies support speculative asset classes

Source: Bloomberg



Source: BofA ML, Bloomberg



Source: JPM, Bloomberg

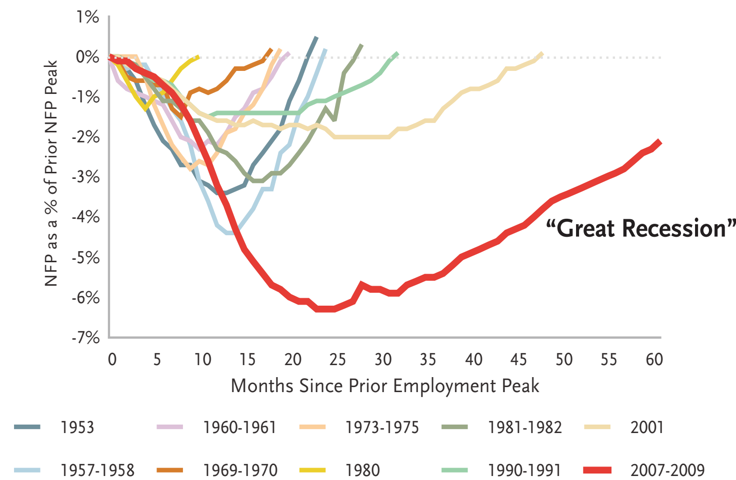
QE3: Launched in September 2012

- Stated purpose: open-ended commitment to fix slack labor markets

  "The Fed will purchase $40 Billion of MBS per month as long as the outlook of the labor market does not improve substantially"

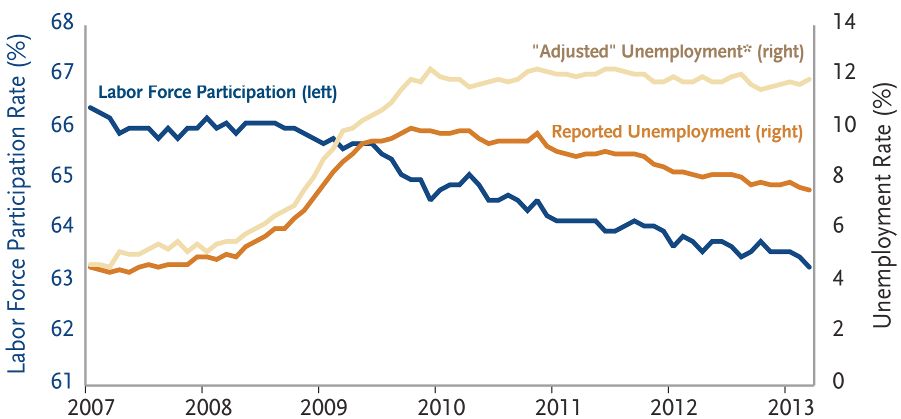
- Essentially, the objective is/was to take a weak recovery and make it strong

Great Recession In Historical Context



Sources: BLS, TCW

Labor Market Stalled



* "Adjusted" rate reflects unemployment level that would prevail if the LFPR stayed at January'07 level of 66.4%.

Source: BLS, TCW

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QE3: An Ease Too Far?

	Announced	Size	Rationale	Result
QE1	2008-2009	$1.725 Trillion	Systemic Risk: – Answer concerns that the Fed "ran out of ammo" when rates hit zero – Address catastrophic collapse in asset values and liquify banking sector	✓
QE2	2010	$600 Billion	– Avoid deflation – Lower real rates at the zero bound	✓
Twist	2011	$667 Billion	Respond to the renewed flare-up of the Euro crisis	✓
QE3	2012	$85 Billion/month	– Remove slack from the labor markets – Take a weak recovery and make it strong	✗

