Consilience
Asset Management

July 01, 2023

Consilience Market Notes:

Who's Going to Buy Our Dollar-Denominated Debt?

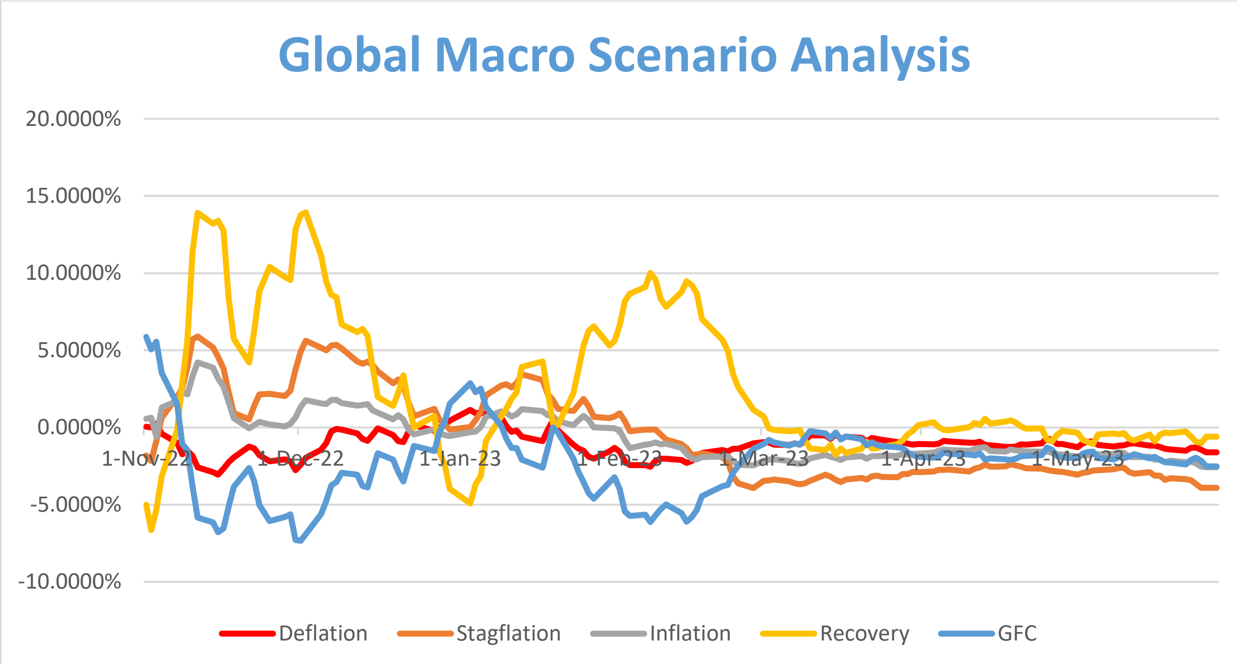
First, an update:

Last year, we at *Consilience Asset Management* added a Macro-Economic component to our *Relative Capital Flow Model**. Using market action, through a process of reverse engineering, we seek to identify which macro-economic climate is being represented in the market at any given time.

This is an important addition to our discipline as central banks across the globe are attempting to unwind decades of monetary expansion. As this unwinding occurs, it could have significant ramifications for the financial market. Thus, there is an increased need to monitor this process and the corresponding macro-economic result.

Below are the ratings of **securities in the five scenarios** that we are monitoring:

Inflation – **Negative,**
Deflation – **Negative,**
Stagflation – **Negative,**
Recovery – **Neutral,**
Financial Crisis – **Negative.**



Source: *Consilience Asset Management*

The above scenarios reflect the current *Capital Flow** composite rating of the securities that have historically generated positive returns in the above economic environments.

In addition, our *Global Macro Indicators** are as follows for the seven asset classes we invest in for our clients:

Global Equities – **Neutral,**
Global Bonds – **Negative,**
Commodities – **Neutral,**
Gold – **Neutral,**
U.S. Dollar – **Neutral,**
Real Estate – **Neutral,**
Cryptocurrencies – **Neutral.**

Now, to this month's report:

The markets can remain irrational longer than you can remain solvent.

- John Maynard Keynes

The mantra from Wall Street is.

The banking crisis is solved….

