

## Gundlach's Predictions for 2013

By Robert Huebscher

January 15, 2013

Don't expect the low volatility that characterized the capital markets in 2012 to continue. Global economic uncertainty remains, and markets are poised like a "coiled snake" to reward or penalize investors in certain asset classes, according to Jeffrey Gundlach.



Gundlach, the founder and chief investment officer of Los Angeles-based Doubleline Capital, delivered his 2013 forecast to investors in a conference call on January 8. His talk was titled "The Year of the Snake," and the slides from his presentation are available [here](#).

"Returns in 2012 were really better than they deserved to be," Gundlach said. "Just about every equity and fixed-income asset class had positive returns."

Risk-taking investors did well last year, he said, as sectors such as convertible, high-yield and emerging-market bonds performed very well – much better than they did in 2011. Those investors were aided by Federal Reserve and central bank policies that dampened volatility, according to Gundlach.

But Gundlach warned investors to be wary of volatility in 2013. Markets this year are more likely to resemble those in 2011, according to Gundlach, when safe investments – like government bonds – were among the strongest performers.

"I am not sure I would advise taking a lot of risk right now," he said.

Let's look at Gundlach's forecasts for stocks, bonds, gold and the dollar.

### **US equities and the economy**

Gundlach's outlook on the US economy was downbeat.

He cited estimates from Goldman Sachs that spending cuts – at the federal, state and local levels – and tax increases would decrease economic growth by 1.75%. The next debt-ceiling debate will be "uglier" than the recent fiscal-cliff rancor, he said.

Indeed, GDP estimates have been decreasing. Bloomberg's forecasts for the first quarter 2013 GDP have been steadily declining over the last two years, according to Gundlach, and those reductions have been even more pronounced for the second-quarter GDP estimates. "Economic growth keeps being over-predicted for forecasting purposes, and I think that is still the case," he said.

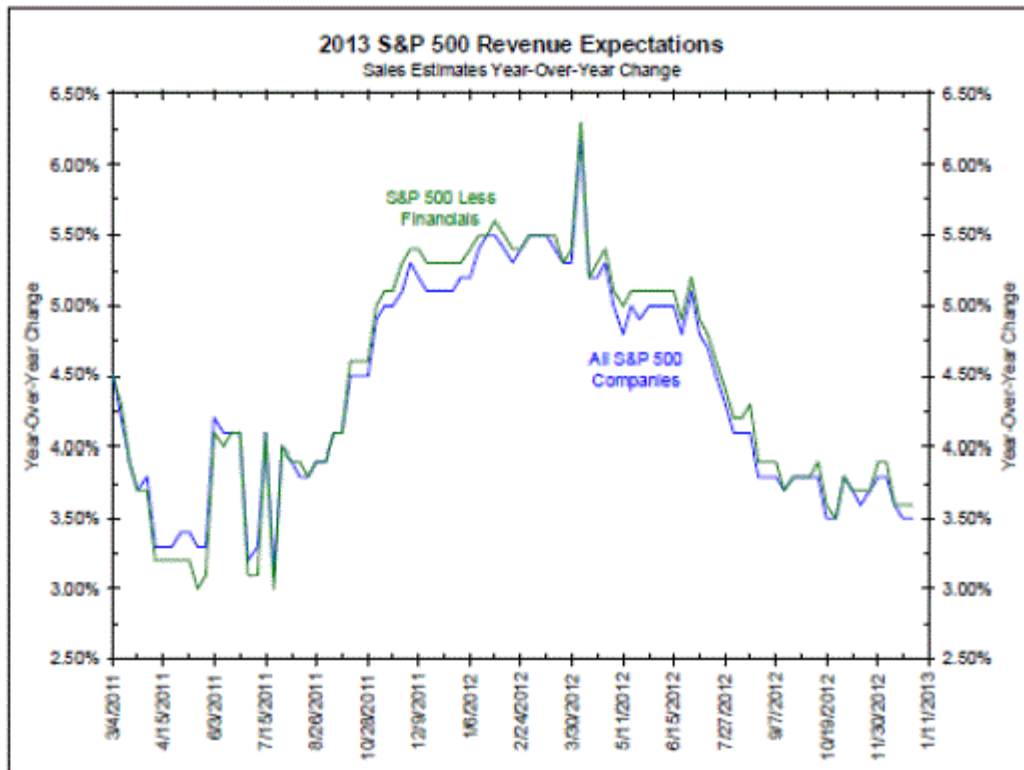
If the sequestration is allowed to occur on March 1, it would be a “big hit” to GDP, he said. Gundlach has consistently warned that federal deficits are the major threat to the economy. “This problem just never seems to want to be seriously addressed,” he said. “Pretty soon, the snake is going to strike, because this cannot go on very much longer.”

