

## Jeff Gundlach: The US will 'Politely Default' on its Debt

By Robert Huebscher

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*A copy of the slides from Gundlach's presentation is available [here](#).*

Today's economic problems, it seems, can be understood through the lens of pop artist Andy Warhol. Warhol, who DoubleLine's Jeff Gundlach calls an "absolute futuristic genius" in his ability to depict trends in American consumerism, showed through his illustrations of everyday objects, such as Coca Cola cans, that products used by the upper crust of society were accessible to anyone in America. That accessibility made it natural for consumers to borrow money to improve their standard of living, leading to a three-decade long explosion in public debt.

Gundlach delivered the keynote address at last week's Morningstar Investor Conference in Chicago. He is the chief investment officer of DoubleLine, the firm he founded after leaving TCW last year. DoubleLine now manages just over a \$3.2 billion in bond funds, mostly in mortgage-backed securities, where Gundlach's expertise is highly regarded.

Gundlach's presentation shared a similar theme with many he gave while he was at TCW, documenting the immensity of U.S. debt obligations and the lack of options for alleviating that burden. As he has stated in the past, he does not consider inflation to be a threat in the capital markets today. He cited six options open to policy makers, but believes a seventh – some form of default – is most likely.

As would be expected from one who manages large fixed income portfolios, he sees opportunities in the bond market, particularly in long-term US Treasury securities and in certain types of mortgage-backed debt.

At the end of his talk he sounded an ominous warning that if inflation *were* to occur, it would happen very quickly.

### **No inflation on the horizon**

"The logic for runaway inflation doesn't lead us to a good explanation of current conditions," Gundlach said. Examining the examples of hyperinflation in Zimbabwe and in the Weimar Republic, he said none of the factors that characterized those situations are features of today's economy: excessive printing of money, high interest rates, rising equity and commodity prices, and, most notably, relentlessly escalating consumer prices.

Instead, he said, the opposite scenario – deflation – is likely to rule.



Currently, the US is committed to \$62.3 trillion in entitlement spending (mostly Medicare and Social Security), against a \$14 trillion (GDP) economy, Gundlach said, and those commitments are growing fast. In 2002, those entitlement commitments were \$26.5 trillion, which means they have increased by \$36 trillion in just eight years. Cumulative GDP over that time period was \$104 trillion.

The fact that one-third of the GDP over those eight years went toward entitlement commitments “is why people believe there needs to be inflation,” Gundlach said, yet it has not happened.

“The problem for the near term is that the load of all of this debt is deflationary,” Gundlach said. “We need to work through these deflationary outcomes.” He said there is a chance that the US will monetize its debt, but he doesn’t think that that’s the correct approach to be taking today.

“I do not believe the inflationary temptation can be succumbed to absent some sort of a crisis,” he said.

Gundlach said that the social mood sends important signals about the fate of the economy. A lot of people have equated excessive borrowing and bailouts with the possibility of inflation, he said. Well-meaning citizens and political groups are talking about balancing the budget. That sounds brave, he said, and fiscal prudence would have been great back in 1992, but the economy today is living on stimulus. “Take the stimulus away, and you’re going to have a double-dip recession or a significant contraction or slowdown of economic growth,” he said.

If interest rates in the US go to 10% on US Treasury bonds, all tax revenues would need to go to debt service, Gundlach said. As bad as the debt problem is today, very low interest rates are to some extent alleviating the burden.

As debt has been building up, Gundlach said, we have not been able to get ourselves out of recessions with any significant job growth. “Debt growth creates a headwind where we need more and more and more debt,” he said.

Gundlach said there is currently no job growth in the U.S. except that accounted for by government hiring. Job growth in the government sector, he said, is virtually self-defeating from a fiscal standpoint. “Government workers are being paid with taxes on borrowed money,” he said. “If you are going to create government jobs, you are just borrowing more money. Those aren’t real jobs.” The net result is that we are mired in a jobless recovery.

