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Generating high cash flows and managing risk with deflation or inflation

By Jeffrey Gundlach

Markets distill human interaction. Within manias and crashes act the opposing human flaws of greed and fear. This dualism will explain market behavior as long as there's a bid and an offer, but it strikes me that a third human condition is at work today. More than fear or greed, need is leading income investors astray.

Money market accounts return zero. Longer-dated Treasuries and Ginnie Mae pass-throughs yield about 4%. These taxable income streams fall well short of the needs of income investors and defined benefit plans. Taking the first orthodox step into credit risk doesn't help much: investment-grade corporate bonds offer on average a 4.5% yield, a glib statistic forgetful of defaults. To add insult to injury, remember the forthcoming surtax on unearned income, likely a harbinger of more to come.

Faced with the anemic top lines of safer havens, the needy feel forced to embrace risk. So they speculate in risky plays on junk bonds, equities and hedge funds – and cover their ears and hum. They pray that default and balloon-refinance risks make only a small dent in the yields of below-investment-grade bonds, already trading at mediocre credit spreads by historical standards. High yield buyers have even swallowed covenants in new issuance as disadvantageous as those of 2006-2007 paper. Likewise, the needy ignore the overvalued fundamentals and de minimis dividends of stocks. After all, in theory, equity has unlimited upside. And hedge funds. Yes, hedge funds are opaque, but that's viewed as a virtue in times like these. In a world where analyzable investments fail to get the job done, opacity invites the buyer to dream.

These risky strategies perform best in times of growth and inflation. That day may come. Washington may indeed try to stoke inflation to goad consumption and, truth be told, to debase the immense unfunded liabilities of the U.S. government. But the inflationists are thinking too many moves ahead on the chess board. Before a possible inflation end game, I believe we must counter further attacks in the deflation middle game. If I am right, nervy gambits for income will end in the heartburn of principal destruction.

Unique opportunity

Fortunately, a conjunction of phenomena in different bond sectors has created a unique opportunity: portfolios can be structured to deliver high cash flows within an envelope hedged against the antipodal risks of inflation as well as deflation. In the process, I believe investment professionals with the requisite skills can integrate hedges against interest-rate volatility and credit deterioration into the same portfolios. In today's seemingly yield-starved landscape, investors can earn high single-digit returns without recourse to dicey trades or taking sides in the debate between inflationists and deflationists.

All the same, let me summarize my deflation case.

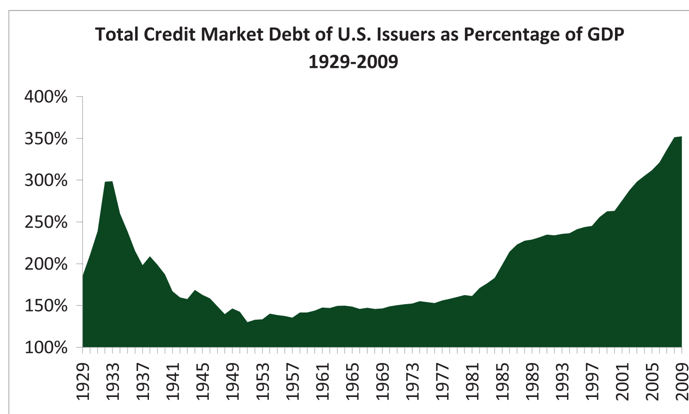

Exhibit by DoubleLine Capital LP from Morgan Stanley, Federal Reserve and Commerce Department data (See Graph top right)

The developed world engaged in a decades-long regime of debt-financed consumerism. That era is coming to an end, but it's a protracted process. The banking and market crashes of 2008 only partially wrote down the developed world's over-leveraged balance sheet. In the United States, the private sector has continued to de-lever, but Washington is fighting it tooth-and-nail through massive borrowing and monetary stimulus.

Unfortunately, the unfunded liabilities are too large. Uncle Sam has failed to reserve, by actuarial estimates, for more than $60 trillion in federal promises to pay, the bulk in the form of Medicare and Social Security benefits. The private sector has hardly completed its balance sheet adjustment. Pensions are maybe 80% funded. State and municipal finances are in no better shape. And the housing crisis is far from over: non-performing mortgages now encompass 7 million households, and that number is rising. In essence, debt is a short trade on the borrowed currency. For decades, the U.S. economy levered up against an unserviceable debt. With the bills coming due, and many headed for default, the mark to market will amount to a vast short-covering on the once-leveraged dollar, keeping deflationary pressure acute.

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The life support of 'green shoots'

Countertrend movements arise within secular trends. The rallies in risky credit and equities stemmed from oversold conditions in March 2009. These moves were sustained on the life support of "green shoots" optimism, the economic response to massive stimulus by the government and Federal Reserve. The stimulus regime, however, is running into practical limits. Short-term interest rates, at virtually zero, have no room to move lower. Treasury borrowing is being offset by private sector de-leveraging. This tug-of-war is visible in the size of all U.S. credit market debt – public and private sector – relative to Gross Domestic Product. Having risen sharply from 1981 through 2008, the slope of the ratio flattened in 2009. The debt-to-GDP ratio has dropped the last few quarters; in part, this reflects an uptick in quarterly GDP, although private sector de-leveraging also is at work.