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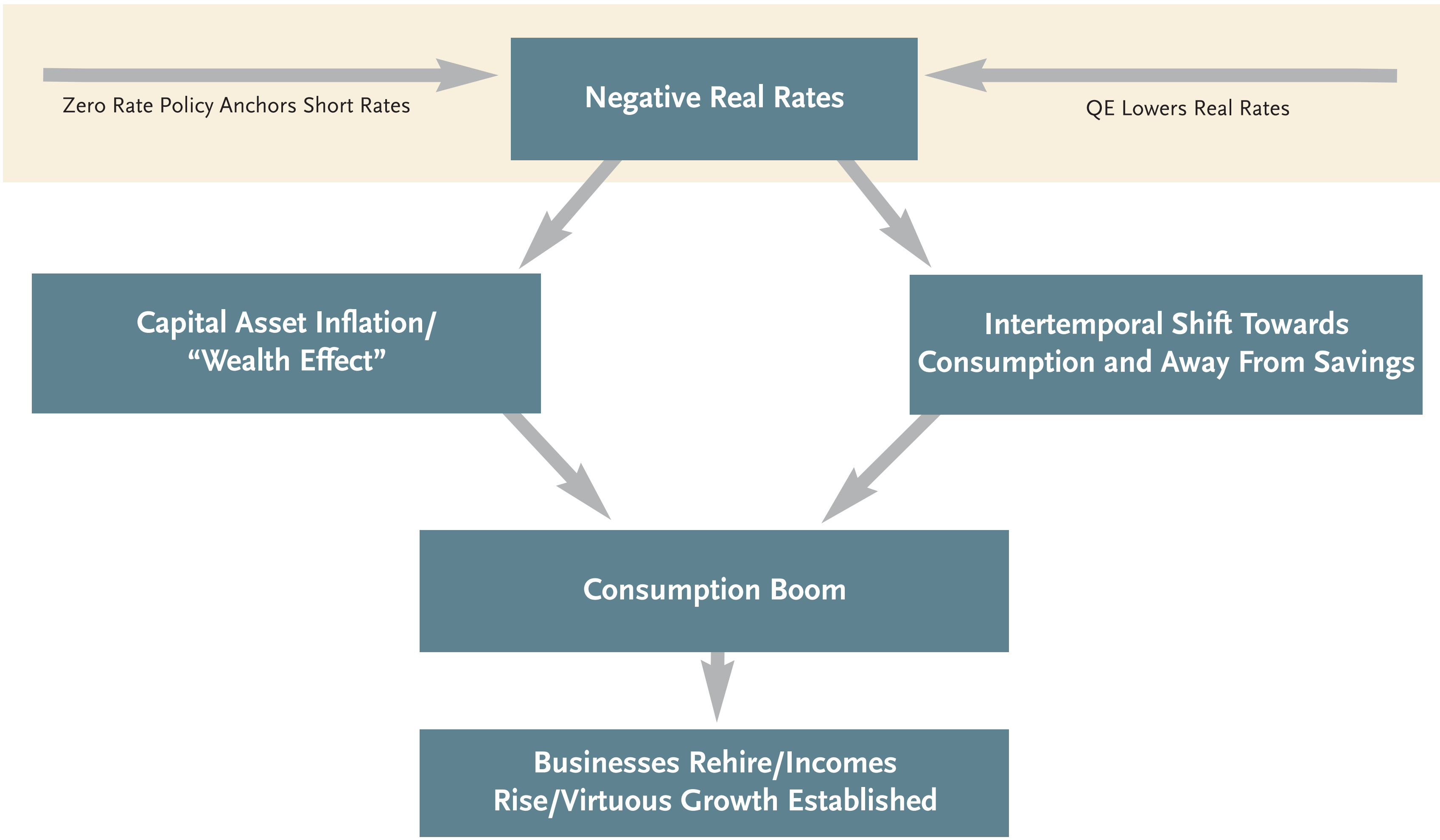
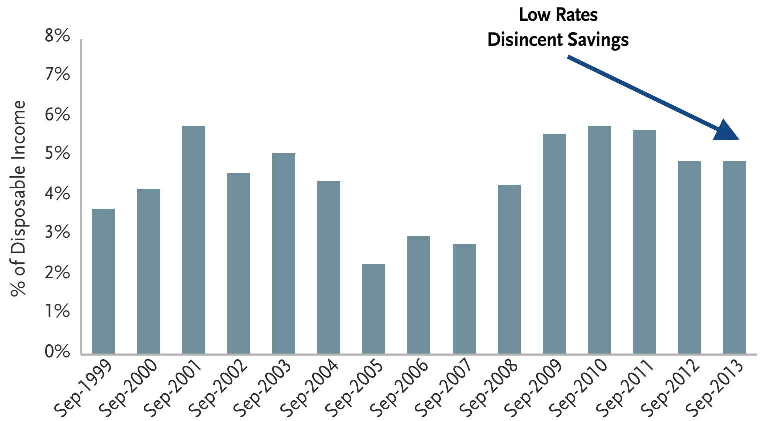
Fed's Theory of the Recovery: Manufacture Aggregate Demand



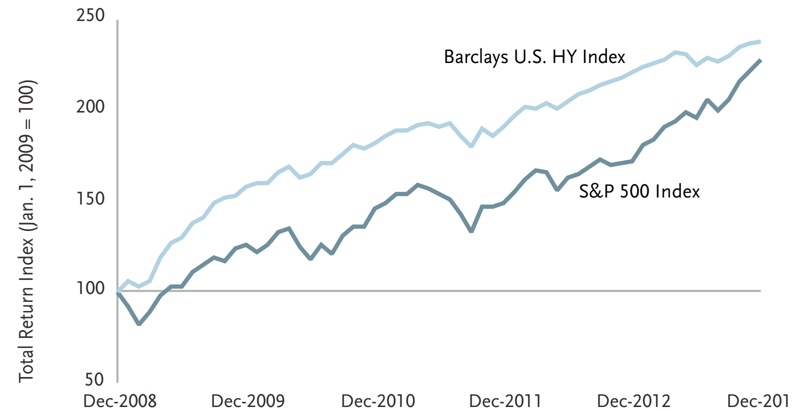
Financial Repression Has Achieved Its Meta-Objectives...

Savings Have Fallen Back to Levels Last Seen During the Housing Bubble...



