Gundlach's Forecast for 2014

By Robert Huebscher
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In his 30-year career as a fixed-income manager, Jeffrey Gundlach has never seen a forecast as solidified across every asset class as is the consensus for 2014. Investors expect stocks to outperform bonds, gold to be a "loser," commodity prices to head lower, domestic markets to outperform non-U.S. markets and the dollar to be strong, according to Gundlach.

But many of those views are wrong, he believes.

Gundlach's projections have earned him a reputation as a contrarian and successful investor. Gundlach, the founder and chief investment officer of Los Angeles-based Doubleline Capital, delivered his 2014 forecast in a conference call Jan. 14.

The consensus is wrong in its assumption that interest rates will rise, according to Gundlach. "I don't think that long-term bonds are going to do all that badly on the yield curve basis," he said.

His talk was titled "The Year of the Horse: 'Let the Race Begin!" and the slides from his presentation are available here.

Gundlach is recognized as a prescient forecaster. For example, he foresaw the collapse of the housing market leading up to the financial crisis. But his forecast last year did not turn out that well. A year ago, he said he would not be surprised if yields were lower at the end of 2013 than they were at the beginning. In mid-2013, he predicted the 10-year yield would be 1.7% by the end of the year. It yielded 3.04% instead. A year ago, he said U.S. equities offered a poor risk-return tradeoff and predicted that economic growth would be slow, volatility would be high and Chinese equities would perform well. None of those were accurate. However, he did correctly predict the poor performance of Treasury inflation-protected securities (TIPS), outperformance in the Japanese markets.

Let's look at Gundlach's forecast for Federal Reserve policy, various fixed-income asset sub-classes, stocks, commodities and other markets. I'll conclude with what he said about Apple's stock and the next big, disruptive technology.

Fed policy, interest rates and the fixed-income markets

Barring any surprises from the economy or spikes in bond-market volatility, Gundlach said the Fed will continue tapering and be "out of the bond-buying program by the end of the year."

Gundlach said that the Fed might even surprise investors by allowing short-term rates to rise at some point during the year. He doesn't expect the yield curve to steepen – the spreads between long- and short-term rates are already at record highs.

Nonetheless, Gundlach said he expects short-term rates to remain low into 2016, although the market's faith in the Fed to keep those promises will be shaken. The short end of the Treasury market will experience more volatility, he said. "The Fed lost a little bit of credibility on its so-called guidance strategy already," he said, "and that may be challenged further."

Gundlach said the downward movement in the 10-year Treasury yield will continue in the near term and that the rise in yield is "fairly complete." In the short-term, he said bond yield may drop to 2.5% on the 10-year.

Mutual-fund flows may work against bond investors. Gundlach said that much of the money that went into bond funds in 2012 was invested with "elevated expectations" and has begun to flow out. He said those outflows began in the middle of last year and will continue during this year.

Driving bond prices higher – and stocks lower – will be investors who need to rebalance to maintain a 60/40 asset allocation. Gundlach said those investors would have to sell 7% of the equity assets and reinvest in bonds as a result of 2013 price movements.

Inflation is keeping interest rates low. There's "no inflation in the pipeline," he said. Deflationary fears in Europe, falling commodity prices and minimal gains in average hourly earnings are preventing inflation from accelerating, according to Gundlach.

Pension funds will be a catalyst pushing rates lower, he said. Pension-plan funding has improved over the last several years, due to equity price increases and lower liabilities. Gundlach said pensions will move to lock in their improved positions by shifting their asset allocation toward fixed income.

Gundlach warned that junk bond investors – particularly those who are also shorting the Treasury market – could face the "mother of all liquidation calls." If Treasury rates fall, a "short squeeze" would confront those investors. With the Fed buying a large percentage of government-guaranteed bonds, Gundlach said this could propel a "violent move" in Treasury bonds, as buyers outnumber sellers. "I would not have a zero Treasury position," he said.

