

# Gundlach's Forecast for 2016

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by Robert Huebscher

Jeffrey Gundlach is a prescient and accurate forecaster. Last week, as he does each January, he offered his market outlook. But unlike prior years, when Gundlach typically offered high-conviction investment ideas, this year he said he would let market movements over the near-term dictate his outlook.



Gundlach spoke to investors on January 12, which was his annual "Just Markets" conference call. He is the founder and chief investment officer of Los Angeles-based DoubleLine Capital.

The slides from his presentation are available [here](#).

"Now is not the time to be a hero," he said. "This is a market where you don't make a lot of money. You try to protect your capital and then play another day."

Gundlach cited numerous problems facing the global economy— for example, recession risk, weak energy prices and competitive devaluations. But the core issue, he said, is that the large, developed economies will not grow fast enough to support high growth globally.

"This is the centerpiece of the problem that is facing the markets today," he said. "Without economic growth potential in the high-growth economies, there just isn't enough growth to go around."

I'll walk through Gundlach's analysis of the global economy and major asset classes. But let's start with his take on Fed policy.

## **Fed policy**

Gundlach compared the Fed's zero-interest rate policy to a tractor pull. Those policies "pulled" not just capital-market returns forward, but also risk-taking and consumption, and with that a lack of volatility. Now, following the Fed's rate hike, volatility has returned to the markets.

Contrary to what Ray Dalio and Jim Grant have predicted, Gundlach does not expect the Fed to reverse course and ease. But he does not believe the Fed will follow through on comments from some of its members that it will raise rates eight more times over the next two years.

Market levels do not support tightening that aggressively. Compared to September 2015, when the Fed backed away from a rate hike because of market conditions, the emerging-market, junk-bond, commodity and S&P indices are all lower – and the dollar is higher.

Indeed, the market thinks the Fed will raise rates by only 60 basis points or so this year, based on the implied futures rates, according to Gundlach.

The most compelling economic data point to support the Fed's rate hike has been the increase in hourly earnings. Ironically, though, not only will that detract from corporate earnings and overall economic growth, but tighter monetary policies will impede further growth in wages.

"What's wrong with the middle class getting higher earnings after years of stagnation?" he asked. "But somehow the Fed doesn't seem to want that."

Spreads in the high-yield market are approximately 700 basis points, about twice the level when a tightening cycle has begun. Gundlach said today's spreads are more typical of an easing cycle.

CPI and PCE data do not support the view that the Fed should raise rates because of inflation fears. The only component of the CPI where prices are rising is shelter, which is based on implied rent. Implied inflation rates, based on the TIPS market, are approximately 1.75% for the foreseeable future. Inflation in the U.S. is lower than in the rest of the world, Gundlach said, yet we are the only major economy that embarked on a tightening cycle.

### **The U.S. and global economy**

Manufacturing is in recession globally, including the U.S., according to Gundlach. The ISM survey data is "crashing," he said.

Data for the service sector, which is the bulk of the U.S. economy, is also weakening, he said. "If it falls much lower, we would have to say that the odds of recession are going up towards 50% in the United States," Gundlach said.

Globally, the dominant force is the Chinese economy. Its weakening has been the driver of lower commodity prices. That has caused weakness throughout the EM, which are highly correlated to commodity prices.

"It is crystal clear that China is incredibly weak," Gundlach said, based on the crash in commodity prices. Longer term, he believes it "doesn't have a chance being what it was in its boom years." China's demographics are too unfavorable and are eerily similar to Japan's before it faced two decades of zero growth and periodic deflation.

China has devalued twice, in August 2015 and again more recently. Both times it triggered extreme volatility in global stock markets. "This seems to be a real Rosetta Stone to understanding what is going on," he said. "And it looks to me like the yuan is going to have to be allowed to weaken further." The only question, he said, is how fast that devaluation will unfold.

Gundlach said it is "difficult to be bullish" on EM equities, which he said were heading lower. He was

similarly adverse to the Shanghai composite and Chinese equities.

Brazil is a huge problem too, Gundlach said. The largest economy in South America, he said it is “basically in a depression,” which GDP contracting at 4.6% annually.

Gundlach reiterated his long-term bullish forecast for Indian equities. “I recommend waiting for the blood in the streets before investing in emerging market equities – when it is as scary as you can possibly imagine, buy India,” he said. “I wouldn’t bother buying all emerging markets.”

By “blood in the streets,” he said he meant the EM index falling approximately 40% from where it is now.

