MACRO Voices
with hedge fund manager Erik Townsend

DoubleLine’s Jeffrey Sherman: Bond Market Pausing but Not Over!

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Erik: Joining me next on the program is DoubleLine’s other Jeffrey, Jeffrey Sherman, who runs the Strategic Commodity Fund for DoubleLine.

Jeffrey, thanks so much for joining us on the program. Let’s start with the big picture. Jeff Gundlach famously called, to the day, the top of the secular bull market in bonds. I think on that day it was 1.32 or something intraday?

And I think it was on that afternoon that Jeff Gundlach declared, okay, this is it. And, sure enough, we’ve been all downhill in price, uphill in yield from there.

Now, for a long time, you guys were saying, hey, past 3%, that’s really the confirmation line where you get past there and it’s really game on. But you’ve changed your view recently. And, as I understand it now, DoubleLine’s view is that, as long as the 30-year stays under 3.22, probably the 10-year yield will be contained. At least for a little while.

So that begs the question: Why is the 30-year suddenly the gating factor? What’s the whole rationale here? Where do you see things? Give us the big picture of Treasury yields.

Jeffrey: I wouldn’t say it’s as much of a change in view as waiting for confirmation to the marketplace. And so, as your listeners are well aware, no one wants to hang their hat on one single factor when predicting markets, even if it is trying to predict the yields and looking at one specific yield.

Yes, famously or infamously, calling what has historically been a pin area marked with a lot of tombstones out there with people trying to call in to the great bond bull market – we did say that back in the summer of 2016 that it sure looks like it is putting in this level – and we got this kind of double bottom in yields or double top in prices around the 1.32 mark. I think it was 1.36. With the low around taper tantrum it got to like 1.32, as you mentioned, intraday, back around the Brexit days.

But what you see is, in the yield market, the 2-year has set a new high. We’re traipsing around that today as we sit here on June 4th. Or we’re very close to the post-financial-crisis high in yields in the 2s. The 5s are sitting very closely. The 10 a little bit inside of it. But the 30-year still hasn’t really breached that taper tantrum high, to start with.

So, let’s frame it as a taper tantrum. Taper tantrum, roughly, you’ve got like a 3.04 for like, it closes – I think that happened on December 31 or Jan 1 of ‘13 through the December 31 ‘13 or Jan 1 of ’14 (or the first trading day, because there’s a holiday in there). That was the taper tantrum high.

But if you look at the 30-year, for instance, it was 3.97. So, roughly 3% on the 10, roughly 4% on the 30-year.

So as we went through this new era through Brexit, as we set new highs – you set a new high on the 10-year – the 10-year closed over that 3.04 a couple of times – in fact got, I believe, near 3.10 at one point in time. I can’t remember if it exactly touched it or not.

But, during this whole time, the 30-year has really double topped in yields or triple topped in yields – at 3.22 a couple of times. Now within about ten trading days ago or so, we did actually settle above 3.22. So all the phones were ringing. Everybody’s asking what does this mean? You know, it closed at 3.24 – is this the telltale sign?

And from technical analysis you wait for confirmation. You wait for a couple of days. We’ve always said, like, is it 3.25? 3.30? Give it a little bit of wiggle room because of the length of duration and how painful that price move is. So it did not confirm in the next – we went below it and we’ve been below it since.

Now, I’d say the world has changed over the last 10 or so calendar days. We had the resurrection of risk once again, through the BTP market and the likes, but we’re holding on the 30-year because it’s the only one that really hasn’t sat out this technical trading range.

The one thing about the technicals, if you look at the shelf or the next area where it can go to, it’s roughly that 3.97 taper tantrum. So, again, we’re waiting for that long bond to corroborate the move. So far, it was kind of the false positive. It didn’t really hold. And you’ve seen yields roughly about 15 to 20 basis points lower than they were a couple of weeks ago.

So, finally, this year the rates market (specifically in the US) is actually acting like that risk-off type of trade.

Erik: Now, for people who are used to thinking of Commitment of Traders reports as an indication of sentiment, it would appear that there is just all-time just huge, huge, huge record short interest in the 10-year Treasury future.

Now, if we were talking about copper futures, there is just no question. That kind of sentiment is a setup for a short squeeze. But the counterargument with Treasuries is the Treasury market is the big market. The Treasury futures market is much smaller.

So is that big positioning on the short side of the 10-year Treasury futures a concern to you in terms of short squeeze risk? Or is the Treasury market overall so big it doesn’t matter?

Jeffrey: That's a great question, Erik. We obviously monitor this. We look at these as – you want to fade the trade as you are recommending, typically when you get extreme positioning, whether that's net long or net short. And that really goes for almost all instruments of trading, including the Treasury market.

So, as you're also aware, the CFTC data comes out on the lag. So we get it each Friday and it's based on a Tuesday positioning and margining. So you don't get that timely information – it comes out, but roughly on a three or four days lag.

