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Gundlach – Where to Expect the Next Crisis

By Robert Huebscher
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Unless there is a crisis, don't expect a major decline in interest rates, according to Jeffrey Gundlach. And if such a crisis occurs, Gundlach warned, it will most likely take place in India.

India is over-reliant on foreign capital to finance its trade deficit and oil imports, Gundlach said. That makes it vulnerable to inflation, higher interest rates and devaluation of its currency. It also makes it vulnerable to the Federal Reserve's quantitative easing (QE) policies – especially the Fed's tapering, which weakens the rupee against the dollar.

Ray Dalio, founder of the hedge fund Bridgewater Associates, has raised similar concerns about India.

Gundlach said it is unlikely for the benchmark 10-year Treasury yield to fall below 2.75% absent such a crisis. Market sentiment would have to "crack," he said, and "it is not going to happen without a catalyst."

For now, bond investors should not fear the worst. "The momentum to higher bond yields is clearly slowing," he said.

Gundlach spoke via conference call with investors on Sept. 10. He is the founder and chief investment officer of Los Angeles-based Doubleline Capital. Copies of the slides from his presentation are available here.

I'll discuss Gundlach's fears about India, but first let's turn to what he said about the U.S. economy and markets.

Monetary policy and the bond market

Rising interest rates are not being driven by inflation fears or fundamentals, according to Gundlach. Commodity prices have been down slightly and are now heading sideways – with no indication of inflation. He said GDP growth would need to return to 3% to provide fundamental support for rising rates.

Instead, bad market sentiment and momentum are at play in the bond market, he said — and "bad sentiment can stay bad for a while."

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Like virtually every other observer, Gundlach attributed the rise in interest rates since May to the Fed's talk of "tapering" its QE. But that is not what he predicted earlier in the year.

Early in 2013, Gundlach said that he had expected the Fed to follow Japan's and Europe's policies by "pegging" its QE policies to the 10-year rate. Japan, he said, has pegged its QE in order to keep its 10-year bond yield at approximately 75 basis points. Europe has calibrated its QE to keep yields on its peripheral countries' debt to "acceptable levels," he said.

But with the "taper talk," the Fed has chosen a "seat-of the-pants" way of handling its QE policies, he said. Gundlach said the Fed is using QE to fund the budget deficit. In that context, he noted, the tapering of QE should be predictable, because the budget deficit has been declining.

Gundlach said he doesn't know what to expect from the Fed now. Fed officials have been quiet on this topic for the longest time since 1996.

Gundlach likened the current interest rate environment to May of 1994, when yields rose sharply. At that time, the ultimate peak in rates came six months after the initial rise, in November of that year. He said the total-return loss on the 30-year Treasury bond has been virtually identical to the loss in the 1993-1994 period.

For several decades starting in the 1970s, Gundlach said, returns on the bond market were positively correlated to those of the stock market. Fears of inflation characterized that period. Since 2001, fears of deflation have been more dominant, and the correlation turned negative — that is, until the "taper talk" in May, when the correlation turned positive again.

India and other emerging markets

"If there is going to be a good candidate for what might blow-up with problems caused by policy changes," Gundlach said, "India would be the leading candidate."

Investors may be tuned in to those fears. Gundlach said that flows into emerging-market ETFs have decreased significantly since the "taper talk" in May.

Price movement in the rupee is signaling trouble. Gundlach said the rupee was up early this year but has lost about 20% of its value since February. Most of that downward movement has been since early May.

Another sign of trouble is the short-term debt-reserve coverage ratio on the INR ETF, which tracks the rupee. Gundlach said has decreased from 600% to only 200%.

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"There is something of a foreign capital flight crisis – or mini crisis at least," he said. "This has already taken place and it may get worse."

For a more positive view on India, you can read this article by the noted economist Raghuram Rajan, who was appointed the governor of the Reserve Bank of India earlier this month.

Gundlach said he would not own Indian stocks, because the market looks "very scary."

China, on the other hand, looks attractive, he said. It does not need foreign capital and has not engaged in QE, because it runs a substantial trade surplus. China also benefits from its 50% domestic savings rate, he said.

"If you are going to have a problem in emerging markets you probably will not make a fortune anywhere," he said, "but at least you would be insulated from the currency run problem that you have in countries like India if you invest in China."

He advised investors to go long China and short India.

Russia is also insulated from foreign capital needs, Gundlach said. But investors must consider problems such as corruption and illiquidity, which are making Russian stocks look relatively cheap now.

He suggested that investors go long in "risk markets" that are insulated from QE volatility and get out of those, like India, that are vulnerable to QE.

Where to seek safety

Investors fearing a crisis need to assess what will be the best safe-haven asset class.

Gold's "monster run" from $600 to $1,800 an ounce between March 2007 and November 2011 coincided with the precipitous fall in housing prices, Gundlach said.

That was not a coincidence. When confidence in real estate eroded, he said, investors chose gold to protect their wealth.

"The minute that the real estate market found a bottom in the second half of 2011," he said, "was exactly when gold peaked."

Expect gold and real estate to be negatively correlated, he said.

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At its current price of $1,350, Gundlach said gold is “something of a safe haven.”

Gundlach has been bearish on mortgage real-estate investment trusts (REITs) in the past, but he said they now “look cheap” – as do closed-end bond funds, broadly speaking. In both case, he said, assets are trading at about a 10% discount to their book value.

“I think they represent value, but I do not think they are going to go any higher anytime soon,” he said. “It seems that the dividends are going to be cut on mortgage REITs.”

Gundlach recommended that investors focus on agency REITs, like Annaly, and others that have suffered recent price declines.

Economic assessment

The broad question is whether the U.S. economy can sustain the rapid rise in interest rates that has taken place this year.

Gundlach said higher rates are already causing problems. “The rate rise really does matter, and we are going to start seeing its effect in consumer behavior,” he said.

Home sales are declining, he said, and job growth in the last three months was slower than the average of the last 12 months. Strong auto sales will come at the expense of other discretionary consumer activity.

He said he is negative on the upper-middle-class discretionary consumer spending due to rising rates.

Gundlach warned that economic data will worsen in the months ahead.

“I do not think interest rates are can spike any higher, because the economic growth factor does not support it,” he said.

“A further rise in interest rates could cause a crisis — maybe in India,” he said.

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