# Gundlach: A “Big, Big Moment” for the Bond Market

## September 12, 2016
## by Robert Huebscher

The bond market is “sniffing out” an unfriendly change in the direction of interest rates, according to Jeffrey Gundlach. Rates are going up, he said, and investors should position their portfolios defensively for a long-term secular rise in rates.

“This is a big, big moment,” Gundlach said¸ and it won’t pay to “be cute” by trying to benefit from short-term price movements, since the dominant trend will be higher rates.

“It pays not to squeeze the last bit of juice out of the orange,” Gundlach said.

Gundlach spoke to investors on September 8 to provide updates on his flagship mutual fund, the DoubleLine Total Return Fund (DBLTX). He is the founder and chief investment officer of Los Angeles-based DoubleLine Capital, known for its fixed-income mutual funds, closed-end funds and ETFs. Copies of his slides are available to download here.

Gundlach said he has been recommending defensiveness all year, even though Treasury rates have gone down modestly.

The narrative that the Fed is committed to aggressively easy monetary policy will change in a way that is “bond-unfriendly,” Gundlach predicted. He explained that July 6 marked the recent low in rates, when the yield on the 10-year Treasury was 1.32%. Since then, yields have risen gently, which he said marks the beginning of the bond market “sniffing out” the fallacy of the idea that “QE will be with us forever.”

The yield on the benchmark 10-year Treasury closed at 1.60% on the day he spoke.

I’ll look at the two factors Gundlach said will be driving the rise in rates. But, first, here’s what he said about Fed policy and the economy.

**The Fed’s dilemma**

Economic indicators are not supportive of a rate increase, according to Gundlach. But that may not stop the Fed from embarking on one – or possibly two – rate hikes this year.

Gundlach said that such a move could reflect a desire on the part of the Fed to "blow itself up." Gundlach did not say what he meant by that phrase; presumably he meant that the Fed would erode the market's confidence in its abilities.

Nominal GDP growth is at a very low level, Gundlach said, typically associated with recessions.

GDP estimates are lower than any prior estimates in this decade, which is inconsistent with the idea that the Fed will raise rates, according to Gundlach. "The data doesn't support a Fed rate hike," he reiterated.

Gundlach said the ISM manufacturing index is low, and the ISM non-manufacturing index is at its lowest level since the Fed began its easy-money policies.

"Clearly this is a bad environment for raising rates," he said, "yet some Fed members are talking about raising rates twice."

Gundlach said the Fed is creating an "alternative universe" by saying it will look only at two indicators – unemployment and inflation.

The economy may not be strong enough to support a rate hike, but Gundlach doesn't think it's headed for a recession.

As long as unemployment is below its 12-month moving average, he said there is "no chance of recession." Unemployment is four basis points below that average. If unemployment ticks up, even slightly, he said a recession is possible but not necessarily likely. The "sufficient" condition for a recession, he said, is if the quarterly unemployment rate goes above its 36-month moving average. The good news, he said, is that it is not even close, and that condition will not be met unless unemployment skyrockets.

Moreover, Gundlach said it is hard to forecast a recession when the Atlanta Fed is predicting real GDP growth of 3.5% for the third quarter of 2016.

Gundlach said that easy monetary policy has helped the U.S. markets, but that the more aggressive version of negative rates adopted abroad has not been good for economies or markets.

Quantitative easing (QE) stopped at the end of 2014, and Gundlach said there has been an uncanny correlation between the Fed's balance sheet growth and the S&P 500. Since the Fed stopped QE, the S&P has risen 4%, versus 17% during QE. In contrast, Gundlach explained, since Europe moved to negative interest rates the DAX and the Nikkei have "gone nowhere." Negative rates have not helped equity prices, nor have they helped global GDP growth. The estimate for 2016 global GDP growth is lower than the actual figures for 2015, he said.

Economic forecasters have consistently overestimated GDP growth, according to Gundlach. “That is the triumph of hope over experience,” he said, “much like a second marriage.”

