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An Interview With Jeffrey Gundlach
CEO and Portfolio Manager, DoubleLine Capital

The Bond King on Brexit, Earnings, and Gold

by Ben Levisohn

Three weeks ago, the unthinkable happened: The United Kingdom voted to leave the European Union.

Prior to the referendum, corporate heads, central bankers, political leaders, and economists all predicted that a vote for a so-called Brexit, or British exit, would be, if not the end of the world, something close to it. The U.K.'s economy would sink into a recession, the EU would start coming apart, and global stock markets would crumble.

The markets have been relatively calm so far, leading some to muse that other repercussions might not be so bad. Don't bet on it, says Jeffrey Gundlach, CEO of Los Angeles–based DoubleLine Capital, which oversees more than $100 billion. In a recent interview, Gundlach, one of the world's best fixed-income investors and a member of the Barron's Roundtable, argued that Brexit is probably the start to a summer of volatility, and explained how Donald Trump could become president of the U.S. He also told us why he's avoiding the stock market.

Brad Trent for *Barron's*

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***Barron's:* The result of the British referendum on membership in the EU sure caught us—and much of the market—by surprise. Did you see it coming?**

Gundlach: We didn't think Brexit was going to happen; we thought undecided voters would be afraid of the unknown and go for the status quo. But it didn't really matter to us. We invest in high-quality bond portfolios. In our diversified funds that also buy stocks, we've been at relatively low risk weightings, and in some really aggressive programs we've been net short certain parts of the stock market.

That's pretty conservative. If not Brexit, what were you worried about?

We've been expecting a summer of volatility all year. One of the ingredients for that cocktail was that the Federal Reserve seemed to be on a death march to raising interest rates. Now, [Fed Chief] Janet Yellen has made it pretty darn clear she isn't going to raise interest rates. That certainty of higher rates has been replaced by this economic and political uncertainty.

It matters to U.S. economic growth if Britain falls into something of a recession. The companies in the Standard & Poor's 500 get more than 40% of their revenue from outside the U.S., and a big piece of that is Europe, so there is a risk there. Then there is the risk that it is really just the beginning of something—that there will be more downside for stocks—and not the end of something. That is a very real risk.

The market doesn't appear to agree. There has even been talk that the U.K. may not

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leave the EU, after all. Do you think that's possible?

The worst thing that could happen would be for the establishment to say we're not leaving. The people said leave. A vote is a vote. I heard somebody say, "It was 52%-48%. Are we really going to let a four-point difference determine our path?" Yes. We do that every year in the U.S. Referendums that raise taxes and build projects come in at 52-48, and we don't revote them. Do you keep voting until you finally get what you want? That is not a democracy. If you say that doesn't count, that gets people who are already angry infuriated. There would be riots if they tried not to leave.

Riots?

What is really happening here is that there's massive technological change, and big changes almost always lead to political instability. People who benefit from the old construct are loath to see it change, because they don't want to lose their power and economic advantage. And so they dig their heels in even harder. That's what we're seeing in Britain right now. People who remember the good old days when they had factory jobs and made a good living—that's been taken away, and they want to do something about it. They want to blame somebody, so let's blame the EU.

Is the situation going to get worse?

Robots are taking an awful lot of jobs. Driverless cars are coming; just think about how many jobs that is going to take away. Think of all the taxi drivers; think of all the Uber drivers who have found a source of income. How about the truck drivers? How about the livery people? A lot of people are out there driving around and getting paid for it. You get a driverless car, and all of a sudden they're unemployed. Not all of them, of course, and not all at once. This is all part of this process.

But it's not just technology, is it?

One of the big problems in parts of Europe is a collapsing labor force. In Italy, the fertility rates are so low, and the baby-boom piece so big, that their labor force will plunge, absent immigration. Demographics are a problem that takes a generation to go away. And then you've got the robots, and they're never going away. And you've got all this debt—the world's debt-to-gross-domestic-product ratio is 240%—so you're already putting a big headwind onto economic growth. Pair that with the demographics, and you get slow global growth.

So you expect more political risk in the market?

This is a train that's moving down the tracks, and I don't see it stopping until substantial change occurs. Minor fixes—like raising the top tax bracket to 39% from 36%—are not going to create an enduring solution. We are going to see it in the U.S., in our presidential election. One of the reasons I believe Trump might win is that Brexit won. The parallels are far too great to be coincidental. They are identical in time. They are identical in mood, in the attitude of "I'm not doing what you say anymore."

Most polls show Trump trailing Hillary Clinton, some by double digits.

