April 18, 2016

Consilience Market Notes:

A Counterintuitive Bull Market

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

Now to this week's report:

The notion that QE has distorted the integrity of market prices is kinda right, but is kinda right in a benevolent manner because without the decision to introduce QE, we would have had another Great Depression. – Hugh Hendry, CEO, Eclectica Asset Management

So QE took away the very real risk of a depression… thus through this lens, it makes sense that equities are worth more today…

But at what cost?

The policy of money printing and artificially low interest rates has promoted further increases in credit debt.

What happens when the market finally sees that through this massive global experiment that every asset purchased with debt has become overvalued?

And what if in removing the throttling controls we find that the deflationary forces are still the dominant force and are overpowering the central banks unprecedented efforts to create inflation?

Will this necessitate a policy of further increasing and debasing the money and credit supply?

Yes! Seven years after the Global Financial Crisis the central banks have decided to "up the ante" and invent even greater and more ingenious approaches to monetary stimulation… i.e., **more debt!**

Historically, this approach of massive over-indebtedness has always resulted in hyperinflation… not the deflationary black hole that policy makers now fear.

This is, unless this newly created debt leads to higher productivity which in turn leads to higher corporate profits, rising incomes and expanding GDP's.

This does not appear to be happening. Instead, these aggressive central bank monetary policies have created artificial demand for corporate debt which companies are exploiting by issuing debt they do not actually need.

Last year **business debt**, excluding off balance sheet liabilities, rose $793 billion, while total gross private domestic investment rose only $93 billion.

Thus, by inference this debt increase went into share buybacks, dividend increases and other financial endeavors, while at the same time corporate cash flow declined.

Such a usage of debt does not support economic growth, employment, higher paying jobs or productivity growth.

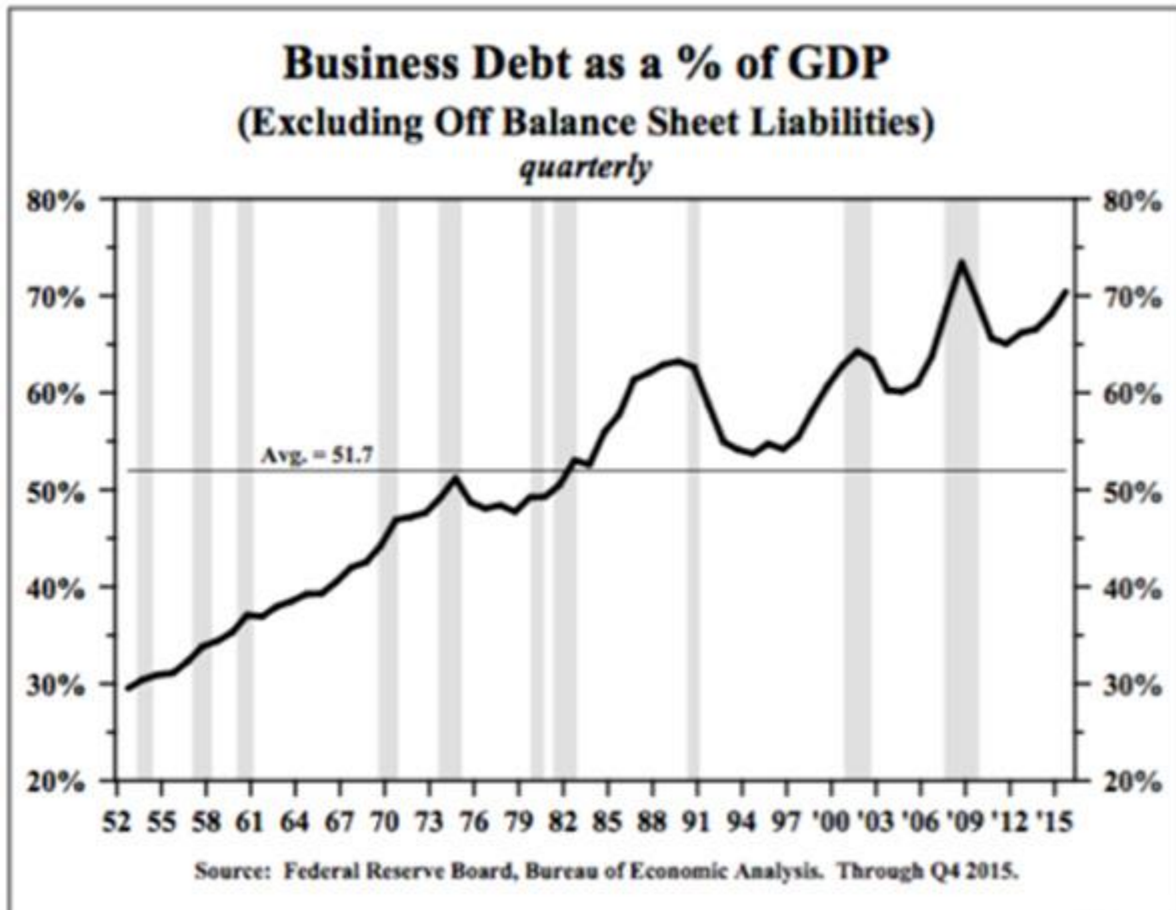


Chart 2

In 2015 the ratio of business debt-to-GDP advanced to 70.4%, far above the historical average of 51.7%. Only once in the past 63 years has this ratio been higher than in 2015. That year was 2008.

