Many of you are avid readers of Thoughts From The Frontline and Outside the Box, weekly newsletters written and compiled by John Mauldin, featuring his own thoughts and material collected through his extensive network.

**Between these newsletters and several books, he has provided great insight into today’s markets and economic events, and we are proud to be Mauldin’s exclusive Canadian partner.**

For the past 10 years, John and his colleagues have put on the annual Strategic Investment Conference (SIC). The lineup of speakers is always impressive and this year was no exception.

**Watch a clip of highlights from the 2012 SIC.**

I have attended five of these conferences and this year’s was perhaps the best.

First, the speakers were impressive (more on that below) and they took on some very interesting and very tough questions. They did not always agree, but I would say there some areas of common understanding.

Here are some of the issues they addressed:

- **What are their favourite asset classes and which ones are they trying to avoid or hedge?**
- **Where are interest rates headed and when?**
- **Will the Euro survive?**
- **Should we invest for inflation or deflation?**
• Will the U.S. dollar get stronger or weaker in the future?
• With so many countries using their central banks to effectively print money, why are we not seeing inflation and why is gold falling in price?

This article will try and encapsulate the presentations we heard over two days and what, if any changes this makes to our asset allocation models and overall investment strategy; my apologies if this runs a little long.

Who Was Talking

I’ll keep my comments short here, you can click on each name for their full bio on the SIC website.

• **Niall Ferguson.** Well known author and Harvard professor from Britain. Perhaps best known for writing “The Ascent of Money.”
• **Dr. Nouriel Roubini.** Often referred to as “Dr. Doom.”
• **Dr. Gary Shilling.** Economist and money manager who predicted in 1981 that interest rates would drop and that long-term treasury bonds (30 years) would be a great investment. He was right on that and still thinks that they make sense even though they only pay 2.7% interest today.
• **Mohammed El-Erian.** CEO and Co-CIO of the world’s largest fixed income manager, PIMCO; they manage $2-trillion.
• **David Rosenberg.** Chief economist at Gluskin Sheff and formerly with Merrill Lynch. Accurately called the U.S. housing bubble in 2007.
• **Charles Gave.** Founder and principal of GaveKal asset management.
• **John Mauldin,** of course. First coined the phrase “Muddle Through Economy.”
• **And several others** who were alternative strategy asset managers with their own thoughts about how to best create returns in a volatile and uncertain world.

What They Had To Say

We start with **Niall Ferguson,** Harvard professor and author of the upcoming book, **The Great Degeneration.**

Ferguson feels there are four main reasons why the U.S. is in a period of relative decline or, at best, sub-par growth.

1. **A breakdown of the implied contract between generations.** Historically, older people made sacrifices for younger people. Now, however, he feels that the younger
generation is being impoverished at the expense of those older. One statistic he quoted was that 22.5% of U.S. children live in poverty, compared to only 9.5% of seniors; yet far more tax dollars go into health care and social security for the elderly than go into programs for the young.

2. **The U.S. has gone from the rule of law to the rule of lawyers.** Tort costs alone are more than 2% of GDP in the U.S. (more than $300-billion).

3. **Excessive regulation (not just in America, though).** One example is the U.S. tax code, which runs to nine million words, or Dodd-Frank (the Wall Street Reform and Consumer Protection Act), which is more than 2,000 pages – The U.S. Constitution is 80 pages long. This makes it constantly more difficult to start or run a business.

4. **The decline of a civil society.** Americans have reduced their voluntary involvement in everything from religion to organizations such as Rotary or the Girl Guides.

In order to support his thesis, he pointed to four areas of the U.S. that are, in fact, growing well and have an improved structure that minimizes the impact of the four reasons above. One of those areas happens to be the Gulf Coast running from Texas to Florida (an area where we hold a number of our U.S. real estate assets).

Ferguson says that one advantage the U.S. has is how easy it is for people to move from a high regulation state such as Illinois to a low one such as Texas, and the result can be seen in better financial outcomes and improved demographics.

In the end, he feels strongly that we have a collective responsibility to leave a better legacy than we found. The book should be a good read.

