

An Asset Allocation Strategy For A Risky Market (Part II Of II)

Jun. 2, 2017 9:00 AM ET | [8 comments](#) | Includes: [AVGRX](#), [EBND](#), [EDV](#), [EMB](#), [EMLC](#), [EWY](#), [GXG](#), [INDA](#), [IVWIX](#), [MCHI](#), [VOO](#), [WARAX](#)



[James Hickman](#)

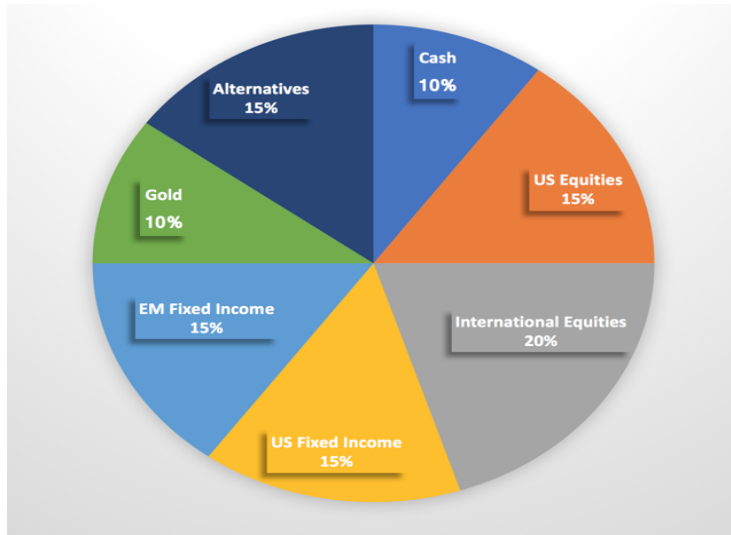
Long/short equity, newsletter provider, macro, value

Summary

- ❖ US Equities deserve a portfolio underweight and select International Equities warrant overweight.
- ❖ Overweight true Alternatives but beware of faux-Alts.
- ❖ Emerging Market sovereign debt offers best balance sheets, growth and fiscal trajectories.
- ❖ Allocate 10% to Gold as a systematic risk hedge.

In the [first article](#) of this series, the case was made for an asset allocation strategy reflecting basic economic realities of the various asset classes, and the respective factors driving them. This article makes the actual asset allocation recommendation. This recommendation assumes a 10-year investment horizon (noting when a particular allocation will require review and adjustment during that period), seeks to minimize expense ratios and is guided, as relevant, by replacement cost economics, macro-economic factor analysis and absolute valuation analysis. Mutual funds and ETFs mentioned as vehicles for asset class exposure are based on our own analysis, but we have no relationship with any of funds or managers involved, economic or otherwise. Individual investors should consult their professional advisor about suitability of any recommendation herein.

Asset Allocations May 2017



Allocate 10% to **Cash** for opportunistic rebalancing.

Equities (35%)

US equities allocation of 15% via Vanguard S&P 500 ETF (NYSEARCA:[VOO](#)). **US equities may rise further, but the risk reward is un compelling.** We have argued for four years that long-term rates will stay below 3% for years, not quarters. The sturdy support of the US stock market - few corrections in excess of 20% when 10-year is below 4% since - suggests downside protection. But investors should allocate capital based on risk/return expectations over the next 7-10 years. In that frame, US equities from current levels, are likely to experience returns significantly below long-term averages, and we believe a drawdown in excess of 50% is likely. For convenience, the factors suggesting high systematic risk from first report are repeated below:

- a [historically over-valued US market](#)
- nearly a full generation of corporate capital allocator [wariness about investing](#) in organic growth and a related plateauing in labor productivity
- corporate profit margins still 40% above historical norms
- US federal debt as a percentage of GDP is up from 64% to 108% since 2007
- an unsustainable and worst-in-world US fiscal deficit trajectory (true of advanced economies broadly)
- sixteen years and counting of US production growth below 2% without a single 4% print
- deflationary demographic trends
- high levels of underlying financial risk from a protracted period of market complacency during the central bank's protracted experiment with zero-bound interest rate policies

The tables below summarize critical macroeconomic and valuation metrics for key countries in each major region. These factors inform both the overall asset allocation and specific country weightings recommended herein. Color codes were added as an optical aid, with red reflecting worrisome and potentially short-worthy factor trends ("Awful"), pink reflecting "Weak," light

green reflecting "Good" and dark green "Great" combinations of sovereign balance sheet, production growth, fiscal trajectory, inflation and equity values. Brief notes are also provided for each country.

