Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

Portfolio Strategies 2015: Investing in an Age of Divergence

JOHN MAULDIN | February 2, 2015

IN THIS ISSUE

With all the negative news out of Europe, how do you find a positive story? Is there a way to structure a portfolio that gives you permission to be more aggressive when there are danger signs all around? Everyone is worried about being blindsided by a significant downdraft in the markets when maybe we should be thinking about making sure we don't miss a bull market somewhere. These and several dozen other topics were on the table when the Mauldin Economics writing team gathered here in Dallas for 3½ days of intensive talk, interviews, and planning. Today we'll go over a few of the highlights of this last week, and I'll share a few reasons to be optimistic about 2015.

The 2015 Strategic Investment Conference

But first, we are finally ready to take reservations for our 2015 Strategic Investment Conference, which will be in San Diego, California, April 29 through May 2. (Note that this year the conference is open to everyone and not just to accredited investors, which makes me very happy.) While I am still finalizing the last few speakers with my conference cohosts, Altegris Investments, we've already secured an outstanding lineup. The plan is for my old friend David Rosenberg to once again take the position of leadoff hitter. The last few years he has come up with surprises to share with the audience, and I suspect he will do the same this year. Then, I'm excited that we have been able to persuade Peter Briger, the head of $66 billion+ [Fortress Investment Group](#), one of the largest private-credit groups in the world. In 2014, Fortress Investment Group was named "Hedge Fund Manager of the Year" by Institutional Investor and "Management Firm of the Year" by *HFMWeek*. Briger knows as much about credit around the world as anyone I know.

Longtime readers and conference attendees know how powerful Dr. Lacy Hunt's presentations are. Then, I've persuaded Grant Williams and his partner in Real Vision TV, Raoul Pal, to join us. Raoul is not a household name to most investors, unless you are an elite hedge fund (and can afford his work), and then you know that he is an absolute treasure trove of ideas and insights. If you are looking for an edge, Raoul is at the very tip. Paul McCulley, now back with PIMCO, will be returning for his 12th year. David Harding, who runs $25 billion Winton Capital Management, which trades on over 100 global futures markets, will tell us about the state of the commodity markets. My good friend Louis Gave will drop in from Hong Kong to help round out the first day. Louis never fails to come up with a few ideas that run against mainstream thinking. I can't get enough of Louis.

The next day my fishing buddy Jim Bianco, one of the world's best bond and market analysts, will join us. I have long wanted to have him at my conference. I get the benefit of his thinking every summer, and I'm excited to be able to share it with you. Larry Meyer, former Fed governor currently running the prestigious firm Macroeconomic Advisers, will be there to tell us when the Fed will actually raise rates. He is a true central bank insider and will be flying in from a just-concluded Fed meeting. He is the go-to guy on Fed policy and thinking for some of the world's greatest and largest investors. Then the intrepid and never-shy-with-his-opinion Jeff Gundlach, maybe the hottest bond manager in the country, will regale us with his insights. Is anybody more on top of his game than Jeff has been lately?

They will be followed by Stephanie Pomboy, whom I have wanted to have at the conference for years. She is one of the truly elite macroeconomic analysts, known primarily in the institutional and hedge fund world, and over the last few years her insights have been a regular feature in *Barron's*. My friend Ian Bremmer, the brilliant geopolitical analyst and founder of Eurasia Group, who is consistently one of the conference favorites (and whose latest book we will try to have for you if it is off the press in time), will join, us followed by David Zervos of Jefferies, former Fed economist and fearless prognosticator, who has an enviable track record since he joined Jefferies five years ago. He is currently quite bullish on Europe (for some of the same reasons I outline below).

The next day we will have Michael Pettis flying in from China to give us his views on how Asia rebalances and China manages its transition. Michael has been one of the most consistently on-target analysts on China and is wired into the thought leaders in the country. And what fun would the conference be without Kyle Bass of Hayman Advisors offering us his latest ideas? We are finalizing agreements with another four to five equally well-known speakers, which will include a few surprises, as well as rounding out the panels. I will share those names with you as we nail them down.

Since the first year of the Strategic Investment Conference, my one rule has been to create a conference that I want to attend. Unlike many conferences, there are no sponsors who pay to speak. Normal conferences have a few headliners to attract a crowd and then a lot of fill-ins. Everyone at my conference is an A-list speaker I want to hear, who would headline anywhere else. And because all the speakers know the quality of the lineup, they bring their A games.