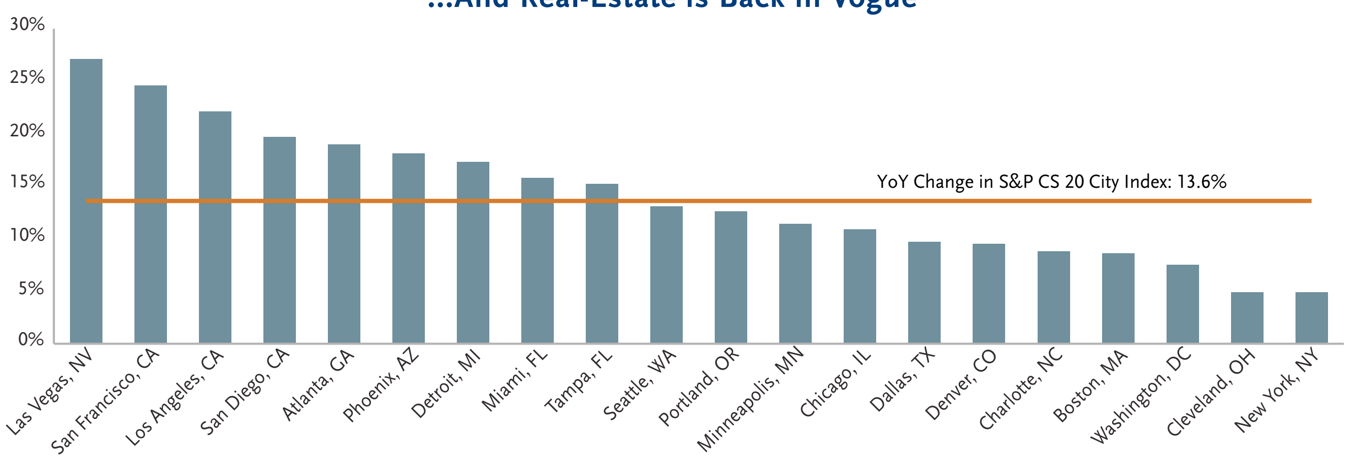
Sources: BEA, Bloomberg

While Financial Asset Prices Are Up Due to "Risk On" Trade



Sources: Bloomberg, Barclays, TCW

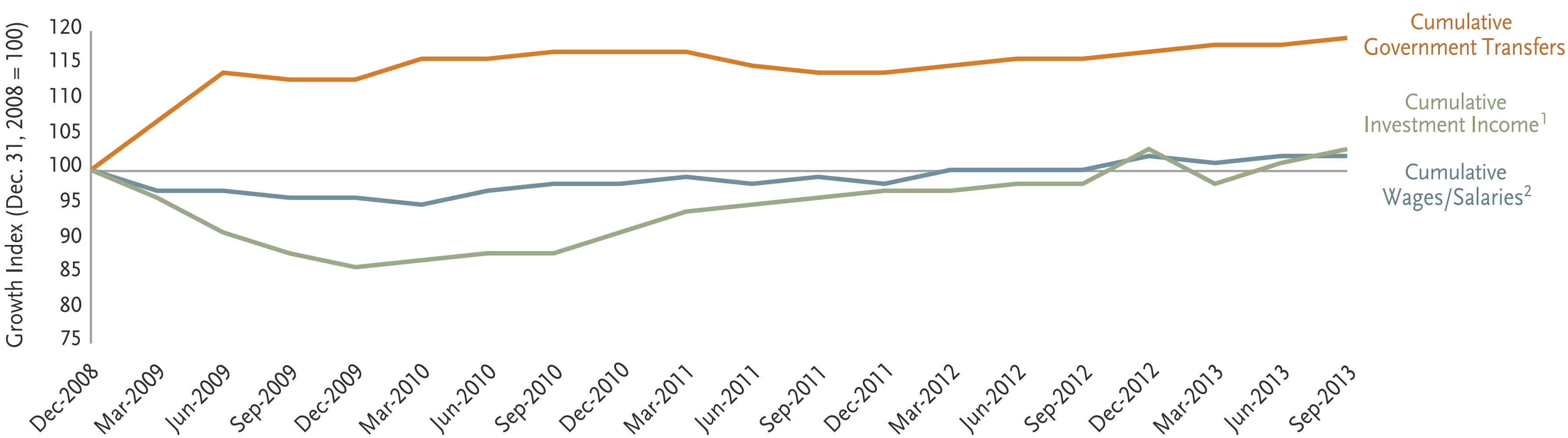
...And Real-Estate is Back in Vogue[1]



Sources: S&P Case Shiller, Bloomberg, TCW
1 As of October 31, 2013

But the So-Called "Wealth Effect" Has Not Boosted Employment-Related Income

Sources of Real Income Growth



	Since 12/31/08	
	Cumulative Real Growth[3]	Annualized Real Growth[3]
GDP	8.7%	1.8%
Employee Compensation	2.4%	0.5%
Government Transfers	19.2%	3.8%

Source: BEA, TCW
1 Includes interest income, dividend income and rental income.
2 Including employer contributions for employee pension and insurance funds and for government social insurance.
3 Data as of September 30, 2013