Macro-economic Trends and Value Metrics by Region/Country

	Surplus/D eficit % of GDP	GDP (local currency)	Net Sov. Debt	Gross Debt/ GDP	S&P Rating	10-Yr Yield	Market P/E	3-yr GDP Growth% (Constant Prices)	PEG	Inflation	Notes
Color code: Awful Weak Good Great											
North America											
Serious fiscal problems looming - but on a relative basis, still a safe destination. Plus deflationary pressure continues. Equities to remain volatile and very expensive. Debt problems likely to take back seat to perceived relative global safety for next 12 months.											
United States (2015)	-4%	18,036	14,401	105%	AA+	2.4%	22.7	2.2%	10.3	1.0%	
Canada (2015)	-1%	1,983	521	91%	AAA	1.6%	22.5	1.9%	11.8	1.1%	Modest deficit and better balance sheet than most advanced economies. But reflected in equities and bond values.
Central and South America											
Strong bond yield, supported by decent GDP growth (2%), solid balance sheet, manageable deficit spending and moderate inflation. BUY 10-Year Notes. Equities look okay on PEG, but PE of 20X+ does not suggest enough upside. SPDR® Bimbg Barclays EM Mkts Local Bd ETF (EBND)											
Mexico (2015)	-4%	18,127	8,633	54%	BBB+	7.3%	20.5	2.0%	10.3	2.7%	Running modest deficit, strong balance sheet, decent GDP growth in world and moderate inflation (4%+). BUY Chile 10-Year Notes AND equities via IGPA local index or iShares MSCI Chile Investable Mkt Idx (ECH).
Chile (2015)	-2%	157	(6)	18%	AA-	4.0%	18.2	2.7%	6.7	4.3%	Outstanding GDP growth of 4%. Running modest deficit, great balance sheet and inflation okay. Equity market reflects strength, but still BUY Peru 10-Year Notes AND IGBVL index or iShares MSCI All Peru Capped Index (EPU).
Peru (2015)	-2%	612	34	24%	BBB+	5.6%	20.5	3.8%	5.4	4.4%	Outstanding GDP growth in the region, among best in world, strong balance sheet, relatively small deficit spending. But inflation has gotten too high - equities look attractive generally - buy via Global X FTSE Colombia 20 ETF (GXG).
Colombia (2015)	-3%	800,849	337,908	51%	BBB	6.3%	12.9	4.1%	3.1	6.5%	Sluggish GDP and elevated inflation (~9%) hurting equities and creating risk for bonds, despite healthy balance sheet and manageable deficit. Insufficient risk reward - looking for evidence of stabilizing GDP and lower inflation.
Brazil (2015E)	-14%	4,501	2,137	47%	BB	10.2%	18.8	1.7%	11.1	9.0%	Tragic mess.
Venezuela (2013)	-10%	1,017	371	36%	CCC	10.5%	58.2	-3.0%	NA	800.0%	Double-digit inflation hammering bonds, skewing PE and leaving markets to
Argentina (2015E)	-7%	5,843	3,046	52%	B	2.4%	245.0	0.8%	306.3	20.0%	