So as we sit around the table, we're talking about this – let's say roughly three, four weeks ago – and say, okay, what is the one catalyst for rates to rise? That is the one thing we keep pointing to, is that the sentiment is so negative in 10s and 30s – the long bond – called 30s, but it's roughly the long bond. I think it's 28 and a 1/2 years, something like that, right now. But what you see is that the extreme positioning typically can set up the reversal.

Now, given the rally we saw in rates in German bunds, the selloff massively in BTPs before the Memorial Day weekend, we expected there to be some form of short squeeze behavior there going on. One, you don't really want to be short going into the long weekend. There's all this risk percolating, three days to unwind it, so maybe I'll just kind of flatten myself out.

And then, given the behavior of the risk-off appetite that you saw that Tuesday morning post Memorial Day here in the US, you say that – okay, it felt like it was running across the curve, maybe it isn't as much a short squeeze.

So we get the CFTC last Friday and the report came out and the positioning seemed just as long on the short side as it's been historically. So what we find there is it didn't have all the makings of a short squeeze. If you reflect upon it, seeing how the curve moved, it did feel like a more risk-off type of appetite and that rates were somewhat responding to that.

So, yes, I do agree with you that's extreme positioning. One thing you've got to think about in the bond market is that, as you're short a bond because you have to pay the carry, you have to pay the yield on it. The more right you are the more expensive that becomes over time to hold that position.

So with a sideways type market, usually in yields it tends to flush out some of these short positions. Because, ultimately, just the cost of carry and not having any price movement to offset that negative carry can be problematic.

So it was somewhat interesting, I would say, to look at the CFTC report we got last Friday and seeing not much change there. But maybe it's because these people are so in the money that they're willing to let it ride for a little bit longer.

We'll have to see if rates don't continue to push up, or if they trade sideways and don't continue to push up. What if that net length stays so short as we've seen, really, over the last

I'd say 12 months or so?

Erik: Now, you've said that your view is still in the longer term toward higher Treasury yields. You're just waiting for confirmation. People who are expecting higher Treasury yields usually are not expecting a recession. But Jeff Gundlach did a webinar on the 8th of May – and we have the chart deck from that linked in our Research Roundup email. (Listeners, you'll find it there. I recommend that you download it as we'll refer to several of those charts.)

Pages 8 through 11. Right at the top of the deck Jeff starts off with recession indicators. It looks like 6 to 12 months out you're seeing a lot.

So how do you rationalize a view that we're not too far away from recession with a view that we're headed higher in terms of Treasury yields?

Jeffrey: Maybe it's that the tail wags the dog here. What it is is the recession indicators aren't flashing extreme warning signals to us at this stage. In fact, very few are. Yeah, the yield curve is a little flat. Historically, if you go through when 2s and 10s goes inside of 50, it typically ultimately crosses zero.

And we know that, historically, when we've crossed zero that's been a recession. Maybe it's a little bit different this time. Maybe it takes a bit longer. There's nothing that says that a strictly monotonic decreasing function that takes you straight to zero through that 50 – it bounces around. Sometimes it bounces around for a year or so. It's one of the things that puts us on warning.

We're kind of worried a little bit about money supply. The velocity hasn't been there, really, since the late 90s. I'm starting to believe that the aberration was – the turnover in money velocity in the late 90s was the aberration and not the norm. And just that deceleration, take it back to the more long-term levels.

But maybe that's because we're financing through debt. We have a larger debt supply, so we don't need to turn it over as much – or the inability to do so.

When you look at the indicators, they're not really saying recession on the horizon. There's a very few that are saying to be on alert. But we think that it's the strength of the US economy – and, again, when I say strength, having a GDP that's roughly 3% year-over-year – it's about 2.8 these days on year-over-year real GDP.

You slap on the nominal, it's in the high 4s. Historically it's been a recessionary indicator. But we've been sub-5 for such a long period of time, when I talk about nominal GDP, that I don't think it has the same impact that it used to. So, from the standpoint of recession, it's hard to see it on the horizon.

But we do think that rates could ultimately cause it. And, because the basis for price tends to be the US Treasury market – you've got the expectations of the Fed continuing to hike. You've got the Fed with the expectations that they're going to continue quantitative tightening in larger and larger doses, going from $30 billion a month currently up to $40 billion a month next month in July, and then by October ratcheting up to $50 billion a month being put in the market.

There's this new supply of bonds coming. And so these bonds exist on the Fed's balance sheet. But they also now need to find homes in investors' hands. And so that means that the investors will be a little more discriminatory than the Fed, who is a price taker, when they're just trying to gobble this up to manipulate the yield curve and manipulate rates. And so these bonds have to clear the market.

And you do this on the back of the tax program. You do this on the back of, essentially, a massive deficit where it looks like it will be over $1 trillion the next fiscal year. And you talk about a lot of supply of rates instead of assets in the marketplace.

So those things structurally set up for higher yields – in addition to the fact that nominal GDP is close to 5%. And, historically, that's the direction, or at least the ballpark, of where the long bond has traded.

