



Gundlach Says Market is “Too Bearish”

By Robert Huebscher

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In an unforgettable scene from the 1976 movie *Network*, the character Howard Beale (played by Peter Finch) exclaims, in an impassioned diatribe, that he is “not going to take this any more!” Jeffrey Gundlach, Chief Investment Officer of the TCW Group, says bearish investors have reached the same breaking point.

Gundlach delivered his remarks in a conference call with investors on March 18.

“People were just too bearish – not on the ultimate outcome, but on the near-term direction of the market,” he said as he explained the reasons behind the markets’ 19% rally since March 9, when he chose the title of his presentation, “You’re Too Bearish.”

Gundlach characterizes the underlying fundamentals in the equity markets as “terrible.” Still, despite the “maximum possible uncertainty” about government programs, monetization, and the level of government borrowing, he says equities could finish the year unchanged from their January 1 level.

Towards the end of the call, Gundlach voiced a bit more optimism. “It would not surprise me at all to see the S&P go to 950 or 1,000,” he said, perhaps believing that market bears – unlike Beale in the movie – will ultimately overcome their pessimism.

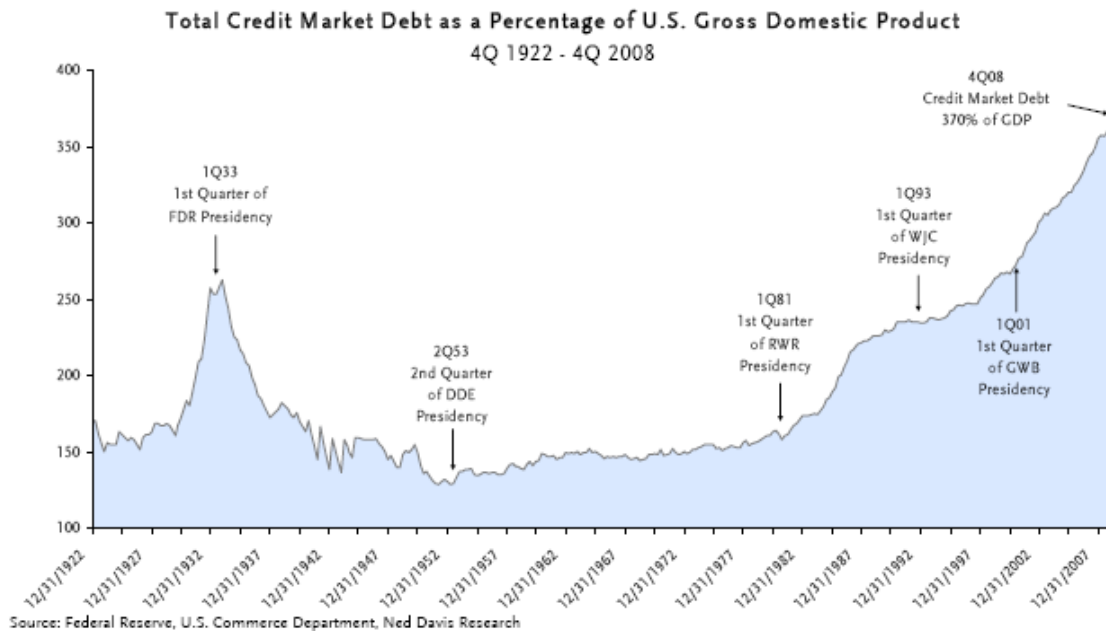
Movie buffs may recall that *Network* ends with Beale being shot to death on air, presumably because of bad ratings.

Overall Market Conditions

The underlying force moving the capital markets is “The Great Leveraging,” illustrated below by the build-up of credit market debt as a percentage of GDP.

The Great Leveraging

- This huge leverage build-up is 30 years in the making
 - Dating back to the days of Ronald Reagan
- The last major increase in leverage occurred as GDP fell during the Great Depression