Attendees routinely tell me that this is the best conference anywhere every year. And most of the speakers hang around to hear what is being said, which means you get to meet them at breaks and dinners. Plus, this year I am arranging for quite a number of writers and analysts to show up just to be there to talk with you. And I must say that the best part of the conference is mingling with fellow attendees. You will make new friends and be able to share ideas with other investors just like yourself. I really hope you can make it.

Registration is simple. Use this link: https://www.etouches.com/2015sicmauldin. While the conference is not cheap, the largest cost is your time, and I try to make it worth every minute. There are also two private breakfasts where hedge funds will be presenting. Altegris will contact you to let you know the details.

And now let's think about investing in an age of divergence.

Don't Miss the Melt-Up

Jared Dillian (who writes the free Mauldin Economics letter The 10th Man and is the editor of *Bull's Eye Investing*) really got me thinking this week as he argued that most people try to hedge for the downside, buying puts and other hedges to make sure they don't lose money in a market meltdown.

But as he showed us, it is actually far cheaper to buy long-term out-of-the-money calls to make sure that you catch a "melt-up." If you had bought long-term calls in 2010 on the possibility that the market would double, you would be up a lot more than 100%. For whatever reason, the cost of betting on a bull market is much lower than trying to protect from a bear market. You have to work a little bit more to find these plays and to make sure you get the right price. Getting my 10-year options on the yen took a little time, but they are starting to pay off. For whatever reason, the cost premium relative to the strike price and recent movement in the yen-dollar cross is actually cheaper than it was when I bought a year ago. I have no idea why that would be, but markets can get to be strangely priced. (And yes, I am tempted to add to my position because of that price structure, even though I have a reasonable position already.)

Jawad Mian argued that Europe is going to be the place to be over the next year. Long-term readers can guess that I was quite skeptical of that view, as I see nothing but problems in Europe; but as the days went on I began to see the trading wisdom in his thinking, especially relative to the US.

First off, the US market is simply looking "toppy" to me. That doesn't mean there is a crash or a bear market in the future (although that is a real possibility), but the outsized returns of the last four or five years are unlikely to be repeated. Will Denyer and Tan Kai Xian of Gavekal have made the case that it no longer makes sense to overweight US equities, which had been the firm's position for many years:

Our issue is that three key drivers of US equity outperformance are going into reverse:

1. **In recent years the Federal Reserve was the most aggressive liquidity provider in the world — this is no longer the case.** In fact, the Fed is making moves toward tightening, while everyone else is easing.

2. **In recent years the US benefitted from an extraordinarily competitive currency — this is no longer the case.** In a very short period, the US dollar has gone from being significantly undervalued against almost all currencies, to being fairly valued against most, to now being overvalued against the likes of the euro and the yen.

3. **In recent years US equities were attractively priced — this is no longer the case.** On a number of measures the market is stretched.

Even though the Federal Reserve rate hike has probably been pushed off into the third quarter, it will soon be priced into the market. Fed rate hikes usually lead to price-to-earnings (P/E) compression, whether or not there are strong earnings. But since almost half of S&P 500 earnings come from outside the US, a strong dollar is going to weigh heavily on those earnings. Procter & Gamble has said currency costs will reduce their earnings by $1.4 billion after-tax this year. They are not alone.

Further, more than half of S&P 500 companies have P/Es over 20; and, to put it bluntly, bull markets do not begin from valuations at this level. The Russell small-company index is down for the last year, quarter, month, week, and day. Small companies in general are in a bear market (though numerous small companies, typically ones that are tech-focused in some way, are having a banner year).

So, where do you go if you are taking money off the table from the US? Counterintuitively, the coming Greek crisis suggests that we might want to look to Europe. To understand why, let's review what's going on in Greece.

