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Gundlach: A Debt Ceiling Impasse Could Drive Rates Lower

By Robert Huebscher
July 19, 2011

Failing to raise the debt ceiling would be a "huge financial calamity," according to Federal Reserve Chairman Ben Bernanke and the general consensus view. But that opinion is "exactly wrong," at least as far as the Treasury market is concerned, DoubleLine's Jeffrey Gundlach said in a conference call with investors last Tuesday.

Rates might actually go down, just as they did after the end of QE2, according to Gundlach.

Gundlach is the founder and chief investment officer of DoubleLine Capital, a California-based fixed-income asset manager.

"If there is no debt ceiling passed, it will force the government to essentially implement a *de facto* austerity program," Gundlach said. Payments to many government departments would stop, including those to some defense contractors. Coupon payments on the Treasury's debt, however, would continue, he said.

While Treasury investors might receive a short-term reward if no resolution is reached on the debt ceiling, Gundlach was far less sanguine about the longer-term outlook.

"We are getting close to the end of the road" and must forestall a larger crisis caused by the government's growing debt burden, he said.

I'll review Gundlach's short-term and longer-term predictions for the resolution of the country's mounting deficit problems and how he expects the Treasury markets to perform over the coming year.

The ultimate resolution to the debt problems

Until now, the debt ceiling has been raised to coincide with the growth in federal debt, in what Gundlach called a "cynical exercise" of raising the debt ceiling to the level of the excess borrowing needs of the government.

He called the current situation in Washington "remarkable" in that both parties are "cemented into a debate where the end game is hard to discern." Neither party wants to raise the debt ceiling without making progress on reducing the deficit, but their views of how to achieve those dual goals are radically different.

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Gundlach said that a debt-ceiling agreement will ultimately be reached, and some tax loopholes will be closed along with some spending cuts in the out years.

Those small changes will amount to “one more kick of the can down the road,” he said.

Over the longer term, the government has four options left to deal with its debt problems, according to Gundlach. It can default on its Treasury bonds, which he said will not happen. It will, however, default on its entitlement obligations, in that future retirees will not enjoy the same Medicare and Social Security benefits as today’s retirees, he said.

Revenue increases might be instated, possibly in the form of a value added tax, an income tax increase or an increase in corporate tax rates. The last option has bipartisan support, he said.

The government could continue to print money and risk higher inflation, he said, calling this a “print-and-pay” scenario.

The fourth option is what Gundlach called “threading the needle.” The government could pursue some inflationary policies which might grow nominal GDP by as much as 6% annually, while freezing government spending and keeping short-term interest rates at zero and 10-year rates below 4%.

But that is unlikely to succeed, he said. The economy can’t grow at that rate while government spending is frozen, because GDP relies too heavily on government programs.

“More realistically,” he said, “we are left with a default on something, which is a form of cutting spending if it’s entitlement programs, taxing or print-and-pay.”

He expects cuts in defense spending and ultimately some reductions to entitlements. Either would be a “weakening factor” for the economy, he said.

Gundlach advised investors to construct their portfolios to defend against all three of those outcomes. Portfolios should contain inflation hedges, an income stream and protection against potential defaults.

Predictions on Europe

As for Europe, Gundlach said that the market has a renewed appreciation of its problems, based on the recent downgrade of Irish debt. He expects similar downgrades for Italy and other peripheral countries and said that spreads are “blowing out” on riskier European debt issues.

Indeed, what happened to Greece a year ago, when its government debt spreads increased sharply, is now happening to the other peripheral countries, he said.

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In the past year, he said he has heard that "Portugal is not Greece," "Italy is not Greece" and "Spain is not Greece." Now, Gundlach said, they "have all turned into Greece."

Default is inevitable for those countries, he said, and they face very negative implications for economic growth. Gundlach said that advisors should be very careful of counterparty risk in the funds they use.

"If there is a global meltdown thanks to a default," he said, "you are not going to be happy with your counterparty risk with credit-default swaps and other synthetic strategies."

Gundlach said that his funds do not have any counterparty risk.

The benchmark 10-year Treasury bond is in the low 3% range based on "nervousness" and reports of economic weakness, he said. It can only get into the 2% level if there is increased fear, which he said could occur in response to a global banking panic resulting from the European situation.

The bloodless verdict of the market

A number of years ago, Gundlach coined the term "the bloodless verdict of the market" to objectively describe what the capital markets are saying with respect to economic prospects.

Through the first half of this year, the riskiest assets — stocks and long-term bonds — have performed best, he said. Low-risk investments, such as Treasury securities with maturities less than two years, have fared the worst.

That outcome is not what most expected entering 2011, he said, when investors feared downturns in riskier assets. This year's rally has left certain asset classes – notably high-yield bonds – priced expensively. Gundlach said high-yield bonds should be compared to long-term Treasury bonds, because they have similar volatilities. Their yield spread to long-term Treasury bonds is near its lowest point in history.

Interest rates could rise, however, if current fears fade away or if there is better economic or employment growth, he said. Nothing in Gundlach's comments suggested that he sees this as likely.

Over the next year, he said it is unlikely that 10-year rates will rise above 4%. That would be "fatal" to the housing market, he said, and the economy "could not sustain" rates that high. On the subject of housing, Gundlach said he does not expect any dramatic improvements in the next couple of years.

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"The bloodless verdict of the Treasury market is convincingly that we are in a long-term bottoming process of yields," he said, which has been his opinion for at least the last year. "If you are thinking big-picture that interest rates are going to rise, I can't disagree with you," he said. "But it is a very long-term process."

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