People don't want to admit that they support Trump. They hide it. A lot of people in Britain didn't want to admit that they were voting to leave. My suspicion is that if Trump is even within the margin of error come November, he'll win by a few percentage points.

Both Brexit and Trump are being driven, in part, by antagonism toward globalization. Protectionism, however, was one of the factors that led to the Great Depression.

The establishment media is putting out a lot of scare pieces about how Trump is going to destroy the world economy; that [his presidency] could lead to protectionism, noncooperation, tariffs, and stuff like that. And, in Europe, you are having a new uptrend in noncooperation.

But I'm pretty sure that if Trump wins—and I do think he is going to win—he is going to increase the deficit. He talks about building up the military, building walls. These things cost money. And if the deficit goes up, which it would under a President Trump, that will give a short-term bump to economic growth. So maybe it is not as scary as people think.

Still, you're invested very conservatively.

When the going gets tough, it is OK to go slow and watch your footing. You don't want to fall and roll down the mountain. You keep hearing about how this is the bull market people love to hate. When I hear that, I just have to shake my head. The S&P is the same as it was 19 months ago. I don't like the value. People say earnings will grow because they're coming off a relatively low base. The guess for 2017 is 15% earnings growth. But how in the world can earnings go up if nominal GDP is rising by less than wages? Profit margins must be squeezed. I'm not so sure that we'll get some big bounce in earnings, particularly after Brexit.

Stocks are close to a new high, leading many to think they'll continue to rise.

The S&P 500 has been going sideways for 18 months. But even so, it really stands out that the U.S. is the last man standing. Italy and Spain are down about 35% from their recent highs; Germany is down 25%; Japan is down 25%; China is down 40%. These are big numbers.

Yet the S&P 500 is sitting right near 2100.

Look, I wouldn't be surprised if the S&P hit a new high. But every time the S&P 500 gets to 2100, you hear, "This is it, this is the one, it is time to buy," which is the strangest way to think about the market. It has gone from 1100 to 2100, so now is the time to buy? If the stock market really is such a great buy at 2100, it will still be a very good buy at 2200. I want the market to prove itself. I would rather miss that 100 points than be the fool who bought at 2100 only to watch it go to 1900.

Why do you think stocks are doing as well as they are?

It has a lot to do with [European Central Bank President] Mario Draghi. He said that we need not just tremendous amounts of central planning, but also the central planners in every country to have some sort of coordinated approach to policy. It sounds like his dream would be a worldwide central bank. To a conservative person like me, it's fairly horrifying. But the markets love hearing that central banks are going to do something, and they think the U.S. may cut rates—may even join the rest of the debt-burdened developed world with negative interest rates. I think it's a false hope.

Despite your risk aversion, you like emerging market bonds. What is the story there?

It is a dollar play. The weaker dollar has been very good for emerging market debt, which is up 12% year to date. We expect the dollar will continue to be weak. For the past year or so, maybe even longer, there has been an incredible correlation between the probability that the Fed is going to hike interest rates and the value of the dollar. The probability of a rate hike is pinned to the ground right now. The market says there is almost zero chance the Fed will raise interest rates through November of this year. The dollar is going to have a hard time, despite the fact that it has been strong recently on the Brexit upset.

How much lower could yields on Treasury bonds go? Could we see a 1% yield?

We just passedthe all-time low on the 10-year yield of 1.39%, which we saw in July 2012. It is no surprise the 10-year has been strong after Brexit. I'm not at all convinced that we are going to see much lower yields in the U.S. But even if we do, you're talking about a de minimis profit. Even if the 10-year yield drops another percentage point, how much will you make? Less than 10%. There are better ways to speculate.

Such as?

Gold miners have a very high probability—if you bought them today and were disciplined—of making 10%. One of the things driving markets lower is a declining belief in—and enthusiasm for—central-planning authorities and the political establishment. In this environment, gold is a safe asset. There's an 80% chance of making 10% in gold; the probability of a 10% gain on Treasuries is 20% at best. I've never seen a worse risk-reward setup.

That doesn't make for a very exciting portfolio.

Our portfolios are high-quality bonds, gold, and some cash. People say, "What kind of portfolio is that?" I say it's one that is outperforming everybody else's. I mean, bonds are up more than 5%, gold is up substantially this year [28%], and gold miners have had over a 100% gain. This is a year when it hasn't been that tough to earn 10% with a portfolio. Most people think this is a dead-money portfolio. They've got it wrong. The dead-money portfolio is the S&P 500.

Thanks, Jeff. ■

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