

Why Gundlach Is "Scared Sick" Of The Global Economy



by Tyler Durden

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As we noted on several occasions, it has been a year where virtually every asset class has suffered negative returns. But emerging market equities have outperformed global indices and, according to Jeffrey Gundlach, that's where investors should put their money "over the next seven and certainly the next 20 years."

DoubleLine founder and CIO Jeff Gundlach spoke via webcast with investors on December 11, in a talk titled, "In Our Time," and the focus was on his firm's flagship mutual fund, the DoubleLine Total Return Fund (DBLTX). The slides from his presentation are available [here](#), courtesy of [Advisor Perspectives](#).

The cyclically adjusted price-earnings (CAPE) ratio for emerging-market stocks is less than half that of the S&P 500. But, in the last two decades, Gundlach said there were times when it was higher. Based on that metric alone, Gundlach said emerging-market equities could outperform U.S. stocks by 100%. But, he warned, investors need to approach emerging markets with a long-term, seven to 20-year, perspective.

As [Robert Huebscher notes](#), Gundlach is in good company with this view. In its most recent seven-year [forecast](#) for asset class returns, Boston-based GMO predicted that **emerging market equities would be the only equity asset class with positive returns over that period**. GMO Chairman Jeremy Grantham, in a recent [interview](#), reiterated his positive outlook for emerging markets. "There is very little chance that you'll come back in 10 or 20 years and emerging will not have beaten the pants off the U.S.," Grantham said. Rob Arnott of Research Affiliates and Mark Mobius, who recently retired from Templeton Investments, have also [predicted](#) outperformance for emerging markets.

That said, if there is a word of caution about these predictions, it is that they are all based on CAPE or similar valuations and the belief that valuations will "revert to the mean" over time. But there is no guarantee if or when that will happen.

CAPE Ratios: S&P 500 vs. MSCI Emerging Markets



Let's look at what Gundlach said about the economy and other markets, courtesy of AP's Robert Huebscher.

"Scared sick to look at it"

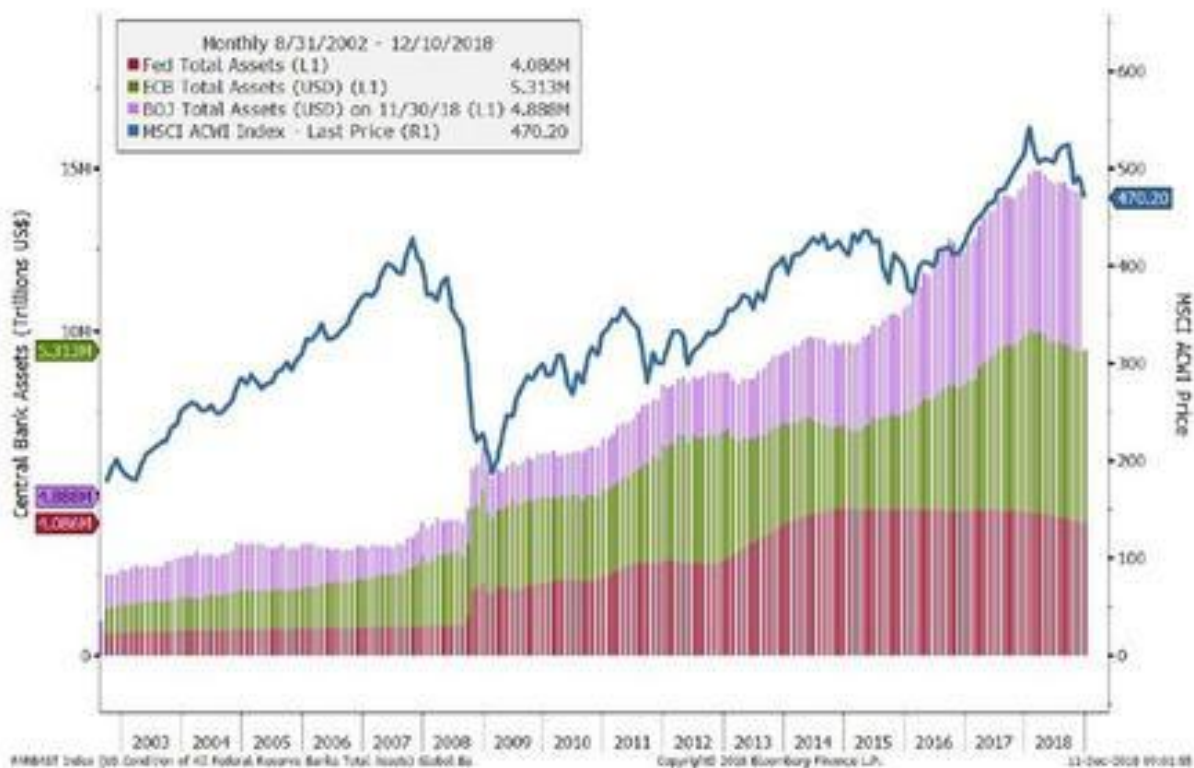
The title of Gundlach's talk was taken from a 1925 book of short stories by Ernest Hemingway with the same name. Gundlach cited quotes from that book to illustrate points during his talk. One of those quotes was, "Scared sick to look at it," which Gundlach said was a fitting reference to some aspects of the global economy.

