April 11, 2016

Consilience Market Notes:

Disturbing The Global Financial Ecosystem

First, an update: Our *Global Macro Indicators* remained **neutral** last week for U.S. equities. *

Now to this week's report: An ecosystem is a community of plants, animals and other living organisms that share the benefits of a particular space or environment such as air, food, water and soil.

In an ecosystem, each organism has its role and purpose. Disturbing the balance of an ecosystem can be disastrous for all the living things relying on it.

It's no different in our financial market community where every investor interacts with other investors based on historic fundamental relationships that have been embedded in market price movements for centuries.

In a biological ecosystem, if we introduce external factors such as too much carbon dioxide or methane, it destroys the balance of the ecosystem which in turn affects those who live in it.

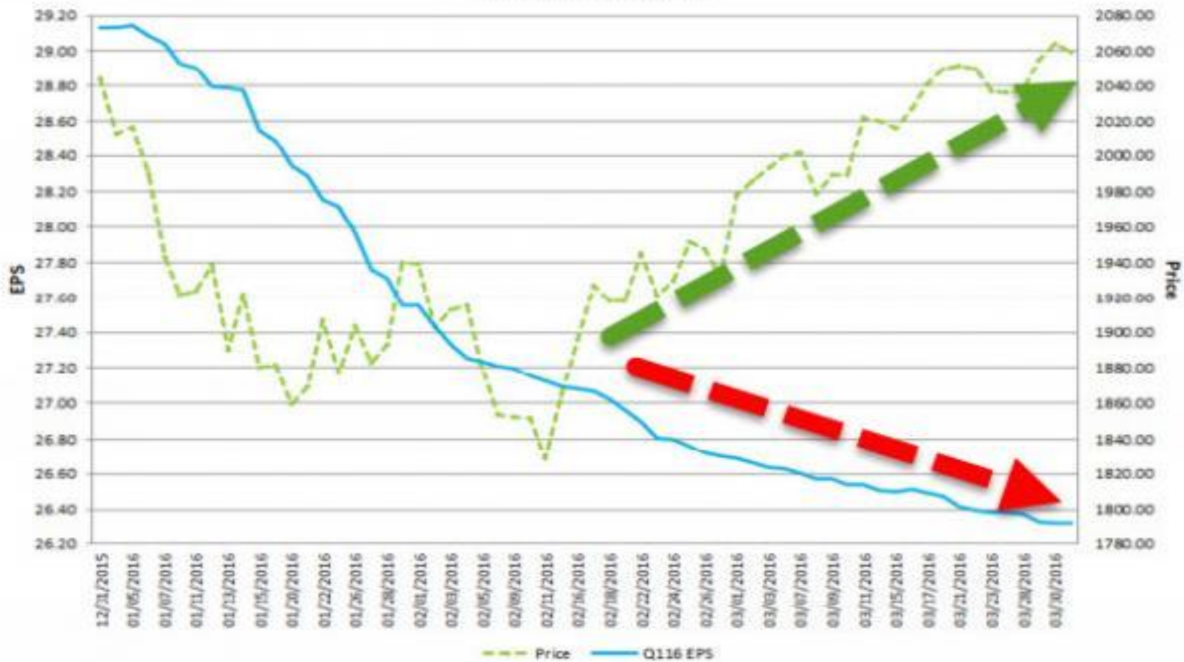
So too, disturbing the balance of our global financial system can be disastrous, not only to the markets and investors but to the global economy!

Have Central Banks introduced "external factors" into the financial ecosystem? Are these disturbing its balance?

In the following chart we can see that "external factors" are being introduced/injected into the financial ecosystem on a regular basis!

As a result, investors are no longer investors, they have even been described as *helpless rats running around the lunatic central planning maze desperately attempting to survive by front running the latest round of central bank purchases*.

The recent stock market bounce occurred as S&P 500 earnings expectations plunged 9.6%... evidence that price action has completely disconnected from reality.



And all it took was **talk** of coordinated easing from most of the world's largest central banks...

As insane as it may be, investors now acknowledge that fundamental analysis is merely an **afterthought** when compared to the far bigger influence of central bank buying.

While this destroys free markets, fuels malinvestment bubbles and rewards cronyism, it doesn't stop central planners — it merely emboldens them.

The latest example of such hubris was on full display last month when the European Central Bank announced a plan to purchase corporate bonds in addition to government bonds in a further effort to stimulate their economy.