He did manage to get himself into trouble when he said he was not a Keynesian, because Keynes wanted to burden future generations to make the economy better now (more borrowing) and this was because he was gay and had no children to leave a legacy to. Needless to say the press brutalized him on those comments.

The next major speaker was **Nouriel Roubini, OTHERWISE KNOWN AS DR. DOOM.**

He correctly predicted the housing crash and financial crisis of 2008, and has been relatively bleak about most asset classes ever since.

He started by saying that we have been in a bull market since the summer of 2012 for four reasons:

- **There is less concern about Europe.**
- **Reduced fiscal risk in the U.S.**
• China’s potential hard landing has been averted so far.
• Israel / Iran tensions have been tempered somewhat.

His other comments and observations include the following:

Japan has had four recessions in three years, the UK has had three, and Europe is in a double dip recession now.

He feels the BRIC countries (Brazil, Russia, India, and China) will be challenged for growth as deleveraging continues globally.

Quantitative Easing (QE) is being used around the world to debase currencies so that countries can increase exports. However, it is globally a zero sum game. If everyone does it, then it has no net effect.

The Euro’s recession is moving from the periphery to the centre and there are currently seven countries with structural problems. Those periphery countries need a Euro at par with the dollar to compete. If Spain and Italy have to restructure, then he sees this as the end of the Euro.

In the U.S., he sees QE lasting with 0% interest rates until the end of 2014, and starting in 2015 rates start to rise for at least two years (does not say by how much).

With respect to emerging markets, he likes the Philippines, Malaysia, Indonesia, Chile, Peru, Colombia and Turkey more than the BRICs combined, and sees China’s growth dropping to 6% by the end of 2014.

He also feels that war risks are still there, because Iran will be able to weaponize its nuclear material within 12 months.

Finally even though Japan is now going through the biggest relative QE in history and has far more debt per capita than America or Europe, he believes they will eventually restructure their economy and create some inflation, which has not been possible for the last twenty years.

Japan’s currency has dropped by 20% against the U.S. dollar, but the economy that would be hurt the most by a cheaper yen is Germany.

**Gary Shilling** is an economist and asset manager in the U.S. who has correctly called interest rate moves for about 30 years.

He still feels that U.S. 30-year bonds, which are currently at 2.7% will continue to drop to 2% before they bottom out.

His reasons include:

• Continued personal and corporate deleveraging.
• Increased personal savings rates, which bottomed at 1% in 2007 and are now at 2.6% (on their way to double digit
rates within five years). When people save more they spend less and that drags down the economy and is also somewhat deflationary.

- He expects the new level of GDP growth for the U.S. to be in the 2% range going forward.
- His portfolio recommendations include U.S. long-term bonds, the U.S. dollar vs. the yen, dividend-paying stocks, health care providers and medical buildings, and North American energy producers.
- He is negative on selected commodities, housing, junk bonds, consumer lenders, and developing countries’ stocks and bonds.

Mohammed El-Erian is the CEO of PIMCO, the world’s largest fixed income manager and, overall, is responsible for $2-trillion in assets.

Right now he feels there is a disconnect between the real economy (underperforming) and the markets (doing fairly well). He coined the phrase the “New Normal” in 2009, referring to a future lower level of growth for the developed world as we go forward.

Japan and Europe are completely stuck with almost zero growth and the U.S. does not have enough growth to create escape velocity that would allow it to deal with its deficits; therefore, emerging markets are where the investment focus should be.

He used a visual of a driver going down a road that will end and lead to a T-junction. Then the car can no longer follow the path it was on: it must turn, and, of course, the new destinations are in the opposite direction.

In Europe, he believes that either the Euro will have to be used by a much smaller group of countries, or a political solution has to be reached which effectively ensures that all countries guarantee each other’s debts (as is the case in the U.S. with all citizens of all states backstopping each other).

In terms of investment themes, he feels that central banks will keep rates low for a long time, so as a fixed income investor they are looking for markets where rates are not tied to what the Fed does (such as private lending to business). He also sees opportunities in emerging market debt. Overall, they are reducing risk and increasing liquidity in their portfolios.

He does not think Japan’s devaluation will work, because Germany and Korea, for starters, will not allow themselves to be priced out of markets where they compete with Japan.

