CMG Mauldin Smart Core Strategy Update

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October 16, 2018 | John Mauldin — It's been an interesting few weeks in the markets. The culprit? Rising interest rates. To understand the implications, let me first set the stage.

In my May 11 Credit-Driven Train Crash letter, I described my friend, Peter Boockvar's perceptive statement: *"We no longer have business cycles, we have* credit *cycles."*

His point is subtle yet critical. Post-crisis growth, mild as it's been, has been largely a function of debt, which central banks encouraged and enabled. The result was inflated asset prices without the kind of "recovery" seen in previous business cycles. Interest rates, i.e., the cost of debt, thus became critical.

With rates now moving up again, premium asset prices are losing their *raison d'etre* and will stabilize and eventually fall. Peter Boockvar says this, not the conventional business cycle, is what will set off recession. That's key. Lower asset prices won't be the *result* of the next recession; but they could be a main culprit in the *cause* of that recession. (Along with a few of the other usual suspects.)

I showed in that letter how companies will need to refinance about $4 trillion of bonds in the next year, almost all of it at higher rates. This will hit debt-burdened companies that are already struggling and make it almost impossible for some to keep operating. Lenders, i.e., high-yield bond holders, will try to exit their positions all at once only to find a severe shortage of willing buyers.

The following week in Train Crash Preview, I listed the steps in which I think the crisis will unfold. They fall in four stages.

- **The Beginning of Woes:** Something, possibly high-yield bonds, will set off a liquidity scramble. It will spread through the already unstable financial system and trigger a broader credit crisis.

- **Lending Drought:** Rising defaults will force banks to reduce lending, depriving previously stable businesses of working capital. This will reduce earnings and economic growth. The lower growth will turn into negative growth and we will enter recession.
- **Political Backlash:** Concurrent with the above, employers will be automating jobs as they grow desperate to cut costs. Suffering workers—who are also voters—will force higher "safety net" spending and government debt will skyrocket. A populist backlash could lead to tax increases that prolong the recession.
- **The Great Reset:** As this recession unfolds, the Fed and other central banks will abandon plans to reverse QE programs. I seriously think the Federal Reserve's balance sheet assets could approach $20 trillion later in the next decade. But it won't work because the world simply has too much debt. They will need to find some way to rationalize or "reset" the debt. Exactly how is hard to predict but it probably won't be good for lenders, or for the holders of government promises, such as pensions and healthcare.

Next in High Yield Train Wreck, we dove deeper into the dream-driven high-yield bond market exemplified by this year's nutty $702 million WeWork bond issue. I quoted Grant Williams, who wrote a masterful takedown of this craziness.

> *Ten years into the ongoing laboratory experiment being conducted by the world's central banks, everywhere you look there are multiple examples of the kind of lunacy those policies have fomented by reducing the cost of capital to virtually zero and forcing investors to take risks they would ordinarily avoid in order to find some kind of return.*
>
> *WeWork is one example of a company for whom, in the face of rapid growth, massive negative cash flows aren't a problem, but there are plenty of others. Uber, Airbnb, Snapchat and, of course, Tesla have all captured the imagination of investors thanks to lofty dreams, articulated by charismatic CEOs—but the day things turn around and the economy begins to weaken or, God forbid, investors seek a return on their investment as opposed to settling for rolling promises of gigantic, game-changing revenues to come, it is over.*

We went on to talk about the insanity of yield-hungry investors practically throwing cash at borrowers while demanding little in return. I also showed how this is not simply a junk-rated company problem, since almost half of investment-grade companies are rated BBB and could easily slip to junk status in a downturn.

The week after we turned to Europe in The Italian Trigger. Unfortunately, Italy isn't Europe's only problem. The big kahuna is Germany, which spent years offering generous vendor financing to the rest of the continent to entice the purchase of German goods. The result: a giant trade surplus for Germany and giant, unpayable debts for those who bought German goods.

