



## **Jeff Gundlach: The Party is Over**

By Robert Huebscher

June 9, 2009

The easy money has been made in the credit markets, as investors have reaped strong year-to-date returns, topped by 17% in emerging market debt and 30% in high yield bonds. Now the markets are in a much riskier position, said Jeff Gundlach, Chief Investment Officer of the TCW Group, in his quarterly update to investors that he titled "It was Great While it Lasted."

"The forward-looking view is getting a lot more problematic," Gundlach said. Markets are "much tougher to call than at any time in this credit crisis."

Since his previous [call](#) with investors in March, high yield bond spreads have narrowed from 2,300 to less than 1,300 basis points, with the safer bonds in this sector now yielding only 10.4% to a no-default scenario. But default rates are rising rapidly, and Gundlach said they are now in the high single digits.

Investment grade corporate bonds yield slightly more than 6% and emerging market bonds yield 8%, which is "not a lot of cushion," Gundlach said.

"The U.S. has been on a debt party for the last 30 years, and there are troubles in these markets based on accumulated debt," he said, noting that investors must confront "bad fundamentals" in the economy and the markets.

Gundlach illustrated the core problem in the growth of debt as a percentage of GDP, as he has in previous talks. Using the president's proposed budget, incorporating what Gundlach believes are conservative spending estimates for proposed programs, he said debt will go to 90% of GDP from its pre-crisis level of approximately 40%. "Basically, we are heading to 100% of GDP," he said.

Once you add in Social Security, Medicare, and other unfunded entitlement program spending, the overall debt burden rises to \$65 trillion.

Household borrowing has been supplanted by government borrowing, but Gundlach said the debt problem is the same whether it is at the individual or national level. "Unless the problem is solved, the government will default, a lack of lenders will force high interest rates, or we will monetize our debt and create high inflation," he said.

Gundlach said the government's financing strategy amounted to a Ponzi scheme.



“Debt is increasing at an alarming rate, but not a fatal rate,” he said. The government can hold things together with incremental monetization until the big debts – Social Security and Medicare – must be paid. At that point, though, we will have to come up with money that right now doesn’t exist.

“As investors we must understand the debt and liabilities of our government and its implications,” Gundlach said.

Gundlach expects the Chinese, Japanese and OPEC – currently the major owners of US debt – to be increasingly leery of our credit status. The government will be forced to increase taxes to fund spending programs, and Gundlach expects those increases to disproportionately fall upon those in higher wage categories. Marginal tax rates exploded during the Depression, from approximately 15% to 60%, to pay for the New Deal programs, and Gundlach foresees similar increases soon.

“Given the disparity in growth rates of income [between high and low wage earners], it is quite likely tax rates will go higher – much higher,” he said. He predicted that both income and capital gains taxes will increase, and he advised investors to incorporate rising tax rates into their portfolio strategies.

### **The equity and credit markets and inflation**

Gundlach forecasted a “significant” downward correction in the equity market soon. “I don’t think we need to sell everything. It may a few months before the fundamentals of debt and low economic growth take over,” he said. “The correction might be half or so of the move that was made this year.”

The dollar and the commodities markets foretell whether the economy is on a deflationary or inflationary path, according to Gundlach, who said we are heading toward inflation. “The dollar has started what could be a big leg down and inflation risk is potentially coming into investors’ psyche sooner than expected,” he said. Commodities are having a “robust” rally and, coupled with a weak dollar, are saying “watch out for inflation.”

To hedge against inflation, Gundlach does not like TIPS, which offer low single-digit real yields. He prefers “high cash flow” assets, such as high yield bonds if they can be purchased their yield levels in March. They will be a cushion, he said, since inflation will lower default rates for corporations and households. He also advocated diversifying into commodities, land and foreign markets not exposed to US inflation.

Inflation in this environment is not due to capacity underutilization, but to money supply growth and the government’s printing press, Gundlach said. He discounted reports of positive news in the economy (“green shoots”) and said he would be alarmed if the massive short-term borrowing and stimulus had not produced some improvement in



economic indicators. Gundlach sees the question as whether growth can be sustained when it is based on debt, and he said the answer is no.

Although the yield curve is already at one of its steepest levels in history, Gundlach expects more to come. The steepness of the curve will reach “significantly new highs – out of context with historical patterns,” he said. The Fed will engineer and keep short rates at zero while the market will rebel against debt and fundamentals, forcing longer rates higher.

Gundlach favors the high yield market over the investment grade market, but he recommends investors avoid both as “a lot of juice” is out of the corporate markets, where he expects spreads to remain stable.

In the mortgage markets, Gundlach said government buying of mortgage securities is no longer able to keep rates low. The key 10-year Treasury rate has bottomed. “This is not good news for supporting the housing markets,” he said, and signals an increase in default rates.

The Case-Shiller housing index is down 30% since its peak, and loan-to-value ratios on many mortgages are now at 100%, since most mortgages were made with 30% equity. “The main driver of default rates is loan-to-value ratios reaching 100% or more,” Gundlach said. “We are at the cusp of a resurgence in default.”

Investors should not embrace reports that the rate of acceleration in the decline in housing prices has abated. As long as housing prices continue to decline at their current rate of 18%, trouble will persist.

Subprime defaults are leveling off, but this too is not as good a sign as a naïve interpretation would suggest, Gundlach said. “This only means there is equilibrium between new defaulters and existing defaulted properties being liquidated through foreclosure sales,” he said. Foreclosure sales are 17% of subprime loans, which means defaults are also at 17%.

Uncertainties in the housing market continue to offer opportunities in the mortgage-backed securities markets, where performance depends not just on interest rates, but on prepayment, default, and loss-severity rates – and the timing of each rate. In this regard, Gundlach described an inefficient market, where investors can earn double-digit yields under very conservative assumptions. Overall, the market is overestimating the risk of future defaults.

In addition, Gundlach said mortgages historically perform well in inflation, because they have a lower effective duration than traditional bonds. “Long term interest rates will rise,” he said, but mortgages “will not get whacked.”



In the fourth quarter of 2006, the Case-Shiller index had fallen by one-half of one percent, and Alan Greenspan said the housing market had hit a bottom. At that time, Gundlach said that Greenspan “had lost his mind” and predicted that the housing market would bottom in 2010. “Now we are very much on track toward that bottom,” he said, adding that “the housing market will not come rocketing off the bottom.”

“We are only in the sixth or seventh inning of this crisis,” he said.

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>