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Gundlach on the Biggest Risk Facing Bond Investors and the Likely Next President

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On December 11 at 5:22pm ET, this article was corrected. In the following paragraph, the next-to-last word was changed from "lower" to "higher": "Gundlach thinks the deficit will go to 13% of GDP in the next recession. That is why, he said, there will be a greater supply of bonds and higher yields."

Fear among bond investors is focused on rising rates, but Jeffrey Gundlach says you should worry about something more sinister. In his webcast yesterday, he also offered his updated 2020 presidential election prediction.

Gundlach is the founder and chief investment officer of Los Angeles-based DoubleLine Capital. He spoke via a webcast with investors on December 10. His talk was titled, "A Rolling Loan Gathers No Moss," and the focus was on his firm's flagship mutual fund, the DoubleLine Total Return Fund (DBLTX). The slides from his presentation are available here.

His talk's title is a play on the phrase, "A rolling stone gathers no moss." Gundlach said his title was originally coined by the hedge fund investor, Kyle Bass, to signify that investors will continue to be paid on the bonds they own as long as issuers can keep rolling over their debt.

The credit worthiness of corporate debt is the number one risk that should concern bond investors. Gundlach issued his strongest warnings ever over the leverage taken on by U.S. corporations and the unrealistically favorable ratings that debt has been given.

Based on Morgan Stanley research, he said that 39% of the bond universe should be rated "junk" and 10% of it rated single-B or lower.

"There is a lot of potential for downgrades," he said, which would be amplified if foreigners start selling the debt they own and the dollar weakens.

"This is the biggest risk facing bond investors," Gundlach said.

As for U.S. politics, Gundlach said the field of Democratic nominees is in such disarray that Trump will likely win reelection. Readers may recall that Gundlach was among the few who predicted Trump's victory in 2016. But Gundlach did not endorse Trump or any other candidate.

I'll come back his comment on bonds and politics, but let's start with what he said about the September 17 incident when repo rates spiked to abnormally high levels.

The great repo fiasco revisited

Gundlach called that incident the "overnight funding dust up," but that characterization belies his concerns. He said there is growing sentiment over whether "we will ever get back to whatever we think was normal," specifically a global bond market free of negative interest rates. Excluding the U.S., 34% of the Barclay's global aggregate index is negative-yielding debt. It was more than half earlier this year, he said.

"It is clear that sustained negative rates have changed attitudes and behavior in Europe," Gundlach said. "People are wondering whether bonds should be excluded from asset-allocation decisions," because of their negative yields. On his recent trip to Europe, Gundlach told investors not to own them.

Fed Chair Jay Powell understands that negative rates in the U.S. would be "devastating for the global financial system," Gundlach said. "The system could not survive very long."

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He said the repo crisis was blamed on a “timing need” to cover tax payments. But that need was known before September 17. He said the crisis was a “very bad sign,” showing lack of liquidity to accommodate the repo market.

“This overnight repo thing is a harbinger of lack of liquidity,” Gundlach said.

The addition of repo reserves to address the problem reversed 40% of the quantitative tightening (QT) the Fed hoped to achieve.

The dollar and global “yield starvation”

The U.S. is not planning on fighting its next economic downturn with negative interest rates, according to comments by Powell that Gundlach cited. But Gundlach criticized other Fed actions, such as the stopping of QT and starting a form of quantitative easing (QE), after promising four rate hikes at the beginning of the year. Gundlach said the Fed plans large-scale asset purchases in the event of a downturn, which could create a buying opportunity for investors prior to that move.

In the next downturn, he said rates will be higher on the long end. He based that on the history of the three-month to 10-year yield spread. It steepened during QE1 when the Fed was buying bonds and stimulating the economy. In QE2 and QE3 the spread behaved the same way. During QT, he said, the yield curve flattened. With the repo facility expansion, he said the yield curve is steepening again.

The dollar is putting a “significant top,” Gundlach said. Its last top was in January 2017. The dollar has been “incredibly stable” this year, he said. “I expect the dollar to weaken, since the Fed is easing.” It was strong because of “yield starvation” across the globe. Foreigners need to buy U.S. bonds because of their yields, but can’t hedge their exposure back to local currencies, because it will drive their effective yields back below zero. Those investors must buy U.S. bonds “naked,” he said, driving the dollar up.

But emerging market debt has been a good investment this year, with a 12% overall return, despite a -70% return in Argentinean bonds. High-yield bonds are up 12.6% and investment-grade bonds have done even better, with a return of 14.2%. Treasury bonds returned 7.2%.