The euro currency union is fatally flawed because it leaves each member state to set its own fiscal policy. There are good reasons for that, but it is not sustainable indefinitely. There has never been a strictly monetary union that has lasted in the history of the world. None. Zero. Nada. The eurozone must get either much more centralized or fall apart. And the current politics are exactly the opposite of what is needed for that type of arrangement. All the Rube Goldberg contraptions the ECB and others invent are temporary fixes. They've worked so far. They won't work forever.

The next installment, Debt Clock Ticking, was a bit philosophical. I talked about debt letting you bring the future into the present, buying things you couldn't afford if you had to pay for them now. But the entire world went into debt for the equivalent of tropical vacations and, having now enjoyed them, realizes it must pay the bill. The resources to do so do not yet exist. So, in the time-honored tradition of lenders everywhere, we extend and pretend. But with our ability to pretend almost gone, we're heading to The Great Reset.

The last three letters in the series got personal for many readers as I talked about pension debt. In The Pension Train Has No Seat Belts, we looked at the demographic challenge facing U.S. pension funds, mainly state and local government plans but also some private ones. We are asking a shrinking group of working-age people to support a growing number of retirees and that's just not going to work.

Finally, in Unfunded Promises, we reached the ultimate debt problem: U.S. government unfunded liabilities. On paper, Washington's debt is about $21.2 trillion… but that doesn't include the $13.2 trillion unfunded, off-the-books Social Security liability, or the $37 trillion Medicare unfunded liability. Those aren't my numbers, by the way; they come from the Social Security and Medicare trustees and are probably understated. My friend, Boston University professor, Larry Kotlikoff, thinks it should be more like $210 trillion. He has a considerable amount of published works and a book he co-authored with fellow Texan, Scott Burns.

That's not all. The federal government also has liabilities for civil service and military pensions, veteran benefits, some defaulted private pensions via PBGC, and open-ended guarantees to entities like FDIC, Fannie Mae, and more.

The major driver of market turmoil is the move higher in interest rates and, frankly, how rising rates impact The Great Reset I see ahead.

I mentioned in last quarter's letter, between now and the other side of The Great Reset I believe we will see significant market turmoil. Perhaps similar to 1999-2002 and 2008-2009, yet this time may be more consequential to portfolios given the extremely high valuations and ultra-low bond yields. It will challenge the traditional 60/40 investor landscape.

We have different leadership in the White House and we have different leadership at the Fed. Interest rates have spiked higher and I expect the Fed to stay the path. Rates will likely move an additional 1% higher from here, barring the economy weakening significantly, which is not my base case. Higher rates are likely the pin that pricks the debt bubble. We are in the very early innings of The Great Reset.

To better navigate the period ahead, my solution is that instead of diversifying your portfolio to different asset classes, which tend to correlate together during periods of market dislocations, diversify a core portion of your portfolio to investment trading strategies that trade into and out of asset classes. The strategists I've selected are experienced and all of them seek growth opportunities while maintaining a level of risk management.

Let's review the last quarter and take a look at what I'm seeing in the portfolio today.

Third Quarter Portfolio Review

Mauldin Smart Core (MSC) is an equally-weighted blend of quantitatively driven, systematically managed strategies combined into a single strategy. The portfolio has a global tactical allocation mandate, meaning we can invest in just about any asset class anywhere in the world utilizing ETFs as the tool to gain the exposures. Importantly, each of the strategists has a "participate and protect" investment process. The process seeks growth opportunities while seeking to minimize losses generally associated with the challenges that present during times of economic recession.

At the end of 2017, the portfolio had significant exposure to equities (66%), taxable bonds (30%) (two-thirds of which was mostly longer-duration bond maturities, including emerging markets and developed market bond exposure and one-third to shorter-duration bond maturities), commodities (3%) and cash (1%). Looking deeper into equities: U.S. equity and U.S. sector equity exposure totaled 45% and international equities 21%.

At the end of September 2018, exposure to equities was 53%, taxable bonds comprised 45% (with half of the exposure in ultra-short-term bond maturities, a reduction in long-term exposure and very little exposure to emerging markets and developed market debt), commodities were 2% and cash was less than 1%. Looking deeper into equities: U.S. equity and U.S. sector equity exposure totaled 48% and international equities comprised 4%.