Global Growth is Slowing



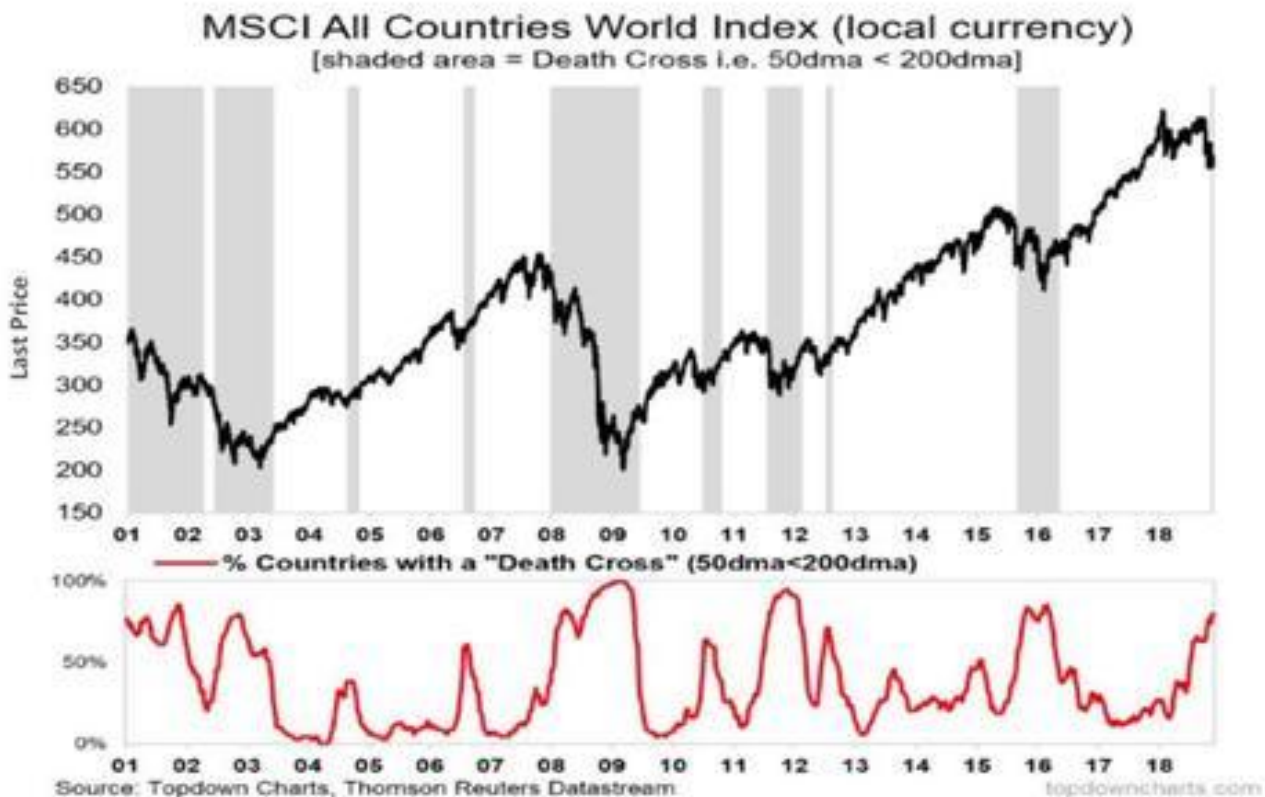
Gundlach returned to a theme from prior webcasts, which is the correlation between global central-bank balance sheets and the performance of equity markets. As central banks have tightened their monetary policies, equity returns have been the victims.

MSCI ACWI and Central Banks



He said that 75% to 80% of global markets are in a “death cross” pattern, where 50-day moving average has fallen below the 200-day moving average.

