Despite a fragile economic recovery – now threatened by falling oil prices – and the likelihood that the Fed will raise short-term rates, the prospects for the U.S. bond market in 2015 are good, according to Jeffrey Gundlach.

“The US is a good place to invest based upon the economic fundamentals being better than other countries,” he said.

Gundlach, the founder and chief investment officer of Los Angeles-based Doubleline Capital, delivered his 2015 forecast in a conference call on January 13th.

His talk was titled “V,” to represent the pattern that bond prices formed last year by peaking in June. The slides from his presentation are available here.

Gundlach’s 2014 forecast, made a year ago, proved reasonably accurate. He correctly predicted the strong performance of the overall bond market (U.S. 10-year yields declined 86 basis points), the flattening of the yield curve and the poor performance of high-yield bonds. He accurately predicted that the Fed would end its quantitative easing (QE) program. He was too bearish on the U.S. equity markets, which returned 13.5% in 2014. Gundlach also correctly predicted the strong performance of the U.S. dollar.

I’ll turn to Gundlach’s 2015 forecast for bond market and other asset classes, but let’s look at his projections for the U.S. economy.

**Will oil thwart the U.S. recovery?**

Trends in employment dominate the positive case for U.S. economic growth. Unemployment has declined to the level it was in 2005, according to Gundlach. Long-term unemployment – those out of work for 27 weeks or more – has “really improved,” he said, and the 14-week rate is in a “healthy condition.”

Some of the jobs are not well-paying. Gundlach said that surveys have shown that businesses are more concerned about the quality of applicants in the labor market than they are about prospects for increased revenue. For that reason, he is skeptical of wage inflation. On a positive note, disability payments have leveled off, as has food stamp usage, he said.
But, he predicts, the decline in oil prices will exert further pressure on wages and on the overall economy.

“All of the job growth from 2007 to today can be attributed to the shale oil fracking situation and the oil Renaissance,” Gundlach said. “If you take Texas and North Dakota out of the data series for job employment, what you see is that we haven’t added any jobs in the United States other than those two regions.”

Gundlach warned that a “collapse” in capital expenditures in the oil industry could trigger declines in hiring and consumer income in various geographical regions. Oil prices approaching $40/barrel will lead to bankruptcies in that industry, he predicted.

Historically, the data show that low oil prices have been highly correlated with future economic growth among G7 developed countries, with an 18-month lag. Gundlach warning against inferring too much bullishness into that relationship because it is unclear whether low oil prices lead subsequent growth or vice versa.

Oil prices have also been highly correlated with headline inflation, measured through the CPI. Low oil prices have not yet been fully reflected in the CPI and, once they are, Gundlach forecast that the inflation will be negative. Indeed, he said it’s already negative when measured over the last six months. That will obviously be bullish for nominal bonds.

Three additional factors will weigh on the U.S. economy and markets, Gundlach said. Since 1871, there have not been more than seven consecutive up years in the U.S. stock market. The last six consecutive up years were 1898-1903, and a severe bear market followed; 2014 marked the sixth year of the current bull market.

“I’m not sure I put a lot of credence in one-variable samples,” he said. “But one thing that is interesting is that it is a lot of years in a row.”

The level of margin debt is “firmly in the bearish camp,” Gundlach said. Margin debt peaked before the dot-com and financial-crisis bear markets, and its level is now higher than those two prior peaks.

Third, the absence of QE is worrisome, according to Gundlach. Each time the Fed paused its QE program in the past, the S&P dropped, he said. “This seems to of been a predictable head wind and it is staring at us again.”

Gundlach expects the Fed to raise rates in 2015, but said it would likely have to reverse course and lower them. That was what happened in 1937, when the Fed mistakenly raised rates during the Depression. It happened again in 2011, when Sweden, Norway, Australia and New Zealand all had to lower rates after their economies weakened following a rate increase.

“We might get a couple of rate increases to see what happens,” he said. “And then once we see what happens they might decide it’s not such a great thing.”
Market forecasts

The median forecast among economists and strategists polled by Bloomberg is a 100 basis point increase in 10-year yields – exactly the same forecast as was made a year ago, according to Gundlach.

“The consensus has got it wrong entering 2015 again,” he said.

Gundlach forecast lower yields in the first half of 2015, but said he was less certain that trend will continue in the second half of the year. “What lies ahead of us seems to be that bond yields will follow the path of least resistance for most investors, and will be lower.”