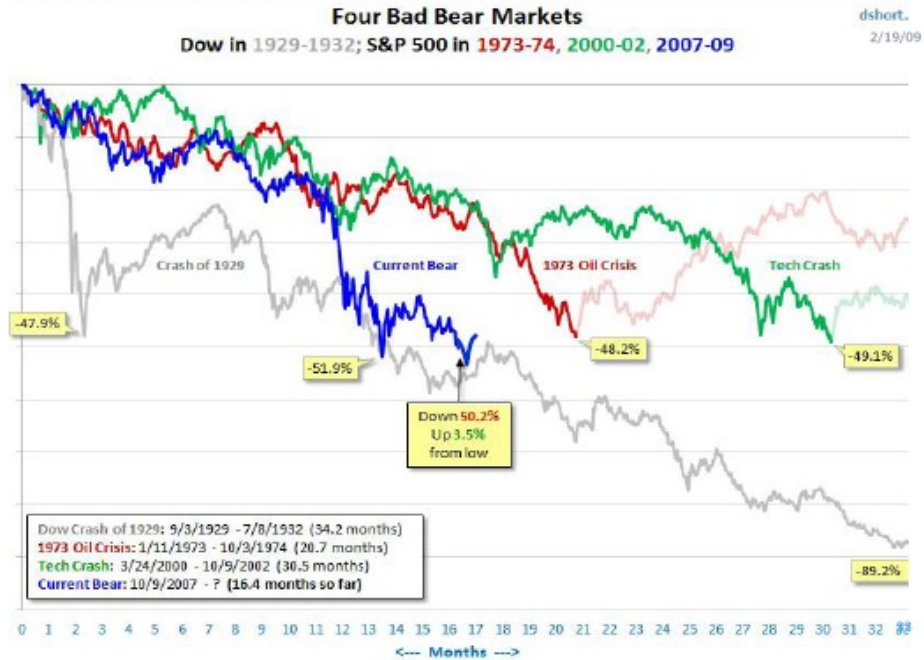


Despite ongoing deleveraging, overall debt as a percentage of GDP continues to rise, because GDP is declining. Gundlach expects this trend to continue until inflation takes hold.

Equity market declines now equal those in the 1973-4 and Dot Com crashes, and the decline is on pace to equal the losses absorbed during the Great Depression.

Previous Bear Markets

- Looking at past recessionary periods, this recession is seventeen months into a twenty-eight month average
- As of March 17, 2009, the S&P 500 was down -50.3%

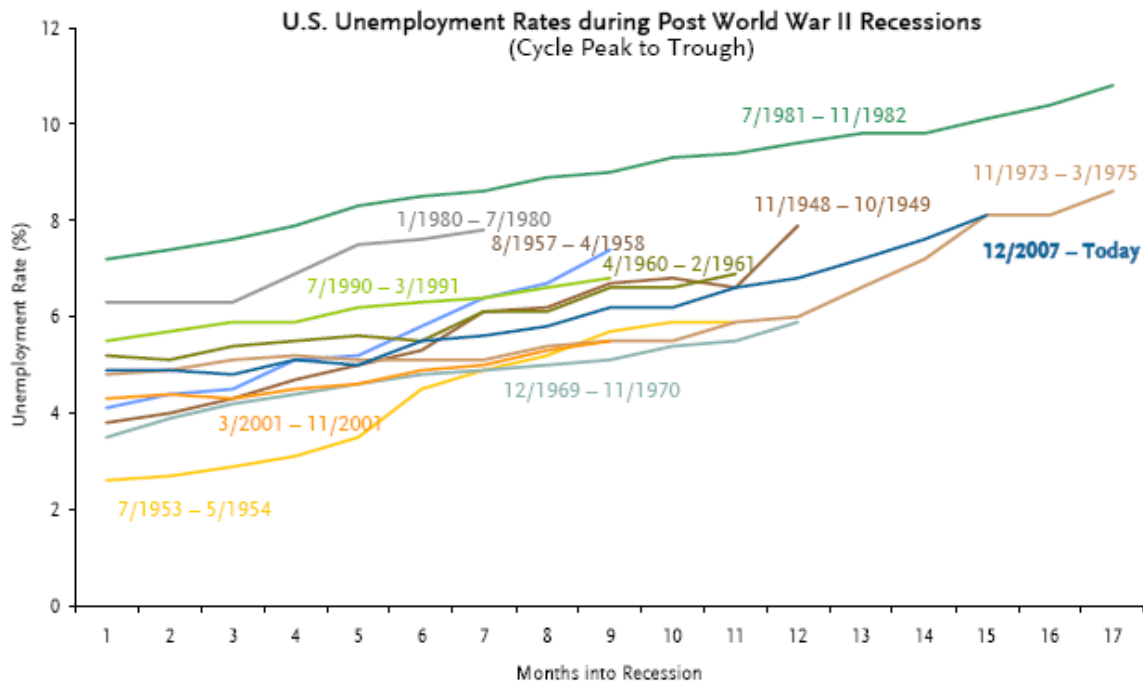


Source: Bianco Research, L.L.C., dshort.com, February 19, 2009. TCW Research updated through 3/17/09.