He said that there are $14 trillion of negative-yielding bonds, representing a third of global GDP. Year-over-year GDP trends have been stable, despite aggressive monetary policies pursued by global central banks. In the U.S., Treasury yields have followed nominal GDP, which has been gently falling since 1980. Nominal GDP has stabilized more recently, and that suggests that bond yields will rise, according to Gundlach.

**The drivers of the rise in rates**

Indeed, the leveling of nominal GDP growth is a key reason Gundlach thinks we are headed for a secular rise in rates.

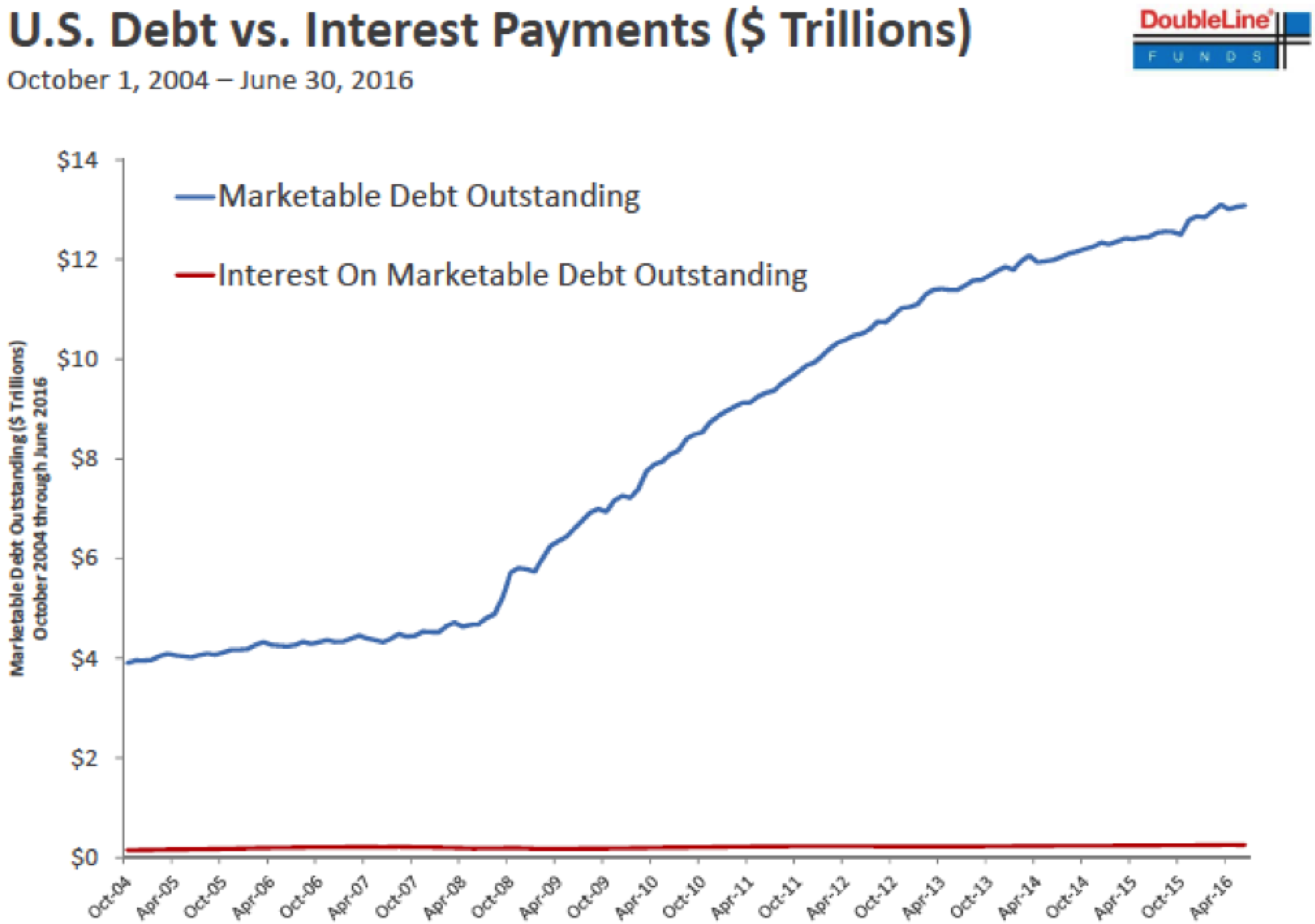
The other reason is that political conditions are indicative of a pending surge in fiscal spending. Both leading candidates – Clinton and Trump (who Gundlach predicted would win, as he has predicted previously) – have advocated for large increases in federal spending on infrastructure projects.