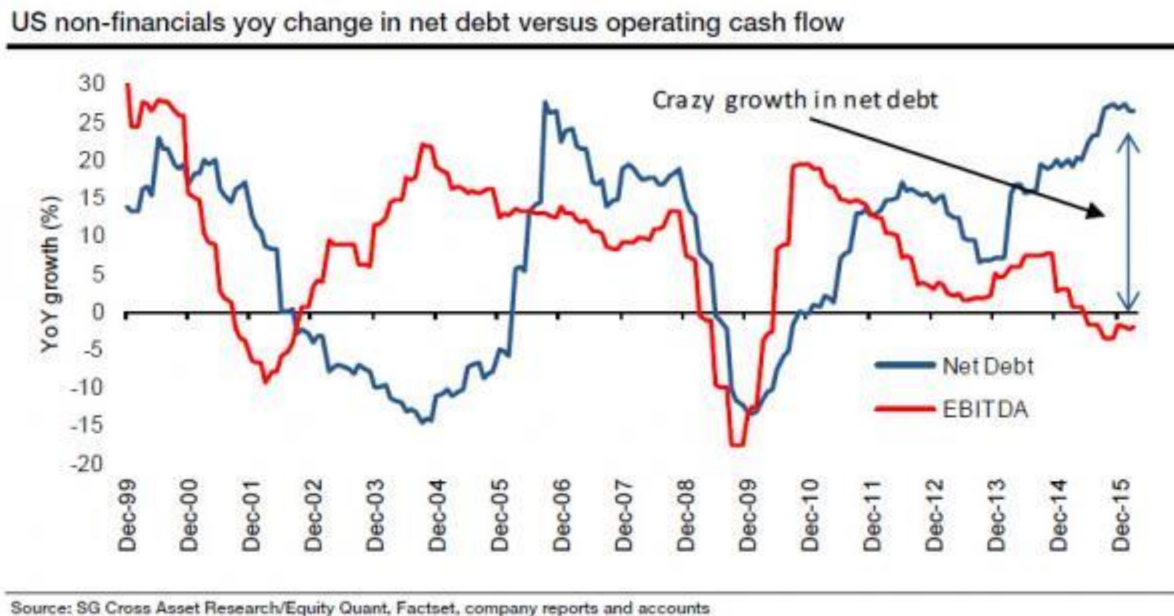
As mentioned, rising debt is fine when accompanied by rising productivity… but when the latter fails to keep pace it becomes the catalyst for a balance sheet crisis.

During the past year, Wall Street's focus has been on whether the markets can sustain another round of rate increases. But in a balance sheet crisis, a rise in rates is not the problem. It's corporate solvency!

As such asset prices are a far bigger concern. And all you need for a balance sheet crisis is declining equity markets (which reduce collateral value), a phenomenon the Fed appears desperate to avoid.

Now we know why…

As shown below, last year corporate debt grew by almost 30% while corporate cash flow declined!



It's no surprise then that last year the U.S. economy experienced weaker economic growth coinciding with a massive advance in debt.

Nominal GDP increased by $549 billion… while U.S. nonfinancial debt surged $1.912 trillion or 3.5 times GDP. (Nonfinancial debt consists of the following: Household debt, business debt and federal, state and local government debt).

During the four and a half decades prior to 2000, it took about $1.70 of debt to generate $1.00 of GDP. Since 2000, however, it has taken on average, $3.30 of debt to generate $1.00 of GDP.

