2020 Market Outlook:
“Just Markets” Webcast Recap

Originally aired on January 7, 2020

About this Webcast Recap

On January 7, 2020, Jeffrey Gundlach, CEO of DoubleLine Capital, gave a 2020 Market Outlook presentation titled “Just Markets.”

This recap is not intended to represent a complete transcript of the webcast. It is not intended as solicitation to buy or sell securities or provide investment advice. If you are interested in hearing more of Mr. Gundlach’s views, please listen to the full version of this webcast by clicking here. You can also learn more about future webcasts by viewing the 2020 webcast schedule at www.doubleline.com under “Events.”
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Global Negative Yielding Debt: Total and Corporate Debt

- In 2019, 10-year government bond yields declined across the majority of developed markets. With yields falling in Europe and Japan, the amount of negative yielding global debt increased during 2019.
- The market value of negative yielding debt, as measured by the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index, reached a high of $17 trillion in August 2019.
  - With global bond yields broadly rising into year-end, the market value of negative yielding debt has declined to $11.8 trillion as of January 3, 2020.
- Negative yielding corporate debt was virtually zero at the start of 2019; as global rates declined, negative yielding corporate debt surpassed $1.2 trillion in August 2019, as measured by the Bloomberg Barclays Global Aggregate Negative Yielding Debt Corporate Index.
  - As global bond yields broadly rose in 4Q 2019, the market value of negative yielding corporate debt declined to $0.5 trillion as of January 3, 2020.

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Global Bank Stocks

- The impact of negative interest rates in Europe and Japan is exemplified in the countries’ bank stocks.
  - The Bank of Japan (BOJ) employed a sub 1% interest rate policy beginning in 1995, which eventually lead to the BOJ adopting negative interest rates in 2016. Since 1995, Japan Bank stocks are down over 80% as measured by the Tokyo Stock Exchange TOPIX Banks Index.
  - From 1995 to the Global Financial Crisis, European banks and United States (U.S.) banks significantly outperformed Japanese Banks.

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- In an attempt to stimulate the Eurozone economy post Global Financial Crisis, the European Central Bank (ECB) introduced negative interest rates in 2014.
- Since the Global Financial Crisis, the EURO STOXX Banks Price EUR Index has significantly underperformed United States (U.S.) banks as measured by the KBW Bank Index.

  - In the U.S., negative interest rates were not introduced by the Federal Reserve (Fed) and the U.S. banking sector has made it back near post-crisis highs. This immense outperformance versus European banks and Japanese banks can partially be ascribed to the Fed's decision not to implement negative interest rates.

- Mr. Gundlach believes that "negative interest rates ultimately over the fullness of time, are fatal to banks" which is why he "applauds (Federal Reserve Chairman Jerome Powell) for not wanting negative rates".

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LEI (YoY) vs. LEI 6-month Annualized

- Mr. Gundlach believes the probability for a recession in 2020 has decreased as several recessionary indicators have improved since August 2019.
- One of the indicators that has historically turned negative before a recession is the Leading Economic Indicators (LEI), which is currently at 0.1% year-over-year (YoY).
  - While there have been false positives from the LEI, there has never been a recession where the LEI did not turn negative before a recession going back to 1960.
- The 6-month LEI shows a higher frequency data point relative to the LEI YoY indicator, which can be helpful in determining the direction of the LEI YoY indicator.
  - The 6-month LEI is -0.4% as of November 30, 2019; DoubleLine's forecast is that the LEI YoY indicator will not turn negative in the coming months but will remain in the sub 1% range for 2020.

ISM Manufacturing and Non-Manufacturing PMI

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- The U.S. Institute for Supply Management (ISM) Purchasing Managers Index (PMI) has been in a downtrend since the mid-part of 2018. One reason for this trend is the global slowdown in manufacturing; in particular Europe and Germany, which have weaker ISM manufacturing prints relative to the U.S.
  - The U.S. ISM manufacturing PMI was 48.1 as of November 30, 2019. A reading below 50 signals a contractionary environment.
- The ISM Non-Manufacturing Index on the other hand, remains in expansionary territory with a reading above 50 at 53.9 as of November 30, 2019.
- In the past two recessions, both manufacturing and services PMIs were close to or below 50 at the front edge of the recession. For this reason, Mr. Gundlach will be watching the ISM Non-Manufacturing Index closely to see if this number starts declining towards 50.

Consumer Expectations

- Mr. Gundlach continues to monitor consumers' expectations of the future vs. consumers' views of the present.

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- If consumers believe the future is going to be worse than the present, the chart will go into the red shaded areas.
- The deeper the red shaded area dips, the deeper the divergence between the consumers' views of the present and feelings about the future becomes more acute.