Gundlach issued a warning to those who short the market, particularly through credit default swap (CDS) positions. Another market decline, he said, could be accompanied by a blowup in the CDS market and short investors – even if they are right about the market direction – will suffer because their CDS counterparty may not be there to pay them.

Unemployment data for the current recession is “unremarkable,” according to Gundlach – completely normal in the context of previous recessions. The chart below shows job losses in the current recession on a path well within the bounds of other post-World War II recessions.

Job Losses In Past Recessions



Source: U.S. Bureau of Labor Statistics, National Bureau of Economic Research

Gundlach forecast higher movement in the value of the dollar, primarily because “de-leveraging is a short position on the dollar.” Along these lines, he expects continued deflation as his “base case” and noted that both the dollar and commodities indices are at the same levels as five years ago.

Fixed income markets

Addressing the fixed income markets, Gundlach offered these comments:

- Investment grade corporate bonds remain at record spreads of 600 basis points and “will continue to widen this year,” he said. “Not much good will happen here, despite the consensus.”
- Investors should avoid floating-rate asset-backed securities, even though their spreads are also at record levels. “The cash flow from these securities is unacceptable,” he said.
- The commercial mortgage-backed securities (CMBS) market remains priced to “better-than-likely outcomes. Defaults will lead to writedowns



and balloons will be extended,” he said. Fixed rate obligations are okay, but investors should avoid floating rate bonds.

- The high yield corporate market has rallied recently but remains exposed to defaults. “Look for wider spreads,” he said.
- Unlike the above sectors, the mortgage market is not priced at record spreads. Spreads are at a level equal to their average over the last two decades. Treasury purchases of mortgages, including the one announced the morning of the call, are the reason. “This is the democratic way to let everyone refinance their homes and to expand existing programs,” Gundlach said, adding that the Treasury actions were very good for the mortgage market. Prepayment rates are up in the agency and non-agency markets and the government will “keep the flame going for refinancing,” he said.

On the broader question of whether government programs, such as the just-announced plan to purchase an additional \$1 trillion of Treasury and agency debt, will succeed, Gundlach said that the government cannot “make the problem go away by papering it with more money. They can change the form of the problem – that is, usher in inflation.”

Bad fundamentals continue to characterize the non-agency mortgage market. “There is no end in sight for sub-prime delinquencies,” Gundlach said. Approximately 40% of all securitized sub-prime mortgages are now delinquent, compared to 10-15% two years ago. Alt-A delinquency rates are approximately half of those in the sub-prime market.

The supply of non-agency mortgages is rapidly diminishing, as forced sellers – mostly foreigners and funds facing redemptions – liquidate their portfolios. Gundlach likened this to “taking a pitch fork and throwing money into the incinerator,” since prices in this market offer attractive opportunities.

In the prime mortgage market, approximately 4% of securitized loans are delinquent. This sector is particularly sensitive to unemployment, Gundlach noted. He forecasts that this rate will go to double digits.

Sub-prime loss severities (the recovery rate for homes that are sold out of foreclosure) have risen from approximately 30% in mid-2007 to the current rate of 63%. “This will continue to rise,” Gundlach said.

Gundlach said the bankruptcy “cramdown” issue, wherein bankruptcy courts may be allowed to restructure the terms of homeowners’ mortgages, will not affect



investors. Only 5% of defaults go through bankruptcy, he said. Given the slow pace of bankruptcy proceedings, it is highly unlikely that significant portions of investments would be affected. "It might create an incentive to declare bankruptcy," he said, but it will not radically change the percentage of defaulters.

The broader issue with bankruptcy cramdowns, according to Gundlach, is whether they "cross the Rubicon." In this case, the Rubicon is the legal framework which protects investors by requiring homeowners to abide by the terms of their loans.

Gundlach is opposed to the proposed \$75 billion program to incentivize mortgage servicers to reduce interest rates, extend amortization schedules, or write down principal. "This would incentivize servicers to abrogate their duty to serve investors," he said. Furthermore, he said government plans to give servicers a safe harbor from lawsuits are unacceptable. His biggest fear is exposure to abuse, such as homeowners purposefully defaulting on mortgages in order to qualify for government programs.

To solve the foreclosure problem, Gundlach advocated a self-policing system based on the tax code. The income stated in loan applications would be compared to the income reported by homeowners on their tax returns. If the amounts do not match, homeowners will either be excluded from loan modifications or would receive a bill from the IRS for taxes on unreported income. "This would be elegant and self-policing," he said.

Gundlach said equity investors in the banking sector still face a strong threat of dilution as the government invests additional capital. Even senior bondholders are not protected. "No debt is sacrosanct, particularly in an institution that is receiving government money," he said.

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