DOUBLELINE® CAPITAL LP

Thought Leadership

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Jeffrey Gundlach – Thought Leadership

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"Hey, Kid, Want Some Candy?" is America's addiction to government stimulus and giveaways, which started during the Global Financial Crisis (GFC). But now, in a COVID-19 world, it's GFC spending on steroids: unemployment bonus checks, large- and small-business loans, business tax cuts, etc. There's probably no end in sight to this government assistance. Both political parties are in cahoots on embracing budget deficits – especially with the upcoming election. It's very hard to see how we will ever get out of this situation. Public debt outstanding as a percentage of GDP is significantly higher than the past peak, even higher than World War II levels. The M2 money supply has exploded, with a 23% increase year-over-year. However, this supply is being offset by the collapse in velocity. We have the lowest monetary velocity of all time, keeping inflation in check – for now.

Amazingly, thanks to the government's "candy," real disposable personal income has been pumped up by $3 trillion or so, something like 15% of GDP. So, the $600 unemployment "bonuses" and checks to most households were very, very substantial in terms of distorting personal income and spending. Even cutting those weekly benefits in half still leads to the systematic problem of making it difficult to bring lower-wage workers back to work. In addition, a lot of money went to small businesses, $2.2 trillion, yet it didn't really seem to help. Revenues have gone in the opposite direction of consumer spending, forcing many local small businesses to close their doors permanently. Larger corporations have been gorging on government "candy" by borrowing tons of money and eliminating their liquidity issues. But my fear is, they haven't eliminated their solvency problems. And, depending on economic fundamentals, we could see downgrades, defaults and lower recovery rates in corporate credit. We have seen an uptick in large corporate bankruptcies, with the cumulative count of corporations with $1 billion or more in debt filing Chapter 11 for this amount of time into the recession well ahead of 2002 or 2009.

The Federal Reserve has been adding to its balance sheet as well. It started out buying investment grade and high yield exchange-traded funds (ETFs). Yet its buying has been trivial in size as the cumulative Investment Grade ETF flows for the past 12 months has more than doubled in size, with over $150 billion of flows as investors have poured into it dying for yield. Yet, the Fed hasn't come close to fully exploiting its buying capabilities. It's not doing any commercial paper facilities. The corporate credit facility has been used by about 20%, including the Term Asset-Backed Securities Loan Facility (TALF) and TALF 2.0. So, it seems to have some dry powder. The markets the Fed has supported have seen substantial snapbacks, particularly at the top of the capital structure, stabilizing things for now in high yield and collateralized loan obligations.

One area the Fed has been buying is the Treasury Inflation-Protected Securities (TIPS) market, where it has increased purchases from 10% to a little under 20% of the outstanding market, which traded thin to begin with. Thin markets mean a little bit of trading can lead to a lot of volatility, so we'll have to watch that. It seems clear to me that the Fed participation in TIPS is one reason why we have such negative real yields. Its manipulation in getting real yields to very low levels is really at odds with economic fundamentals. That's one reason I prefer nominal bonds over TIPS.

THOUGHTS ON THE MARKET

Interest Rates

The yield curve has been steepening. The Fed doesn't much care about the 30-year yield rising, at least up to a point. Its yield is already up 80 basis points (bps) or so. The 10-year looks like it is being pegged and really should be higher based on comparison to the copper-gold ratio, which indicates the 10-year should be around 1.25% instead of the current 70 bps. Even comparing the 10-year to a cyclical/defensive equity ratio sends the same signal that the 10-year is too low based upon fundamentals. It's a rigged system.

U.S. Dollar

The dollar has been rising a little recently. I turned positive on the dollar for the first time in quite a while for the near term. I believe the dollar got ahead of itself on the downside and has begun a countertrend rally. The recent activity in the stock market vis-a-vis the dollar has been following a pandemic pattern. So, if the dollar goes up, I think the S&P 500 Index goes down.

Gold

I turned positive on the dollar a few weeks ago and negative on gold shortly after that. The dollar going down is usually good for gold. Gold has had a huge run-up, and I believe it will go higher over time. Right now, the trade location isn't attractive, but I'm bullish on gold in the long run.

Equities

S&P 500 Index market cap versus GDP is the highest of all time, making this the most overvalued in U.S. market history. FAAANM (Facebook, Alphabet, Amazon, Apple, Netflix and Microsoft) divided by the S&P 500 since June or early July have actually been underperforming the S&P 500 Index, which is not a good sign. The generals have abandoned the battlefield. The price-to-earnings (P/E) ratio is looking similar to 1999 levels, and the CAPE ratio looks like 1929. P/E ratios have had the greatest six-month expansion in 30 years.

Credit

The corporate bond market is distorted versus prior recessions, with the leverage ratios being 50% higher and spreads having not widened like in past recessions. Companies are clamoring to issue debt, solving liquidity needs while investors are accepting very low yields. With the investment grade market being rated way lower than it used to be with more and more BBB, the solvency risk rises with downgrades and defaults.

Housing

Housing has been one positive market, with 30-year mortgages lower by 83 bps, pending home sales have skyrocketed and housing starts have rebounded. All of which has led to higher home prices in certain markets and lots of supply in other high-tax states.

DEFINITIONS

CAPE® Ratio – This ratio is a valuation measure that uses real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle. It is also known as the Shiller P/E ratio. The P/E ratio is a valuation metric that measures a stock's price relative to the company's earnings per share. EPS is a company's profit divided by the outstanding equity shares.

Credit Quality – Determined from the highest available credit rating from any Nationally Recognized Statistical Rating Agency (NRSRO", generally S&P, Moody's, or Fitch). DoubleLine chooses to display credit ratings using S&P's rating convention, although the rating itself might be sourced from another NRSRO. The firm evaluates a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when the rating agency has not issued a formal rating, the rating agency will classify the security as nonrated.

Gross Domestic Product (GDP) – The total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

M2 Money Supply – Calculation of the money supply that includes all elements of M1 as well as less-liquid "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds and other time deposits.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.

DISCLOSURE