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Gundlach's Forecast for 2020

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Expect a steeper yield curve, according to Jeffrey Gundlach. Investors should be "defensive" with respect to long-term bonds. Gold will go up, inflation will be subdued, there is a 30% to 35% chance of recession and – his "highest conviction" idea – the dollar will weaken. His most surprising prediction, though, was that Bernie Sanders will emerge as the likely Democratic nominee, which he said is also the biggest risk facing the market in 2020.

"Don't expect returns on stocks or bonds to come anywhere close in 2020 to where we're in 2019," he said.

Gundlach is the founder and chief investment officer of Los Angeles-based DoubleLine Capital, a leading provider of fixed-income mutual funds and ETFs. He spoke to investors via a conference call on January 7. Slides from that presentation are available here. This webinar was his annual forecast for the global markets and economies for 2020.

Before we look more closely at his 2020 predictions, let's review hisforecasts from a year ago.

His most prominent prediction was that 2019 would mark the start of a period when the bond market would have to reckon with the rising federal deficit and liabilities from Social Security and other entitlements and that the cost of financing that debt would rise. In fairness, though, he also predicted that the 10-year yield would decrease in 2019. Interest rates went down last year, with the benchmark 10-year Treasury yield declining by 74 basis points, from 2.66% to 1.92%. (correct)

Gundlach predicted that a recession was unlikely in 2019. (correct) He also said that there were "ominous" signs from the housing market. But housing starts actually increased 0.6% from January through November as compared to the same period in 2018. (wrong)

He predicted the dollar would weaken in 2019 and that emerging markets would, as a result, do well. The U.S. dollar index (DXY) rose approximately 1% last year (wrong) but emerging markets, based on the iShares MSCI Emerging Markets ETF (EEM), returned 18.20% (correct).

Gundlach advised against investing in Europe. But the iShares MSCI Eurozone ETF (EZU) returned 23.27% last year. (wrong)

He was bullish on bitcoin and predicted it could gain 20% in 2019. It actually returned 97.3%. (correct)

He said commodities had a "50%" chance of making money. The S&P GSCI commodities index posted a modest gain of 2%. (correct)

He predicted the yield curve will steepen in 2019, based on the two- to 20-year spread. That spread increased by 18 basis points, from 16 to 34 basis points. (correct)

He was bearish on corporate bonds and cited excessive leverage in the private sector. The iShares Broad USD Investment Grade Corporate Bond ETF (USIG) returned 13.99%. (wrong)

That's six correct and four wrong.

Deciphering the global economy

Gundlach gave an overview of the performance of the global markets, focusing on banks and the financial sector. U.S. financials have performed very well relative to Europe and Japan since the financial crisis, and that has been because rates in the U.S. have remained higher than other developed markets. He said it is also because U.S. stocks overall have performed better than those in Europe or Japan.

He noted that the amount of negative-yielding debt outside the U.S. has decreased from $17 to $18 trillion last year to

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approximately $11.8 trillion now.

But that negative-yielding debt is still hurting non-U.S. banks, which he said cannot be healthy under those conditions, citing Deutsche Bank as an example.

His prescription for Europe is to “stop negative rates.”

The Fed is “solidly on hold,” Gundlach said. Market-based models indicate there is as much chance of a cut as a hike over the course of 2020.

Real GDP growth in the U.S. is predicted to be 1.8% this year, following 2.3% in 2019.

As for his 30% to 35% recession prediction, Gundlach said the key to the economy is the labor markets. There are some early signs, based on weekly unemployment claims, that it might be weakening, but it is not alarming yet.

The leading economic indicators (LEIs) are “flashing yellow” for a recession, he said, and the manufacturing PMIs are flashing a “very faded, faint yellow.” But consumer confidence, as measured by the Conference Board, is at historically high levels. However, other surveys that ask how consumers feel about the present compared to the future, are giving less positive readings, he said.

Wage growth, which had been at approximately 2% for five years prior to 2017, has spiked to 4% a few times since then, only to recede. It is now at 3.7%. Gundlach said the Fed might allow wage growth to go above 4% before adjusting monetary policy, as it still wants to create more inflation.

Gundlach characterized the Fed’s action in the repo market on September 17 as temporary. But he said that the Fed should be expected to engage in quantitative easing 4 (QE4), purchasing long-term and mortgage-backed bonds, if long-term rates were to rise.

Long-term rates will rise, he said, causing the yield curve to steepen and that would create a buying opportunity for bond investors.

Sanders coming surge

Gundlach gained notoriety for predicting, early on, Trump’s victory in 2016 and he hasn’t shied away from continuing to predict political outcomes.

The polls show Biden tied or ahead of his rivals, but Gundlach said, “I seriously do not believe that Joe Biden is going to win the nomination.” He said that the “vilification of billionaires” will be a big theme in the election and that will benefit Sanders.

“I just can't even imagine how ugly it would be for Joe Biden and Donald Trump to be onstage for two hours,” Gundlach said. “Biden will have a really hard time in a one-on-one debate for two hours because he seems to run out of energy in a debate with six or seven people after an hour and a half or so.”

Elizabeth Warren is “down for the count,” according to Gundlach and Pete Buttigieg is too young and lacking in experience to sway enough voters.

As Warren falters further, it will propel Sanders, he said.

Whether Sanders beats Trump will depend on the economy, he said, and he did not predict an eventual winner.

More predictions

The dollar will weaken this year, according to Gundlach. That will be driven by foreigners divesting some U.S. assets, and by the fact that the U.S. budget deficit is worse than those in major European economies.

A weakening dollar will lead to higher commodity prices, he predicted, and strong performance in emerging markets.

Gundlach discussed two other indicators – the copper/gold ratio and the ratio of nominal U.S. GDP growth to the German bund yield – that forecast a rise in the 10-year Treasury yield.

He also was not overly fearful of market turmoil from the tensions in the Middle East. Gundlach said the U.S. has the

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capability to take out a car with a drone strike, so it should be able to inflict precise damage to Iran’s oil facilities that would disable its production for a few weeks, rather than totally destroying an entire operation. That way, U.S. strikes could carry the implicit threat of precision strikes being repeated as necessary.

“I don't like European stocks with all the rancor over there and the negative interest rates in particular,” he said. But he advocated allocating more to non-U.S. stocks “than typical.”

“I'm not a big fan of investing in China,” he said. “I just think there's a lot of uncertainty.” But, he said, a phase one or “more broadly spanning” trade deal is likely before the 2020 election.

The high-yield bond market has been distorted because investors are “throwing caution to the wind” in their search for yield. One of the “worst investments in the bond market” are BB-rated bonds, he said. Nor does he like BBB-rated bonds – he prefers emerging market debt.

“I don't think it's going to be the boring 20s, nor do I think it's going to be the roaring 20s,” Gundlach said. “It's going to be a highly volatile period.”

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