Jeffrey Gundlach Says We’re Getting Closer to a Recession

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Jeffrey Gundlach *PHOTO: JEREMY LIEBMAN*

Barron's: What's the good word, if any, on the economy and the markets?

Jeffrey Gundlach: We are more cautious about 2019 than about this year. We always start by asking whether a recession is coming. We have found about a dozen indicators to be helpful on a forward-looking basis. At the beginning of this year, not a single one was negative. We look at the leading economic indicators, consumer and small-business sentiment surveys, GDPNow from the Federal Reserve Bank of Atlanta, and other things. The one indicator that is somewhat negative is the yield curve, which has flattened pretty relentlessly for the past year or two as the Fed has been tightening. There's a narrative out there that says the flattening yield curve isn't sending any message about a recession, and that couldn't be more wrong. In fact, with rates so low, the yield curve signal is even stronger than usual.

Jeffrey Gundlach's Picks

Company / Ticker	**Price 7/11/18**
Invesco Senior Loan / BKLN	$23.02
SPDR S&P Oil & Gas Exploration & Production / XOP	43.28
iShares MSCI Brazil / EWZ	32.74
Tortoise MLP / NTG	15.60
WisdomTree Japan Hedged Equity / DXJ	53.73

	Yield 7/11/18
2-Year Treasury Note	2.58%

Source: Bloomberg

What exactly is it signaling?

We are getting closer to a recession. When the curve goes flat from the two-year Treasury to the 10-year [meaning that the yields are identical], the recession risk is at least a year away. Recently, that spread was 28 basis points [hundredths of a percentage point], which is pretty close to being flat. It is flashing yellow. It needs to be respected. The other reason to think 2019 might be more problematic is that quantitative tightening has just started. The Fed has started to let bonds roll off its balance sheet [the central bank isn't buying new bonds when many current holdings mature]. Several billion dollars of bonds per month are coming due, but by October the amount will be up to $50 billion per month.

At the same time, the Fed has said it intends to keep raising interest rates, probably twice more this year. That, together with the signal from the yield curve and perhaps $600 billion of quantitative tightening, and a budget deficit that is growing, is an issue. The strangest thing is that Congress passed a $280 billion tax cut and spending increases so late in the cycle, and with interest rates rising. It's like a death wish. The U.S. is taking on hundreds of billions of dollars of debt while raising rates, which means our debt-service payments are going to be under serious pressure to the upside.

Where do you expect the 10-year bond yield to end the year?

I thought the 10-year would get above 3% this year. It did so, briefly. More important, the long bond [the 30-year Treasury] closed above 3.22% for one session. You'd need more than one close like that to send a signal. It turned out to be a buying opportunity. I expect the 10-year yield to be range-bound for the rest of the year. Rates should be much higher, based on nominal gross domestic product, which probably ran around 5% in the second quarter. But weirdly, again, in this era of quantitative easing, if you average nominal U.S. GDP and the German Bund's 10-year yield, that's where the 10-year Treasury yield is. The German 10-year yields 30 basis points. Average that with nominal GDP of 5% and you get about 2.65%. So, 2.65% is my year-end number.

JEFFREY GUNDLACH'S REPORT CARD

Company / Ticker
Energy Select Sector SDPR / XLE*
Tortoise MLP / NTG
Invesco Senior Loan / BKLN**
iShares MSCI Brazil / EWZ
WisdomTree Japan Hedged Equty / DXJ

*Closed position. Now recommends SPDR S&P Oil & Gas Explorati
**Name change from Powershares Senior Loan Portfolio effective 6/

Source: Bloomberg

What is the best way to invest in this sort of environment?

Be conservative. I still recommend low-risk, relatively low-duration bonds. I recommended PowerShares Senior Loan Portfolio at the January Roundtable [now Invesco Senior Loan (ticker: BKLN)]. It has been a good performer, up almost 2% year to date, whereas most bond strategies are negative.

I still favor commodities. They are weirdly strong, given how powerful the dollar has been. Commodities prices have been spooked recently by the tariff situation, but that is a buying opportunity. I recommended the XLE [the Energy Select Sector SPDR exchange-traded fund] at the beginning of the year. Now I prefer the XOP [SPDR S&P Oil & Gas Exploration & Production]. It just hit a high for the year, but we are looking for further gains in the commodities complex.

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You recommended iShares MSCI Brazil [EWZ] in January as a commodities play, but it has done poorly. Are you sticking with it?

It did great for a while, and then things changed with the dollar and political news in Brazil. I like it even better now. Brazil is supercheap. I am also sticking with Tortoise MLP[NTG], a fund that buys master limited partnerships. Oil has rallied, but this security has fallen. They haven't cut the dividend in five years. [Tortoise MLP yields 10.7%.] Tortoise has been forgotten by the market. I still like WisdomTree Japan Hedged Equity [DXJ], too. The Bank of Japan remains highly supportive of maintaining liquidity conditions, in contrast to the Fed and, increasingly, the ECB [European Central Bank]. But Invesco Senior Loan Portfolio is my favorite thing. The interest-rate risk is extremely low, and it yields about 5.5%.

Overall, I see a middling year for the market. Everything seemed magical in January, what with synchronized global growth and markets accelerating to the upside. We haven't been able to get back to that frame of mind since February—or that market level. The Bitcoin buying frenzy led the stock market higher. Bitcoin started crashing in mid-December. I said at the Roundtable that I thought it was a mania. Now, it is down 70% from the high.

Two years ago at the Roundtable, you said Donald Trump would win the presidential election. What does your crystal ball say about the House and Senate races this fall?

The Republicans will keep both houses of Congress. The Democratic message is getting hard to find. Socialism isn't a winning message yet. You will need a recession before it becomes one. You could get a hard left turn if the recession comes before 2020. There would be an impetus to throw out the Republicans. But it isn't a winning message with the economy growing by 5%.

One more thing: I like the two-year Treasury note. It is so unglamorous, but you'll get the yield, and you're probably going to want that liquidity sometime in the next couple of years.

Thanks, Jeffrey.

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