



Jeffrey Gundlach on Bonds, Stocks and Gold

By Robert Huebscher

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Jeffrey Gundlach is the co-founder, Chief Executive Officer and Chief Investment Officer of [DoubleLine Capital LP](#), a Los Angeles-based asset manager. He was formerly associated with TCW, where he was Chief Investment Officer and head of fixed income activities. Mr. Gundlach is recognized worldwide as a leading expert in mortgage-backed securities and investment asset allocation. Morningstar has nominated Mr. Gundlach for Fixed Income Manager of the Year multiple times, and he won the award for 2006. In 2009, he was nominated by Morningstar for Fixed Income Manager of the Decade. In December 2009, Mr. Gundlach and his long-term colleague Philip Barach co-founded DoubleLine Capital with more than 40 financial professionals from their former firm. DoubleLine today employs 50 investment, client service and administrative personnel. The firm manages portfolios invested in mortgage-backed, government, corporate and emerging markets securities, with investor participation via separate accounts and [mutual funds](#). Mr. Gundlach is lead manager of the DoubleLine Total Return Bond Fund (DLTNX/DBLTX) and the DoubleLine Core Fixed Income Fund (DLFNX/DBLFX).

We spoke with Mr. Gundlach on August 31.

You recently reduced your position from “overweight” to “small underweight” in Treasury bonds, and you cited “divergent behavior across the yield curve.” Can discuss that behavior and the rationale behind your move?

One of the things that I have learned during 25 years managing money – longer than that now – is to pay attention not only to what seems to be happening macro-economically, in terms of data releases, policy trends and the like, but also how the market is reacting. I found that some of the most important turns in markets are accompanied by what we call “divergences in the market.”

For example, the Shanghai Index of Chinese stocks often now leads the United States stock market. In April, when the Chinese stock market was dropping fairly persistently, the US stock market was going up and staying firm at the highs of the year. That's what we call a divergence. You have a market (the Shanghai Index) that was acting badly and has actually been the dominant market. It signaled there could be weakness ahead.

When there is talk in markets about a trend – this is common in the currency and commodity markets – and people are repeating this trend as if it is gospel truth, that can fly in the face of easily identifiable facts. That's something to take notice of.



For example, last fall you couldn't read a newspaper, listen to the radio, or watch CNBC without hearing somebody say the dollar is dropping. The dollar is weak. The dollar is pushing to new lows. What was strange is that it wasn't true. The dollar actually had gone to a low in the second quarter of 2008, and all through 2009 it stayed above that low. You get this strange contradiction when people act like something is performing very badly – in this case, the dollar – but if you just look at the true nature of the market, you can see that's not true.

Today that's true in the commodity markets with gold. People are acting like gold is pounding out new highs every single day. Yesterday it went up quite a lot. People were saying, "look how well gold is doing. Gold is the winning investment." But the truth is, gold is not higher than it was in June. It's actually below its high in June. That's something to watch out for.

What does this mean for the bond market?

I like to watch how different parts of the yield curve behave. I'm not talking about short-term movements. I'm talking about major changes. The real orthodox low in bond yields occurred in late 2008. The stock market crashed, and the economy was melting down. The Fed responded with so-called quantitative easing, and started to buy Treasury bonds and mortgages. There was a huge decline in bond yields in the second half of 2008 culminating at the end of December of 2008, when the two-year Treasury got all the way down to about 75 basis points. The five-year Treasury got down to about 125 basis points, about a percent and a quarter yield. The ten-year got down almost to 2%, to about 206 or 207 basis points. The long bond, the 30-year Treasury got down to about 2.5%.

The market started to get better in 2009, as the "green shoot" mentality in response to the deficit spending propped up consumption and managed to normalize the markets a little bit. This year we started to go down in yield with the recovery flagging.

Now the two-year Treasury has gone down again in yield, and it has actually gone to a new low. It went lower than that 75 basis point or so level seen in late 2008, and now it's down to about 50 basis points. The five-year Treasury went almost all the way back down to where it was at what I call the orthodox low it made in December 2008, but it didn't actually match that low, and certainly didn't break through it. Basically it met it. The 10-year Treasury didn't even get really that close to its low in late 2008. It got to about 2.4%, and the 30-year Treasury only got down to about 350 basis points, almost a full hundred basis points away from its low.

