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INSIGHT

VIEWPOINT

More Is Better

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Mr. Cudzil is head of U.S. Credit Trading, overseeing the U.S. Fixed Income group's trading of corporate and high-yield securities and derivatives. Prior to joining TCW in 2012, Mr. Cudzil was a high yield bond trader for Morgan Stanley and Deutsche Bank, specializing in project finance, aviation, and energy securities. He was previously a portfolio manager for Dimaio Ahmad Capital, managing the multi-strategy credit fund and aviation fund and leading the firm's risk management team. Mr. Cudzil began his career as a corporate bond trader for Prudential Securities and has also traded investment grade and high yield debt for Credit Suisse and Goldman Sachs. Mr. Cudzil earned a BA in Economics from the University of Pennsylvania.

It is clear that central banks globally know only one path forward: more is better than less. More stimulus is better than less stimulus. More money is better than less money. Draghi met expectations on Thursday and communicated that the European Central Bank (ECB) will be as aggressive as they need to stimulate the Eurozone. He took deposit rates into negative territory and announced he will now be buying corporate bonds. And, if that doesn't work, don't worry because the ECB will keep a watchful-eye on the data and remain open to doing more; whatever it takes! It's like that old central-banker-saying goes: nothing in moderation. Less than one week later, the Chair of the Board of Governors of the Federal Reserve, Janet Yellen, presents her own unexpectedly dovish communication to the markets. Chair Yellen acknowledged the stresses in the financial markets and risks to the downside in the global economy. Well, if expanding the balance sheet as lender of last resort worked in times of crisis well then expanding the balance sheet to buy even more assets once prices are beyond distorted must be even better, right? That'll rekindle those animal spirits! Take deposit rates negative and communicate to the world that they should expect asset prices to decline in the medium term; that will really stimulate the entrepreneurial spirit.

How is an investor to proceed? We have all heard the mantra in the past, "Don't fight the Fed." Well, now one would be fighting the Fed, the Bank of Japan (BOJ) and the ECB. All of that accommodation is difficult if not impossible to ignore. One has to respect the ability of central banks to manipulate, I mean stimulate, the markets. One has to respect the fact that the ECB will be buying corporates. One has to respect the fact that a growing percent of global government bonds are yielding less than zero. All of this should support continued credit creation and subsequently be supportive of risk assets, right? As a matter of fact, in the most recent weeks, there is a growing chorus of folks that are talking about the opportunities in U.S. credit (both IG and HY) and EM credit. Supportive central banks + wider credit spreads = buy credit. What can go wrong?

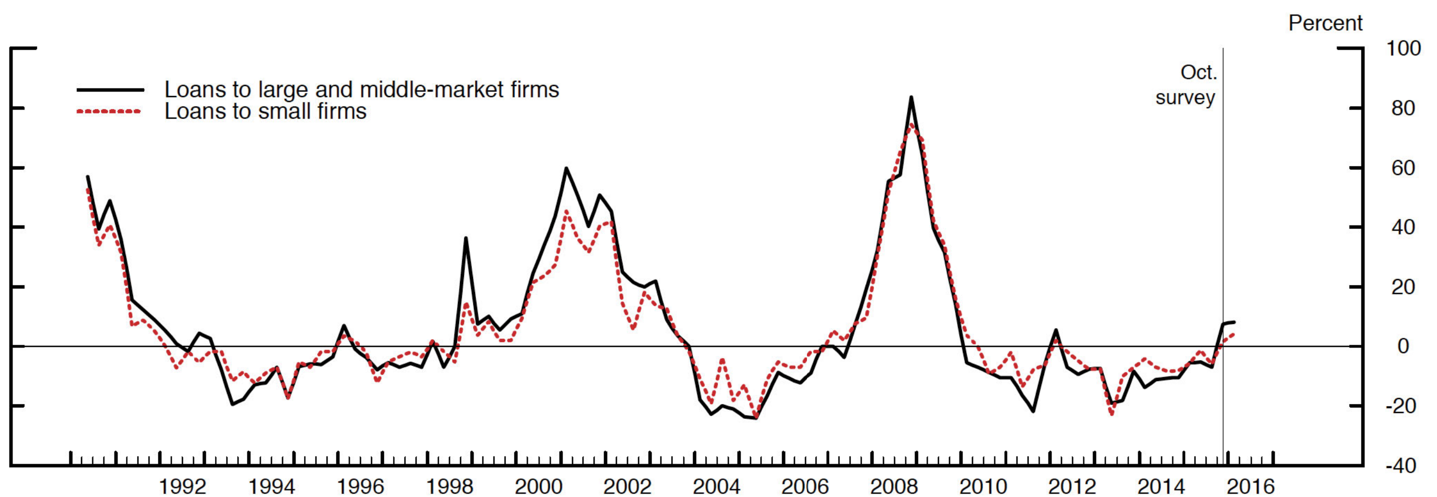
The bull case has been made: there are not a lot of places to turn to get positive yield in the world, corporate fundamentals are fairly supportive, domestic economic fundamentals are supportive, market technicals are supportive and spreads are attractive. All of these points have some validity. The U.S. economy is projected to grow at about 2% this year. The U.S. has created a significant amount of jobs and we have seen a marked decrease in unemployment. We have removed significant slack from the labor market and that should lead to wage inflation at some point. Corporate fundamentals have deteriorated with leverage rising but cash balances and interest

coverage ratios remain healthy and leverage is not alarmingly high. There is hardly any arguing that the corporate market has widened significantly over the past 9 months and hence offer more value. Wider spreads mean a more attractive entry point than tighter spreads. And certainly one can argue that the market is in solid technical shape with recent sizeable inflows supporting that thesis. The markets have spoken. Since February 11 the markets have roared higher: the high yield index has produced a solid annual return of ~7% over the past month. The investment grade U.S. credit index is ~45bps tighter and the S&P is higher by ~12%. And these moves mask some of the underlying sector performance with some of the most beaten down cyclical sectors turning in spectacular performances of over 25% returns! And coincidentally there is a growing chorus of investors sending the all-clear. Well, it wasn't more than 6 weeks ago when the high yield index was down almost 5% on the year and the investment grade credit index was over 40bps wider on a year-to-date basis as well. So, the key question remains the same: was that widening the opportunity to buy credit before the remediation or is this tightening an opportunity to de-risk ahead of a deleveraging?

As always, the question is a simple one: are we being appropriately compensated to take the risk? We think the simple answer is no. TCW is of the opinion that we are approaching the end of the credit cycle and the deleveraging is still yet to come. Was the recent risk spasm and associated spread widening not enough to create the buying opportunity? Was that not enough to pull in the opportunistic investor and bring new capital to the marketplace? Why do we remain convinced that the market is due to experience more volatility and further weakness?

Firstly, we think the capital markets cycle drives the business cycle. Credit availability to lower quality borrowers leads to the creation of excess credit and ultimately increased loan losses. Secondly, these loan losses will cause banks to begin to increase the cost of capital to all borrowers. These tightening lending standards will drive an increase in defaults across the market.

Net Percentage of Domestic Respondents Tightening Standards for Commercial and Industrial Loans



Source: Federal Reserve Senior Loan Officer Survey

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Thirdly, we do not think this commodity-related weakness and subsequent increase in default rates will remain contained to the commodity and energy sectors. We think the second and third order effects of capital expenditure cuts, job losses and increased costs of capital will result in tighter lending standards. Ultimately, more debt is not the answer to a market with too much debt. The market now must move toward deleveraging and this will ultimately lead to tighter lending standards, increased defaults and wider spreads. Maybe there can be too much of a good thing after all. ■

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