Based on a proprietary relative-value analysis that Gundlach said he has been using for 20 years, investment-grade bonds are at a very rich level versus Treasury bonds. But high-yield bonds are even more overvalued. Gundlach said it would be more appropriate to call them "not-so high-yield bonds." Still, he doesn't expect a high rate of defaults among those bonds. "I think we skipped a default cycle," he said.

Yet another sign of lower rates is the value of emerging-market currencies against the dollar. When emerging markets strengthen against the dollar, rates tend to go down, he said, and recent movements suggest lower yields for the near term.

Mortgage rates are heading up, Gundlach said, and the housing market is "softer than people think." Data such as existing and new home sales and housing starts are off their lows in 2009-10, but he said they've "only recovered back to levels that used to be characteristic of the depths of a recession." Demographics and household formation are "wildly against the concept of homeownership going higher," he said.

Municipal bonds are slightly overvalued, he said. Investors who are willing to tolerate volatility will get rewarded for the risk in Puerto Rico's bonds. Too many politicians rely on votes tied to the stability of Puerto Rico to allow a crisis there, according to Gundlach. "Puerto Rico's bonds are going to make it to the other side of the valley," he said.

Gundlach still doesn't like TIPS, but his distaste for them has waned as their prices have fallen. He warned, however, that TIPS prices are likely to decrease further before inflation sets in, because real interest rates will rise in advance of a spike in inflation.

Stocks

Gundlach pointed to a number of ominous signs for the stock market.

He displayed charts showing that the run-up in the stock market has nearly paralleled the increase in the Fed's balance sheet. He said continued tapering might mean "weakness incrementally for risk assets," which would take away support for the stock market.

Margin debt doesn't get enough attention, Gundlach said, and it is at a very high level now – consistent with levels at the previous two market peaks. "You should watch the margins very closely, because if it hooks over and starts heading down, it removes another key support for the stock market," he said. Today's bullish market sentiment reinforces Gundlach's belief that stocks are nearing their peak.

Even market technicals look bad, he said, with the stock market "extremely extended" above its 200-day moving average.

The average price of the S&P 500 during the second half of 2013 was approximately 1,750, and Gundlach said investors will "get nervous" when the price drops below that level, as investors who were dollar-cost average will be underwater.

"About everything that tends to characterize the vicinity of a top in the equity market seems to be in place," he said. "The stock market is at best fully valued, maybe a little over."

Stock-market volatility, which was extremely low in 2013, is likely to increase. Gundlach said this is consistent with this being the Chinese year of the horse.

Commodities, currencies, gold, Apple and the next big technology

Gold will see a price of at least $1,350 at some point during the year, Gundlach said. It is now $1,209. He added that he likes gold-mining stocks as a diversifier – which has been his position for the last couple of years – and as an outright purchase.

For other commodities, Gundlach offered only vague predictions. "It seems to me we are going to have to see some form of volatility in the commodity market during 2014," Gundlach said. "Commodities are going to have to have a move this year. I'm not convinced which way it's going to be," he said.

For at least the past several years, Gundlach has favored dollar-denominated investing in emerging markets, and he expects the dollar to head higher in 2014. That call is now aligned with consensus views, although he said that as recently as 2012, local-currency emerging-market funds were extremely popular.

On Nov. 7, 2012, Gundlach said Apple stock would fall to $425. At the time, it traded at $560 per share. By the beginning of March, Apple had fallen to below $420.

Now, with Apple back to $541 as of Jan. 17, Gundlach said he "likes it in a portfolio." He said it has very low correlation to other stocks and generates a lot of cash flow. He said it may go to $600 in 2014, but it's unlikely to exceed that this year.

Gundlach concluded the call with a long-term prediction: Three-dimensional (3-D) printing will be one of the most monumentally transforming and disruptive technologies. He said 3-D printing applications extend from fabricating automobile replacement parts to building homes – potentially in less than 24 hours.

3-D printing is part of an ongoing trend, Gundlach said. A class of laborers is becoming unemployable as their skills are being replaced with technology. Investor psychology and investment analysis have not fully incorporated the potential of this transformation, according to Gundlach.