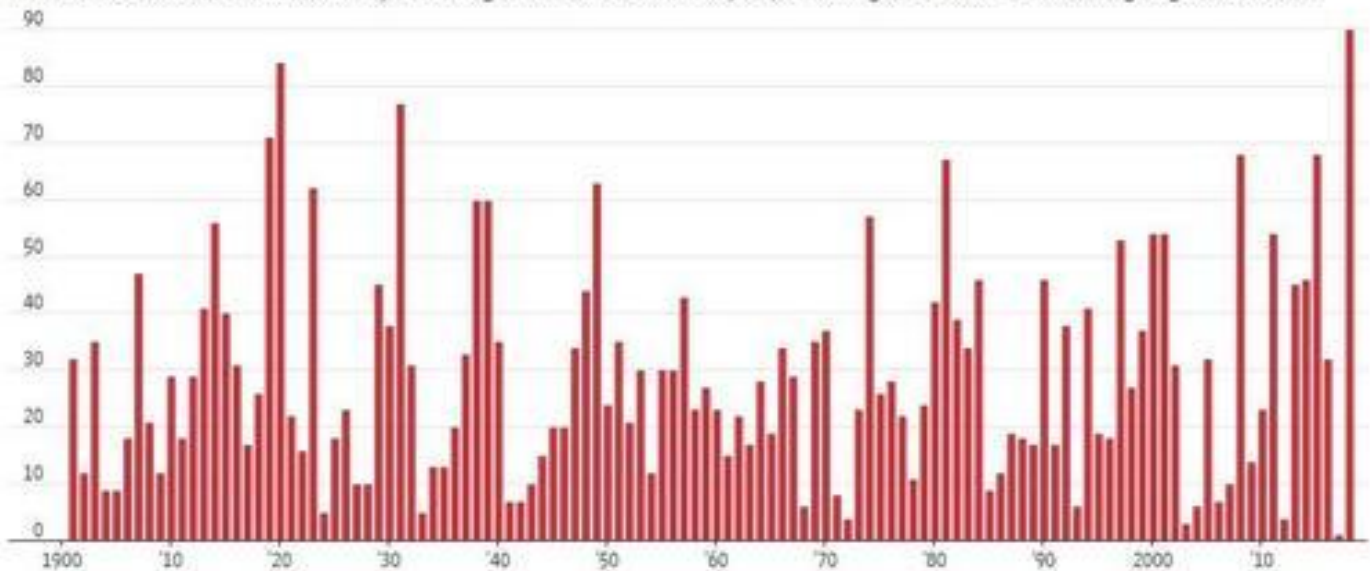
Global Death Cross Breadth



Gundlach [predicted](#) in January that the S&P 500 would show a loss in 2018 and, with stocks near unchanged for the year, he reiterated that prediction. He added that 90% of asset classes have negative year-to-date returns, which is the highest such percentage since 1900.

Under Pressure

A record share of asset classes have posted negative total returns this year, according to Deutsche Bank data going back to 1901.



Europe is "absolutely horrible" in terms of economic growth, Gundlach said. All global PMIs are "collapsing" (i.e., below 50) due to trade wars and rising wage pressures, which may abate if the global economy slows. Wages in the EU are up 2.3%, as well as in the U.S. (3.1%) and U.K. (3.3%). Producer prices have stopped rising, he said, which is a piece of good news.

As an example of the plight of how export-sensitive markets being harmed by tariffs, Korean stocks are in a sold bear market, down approximately 23% this year. He also noted that two non-U.S.-based financial stocks, Deutsche Bank and Credit Suisse, are at or near all-time lows.

“He felt sure he would never die”

That quote, Gundlach said, describes the attitude of many toward the U.S. economy, which has been the leader among developed countries.

The U.S. is stronger than the rest of the world, according to Gundlach. Its nominal growth is strong at 5.5%, although real growth in only 3.0%. U.S. leading economic indicators (LEIs) remain strong, he said, and are not close to turning negative, which would signal a recession. But global LEIs are much weaker, he said, and approaching zero.

Manufacturing PMI: New Export Orders



“It is quite possible there will be a global recession,” Gundlach said.

Other readings in the U.S. are non-recessionary, he said, including business, consumer, homebuilder and CEO confidence levels. U.S. PMIs are “volatile” but at elevated levels. Much of recent GDP growth has been from inventory building, Gundlach said; without that it would shave 1.2% from GDP growth.