Lower yields in non-U.S. markets will continue to be a positive force for U.S. bond prices, as Gundlach has noted in prior webcasts. German two-year bonds yield 69 basis points less than their U.S. counterparts, he said, a new high for that spread.

“No wonder people would rather park money in the dollar than the euro when you’ve got a yields advantage for short-term security,” he said.

Both German and Swiss yield curves are now similar to Japan’s, Gundlach noted. (He spoke before Switzerland allowed its currency to float, which triggered an increase in its rates.)

“Maybe the U.S. 10-year can make it all the way down towards Germany,” he said. “The path of least resistance has been accelerating to a lower 10-year yield.”

Oil prices will remain low. “Oil simply cannot rally,” he said. “I said bond yields simply couldn’t rise last year. Well, if something can’t rise it has to fall. That’s oil.” Gundlach said he would not predict what the low would be for oil prices.

Gundlach said high-yield energy bonds would be a “reasonably good trade to enter.” But he said they should be hedged with long-term Treasury bonds. Interest rates won’t rise unless oil prices rally, he said, so the Treasury bonds protect against a further decline in oil prices.

Energy bonds could exert downward pressure on the overall junk-bond sector, Gundlach said. Junk yields have been widening, and fund managers could be faced with redemptions. That would lead to forced selling, which would drive prices down, as managers unload first the more liquid positions and then the illiquid ones.

“At some point you get into phase two of the widening cycle; managers can’t sell any more of the liquid so-called good names because they already sold them all,” he said. “Then what happens is the illiquid names are increasingly for sale, and the weakness in those names starts to drag everything lower.”

Gundlach said it was “okay” to buy “some” junk bonds, but he is underweight in his funds. The good news, he explained, is that default risk in the high-yield sector is low. Most companies have refinanced and the bulk of maturities don’t occur until 2017 to 2018. “There are a lot of reasons to think that yields
will start rising five years from now,” he said. “There’s not a great logic when they are supposed to start rising five days, five weeks, maybe not even five months from now.”

“TIPS are for losers,” he said, although they are “cheap” on a valuation basis. But his forecast for low or negative inflation makes TIPS too unattractive to buy. He noted that the implied inflation rate, measured by the two-year TIPS market, is negative. Longer-term implied inflation rates are higher, and Gundlach said there will be a more opportune time to buy TIPS.

Gundlach likes Puerto Rican high-yield bonds, especially for high-bracket investors, such as those in California. “I expect those bonds to get cheaper during periods of distress,” he said. “Although they’re going to be money good, so they are worth owning for the goal line.” He noted, “They are for the speculative part of your bond portfolio for sure.”

Now is as good a time as there has been in the last three years to invest in gold, Gundlach said. If problems in Greece accelerate and a currency crisis develops, gold will be the beneficiary.

Don’t invest in REITs that own shopping malls, Gundlach warned. The movement of retail sales from brick-and-mortar enterprises to on-line channels is not fully reflected in mall REIT pricing, he said. Those securities yield 3% to 3.5%, which he said was a “horrible” payoff for a sector that is headed for the “retail graveyard.”

**A final prediction**

Oil was the dominant theme in Gundlach’s call, as he expects its effects to ripple through the U.S. and global economies this year.

Despite the positive effects of lower oil prices – Gundlach said it could boost U.S. GDP by 0.7% – he was more worried about negative repercussions.

“Usually when there is a huge shock to the system – either a big default problem or in this case a big implosion of the price of one of the most important commodities –it leads to a rippling effect that is not fully understood going into it,” he said. He compared the unforeseen consequences to Ben Bernanke’s prediction in 2007 of limited problems in the housing market.

The energy sector represents 35% of all capital expenditures among S&P 500 companies, according Gundlach. “That could literally fall to zero,” he said.

Weak oil prices will been more destabilizing for non-U.S. economies, especially energy producers. Gundlach predicted the dollar will head higher. Despite the fact that the dollar is a “crowded trade,” he said currency trends are persistent and long-lived. “The fundamentals underneath the dollar remain strong,” he said.

The combined effect of the unprecedented and unexpected fall in oil prices, the fragility of the U.S. economy and the uncertainty regarding Fed policy drove Gundlach’s final prediction: higher volatility.
“This year will have substantially higher volatility than 2013 and even 2014,” he said, “and it will be seen in people’s anxiety level and therefore asset prices.”