	Surplus/D eficit % of GDP	GDP (local currency)	Net Sov. Debt	Gross Debt/ GDP	S&P Rating	10-Yr Yield	Market P/E	3-yr GDP Growth% (Constant Prices)	PEG	Inflation	Notes
Color code: Awful Weak Good Great											
Western Europe											
A fiscal risks persist, stifling growth, plus cultural risk. Shorting 10-year makes sense at some point. Would not touch equities.											
France (2015)	-4%	2,181	1,923	96%	AA	0.9%	19.8	0.8%	24.8	0.0%	Big rebound in bonds. GDP growth to remain sluggish under currency constraint of EU. Equities rich, all considered. Bonds vulnerable w bad balance sheet, weak growth and ongoing deficit spending, but being helped by deflation.
Spain (2015)	-5%	1,081	862	99%	BBB+	1.6%	20.4	0.9%	22.7	-0.5%	10-Year yields will rise, but probably years away. Equities look rich since 20%+ rise after BREXIT vote. Uncertainty too difficult to handicap.
United Kingdom (2015)	-4%	1,870	1,502	89%	AA	1.2%	36.2	2.4%	15.1	0.0%	Continues to bear disproportionate share of EU burden, especially w UK going. Balance sheet in good shape. Equities cheap v US, but growth constrained. 10-Year to decline at some point. Neutral position.
Germany (2015)	1%	3,033	1,439	71%	AAA	0.4%	19.8	1.2%	16.5	0.0%	Italy's woes continue. 10-yr yield absurdly low. Government blocking bond shorting. Steer clear.
Italy (2015)	-3%	1,636	1,854	133%	BBB-	2.3%	24.8	-0.4%	NA	0.0%	Solid economy already priced into equities and bonds.
Netherlands (2015)	-2%	676	232	65%	AAA	0.6%	21.0	1.1%	19.1	0.0%	Equities expensive, as well as bonds. Healthy economy but anemic growth.
Norway (2015)	5%	3,131	(8,740)	28%	AAA	1.7%	30.8	1.6%	19.3	2.2%	No reasons for optimism.
Portugal (2015)	-4%	179	218	129%	BB+	3.4%	34.1	0.4%	85.3	0.5%	Slow, steady and risk averse.
Sweden (2015)	0%	4,159	(19)	1%	AAA	0.6%	17.0	2.0%	8.5	0.7%	Equities and bonds reflect healthy economy, leaving little upside.
Switzerland (2015)	0%	639	157	46%	AAA	0.0%	24.5	2.4%	10.2	4.9%	The economic death spiral continues.
Greece (2015)	-3%	176	311	177%	B-	5.6%	15.4	-0.9%	NA	-1.0%	What a difference a bailout can make. In 2010, Ireland was part of the EU and IMF bailout. Now its balance sheet is in order, economy is growing rapidly, and its 10-yr is yielding less than 1%. Equities are not cheap, except relative to recent growth. 2017 to mark 4 straight yrs Ireland grows fastest in EU. Equities reflect it already.
Ireland (2015)	-2%	256	171	79%	A+	0.9%	20.6	11.5%	1.8	0.0%	

	Surplus/Deficit % of GDP	GDP (local currency)	Net Sov. Debt	Gross Debt/GDP	S&P Rating	10-Yr Yield	Market P/E	3-yr GDP Growth% (Constant Prices)	PEG	Inflation	Notes
Color code:			Awful	Weak	Good	Great					
Asia											
Singapore (2015)	3%	403	421	105%	AAA	2.2%	23.8	3.3%	7.2	0.0%	Running small fiscal surplus that should manage debt. Above average growth compared to other advanced, but little inflation and neither equity nor debt markets cheap.
China (2015)	-3%	69,629	29,884	43%	AA-	3.7%	7.6	7.3%	1.0	2.0%	Public and private debt over 200% of GDP and spike in credit versus GDP growth historically portends financial calamity. Equities look cheap even under slower growth scenario, but concerns over hard landing, artificially weak currency (deflator over 3), and governance concerns likely to persist, and no positive catalyst in sight.
India (2015)	-7%	135,761	93,770	69%	BBB-	6.9%	25.4	7.5%	3.4	5.5%	Strong growth, fiscal deficits persist. Inflation okay but worth monitoring - and already reflected in yield. Equities remain buoyant relative to China and could be vulnerable. Do not see any upside for 10-Year Notes any time soon. Equities worth an allocation.
Japan (2015)	-5%	499,211	625,571	248%	A+	0.0%	18.4	0.6%	30.7	0.8%	Stagnant GDP, running trade deficits as of 2011, enormous demographic problem, significant household, financial and non-financial debt and end-game approaching for domestic savings absorbing low interest rate debt. SHORT the Yen (YCS - ProShares UltraShort Yen) and 10-Yr Notes. Healthiest economy in world. But equity valuation excessive and yield already reflects it.
Hong Kong (2015)	1%	2,397	2	0%	AAA	1.5%	40.8	2.7%	15.1	3.0%	Pretty solid economic profile, sluggish but steady growth, good balance sheet and cheap equities. Bonds fairly priced. Mini-US?
Taiwan (2015)	-2%	16,688	5,770	36%	AA-	1.1%	14.6	2.2%	6.6	0.0%	Economic star of of Asia - low debt burden, balanced budget, outstanding growth, and solid demographic trends. But President Duterte is a volatile, unpredictable and violent populist.
Philippines (2015)	0%	13,307	4,630	35%	BBB	5.1%	19.0	6.4%	3.0	1.4%	Strong balance sheet and fiscal surplus. Solid Q1 GDP of 2.6% but decelerating. Equities look cheap on PENG basis, but lack of catalyst may require patience. BUY (EWY) - iShares MSCI South Korea ETF, South Korean Won and 10-Year Notes (requires local broker). New Pres seeking better ties w North, cooler to US.
Korea (2015)	-2%	1,558,592	556,385	34%	AA	2.3%	12.6	2.9%	4.3	0.7%	