Clinton’s plan calls for $275 billion in spending, he said, while Trump’s plan calls for twice that figure.

Such spending can be justified by data on the deficit and debt.

Debt-to-GDP has stabilized since 2011, he said, and the deficit is “low” compared to where it was a few years ago. This opens up the likelihood of fiscal stimulus, a scenario which Gundlach said “is not on people’s minds.”

The average interest rate paid by the federal government has been coming down since 2004. Debt has gone up “massively” since 2008, but interest payments have been frozen. Gundlach predicted that Americans will be shown versions of the chart below, as politicians attempt to justify the ability of the government to borrow as a means to support additional spending:




The chart shows that, despite the large increase in federal debt since 2008, the amount of interest paid on that debt has barely increased. That is the result of lower interest rates, he said.

Gross investment by the government as a percentage of GDP is at a 70-year low, Gundlach said, while infrastructure support is “clearly needed.”

Pension plans could be borrowing too, he said, just like governments. Pension funding has not recovered since the crash in 2007-2009. Pensions have shifted to bonds, missing out on the post-crisis stock market rally. Pensions are guilty of a “mass psychosis,” he said, because there was no reason to allocate to fixed income when they were tremendously underfunded. It was like 30 years ago, he said, when pensions could have locked in double-digit rates with a 100% bond allocation.

“The idea that fiscal stimulus is needed is getting sniffed out by the bond market,” Gundlach said. He cited data showing that the occurrence of the phrase “fiscal stimulus” in the media has exploded in the last year.

“Fiscal stimulus is the next move,” Gundlach said, “and it is not bond friendly.”

There will be two effects of an increase in fiscal spending, Gundlach said, and both will push rates higher. The supply of bonds will increase, and GDP growth will be higher.

“How can rates rise?” he asked rhetorically. “That’s how.”

**What should advisors do?**

Gundlach commented on valuations in certain sectors of the bond market and spoke about how advisors should be positioned more generally.

Corporate bonds are highly overvalued in two ways, he said. Spreads have tightened, despite rates falling, which is very rare. Also, he said those bonds have very long durations – an average of 7.6 – which is almost as high as the 10-year Treasury, mainly because corporations have borrowed aggressively to take advantage of low rates. “If rates go up,” Gundlach said, “you will lose money quickly in corporate bonds.”

Corporate credit broadly is not a great bet, Gundlach said. Emerging-market debt has done better than corporate bonds this year (it is the top-performing bond sector this year, up 15.2% in dollar terms), and he said they are a “better way to take credit risk.”

Mortgage REITs at a 10% yield are “fine,” he said, “but nowhere near as attractive as they had been in the past.” The spread to utilities has narrowed, he said, and investors are “just getting the yield.”

During the question-and-answer period, he was asked why investors are buying utilities at 2% instead of closed-end funds at 8%-10%. “People don’t understand closed-end funds and similarly don’t understand mortgage REITs,” he said. “It is ignorance. If the world were more sophisticated, closed-end funds would be trading closer to their asset values.”

Gundlach defended a call he made in July, which was to “sell everything.”

He said that call was made in the wake of his prediction that bonds were bottoming at the time. He said that advice was not intended to be taken literally. His message then, as it is now, was to “get more defensive,” he said.

“Stay defensive on interest rate risk,” he said, and ideally maintain a lower duration than the Barclays AGG, which is 5.5.

He said investors should shift from index or aggregate bond funds to lower duration funds and less risky assets broadly.

And, he said, move a little bit more to cash.

Gundlach noted that call is consistent with what Gary Shilling recently advised. Shilling has long called for a 2% 30-year yield. When that yield got to 2.09% earlier this year, Shilling said to raise cash.