And so there happens to be a disconnect. That's why we're focused on the 30-year right now. There's a really big disconnect over the long-term growth and inflation prospects, of being talked about in the marketplace, but the long bond is really not buying into it.

So the rest of the curve is saying, look, if we're going to put pressure on the front end, it sounds like Treasury finance is going to happen front to belly, it's not really clear what Mnuchin's plan is for all of the issuance this year, especially as you get this new supply. And so, ultimately, it's just somewhat bearish for rates, just on the fiscal side of the equation.

And yet on the technicals of the Fed's balance sheet, there's a lot of bonds that have got to be digested. And, on top of that, you have the corporate bond market, you have the international markets. There's a lot of debt that needs to hit the markets for the next year or so, which should put pressure on global rates, regardless of the positioning.

Ultimately, it could become recessionary and you get the rally there. But we think that you have pain first and that's what causes that chain reaction.

Erik: Let's talk about the US dollar next. You've got in that same May 8 slide deck quite a few – it looks like Page 22 through 27 – are all US dollar. And it looks like maybe I'm not the only dollar bull left after all. Maybe you also have a bullish view.

What's your outlook for the dollar?

Jeffrey: It was short-term bullish. Really, because you had the positioning, as we kind of alluded to, in the other markets, but there was this massive short on the dollar. If you actually look at what happened, the time the dollar started to rally in the middle of April, there was a decoupling of rates.

If you just simply (as an analogy here or an anecdote) look at the US 10-year versus the German bund 10-year – and we were pretty much trading somewhat in lockstep with each other – one would pull the other up, and down, and vice versa. But something happened in the middle of April, and there was a bit of decoupling where you started to trade down to sideways on bunds where we continued to press up on our US rates as well.

And, again, that's where we set the highs of the year. And the dollar fed through. Some of that was because, now, the disconnect between interest rate parity – when you look at it you think, oh, the dollar should rally just because of this huge interest rate differential.

But you also have to take into account the supply of Euros and dollars in the market. You've got to look at the cross-currency basis. And that's what was driving hedging costs so high. And so we do believe that, ultimately, it does come back and probably does reverse, just because the fiscal tenability and these things that I alluded to in the issuance calendar of the Treasury here in the US –

But in the short term it's hard to be dollar bearish right now. We've got the rate differential still back in this same spread. And if there is indeed any pickup from the ECB of actually tapering, perhaps, starting to move interest rates in the first quarter of next year – and that's not really a very popular view – but if that were the case we think that could actually stage for the reversal back in the dollar.

So this 115-ish on the Euro, we've been holding this area pretty well here. Again, it's hard to see how the dollar has much strength left without rates going up. But if rates go up and, let's say, the Eurozone stays where it's at, I do think there could be some short-term strength left in this dollar. But we think it's relatively short-lived.

We are seeing, roughly, a 96 handle on the DXY. We kind of tested that area – I haven't really gotten through it. I think we said 94.5-ish today on it. It's one of the things where it's probably neutral for a little bit. But we do think the next leg is down.

Erik: Okay, good, because that sets us up perfectly for the next questions. You think it's short-lived upside and then down. But something I've seen you guys say in the past that has baffled me (and, I know, a lot of people), is you believe that a bearish dollar outlook and a bearish bond outlook are entirely compatible.

In other words, that usual expectation that rate differentials – if the US is offering a better Treasury rate than the German bund – that's going to attract international capital, that's going to make the dollar go up. You're saying it doesn't have to play out that way.

Please elaborate. Why is that possible? How is it that the global marketplace can ignore that differential opportunity?

Jeffrey: Well, it's not just differentials. It's forward pricing differentials. And I think that's what sometimes gets lost in the – just looking at – okay, here's the yield today versus the yield in the future, because we've got to look at the forward curves and how the market is thinking about pricing these future hikes in the market too.

Or shifting – let's just assume it was a parallel shift, which we know it tends to flatten in the US – it does flatten in a lot of countries when you raise rates – but I think it's that forward rate differential that has been driving the dollar.

And so, even with higher yields in the US, it's that expectation of changing the direction through QE to taper to actual quantitative tightening (if that ever takes place – because, yes, they've got to move their rates first), that logic path takes you to where you can actually get a declining dollar as people start to price in the expectation of the markets.

Now, a lot of people would say, well, what that analysis is fraught with is that the ECB will never be able to move. And if they do it will destroy their entire market.

So that's probably the biggest risk to that thesis, is that the ECB can't actually pull through on that decision. But that's one way we think about it.

And I think the dollar has benefited too. We've had some turmoil in the market where there has been capital flight.

But I do also believe that, given that we've had such a nasty negative interest rate policy in the Eurozone, that if you start tapering you get the interest rates off zero – and let's say you get yields back to, I don't know, call the German bund one hundred basis points on the 10-year – people will bring capital home that's been here in the US hedged and take it back to the Eurozone.

Because why deal with all this hedging and everything? I can get paid better here. And it makes sense. I'm in my own currency.

