Gundlach's Top ETF Recommendation

November 17, 2017

by Robert Huebscher

The money to be made is in non-U.S. markets, according to Jeffrey Gundlach. For long-term investors, he recommends a specific ETF.

That ETF is INDA, the iShares fund that tracks the Indian equity market. He singled out India because of the growth of its workforce and its tradition of education and technology.

"It could go up 1,000% in the next 20 years," Gundlach said, "just like China did." INDA is up 32% year-to-date and carries an expense ratio of 0.71%.

Gundlach is the founder and chief investment officer of Los Angeles-based DoubleLine Capital. He spoke at the Schwab IMPACT conference on November 16. His talk was titled, "2017: At the Home Stretch."

I'll go over what he said about the global economy and why he believes emerging markets are a compelling opportunity, along with some "insane" developments in various asset classes.

The global landscape

This has been a very easy year for investors, he said, with no volatility in bonds, although short rates have gone up. The S&P is up 17%, but he said investors would actually have been unlucky to have over-allocated to it, since some of the emerging markets have performed better.

"There is a narrative of a synchronized global expansion," he said, "which is correct." Of the 35 OECD and 10 non-OECD countries, most have accelerating growth and the rest are standing still, according to Gundlach. The global manufacturing and service PMIs are in uptrends and at highs for their last 20 months. Real GDP growth in the emerging and developed markets is increasing, he added.

The central issue that characterizes the economic landscape is a contradiction in policy, according to Gundlach, with the European Central Bank (ECB) and the Fed pursuing different monetary policies, despite similar economic conditions.

In Europe and the U.S., he said, GDP growth, inflation, manufacturing and retail sales are the same or better levels as compared to recent prior years. But the Fed is tightening, by raising rates and engaging in quantitative tightening (which he said has been given the more pleasant-sounding name of "normalization"). In Europe, however, there is quantitative easing (QE) and negative interest rates.

Historically, Gundlach said, the ECB has tightened in similar environments. All its prior rate cuts were when the European PMI was below 56, where it is now.

The ECB's policies have depressed interest rates across Europe, particularly the benchmark German 10-year bond, which Gundlach said has been effectively pegged at approximately 50 basis points. This has driven investors, especially those in Europe, to favor higher yielding U.S. Treasury securities over German bonds.

"Draghi has created the pedestal upon which interest rates rest," Gundlach said.

"Things will change when the German 10-year floats above 50 basis points and starts to break loose on the upside," Gundlach said. "If it goes above 50 it will hit 100 in a week, and the U.S. 10-year [yield] will be unfettered to the upside."

No recession in sight

There is very little evidence of a recession in the next six months, according to Gundlach.

He cited a number of technical indicators that are not signaling a recession. The Conference Board leading economic indicators, going back 30 years, have steeply declined below zero prior to the last three recessions. "There is never a recession without those going below first," Gundlach said. "Those indicators hit zero in 2016," he said, "but they are downright strong now." The ISM manufacturing and services PMIs, which plummet in advance of a recession, are both rising now, he said. All these indicators give three- to six-month warning, he said, and added that consumer confidence is high, but that "doesn't guarantee anything."

The best tell-tale sign of a recession is the yield spread between high-yield (junk) bonds and Treasuries, Gundlach said. About 250 days prior to 2001 recession, spreads widened, and in 2007 it was very similar, he said. Currently those spreads are subdued, he said, "so a recession is unlikely, at least in the next six months."

The Fed watch

According to the "dot-plot," which tracks the expectations of interest rate movements among the Fed governors, there will be three raises in each of the next three years, Gundlach said. "But the bond market doesn't agree." It says that there will be 1.5 rate hikes in the next two years.

Who is right?

"The answer to that question will determine how the bond market and the dollar fare," Gundlach said.

Gundlach is betting with the bond market.

He presented a graph that showed that the S&P 500 has gone up in lock-step with central bank balance sheets. As further evidence of that relationship, he showed that stock prices have declined when earnings were revised down, and vice versa, but that relationship broke down during periods of QE, when stock prices went up "perpetually," he said.

"QE appears to help risk assets, but it won't be the tailwind it was during the last six years," Gundlach said.

With quantitative tightening, assuming the ECB does not tighten, global central bank balance sheets will be flat. But equity investors will still benefit from expanding balance sheets for a few more months, according to Gundlach.

