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Portfolio

# DoubleLine's Jeffrey Sherman: 2 Wild Cards That Could Derail the Economy

by **Jane Wollman Rusoff**

"Investors need to be worried about inflation. But it's not a stagflation world yet," Jeffrey Sherman, deputy chief investment officer at DoubleLine, tells ThinkAdvisor in an interview.

"The best asset class to hedge against inflation is commodities," he argues.

The lead portfolio manager for multi-sector and derivative-based strategies at DoubleLine, of which Jeffrey Gundlach is CEO, Sherman forecasts inflation next year at about 3.5%. The current rate is 5.4%.

As for the stock market and overall U.S. economy, both will further "moderate." But "that doesn't mean we're going into a contraction," Sherman, based in Los Angeles, says.

In fact, his outlook for the corporate-environment economy for the next 12-18 months is, in his own words, "pretty rosy."

Next year, he expects 3%-4% growth even as earnings growth will slow, he predicts.

A chartered financial analyst, Sherman was named one of "10 Fund Managers to Watch" by Money Management Executive Magazine in 2018.

On his popular biweekly podcast, "**The Sherman Show**," he interviews a wide range of guests, recently including the founder of a firm that helps companies deal with anti-money laundering for cryptocurrencies.

(Credit: Allison Bell/ALM)

In our interview, Sherman discusses two big wild cards that, he says, could derail the economy. And because of interest-rate risk, he continues to recommend caution in the corporate bond market.

As for the surprise U.S. labor shortage, employers need to give workers incentive to return to jobs — like better compensation — since "labor has the upper hand for a little bit."

ThinkAdvisor interviewed Sherman, formerly a portfolio manager and quantitative analyst at TCW, on Oct. 14.

Speaking by phone from Los Angeles, he was straightforward, if not hopeful, about ending the coronavirus pandemic when he said:

"If we get herd immunity, [it] becomes [eventually] just like the common cold. That's ultimately what we're gunning for and what the vaccines and herd immunity are about."

Here are excerpts from our conversation:

**THINKADVISOR: What's your broad assessment of the U.S. economy?**

**JEFFREY SHERMAN**: The economy has become a different economy over the last 20 months. There will be pluses and minuses to that.

**What's your outlook for the economy for the next 12 to 18 months?**

For the corporate environment, pretty rosy. I'm more sanguine than most. Just because the earnings rate growth decelerates, it's still growing. The economy expands 3% to 4% next year on a real basis.

Now, that doesn't sound like a recession. Earnings aren't going to grow as fast, but they're still going to grow.

We'll be fine from an economy standpoint, and asset prices will readjust to the environment that we're in.

The stock market and economy will [further] moderate, but that doesn't mean we're going into a contraction.

**When did the U.S. emerge from the recession of 2020?**

The National Bureau of Economic Research declared in July 2021 that the recession was over in April 2020. It was the shortest recession on record: Started at the end of February, ended at the end of April.

**What are wild cards that can derail the economy?**

Significantly higher inflation or the resurgence of the coronavirus.

Investors need to be worried about inflation.

We're in about the fifth or sixth month of inflation, running at an annualized rate year-over-year of about 5%. Some of the drivers are likely to be transitory, such as airline tickets and hotel prices.

The Fed has in fact stopped using the term transitory. So it seems to have changed its tune.

Even though many transitory things will subside over the nearer term, at some point next year, other parts that are bigger components of the CPI [Consumer Price Index] will start to increase.

Next year we're probably talking about inflation in the mid-threes — 3.5%, though it's very hard to forecast right now because of all the uncertainty.

**Some have been worrying lately about the specter of "stagflation" because of the inflation rate. Are we headed there?**

We're not in a stagflation world yet. The word stagflation makes people think of the late '70s, early '80s, with double-digit inflation and relatively low growth rates.

Next year is expected to be in the 3% to 4% range of real GDP growth. If inflation comes down a little bit and we get the right mix of growth with inflation, I don't think it's stagflation.