After El-Erian spoke, he was on a panel with Roubini, Shilling and Ferguson – definitely a brain trust. In bullet point form here are the key takeaways:

- **Roubini:** Greece will eventually leave the Euro; in fact, there are four tail risks, including a complete Euro split, the Iran/Israel conflict, U.S. fiscal issues, and a hard landing in China.
- **El-Erian:** Slower overall growth will drag commodity prices and commodity currencies (Canadian and Australian dollar).
• Shilling: As stated, U.S. long-term rates continue to drop while currency appreciates.

• Ferguson: Fiscal policy is at odds with monetary policy; reduced government spending will negate the impact of the Fed monetizing debt.

On Friday we heard from David Rosenberg who is chief economist for Gluskin Sheff in Toronto and who also has a reputation as a “perma-bear.”

He has been a deflationist for many years and missed a good part of the bull market from 2009 to today, but now is more concerned with future inflation and higher interest rates.

While this recovery since 2008 has been well below others, he feels that fairly soon there will be pressure to increase wages relative to corporate earnings and inflation will follow. He expects that the Fed in the U.S. will get its goals of 6.5% unemployment and 2.5% inflation in early 2014 and if that happens, then rates will start to rise.

Yet with equities he is still fairly bearish and compares the S&P 500 to a Potemkin village (not much substance behind it).

He is the opposite of El-Erian and Roubini. He sees real estate and commodities doing well, including commodity currencies (so he’s bullish on the Canadian dollar). He does not like high yield bonds or long duration government bonds.

The next speaker was Charles Gave, who founded the investment firm Gavekal based in Hong Kong.

His major theme was that the U.S. dollar is undervalued and that a combination of re-shoring of manufacturing to the U.S. (lower energy costs and rising foreign labour costs) along with the impact of shale gas and oil on U.S. energy dependency will cut that trade deficit by more than 50% over the next few years. (Read our own newsletter on this, GAME CHANGER, written March 21, 2013.)

He is quite bullish on equities overall and has no concerns about inflation. The trade competition going on now will continue. Japan had its currency rise about 45% from 2008 to 2012, which benefited German and Korean exporters and the cost of Japan. Now Japan is trying to reverse that trend by devaluing and exporting cheaper goods. Overall this tends to be deflationary.

Summary

In my estimation, the following were the key takeaways from the conference; one in which the speakers took opposing positions.

• Central Bank involvement in active monetary policy lasts for a few years more and likely means lower-than-normal interest rates for quite a while.

• U.S. dollar rises on a trade-weighted basis.
• The Euro will struggle to survive. Political union will be a tough sell in Europe.
• Better growth and opportunities in emerging markets.
• The Yen will remain relatively cheap against other currencies.
• Overall concern regarding quality issues with high yield bonds and relative spreads over
government debt.
• Renminbi (the official name for China’s currency) becomes one of the world’s future reserve
currencies, but might not diminish the Dollar; it might reduce the use of the Euro or Pound.
• Virtual split opinion on the issue of commodity prices, which has a material impact on the
Canadian dollar.
• Overall, deleveraging continues and that tends to be more deflationary than inflationary.

Impact on our asset allocation model and overall investment strategy

We were not surprised by the observations of the main speakers at this conference and I’d say we’re
inclined to agree with the summary above. While they do not suggest large changes in any of our
clients’ portfolios, we are making the following recommendations.

• **Increased exposure in fixed income, real estate and equities in both the U.S. and globally.** Most investors have too high a concentration in Canadian-dollar-based assets. Over the last decade or so, those assets have outperformed most global and U.S. asset classes. However, over much longer periods of time, returns have been similar. Therefore, it would be reasonable to expect some mean reversion in returns over the next decade.
• **We will continue to look for private debt options** (such as commercial mortgages) to enhance yields on fixed income over what is available via corporate bonds without a material increase in risk.
• **We will be looking to reduce overall credit risk on high yield bonds** as a defensive approach to this sector.
• **Continued use of covered calls and puts** on a large portion of our equity positions.
• **Continue to acquire strong real estate assets** with a particular focus on U.S. commercial and multi-family properties.