April 25, 2016

Consilience Market Notes:

Stock Prices Are Not an Indicator of an Economy's Health.

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

<u>Now to this week's report</u>: From a "fundamental" perspective there is not much good economic news. Does it matter?

To answer, take a look at the following chart which shows one of the nominally best performing stock markets in the world… Venezuela!

It stands at more than 16,000 points today, after rising more than 16-fold since early 2013 alone!

Yet, Venezuela's economy is in such a bad state, that people have to queue for hours to acquire staples like bread, oil, flour or toilet paper. All these goods are rationed these days. There is hyperinflation and the government has taken numerous financial repression type measures so as to contain capital flight.

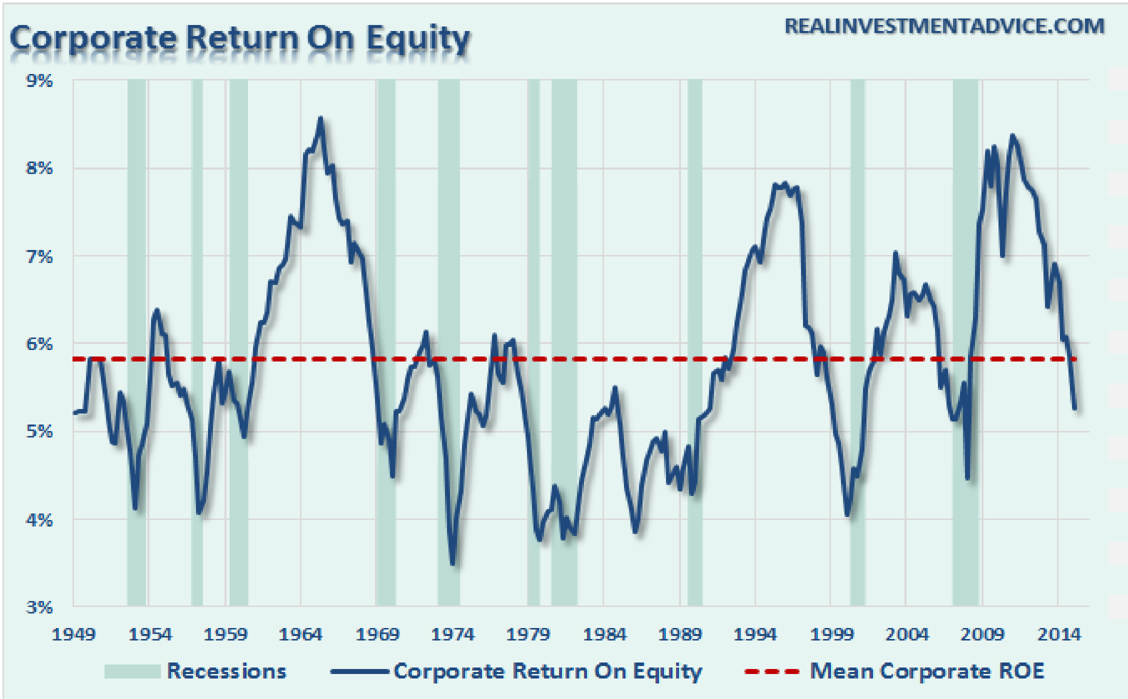
In this particular case it is of course glaringly obvious what an important role monetary inflation plays in the stock market's trend.

But will the S&P 500 rise 16-fold in the next few years?

Probably not… but it cannot be ruled out that the stock market will eventually break out to new highs due to the aggressive monetary policy of the Federal Reserve – although I believe that its long term returns are still going to be valuation-dependent.

