



## Jeff Gundlach: A Survey of the US Capital Markets

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In a January 21 conference call with investors, Jeff Gundlach, Chief Investment Officer of the TCW Group, provided a broad overview of the markets, identifying those sectors that are attractively valued for 2009, and those that are not.

The biggest investment dilemma for advisors, Gundlach said, is whether to go from a defensive posture – seeing cash as the only safe option – into “some attractive sectors that might seem cheap.”

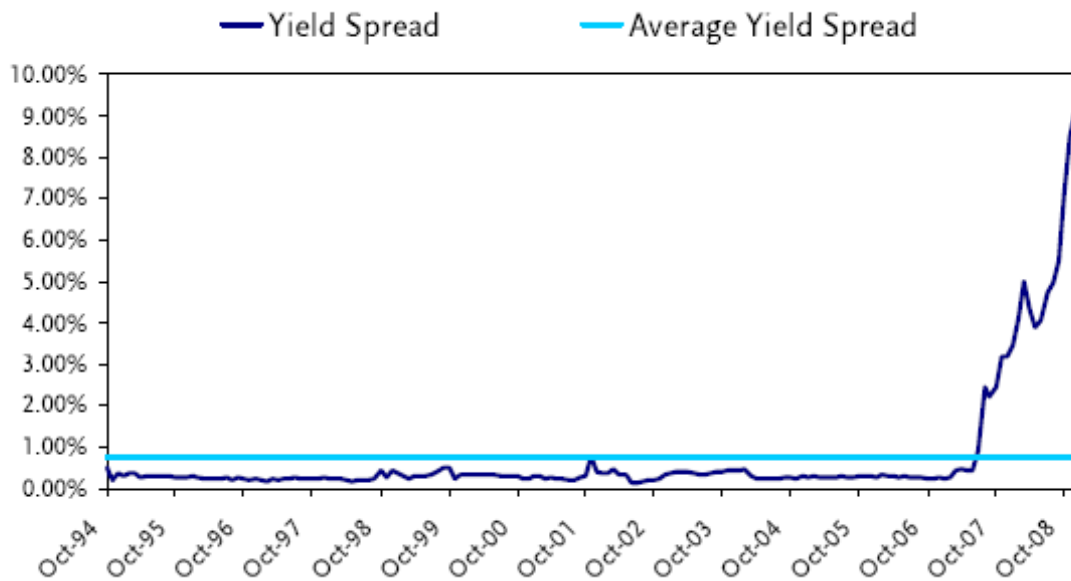
Some sectors of the credit markets are attractively priced, he concluded, but the US equity market is “not cheap yet.”

The “inflation program must gain traction” before the equity markets improve, he said, pointing to an improvement in commodity prices as the likely signal of such a shift. “At some point, commodities will go back up with a vengeance,” said Gundlach. He offered no specific forecast for the timing of this move.

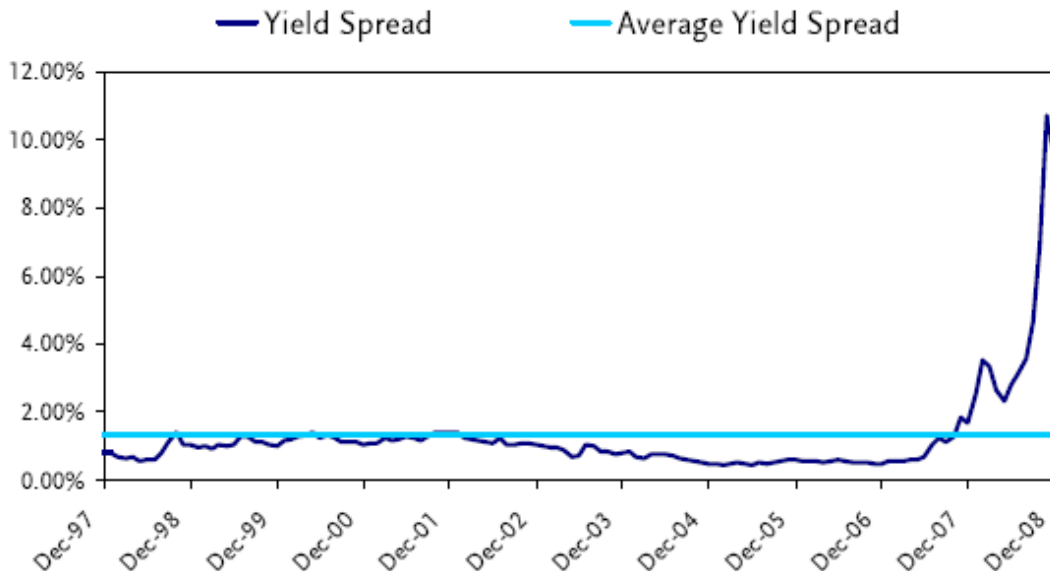
Over the last 18 months, the dollar (when measured against a weighted basket of currencies) has moved inversely to commodity prices, culminating in the current situation where commodity prices have plunged and the dollar has strengthened. Gundlach believes a surge in commodity prices will be accompanied by a decline in the dollar.