	Surplus/Deficit % of GDP	GDP (local currency)	Net Sov. Debt	Gross Debt/GDP	S&P Rating	10-Yr Yield	Market P/E	3-yr GDP Growth% (Constant Prices)	PEG	Inflation	Notes
Color code:			Awful	Weak	Good	Great					
Eastern Europe											
Finland (2015)	-3%	209	(106)	63%	AA+	0.5%	24.5	-0.4%	NA	-0.2%	Solid balance sheet and fiscal picture. High PE may have more to do w recession depressing earnings than high prices. Tough to invest in recovery.
Hungary (2015)	-2%	33,712	24,060	75%	BBB-	3.3%	10.7	2.8%	3.8	0.0%	Borderline investment grade, but decent balance sheet and modest deficits should keep rating agencies from downgrading. Equities cheap but no meaningful exposure in EM ETFs.
Czech Republic (2015)	0%	4,555	1,836	40%	AA-	0.8%	14.3	2.2%	6.5	0.3%	Solid balance sheet, budget neutral reflected in rates. Equities attractive but hard to find exposure.
Poland (2015)	-3%	1,790	290	51%	BBB+	3.4%	17.6	2.7%	6.5	-1.0%	Solid balance sheet, deficit spending a little high, and strong GDP (3.5% in Q1). EZ trouble starting to impact, inflation slightly high and central bank recently raised rates. Net of it all: equities look attractive BUY iShares MSCI Poland Investable Mkt Index (EPOL), despite slowing growth in GDP. Polish Zloty and Bonds attractive though need to buy locally.
Russia (2015)	-14%	59,750		0%	BB+	7.7%	7.1	-0.6%	NA	7.0%	Very attractive equities valuation, healthy balance sheet with balanced budget and solid yield. Heavy commodities exposure and significant governance concerns. Inflation remains high. Risk reward not adequate - looking for transparency and rule of law from Putin (but not expecting it).
Other											
New Zealand (2015)	0%	246	16	30%	AA	3.1%	16.6	2.6%	6.4	1.0%	Great balance sheet, relatively strong GDP growth (2.4% in Q1 2012) but fiscal deficits are a concern. Equities already reflect strong fundamentals. BUY NZ \$ and 10-Year Notes (local broker).
South Africa (2015)	-4%	4,013	1,790	39%	BBB-	8.8%	15.4	1.7%	9.1	5.5%	Yield looks fairly safe and attractive despite rating, though notable inflation. Relatively strong balance sheet. Sluggish GDP growth. But 20% of exports go to Europe. BUY equities via JALSH local index or iShares MSCI South Africa Index (EZA).
Australia (2015)	-7%	1,500	288	24%	AAA	2.7%	19.9	2.4%	8.3	1.7%	Solid yield supported by healthy balance sheet and manageable deficits. Equities look somewhat attractive as well. Housing bubble is a big worry. History of hyperinflation in 1990s to early 2000s, political and governance risk mitigate appeal of good balance sheet, modest deficits, attractive equity valuations and high debt yields. Other than investing locally, small number of diluted ways to play.
Turkey (2015)	-18%	1,480	462	39%	BB	10.3%	11.1	3.7%	3.0	7.7%	
Israel (2015)	-3%	1,164	709	64%	A+	2.2%	19.4	3.3%	5.9	-0.6%	Solid economic profile, high geopolitical risk, tough to find exposure.