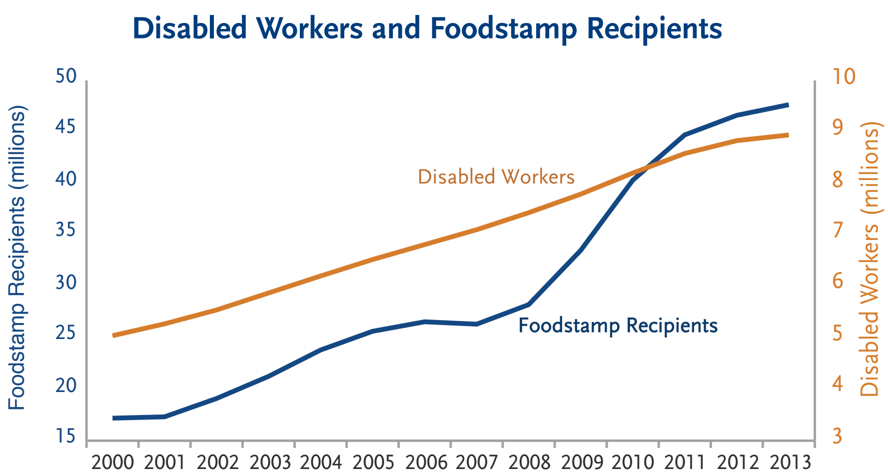
When Is a Wealth Effect Not Effective?
A Rising Real-Estate Tide Lifts All Yachts… But Not Everyone Owns a "Yacht"!

- Owning multiple properties means you are "long" housing
  - Higher prices enrich those who are "long"

- Owning your "one and only" aspirational home means you are flat
  - People are naturally long real-estate

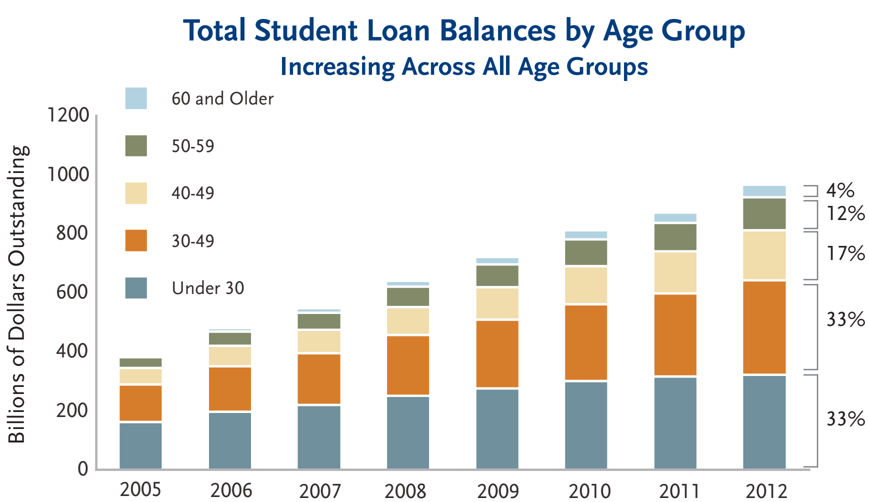
- Renters and those in starter homes are "short"
  - Higher prices impoverish this group
  - Rents rise/starter home prices climb
  - Higher lifetime mortgage/rent payments

Meanwhile, Government Transfer Payments Disincent Growth in the Labor Force



Source: SSA

- Higher disability outlays means more of the older and skilled are incented to leave the labor force



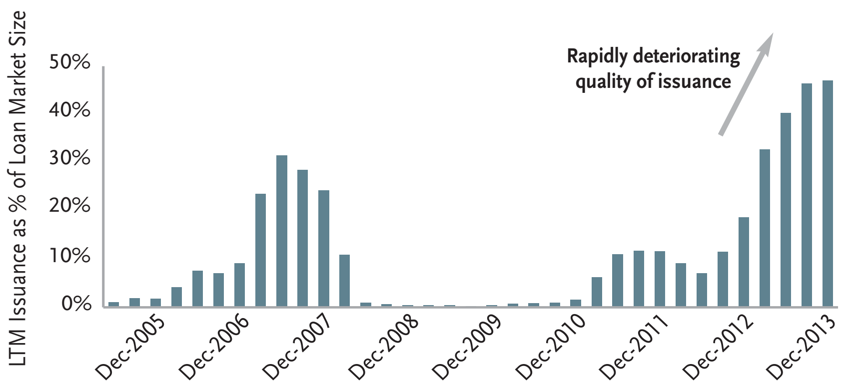
Source: FRBNY Consumer Credit Panel / Equifax, TCW

- More student loans means more of the young and energetic are "warehoused" in school