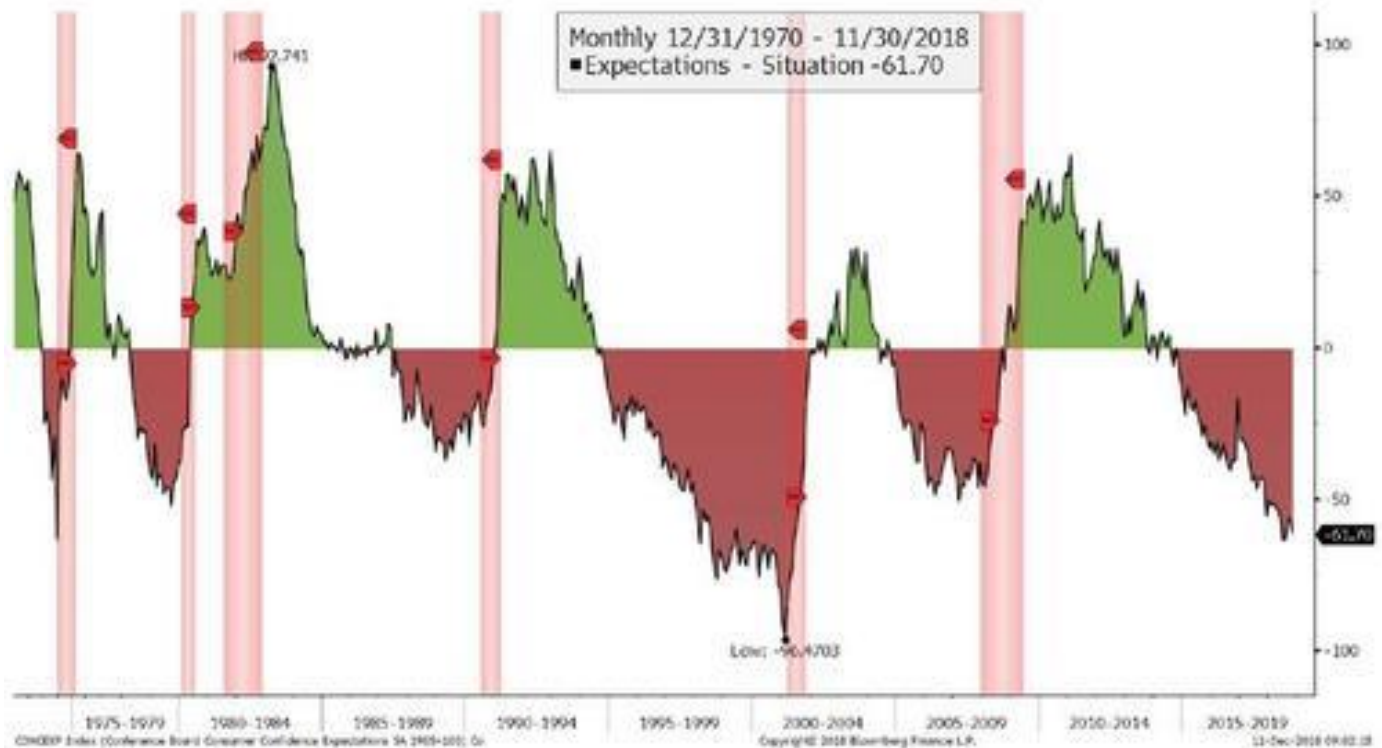


U.S. GDP Inventory Contribution



Consumer optimism is “lopsidedly” negative, though. It is flashing a “somewhat negative” signal, he said, “about as bad as it gets prior to a recession.”