Gundlach commented briefly on the Republican's proposed tax plan. He said that previous tax cuts, by Reagan and George W. Bush, were sold as revenue-neutral, but actually increased public debt relative to GDP.

"The deficit is expanding and will accelerate in the next few years," Gundlach said. "If there is a tax cut, it will amplify that, and that has to be bond unfriendly."

The inflation and commodity outlook

Gundlach was skeptical of the health of the labor markets. He said that the 4.1% unemployment rate would be as high as 8% if the labor participation rate had been constant since the global financial crisis. He also noted that job losses have been confined to those younger than age 55.

Core CPI and PCE inflation measures are "down-trending" below 2%, he said.

"Whether the bond market or the Fed is right will depend on where this goes," he said, in reference to whether there will be 1.5 or six rate hikes in the next two years.

Commodities are cheap relative to the S&P 500, he said. But that trend has leveled off and stocks and commodities have been at the same relative valuations during the last three years, according to Gundlach.

"Commodities are secretly starting to rally," he said. "Maybe you should buy a few now, particularly industrial commodities, like copper." He said that investment thesis corroborates the synchronized global upturn.

The emerging market opportunity

The dollar has rallied since 2011, Gundlach said, but is now heading lower. As a result, there is money to be made in non-U.S. markets, especially the emerging markets.

Emerging-market outperformance has historically happened when the dollar has weakened, and Gundlach said this has been an extremely tight correlation.

"This is a good trade," he said. "There is a lot of ground to be made up in non-U.S. stocks versus U.S. stocks."

The U.S. market is “painfully expensive” on a price-to-sales metric, Gundlach said, and margins are at their all-time highs. “Revenues have to go up quickly or you are going to see a lot of rot,” Gundlach said. The overvaluation of U.S. stocks is concentrated in bigger stocks, he said, in both the S&P and the NASDAQ.

By contrast, emerging-market stocks are very cheap when measured by capitalization-to-GDP, he said, and are 60% cheaper than developed markets.

“Emerging markets are cheap relative to the S&P and have been getting cheaper from 2013 to 2016,” he said, “but have risen since the start of 2017.”

Emerging markets are cheaper than the S&P based on the Shiller CAPE ratio, Gundlach said. That ratio is 16 for emerging markets versus 30 for the U.S. – only in 2000 was it higher.

“It is not foolhardy to predict convergence, which would be a 100% outperformance for emerging markets,” Gundlach said.

Some insane developments

Gundlach commented on a number of developments in the market that he called “insane.”

“Bitcoin is weird and maniacal,” he said. It is not a currency, because it is too volatile. Bitcoin futures are about to be listed, he said, and noted that when uranium futures came out in 2007, it was exactly when its price peaked.

On a similar note, he said that futures are coming out on the FAANGS (Facebook, Amazon, Apple, Netflix and Google), along with a few other high-momentum stocks.

European high-yield bonds yield 1.98% assuming no defaults. But the five-year Treasury yields 2.06%, so he said there is no reason to buy European junk bonds.

The seven-year moving average of nominal GDP is much higher than the 10-year U.S. Treasury yield, although the two have tracked very closely on a historical basis, Gundlach said. Given the GDP numbers, the 10-year should be at 4.1%, Gundlach said.

“If nominal GDP goes up, it will push yields higher,” he said.

“Investors have foolishly piled into credit at the wrong time,” Gundlach said, referring to the flow of assets into high-yield and investment-grade bond funds and ETFs. He called those investors ‘return chasers’.

He warned of dangers in the high-yield market. “Covenant-lite” (bonds with weak protections for investors) as a percentage of total loan issuance has averaged over 70% for the last three years, versus never being above 33% from 2003 to 2012.

With regard to the investment-grade market, he said the average duration is 7 but investors “don’t think prices can go down. Watch out, they have interest-rate risk.”

By contrast, there have been no net flows into mortgage-backed securities since 2013.

“Buy things that people foolishly don’t understand, like mortgaged-backed bonds,” Gundlach advised.

“Get out of things, like investment-grade bonds, that people don’t understand are truly bonds with long durations and interest-rate risk,” Gundlach said. “This is especially important late in the cycle, particularly if we are looking at a recession down the line.”