Source: International Monetary Fund and other public sources.

International equities (20%) offer more interesting value opportunities than the US. We remain cautious about **China** because of chronic misallocation of capital and a poor balance sheet when shadow debt is appropriately included, corruption and lack of transparency. But current market levels, 7.6 PE and 1.0 price-earnings to growth ratio ("PEG") warrant 5%

exposure via iShares MSCI China (NYSEARCA:[MCHI](#)). See tables below - dark green shading suggests stronger macro and better investment potential, light green positive but less so, orange not attractive, and red borders are short-worthy - see notes for equity versus debt.

We also like **South Korea** via iShares MSCI Korea Capped (NYSEARCA:[EWY](#)), **Colombia** via Global X MSCI Colombia ETF (NYSEARCA:[GXG](#)) and **India** via iShares MSCI India (BATS:[INDA](#)), each with a 5% allocation. Despite strong economic fundamentals and attractive valuations, the **Philippines** carries significant risk given its volatile and controversial President Duterte and recent imposition of martial law. **Turkey** presents an attractive trend-and-value profile as well, but also bears substantial geopolitical risk.

Fixed Income (30%)

Allocate **15% to long-term US fixed income** using Vanguard Extended Duration Treasury ETF (NYSEARCA:[EDV](#)), but be opportunistic. Using US 10-year as a benchmark, if rates near 3%, add exposure up to 20%; if they fall to 1.5%, trim back to 10%. In addition to the enduring, structural deflationary headwinds created by the financial panic, long-term rates simply do not rise in the absence of robust production growth or inflation, both of which remain far below average.

Allocate **15% to emerging market bonds** as follows: 5% to SPDR® Bloomberg Barclays Emerging Markets Local Bond ETF (NYSEARCA:[EBND](#)), 10% to VanEck Vectors J.P. Morgan EM Local Currency Bond ETF (NYSEARCA:[EMLC](#)). Both of our suggested EM debt ETFs are local currency denominated. If you think there is more risk of a dollar retreat, a breakdown in the currency carry trade (selling low cost \$ to finance purchase of higher-yielding EM assets) will cause significantly more harm to these local currency funds. An alternative, US dollar denominated EM Bond fund is iShares J.P.Morgan USD Emerging Markets Bond (NYSEARCA:[EMB](#)).

It's a sign of the new normal that systematic risk is worryingly high, the third longest recovery in US history is also the weakest, and emerging market sovereign debt is part of the solution. But existing debt levels, fiscal trajectories and production growth are far better in places like **Mexico, Chile, Peru, Colombia, New Zealand, the Philippines and South Korea**.

Gold (10% to physical gold bullion)

Gold is an asset class unlike other commodities in that prices for the latter cycle around the replacement cost of the commodity itself, whereas gold has demonstrated for thousands of years that it is regarded as a store of value, a hedge against inflation. We continue to believe US inflation will remain a non-issue for the next several years. But gold is also a hedge against exogenous risk, showing no correlation to traditional asset classes and during periods of crisis or black swans, an actual inverse correlation. During the period that the S&P 500 experienced a 60%+ maximum drawdown between 1970 and 1983, gold increased 360% in real terms. During the tech bubble crash between 2000 and 2003, the S&P 500 dropped 50%, and gold rose 30%. During the financial crisis, when the S&P 500 dropped nearly 50% again from peak, gold rose 70% in real terms. Given the high levels of systematic risk we observe across financial markets,

we believe gold warrants a significant allocation, despite its high levels versus history. We recommend gold bullion out of concern for counter-party risk in the event of another financial crisis.

Alternatives (15%)

Allocate 15% to alternative asset classes. Investors with access to private fund vehicles managed by proven investors in repeatable strategies, including cash flowing distressed real estate, ultra-lower middle market private equity, venture capital outside of the coastal bubbles and carefully vetted hedge funds should consider a higher allocation than 15%. For those without that kind of access, we suggest 5% to Dreyfus Dynamic Total Return Fund (MUTF:[AVGRX](#)); 5% to IVA Worldwide Fund (MUTF:[IVWIX](#)); 5% to Wells Fargo Absolute Return - GMO as subadvisor (MUTF:[WARAX](#)). This asset class warrants a more detailed discussion given its short, and so far, controversial history.