→ **Fewer workers = less output**

Zero Rates Distort Capital Flows Resulting in Forward Imbalances

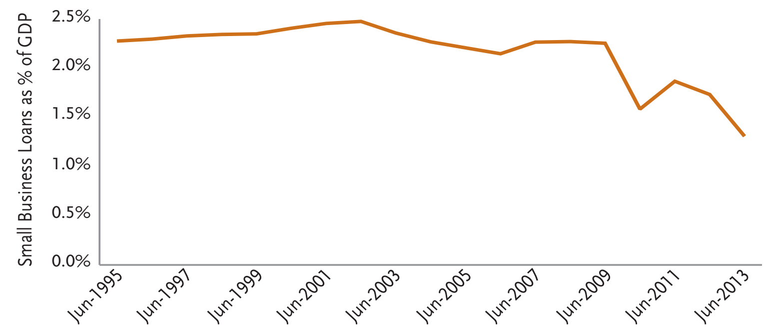
Covenant-Lite Loan Issuance



Source: BofA Merrill Lynch

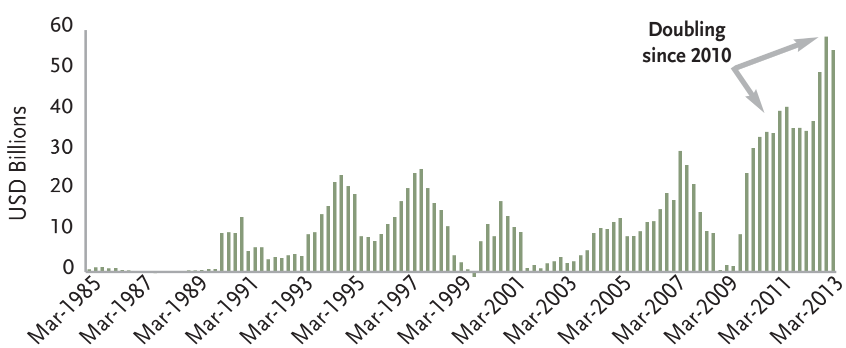
Small Business Loans Continue to Decline

1995 – 2013



Source: SBA, Bloomberg, TCW

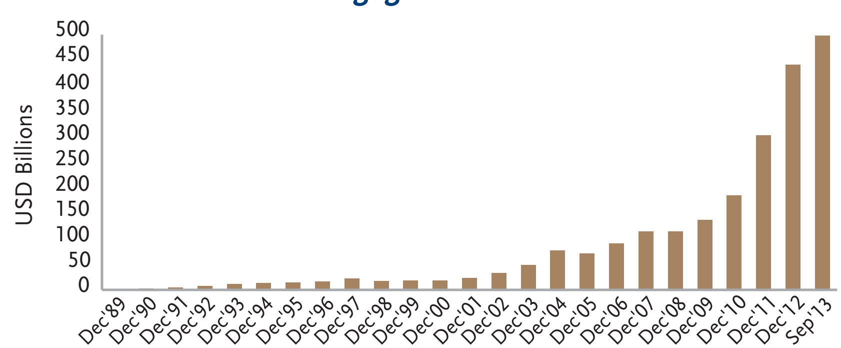
Net EM Credit Issuance*



*Includes sovereign and corporate bonds issued in global markets.

Source: BofA Merrill Lynch

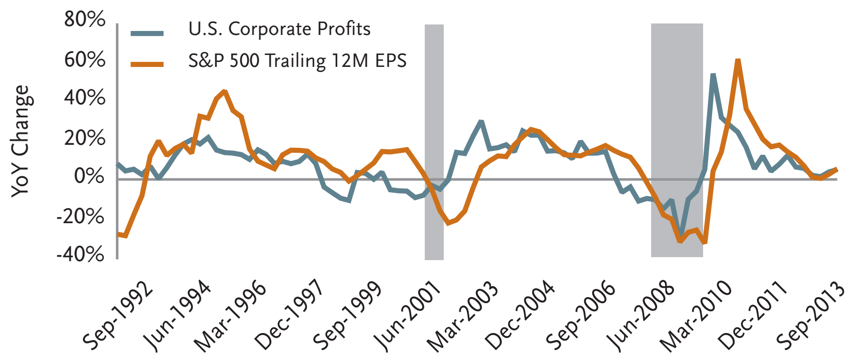
Mortgage REIT Assets



Source: SNL Financial

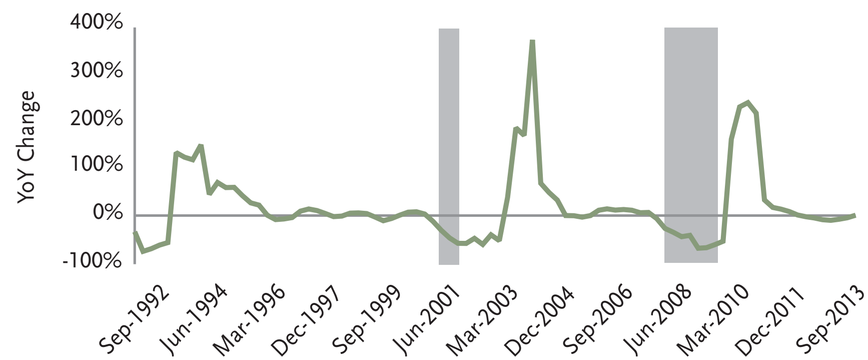
Stocks Up, Profits Flat: Fundamentals Decoupling

Corporate Profits Growth: Stalled



Source: Bloomberg and BEA

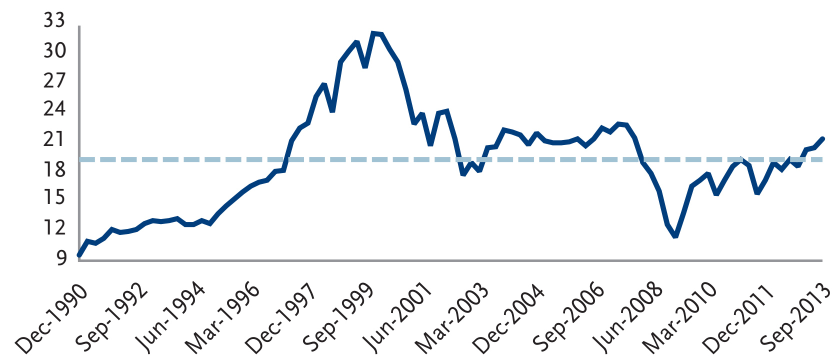
S&P 500 Profit Margins: Flat-Lined



Source: Bloomberg

"I was spreading some risk around, and apparently it all wound up in your portfolio."