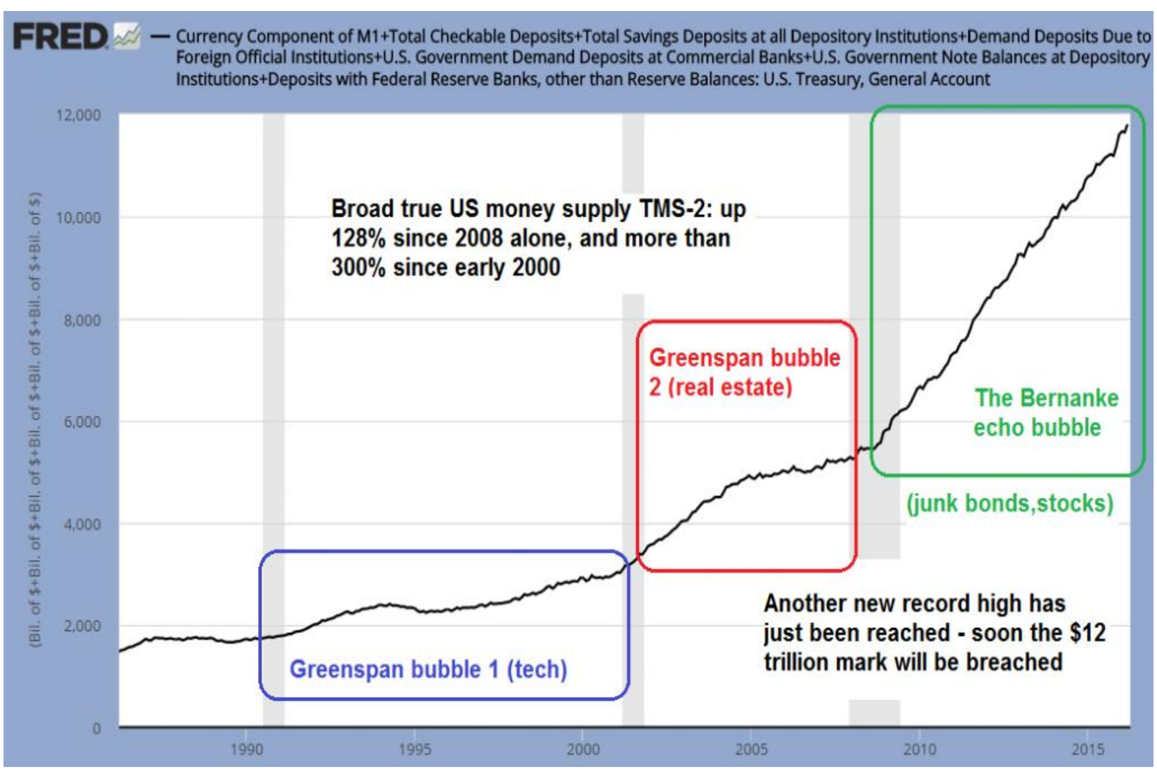
The monetary stimulus, low interest rates, accounting rule changes and debt-funded buybacks which are currently the primary driver for rising stock prices are both artificial and finite in nature.

If we examine the current collapse in companies return on equity, we are certainly getting a pretty dark message about corporate health and profit margins.

