2018 Market Outlook: “Just Markets” Webcast Recap

Originally aired on January 9, 2018

About this Webcast Recap

On January 9, 2018, Jeffrey Gundlach, CEO of DoubleLine Capital, gave a 2018 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 2018 webcast schedule at www.doubleline.com under “Events.”
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Global Economy

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- Global growth is in sync across major developed economies from the perspective of quarter- over-quarter (QoQ) growth, and is expected to continue for the next two quarters Purchasing Managers Index (PMI) across major economies are signaling expansion, with very few countries printing numbers below 50 (meaning mild contraction)
- South Korea’s stock market (KOSPI) had great returns in 2017, which is generally a good sign for global growth, as much of their economy is driven by exports
- Nominal Gross Domestic Product (GDP) in U.S. and Germany is around the same levels, yet Germany is easing and the U.S. is tightening

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  - German 2-Year Bund Yield: -61 basis points (bps)
  - U.S. 2-Year Treasury Note Yield: 196 bps
    - 257 bps spread between the German 2-Year Bund and U.S. 2-Year Note
  - German 10-Year Bund Yield: 44 bps
  - U.S. 10-Year Treasury Bond Yield: 254 bps
    - 210 bps spread between the German 10-Year Bund and U.S. 10-Year U.S. Treasury (UST)

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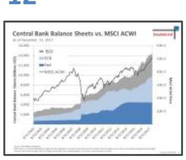

- The Federal Reserve (the Fed) has raised rates five times and is planning on three more hikes in 2018 per the Fed Dot Plot
  - By October of 2018 it is expected that there will be $600 billion of excess bond supply from debt rolling off the Fed’s balance sheet
  - The new tax package is estimated to reduce revenue to the Treasury by $280 billion
  - In addition to the current deficit, increased military and infrastructure spending, both of the above occurrences could put the Federal deficit for Fiscal year 2019 at $1.9 trillion based on some analysts estimates

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- The European Central Bank (ECB) raised their GDP forecasts for 2017, 2018, and 2019 yet they continue Quantitative Easing (QE) to the tune of 30 billion euros per month as promised by Draghi through September of 2018
- Global Stock Markets for mostly all developed and emerging economies experienced positive returns for 2017 with very low volatility
- Global Bond Markets noticed mixed returns in 2017 across economies
- The Morgan Stanley All Country World Stock Index (MSCI ACWI) has moved almost in lockstep with the size of major central bank's balance sheets since the end of the recession in 2009.
  - Fed + ECB net purchases are expected to turn negative in July of 2018, which could bring pause and reversal to the uptrend of the MSCI ACWI

U.S.

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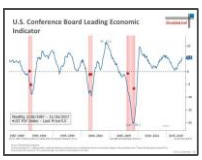

- While we have been experiencing a slower growth recovery than normal (2% annual growth), at 34 months in duration we are in the midst of the one of the longest economic recoveries in history
- Of all the indicators DoubleLine monitors to identify an approaching recession, none are currently signaling an economic contraction in the next 6 months
  - Leading Economic Indicators (LEI) are positive at 5.5 year-over-year (YoY). A reading below 0 would indicate the potential for an economic recession
  - The U.S. Unemployment Rate is well below its 12-month moving average at 4.1%. We would need to see a reading above its 12-month moving average before the potential for an economic recession.

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  - Institute of Supply Management (ISM) Manufacturing and Services PMI both currently look health above 55. Above 50 means the economy is in expansion and a reading below 50 means the economy is in contraction with the potential for a recession.
  - Small Business Optimism, Consumer Confidence, and Chief Executive Officer (CEO) Confidence are at cyclical highs
  - Factory orders are at a 14-year high
  - High Yield (HY) spreads relative to the UST do not signal recession for at least 12 months. Typically, before a recession you look for a spread widening within HY both 1 year and 6 months prior to a recession.

Stocks

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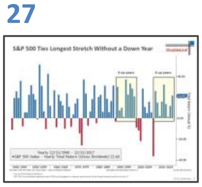

- After nine consecutive years of positive returns, the S&P 500 just tied its longest streak since 1940
  - Mr. Gundlach believes after an encouraging start to the year, the S&P 500 2018's total return will be negative.
  - The lack of volatility and complacency in the marketplace is alarming
  - The S&P 500 is approaching a new record as it nears the most number of trading days without a 5% correction
  - Of the last 28 calendar years there have been 23 years in which the Volatility (VIX) Index had not traded a single day below 10. In 2017 there were 52 trading days below 10
  - Both the Shiller P/E and the forward P/E multiple for the S&P 500 have only been at today's levels twice before in history; before the Great Depression and the Tech Bubble.