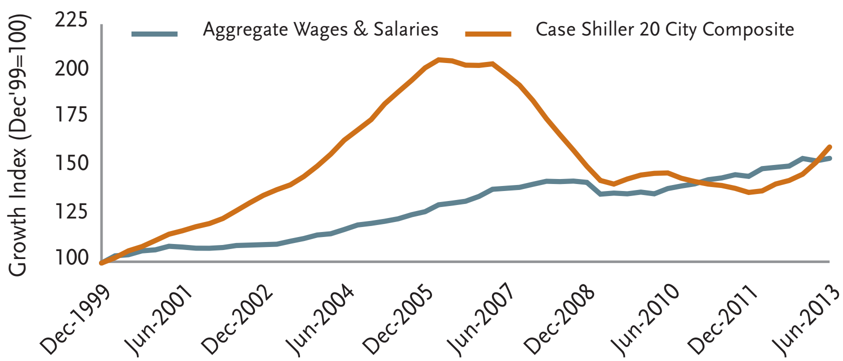
S&P 500 Price/Earnings From Continuing Operations Ratio[1]



1 The multiple captures the ratio of index price to EPS from continuing operations.
Source: Bloomberg, TCW

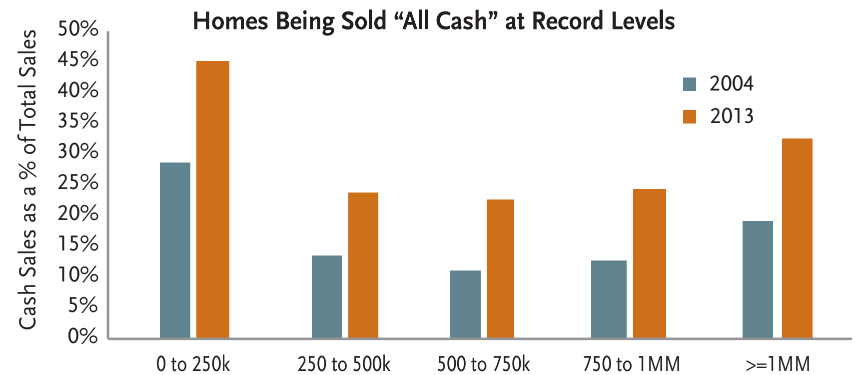
Home Prices Defy Dismal Wage Growth and Depressed Household Formations

Home Prices Decoupling from Wages (again)...



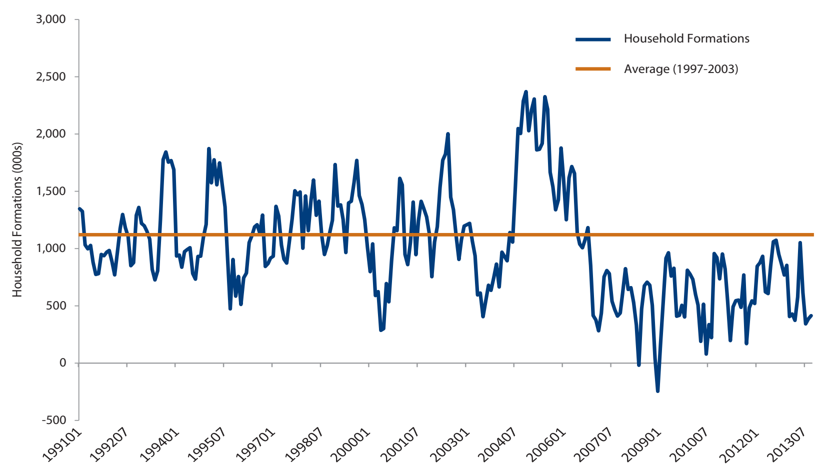
Source: BEA, Bloomberg

...as the Fed's Financial Repression Has Pushed Yield Hungry Investors into Housing Sector



Source: DataQuick, Morgan Stanley Research, TCW

But the Ultimate Driver of Housing Demand, the Rate of Household Formations, Remains Depressed



Source: Census Bureau/Haver Analytics, Morgan Stanley Research

The Fed's Keynesian Response: Not Enough Animal Spirits

- The Fed has assumed its policy prescription conceptually correct, but that a series of unfortunate events have impaired the efficiency of monetary policy