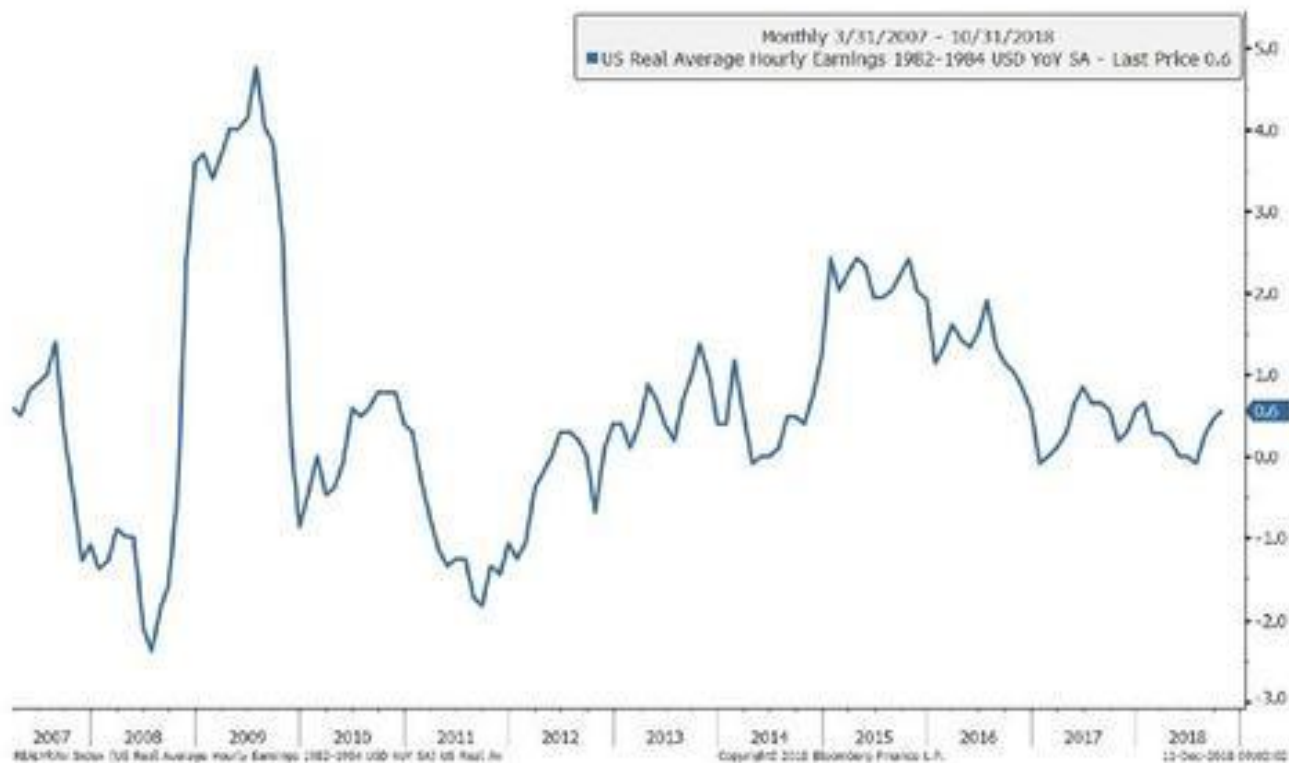
Consumer Confidence: Expectations vs. Current Situation



High-yield spreads have widened by only 100 basis points and need another 100 basis points to give a convincing signal of a recession.

Real hourly average earnings are at a low point for the last four years, according to Gundlach. Homebuilding and buying is slow and "surprising to the downside," he said. There are fewer potential buyers and excess housing supply - that is rising. High-end housing in markets like NY, NJ, CT and CA are much weaker due to the consequences of the Tax and Jobs Act - specifically the non-deductibility of state and local income and property taxes.

Real Average Hourly Earnings (YoY)

