

## Jeffrey Gundlach: No Double-Dip Recession ... but

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The slides from this presentation are available [here](#).



The economy won't suffer a double-dip recession, according to Jeffrey Gundlach. But that doesn't mean the DoubleLine co-founder, CEO and CIO expects strong economic growth.

To the contrary, Gundlach said that we haven't yet recovered from the recession. "The people who are looking for robust and sustained growth are really kidding themselves," he said. "The trends are for a long period of debt repayment and weakish growth."

Gundlach delivered his remarks in a talk to fund shareholders last Tuesday. We [interviewed](#) Gundlach two weeks ago, and much of his talk covered the same ground as our interview. Those comments, many of which dealt with divergences in the markets and Gundlach's reasons for decreasing his holdings in Treasury securities and correspondingly increasing those in high-yield bonds, are not repeated below. A summary of his comments on the broader economy and trends in housing and the fixed-income markets follows.

Even though the economy faces severe challenges, Gundlach said that equity markets might display strength, aided by government policies that incent investors to take more risk, which could cause a surge of flows into stock funds.

He also expects strong performance in those sectors of the fixed-income markets where [DoubleLine's funds](#) are invested.

Before we look at the positive signs Gundlach sees for the markets, however, let's review his gloomy assessment of the economy.

### **A jobless recovery?**

Gundlach was starkly critical of how the government measures economic growth through its GDP reporting. The government overstates economic growth, he said, because its GDP numbers do not properly reflect the effect of deficit spending. When the government uses borrowed money to fund a stimulus plan, the growth created by that stimulus should be offset by the amount borrowed.

"It's like a person who earns \$50,000 and then takes out a \$10,000 loan," he said. "You wouldn't say that person now earns \$60,000."



Job creation is a more honest measure of economic growth, Gundlach said. On that score, he said that we face a “huge non-employment situation.” In fact, much of the job growth reported recently has been on government payrolls. That also represents a burden on the private sector, he said, because the salaries of those workers are funded through tax revenue and borrowings.

A jobless recovery is an oxymoron, he said. Without job growth there is no economic growth.

The employment-to-population ratio has declined by 8% in the last two years, a development that Gundlach called “disastrous.” Even that statistic is distorted, though, because it does not correct for the growth in government payrolls. The government payroll as a percentage of non-farm payrolls is now two percent higher than its average level since 2000.

Unemployment is at its worst level since the start of the recession, as compared to the previous 10 recessions.

Federal unemployment compensation has soared from approximately \$25 billion annually prior to the recession to nearly \$200 billion. Gundlach said that the government estimates those payments will “miraculously and instantaneously” decrease to approximately \$75 billion over the next several years. That could happen only if the government stopped paying unemployment insurance, a policy decision which Gundlach said would be unwise.

To underscore how unreasonable the government’s assumptions are, Gundlach said that, at the current rate of job creation, we will not return to March 2008 employment levels until 2017. It would take 463,000 new private sector jobs per month to return to that level in the next two years.

Nominal GDP has been virtually flat since 2007, Gundlach said. He also presented data provided by the analysts at DoubleLine, which showed nominal GDP after it was “corrected” for the cash for clunkers and other stimulus programs. By that measure, he said nominal GDP has been flat since 2002.

“There has been zero growth if you do the proper accounting,” Gundlach said.

### **The positive news for the market**

“Viva Las Vegas,” a 1964 movie with Elvis Presley and Ann Margaret, provided the title for Gundlach’s presentation. He likened government policy decisions to spinning a wheel in a game of chance.



Policy makers, he said, face a range of choices: printing money, stimulus measures, increasing or decreasing taxes, debt forgiveness, a VAT or wealth tax, and a “polite” form of default – which might be in the form of taxing municipal bond income. “Washington,” he said, “may be spinning to choose a path,” and its decisions are causing dislocations across the financial markets.

The net effect of policies thus far – specifically, zero interest rates – has been to incent investors to take greater risk, Gundlach said.

That incentive has had only modest effects, since fund flows have been strongest among bond funds. However, Gundlach said stocks could “outperform” as “money flows out the risk curve” and stocks face less competition from bond funds.

Turning to the bond markets, earlier this year Gundlach said the best “no-brainer” investment one could make would be to bet on the flattening of the yield curve. That call turned out to be correct, and Gundlach said it is still highly probable the yield curve will flatten further.

Gundlach also discussed the important trends in residential housing, a sector that represents more than half of his Total Return Fund (DLTNX/DBLTX) via non-agency residential mortgage-backed securities.

Loss severities, which indicate how much investors recover on defaulted properties, have been flat since 2008 in both the sub-prime and Alt-A markets. Gundlach expects a positive impact to his holdings from refinancing due to low interest rates, which would benefit holdings currently below par (a large portion of the Total Return Fund).

Default rates, however, are continuing to rise, and are now at 10% for prime mortgages. Only 2% of defaulted prime properties are being liquidated, so a backlog of foreclosed properties is building. Sub-prime and Alt-A default rates are similarly increasing, but those properties are liquidating at a sufficiently high rate to prevent a similar backlog.

Unlike most of his competitors, Gundlach said he anticipated the recent increase in refinancing among agency mortgage-backed securities, and this has contributed to his strong performance both on an absolute basis and relative to his peer group.

Overall, non-agency mortgages, which represent the largest portion of the Total Return Fund, dominate Treasury and agency mortgage-backed bonds on a risk-adjusted basis, according to Gundlach. They are very competitive with corporate bonds, and the primary risks are in prepayments and in whether service companies will provide timely forwarding of payments. Gundlach said approximately 15% of the Total Return Fund is in premium bonds that are exposed to prepayment risk.



Gundlach concluded his talk with a strong warning to quantitative funds designed to outperform bond indices, such as the Lehman-Barclays Aggregate Bond Index. A day ago, Gundlach said, Barclays changed the formulation of its index, causing its duration to increase by 1.1 years and its yield to increase by 37 basis points, a change that resulted in extreme stress for funds modeled after it.

“This model-based investing nonsense should be put to bed once and for all,” Gundlach said.

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