Gundlach: Recession Probability is 80% to 90%

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by Robert Huebscher

Many of our readers will ask why it is not 100%, but Jeffrey Gundlach said the probability of a recession in the U.S. in 2020 is 80% to 90%.

“The probability is 80% there is a recession this year,” Gundlach said. “I would even put it at 90%.”

Gundlach spoke to investors via a webcast, which he titled “The Price is Right,” and the focus was on his flagship total-return fund (DBLTX). Slides from that webcast are available here. Gundlach is the founder and chairman of Los Angeles-based DoubleLine Capital.

He chose his title two weeks ago, because it takes that long for him to get compliance approval. He thought then that markets were mispriced. “Something was about to give,” he said.

Indeed, it did.

He said that the Treasury market is up 5.5% this year, but investment-grade bonds are down 10%, high yield is down 12% to 15% and emerging-market debt is off by 7% in dollars (and 12% to 15% in local currencies).

Those sharp price moves have been accompanied by a scarcity of liquidity.

There is about a 40-basis-point spread in the commercial paper market, according to Gundlach. In the corporate market, the lack of liquidity is showing up in large divergences in price, depending on the transaction size.

Let’s look at Gundlach’s survey of the economic and financial destruction wrought by the coronavirus.

The heavy hand of the Fed

With the Fed cutting rates to near zero, it is admitting that “we are not going back to anything normal,” Gundlach said. That move took the 10-year Treasury yield briefly to 31 basis points and the 30-year to 71 basis points. Gundlach was not surprised by those moves, he said, but rates have risen a lot since then. That subsequent increase was the result of rising expectations of bond issuance to finance bailouts of industries such as the airlines and of social support measures to help those out of work, he said.

Gundlach is worried about those bailout policies being abused.

“Once you start giving cash to businesses to pay employees,” he said, “I can’t imagine the level of corruption and graft that will show up.”

There could be $1 trillion in stimulus, he said, but “that could be just the ante.” Gundlach quoted Treasury Secretary Steve Mnuchin as saying, “This is not the time to worry about the deficit.”

Gundlach said, tongue-in-cheek, “there never has been a time when people worried about the deficit.”

The Fed now fully admits it is doing quantitative easing (QE) and it is helping the mortgage market, which Gundlach said is much needed.

A fiscal stimulus on the scale Gundlach predicted will result in a “massive” amount of bond issuance, he said. “Guess what? Interest rates will going up.”

“The Fed may have to buy the entire bond market,” he said. “But right now, the market is pricing the outcome that the Fed won’t ramp up its purchases until the pressure builds from rising rates.”

A contracting global economy

Not surprisingly, Gundlach said global GDP forecasts have been slashed. China's forecast has been cut by 100 basis points. Ed Hyman, founder and chairman of Evercore ISI and head of economic research, is calling for an annualized 10% contraction in U.S. GDP for the second quarter, according to Gundlach.

The purchasing managers index (PMI) for manufacturing in China show a collapse from 50 to 35, and the services PMI from 55 to 30. Those are "massive contractions," he said. China is the only country with a big collapse that has shown up in the global data, and it presages what will surely be a bigger collapse in the global PMI once data from others countries is available, he said.

U.S. growth will be slower than at any time in the last 12 years, Gundlach said.

The economy was already weakening going into the coronavirus episode. "This is the end of the post-war expansion," he said, "the longest such expansion." It follows the 2010s, which was the first decade without a recession.

The leading economic indicators (LEIs) are signaling a recession, as was yield curve when it inverted in 2019. But Gundlach said that inversion was not a reliable signal, because the Fed can react to erase the inversion.

Jobless claims were heathy before the crisis, but they are about to show signs of a recession, Gundlach said. Consumer sentiment was good, but he expects it to be in a "free fall" when the March data is available.

"If the past is prologue," he said, "unemployment will go up with the weakening economy."

Gold, oil, stocks and bonds

The yield curve has steepened markedly since the start of the coronavirus crash, which he said is typical of the onset of a recession. The 2-year to 10-year spread is 50 basis points and the 5-year to 30-year is 90 basis points. "It will continue to steepen markedly," he said, "due to the Fed slashing rates and to an oncoming massive stimulus."