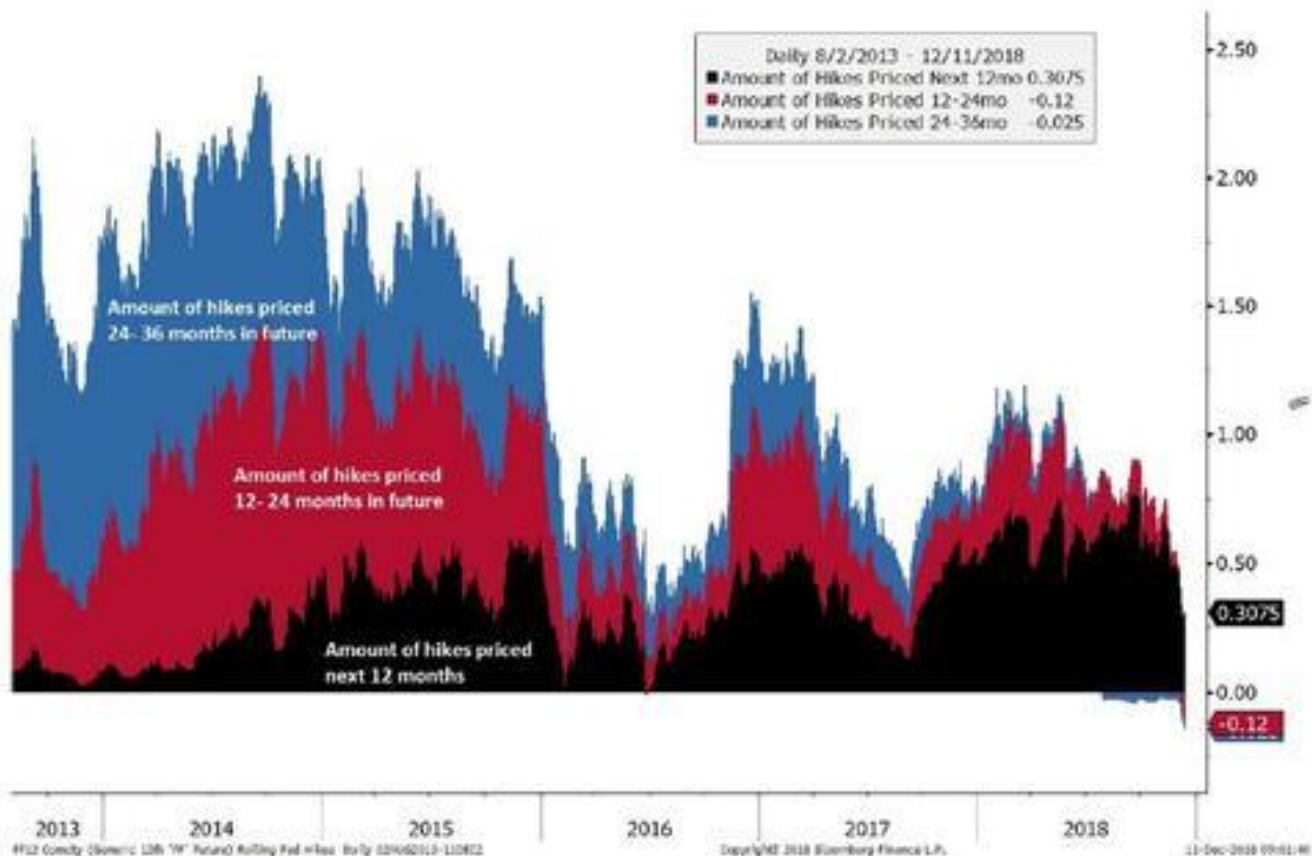


With the Fed funds rate at 2.2%, it is at the lower end of a neutral rate for the economy, according to Fed Chairman Powell. But Gundlach said the Fed is “scared sick” of the plight of the stock market and the fact that the five-year Treasury yield is less than the two-year yield. **“The Fed is worried about the flatness of the yield curve,”** he said.

The market is now predicting a more dovish Fed policy, but the Fed is not in sync with this, according to Gundlach. The bond market expects that the Fed won’t tighten in 2019 or 2020, he said.



Hikes Implied by Fed Funds Futures



According to the Taylor rule, the Fed funds rate should be near 5%, and Gundlach said that it too is out of sync with the market.

