Jeffrey Gundlach's Thoughts - *Views as of July 12, 2016*

The Brexit vote has come and gone without much of a problem. In fact, one of the better performing stock markets ironically is the UK. The real problem I believe for the European Union is the banks. If we compare Bank of America stock performance leading up the credit crisis and Deutsche Bank stock performance from July 2013 through last week, we see a very similar situation where the performance is very stable, slightly appreciating and then a total collapse. Deutsche Bank has really accelerated to the downside, now at $14. When it gets into single digits, you're going to see a similar concern about the European banking system. We have seen talk from Italian officials about the need for a bailout and even German officials saying there may be a EUR150 billion bailout required to get the German banks in order. The response to these banking insolvencies will probably be things that are bond unfriendly in terms of inflationary or fiscal pressure and will catch most people by surprise. It could completely change the game.

The need for real stimulus in either bank bailouts, helicopter money or large fiscal stimulus will be deemed to be massive. And this will be a preferable solution, based upon negative interest rate experiments which have not worked. In fact they have produced the opposite of the desired effect. They have not helped stock markets and have weakened the currencies; both the Yen and the Euro are stronger now than when their central banks first went negative.

This leaves the U.S. bond market betting against a Fed rate hike this year and less than 50% of a single rate hike next year. Nominal GDP is very low and at levels that are usually correlated with a recession, but this time it's different. We're in a much lower inflationary period. The quarterly unemployment rate has not crossed over its 3-year moving average, which always indicates a recession. The moving average is way above the current rate of 4.9%. We do see negative job growth over the past ten years except in the 55 and up crowd. They don't want to work but are forced to due to low rates and insufficient savings.

I think this is one of the most interesting moments in the U.S. bond market in years. I've never seen a worse setup with the combination of yields that are not moving to new lows with any kind of momentum to divergences across the yield curve. It's the type of sentiment rarely seen in the bond market. We're looking at a long term bottoming process here. The 2-year is in a rising trend. The 5-year is trending higher less vigorously. The 10-year will probably correct further to the upside. I wouldn't be surprised if it goes to 1.7% as the base case. Clearly it's a dangerous market technically when you go to a minor new low in the 10-year, then two days later completely reject it. I would be cautious of duration.

Markets –*U.S. Dollar* – I believe we're in the middle of a range.

Markets – *Mortgages* – Have been the big loser this year because credit has been such a star. They have a shorter duration and have underperformed. However, they may be the best performing sector if we see a potential back up in rates.

Commercial MBS have done better than GNMAs. We're favorable on the CMBS market.

Junk Bonds – Are "ok" from a valuation perspective versus long-treasuries but may be in for some volatility broadly speaking. They are dangerous because of their illiquidity. I'm much more comfortable with taking risk in emerging markets.

Loans – Defaults are on the rise. Upgrade-to-downgrade ratios are overwhelming. The recovery rates are starting much lower than they have in the past two default cycles.

Emerging Markets – Are doing great. They're up more than junk bonds. They're volatile but we like the set up here because the dollar has not been rallying and is in a range that has been copacetic for emerging markets.

U.S. Equities – Watch out for minor new highs potentially getting rejected.

Commodities – The decline of late last year has been reversed. Silver and gold have been the strongest parts of the CRB Index which mask the weakness in areas like copper and industrial metals.

Oil – Is trapped for now between $45 and $50 zone. 70/30 chance it breaks out to the downside.

Definitions & Disclaimer

Definitions

GDP = Gross Domestic Product is the amount of goods and services produced within a given country/territory. **Thompson/Reuters CRB Index** = An arithmetic average of commodity futures process with monthly rebalancing.

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