Liquid alternatives became the rage following the financial crisis, during which certain strategies, usually in the structure of illiquid limited partnerships, delivered low and sometimes inverse correlations to a collapsing market in which more traditional asset class correlations spiked. **The rush to package "liquid alternatives" strategies in a mutual fund structure was breathtaking, and portended a likely correction.** As a proxy for total AUM in liquid alternatives, Morningstar reported "Managed ETFs" it tracked amounted to \$27 billion in Q3 2010, and reached \$103 billion by Q1 2014. We tracked several dozen open end mutual funds in the liquid alternatives space since 2012, and of the 27 on our list that remain active (10 were shut down), assets under management have dropped by over 35% in the last 3 years, from \$134 billion to \$86 billion. The average cumulative return across those 27 funds in the three years has been -4%, while the S&P 500 Index has been up 26%. Managed ETF funds tracked by Morningstar dropped from the \$103 billion high to a low of \$76 billion in early 2016, but are on the rise again into 2017.

Some of the more spectacular drops in liquid alts fund AUM in the last three years include Marketfield Fund (MUTF:[MFLDX](#)), down \$20 billion in AUM to \$500 million; Absolute Strategies Fund (MUTF:[ASFIX](#)), which has gone from around \$5 billion in AUM to \$500 million (decline has been over more than three years); F-Squared, which went from sub-advising on around \$25 billion in AUM into bankruptcy (based on damaging investigation); Good Harbor (MUTF:[GHUIX](#)), which went from over \$1.5 billion to less than \$100 million; and Ivy Asset Strategies, which went from over \$28 billion to less than \$4.5 billion. We are neither recommending nor criticizing any of these products. Instead, we cite them to illustrate that theoretically sound strategies can significantly underperform for protracted periods.

Investors should be mindful that strategies built for non-correlation and risk mitigation drag on returns during buoyant markets and the expected payout occurs during "black swan" maximum-drawdown periods. Any liquid alt showing high market upside capture and correlation is either cheating or relying on a risk on/risk off algorithm that ignores fundamental valuation. Assets have exited the asset class as returns disappointed in the zero-bound interest rate policy market run, and the accompanying, historically low downside volatility.

For investors contemplating the plunge into a less liquid hedge fund, be selective. The HFRI Equity Hedge Index, a proxy for hedge fund performance, shows hedge funds have been lagging passive exposure to the S&P 500 on a 5-year and 10-year basis (the former has underperformed the latter by 5.2% per annum and 0.6% over last 5 and 10 years, respectively, but still has an outperformance edge over the last 15 years of 2.2%). Increasingly crowded trades have driven broad underperformance, as hedge fund assets increased 9X from 2000 to 2010, from \$119 billion to \$1.7 trillion, and are currently over \$3 trillion, according to Barclays (NYSE:[BCS](#)). Assets under management have not actually declined with hedge fund underperformance of putatively safer and certainly less expensive passive investment vehicles, but the 20% annual growth rate has meaningfully slowed to "just" 10% in the last five years.

The growth rate in assets in the private equity and venture capital spaces have been similarly robust, and an argument can be made for coastal bubbles in the latter.

The alts funds we recommend come with a warning that returns may continue lagging if broader public equities markets keep rising and correlations remain high, under the persistent low-interest rate scenario we expect. **But we continue to fear a Minsky moment in which high systematic risk manifests in actual, substantial asset price declines, triggered by a relatively small catalyst.** The low downside volatility represents risk apathy and masks growing financial instability. Any negative surprise could trigger the correction, despite the support of low rates. There were 40%+ annual drops in equities markets during each of the sub-3% long-term rate periods following the Japanese 1989 and US 1929 financial panics, and the 1873 railroad crisis in the US was followed by -0.8% compounded returns despite sub-3% yields.

Conclusion

Lessons dearly learned in the last two ~50% stock market declines, during which correlations between and among historically independent asset classes spiked toward 1.0, fade in the euphoria of protracted upward market movement and historically low downside volatility. The signature error giving market timing its bad historical name is staying with the herd when asset values reach historically extreme highs and lows - when a legitimate narrative has an illegitimate and unsustainable impact on prices. Positioning one's portfolio today to reflect the high-and-rising systematic risk of US equities is sensible, provided the investor does not panic and jump back in if another 10% upside is missed.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.