And so I think some of this is the dynamics of the global trade flow that we're seeing. At some point, people will want to just stop messing around with the hedging. And, again, it depends on how that cross-currency basis looks in the future. It just isn't as appealing to do so.

So we could actually see that rising rates in the Eurozone leads to a repatriation of capital back there. Which ultimately is that drag on the dollar.

So there's a few ways to get there. There's a couple of holes in certain sides of it. But we do think that it is set up for that direction at this stage.

Erik: Okay, so it's the unwind of the dollar carry trade that's already in play that's really going to explain it. That makes perfect sense.

Jeffrey: Yeah, you probably said it much more succinctly than me in calling it the carry trade. I used to joke around the office that we are the carry currency these days. And so that's exactly the way to think about it – the unwind of the carry trade that actually gets you there.

Erik: Jeffrey, I was particularly interested in Page 55 of Jeff Gundlach's May 8 presentation where you show the junk bond market kind of rolling over. And it made me think about this whole big picture. Because, on the one hand, you guys are saying Treasury yields are headed higher – maybe not right away, but eventually, once we get market confirmation – yields headed higher. That suggests being short Treasuries.

The thing is, it's kind of hard to justify shorting Treasuries if you think that it's not that far over the horizon that the next recession is coming. On the other hand, shorting high-yield, or international high-yield, to me feels more attractive.

So where are the actual trades coming up here? Is it on Treasuries? Or are the high-yields going to be – and I guess, particularly, the contrast between domestic and international high-yield – is that where the better shorts are going to be?

Jeffrey: On paper you'd look at it and say, look, the international high yield market is the place to look. We did a webcast late last year called "Wack-O Season." And we talked about the aggregate index yield within the Eurozone.

I think it was double Bs were inside of 10 years. I think the aggregate index, actually yielded on an absolute basis (so just the yield-for-yield), not only looking at currency and differentials there, there was less yield on the aggregate index of European high-yield issuers than there was just buying a 10-year Treasury in the US.

And so that's one of those strange dynamics where you say, okay, that's got to be an outright short in the international markets. The problem is, you know it's liquidity behind these names. You know, they're somewhat crowded from who owned them, so you can get squeezed out of that position once again as well.

The thing about high yield in general – it's expensive to short. So this is one of those things where it's not like a stock (you can short a stock; it doesn't move) – you're essentially just paying your prime broker to have that position.

Well, when you're shorting high yields, you're paying your prime broker plus you're paying the yield. At a yield of 6 and a 1/4 today, that gets pretty rich to go out there and bet against that positioning. So when we look at why we're kind of skeptical of the high end, it's not the fundamentals. The fundamentals in the market are still okay.

Yes, there's leverage there. Yes, there's some shaky names, but everybody knows it's a very bifurcated market. It's a tight market on the higher end of the high-yield spectrum, the higher quality. It's a typical high-yield market in the junky stuff that has hair on it.

But when you start thinking about rates, because we got through quantitative easing – if you recall, Bernanke's function behind this was to create the wealth effect (that's what he stated) by keeping rates low. It extends people up the risk spectrum, they go and take incremental bets. The idea here is that spreads got pretty tight. But they got tight not just in spread – the yield itself got extremely low.

And so what happens at low levels if the Treasury market resets upward, which it has in a somewhat meaningful way, specifically over the last six months since we brought on the new tax plan, rates have had a pretty sharp move. If that continues, it's the repricing mechanism of all spread assets. You've seen it even here today in investment grade where it is a yield product, but it has a very long duration.

And so, year to date, the worst-performing sector of the US bond market has been investment grade corporates. Well, except if you look at 30-year zeros or something on the Treasury market. But if you look at aggregate markets, that's the way it plays out.

So the same idea here for high yields: Is 6% yield enough if the 10-year yield is 4%? I'd argue no. And so you get this weird thing where these bonds start to exhibit more duration or they have negative convexity if they're trading yield to call. So the high yield market has some issues.

But when you look at it, still, corporate America is as profitable as it's ever been, given some of the benefits of the tax plan. So, yes, they're going to not be able to deduct as much interest going forward. It's 30% of EBIT for US corporate names. It's tax deductible. But I still think it's a hard thing to want to short.

Can the price reset? Yes. I think you're better off – if you think rates are going up and you want to put the short on that you've got to do it just in the rates market. I think that's the way – it's a pure play and you don't have to worry about some of these other nuances.

But if we get a meaningful move in rates, yes, all spread product needs to reprice.

Erik: Coming back to the Treasury market in the United States, we talked about the shorter term – you guys are basically waiting for confirmation through the 30-year and then you're bearish again.

Let's talk about longer term. Do I understand correctly that DoubleLine's view is basically over the next few years we should expect to return to what I'll call historically normal interest rates? Let's say 10-year yields 6% plus?

Jeffrey: Yeah, that's something we put out a couple of years ago. I think at the time the 10-year was at 1.50 and we got a lot of those emails that say you're out of your mind. They used a few more expletives.