### **Six policy options**

There are, basically, six ways to get out of the debt problem, and Gundlach said three are not plausible.



The first is to increase GDP growth, which he said “doesn’t seem to be happening in the near term.” Lowering interest rates on government debt, the second option, has already been done. Greece was able to avoid default, at least temporarily, through a foreign capital transfer, the third option. While other countries were able to help Greece out of its debt problems, none are likely to give money to help the US out of its deficit crisis, Gundlach said.

Of the remaining three options, none are attractive or likely to be effective.

One is to increase taxes, which Gundlach thinks will happen. “You have a tax increase coming and a radical policy shock that will affect investments in the economy,” he said. Making that likely is popular outrage about bailouts and growing sentiment toward balancing the budget. He expects tax increases to come immediately after the November elections, and warned the audience to “watch out for 2011.”

Another possibility is to cut spending. “Even President Obama put forth a fairly quaintly titled piece of legislation to try to pay lip service to fiscal conservatism,” Gundlach said, referring to the Reduce Unnecessary Spending Act of 2010. “They’re trying to save \$20 billion through this bill over two years. Obviously \$20 billion is very close to a drop in the ocean, but you can see a movement in society towards increasing taxes.”

Cutting spending will be difficult, Gundlach said. “No one in Washington gets elected by saying, ‘I’m going to cut entitlement payments,’ and no one wants to talk about it,” he said.

That leaves the final option, which is to print money. That has already occurred, Gundlach said, but only to a very limited degree. The US has printed about a trillion-and-a-half, which he said was “nothing.” “We have \$50 trillion of credit market debt and another \$50 trillion unfunded promises to pay. There are \$600 trillion of derivatives that could blow up at any time,” he said. “I just don’t think that we can realistically print that kind of money absent a huge crisis.”

Gundlach sounded an optimistic note about the flexibility of our economy, which he said has helped the US grow out of recessions in the past. Adaptability, however, will come hand-in-hand with austerity, which he said was the “new cool,” reflecting the desire of governments to get the “fiscal house in order.” That requires sacrifice, which he said was inconsistent with increased economic growth.

Ultimately, though, Gundlach expects a seventh option: “some type of polite default, at a minimum, will happen.” He expects the US to renege on some of its debt or entitlement obligations, such as by imposing a tax on the maturity of government debt or by cutting back on entitlements. “That would be a way of engineering a default in a creative way,” he said.



## **Opportunities in Alt-As**

After outlining his deflationary thesis and the paucity of policy options, Gundlach discussed market conditions affecting his funds.

To illustrate the opportunities in mortgage-backed debt, Gundlach discussed a specific security – an Alt-A Wells Fargo bond that was issued in 2007 (which was a year when many securities backed by poor credit were issued). This example trades at 68 cents on the dollar and has a coupon of 5.75%.

An Alt-A bond has loans made to borrowers with better credit records than those in the sub-prime category, but not as good as that of a prime borrower.

Gundlach said the loans underlying this bond are from “good borrowers” with FICA scores higher than their Alt-A status would indicate. The loan-to-value ratios on the loans are not yet in the territory where homeowners will “mail in the keys” and default. “This one hasn’t suffered that problem yet,” he said, although about 15% of the loans are not currently paying.

Even assuming for the worst-case scenario of a continued dip in the housing market and an increased rate of defaults, Gundlach still believes this bond would yield over 13%. Even if rates rise, the bonds will increase in value he said, and they are inversely correlated to Treasury bonds. “These bonds protect you for the inflation case or the monetization case to an extent that other bonds do not,” he said

## **A final warning**

Gundlach concluded his talk by warning that at some points “something bad” could happen relative to risk, causing the dollar to drop and Treasury yields to rise. “That is what you need to watch out for.”

“If the world starts to behave differently,” he said, “you need to sell immediately, because you don’t have much time. So I suggest that all of us watch the way the markets react to bad news regarding risk. If their behavior changes, you have to sell very, very quickly.”

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