Gundlach walked through each sector of the fixed income markets (providing the historical spread data below) and offered his forecast:

- **Floating Rate ABS** – These currently trade at record-wide spreads of 900 basis points over LIBOR. Since LIBOR is currently zero, they yield 9%. There is no principal paid and no real demand for these securities. Gundlach expects the Fed “will do everything it takes to keep short-term interest rates low for at least all of 2009.” Consequently, he does not like this sector, and he believes it will be the last to rally.

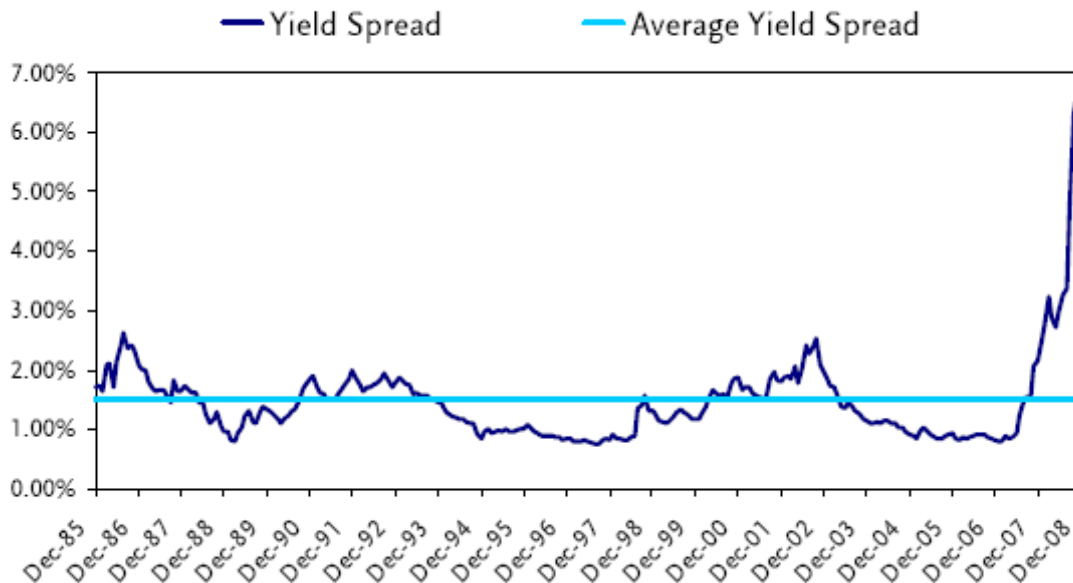


- Fixed Rate CMBS** – Spreads are now at record levels, 11% over Treasury bonds. But the downturn in the commercial real estate market will come after that of the residential market. Gundlach said that CMBS are “a long way from turning positive,” and that fundamentals will not improve in 2009. He does not recommend this sector, nor does he recommend floating rate CMBS.