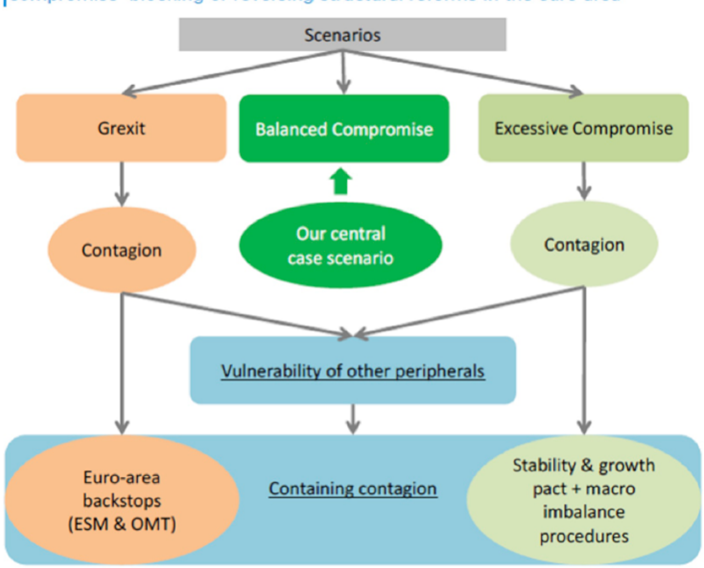
The Euro-Positive Greek Crisis?

As we read the headlines, it would appear that Europe is heading for a major confrontation over Greece. The Germans and other Europeans have made it very clear that there will be no haircut on Greece's debt. Tsipras and his left-leaning coalition party, Syriza, were elected on the basis that there would have to be major haircuts in the Greek debt, as well as relief from the austerity requirements imposed by the Troika (the ECB, IMF, and European Commission) in the wake of the last Greek bailout.

Within a few weeks, Greece will need significant loans to make its debt payments and to pay its bills. The requirement for getting those loans is that Greece must adhere to the regime that was agreed to by the previous government. Tsipras and company have made it quite clear that they do not intend to do so. If they don't, it is highly unlikely that they will get the Emergency Lending Assistance (ELA) from the European Central Bank that would be needed to bail out their banks. Money appears to be leaving Greece, and deposits are at their lowest levels since 2012.

A Greek exit from the Eurozone has the potential to precipitate a crisis. An excessively permissive compromise by the Eurozone might also create a crisis. Deutsche Bank gives us the following chart (hat tip to my friend Barry Ritholtz at *The Big Picture*):

Figure 1: A balanced approach requires avoiding Grexit without an excessive compromise blocking or reversing structural reforms in the euro area

