

Gundlach – ‘The Cusp of a Global Banking Panic’

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Don't interpret last week's volatility as merely a reaction to S&P's downgrade of US Treasury debt, according to Doubleline founder and chief investment officer Jeffrey Gundlach. Investors are actually fearful of a global banking crisis, he said, because many countries face a perilous choice – defaulting on their sovereign debt or inflating their way out of trouble.

“The markets are in a state of panic,” Gundlach said. “This is not really a great time to be a seller of anything.”

Gundlach spoke with investors on Wednesday via a special conference call to address the heightened market volatility.

Bond yields decreased following S&P's downgrade, as Gundlach [predicted](#), and he said Wednesday that they will likely continue to fall. Incremental moves to address the deficit will force yields lower by weakening the economy and decreasing the supply of Treasury bonds, which will drive prices higher.

It's unlikely the S&P will close above 1,250 for the next several quarters, he said, and he advised selling “risk assets” if it approaches that level.

Bernanke's interesting rhetoric

On Tuesday, the day before Gundlach spoke, Fed Chairman Ben Bernanke announced that short-term rates would be kept near zero until at least mid-2013.

Gundlach, however, is not convinced this will happen.

He said the Fed could change its position “at any time” without penalty. “It is an interesting bit of rhetoric,” Gundlach said, but not one that investors should take at face value.

The problem with the Fed's announcement, he said, is that it contained no new information. Rates are already low and are being kept there by market forces. “What the Fed did yesterday didn't help the market psychology in any way.”

Bernanke said the economy is a lot weaker than it should be, but the announcement that he will keep rates low represented an unhelpful lack of action of the Fed's part, according to Gundlach.



Gundlach said QE3 was unlikely because QE2 didn't work – it only caused a “weird allocation of capital” and “euphoria in certain assets.”

A more appropriate action, he said, would be a “direct stimulus” in the form of an increased spending program. But the economy is threatened instead by a \$350 billion fiscal drag – representing approximately 2% of GDP – from the sun setting of the Bush tax cuts and payroll tax cuts.

The US economy has been “living on stimulus,” he said, and once measures such as the 2009 stimulus go away, GDP growth is likely to be negative.

Gundlach criticized the work of some economists, such as John Williams of Shadow Stats, who have claimed that the government systematically understates inflation and that, if inflation were measured using old methodologies, it would be 6% or higher. If that were the case, he said, real GDP growth would have been negative for some time.

The trouble in Europe

Gundlach said media reports about a downgrade of French sovereign debt are misguided.

The concern is not about French debt, French banks or the French government, he said. “This has to do with bank exposure to a default problem around the periphery of Europe.”

That exposure is enormous, he said.

“Right now you are on the cusp of a global banking panic,” he said, which explains why firms such as Societe Generale have experienced sharp declines in their stock prices. The “really bad news,” Gundlach said, is that Societe Generale is “going in front of the microphone denying rumors.” This is reminiscent of Citigroup in 2008, which denied problems at the time of the Lehman bankruptcy only to seek a government bailout shortly afterwards.

Gundlach described the escalation of Europe's problems as a DEFCON spiral. DEFCON 1 — the highest level of military readiness for war — happened in the first quarter of 2010, which Greek debt rose 300 basis points above the German bund. At the time, the Greek finance minister said those rates were usurious and would be a really big problem.

Gundlach said that comment opened his eyes as to the seriousness of Europe's problems.

DEFCON 2 occurred about a year ago, when Greek spreads went to 1,000 basis points over German bunds. At that time, Ireland and Portugal went to DEFCON 1.



Gundlach said Greece went to DEFCON 3 earlier this year when its bonds began to trade on a price basis instead of a yield basis. They were priced at \$.50 on the dollar. Portugal and Ireland went to DEFCON 2, and Spain and Italy went to DEFCON 1.

Today's problems, he said, are because France is looking like it is at DEFCON 1.

Gundlach said few solutions remain to Europe's problems other than default or inflation through a "print-and-pay" scheme. "If you run a default though, then you have a global banking problem," and he said it was not clear whether this would be preferable to high inflation. He said that further clarity would come in the next few weeks.

The US bond market

While Europe faces a binary choice between default and inflation, the path for the US is far more predictable, according to Gundlach.

He said the US could face a Japan-like bond market, with 10-year bond yields as low as 1%, if the government continues to address the deficit in an incremental manner.

But most investors are not fully invested in the US Treasury market, he said. All but a few outperformed the Barclay aggregate index this year because they missed out on the rally in government bonds.

Gundlach said investors should "keep their eyes wide open" for a print-and-pay scheme from the US, which would lead to an increase in Treasury yields. But he said there are no signs of that from Washington.

Two mistakes to avoid

All investors should avoid two potential mistakes, Gundlach said.

The first is owning a money-market fund. The decision is really easy, he said, since those funds yield zero. "Just don't own it," he said. "Put the money in a T-Bill fund," since money-market funds carry risk.

The other mistake to avoid is owning funds with counterparty risk. Gundlach said many large bond funds have significant counterparty risk in the form of credit default swaps and other derivative instruments.

"Anybody who is taking counterparty risk and is not getting paid for it is exposing themselves to potentially catastrophic losses," he said. "Even if you think the possibility of that catastrophic loss is .01%, you shouldn't do it, because you are being paid zero."

Indeed, Gundlach advised taking a very conservative stance in the market.



He said the market just descended the “first hill of a roller coaster” with powerful losses in equities and equally strong gains in bonds. “The idea that this is about to reverse on a dime is just absurd. I’ve been at this game far too long. When you start to see the momentum work in this direction, it is not going to reverse on a dime.”

Gundlach said investors don’t need a lot of risk in their portfolios and that he did not have much personally or in Doubleline’s go-anywhere multi-asset fund.

The economy and the debt problem are bad, he said, and there are a lot of problems that need to be resolved. “As that happens we will calmly and hopefully be more right than wrong, make moves to capitalize and make profits while successfully protecting capital and making our way through the rapids.”

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