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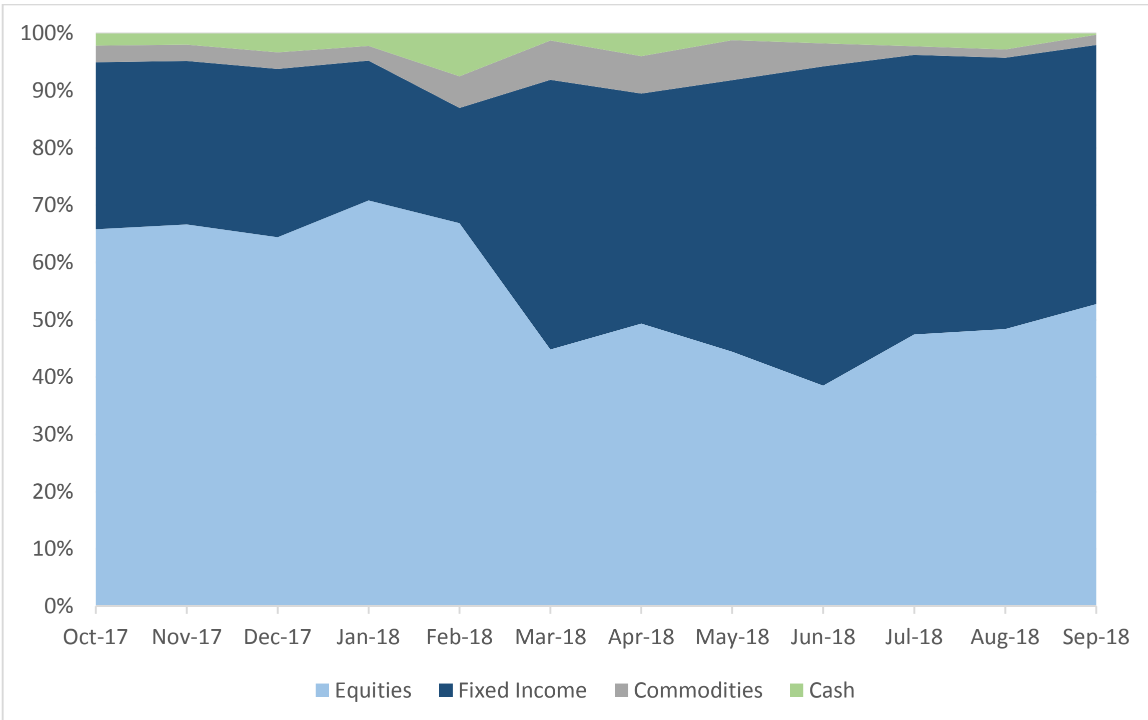
The following three heat maps show our monthly portfolio exposure by asset class, equity exposure (differentiating domestic, international developed and emerging markets exposure) and fixed income exposure broken down by fixed income category.