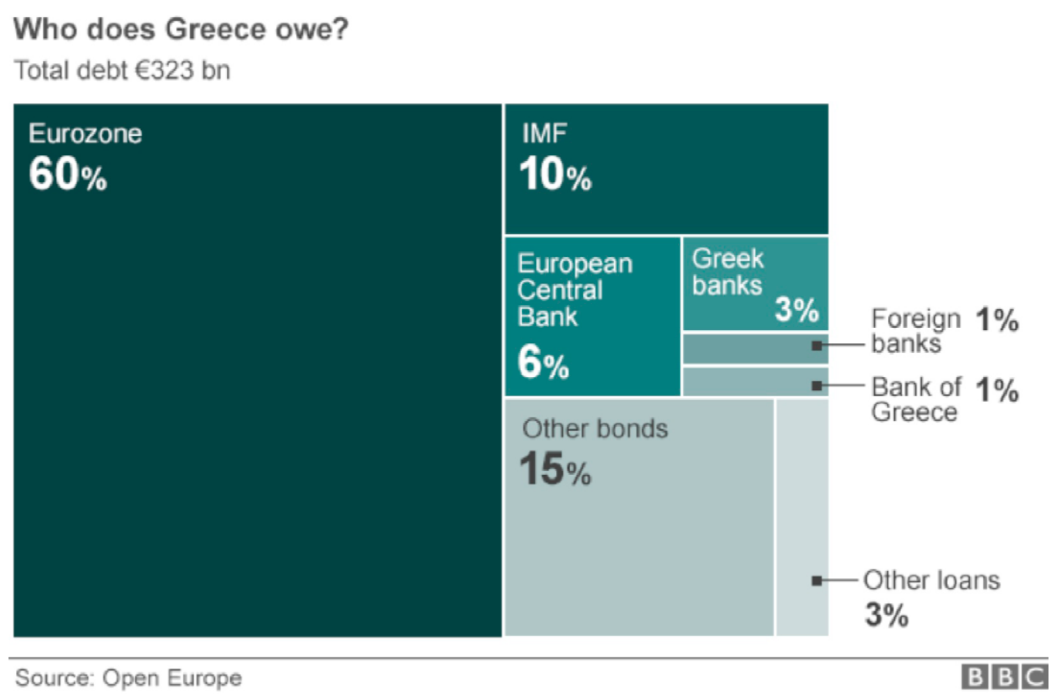


Source: Deutsche Bank

Everybody, and I mean everybody (not just the Germans), recognizes that Greece cannot actually pay its debts. A 175% debt-to-GDP ratio is simply unsustainable at an interest rate of 4%, let alone at the level to which rates have risen to in the last few months. While Greece is running a primary surplus, which means they are taking in more revenue than they're spending (if you don't count interest and loan repayment costs), they are nowhere close to actually covering the interest-rate expenses they are accumulating. They are digging themselves an ever-deeper hole, and the austerity measures are keeping the country mired in a state of depression.

However, if Europe does the seemingly humane thing and forgives the bulk of the debt, then parties on both the far left and the far right throughout Europe may demand the same deal that Greece gets. You can almost guarantee that far-left coalitions in Italy and Spain and the far-right party in France would come to power as a result. That would eventually blow up the Eurozone and potentially even the European Union — not exactly what European leaders want.

This is not a situation that is going to fester for a long time, as the clock is ticking and debt payments will have to be made in the very near future. So what will happen? I think it might help us to look at who actually owns that Greek debt.



There are restrictions on what the ECB and the IMF can do in regards to debt relief, and private investors are not going to be thrilled with any solution that does not fulfill the terms of their bonds. Coming up with a compromise is going to be very complex.

That said, my sources tell me that a tentative deal has already been reached that will look like the balanced compromise scenario in the chart above. Tsipras, so I am led to believe, has tentatively agreed to a deal by which the bulk of Greek debt will be extended to 40 or 50 years at 0% interest, or something in that range. That is not the debt forgiveness that he promised his followers, but it is the next best thing.

The Greeks are a classic case of dysfunctionality. They want to eat their cake and have it, too. They want their debt to go away, but they want to stay in the Eurozone. And while the compromise outlined above does not make the debt go away, it does stop the immediate pain. As part of that compromise, it appears that some of the austerity controls will be relaxed, allowing Tsipras to fulfill some of his promises. His challenge will then be to convince his followers that he got them a good deal and that debt forbearance is almost as good as debt forgiveness. It should be an easy sell to a sophisticated electorate, but it is not altogether clear that the Greeks are that economically sophisticated, and it may be that they are just generally pissed at the Germans and ready to duke it out.

Along with ECB's quantitative easing, debt extension will push down Greek interest rates and help defuse the simmering crisis that is Europe. The ECB's QE is going to delay the crisis that I believe is eventually going to come to Europe, for at least a few years. It doesn't address north-south imbalances or the lack of reform or significant entitlement program cost increases; it doesn't deal with the real problem of the French budget and debt; and it glosses over the 135% debt-to-GDP ratio that Italy has already run up and that seems to be rising. It does, however, postpone the immediate crisis for maybe two years.

European stocks are a much more attractive buy than US stocks on a valuation basis. The euro should continue to fall, so if one were to purchase specific European companies (rather than general indexes) on a currency-hedge basis, there is a real opportunity for outperformance. This is almost exactly the same proposition I've been arguing for in Japan for several years, and one that has been working.

And if discussions break down and we get the dreaded Grexit (which is still a possibility if you listen to the rhetoric of the new finance minister), then we get chaos for a while, but Europe might be better off and a far more stable place, which is also positive. So, either way, MAJOR European problems are postponed, and everyone will revert to happy talk and markets should rise.

Some final thoughts on Greece. Syriza comprises an amalgam of parties stretching the spectrum from center left to insanely left. They have never been in power, and they have no clue as to what running a country actually requires. Greece is essentially starting a rookie quarterback in their equivalent of the Super Bowl. Sometimes that turns out well, but I wouldn't bet on it. Recent statements and actions by various new ministers in Greece are not encouraging. They look like the Keystone Cops of governing.

If Tsipras and Syriza use this opportunity to clean out some of the corruption that is endemic in Greece, and do so without replacing it with any of their own, that would be positive. However, Syriza gave the far-right-wing separatist party (their majority coalition partner) the position of minister of defense, whereupon the appointee demanded and won the right to execute defense purchasing contracts with just one signature – his. Which could be a step back to corruption as usual in Greece. If the corruption is not dealt with, things are not likely to improve. Syriza still has to govern, though, making the trains run, making sure healthcare is available, etc. The jury is out, and it would not surprise me if voters get frustrated in less than a year and we see Greek elections again.