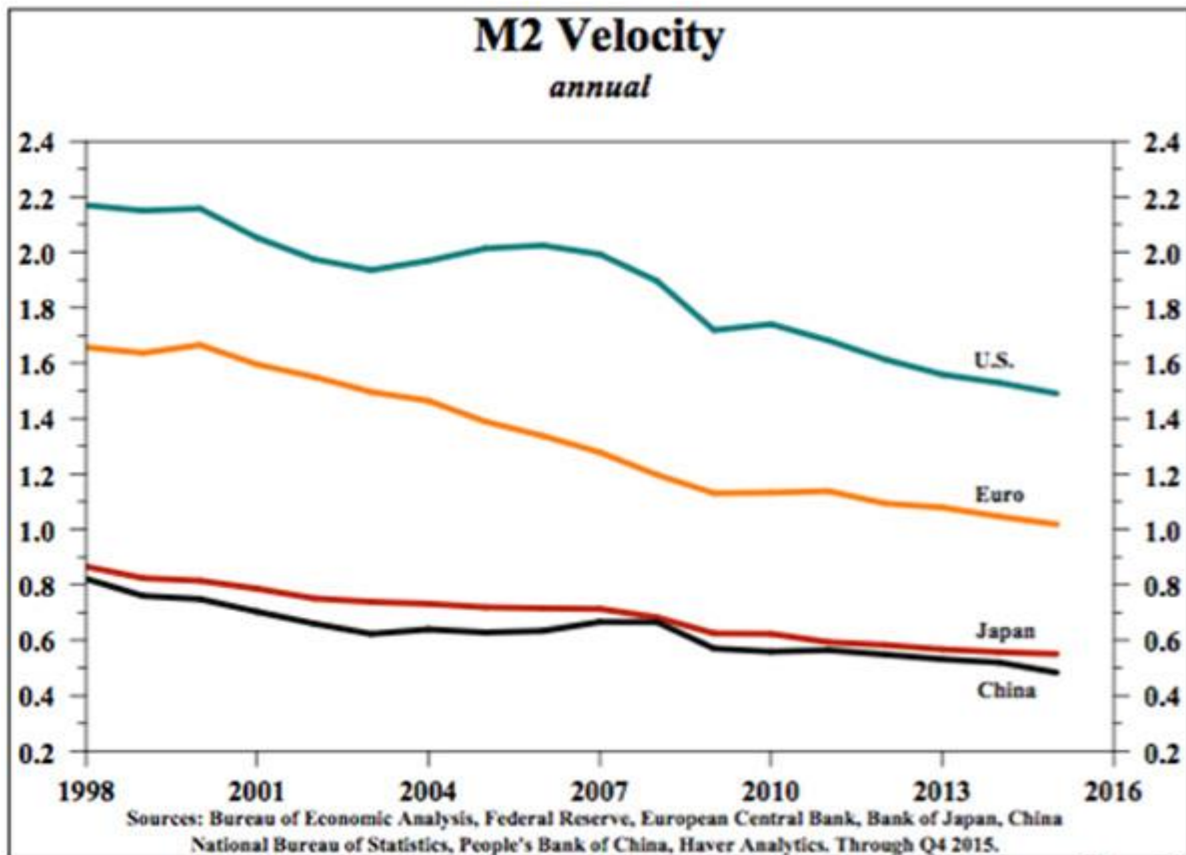
So here's another stat that suggests that the type and efficiency of the new debt is increasingly non-productive.

This is not just a U.S. problem. The Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China have all been unable to gain economic traction.

These slowdowns have occurred in spite of numerous unprecedented monetary policy actions – quantitative easing, negative or near zero overnight rates, forward guidance and other untested techniques.

The only thing they have to show for their efforts is… you guessed it: A mountain of debt! At year-end the ratio of total public and private debt relative to GDP stood at 350%, 370%, 457% and 615%, for China, the United States, the Eurocurrency zone, and Japan, respectively.

Since nominal GDP is equal to money (M2) times its turnover, or velocity (V), growth in a country's GDP would be accompanied by a rise in (V). Yet… velocity has fallen dramatically for all four countries since 1998.



Functionally, many factors influence (V), but the <u>productivity of debt is the key</u>.

Money and debt are created simultaneously. If the debt produces a sustaining income stream to repay principal and interest, then velocity will rise since GDP will eventually increase by more than the initial borrowing.

If the debt is unproductive, then velocity will fall. Thus, falling velocity is a symptom of extreme over-indebtedness and non-productive debt.

What are the investment implications?

In the short run, central banks will be required to continue in their efforts to expand their money supplies at the cost of increasing debt as the alternative would be a balance sheet crisis.

But, in the long run, their efforts will most assuredly bring this crisis about! They are clearly "stuck between a rock and a hard place!"

But in the meantime, counterintuitively, this policy will bode well for the stock markets.

What should investors be watching for evidence that the "gig is up?"

Lack of a market response to new central bank initiatives, a falling dollar and rising inflation as evidenced by rising commodity prices.

The good news: My opinion is that this will set the stage for **a new bull market**… although not for stocks, but rather in hard assets like gold, energy, agriculture and other metals.

Between now and then, we will likely continue to experience the disparity between the real economies and the stock markets of the world.

As pointed out, the engineered expansion of debt can propel the stock market higher, but it does so at the expense of productivity.

An economy stuck in a low productivity growth rut cannot enjoy high nominal wage growth, reasonable inflation and steady corporate profits all at once. Some things are just impossible.

So which will it be? New market highs with ever-increasing debt and central bank induced expanding PE multiples or rising wages and inflation? Because the Fed can't have it both ways and their primary objective is preventing a crisis, we should expect the former!

At *Consilience Asset Management* we employ a process that targets assets where investment capital flows are favorable. As part of our risk management process, when capital flow trends reverse, asset classes to avoid are identified. Currently these trends favor equities.

As these trends change, so will our focus and asset allocation posture. Along the way, our goal is to employ all of the tools at our disposal to manage client assets through these volatile times.

Consilience Asset Management
Roger Faulring – Partner/Portfolio Manager
Michelle Malone – Partner/Investment Advisor
Donna Stone – Partner/Investment Advisor

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*At a **neutral** rating, our equity allocation is at "target weight". Each client's target weight is determined by their investment objective and risk tolerance.

**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.