- Currently, consumers' views of the present are quite strong while consumers' expectations of the future are less robust.
  - When consumer confidence of the present situation starts to deteriorate, this chart will begin to display a distinctive recessionary look as the shaded red area begins to shrink.

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Leading: Initial Jobless Claims

- Mr. Gundlach believes the labor market is paramount to the future economic outlook. Currently initial jobless claims are at a very low level, with an actual reading of 224,000 as of December 28, 2019.
- Another recession indicator DoubleLine follows is the U.S. initial jobless claims four-week moving average vs the trailing five-year moving average.
  - When U.S. initial jobless claims start to rise and breakthrough the five-year moving average, it usually occurs at the front edge of a recession.
  - If the four-week moving average for unemployment claims rises above the initial jobless claims five-year moving average at 244,000, Mr. Gundlach believes this would be a strong recessionary signal.

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U.S. Average Hourly Earnings (YoY)

- U.S. average hourly earnings YoY growth remained stagnant near 2% during the five year period between 2012 and 2017. Over the past year, wages have started to exhibit an uptrend.
- As of November 30, 2019, average hourly earnings YoY printed at 3.7%. Prior to the last three recessions, YoY average hourly earnings have peaked near 4%.
- Historically, the Fed has raised the Fed Funds Rate to combat wage pressure; this time the Fed is doing the exact opposite by easing rates instead of tightening.
  - Mr. Gundlach believes the takeaway is that the Fed wants higher inflation as measured by the core personal consumption expenditure (PCE), and that U.S. average hourly earnings YoY growth could rise above 4% as the Fed is not explicitly trying to combat higher wages.

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Measures of Core Inflation

- Despite most measures of core inflation registering above 2%, the Fed's preferred measure of inflation, core PCE, has remained below 2% since October 2018.
  - Mr. Gundlach believes that the Fed utilizing this measure of inflation allows them to justify not hiking rates while simultaneously giving them the option to cut rates.
- The Fed has begun to discuss "symmetric inflation" meaning inflation needs to rise above 2% to make up for the time inflation was less than 2%. Since the Global Financial Crisis, core PCE has only registered above 2% for two brief periods of time in 2011 and 2018.

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- Mr. Gundlach does not expect a rise in short-term rates any time soon given Chairman Powell’s statement on inflation at the Fed’s October news conference, "I think we would need to see a move up in inflation that's persistent before we would even consider raising rates to address inflation concerns.

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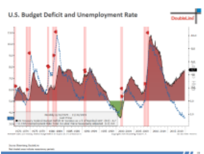

Fed Balance Sheet and 3m10y UST Spread

- With the Fed engaging in repo operations since September 17, 2019, their balance sheet has expanded at a similar pace to previous quantitative easing (QE) programs.
- Mr. Gundlach notes that there appears to be a high correlation between the expansion of the Fed’s balance sheet and the steepness of the U.S. yield curve.
  - During QE 1, QE 2, and QE 3, the balance sheet of the Fed was expanding and the shape of the yield curve, as defined by the difference in yields between the 3 month U.S. Treasury (UST) Bill and the 10 year UST Note, steepened.
  - During the Fed’s “Operation Twist”, tapering, and quantitative tightening, the yield curve flattened.
- DoubleLine’s base case is that the Fed will continue to expand their balance sheet which will likely lead to a steeper yield curve. This is one of the reasons Mr. Gundlach believes investors should remain cautious at the long-end of the bond market.
  - As of December 31, 2019, the Fed’s balance sheet was $4.2 trillion.

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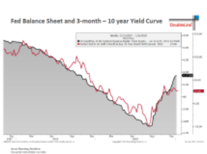

U.S. Budget Deficit and Unemployment Rate

- The U.S. budget deficit continues to grow during an economic expansion. Historically, the opposite has held true, as the U.S. budget deficit tends to shrink during an economic expansion and grow during a recession.
  - Currently the U.S. budget deficit is at 4.7% of gross domestic product (GDP). Absent the Global Financial Crisis, the current growth in deficit as a percentage of GDP is in line with the depths of previous recessions.
- If history holds true, the U.S. budget deficit would grow rapidly in the next recession, which Mr. Gundlach believes could be bearish for both long-term Treasury bonds and U.S. stocks.

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U.S. Dollar (USD) and Twin Deficits

- The twin deficit, which is the current account deficit plus the fiscal deficit, is highly correlated to moves in the USD, typically with a lag.
- The U.S. budget deficit has been expanding and the trade imbalance continues to grow as the trade deficit has expanded since President Trump’s inauguration.
  - This is one of the reasons Mr. Gundlach believes the USD will weaken in the short to medium term.
- The U.S. is growing their budget deficit at a faster pace relative to other developed markets in the Eurozone. Mr. Gundlach believes this should strengthen the Euro relative to the USD.