Finally, as my friend Mish Shedlock points out, even if Greece is able to take its primary surplus and apply it to the debt, it will take multiple generations to get the debt under control, even at zero interest. A debt-to-GDP level of 175% is just a monster number in a country where government spending is already a major part of GDP.

My central case is that the Eurozone will create the compromise for Greece outlined above and that when the next European crisis hits, probably triggered by France, Europe will either have to create a true fiscal union and mutualize the debt of all countries or break up the Eurozone. Since an increasingly large portion of Europeans (especially younger voters, who are becoming the majority as time goes by) want to keep the European Union, and since we are talking a political decision and not an economic decision, I think they will end up neutralizing Greece's debt. Then the debt problem then simply goes away. Voilà! Problem solved. Opa!

Getting Permission to Take Risks in Your Portfolio

We were doing a roundtable interview with all of the team (much of which will be on video in a few weeks), and the issue of portfolio design came up. Worth Wray noted that if you have a properly constructed core portfolio to anchor your investments, then it gives you permission to seek "alpha" and select macro-type plays. Tony Sagami chimed in that he has always argued for that approach: investors should have a "core and explore" structure in their investment portfolios.

There are a growing number of academic studies which point out that growth in the portfolio of an average investor is highly correlated with overall global growth. That suggests that a portfolio structured to take advantage of global growth is appropriate for most investors.

I am in wholehearted agreement, but I want to make it clear that a core portfolio is not a buy-and-hold portfolio in today's environment. A buy-and-hold portfolio is an invitation to volatility and disappointment. The wide variety of investment offerings, especially in the $2 trillion ETF world (which will grow to $5 trillion within a few years), allows you to create a global core portfolio with a basket of low-cost ETFs. If you then allow each ETF to determine its own entry and exit points, you can potentially reduce your overall portfolio volatility and have the potential to increase your returns over those you would see with a buy-and-hold structure.

Then, with your core taken care of, you can explore the potential of a falling yen and euro, buy potentially rising European stocks, make a commodity play when appropriate, and acquire a few strategic alternative funds to round out your portfolio. Depending on your net worth, you can take advantage of private equity and special offerings. Real estate and income plays may also help round out your investments. Because your core portfolio is the anchor, you now have permission to place small bets on a number of strategic ideas that you feel have potential, while at the same time maintaining risk-management discipline with regard to the "explore" portion of your investments.

There are multiple firms and advisors that attempt to do something like this today, some more successfully than others. Within a few months, I will be announcing what I think is a new and better-integrated approach to structuring a core portfolio. We have been working on this for some time, and I believe it is now ready for prime time. We're going to share our approach with you, and perhaps it will inspire your own ideas, or you can join us in what we're doing. This is not to say I am not still a fan of carefully selected alternative investments, but I have come to realize that a new and different approach to total portfolio investing is now possible with the latest technology and offerings. We are hopeful that this new tool will help brokers and advisors around the world design portfolios for their clients in a more strategic way, as well as keep fees and extra costs down. Stay tuned.

The Cayman Islands, Dallas, Orlando, Geneva, and Zürich

This next week will look a little more normal before I head off to the Cayman Islands for two back-to-back conferences and a little R&R. Then on February 19 I will be speaking in Dallas for S&P. Brokers and registered investment advisors are welcome to attend. The following weekend I will be in Orlando speaking at the American Banking Association's national conference on behalf of my friends at Altegris Investments. Then from the 15th through 19th of March I will be in Switzerland, first in Geneva and then in Zürich.

I'm finishing this letter on Sunday morning, though you are seeing it on Monday. In a few hours we will begin to prepare for some 80 people showing up at the house to watch the Super Bowl. While this year probably the only way I could end up happy is if somehow both teams lose (along with much of the country, I am still pretty bitter about the referees taking what was a clear win away from Dallas), Super Bowl Sunday is a fabulous excuse to throw a party for all your neighbors, friends, and family and stack the kitchen with all manner of comfort food. And for those of you who actually cared who won, I hope your team prevailed. I will get to be the winner because of so many friends coming over.

And on that note, I'm going to run to the gym and get on the bike and see if I can work off ahead of time a few of the calories that I know are going to be coming my way. I hope you have a great week.

Your seeing chili, barbecue, and guacamole in my very near future analyst,

John Mauldin

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