"This is a tricky environment because you are losing money on all bonds," he said. There was a "V bottom" in yields, which reached their nadir after the Fed rate cut. "It would be sensible that was the trough."

Yields are going up Europe, which Gundlach said could be the result of a "risk-parity selloff." Presumably he meant that a risk-parity strategy entailed owning bonds, possibly on a levered basis, and investors were now selling those bonds.

Gold broke out and was above $1,700 and had gone to new highs in every currency except the dollar, he said. Gundlach said he is "neutral" on gold and that the action on gold says there is "a lot of money moving around. With the dollar strengthening and gold going up, it is showing a flight to quality demand."

Ultimately, gold will go higher, he said.

Oil prices are down to levels last reached in February 2017, when cheap oil caused disruptions in the stock market. Oil was at $26/barrel on the day he spoke. The strong move by the Saudis, he said, signaling a ramp up in production, has caused "pain throughout the world."

The oil rig count is down from its high in 2014, but oil production is up. "There won't be any drilling," he said. "We are going to have to deal with low demand and huge supply."

Turning to the U.S. equity market, Gundlach said it benefited from buybacks that started in 2010, peaked in 2018 and were still strong through last year. The debt financing that underwrote those buybacks is gone, he said, and so is a major support for stock prices.

He said he has been getting "less negative" on the stock market in the last few trading days. "The market will be very volatile. You can wait."

Debt warnings

We are looking at national debt of $30 trillion, or 15% of GDP, Gundlach predicted. That would be a substantial increase from its current level of approximately $23 trillion.

He blamed the huge buildup of debt during the prior decade of economic strength.

“This is why interest rates will rise at the long end,” he said. “This is why the Fed will need to ramp up, for example to support the bond and mortgage markets.”

He warned about adverse, unforeseen implications of targeted stimulus measures. It’s easy to get money if you are a big restaurant chain, he said, but not so for small operations. “There could be some real anger as a result of this,” Gundlach said, fueled by rising inequity in the U.S.

A perfect storm in the bond market

In prior webcasts, Gundlach has warned about BB-rated corporate bonds because of their narrow spreads. Those bonds are down 15% year to date.

As a result of the lack of liquidity, he said, a lot of funds and ETFs are priced too high, including those in the investment-grade, high-yield and muni markets. Those funds have price discounts because the indices against which they are priced have not caught up. “The underlying index is overpriced,” he said, “due to a time delay. Price discovery is lacking in this market.”

“The gods put together the perfect storm for this bond market,” Gundlach said.

Dealer inventories don’t exist despite a huge buildup in corporate debt. In the global financial crisis, he said, this was not so; inventories were much higher.

Trading desks are no longer connected physically, he said, “which obviously will decrease inventory. They cannot facilitate liquidity.”

As he has said in the past, the BBB market has grown considerably. The spread from BB to BBB has gone from 50 to 300 or more basis points, he said. A lot of BBB-rated bonds will be downgraded and the yield differential is 318 basis points. “When you get downgraded, and your yield goes up 300 basis points, that means a sharp drop in price.”

The energy sector of the high-yield market is suffering *en masse,* due to the oil markets.

But the ratings agencies are “on the case,” he said. Downgrades are now far in excess of upgrades. “There will not be upgrades to speak of,” he said, “and downgrades will come fast and furious.”

Don’t buy Treasury bonds

Bond investors should stay liquid and wait for opportunities, he said. “The market will snap back.”

But when the market puts in a low, he said, unless there is a massive shift from the Fed, the low will be retested.

Interest rates went up after they went to a “panic low” because of the expectations of a stimulus and deficits. “Until the Fed buys bonds, the path of least resistance is higher yields. The response to the downturn is moving to helicopter money, which is inflationary. That is the worst possible setup for the 10-year Treasury,” he said.

“You are not getting much compensation for owning it. What is the point? What could you hope to make?”

Gundlach said he is not going to buy Treasury bonds now, except for potentially closed-end funds (CEFs). CEFs were completely “destroyed” by illiquidity, he said. But beware of funds that own energy bonds.