That's a classic divergence where part of the yield curve, the one that is controlled by the Fed, goes down to a new low, but other parts of the market don't corroborate that type of activity. The orthodox low in yields will ultimately prove to have come in late 2008.



Have yields bottomed out?

With the non-confirmation of the new low in the two-year, and the matching of the low in the five-year, it looks like we're carving out a very long-term bottom in interest rates. I say long-term because we are talking about the reversal of nearly a 30-year trend. This carving out of a new low is almost two years in the making, from late 2008 to the fourth quarter of 2010. It probably could stretch on into 2011.

Let's start with the premise that I'm fond of now, that you're not going to go to a new low on the ten-year. Once you are at 2.45%, then there's not much profit potential left, and you are starting to get a very, very negative risk-reward set up in the Treasury bond market. That is pretty much un-debatable. When you think about the two-year Treasury yielding 50 basis points, the total return that one will receive holding it for two years is 1%, a half a percent a year.

Whenever people talk about comparing one market to another over a two-year time frame, if market "A" has a return within one percentage point of market "B," most people would say they are the same. They wouldn't say, "oh look, this market did a full whopping 1% better than this other market. What a dominating performance!"

The two-year Treasury basically is going to give you a cash return. It has no chance of giving you anything that would be remarkably different from a cash return. It only has a chance of costing you from an opportunity perspective, if you think of a CD or something you'd lock in for two years that might have a penalty. It's not like you're going to lose money on the two years. It's more of an opportunity cost. Over the next two years I'd like to think that any investor will find some short-term opportunity that will have a risk-reward profile better than a 1% return.

For example, home-building stocks are down a lot and facing bad fundamentals, but at any moment they could have a 25% price increase. I'd rather have my powder dry to participate in that, than just stick money into something that's going to give you effectively a 0% return for two years. The risk-reward on short-term bonds versus cash in the Treasury market is terrible.

The ten-year Treasury went through 2.5% and it's struggling with that level, but it's down near that low. What are you really hoping for here? That it goes to 2.25%? I'll acknowledge that the ten-year Treasury could certainly make it to 2.25%, maybe even a little lower, but who cares? That's a 20 basis-point drop in yield. So what? You make a percent and a half capital gain. Big deal!

The risk-reward set up against this divergence on the yield curve looks poor in Treasury bonds. We've been looking at this long-term carving out of a bottom taking place. It really became an asymmetrically negative risk-reward once the ten-year went below 2.5% from our point of view.



I just want to be clear – are you bearish across the yield curve? It's not just the two-year or the five-year?

I'm not bearish. This is too long-term of an idea to say that I am losing sleep at night because I am bearish on the Treasury market. There are no real problems in owning the Treasury market. We are carving out a bottom. It may take another nine months before you start to see rates go up. As an investor who allocates money across bond portfolios, once the ten-year is below 250 basis points, I don't really see the risk-reward set-up versus other opportunities in the market as being sensible.

One of the things that we are expert in is in mortgage-backed securities. In the non-guaranteed mortgage market, we feel highly confident that we can make investments that will return 7% to 9% per year. How in the world am I going to get a higher return from the ten-year Treasury than that? This year you did. It was okay to own the ten-year year to date, because the yield dropped from 4% to 2.5%, creating a total return of over 15%. Not only did you have the potential, but the reality is you received a 15% return on a ten-year Treasury from April through today and even higher on 30-year Treasury bonds.

Going forward, however, the math just doesn't work. The capital gain potential is too small. The interest income is too small to sum up to something that is better than opportunities away from the Treasury market.

When you spoke at the Morningstar conference in June, you said that inflation was not likely in the short term. You saw deflation as the likely scenario. Have you changed that view?

No, not really. When I say that the fundamentals still argue for low yields, I believe that. The primary fundamental I'm referring to is the inflation trend. When I calculate the likely return prospects from Treasury bonds versus other fixed income, it doesn't favor the Treasury market anymore.

The "inflationists" may ultimately be right, but you can't go from our situation today to a full-on inflationary situation without a crisis first. People are starting to realize that deflationary burdens really are painful. We might get to a place where the inflation fighters, who remember and don't want to relive the 1970s, come to believe that inflation is a better outcome than a deflationary spiral. People could start to favor massive stimulus programs, which are out of favor now, again. They may come back in favor.