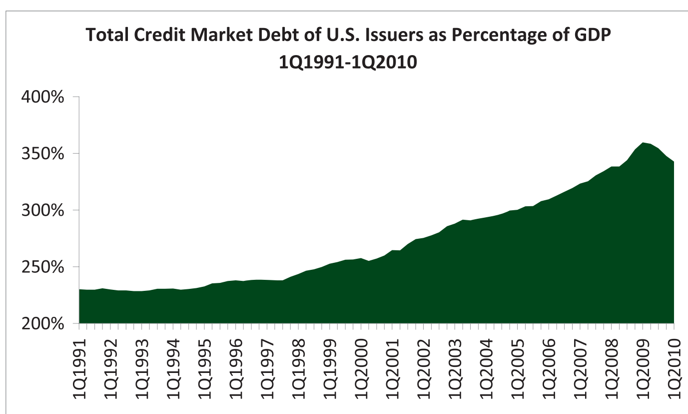

Exhibit by DoubleLine Capital LP from Federal Reserve and Commerce Department data

As we have seen, when markets take notice of debt bombs, the repricing strikes with speed and violence. Witness the unraveling of euro-denominated financial assets. The ensuing flight from euro-denominated paper may assist U.S. Treasury borrowing for the time being. But where will Washington turn once the world at last takes notice of our debt bomb?

Analysts still reference the near 80% gain in the S&P 500 from the bottom in March 2009, but to my eye, the more interesting fact is the lack of progress by stocks since last September. More recently, debt bomb fears across the Atlantic have been a definite cooler for stocks here at home. The April-May sell-off in U.S. equities and the schizophrenic trading in May-June suggest distribution under way. Stocks are moving from once-strong hands.

Let's turn from the bloodless verdict of the markets to economic fundamentals. To date, the Keynesian and monetarist campaigns marshaled by Washington have failed to generate credible signs of a self-sustaining recovery. I find most telling the behavior of the U.S. labor market. Debt-financing, since the 1980s Washington's antidote for recession, largely failed to spur private sector jobs growth out of the recession of 2001; it has utterly failed to do so in the wake of the recession that started December 2007. The old playbook is failing as our economy mutates away from its manufacturing base. In fact, I suspect that debt-based rescue schemes have become detrimental to the creation of productive jobs.

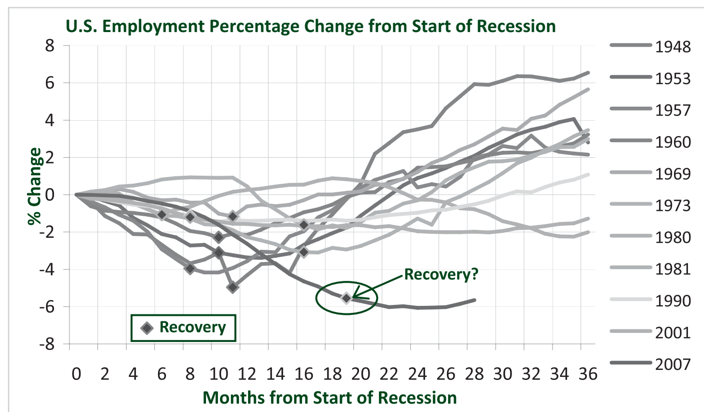

Exhibit by DoubleLine Capital LP from Bureau of Labor Statistics and Federal Reserve Bank of Minneapolis data

So my base case is deflation and its attendants: recession, deteriorating credit and, at the long end of the Treasury curve, tame-to-falling Treasury yields. That said, I distrust portfolios constructed on unidirectional, all-or-nothing macro outlooks, even on my own base case. Everyone makes mistakes. A mistake in security selection involves that security. A mistaken macro bet engulfs the entire portfolio.

Here's the good news

Here's the good news: today's market affords an opportunity to develop a portfolio that generates high cash flows while managing risk under both my base case and an alternative future of inflation, growth, improving credit and rising yields. The idea is to exploit the juxtaposition of two market conditions: distressed pricing in the mortgage credit segment of the bond market and the historically steep slope of the U.S. Treasury yield curve.