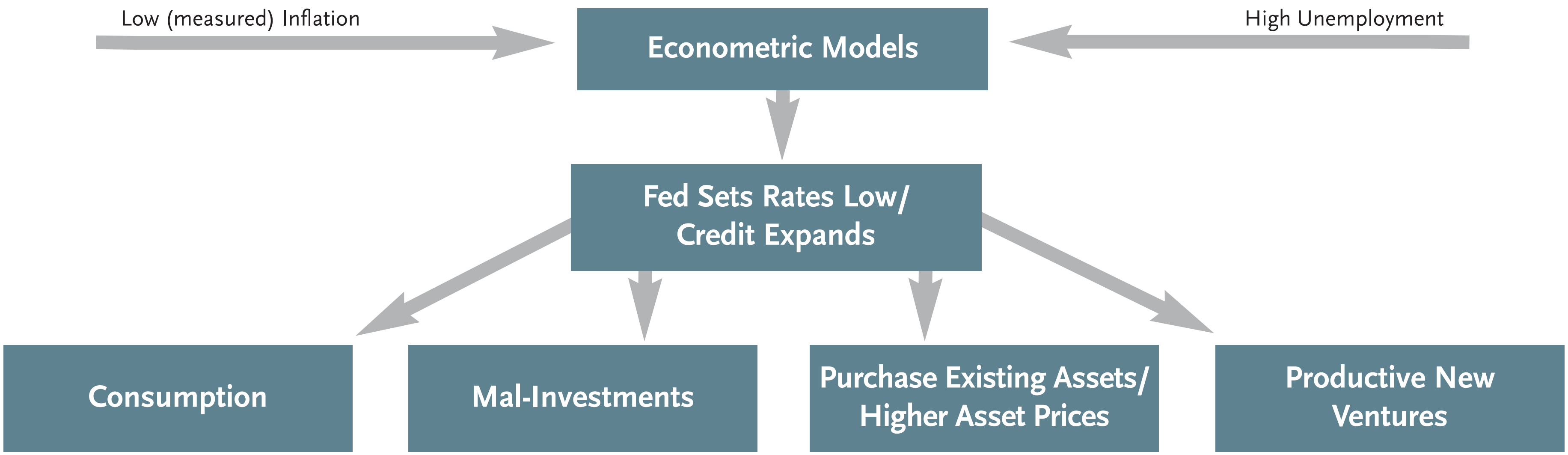
Banking Weakness
(2009-2010)

Eurozone Crisis
(2010-2011)

Japanese Tsunami
(2011)

Housing Malaise
(2009-Present)

Fed Targets the Quantity of Credit Creation–But Not the Quality of Credit Creation



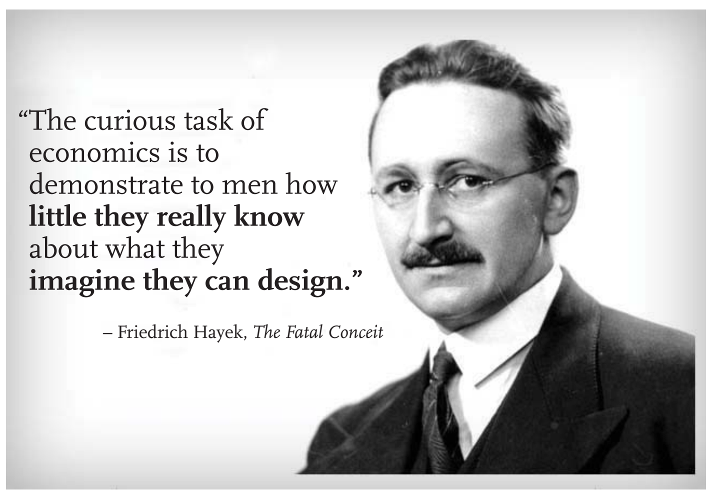
Uses of Credit	Result	Expands Demand	Expands Supply
Consumption	Spend today, repay debt tomorrow	✓	✗
Mal-Investments	Bridges to Nowhere, Bad debt is manufactured	✓	✗
Higher Asset Prices	Distorted asset markets/asset bubbles	?	✗
Productive New Ventures	Wealth/Growth/Job Creation	✓	✓

- Econometric models know history only, they do not grasp the contemporary subjective realities of individuals and businesses
- The Fed cannot control how new credit gets used
  - More consumption, mal-investments, and higher asset prices do NOT a recovery make!
  - In the end, only the launch of productive new ventures results in enduring growth

The Austrian Response: Blame Low Interest Rates

- The Keynesian focus on spending foundationally misapprehends the mechanics of economic growth
  - Installing a swimming pool is spending, but does not create a unit of productive capital
  - Monetary policy works "within the cycle" but cannot in and of itself re-arrange capital and labor resource so as to make them more valuable and more productive
  - Individuals with good information and proper incentives create the jobs and the growth

- Productivity enhancements and output growth are inhibited by an excessively low cost of carry
  - Ordinarily, an inefficient producer will sell his land/factory to a more efficient producer and earn interest with the proceeds
  - Why bother selling a low earning asset if you can only reinvest at zero?