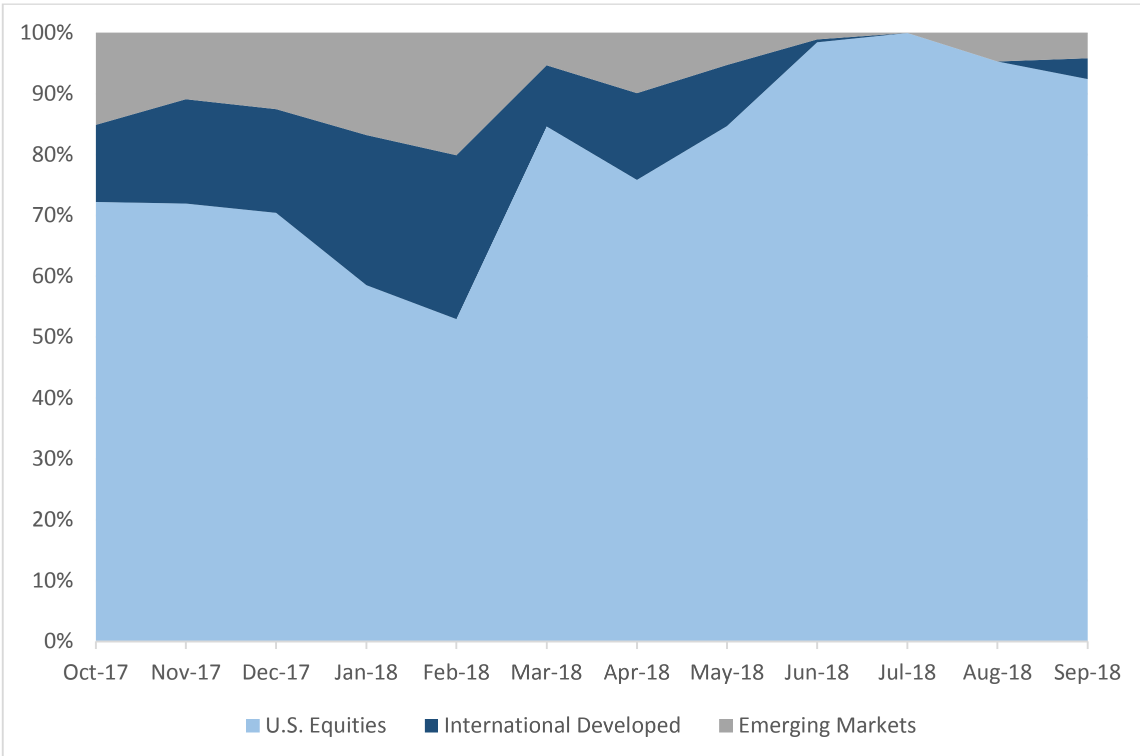
CMG Mauldin Smart Core Strategy

Asset Allocation Changes Across Major Asset Classes (Trailing 12 Months)