But the thing about it was just thinking about the dynamics. Looking at the setup between Medicare, Social Security, the deficit – before the tax plan. And looking at, structurally, the direction we're heading. And so if we're getting out of quantitative easing, we've got to think back in old-school thinking about let's go to fiscal policies where we set up what kind of deficits are we running, and where are we in the cycle?

So the 6% number was thrown out that, look, if we have to service these trillion dollar deficits. To do so at the market rates, and perhaps some of that has a dose of inflation within it, and maybe that's an inflation number that goes beyond the Fed's symmetric target. Even though some would argue you can't get there.

Of 3%, because they're targeting 2 – say it says 3 and they let it go a little hot to 4. And maybe it's 3 and a 1/2. You're running at 2 and a 1/2 percent real GDP gets you closer to a 6 nominal. Maybe that's how you get there. That was kind of the thinking.

And the idea behind it, too, is that at some point people are going to get dissatisfied with this disinflationary pressure and they're willing to allow some form of inflation. And perhaps that is through new thinking as the demographics in this country shift and everybody is focused on the aging side.

But let's focus on the other side of the equation. Let's focus on the millennials, who will be a large voting cohort in 2020. And if there was some assimilation there you get to the point of voting as people think that they don't like things out there, they don't want to pay for it, they believe more socially. You could easily see these being larger and larger deficits.

And so that was an idea we threw out a couple of years ago. We're halfway there, really, when you look at almost a 3% 10-year today. And it doesn't seem as strange as when we were first discussing it. But we were looking through the end of QE, thinking about trading back on fundamentals, and that's how we got to those levels.

So I think it's an interesting – I don't think the midterms are as important. Again, people put too much focus on politics I think. But I think the 2020 election could be interesting as we see this kind of more socialist type of viewpoint – basic income for everybody, there's a lot of things out there that look very socialist in nature which could lead to a more inflationary type of environment.

And so that's the thing that we're trying to put in investors' minds. Don't get lulled into this current behavior of negative interest rates and zero. Maybe we actually do see a return of inflation. And it's an inflation that actually people are asking for. And that's the difference in the two viewpoints.

Erik: I want to push a little bit harder on that, because I do understand the argument for getting to higher rates. But the thing is, to get to 6% – I mean, right now the US government's cost of borrowing is as high as it's ever been. And it's as high as it's ever been on twice the principle that we used to have back when we had 6% rates. So if we go from here back to 6%, we're going to double the US government's cost of borrowing, which means it's going to be twice as high as a percentage of GDP than it's ever been before.

And it seems to me like it would take massive, massive inflation – a lot bigger than just 4% – in order for that to all actually work out.

Am I missing something? How do you double the US government's cost of debt service from where it is today without creating an incredible fiscal crisis?

Jeffrey: The equity bulls would say we grow into it, right? That's the whole thing. If the economy is doing okay. But, you know, it's the question that's been on everyone's mind since the early '80s: Do deficits matter?

And it's not a household balance sheet, you know. As people have pointed out in the past, you can't apply that same thinking because we have a printing press. Right? At the end of the day. So that's to your point.

Maybe inflation is significantly higher than level to be able to service the debt. But if you're financing longer and longer, does it matter as much? I don't have the answer to that.

Like, maybe that's where we do glom on to the 50-year bonds and the 100-year bonds. We'd lock in that financing. Maybe make them callable to where, hopefully, during the next recession you could be able to call it down. So it is a conundrum, because when you look at the deficit today as a percentage of GDP – it's very rare through history do you have this level of debt as a percentage of GDP (again, on the current deficit, not in aggregate) without there being a recession.

The only other example you can point to is the late '60s. And we know that led to an inflationary environment. I think there were more factors in play, like going off the gold standard, globalization, free float fiat currencies, I think that drove a lot of that where we tried to figure out where equilibrium was.

But when you start to think about the deficit and, just to say, well, if we have to finance at these levels, it's not sustainable or tenable, that's a good observation. It doesn't mean you don't go in that direction. And so the question becomes: What does everything else look like?

And, look, by the time we get to 6 you're probably – at some point you've got to be rooting for the recession. Those bonds would look golden at 6% at that point. But, look, if it's a slow grinding pace, and we're trickling this in, we're borrowing longer, it is something that can be done. It's just not long-run sustainable.

And I think that's the question you're really asking. But it doesn't mean it can't happen for a period of time.

Erik: And how long do you think it can go on before that unsustainability really results in an outright crisis?

Jeffrey: Well, I think if the US is borrowing at 6, you've got to ask what are the Germans doing at that point? When they're in charge of the ECB, I don't see it being this kind of vacuum where we're sitting there by ourselves.

So there's a lot of things that have to go into play to get to that level. You know, let's break 3.22 on the long bond. Let's get the long bond with the four handle before we start talking about 6% on the 10-year. How about we do that?