Interestingly, when the Federal Reserve first announced the concept of Quantitative Easing (QE)… or one of many external injections into the financial ecosystem… many assumed, based on natural, un-obstructed historical relationships that printing money to buy bonds would be immediately devastating for the currency in question.

Yet, they printed, and the dollar rallied! So I guess if Central Banks can artificially uncouple stock prices from earnings, they can print money without its corresponding devaluation!

So, will further QE weaken a nation's currency or strengthen it? It's an important question to ask in this increasingly twisted world of global finance. As has been demonstrated, it can actually strengthen a currency, **at least in the short run.**

As the former head of the Federal Reserve Dallas branch, Richard Fisher admitted in an interview with CNBC, the U.S. central bank in particular has made its business the manipulation of the stock [and bond and currency] markets…

But wait…how do the world's Central Bankers think they will ever get away with it? Especially when they have accomplished all of their schemes with increased money printing funded by more debt?

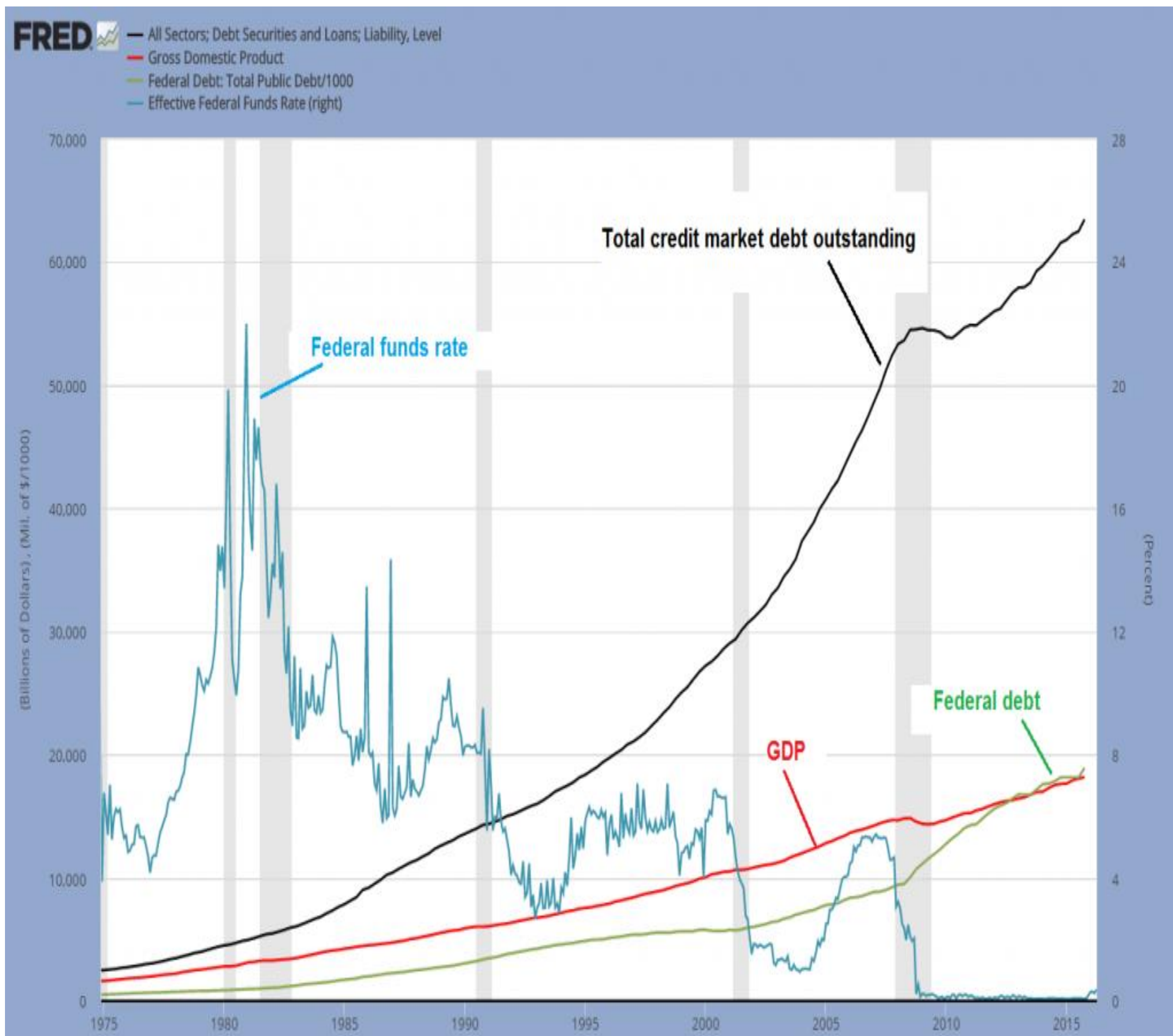
How can they believe – even for a minute – that a debt problem can be solved by adding more debt? Well, maybe because they have gotten away with it before.