The debt crisis is solved…

Inflation is under control…

Stocks are fairly valued…

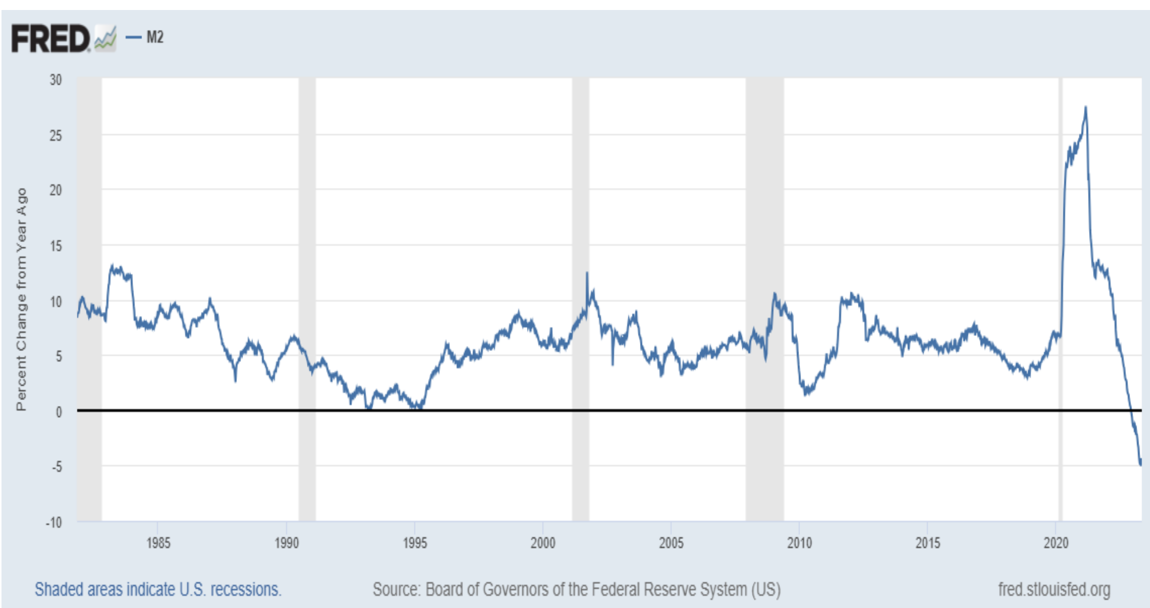
Stocks are in a new Bull Market…

My response… Not so fast.

Following a dramatic rise in interest rates and reduced liquidity from the Federal Reserve in 2022, this, after a brief pause, the Fed appears to be prepared to raise rates further and once again reduce liquidity to the banking system for the remainder of this year according to BofA Global Research.

Based on the machinations of the "fractional reserve banking system," the "brief pause" during the regional bank crisis should have resulted in an increase in money supply growth. But as shown below, it did not.

In fact, with negative growth now falling near or below -5% for the second month in a row, money supply contraction is the largest in modern history.



Needless to say, this type of liquidity event can have a significant impact on the financial markets.

Note, in the following chart, in spite of the decline in the money supply, liquidity actually improved since the end of 2022. And as shown, the equity market responded in kind.

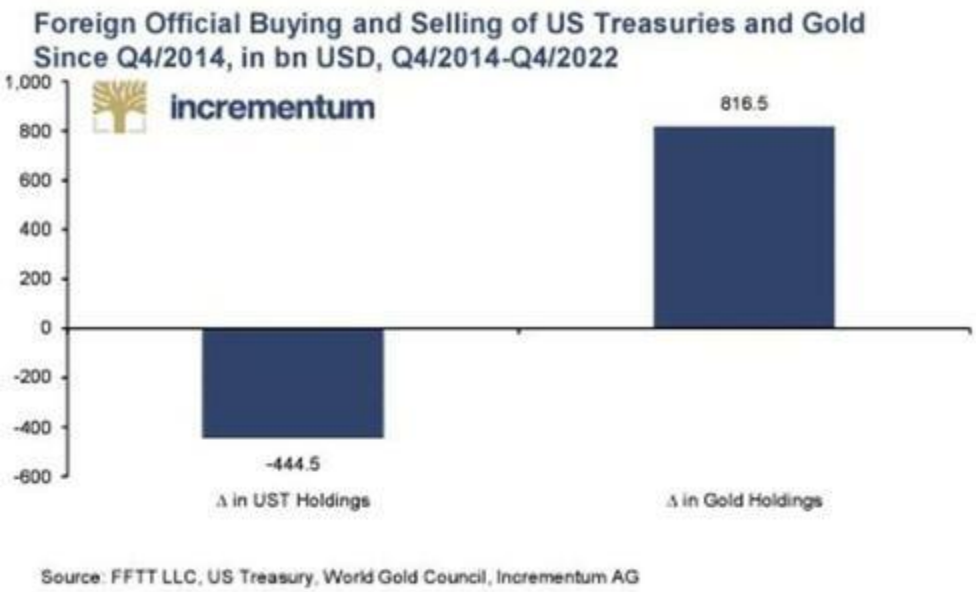
But, if liquidity quickly drops back to below where it was five months ago, one could expect an equity market reversal as well.