Erik: Okay, fair enough. I want to move on to another topic though, on that same point. Now, I've got to believe that if somebody just read their first macroeconomics text book they've got to be listening to this saying, wow, this guy is talking about 6% Treasury yields. Double what they are today. He must be super-bearish on gold.

You're not super-bearish. You're super-duper bullish. So going on there. How is that you see dramatically increasing Treasury yields – which normally is considered the competitor to gold – and at the same time you think gold is maybe on the edge of a major breakout here?

Jeffrey: Well, the technicals say we've got to break through $1,350, which has been a massive, massive resistance point. We've struggled to get through that. You know, we're right at $1,300 – I think we're $1,293 or something before I came in and started talking to you today. So we still aren't even testing that.

But it's real yields that matter. It's not just outright. So you've got to bring inflation back into it. And if that inflation is the bulk of what's getting us to that 6% 10-year, that does argue for the gold case, perhaps. Again, massive tracking error between inflation and gold as you look long term. The tracking error is essentially the volatility of gold. But it's how people think about it.

Secondly, on the gold side, if we get to those levels there's going to be folks like yourself that just call it – What you were saying? How is this tenable? How can we actually service this debt? And it's that fear of the government fiat currency that will drive people back to gold.

I think gold has been challenged a bit by the crypto community. The folks we talk to that seem to be with their tinfoil hats and loving crypto – and, again, not criticizing anybody in crypto here – but a lot of those were gold bug folks or silver bugs that we saw back in 2011, for instance, on the silver side.

The idea here is, I think, it's not a coincidence that this rise of cryptocurrency has taken place when we have negative yields in other parts of the world, where people lose faith in central banks. They lose faith in their government.

And that's what gold has always been around for is that kind of biblical street credit it's had for at least 2,000 years – I won't argue how long that's been. But, from the standpoint of people looking at alternatives to get away from the fiats, I can still see gold catching that structural bid and ignoring yields and inflation because it's fear of the government stealing their money or not pursuing the policy that they want.

Erik: Now, moving beyond precious metals to commodities generally, you guys are bullish commodities generally as well. What's the thesis there? What's the macro outlook?

Jeffrey: One is it's when you look across the various sectors of the market. Of all the sectors, people talk about overvaluation, undervaluation, you don't hear too much on the undervaluation. But when we get in the overvalued camp, you can throw a lot of asset classes in there. The one we haven't heard of is, actually, the commodities being overvalued at this stage of the cycle.

There's a few reasons for thinking about it. Historically, commodities tend to be more late-cycle performers. They don't do well in the middle of the business cycle because it takes that last level of leverage buying. That competition towards the end tends to have a higher demand for both energy and industrial commodities.

The agricultural sector has been really, really beaten up the last few years. And we're starting to see some lives in that again. And, further, the thing that the dollar doesn't have continued strength, at least doesn't present a headwind for it as well.

So it's been an under-loved, under-owned asset class. Yes, there's been a new appreciation in the last six or seven months. Capital has been flowing within the space, I think, for about nine or ten months straight when you look at both institutional demand as well as some of the retail flows.

And so, again, we think it's one of the things that people should think about again as they determine their asset allocation.

I was telling this story to some people after the commodity market was down four years in a row and it finally had a positive rate of return in the double digits – that was its first positive return in five years. It was up 12% and what was the S&P? Up 13!

So the time it gets its year in the sun, people don't even care about it because the beloved #1 holding of everybody tends to be US equities – at least that's what they tell you these days – and so it didn't even get to have a chance in the sun for the year it put that positive return together.

Last year was kind of a flattish type of year. So far, the year to date, it's roughly one of the better-performing sectors of the market. So we still think there's a little bit of legs to this trade. Even with the dollar's strength over the last – I said about mid-April – so we're talking right under two months we've had this dollar strength roughly 6–7% up off the bottom.

And you're still seeing commodities trade okay, though they seem to be underinvested.

When you look at the metal sector – I'm talking about industrial metals – there haven't been really any big mine finds in the last few years. There hasn't been this huge research and development that's going on in capex being spent there.

And so, if you think about how long those cycles are to build some of those positions, or at least to build the mines, the smelting plants, the roads, all those great things that get you to be able to refine copper, nickel, zinc, whatever it may be – it does take a long period of time and it's been underinvested. So, if you believe in the continuation of the growth story, we still think there are some legs left in this part of the commodities cycle.

Erik: Jeffrey, I want to talk about the fund that you manage, the Strategic Commodities Fund there at DoubleLine. Normally, I wouldn't do this to you because I hate to hit a guest with a difficult challenge. But you're one of the few guys who has a good answer to it.

So, the normal objection I have to any macro-driven commodities strategy – especially when somebody is trying to run a fund like some of these agriculture ETFs or something – a lot of investors don't understand the technicalities of contango, which is the market condition where each successive contract is priced higher than the one before it. So that means even if the price of copper is up 40% in the year, the trader who's got a long position in copper futures and has to roll them over each month, and basically pay that contango as a carry-forward yield, ends up with a massive tracking error and dramatically underperforming.