You increased your position in corporate bonds, and in particular high-yield bonds. Can you describe your reasoning behind that move?

I really look for divergent behavior in markets, and I look for opportunities that for whatever reason are lagging behind the message others are getting about the wider market. During



the month of August, the investment-grade corporate bond market did pretty well. It rallied because interest rates fell, and the fundamentals were holding up. But the high-yield bond market has done pretty lousy since the spring, has been an under-performer, and has had a lot of supply. It has some catching up to do to get in line with the investment-grade corporate bond market.

The stock market has been weak, but it hasn't really collapsed. We are not really getting a signal of stress or credit risk in the months ahead for the stock markets. The junk-bond market had really bad default problems in 2008, and it got to a point where it had about a 14% twelve-month rolling default rate, which is really the highest in generations – in the history of the high-yield bond market. That was one of the reasons why it crashed in price. But the default rate in the high-yield bond market has been very low for the last 12 months, at only 2.9%.

While defaults are very likely to increase in an 18-month time frame, they are at the same time very likely to stay in the low single digits in the months ahead. That will give investors cover and comfort to clip the higher coupon and the higher yield of the high-yield market while that is happening. For the time being, yields will be quite high, because the default rate is in the very low single digits. You are likely to earn 6% or 7% on a default-adjusted basis in the high-yield bond market, which looks pretty dominant against the Treasury bonds that we sold to buy them.

Let's talk about the mortgage-backed market. When you spoke in June, you highlighted the Alt-A segment of the market. Where do you see the best opportunities now in mortgage-backed, which is your core expertise?

Right now one of the fundamental mispricings in the mortgage market is the dichotomy between the way the world is fearful that the Ginnie Mae market will be refinanced while the non-agency market continues to be analyzed as if refinancing is an impossibility. Clearly, refinancing potential is much higher through the government agencies than it is in the private market, where credit is tight. But it's ridiculous to believe that there will be no refinancing of the nonguaranteed mortgage market. It will be subdued relative to Ginnie Mae's and Fannie Mae's, but it won't be zero.

Many of these non-agency securities that are trading at \$.60 to \$.70 on the dollar might pleasantly surprise with something like 10% of the loans refinancing. That would mean you'd get 10% of your money back at par, which would be a pretty nice ride from \$.60 or \$.70 on the dollar. A 30- or 40-point gain on 10% of your portfolio isn't bad. That's on top of a security that is paying something like a 6% coupon, which means that you are generating an income flow in the high single digits (coupon divided by dollar price), plus some of your money coming back on a capital-gain basis.

I see 15% return possibilities in parts of the market, but you have to analyze them very carefully. You need to have a pool of mortgages and recognize they are non-guaranteed,



and a lot of them are underwater, and a lot of them have had low documentation and other problems that will prevent them from refinancing. You have to pick the pools carefully to make sure there is some refinancing potential, but the ones that have that potential could well deliver returns into the mid-teens.

What are your thoughts on the municipal bond market?

The muni-bond market is in a good place technically but a bad place fundamentally. It's challenging. The technical part that is good is that tax rates are likely to go up. Because yields are so low on taxable investments, it is very difficult for investors to part with their muni-bonds, because they can't find an alternative that will be as attractive generically speaking on an after-tax basis. For that reason, munis have been doing fairly well. As long as we are in this zero-interest-rate environment in the cash market and have 2.5% Treasury yields, the muni-market's technicals will probably keep it firm.

The fundamentals, though, on the muni-market are very bad. They are clearly worse than at any time in anyone's memory, with the battles that are going on between the pensioners at the state level and the bondholders who basically providing the funding. The volatility of the muni-bond market is likely to be higher than we've experienced. Investors that are tempted by the after-tax yield – and it is understandable to see why they are – should certainly be buyers on weakness instead of strength, because there will be volatility.

One of the poster children for municipal concerns is California GOs. At the end of the day I deeply believe that California GOs are going to end up constitutionally being paid, but there will be high volatility, which means investors can pick their spots and buy opportunistically.

If an investor is willing to hold those bonds to maturity, then there is a very high likelihood that they'll get all their interest and their principal back, right?

That's true. It is possible that the unthinkable could happen somewhere down the line, because we are in an environment where the unthinkable has happened so many times in the past three years. It has become commonplace, with bailouts of car companies and of major banks.