After World War II, for example, the debt-to-GDP ratio among industrialized nations was higher than today. But after the war, the economy boomed and the debt was reduced.

Again, at the beginning of President's Reagan's first term, economists worried about large government deficits. But once again, a spurt of growth with low deficits during the 1990's reduced the debt to a more manageable level.

So, why worry?

Because this time growth is slowing, productivity has stalled and total U.S. debt is 350% of GDP… and global debt now exceeds $200 trillion!



Total US credit market debt (black line), federal government debt (green line), GDP (red line) and the federal funds rate (light-blue line).

So what's an investor to do? How can one manage money with such outright market manipulation?

As we've said in our closing words each week: These are clearly challenging and unprecedented times and therefore it is important for the astute investor to be nimble and pay close attention!

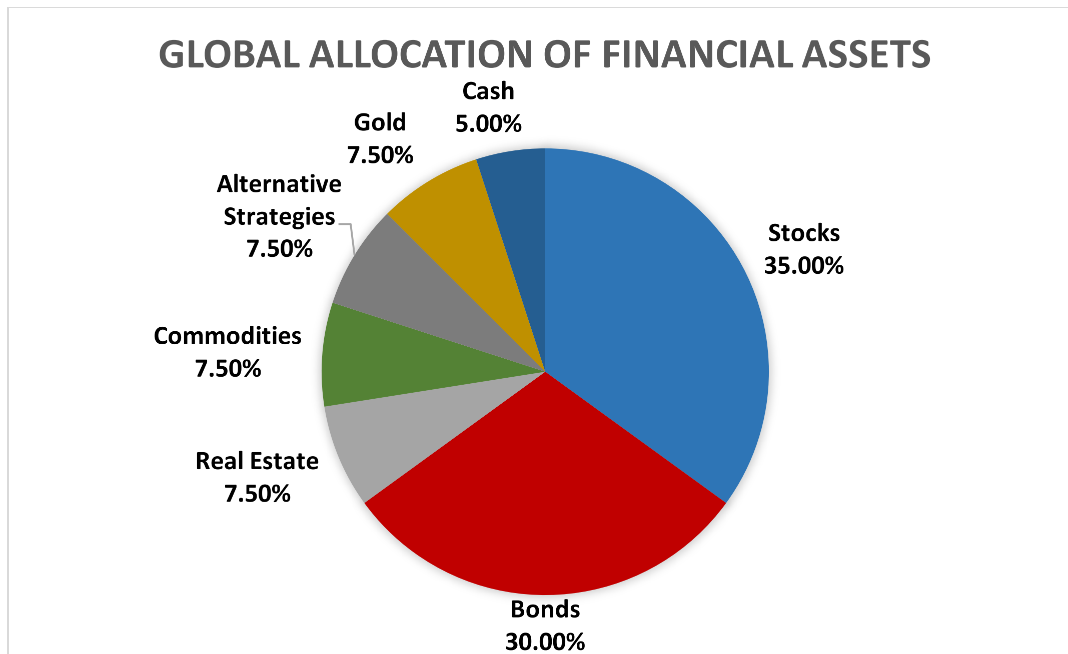
And although we are not calling for an end to the current bull markets for stocks and bonds, we are cognizant of the inconsistencies and irrationalities of their current levels relative to their underlying fundamental values.

As such we employ an investment discipline that circumvents the effects of Central Bank market manipulations and resulting distortions. The cornerstone of our process is our *Global Macro Capital Flow Model.*

In this model, we monitor the movement of capital among the approximately $200 trillion of tradable global financial assets. Based on supply and demand, markets trends can be identified regardless of their driver.

Thus even artificial sources of incremental buying or selling will be identified and thus provide evidence of investment opportunities.

Below is a picture of the distribution of the world's liquid investment assets as a percent of the $200 trillion total…



Source: BIS, Thompson Reuters, World Bank, World Gold Council, Financial Analysts Journal, (January 2014).

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

At *Consilience Asset Management* we employ this process to deploy client assets where such investment capital flows are favorable. As part of our risk management process, when capital flow trends reverse, asset classes to avoid are identified.

Our goal is to employ all of the tools at our disposal to manage client assets through these volatile times.

Consilience Asset Management

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*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.