Copper / Gold vs. U.S. Treasury (UST) 10-year yield

One of the leading indicators Mr. Gundlach watches for the future direction of the 10-year UST yield is the Copper / Gold ratio.

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- As of January 6, 2020, the Copper / Gold ratio implies the 10-year UST yield should be right where it is, at roughly 1.80%.
    - If the price of Gold were to drop, this ratio would move higher which would potentially support a steeper yield curve
- Another indicator is the average of U.S. nominal GDP YoY and the German 10-year Bund yield.
    - With the Atlanta Fed GDPNow forecast indicating U.S. Real GDP for the fourth quarter 2019 of approximately 2.3%, Mr. Gundlach believes the fourth quarter 2019 U.S. nominal GDP YoY will be near 4.5%. The German 10-year Bund yield is roughly negative 30 basis points (bps), which, when averaged, would suggest the 10 year UST yield should be closer to 2.10%.

Commodities/Dow Jones Ratio

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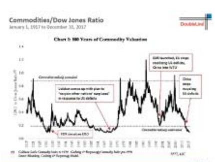

- This chart shows 100 years' worth of data comparing the ratio of the Goldman Sachs Commodity Index vs. the Dow Jones Index.
    - A ratio near 0.9 signals that commodities are overvalued while a ratio near 0.2 signals commodities are undervalued.
    - The ratio has ranged from 1.2 to 0.1; it is currently below 0.2 which has only occurred three times in the last 100 years. The previous two occasions were in 1929 and in the 1960's.
    - Mr. Gundlach believes this bodes well for commodities on a valuation basis but cautioned that it could take a long time before commodities begin to significantly outperform.
- In 2019, every sector of the Bloomberg Commodity Index had a positive return, with the exception of grains.
    - With a weaker dollar forecast, commodities have the potential to be an attractive asset class in 2020.

S&P 500 vs MSCI EM Normalized to 1/26/2018

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- The high for emerging market equities as measured by the MSCI Emerging Markets Index was January 26, 2018. For the majority of 2018, U.S. equities outperformed emerging market equities amid a relatively strong USD.
- Since October 2018, the underperformance of emerging market equities has been trivial relative to the S&P 500 even with a slightly appreciating dollar.
- Mr. Gundlach's expectation for a weaker dollar would generally be a tailwind for emerging market equities.
    - This is one of the reasons why Mr. Gundlach is advocating for an equity allocation that is weighted more toward non-U.S. equities than typical.

Korean Stock Exchange (KOSPI)

- Mr. Gundlach believes one of the best ways to gauge the markets attitudes towards global trade is to follow South Korea's stock market, where nearly half of their GDP is export driven.
- Not surprisingly, when the global economy slows down or trade activity slows down, it often results in a lower KOSPI share index price.

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- Despite the perceived optimism of a phase one trade deal between the U.S. and China, Mr. Gundlach finds it material that the KOSPI Index has not rallied closer to its pre-trade war high in early 2018.
- To Mr. Gundlach, this signals that the market does not anticipate a more broadly spanning trade deal to be reached before the U.S. Presidential election in 2020.

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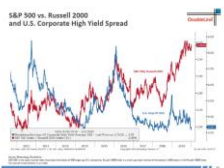

S&P 500 vs. Russell 2000 and U.S. Corporate High Yield Spread

- Since 2011, the outperformance of the S&P 500 relative to the Russell 2000 has had a high correlation to the option adjusted spread (OAS) of U.S. high yield.
  - The Russell 2000 consists of companies with smaller market caps that are more economically sensitive to the growth prospects of the U.S.
  - When the Russell 2000 is outperforming the S&P 500, it usually implies prospects of strengthening U.S. growth and the OAS on U.S. high yield subsequently tightens.
- This relationship did not hold true in 2019 as the S&P 500 outperformed the Russell 2000 and U.S. high yield OAS also fell.
  - Mr. Gundlach attributes the discrepancy to the lack of yield in global fixed income markets which is causing increased demand for U.S. high yield.

BB-BBB Corporate Spread Differential

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- Yield starved investors are potentially one of the reasons for the spread tightening between U.S. BBB corporate credit and U.S. BB corporate credit.
  - At 62 bps, the spread differential between the two cohorts is near its lowest level of the past 25 years.
- At an index level, the yield to worst on the Bloomberg Barclays BB U.S. High Yield Index is 3.60%, as of January 3, 2020.
  - Historically in a recession, high yield bonds suffer defaults and significant price depreciation. With this type of downside risk in a recession, Mr. Gundlach believes investors are better off on a return-per-unit-of-risk basis to buy the S&P 500 vs. U.S. BB high yield, which have a capped return of 3.60% if held to maturity.
- Mr. Gundlach stated, "stay away from BB (U.S.) corporates is my message."

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