Let's say you could read any day's *New York Times* and had the advantage of being able to see into the future. If in 2005 you received a copy of the 2010 *New York Times*, you probably wouldn't believe what you were reading. But since the unthinkable is now the norm, at some point the municipal bond market may become subject to taxation. That is a bigger concern than a default concern.

Does it worry you at all that so much money has flowed into bond market funds, particularly from individual investors, and that money might flow out just as quickly as it flowed in?



I'm concerned up to a point, but I'm not concerned to the point that you've outlined. It isn't going to flow out as quickly as it flowed in. More likely it will be like the way China is viewing the Treasury market. They are not buying anymore. They are selling a little, but they are not bailing out. That will be likely the way bond flows will level off thanks to the very low interest rates.

I wonder if equity flows won't increase in the relatively near term. As we talked about earlier, with the low yields on a two-year Treasury, some opportunistic stock investing starts to become a reasonable alternative even if there will be volatility and you don't want to go in on a buy-and-hold basis. It just seems like investors have been pushed out the risk spectrum in the bond market, out the yield curve, out into risk sectors thanks to zero interest rates.

Once you get the 10-year Treasury down to 250 basis points, you start to wonder why – I know this is becoming a popular theme – a portfolio of good-quality, low-debt, dividend-paying stocks isn't a reasonable alternative. The dividend is moderately higher than the yields on the ten-year Treasury. That relative value judgment seems sensible to make even though you're talking about substantially higher volatility in the stock market. You don't have an earnings penalty from moving from the ten-year Treasury in to stocks.

I could easily see investors at the margin and on a trend basis curtailing their bond flows and moving instead into the equity market. That's strange for a bond guy to say. Bond guys are always supposed to say "stocks or death," but on a relative-value basis the stock market is starting to offer competition, based on the dividend yield relative to the Treasury market. There is no denying that fact.

You touched briefly on gold before. Do you have any particular views on gold, or commodities in general at this point?

I'm agnostic on the gold market. It is awfully faddish. Gold flows have been up something like nine years in a row. If you said seven years ago that you were interested in buying gold, people would want to get away from you at a cocktail party, because you were some kind of a freak. Now, you turn on the radio and you've got these talk show hosts all touting gold vendors. They say, "I buy my gold from XYZ gold group," as if the next questions should be, "who do you buy your gold from? You are buying gold, right?" It is awfully faddish.

At the same time, the undeniable case for gold is that if it becomes even more faddish, there really isn't that much of it. It is scarce. If everybody decides they want a 2% or 5% allocation – it doesn't have to be very big on average – it is certainly supportive of the price. Undeniably, the situation in Europe with Greece that's all gotten all the headlines has not been resolved. When you have that type of problem with certain pockets of government debt, it is not surprising that investors diversified.



One of my phrases that I cooked up about three years ago was investors need to “diversify their diversification,” which means we’ve got to get away from the idea of a diversified portfolio of 60% equities and 40% bonds. There are other asset classes that you need to think about, because we are not going to be in the same paradigm going forward that we have been in for the last 30 years. We had a debt-driven, unnaturally stable economy, thanks to debt coming to the rescue every time the economy, left to its own devices, looked weak.

Gold and other real assets like land, non-US investments, and developing countries with a standard of living going up thanks to globalization, are things that investors should have started diversifying into – including gold if you are so inclined. I’m not a big gold guy, but anything that’s sort of a currency unto itself could fill that role. It could be gemstones. It could be land.

Could it be oil?

Sure. It could be copper mines. I was talking to the guy who founded Qualcomm, and he said “no copper. The world is wireless.” But you still need copper for electricity, if nothing else.

All of these things are sensible alternatives. At the end of last year the Greek bond yield, which no one talks about anymore, was at 5%. When people woke up to the problems with their fiscal situation, it pushed through 6% and exploded up briefly on an intra-day basis to 20%. Do you know what it is today? It’s at 12%, not exactly low. In spite of the bailout from the northern European countries, the situation in southern Europe is probably moving on to its second chapter. Now that the summer is over, people are going to start coming back and looking at things.

Gold could benefit in the short term from some of that. Gold has gone up a lot. It’s getting very trendy. To the extent that one worries about bonds for being trendy, you should equally worry about gold as being trendy.

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