The bigger question is, if the Fed increased liquidity, yet money supply declined, where did the money go?

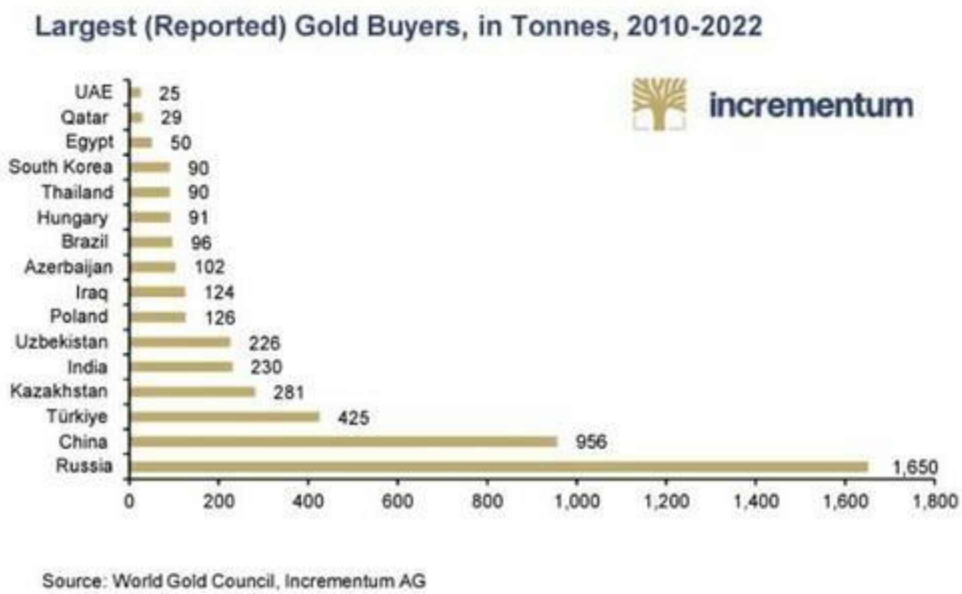
One theory is the Fed is buying our own maturing debt. If the Fed creates liquidity and buys a maturing Treasury Bond, it makes sense that there would be no increase in the money supply.

But why would the Fed do this? Because foreign central banks, who we have relied on to buy our debt, are no longer net buyers.

Rather, these central banks are making historically unprecedented amounts of purchases of gold instead of U.S. Treasuries.



And who are these buyers of gold?



Notice that China is number 2 on the list. Previously they have been the second largest buyer of US Treasuries behind Japan as the number one, and now they are the second largest buyer of gold.

This could be a problem. According to an analysis by Goldman Sachs, the US Treasury may have to sell $700 billion in T-bills within the next six to eight weeks just to replenish cash reserves spent down while the government was up against its borrowing limit.

Goldman also estimates, on a net basis, the Treasury will likely have to sell more than $1 trillion in bonds this year.

Who is going to buy all of those bonds?

If there are not enough foreign buyers of this debt, the Federal Reserve would be forced to monetize some of this debt… (print money to buy our own debt!)

That means a return to quantitative easing.

In order to prop up the bond market and keep prices higher than they otherwise would be (and interest rates lower), the Fed would ultimately have to buy additional bonds to boost demand. It will buy those Treasuries with money created out of thin air.

And that my friend is inflation.

But this may be a symptom of a much bigger problem.

According to the May 24, 2023, *In Gold We Trust Report* by Incrementum AG, the so-called "BRICS" countries (Brazil, Russia, India, China, and South Africa) will announce the creation of a new currency at its annual leaders' summit conference on August 22–24 of this year.

If this occurs, this could be the biggest upheaval in international finance since 1971 when the US went off the gold standard.

Is the world (the US in particular) prepared for such a geopolitical shock wave?

It appears likely that a new "BRICS" currency would be linked to a weight of gold. This plays to the strengths of BRICS members Russia and China. As shown above, these countries are the two largest gold producers in the world.

