Gundlach Sets the Record Straight

By Robert Huebscher
March 22, 2011

In the wake of the massive earthquake in Japan, markets have driven stocks there to prices that are clearly "cheap," according to Doubleline's Jeffery Gundlach, who said that Japanese stocks are "a lot cheaper than they were a week ago, when they were already undervalued."

Gundlach spoke on March 15 via a conference call with his investors regarding the launch of Doubleline's Multi-Asset Growth Fund (DMLIX).

Japan faces a long struggle to rebuild its already depressed economy, Gundlach said. He dismissed arguments that say that Japan's adversity will lead to a boom of activity as it rebuilds its economic capacity.

"When you destroy factories or homes, clearly, the wealth of the nation has been reduced and not increased," he said. "You can't rely on natural disasters as your way to success. "

Gundlach also commented on conditions in the municipal bond and junk bond markets, but let's first turn to his forecast for U.S. equities, where he corrected errors that appeared elsewhere in the media.

Can the S&P go to 500?

In an interview that appeared in *Barron's* in February, Gundlach was quoted as saying the S&P 500 "will hit 500 in the next couple of years."

The problem is that he never said that.

According to Gundlach, what he said was, "if deflation truly wins, then the S&P 500 would go down to 500 or lower."

Gundlach's bearish forecast for equities was conditioned on the contingency of deflation winning out, and no winner is emerging in the tug-of-war between inflation and deflation. He said the conflict now between inflation and deflation is like a humidifier and a dehumidifier operating in the same room, and it is not clear which will prevail.

In August of last year, he was so concerned about the threat of inflation that he took the duration on his hedge fund down to one. But in February deflation fears prevailed, and he took the duration of that fund to 10. Now, he said, deflation forces may be slightly stronger, but not pervasively so.

Gundlach said he was also incorrectly quoted in *Barron's* as saying that prices of closed-end municipal bond funds would decline to 40% of their net asset value.

What he actually said was that in September and October of 2008, some closed-end funds briefly went down to 40% of their net asset value. That was not a prediction, but a historical observation of a "hyperbolic outcome" that resulted from the panic surrounding the near collapse of the global banking system, he said.

Nonetheless, Gundlach said last week that he expects muni funds to trade at discounts and that long-term municipal bonds will go down in price. He said this "has to happen regardless of the direction of interest rates," and that defaults are not the primary risk for municipals.

The direction of interest rates on Treasury bonds will determine the fate of muni prices. If Treasury rates go up, Gundlach said, munis will go down in price simply because of their duration. Conversely, if Treasury rates fall, it would be because of a weakening economy and a deflationary scenario. In this case, state and local governments would face revenue shortfalls and the increased perceived risk in muni bonds would drive their prices down.

The only way investors will "win" in munis, Gundlach said, would be if the rate on the 10-year Treasury bond stays between 3% and 4%.

But Gundlach also said that he expects Treasury rates to stay in that range for the balance of 2011, therefore tempering his concerns about munis, at least until next year.

Problems in the junk market

Gundlach said the risk premium in equities is superior now to that in the corporate bond market, and the opportunities in the junk market are especially bad.

High-yield bonds, Gundlach said, are more than twice as volatile as investment-grade bonds. On a loss-adjusted basis, however, their yields are only 100 basis points higher. He said yields of 4% to 4.5% are available in the investment-grade market, and junk yields are now 6.75%, assuming no losses from defaults.

"We all know that there will be losses [from defaults]," he said, perhaps not this month or next month, but certainly over the next two to three years. He said those losses would be in line with their historical rate of 4% and, assuming a 50% recovery rate, that would reduce the effective yields on high-yield bonds by approximately 200 basis points.

Most high-yield bond funds have expense ratios of 100 basis points, Gundlach said. If you begin with 6.75% yields and deduct 100 basis points in expenses and 200 basis points in losses from defaults, he said 4% would be “your dream case on a single-sector high-yield fund. That doesn’t sound good at all.”

Indeed, Gundlach said high-yield bond funds are the “worst possible setup.” His rationale was straightforward and should be a warning to investors considering any tightly focused fund following a rally in that sector.

When the high-yield sector does well, as it did recently, it attracts attention and draws assets, particularly in a period of low defaults. “That has certainly happened in the high-yield market in the last few months,” he said. “Money has been pouring in.”

Portfolio managers of those funds must deploy that money into high-yield bonds, because that is the single-sector focus of the fund. “They call up Wall Street and say, hey, have you got any deals for me to buy?” Gundlach said. “Wall Street just starts grinning, and says, ‘We've got a whole bunch of garbage companies waiting for the moment when some joker would lend them money.’ ”

Those funds end up becoming “toxic waste dumps” for the all sorts of weak credits, he said, such as covenant-light bonds.

“Those putting money after a rally at tight spreads in high-yield bond funds are not going to want to open their statements and find out that they ended up being the guy who financed all the marginal companies,” he said.