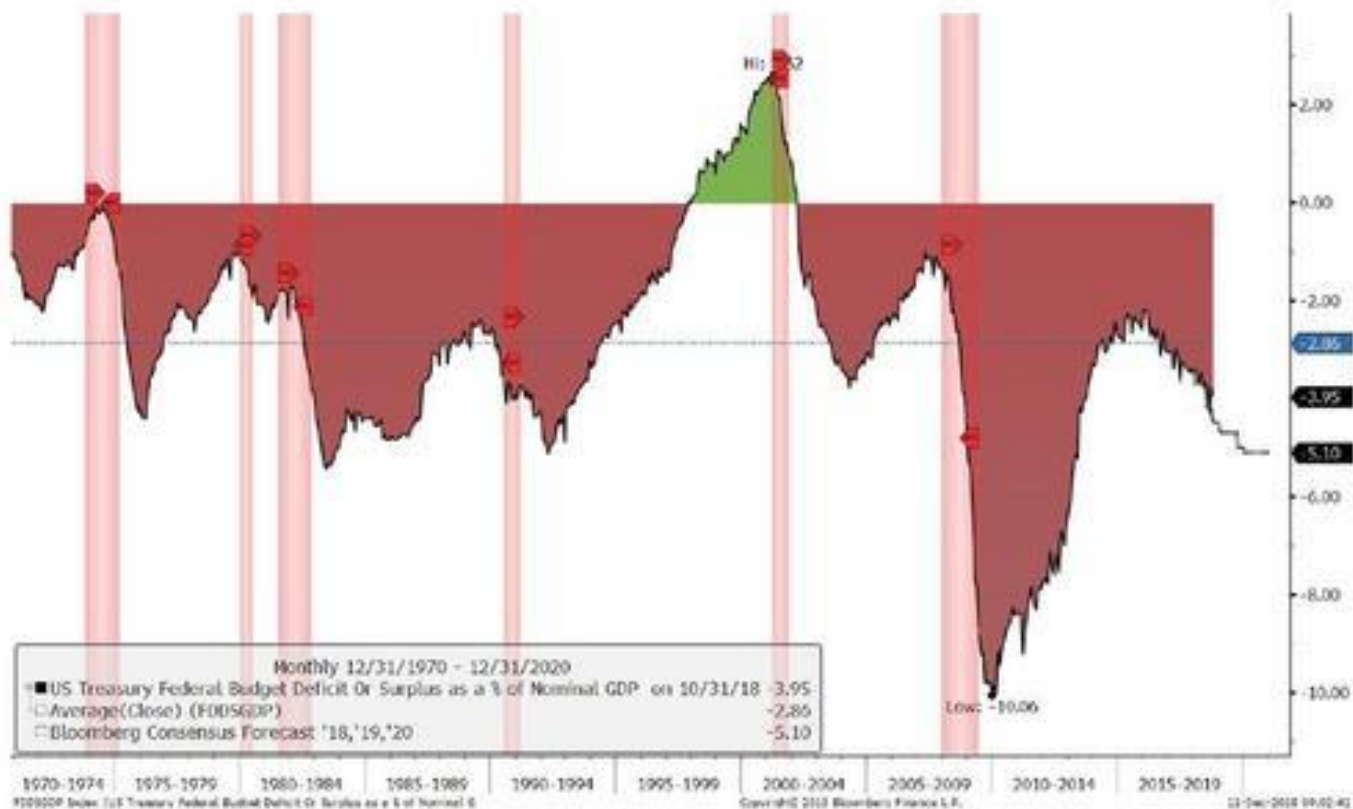
Suicide redux

“You have to be concerned about how little the bond market has rallied,” Gundlach said, in respect to the last month and a half. Yields on the 10-year Treasury bond have fallen about 30 basis points since early November.

“That is not much of a rally given the carnage in the global markets,” he said. One reason, Gundlach said, is the supply of bonds. He said that five or six years ago he predicted that 2019 would be the problem year for rising federal deficits.



U.S. Budget Deficit % of GDP

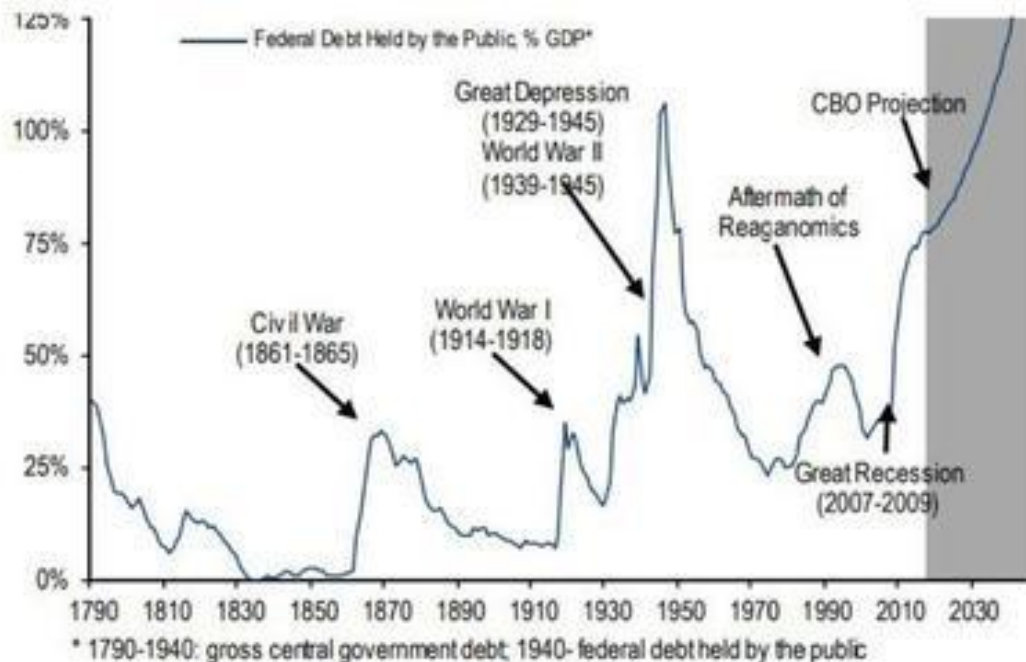
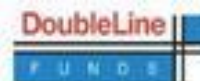


“The debt problem is very real,” Gundlach said. We are in a “horrendous situation” because the economy is expanding but so is the debt.