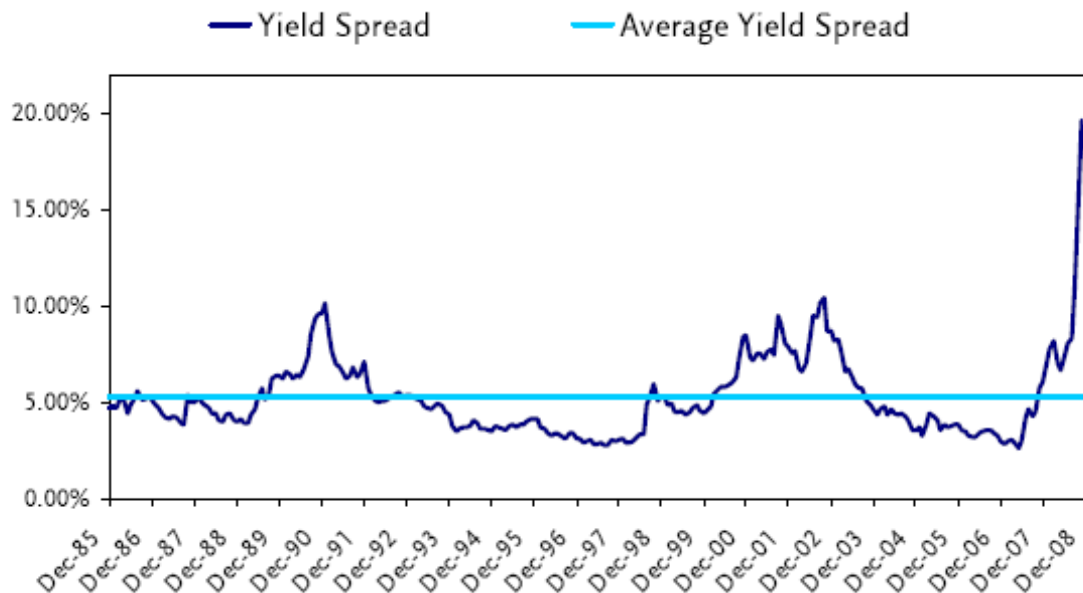




- **Investment Grade Corporate Bonds** – Prior to 2008, spreads on investment grade corporate debt ranged between 100 and 200 basis points over Treasury bonds. Many investors did well buying corporates when spreads went over 200 basis points and selling under 100 basis points. That relationship ended in 2008, as spreads widened, ultimately reaching nearly 700 basis points in November. They have contracted slightly since then, but Gundlach believes this sector is still cheap — albeit not as cheap as non-agency bonds (discussed below). TCW owns this sector in a number of its funds.



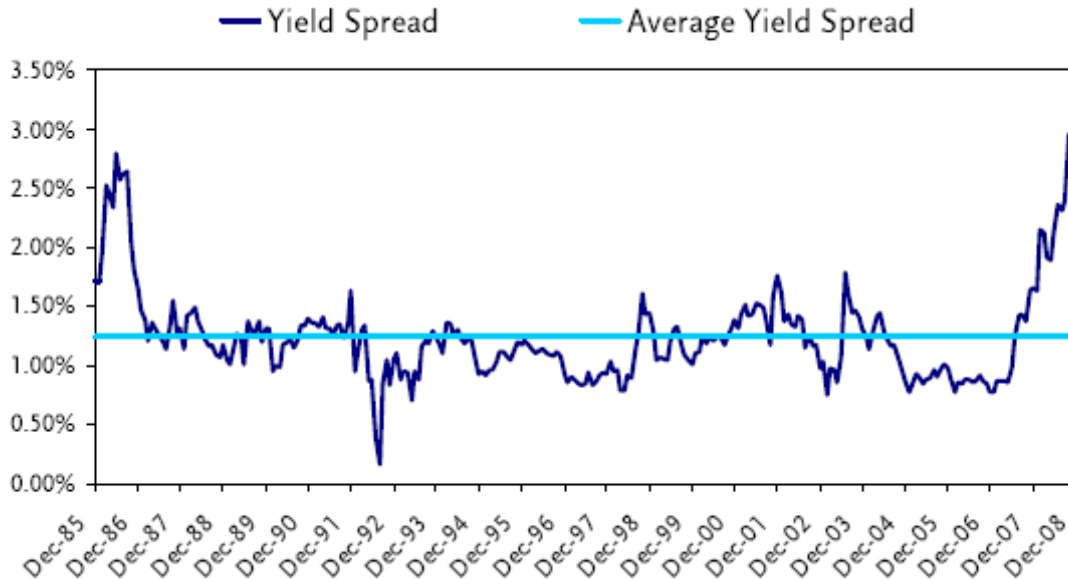
- **High Yield Corporate Bonds** – Spreads on these bonds have moved in tandem with investment grade corporate bond spreads, widening to a record level of nearly 20% in November of 2008 and then contracting to a current level of approximately 17%. Gundlach said this sector was attractive at a “tactical but not structural” level, meaning that he would take advantage of trading opportunities but would not recommend strategic asset allocation to this sector.