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Emerging Markets (EM) Equities

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- Not a great time to be buying EM from a trading standpoint, but long-term Mr. Gundlach continues to believe EM is attractive for an investor
- The Shiller Ratio of EM is just over half of the Shiller ratio of the U.S.
- Mr. Gundlach still favors foreign investing long-term, but expects a bit of a countertrend play short-term (U.S. outperforming in near-term)

U.S. Dollar (USD)

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- The USD determines the fate of the S&P relative to EM tremendously
  - If USD depreciates that bodes well for EM equities
  - Mr. Gundlach believes we will have a short-term rally in the USD but the big move will be to the downside
    - The Fed plans to raise interest rates three times in 2018 but it is priced in. Fed tightening will likely go through unless the economy weakens
    - Where we could get a surprise is out of Europe with a change in ECB rhetoric on easing policy. That would mean the prospects for the Euro to go up would increase, and Dollar would decline

Japan Equities

- Solid rally 2nd half of 2017 and appears to be in rally mode now
- They are changing their rhetoric a bit on the long end so we will see what happens there

European Equities

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- Mr. Gundlach believes European equities remain a value trap with very ability to valley and looks to be one of those things that is cheap but getting cheaper. EM has had ability to rally. The yen has shown the ability to rally, but Europe has not.

Bitcoin

- Mr. Gundlach believes the fact CNBC is asking every guest about it may suggest we are near a mania phase
- It can certainly go up, but Mr. Gundlach said on CNBC December 13, 2017 that if you shorted bitcoin today, you may go under water in the short term but long term you may end up in the money.
- Bitcoin is an unknown, is unproven and is dubious of long-term value and success
- Bitcoin is a very different investment from DoubleLine’s conservative DNA and focus on risk-management

Inflation

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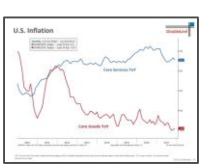

- Inflation is the tale of two rates: Core Goods (YoY) and Core Services (YoY)
  - Core Good (YoY) is deflating at -0.9
  - Core Services (YoY) is inflating at 2.5
- The way you would get a breakout in Consumer Price Index (CPI) is if Core Goods goes up, but it doesn’t appear to be trending that way currently
  - However, some underlying forward-looking indicators for Core CPI are on the move to the upside
    - New York (NY) Fed Underlying Inflation Gauge (UID) with 16-month lead suggests higher inflation
    - U.S. GDP (Gross Domestic Product) with 18-month lead suggests higher inflation

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Commodities

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- Mr. Gundlach and DoubleLine are bullish on commodities in 2018
  - History – commodities show tremendous cyclicality versus the S&P
  - During the 70's, commodities went on a bull run that was roughly 8x the S&P 500. Then in 1982, the stock market started to rally and commodities gave it all back
  - Commodities went on another bull market run into the peak of '08. This time it was 9x the S&P. Since then commodities have given that all back and been selling off while stocks rally
  - Mr. Gundlach believes we are at a point similar to the 70's when commodities were a screaming buy and where it was a decade and a half later. Commodities have been weak but we do not see it as a value trap anymore due to the recent rally
  - Looking at commodities and recessions back to 1970's commodities rally leading into recessions

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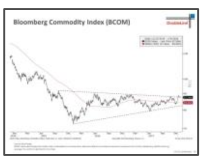

  - Commodities always rally sharply, much more sharply than they have so far, late in the business cycle as we lead into a recession. DoubleLine believes it is getting late in the cycle.
  - Bloomberg Commodity Index has broken out about its 200-day moving average and broken above the down trend line
  - Commodities have been crawling along the two standard deviations cheap for the past two years
  - In general, Mr. Gundlach thinks investors would benefit from broad commodity exposure going forward

Interest Rates

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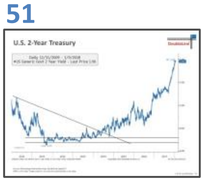

- 2-Year Treasury Note
  - Bottomed out seven years ago
  - Good reason to believe that 2.50% could be possible on the 2-Year Treasury
  - It won't make you rich, but Mr. Gundlach does recommend buying the 2-Year Treasury. It yields more than S&P 500 and when it matures it may be good timing to have cash on hand to invest
- 5-Year UST
  - More of a sideways look after its bottom in 2012, but has cleared pivot point at the high of 2017 and is now moving higher
- 10-Year UST
  - Lots of momentum to the upside, broke its trend line in 2016 after the election