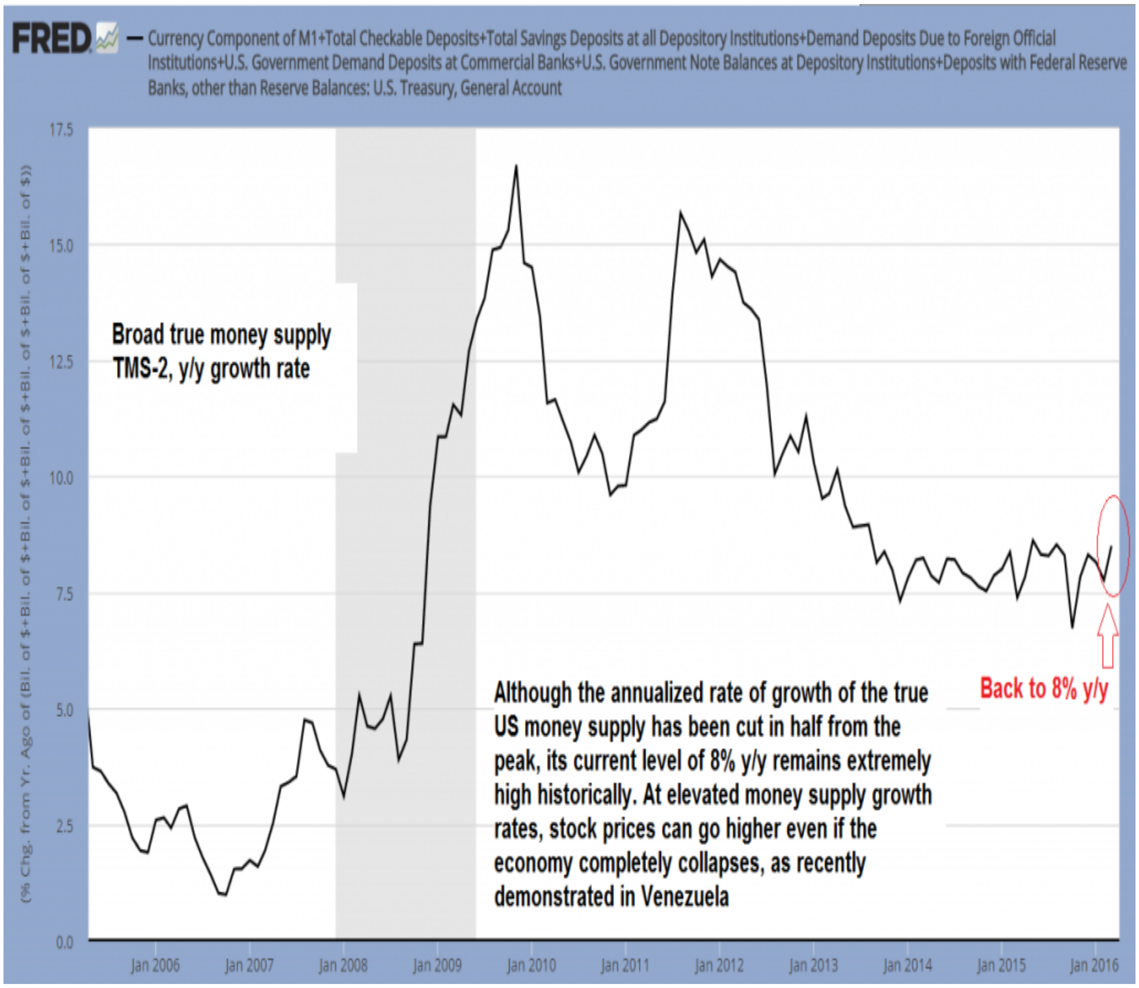


But despite collapsing profit margins, ROE, and surging corporate debt levels, stock prices remain near all-time highs. So have global Central Banks actually figured out how to repeal economic cycles and keep investors permanently aligned to the markets?

Well, kind of… as with Venezuela, the world's stock market gains are largely a function of monetary inflation… and at the moment, there is still plenty of monetary inflation in the US!



The good news is that money supply is growing at a historically high level of 8% y/y. The concern is that it is significantly lower than its 2009 and 2011 peaks.

