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INSIGHT

TRADING SECRETS

One Rate to Rule Them All

TAD RIVELLE | APRIL 2015

Rather than listen to what prices are saying, central banks prefer to talk. Asset prices are told to levitate, interest rates are commanded to kowtow, and product markets are told to walk faster. The happy result of all this orchestration is supposed to be steady growth and a stable financial system. However, the precision with which central banks direct the clouds is very much at odds with the tumult of market realities. Prices are continually ebbing and flowing as preferences shift, as capacity and demand seek to balance one another, and as new information is injected into the marketplace. Even were an august body of central bankers able to determine the "right" level for stocks, bonds, real-estate, and inflation, the answers would be wrong the moment after they had been right. In other times and places, central planners tied themselves up in knots calculating production schedules and setting prices that could have been readily revealed by a functioning market. Central planning proved to be an utter failure not because the planners weren't smart, but because no one is smart enough to know what is or will become the mutating matrix of desires that reside within the heads of millions of consumers, savers, borrowers, and investors. Monetary policy is predicated on counting everything that can be counted while ignoring the individual preferences that really count. Prices established through the normal course "negotiation" of buyers and sellers reflect real preferences; any other price is an artifice. Investors who are basing their retirement expectations on the supposed omniscience of central bankers may want to think again.

Case in point Europe. Hoping to stimulate something, the European Cental Bank (ECB) has driven some 2.6 Trillion euros worth of sovereign debt into negative yields. These negative yields have slammed the euro, effectively cutting the global price and wage of everything and everybody in the Eurozone (EZ). So, the ECB "gets" the fact that wages and prices in the EZ are uncompetitive. But rather than grounding its policies in reality, the ECB has used QE to contrive a fantastical rate structure. Were markets allowed to operate freely, the result would be that EZ prices and wages would adjust lower in search of proper market clearing

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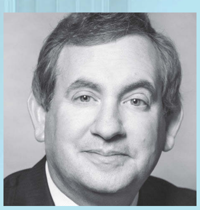

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Tad Rivelle is Chief Investment Officer, Fixed Income, overseeing over $130 billion in U.S. fixed income assets, including over $80 billion of U.S. fixed income mutual fund assets under the TCW Fund and MetWest Fund brands. Prior to joining TCW, Tad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

levels. Rather than accept that sometimes prices need to go down as well as up, the ECB uses QE to arrest necessary market price adjustments. Why? Because the ECB, like their brethren central bankers elsewhere refuse to hear the markets and further equate deflation with economic annihilation. But, economic growth and deflation have gone hand-in-hand before (e.g., in the U.S. in the mid-1950s) and, more to the point, the "theory" that says consumers will just stop buying when prices fall is belied by the everyday experience of computers, smartphones, airline travel, and gasoline. Deflation is a price signal telling us that there is an excess of capacity over demand. Sure, demand can be temporarily boosted by fiddling with interest rates; but sooner or later rates have to return to market levels. So the ECB is left with a choice: let prices and wages fall to levels commensurate with the productivity of the European worker or indefinitely enable the excess capacity problem the market is trying to fix.

Where did central banks get the notion that artificial interest rates can cure fundamental economic maladies? If the productivity of a workforce cannot validate a wage rate, no amount of cheap credit is going to alter that reality. Europe is 19 countries, one low rate, and yet Germany and Austria sit pretty with unemployment at 5-6% while Spain and Greece wallow in a depressionary milieu. To argue that the ECB should go on falsifying rates fearing that deflation would make matters "worse" in peripheral Europe, begs the question: how much worse might it get? More to the point, if growth were a function of policy rates, how could unemployment levels be so radically different within the same monetary zone? Yet, Germany's relative prosperity is no mystery: Germany's constellation of labor and capital is competitive in a way that Greece's are not. Hence, German factories service their "fair share" of global aggregate demand while factories in Greece and Spain languish. Central bankers can go on "manufacturing" aggregate demand, but the simple truth is that demand will be satisfied by the efficient producer, not the uncompetitive supplier.

Many draw a distinction between the dysfunctions of Europe with the hope and promise of central banking in the New World. Yet, market principles work precisely because they reflect universal human realities. When the trumpets blew for QE and zero rates at the Fed, the supporters of such policies called for a "recovery summer" in 2010, an "exit strategy" in 2011, a 6.5% unemployment "trigger" in 2012, a "taper" in 2013, and maybe, just maybe a rate hike in 2015. The Fed has become a study in cognitive dissonance. On the one hand, the Fed tells us that its policies are working. On the other hand, the Fed frets that after six years and trillions in balance sheet expansion, the policies aren't working well enough to get off the zero bound.

But aren't lower rates better than higher, you say? Aren't they "stimulative" and lead to better outcomes? In effect, doesn't the Fed know better than the market how much and at what price credit should flow? Such foundational misunderstandings conflate the loanable funds market (which the Fed controls) with the market for real capital resources (which marches to the beat of a market drummer). Interest rates – like all prices – are not arbitrary constructs. Prices that are either too high or too low, by definition, lead to suboptimal outcomes. The Fed's control over loanable funds does not re-arrange economic reality. The elasticity of actual resources such as skilled labor, patents, concrete, electricity, etc. is far lower than the elasticity of electronic excess reserves created by the Fed. Resources do not simply expand because there are more claims on those resources! And, to use a scarce resource one way is to preclude its use in another way. This means that there are real opportunity costs associated with all activities. Pretending that scarce resources are free for the taking only means that the "rationing" of those resources ceases to be based upon market precepts. Rather, allocation preferentially shifts to those sectors (e.g., housing) that Fed policies favor. And, distorting resource allocation hampers growth even as it encourages a bull market in malinvestments.

While we may all hope that this global experiment in extreme central banking will end well, hope has never been a great predicate for an investment. The consequences of central bankers using their One rate of Power to control Planet Earth's growth and inflation may prove as rueful as that One ring did in Middle-Earth. ■