Unemployment is ticking up, he said, which will put additional pressure on the budget and the deficit.

As he has said in prior webcasts, **he described the combination of increasing deficits and the Fed raising interest rates as a “suicide mission.”**

U.S. Federal Debt as % GDP

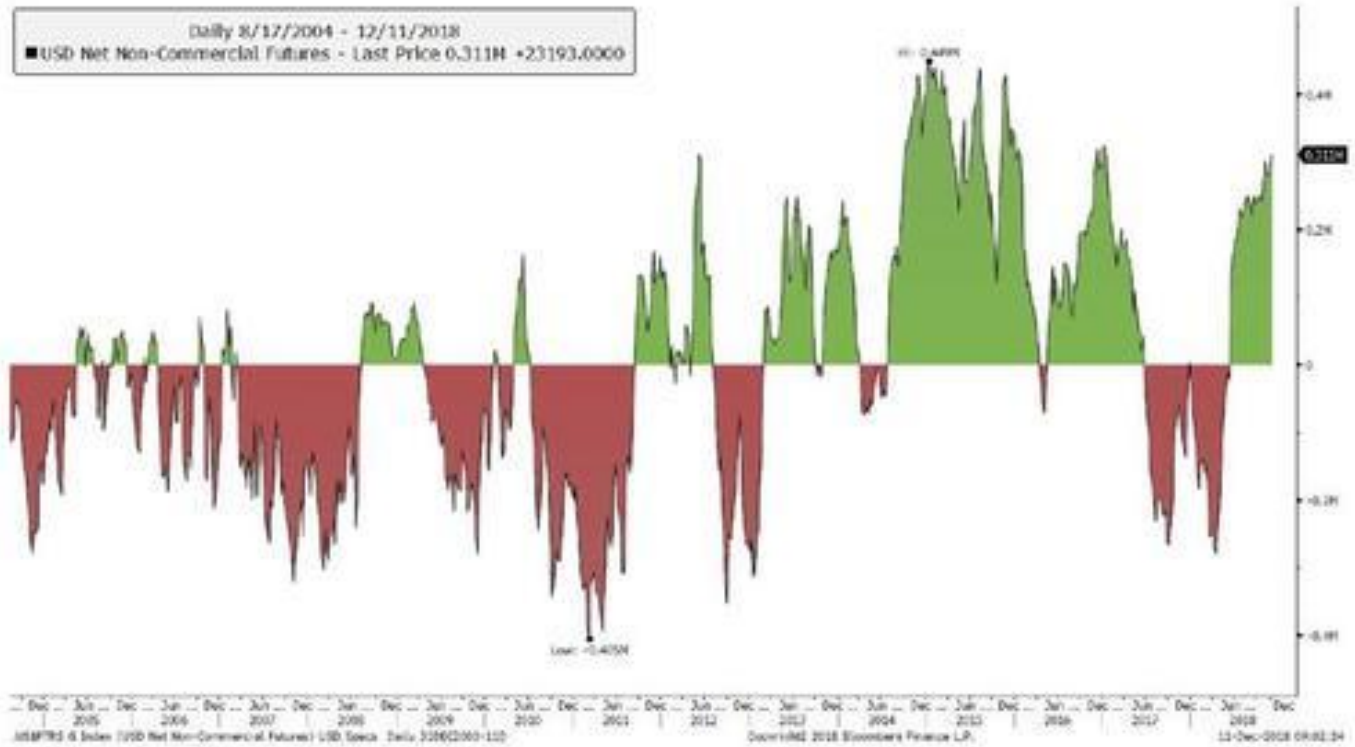


Source: BofA Merrill Lynch Global Investment Strategy, Reinhart & Rogoff (2010), Haver

He called the recent action in the bond market a “knee-jerk rally” and said that rates are being held up because of an excess supply of government bonds.

Gundlach commented on how the dollar is affecting interest rates. He said dollar positioning is “wildly bullish” and predicted that the next big move will be down. Indeed, he said, higher deficits correlate with dollar weakness.

U.S. Dollar Net Speculative Positioning



Commodities have been weak lately, but he expects them to improve as the dollar weakens.

Commodity Prices



Returning to the theme of his prior [webcast](#), Gundlach reinforced his warnings to corporate bond investors.

Investment-grade corporate bonds remain very overvalued, he said, at about 1.5 standard deviations above comparable Treasury bonds. He said to avoid them, especially if one is worried about rising interest rates.

With Advisor Perspectives

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