ADVISOR PERSPECTIVES

Gundlach: Investors are asking the Wrong Question

By Robert Huebscher
March 12, 2013

If you're trying to assess the Federal Reserve's so-called exit strategy from quantitative easing, then you're asking the wrong question, according to Doubleline's Jeffrey Gundlach. Quantitative easing is a permanent policy tool, he said, and investors should be asking what that means for their investment strategy.

Speeches by Fed Chairman Ben Bernanke and minutes of the Fed's meetings have made it "crystal clear" that the Fed will not deviate from the "Big Easy," Gundlach said.

Big Easy, Gundlach's reference to quantitative easing, was the title of a presentation he gave to investors on March 5. Gundlach is the founder and chief investment officer of Los Angeles-based Doubleline Capital. Copies of the slides from his presentation are available here.

The exit strategy is essentially inconsequential, he said. "I don't really care what the Fed's ultimate strategy is because it's not relevant to today's investment horizon," Gundlach said.

Gundlach identified a number of consequences of continued quantitative easing and their implications for investors. For example, he was bullish on Treasury bonds, Japanese stocks and silver – but not on gold.

Let's look at what Gundlach said of what the Fed's strategy means for the markets. I'll also revisit one of Gundlach's most noteworthy – and correct – predictions: that Apple's stock would eventually decline to $425.

Life in the Big Easy

Although he accepted quantitative easing, Gundlach did not approve of it.

Quantitative easing has provided "incredibly easy money through circular financing schemes aiding and abetting the deficit spending everywhere you look," Gundlach said. Not only is it the Fed's chosen policy tool, but quantitative easing has also been applied by the Bank of England, the European Central Bank, the Swiss central bank and, most recently, the Bank of Japan.

"The Big Easy is all about central balance sheet expansion," he said.

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.

Since the onset of the financial crisis, the Fed and the Bank of England have increased their central bank balances by approximately 15% of GDP. The Bank of Japan increased its balances at a slower pace until February 2012 and accelerated after that, Gundlach said. U.S. easing amounted to a boost of approximately 3.5% of GDP annually, he said. Without this expansion, "you would have much lower GDP, perhaps because you would have less borrowing and less fiscal stimulus by that amount."

In the week before Gundlach's speech, the newly released Fed meeting minutes revealed an internal debate about the merits of quantitative easing and balance sheet expansion. But Gundlach said it was "ridiculous" to be worried about that.

"I would hope that at these Fed meetings they are talking about the merits and potential negative consequences of quantitative easing," he said. "What if they weren't talking about it at the Fed meeting? That would be the cause to be super-worried about what's going on – if they're running these experimental policies and extraordinary measures without anyone even worrying about it."

"The Fed is going to keep this going not for months, but for years," he said. "As investors, we just have to accept that."

Gundlach said the Fed would not hesitate to increase its bond-buying if interest rates start to rise, "simply because the math of the debt-to-GDP ratio argues that it needs to do that to keep the deficit from really exploding due to interest expense."

The consequences, intended and otherwise

As in the past, Gundlach was critical of U.S. fiscal policy. He said that various attempts at fiscal reform – sequestration, tax increases and spending cuts, for example – have not had much of an impact on our deficit. He expects the fiscal outlook to worsen until a crisis unfolds.

The same will be true of quantitative easing, he said. "You can do it for a while and it doesn't seem to have any bad consequences," he said. "Then all of a sudden, something dramatic happens."

The members of the Fed have convinced themselves that they have it "fully under control," he said, but investors should not be so complacent.

Gundlach said his "rule of investment risk" states that the frequency of problems multiplied by their severity remains constant. If problems become more severe, they occur less frequently, and vice versa. Quantitative easing, he said, is designed to decrease the

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.

frequency of problems, by pushing them further into the future. But that will increase the severity of the problems once they occur.

Gundlach noted some of the negative consequences of quantitative easing and ineffective fiscal policies. One has been high unemployment, he said. (He spoke before the release of data which showed a 0.2% decline in the unemployment rate.)

But the unemployment rate doesn't reveal the true extent of the problem, Gundlach said. The employment-to-population ratio hasn't budged since 2010. It was 65% in 2000 and is now approximately 58%, he said.

Quantitative easing has taken jobs away from younger people and forced older ones to return to the workforce. Younger people have been disproportionately affected by high unemployment. Income is declining as well, he said. Since 2000, there has been a 15% decline in the average earnings of full-time workers between 25 and 34 years old, he said. At the same time, the cost of tuition and fees at public four-year universities is up approximately 70%, he said.

The older generation is suffering, he said, because low interest rates mean they can no long obtain sufficient income from their retirement funds. That is forcing them to seek employment.