That's the reason that the oil ETF underperformed for years. You've actually got an answer to that question, which very few people who are running commodity funds do. Tell us your response to that objection that investors in any commodity strategy ought to have.

Jeffrey: You mentioned the contango shape of the curve. There's the opposite side that can happen too, which is backwardation, where, as you mentioned, the futures prices line up in downward fashion. So that it is cheaper to buy something in the future than it is to consume today.

And both of those markets do connote something from a fundamental basis.

Typically a contango contract means you have an oversupplied type of market that you're trying to incentivize consumption today, so pulling down that front price for instantaneous consumption.

And the converse is true when it's in backwardation. Historically, that signals that you have a tighter type of market that you're trying to penalize people for consumption today. If you can defer that consumption it's cheaper.

So what we did is we worked together with someone in developing a basket or an index of exposures that focuses on things that tend to trade more in backwardation than not. Now, understanding that, you're not looking contemporaneously at the curves to make that assessment. You are using back testing, you're using history to think about it. But you're also coming up with a structural rationale of why that should be, or at least better than other parts of the market.

What we ended up doing was launching a strategy that uses a backwardation-focused index. So we choose 11 commodities: roughly a third in the energy sector, a third of the dollar exposure within metals (and that's going to be industrial metals, not precious because precious should trade in contango structurally), and then some of the agriculture and livestock to round up those positionings. So a third, a third, a third.

So, at least on a dollar basis, that gives you some exposure across various markets. And, again, it's not trying to time the backwardation or wait for it or rank on it. What it is doing is actually looking overall over the cycle and trying to harvest it.

And today, actually, Erik, I've got to say there are a few commodities in this basket that actually do indeed trade in backwardation. For example, copper that you were referring to is one of them as well.

When you start to look at markets, what you find is that it may be the point on your curve that you're looking at, so nothing necessitates one has to trade front month contracts and roll them over. So there's been a lot of innovation over the years. We've written a couple of papers about it, talking about some of that innovation.

And, again, this doesn't just focus on front month. It tries to be smart about the way it allocates across the curve. And you'll find that you can find backwardation in markets more frequently if you go out the curve than actually just focusing fully on the front end.

Erik: You're very much using the same strategies that I do, because getting out on the curve and away from the contango, especially that exists typically at the front end of the WTI market, is one of my favorite tricks. So great minds think alike.

Jeffrey: Yeah, and you could have easily lost 50% per annum. I think the roll was costing you roughly 50% per annum to roll oil, while oil prices were declining in 2015. So it can be pain when your spot price is falling apart as well.

Erik: Yeah, and something that just blows my mind is the number of supposedly professional commodity traders who just think you trade the front month and roll it every month. The idea of contract selection and choosing where on the curve – you've got to look for liquidity too – but where on the curve you want to be based on your fundamental view. Most people don't do it. It's amazing to me.

Jeffrey: It is. And what would you expect from a bunch of bond guys except to look at the curve?

Erik: Exactly. I want to ask you another question though, because something else that tends to encumber a lot of very simplistically managed commodity funds – if you take something like a long-only strategy, or even a more sophisticated long/short strategy where the mandate says you're always long/short 50/50 – that works in equities.

But in commodities, where you have typically a lot of very strongly trending markets, you need more flexibility than that. And that's why I always get concerned. Any time I look at a commodity fund I want to know whether or not the manager is roped into a specific long/short percentage that he has to comply with. Because I know that works against you, as a commodity trader myself. You've got a dynamic strategy where you're not necessarily long focused or long/short. You can go either direction, depending on market conditions.

Tell us more about that.

Jeffrey: You pointed this out, rightfully so, Erik. When people talk about commodities it's like, look, I want to have exposure when they go up. And, of course, then when they go down they want you to be short or at least not in that market. So, given the fact that we're not clairvoyant, it's tough for us to figure out which is the optimal strategy.

For many years around here we ran a long/short strategy as you're describing, where we're dollar neutral, we're long five or six commodities, and short the comparable amount. And, by doing so, really that becomes an absolute return strategy.

But you do realize that at times you're long energy, short ag. Or you're long ag, short energy. You end up having these positions that don't look like an absolute return strategy. So what you have is you're going to get vol when you do that stuff.

Our experience has been high single digits, roughly 8–9% per annum, when one does that. So it's a good strategy. People like getting sideways to down-markets, but you're not really trading the underlying asset class. You're turning something into an uncorrelated asset, which is alpha hedge fund type of things, which is good.

But is it really trading that asset class? And, again, we can argue whether commodities should be one or not.

What we decided to do, we said, look, we think there is a better way to do this kind of long-only stuff, we believe in our long/short process. Is there a way to marry these two things together without just overlaying it and creating massive amounts of leverage? And also thinking about how horrific some of the drawdowns have been in long-only investing.