Gundlach noted that he was hardly alone in his pessimism, citing the recent decline in analysts’ earning estimates visible in the figure below:

## 2013 S&P Revenue Estimates

March 3, 2011 through January 1, 2013

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Source: Bianco Research, LLC, Week of January 2, 2013

Analysts were optimistic in late 2011, and equities performed well last year, Gundlach said. But if estimates fall much further, he said, “it will be very difficult to see what would be the support for the equity markets.”

“It is very difficult to see how we are going to get the type of economic acceleration that some people are hoping for,” Gundlach said.



Gundlach warned the market technicals were unfavorable. He cited Richard Russell's Dow Theory letters, which argue that if industrial companies are doing well, then so should shipping and transportation companies. The Dow transportation index had its high at 5,618.25 last year, Gundlach said. But even though the S&P 500 reached a new high very recently, the transportation index is still below its prior high, indicating a non-conformation of the recent market rally.

Gundlach said investors should watch to see if the transportation index exceeds 5,618.25 in 2013. If that happens, and the industrial index reaches a new high as well, it would be a "bull buy sign."

But if that fails to happen, he said, it would signal trouble ahead.

For now, Gundlach said US equities offer a poor risk-reward tradeoff, and he said investors stand to lose more in equities than in an intermediate-duration bond fund. He wants to see lower prices before US stocks become attractive.

### **Japan, China and other non-US markets**

Gundlach's distaste for US equities was offset by his enthusiasm for Japanese and Chinese stocks.

He acknowledged that the 26% rally in Japanese stocks since they reached their bottom made those stocks less attractive than when he [called](#) them his best high-conviction investment idea in December. They are probably due for a correction, he said, "but I love the Japanese stock market for long-term investment."

Gundlach said the S&P 500 has grown 18-fold since 1979, but the Japanese market has gone up only fourfold.

He said going long the Japanese market and short the S&P 500 is a "great trade." In the event of inflation, Gundlach said he was virtually certain the Japanese Nikkei would outperform the S&P 500.

The Shanghai stock market is similarly attractive, he said, adding that China may be able to avoid a hard landing in its economy.

"I would certainly own the Shanghai and the Nikkei in lieu of developed stock markets," he said. He recommended a similar pair trade as he did for Japan – shorting the S&P 500 and going long the Shanghai.

Gundlach does not see similar bargains in Europe. "I'm really uninterested in European bonds of any stripe," he said.



Investors who bet against French bonds in 2012 did poorly, but Gundlach said a similar bet in 2013 is warranted. “France probably is a good short, ultimately, against their fiscal situation,” he said.

“I just don’t believe that the European situation has been resolved in any way,” he said. Although yields on European bonds have decreased lately, Gundlach said that would likely prove temporary.

### **The US bond market**

Talk of a “bond bubble” is overblown, according to Gundlach.

Treasury bonds are not overvalued, he said, relative to other fixed-income sectors. He attributed his assessment of Treasury valuations to the 60-70 basis point increase in their yields since they bottomed in July of last year, during which time yields on other fixed-income asset sub-classes came down.

“I actually kind of like the U.S. Treasury bond market when it’s up at about 2% or so, particularly when we look at some other asset classes,” he said. “There are plenty of asset classes that have tons of risk that yield 4% or even 3% on a risk-adjusted basis.”

Investment-grade corporate bonds are the most overvalued of those, Gundlach said. Their yields have come down to 3.7%, even though they have the same duration as 10-year Treasury bonds.

High-yield bonds are “not cheap” in terms of their valuation, Gundlach said. They now yield less than 6% on average, from which he said you should deduct 200 to 300 basis points to compensate for defaults.

Ginnie Mae mortgage-backed securities are fairly valued, he said, and they are clearly better than investment-grade corporate bonds.

Municipal bonds are also fairly valued, according to Gundlach.

### **Gold, the dollar and the classic question**

“One way or the other, there is going to be a big move in gold in 2013,” Gundlach said. Gold’s sideways move over the last 14 months is unlikely to repeat, he said; gold will likely be volatile in 2013.

The dollar has been similarly free of major volatility over the last few years, Gundlach said. Despite “all that has been going on,” he said it has been remarkable how stable the dollar



index has been. But he also said the dollar could be another “coiled snake,” with the potential to move in either direction.

Elsewhere among commodities, Gundlach said he was fond of both energy and agriculture as good long-term investments. Corn yields have been declining because of drought conditions, he said, and corn supplies (based on silo storage) are low. Both bode well for corn prices. Gundlach recommended buying either energy or agriculture assets if prices decline from current levels.

Gundlach is asked one question virtually every time he gives a presentation: What will the yield be on the 30-year Treasury bond one year and three years from now?

His answer to that classic question this time was bi-directional. A year from now, he said, he would not be surprised if the yield was lower than it is today. Three years from now, though, he said it would be higher – perhaps by “a fair amount.”

That response echoed his overall theme of a year of increased volatility. He ended his presentation with a final admonition that returned to his core theme: “Don’t expect the stability of 2012 to endure all the way through 2013.”

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