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  - It would need some catalyst to take out its resistance level of 2.63%, but if it does, it will accelerate to 3.00% quickly
  - The next level would be 3.00% which was the high at year-end in 2013 when Mr. Gundlach was bullish on bond market
  - If you get above 3.22% on the 10-Year, then it's truly game over for the ancient bond bull market
  - The 10-Year has a push/pull relationship with the German Bund pulling it down and Nominal GDP pushing it up. If either moves higher the 10-Year will go up and both seem possible

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High Yield (HY) and Corporate Bonds

- HY spreads cannot go much lower than 300 basis points over 10-Year UST, Investment Grade cannot go much lower than 75 basis points over 10-Year UST and we are in the vicinity of those levels
- DoubleLine believes this is a bad time to be buying corporate bonds. Mr. Gundlach says you are buying after “almost all the juice is out of the orange”. Since bottom in yields on Treasuries since say February 2016, Treasury yields have gone up roughly 75 basis points but corporate yields have gone down
- Investors piling into corporate bonds and think they have little interest rate risk could potentially learn a very brutal and costly lesson

Recession

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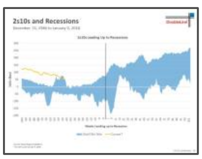

- All recessionary indicators are flashing “no recession”, which means that it is priced in to a lot of markets
- Mr. Gundlach believes when things change, they’re not likely to change to more optimism
  - As a result, DoubleLine expects a run early in 2018 in U.S. Equities but eventually they will end the year down
  - Mr. Gundlach suspects we will have a recession in the next two years and when we get that recession you’re going to want to have liquidity to buy things.

Question and Answer

Will Gold/Silver fall in a rising-rate environment?

- “Not really. Isn’t it maybe that rising commodity prices lead to rising interest rates? Maybe it’s not interest rates affect commodities; maybe its commodities affect interest rates. I could easily see commodities going up as we go late cycle because they always do, and interest rates tend to start rising, actually, late cycle because of the economy. So, let’s see what happens.”

Do you still see the 10-Year UST at 6% by 2020?

- “I never said 2020, I said a year or so after our next presidential election or so. So a little later than that, but yes.”

More upside in the German yields from here or in U.S. yields?

- “Clearly, to me, its German yields. Same fundamentals and the yields are 200 basis-points+ different.“

Buy Commodities broadly, a basket, or specific ones?

- “A basket”

With most recession indicators currently benign is there any reason to doubt the equity market continues to rally for the next six months?

- “Yes. There is a lot of reason to doubt: overbought; over belief. Like I said earlier, what’s obvious is already priced in. What we know today does not fuel the next 6 months of the market; it fueled the last six months, the last six weeks. Markets are discounting functions. You do not have incremental market insight if you have a certain economic outcome that’s believed, going forward. It’s the opposite.”

Question and Answer

HY spreads are at a 10-Year low. Do you think that they'll rally even lower, towards the '07, 05, and '97 lows of sub-300 spreads?"

- “Well, they will in the short-term if Treasuries continue to sell off, but not for long. Because once investors realize that they're going to lose money in corporate bonds with rising rates with really no cushion left, I think they're going to widen out. So, I don't like corporate bonds, at all.”

Interest Rates are moving higher. At what level do rates start impacting equities negatively?

- Above 2.63% on the 10-Year. That’s it. If the 10-Year goes above 2.63%, it’s not going to going to go to 2.65%. It is going to accelerate higher, and the equity market is going to be spooked and maybe that’s the cocktail that is coming our way

Definitions

ISM: ISM Manufacturing Index is based on a survey of 300 manufacturing firms by the Institute of Supply Management.

Volatility Index (VIX): The VIX shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge".

Shiller Barclays CAPE® Ratio: CAPE® stands for Cyclically Adjusted Price-Earnings. The CAPE® Ratio is a valuation metric that takes the current price of an equity or index divided by its inflation adjusted average of ten years of earnings.

Conference Board U.S. Leading Index (LEI): Leading indicators include economic variables that tend to move before changes in the overall economy. These indicators give a sense of the future state of an economy.

PMI - Purchasing Managers Index: An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

Bloomberg Commodity Index (BCOM): is calculated on an excess return basis and reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification. Roll period typically occurs from 6th-10th business day based on the roll schedule.

Morgan Stanley Capital International All Country World Index: A market-capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, including both developed and emerging markets.

Underlying Inflation Gauge: Captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.

One cannot invest directly in an index.

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