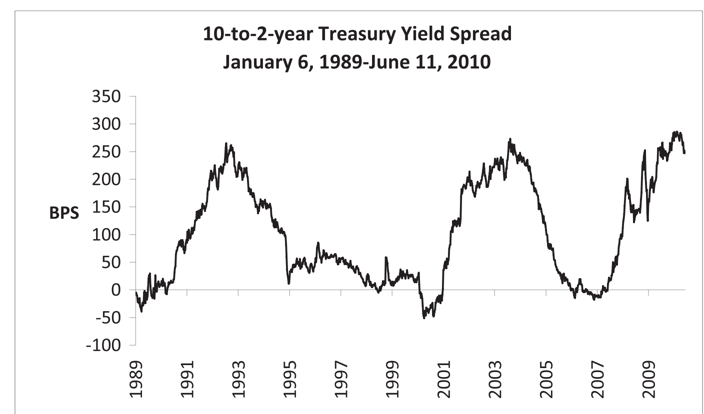

Exhibit by DoubleLine Capital LP from Bloomberg Financial Services data

In a context of near-record maturity spreads, deflation lowers yields at the long end, flattening the curve. So I'm fond of high-duration securities backed by the full faith and credit of the U.S. government. In particular, I like long-dated Treasuries and long-dated tranches of collateralized mortgage obligations (CMOs) backed by Agency mortgage-backed securities (MBS). The trained professional investor can obtain yields of about 7% in this corner of the mortgage sector. Furthermore, if yields narrow at the long end, prices on these securities should rally, reaping the bonus of capital gains while the investor clips the healthy coupon.

That's an attractive trade assuming my base case, but watch out. Everyone makes mistakes. Regardless of asset class, income investors should beware portfolios that gamble on unidirectional market forecasts. My base case is further deflation. What if my base case proves wrong and inflation accelerates? The likely result would be a surge in interest rates, the bane of high-duration investments. Another corner of the mortgage sector holds the solution. Portfolio managers can pair allocations to high-yielding high-duration securities with allocations to a different investment that also delivers high cash flows but exhibits negative duration – in other words, an asset whose price rises with Treasury yields. Among the assets with these characteristics are certain distress-priced mortgage bonds whose principal is not guaranteed by the U.S. government, also called legacy non-Agency residential mortgage-backed securities (RMBS). The careful pairing of long-dated Treasuries/Agency CMOs with non-Agency RMBS results in lower portfolio duration than that of the Barclays Aggregate U.S. Bond Index.

A world of rising Treasury yields

Despite the 2008-2009 rally in many credit assets, certain senior non-Agency RMBS remained priced to depression-like scenarios. It is rare for credit to remain priced for the kind of loss rates that would occur only with a major depression. Corporate yield spreads, for example, blew out to depression-like wides in late 2008 but soon entered a multi-quarter compression. In contrast, pricing of certain non-Agency RMBS can offer returns in the double digits even assuming depression-like fundamentals.

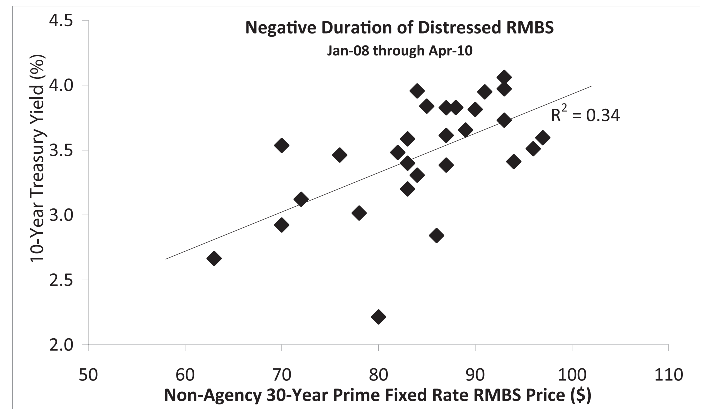

Exhibit by DoubleLine Capital LP from Amherst Securities Group and Bloomberg Financial Services data

Now imagine a world of rising Treasury yields. That scenario is consistent with a world of economic growth and accelerating inflation, or at least consensus expectation of these phenomena. Growth and inflation are bullish for depression-priced credit. Default rates should fall, and recovery rates on liquidated collateral should improve. In such a context, depression-priced mortgage credit should rally. This relationship is demonstrated in history as well as explained by theory. Since depression discounts became the rule in mortgage credit, prices of certain non-Agency RMBS have rallied during back-ups in Treasury yields and fallen during declines in Treasury yields.

Asset managers can blend investments with offsetting interest-rate correlations to create portfolios that can realistically generate returns in the high single digits while exhibiting low interest-rate sensitivity. In my view, this integrated trade solves the income problem while steering a safe course between the shoals of credit and duration risk. Investors can feed themselves without banking on dreams.

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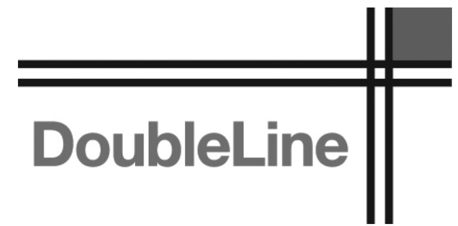

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