“This is a really broken model that I'm sure will be much in the conversation about how to run the society as we move forward in time,” he said.

What this means for the market

The U.S. stock market has benefited from easy money, Gundlach said. QE1, QE2 and Operation Twist have all correlated with higher stock prices. But Gundlach wasn't particularly upbeat about the prospects for U.S. stocks in the future.

Gundlach discredited the notion that retail investors are about to start a “great rotation” from bonds into stocks. Retail ownership of stocks, he said, is already fairly high – about the same level as in 2007. Moreover, such a rotation would require new buyers of stocks. But for every buyer there must be a seller, and it isn't clear which sellers would support a round of buying by retail investors.

Gold has also been a big beneficiary of easy money – until the last year or so, he said. Until then, the price of gold rose in tandem with the increase in central bank balance sheets. Gundlach said gold prices are at the lower end of their range over the past year and a half, and gold's current price is a “reasonably good entry point.”

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.

But Gundlach now prefers to own silver in his funds instead of gold, because silver has a higher beta. Silver was very much in favor a couple of years ago and is now out of favor, he said. Its price has gone from $50 two years ago to approximately $28 per troy ounce now.

"This is probably a good time, if you've been thinking about metal buying and other real asset bonds, to go forward with it," Gundlach said.

Interest rates have risen since July 2012. Gundlach said he increased his allocation to Treasury bonds by 5% in his total return fund in the last few weeks. While Treasury prices have declined since July, prices of riskier assets (except high-yield bonds) have risen. That means the "relative value has swung more in favor of Treasury bonds," he said.

Gundlach doesn't expect interest rates to rise. When asked what the 10-year bond would yield at the end of the year, he said – somewhat jokingly, adding unnecessary precision to his answer – that it would be 1.63%.

"Ten-year Treasury bonds above 2% represent reasonable value, versus the high prices now on many areas of the credit market," he said. "I prefer a 30-year Treasury yielding 3.25% to a double B-rated high-yield basket yielding 4.25% to no losses [defaults]."

The pace car in the Big Easy

Japan is now setting the pace for aggressiveness in the global quantitative easing derby, Gundlach said. The ultimate consequences for the country's "great debasement" will be dire, but in the short term, Japanese stocks will rally, he said.

Japan has a "horrific" debt-to-GDP ratio of 240%, Gundlach said, up from 212% a little over a year ago. Government spending has increased in every quarter since 2008, and the only way its government can sustain future spending is with "massive money printing," he said. Japanese society has accepted that; newly elected Prime Minister Shinzo Abe ran on that policy.

Japan's birth rate has fallen from 19 births per 1,000 people in the 1970s to approximately eight per 1,000 today. Its declining population is its biggest problem, because there are fewer workers per retiree. Added to Japan's shrinking private savings pool and negative trade balance, there is no longer any way Japan can finance its deficit, Gundlach said.

Accordingly, the value of the yen has "collapsed" relative to the dollar since November, Gundlach said.

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.

But the other consequence has been in the Japanese stock market, which has risen by approximately 30% in dollar terms since November. A weak yen is good for exports and helps Japanese industries, he said.

Those who bet that Japan's unfolding crisis would translate to higher bond yields were mistaken, Gundlach said. Japan has succeeded in keeping interest rates low.

Those who believe that quantitative easing helps stocks markets – and also believe that growth and prosperity through strong exports helps an economy – should be particularly fond of Japan's equity markets.

Gundlach said it's likely the Nikkei will be up 20% in dollar terms this year.

"Japanese stocks are cheaper than U.S. stocks," Gundlach said. "If I was forced to own one stock market, it would be the Japanese stock market."

Gundlach on Apple

On Nov. 7, 2012, Gundlach predicted Apple stock would fall to $425. At the time, it traded at $560 per share.

It closed at $420 the day before he spoke last week, validating his forecast.

Gundlach's prescience is well documented. He predicted the collapse of the housing market that precipitated the financial crisis and, more recently, the bond market's top in July 2012.

But he offered only limited advice for Apple's investors.

"I don't have an opinion now," he said. "The beautiful thing about markets is you don't always have to have an opinion." He said that is particularly true of a bond investor such as himself, who only owns stocks in his macro fund.

Gundlach left his audience with a hint of where Apple might be heading, though. He said it wouldn't surprise him to see the stock go up now that the price is at "about fair value."

Don't get too hopeful, though. Gundlach said it will be a long time before Apple sees $700, the price which it traded at as recently as September 2012.

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php

© Copyright 2013, Advisor Perspectives, Inc. All rights reserved.