Gundlach showed historical data that illustrated that dollar weakness has been correlated to current account and budget deficits. When the two combined grow as a percent of GDP, he said, the dollar weakens. “As deficits continue to widen,” he said, the dollar will get “in sync” and weaken further. But, he said, it may take economic weakness in the U.S. to initiate a strong move down in the dollar.

Retuning to a common theme in his webcasts, he said U.S. debt outstanding has “exploded” since the 1940s. Corporate debt has been “put on turbochargers” and is accelerating faster than ever. He warned about similar fiscal deficit expansion at the federal level. There is no hope that the Democratic Party will produce a nominee who would curb deficits, he said.

Gundlach thinks the deficit will go to 13% of GDP in the next recession. That is why, he said, there will be a greater supply of bonds and higher yields.

In previous webcasts, Gundlach has said there was 65% chance of a recession by end of 2020. But now, based on consumer confidence and the leading economic indicators (LEIs), which are above zero (and heading up), the odds are 35% by the end of 2020. Those odds, he said, are the same as the consensus.

Germany is running a current account surplus and rest of Europe has small deficits, which led Gundlach to wonder whether positive rates in the U.S. are a result of our need to issue debt to fund our deficits.

He noted that Greek 10-year yields are lower than those in the U.S. In 2011, they were 20% and as recently as 2016 those yields were 12%.

The problem in corporate bonds

In the near term, he said the long end of the curve is “heading up” and the yield curve will steepen, until the Fed decides to implement large-scale asset purchases.

The copper-gold ratio suggests that the 10-year should be approximately 2%, according to Gundlach. Based on nominal 10-year GDP and the German bund yield, an indicator he has found to be highly reliable, the projected 10-year yield is 1.76% to 1.9%, depending on the next release of nominal GDP.

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At the end of October, Powell said that he needs to see a significant spike in inflation before raising rates. “The Fed is basically telling you it wants sustained real inflation before it would consider raising rates,” Gundlach said. “Maybe they will cut rates, but they won’t raise them. I am surprised the long end of the market isn’t weaker.”

Foreigners have been buying U.S. assets, he said, but that is unstable. If the economy weakens, those investors will want to “get out.” A lot of “potential selling” could happen, Gundlach said. Broker dealers outside the U.S. are not regulated with the same type of circuit breakers in the U.S. that prevent rapid declines, according to Gundlach.

In the U.S. corporate bond market, dealer inventories are “nonexistent,” Gundlach said, despite continued issuance over the last 20 years. The quality has collapsed in the last 30 years. Bonds rated single-A and above were 68% of the market in 1998, but are now only 40%. The lowest tier of investment grade (BBB) has filled the gap, according to Gundlach.

“That’s a real problem when the next recession comes,” Gundlach said. “Those bonds are close to junk status.”

Corporate debt as a percent of GDP went from 40% to 47% over the last decade. That ratio historically collapses in recessions, Gundlach said. “When that happens it will be very difficult to get out in the middle of it.”

He reminded listeners that in past recessions bond downgrades outnumbered upgrades by two-to-one.

He said that corporate leverage, based on the ratio of investment-grade and high-yield (ex-commodities) bonds to corporate EBITDA, is “very high” on a historical basis. If one were to include commodities in that ratio, “it would be much worse,” he said.

The political outlook

Assessing the potential Democratic nominees, Gundlach said that Joe Biden has “no chance.” Nobody will vote for him who watched what he was doing, Gundlach said, particularly that he can’t formulate sentences.

Elizabeth Warren has completely “petered out,” he said, citing data from the betting markets (predictit). Wall Street has completely discounted the possibility that she might win and implement policies that would threaten economic growth. Gundlach said the market “foresaw her demise and got it right.”

Pete Buttigieg is “really impressive,” he said, and the best candidate on his feet since Ronald Reagan. But he is 37 years old and “looks 21, which can’t be overcome.”

Bernie Sanders could emerge as a nominee if he gets Warren’s support, Gundlach said, but otherwise has a small chance of getting the nomination.

He doesn’t see Michael Bloomberg winning either.

The strongest candidate among the Democrats is Hillary Clinton, Gundlach said. She is at 10% in the betting markets, tied with Bloomberg. But he doubts she will enter the race.

“The base case is that Trump will win,” Gundlach said, “because the Democrats are a mess.” He added that Trump will not be removed through the impeachment process.

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