### **The U.S. bond market**

Interest rates had been rising in the short end of the bond market (the two-year was 1.09% in December), but have stopped rising more recently (it is 92 basis points now). The implication, Gundlach said, was that the two-year Treasury market doesn’t expect another rate hike.

“The Fed needs to ratify the message of the two-year. They need to get away from this mechanistic raising of interest rates in the teeth of falling nominal GDP, crashing commodity prices and now weak equity prices,” he said.

Investors should pay close attention to the five-year Treasury, he said. It has traded within a range of 1.25% and 1.75% since 2013. A move above 1.75% would signal the potential for another 60-70 basis point increase. Such a move would indicate that the Fed is ready to “blow up the short end of the yield curve,” he said, in which case the overall yield curve would flatten

“I’m recommending investors not be locked into an interest rate idea right now for the year 2016,” he said, “instead let’s let the market tell us.”

Gundlach said the yield on the benchmark 10-year Treasury would “break to the upside.” But he also said he had very low conviction for that forecast and would not commit to a position unless the 10-year moves out of its current trading range.

“Success or failure for bonds in 2016 is going to be based on which way this breaks,” he said. “And it should break in the few days or weeks ahead.”

This is a dramatic shift from a year ago, when he forecast (correctly and with high conviction) that the 10-year yield would end 2015 where it began.

### **Energy, high-yield and investment-grade bonds**

Gundlach has been correctly bearish on energy prices, and he reiterated that position. He is worried about geopolitical instability with a lame-duck U.S. president, who, he said, will not react militarily to

“bad actors.” Gundlach spoke on the day that the Iranians seized a U.S. navy vessel that had apparently breached its territorial waters.

Even if energy prices stabilize or increase, Gundlach expressed concerns that were highlighted with the gating of the Third Avenue high-yield mutual fund. There are many more funds like Third Avenue’s, he said, and many of those are leveraged. If redemptions increase among those funds, he said the market would not have enough liquidity to trade efficiently.

Leverage in the high-yield market is at an all-time high, according to Gundlach. A lot of junk bonds will default unless there is a “monster rally” in commodity prices, he said.

Another problem for high-yield issuers, Gundlach said, is that many were able to hedge their energy exposure a year or two ago, but now those hedges are expiring.

A few years ago, only 7% to 10% of U.S. companies were losing money. Now it is close to 20%, which he said was “incredible.” That will lead to a credit-downgrade cycle, according to Gundlach, which may have already begun.

He said he “may be a buyer of junk bonds down the line” and that it would be one of the “better opportunities to come around in years.” But he will wait for improvement in the commodity markets.

Investment-grade spreads have been widening as well and will continue to do so, he said, as long as global growth is challenged.

## **U.S. equities**

High-yield prices are correlated to U.S. equities, Gundlach said, and the junk bond market tends to weaken about two years before a peak in stock prices. Now, he said, one of two things has to happen: The S&P has to fall or credit has to rally.

The odds, he said, are much greater that the S&P will meet the high-yield market at lower levels.

Profit margins have declined for U.S. corporations, which historically has been associated with recessions. S&P earnings have “massively underperformed” expectations this year, Gundlach said. Forecasters are calling for 18% earnings growth, but he is very skeptical this will be achieved.

The breadth of the stock market is “terrible,” according to Gundlach, with index prices being held up by a handful of stocks. “There is a stealth bear market going on,” he said.

## **The dollar**

Gundlach correctly predicted the rise of the dollar in June 2014. Now, he said, its rise is over. This position, he said, is a contrarian view. Just because the Fed is tightening does not imply a stronger dollar, he said.

He showed that during all Fed-tightening periods since 1986, only once did the dollar rally. "As is often the case, these general consensus viewpoints simply don't respect history," he said. "If you'd just do a little homework, you'll see it's wrong."

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## **Gold**

Gold has started to rally, Gundlach said. A year ago, he predicted gold would reach \$1,400, which turned out to be his least accurate forecast.

He stuck with that forecast for 2016. His bullishness is based, in part, on a belief that emerging market investors will buy more gold as their economies and currencies weaken.

## **A cautionary forecast**

Gundlach expects a continuation of what happened following the Fed's rate hike. "We will see market struggle in the first part of this year and then create potentially a very good buying opportunity later in the year," he said.

Nominal GDP, which is at 3.1% annually, has been a very reliable indicator of 10-year Treasury yields. But 10-year Treasury yields are only 2.11%.

Perhaps the "path of least resistance" will be up for the 10-year Treasury, he said.

But if recessionary trends prevail and nominal GDP contracts, he said, "we may be looking at a real catalyst for a breakdown in Treasury yields."