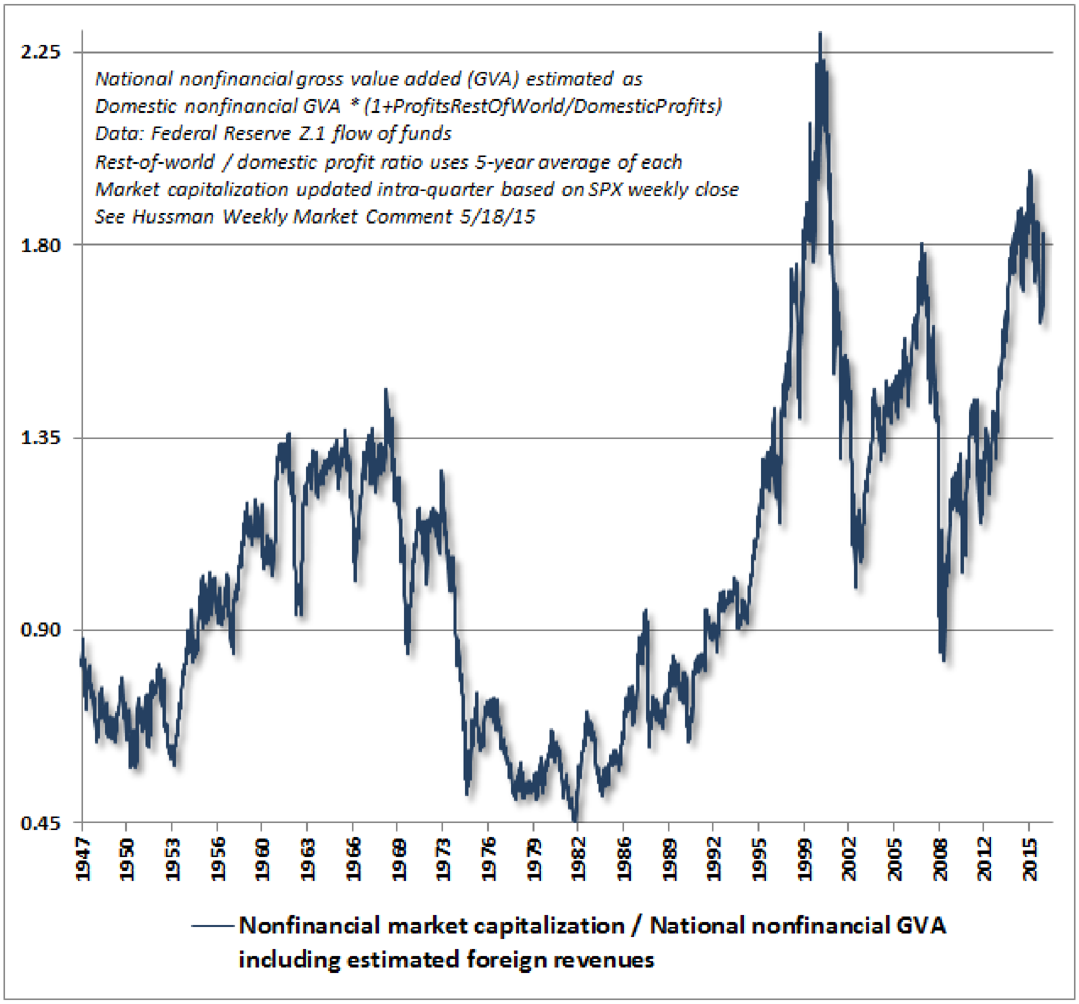


And ultimately this trend must end, at which point economic health and stock's fundamentals will matter again! So where would we be if monetary stimulus, low interest rates, accounting gimmickry and debt-funded buyback were scaled back or discontinued altogether?

That would leave stocks especially vulnerable as investors would be forced to reckon with this huge disparity between prices and their fundamental as earnings which are now nowhere near levels that would vindicate their expectations.

For example, the stock market's valuation is already between the highest and third highest in history depending on how it is measured.

To see how extremely overvalued the market is, take a look at John Hussman's chart below; which measures stock market valuation as the ratio of non-financial market capitalization to national non-financial gross value added (GVA) ***.



In terms of this measure, the market has only been more overvalued than today at the peaks of 1929 (not shown here) and 1999/2000. Today's market is more over valued that it was prior to the 2007-2009 crash.

However, neither declining earnings nor extreme valuations mean that the market has to decline or cannot keep rising even further!

After all, it has happened before.

But… the opposite can happen as well: in 1973-1974, S&P 500 earnings rose every quarter – and yet, the market fell by 56%.

Although money supply growth remains historically strong and investors are desperately chasing returns in today's low interest rate world, an extremely overvalued market is always highly vulnerable to a change in perceptions.

In addition, the high rates of monetary inflation and the weakness of the accompanying economic recovery suggest that the threshold at which the pace of money supply growth will become too slow to maintain asset prices at such lofty levels is much higher than it used to be.

Yet, few investors appear to be worried today. People are distracted by the endless central banking interventions.

The embedded flaw in this new logic is that central banks are creating the perception that nothing can go wrong...

In the last few weeks Janet Yellen has stated that she sees no bubble in the US, Ben Bernanke has restated his helicopter money speech, and Mario Draghi said that the ECB's policy of printing money and negative interest rates is working!

Yet taken together, these have made virtually no difference to the economic recoveries other than to inflate asset prices. Thus, a reasonable amount of caution is warranted here…

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.

Addendum to this week's report:

"*Why Your Advisor Doesn't Like the Fiduciary Rule*" is the title of an April 16 article in Barron's about the new Department of Labor (DOL) rules that apply to ERISA investments held in accounts like 401k's and IRAs.

Those new rules "aim to curb conflicts of interest by imposing what's known as a fiduciary standard."

Noting that the rules already apply to investment advisors… Barron's explains, "Brokers advising on retirement plans will be required to charge 'reasonable' compensation, and no longer will be allowed to consider their own compensation in deciding what products to recommend to clients."

"One consequence may be the diminishing use of high-cost, high-commission investment products such as variable annuities' and non-traded real estate investment trusts.

Actively managed mutual funds are likely to come under more scrutiny, as well: Advisors will no longer have leeway to recommend mediocre ones that pay attractive commissions. Low-cost exchanged-traded funds, by comparison, may come out a winner."

We agree. At *Consilience Asset Management* we have always endeavored to avoid higher-cost, actively managed mutual funds and other high commission investment products.

Consilience Asset Management

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

*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.

***GVA is the grand total of all revenues, from final sales and (net) subsidies, which are incomes into businesses. Those incomes are then used to cover expenses (wages & salaries, dividends), savings (profits, depreciation), and (indirect) taxes.