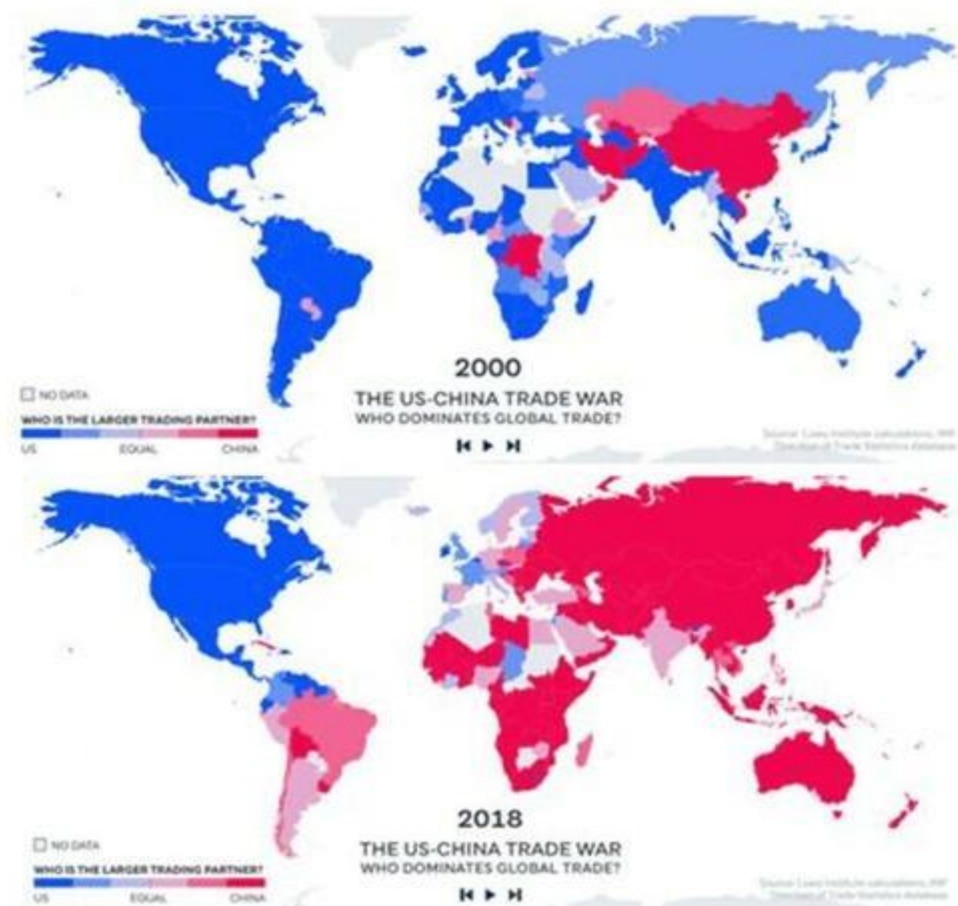
Again, according to above referenced Incrementum Report, officials of the annual BRICS summit have hinted that they will focus on the creation of a new currency that could rival the U.S. dollar or euro, effectively bolstering their global de-dollarization campaign.

If this were to occur, the market implications could roil exchange rates and capital markets for years to come. In such a scenario the dollar would lose value due to inflation resulting from the lower value. It will take more unbacked paper dollars to buy goods and services relative to a gold backed currency.

As shown below, there is strong evidence that the world is steadily looking outside the USD for global transactions.

In fact, as shown below, throughout Q1, global central banks have been engaging in record-breaking levels of Chinese Yuan (CNY) currency transactions vs. US dollar transactions.

To date, more nations are using the yuan for energy and real asset deals.



Source: Visual Capitalist

See the trend?

So far, the US has successfully "bought time," holding the system together with proverbial duct tape and paperclips. But eventually, time will run out. To quote Ayn Rand, "You can ignore reality, but you can't ignore the consequences of ignoring reality."

In light of this, what should an investor do?

My advice is to pay close attention to our *capital flow* indicators as summarized at the beginning of this report and described below, and as they change, so should the asset allocation of your portfolio.

In our seven asset classes listed, there are both inflation and deflation sensitive options. It is my belief that it would be prudent for investors to allocate a portion of their assets outside the traditional markets of stocks and bonds and into alternative asset classes. Some of these are included in our seven assets listed on page 1 of this report.

It is important to note that alternative investments can result in increased portfolio volatility and as with traditional investments like stocks and bonds, are not guaranteed and can decline in value.