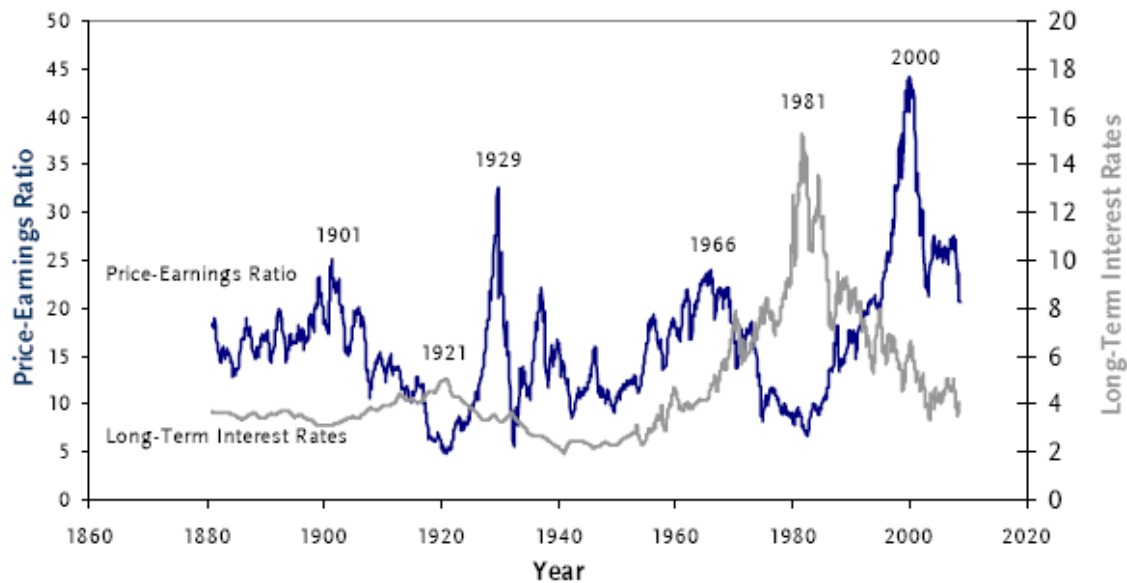
- Municipal Bonds** – Gundlach believes that yields on these bonds will increase, due to fundamental problems across the range of issues. Fiscal problems with state and local governments will lead to ratings downgrades, but not necessarily to defaults.
- Mortgage Backed Securities** – Gundlach was the most bullish on this sector. Spreads on these bonds went to all-time record levels of nearly 300 basis points in November 2008, but they have since reversed and are now near their historical average. These spreads have been “engineered,” according to Gundlach, because the Fed has been buying these bonds to stabilize the housing market. He also cited the “incredibly important fact” that mortgage refinancing is not good for the holders of GNMA securities, since these are trading over par (and refinancing brings the value to par). By contrast, refinancing will be extremely good for non-agency bonds that are trading at steep discounts. Refinancing is problematic for non-agency bonds, since many are plagued by underwriting problems, declining housing prices, and appraisal issues. But Gundlach expects full-scale government action to accelerate refinancing, which will contribute to out-performance in this sector. Refinancing applications are up 7.5 times over the last couple of months, he noted. While government programs to restructure mortgages are possible, Gundlach said, he sees little chance that these would adversely affect this sector. Such programs are likely to be directed to sectors where borrowers were “tricked:” floating-rate securities (sub-prime, option-ARM, and Alt-A). These programs would be “overwhelmed by the global



action of lower rates leading to refinancing,” which would in turn be positive for this sector.



Gundlach also provided data for the US equity market (see below) that showed one-year trailing price-to-earnings ratios for the last 150 years. “The market is not cheap,” he said — for it to be cheap, P/E ratios would need to be in the single digits. He noted, for example, that in 1982 P/E ratios declined to six, and he suggested that P/E ratios would need to decline to comparable levels for equity market valuations to be consistent with current valuations in the fixed income markets. “The equity markets do not make sense in a historical time frame,” he said.



In spite of these attractive opportunities, Gundlach said “Nothing says get out of cash.” “Do not pour into high-risk sectors until commodities and the dollar move differently.”

Gundlach also said that he expects inflation will arise sooner than most people think. Although he said the common view among large asset managers has changed from inflation to deflation over the last six months, Gundlach is wary. “I am always skeptical of a 180-degree turn,” he said. “There is so much monetization going on. Inflation will happen in 2009 or 2010.”

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