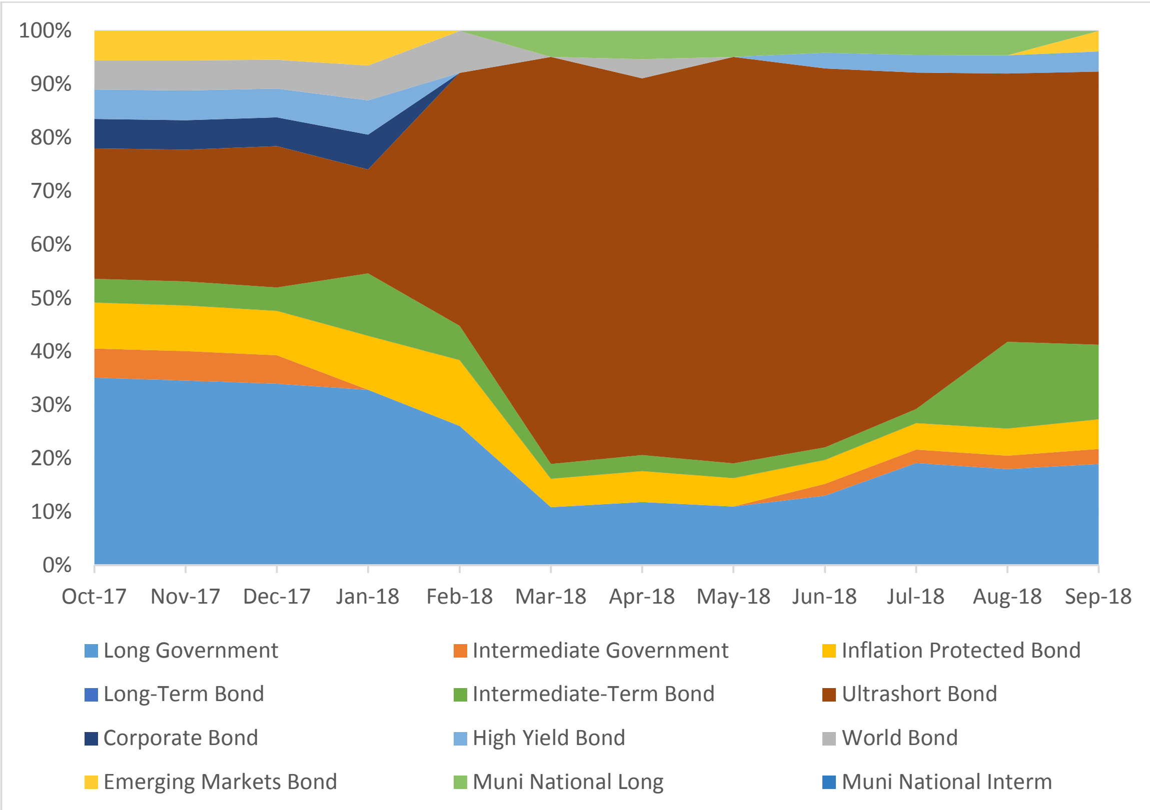


CMG Mauldin Smart Core Strategy

Equity Asset Allocation Changes (Trailing 12 Months)



CMG Mauldin Smart Core Strategy
Fixed Income Asset Allocation Changes (Trailing 12 Months)



Several important observations:

In the 15 days since the end of the quarter, our managers have reduced their U.S. equity exposure significantly, increasing their exposures to Asian equity somewhat. As a group, they are reducing their equity exposures to the U.S. markets.

I know that every one of you wants to ask how we did during the recent market drawdown (as of this writing it looks like there is a significant recovery in process, but it remains to be seen if the drawdown eventually continues or the market moves back up, as many are forecasting, or decides to churn sideways). I am pleased to report that the fund performed almost exactly as I designed it (this is when I need to remind you that past performance is not indicative of future results).

From the highs in early October through the current rebound, the S&P 500 Index and the Dow Jones Industrial 30 were both down approximately 7%. The NASDAQ 100 was down approximately 9%. The Mauldin Smart Core was down 3.5%. Let's break down some details.

First, this was early innings in a potential bear market. The most dangerous time for our fund is in the early innings of a bear market. We will generally still have significant equity positions, although the longer the bear correction goes on, the smaller that equity participation will be.

In October we have reduced our equity exposures almost another 10% and if you were looking at the individual ETF positions, you would notice that there's been a significant shift out of the U.S. Further, that equity exposure is represented with well over 20 ETFs, many of which are quite targeted, and while they may have participated in the drawdowns, they did much better (relatively speaking) than the overall larger indexes. This is why we have the smaller drawdown.

One of the things you will notice as you look back over the three heat maps (and if you are in my position, can look back for the last two years) you could see the portfolio "breathing." In February of 2017, we were well over 90% long equities. Which, even though it made me nervous, was the correct position for that time. Just as Luke had to trust The Force, I have to trust the strategists (also known as quants) who have designed The System. And they in turn have to trust their own systems.

Now, if a recovery ensues, we will participate in that recovery but from a relatively higher base. Frankly, I don't know if it will be meaningful by the end of the year. Maybe it will, maybe it won't. Where I firmly believe it will become meaningful is when we enter into a full bear market. This is when we will see the true value of Mauldin Smart Core as recoveries always follow true bear markets.

I hope this last little bit has given you some insight into how I went about designing the strategy. My goal is to get you from where we are today to the other side of The Great Reset in the best possible position. This is a long-term strategy and it will not play out in the next six months or one year. To fully get to the other side will mean that we are in the middle of the 2020s. It is going to be a volatile period and you're going to need to diversify your portfolio into trading strategies and other asset classes that offer different income streams than traditional equity investing. I know I keep pounding the table on that, but it is at the center core of my beliefs.

Concluding thoughts

Far too often, investors compare everything they own to the S&P 500 Index. If you own a global tactical portfolio or a broadly diversified stock and bond portfolio, it is simply a mistake to compare a diversified portfolio to a singular risk (i.e., U.S. large cap stocks). In the next quarterly letter, we're going to look at benchmarks that are more appropriate than a U.S. large-cap index fund.

I believe you can continue to seek growth opportunities but do so in a way that provides a level of protection in down markets. Passive buy-and-hold with dollar cost averaging may work well for someone in their 20s and early 30s, but not well if you are near or in retirement.

Thank you for your interest in MSC. I hope you find this update helpful. If you have any questions, please reach out to your CMG Advisor Representative. To learn more about the strategy or how to invest, email me at mauldin@cmgwealth.com.

Yours truly,

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