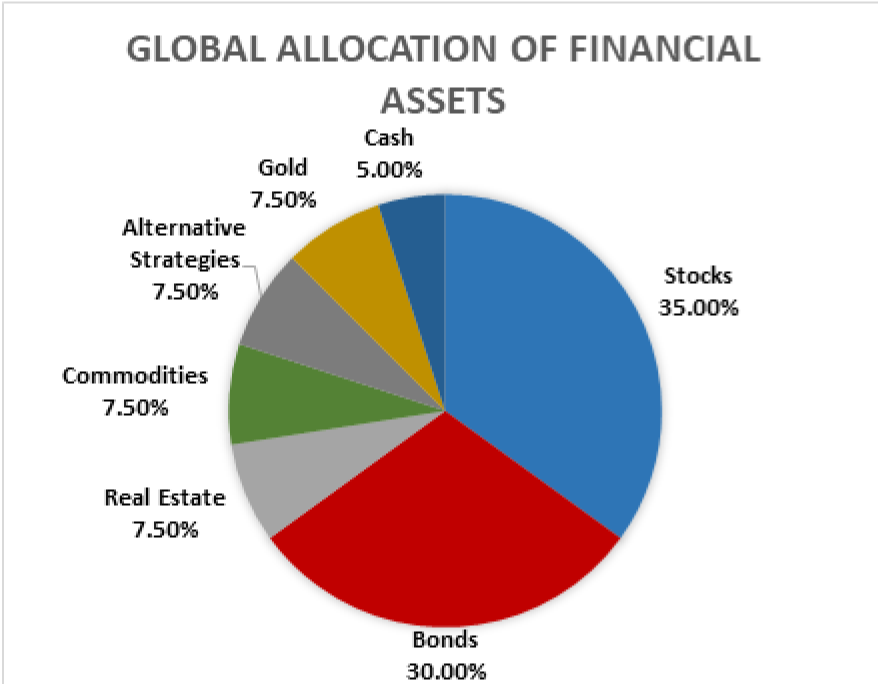
Conclusion: Recognizing that we are in uncharted waters with multiple moving parts, we must admit that there is no way to tell in advance exactly how this will unfold. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of information from multiple sources, applying that information to imagine a plausible world different from today's, understanding how new data points fit (or don't fit) into that world and adjusting accordingly.

Although this will be no easy feat, our answer at *Consilience Asset Management* is to employ a discipline that we believe has the ability to circumvent the effects of these uncertainties and disparities between the above noted risks and actual market action. Ultimately, it will be the forces of supply and demand that will drive prices of financial assets higher or lower, regardless of the fundamental, geopolitical or economic circumstances.

The cornerstone of our process is our *Global Macro Capital Flow Model*.

In this model, we monitor the movement of capital among the approximately $250 trillion of tradable global financial assets. Here, market trends can be identified regardless of their driver; debt, geopolitical, economic, or other…

Below is a picture of the distribution of the world's liquid investment assets as a percent of the $250 trillion total…



Source: BIS, Thompson Reuters, World Bank, World Gold Council, Financial Analysts Journal, (January 2019).

(The performance quoted herein represents past performance. Past performance does not guarantee future results)

By measuring the capital flows of each of these categories relative to the total, both favorable and unfavorable investment trends are identified.

At Consilience Asset Management, we employ this process in deploying client assets.

A more complete description of our model and process can be found on our website: www.consilienceassetmanagement.com under the tab "Our Process."

Based on this, the ratings for each of the eight asset classes that we monitor are included each month at the beginning of this report.

We are entering a new phase, as the decade-long bull markets for stocks appear to be winding down. We are cognizant of the new challenges inherent due to the structural changes noted in this report, as they will have a huge impact on the current supply/demand dynamics in the global marketplace.

As such, we realize that these are clearly challenging and unprecedented times and therefore it is important for the astute investor to be nimble and pay close attention!

Consilience Asset Management
Roger Faulring – Managing Partner/Sr. Portfolio Manager/Investment Strategist
Michelle Malone – President/Investment Advisor
Donna Stone – Managing Partner/Investment Advisor

*Our Global Macro Tactical Strategy seeks to identify favorable investment opportunities among seven primary asset classes. Capital is rotated to the specific markets in an effort to control risk by underweighting or eliminating exposure to markets that exhibit elevated risk.

*Our Relative Capital Flow Model is the cornerstone of our tactical allocation decisions and is augmented by our Behavior, Economic, Monetary and Stability indicators.

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