But inflation is likely to stay elevated. What should be on investors' minds is that if you're just sitting in cash, you don't have the ability to outstrip inflation. Cash yields zero.

Investors need to own some things that are correlated to inflation, and the best asset class that does that well is commodities. It isn't bonds.

**What's a good hedge against inflation, then?**

One way is to have a 5% to 10% allocation to commodities.

**What about labor's challenge to the economy?**

You're seeing labor demanding more in terms of wages, benefits, flexibility as to where they work — they don't want to go to the office, maybe, all the time. People want to change careers.

So there's a different dynamic that's taking place; and, obviously, wage pressure is underneath all of that. If it continues, it could put a little bit more upside to the inflation number as well.

**What needs to be done about the labor shortage?**

There aren't enough people in the unemployed labor force to fill the roughly 10.5 million jobs that are available. So you need a way to incentivize people to come back into the labor force.

In some industries, wages are going to have to increase to incentivize people to work. But labor has the upper hand here for a little bit.

**Regarding this, what will you keep an eye on over the next couple of months?**

I'm going to watch what retail sales look like — consumption data. Now that benefits have expired, we're seeing challenges.

**What are your thoughts about interest rates?**

They're still too low. Next year you should see the 10-year Treasury north of 2%. So investors need to be cautious on their interest-rate exposure in the fixed income market.

**When we talked in February, you warned about the corporate bond market. Are you still calling for caution?**

Yes. The caution I see is due to the interest rate risk, not the default risk. The corporate bond market has roughly almost as much interest-rate risk as the 10-year Treasury.

The default risk is relatively benign, which is reflected in the spread. Spreads are really tight by historical standards.

For people who do want exposure to corporate America, I like things such as bank loans, parts of the CLO [collateralized loan obligation] market, which packages up bank loans and things that have lower interest-rate sensitivity, like residential mortgage-backed securities.

Asset-backed securities, such as loans, are attractive because they float.

They don't have a fixed coupon; they have a coupon that's tied to the Libor rate. That means each quarter, they reset. That dials down interest-rate sensitivity.

So these assets look pretty attractive today, given that we currently have a benign default environment.

**Please discuss the economic threats now associated with the coronavirus.**

COVID-19 will be around in 2022, unfortunately. What could go wrong is that you can get more new contagious variants and breakthrough cases.

**Will that upset the economy?**

It absolutely can. But the damage of shutting down the economy and forcing everyone to stay home is greater, for a society, than some people getting sick and, unfortunately, dying.

If we get herd immunity, it becomes [eventually] just like the common cold. I don't want to be flippant, but that's ultimately what we're gunning for and what the vaccines and herd immunity are about.

**Jeffrey Sherman, CFA**
Deputy Chief Investment Officer
DoubleLine Capital

As DoubleLine's Deputy Chief Investment Officer, Jeffrey Sherman oversees and administers DoubleLine's Investment Management sub-committee coordinating and implementing policies and processes across the investment teams. He also serves as lead portfolio manager for multi-sector and derivative-based strategies. He is a member of DoubleLine's Executive Management and Fixed Income Asset Allocation Committees. He can be heard regularly on his podcast "The Sherman Show" (@ShermanShowPod) where he interviews distinguished guests, giving listeners insight into DoubleLine's current views. In 2018, Money Management Executive named Jeffrey Sherman as one of "10 Fund Managers to Watch" in its yearly special report. Prior to joining DoubleLine in 2009, he was a Senior Vice President at TCW where he worked as a portfolio manager and quantitative analyst focused on fixed income and real-asset portfolios. Mr. Sherman was a statistics and mathematics instructor at both the University of the Pacific and Florida State University. He taught Quantitative Methods for Level I candidates in the CFA LA/USC Review Program for many years. He holds a BS in Applied Mathematics from the University of the Pacific and an MS in Financial Engineering from the Claremont Graduate University. He is a CFA® charterholder.

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