The End of Financial Repression Is Nigh…

Will it be the Thrill of Victory…

Fed's Keynesian approach is proven right

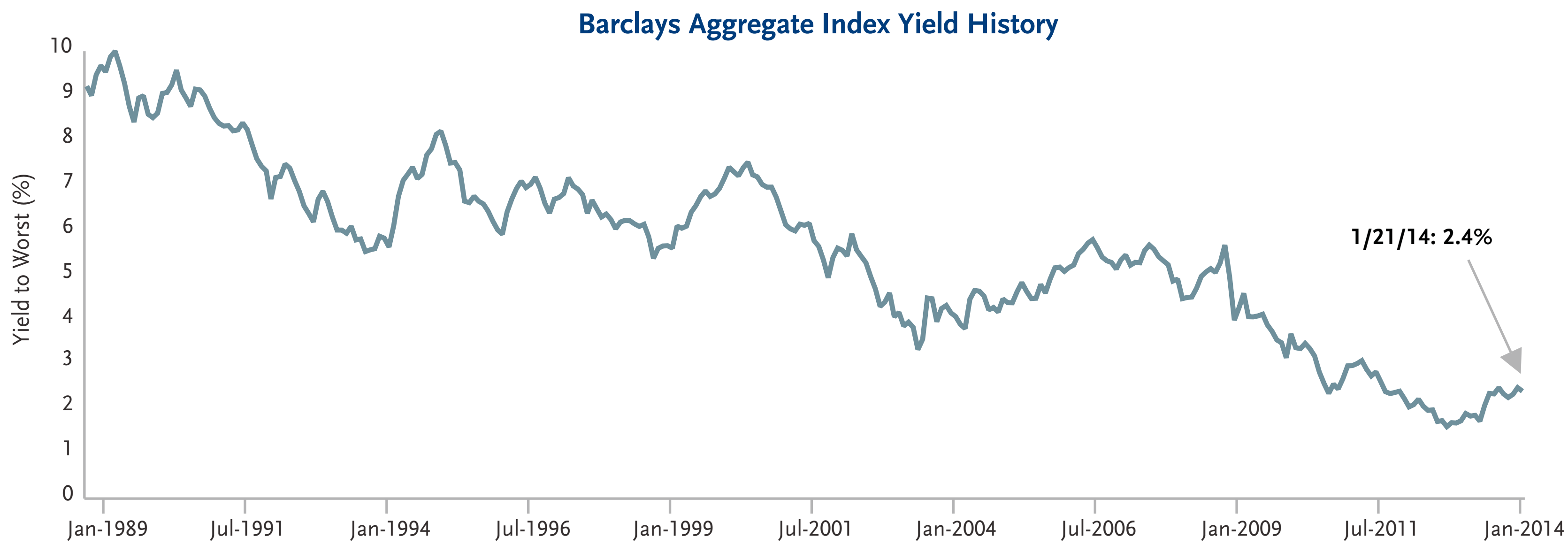
- Rates higher
- Risk premia stay moderate

or the Agony of Defeat?

Centrally guided/directed credit pricing fails to lift demand for labor

- Rates higher
- Risk premia "blow out"

The Opportunity in Fixed Income: Or Lack Thereof!



Source: Barclays

	Total Return (annualized) 1 Year	3 Year	5 Year	"All-in" Yield
U.S. Treasury	-2.5%	2.1%	4.0%	**1.4%**
Agency MBS	-1.2%	2.7%	4.7%	**2.9%**
IG Corporates	-1.3%	4.4%	9.0%	**3.4%**
HY Bonds	7.1%	8.9%	13.3%	**6.5%**
Leveraged Loans	5.7%	6.0%	4.5%	**5.0%**
Non-Agency MBS	12.8%	12.3%	7.0%	**5.7%**
CMBS	0.9%	5.7%	9.0%	**2.4%**
EM Sovereign	-4.1%	4.9%	9.7%	**5.9%**
EM Corporates	0.3%	4.7%	9.7%	**5.8%**

Data as of September 30, 2013

Bond Market Opportunities Are Tiered

Tier	Sectors	Theme	Yield	Duration (years)	Exigent Question
1	Treasuries Agency MBS	"Riskless"	1.4%[1] 2.9%[2]	5.7[1] 5.2[2]	When does financial repression end?
2	Corporate Bonds High Yield Leveraged Loans	Equity-Linked	3.4%[3] 6.5%[4] 5.0%[5]	6.6[3] 4.4[4] N/A	How does financial repression end?
3	Non-Agency MBS	Housing-Linked	5.7%[6]	4.7	Whither housing/inflation?
4	EM Sovereign EM Corporates	EM Fundamentals Driven	5.9%[7] 5.8%[8]	6.8[7] 5.1[8]	Will strengthening fundamentals keep EM insulated from U.S.?

1 BofA Merrill Lynch US Treasury Index
2 BofA Merrill Lynch US MBS Index
3 BofA Merrill Lynch US Corporate Index
4 BofA Merrill Lynch US High Yield Index
5 Credit Suisse Leveraged Loan Index
6 BofA Merrill Lynch estimate for Alt-A Hybrid WAC RMBS
7 JPM EMBI Global Diversified Index
8 JPM CEMBI Broad Diversified Index

Data as of September 30, 2013

Biography

Tad Rivelle
Chief Investment Officer–Fixed Income
Group Managing Director

Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing $85 Billion in fixed income assets, including nearly $50 Billion of 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 which he cofounded. Tad heads a fixed income team that has been nominated for Morningstar's Fixed Income Manager of the Year seven times over a 12-year period and won the award in 2005. Mr. Rivelle was also the co-director of fixed income at Hotchkis and Wiley and a portfolio manager and vice president at PIMCO. Tad holds a bachelor's degree in physics from Yale University, a master's degree in applied mathematics from University of Southern California, and an MBA from UCLA Anderson.

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