What we ended up doing was saying, okay, look, let's take our beta exposure, this basket of backward dated commodities, and if we get bullish on the market we can be 100% long. When it's bearish on the market or lack of direction you're 50% long. And let's toggle between these two strategies. So let's use the long-only to always have at least half the portfolio because –

Again, you know commodities as well, trading them, Erik – that when you do that the reversal can come real quick. No one saw it going from $28 a barrel in (W)TI down to $26, and the next day going to $40 over the course of four weeks. So you've got to have something in there that still exposes you to that long-only aspect.

So what we decided to do was marry this backwardation concept (which, again, is rooted in the theory of thinking about long-only exposures), use our long/short (which is curve trading term structure thinking about extracting that convenience yield of the market), and then also pairing that with some form of momentum – the time between the two exposures. And we found that it seems to work a lot better.

I've been doing this combo idea for about three years now. We just had our three-year anniversary on our strategy. And it's done about 800 points net of fees over the Bloomberg Index.

We've had down markets, we've had up markets, we've had sideways markets, and it's done relatively well. So, thus far, it's behaving as we expect in terms of mitigating some of that drawdown. We're getting comparable vol back to the market because our backwardation basket is a little more volatile than the market, just given what we're trading.

And so, in general, we think it gives you a good diversified exposure. That's why we call it the Strategic Commodity Fund. We said don't try to time it, put this in here as a small allocation, a couple of percent in your asset allocation, and let us worry about those tactical moves based on the breadth of the commodity market. And that's what the strategy does.

Erik: So you're clearly doing some pretty fancy tricks here. Because one of the things that I always look at when I'm looking at a 2 and 20 hedge fund where you're paying a pretty significant performance fee is: Is the manager really doing anything to justify that performance fee?

Well, you're doing plenty of very sophisticated things here that would justify a hedge fund type of fee structure. But you're not charging one. This is an exchange-traded product. You're basically charging ETF kind of management fees.

Why is that? I mean it seems to me like you're earning the performance fee that you're not charging. What's going on here?

Jeffrey: You're probably right. But maybe it's just the disillusionment with commodities that we started off with – that these have been under-owned and allocated to and that people have been discouraged about. I think what we're trying to do is say, look, here's this – it's relatively simplistic the way I describe it. Yeah, it sounds exotic. There all these legs to the trade, but what it does it is distills it down to pretty simplistic things.

And so what we're saying is, look, we're trying to help you to the downside. We're still giving you some beta, so we've got to dilute down the fee because we're offering you at least half beta. So beta, maybe it's not commoditized, proving it's a little better. It's smart systematic; maybe it's worth a little bit extra.

And in the timing and the long/short, we think for as much exposure as we're giving you we're getting paid for that. But you're talking about an expense ratio a little bit over one. It's in a mutual fund format, so it's not an ETF because of what we're doing, the active management component on it.

It sits in a mutual fund wrapper and so it's north of $400 million today. It's had pretty good performance over the cycle.

Again, a lot of it is education. And then people learn more. We say, look, we can enhance on this stuff too. So this is meant to be out there to get people's feet wet to welcome them back to the asset class if they want to be. And so we thought it was the right format for an investor.

And, again, it's under-owned in most retail type of accounts, so if you get a little bit of market share there and get exposure it can still be something that helps you in your overall asset allocation.

Erik: Well, that makes me wonder too. Is this a bigger-picture strategic direction for DoubleLine? Because I think everybody thinks of DoubleLine as a very well-respected <u>institutional</u> money manager. But a lot of the products you've been introducing in the last few years have been either exchange-traded or mutual funds.

So is this just your strategy, to start making everything available to everyone? Let the little guy in? What's driving this?

Jeffrey: We've always had some retail presence. We have a lot of institutional clients who are in our 40 Act funds, so they're ETF or mutual funds. You also have to look at where the market is going. People want more liquidity. The reason we offered three actively managed ETFs was that people were asking for it.

People wanted us to be in that wrapper. Some people only buy ETFs these days. They just have this in their minds: I'm only going to buy ETF because I want instantaneous liquidity or at least the perception thereof. So, from that perspective, it's give the people what they want, too.

It's not trying to be overly pedestrian with it, but if people are asking you for it in this vehicle, and you can manage to do that wrapper, to us we're indifferent whether it's a hedge fund, it's a mutual fund. The only that thing we're worried about is does the liquidity match the liquidity of the underlying.

As long as you can get in that ballpark, you can make sure that you're not trying to take an illiquid product and put it in 40 Act or daily liquidity vehicles. To us that's fine. So I would say we consider ourselves markets people, we consider ourselves macro folks.

What we're trying to do is offer things that we think we have a skillset in. We have two equity products out there that are systematic equity where we run actively managed bond portfolios to try to outperform through the cycle.

So what we try to find is good ideas. We think if they're good they have a place in the market. That's what's important to us. And so, again, if there is demand for something and we think we have an expertise in it or that we can do something better or more creative, more value added for the client, we're going to be all over it. So we try not to put constraints around ourselves about what that wrapper looks like.

Erik: Well, Jeff, I can't thank you enough for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.