Consilience
Asset Management

April 4, 2016

# Consilience Market Notes:

## Monetary Madness – Part 2

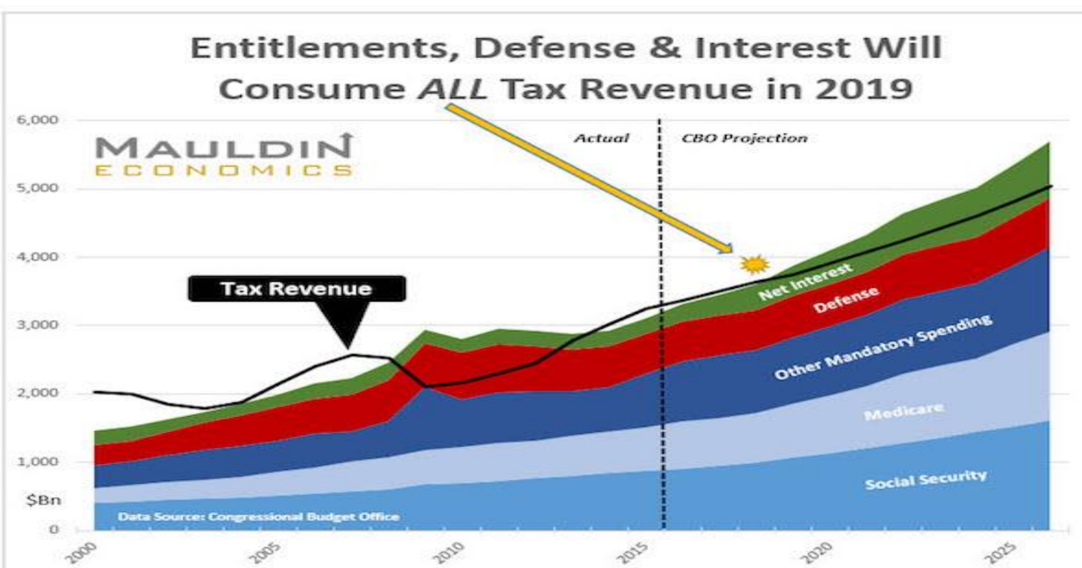
First, an update: Our Global Macro Indicators for U.S. equities remained **neutral** last week with further improvement in our global capital flow and monetary indicators.*

Now to this week's report: *Economic reality is going to force the next president to focus on serious crisis management.* – John Mauldin

In January 2017, it will be the weakest recovery in modern history which will have stretched on for 81 months and the national debt will top $20 trillion.

The budget deficit is now running close to $500 billion.

It's likely that sometime in 2019, entitlement spending, defense, and interest will consume **all** the tax revenues collected by the US government.

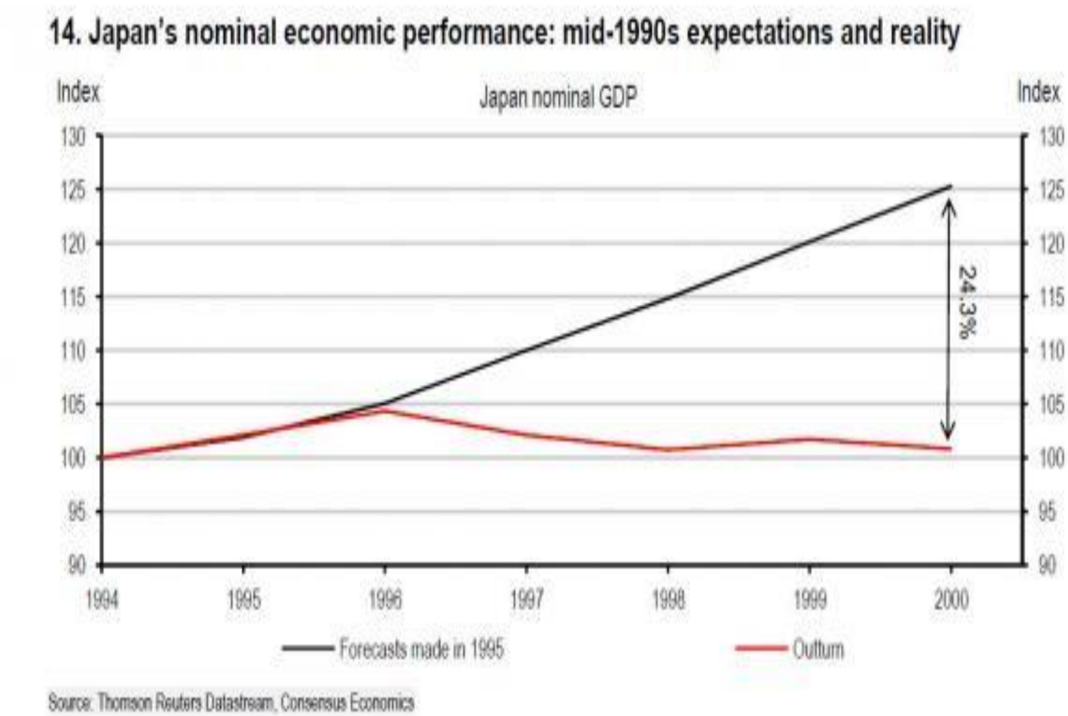


That means all spending for everything else will have to be borrowed… and there are only three ways to reduce that deficit:

1. Cut spending,
2. Raise taxes, or
3. Authorize the Federal Reserve to monetize the debt. i.e., print more money and pay off the debt with devalued dollars.

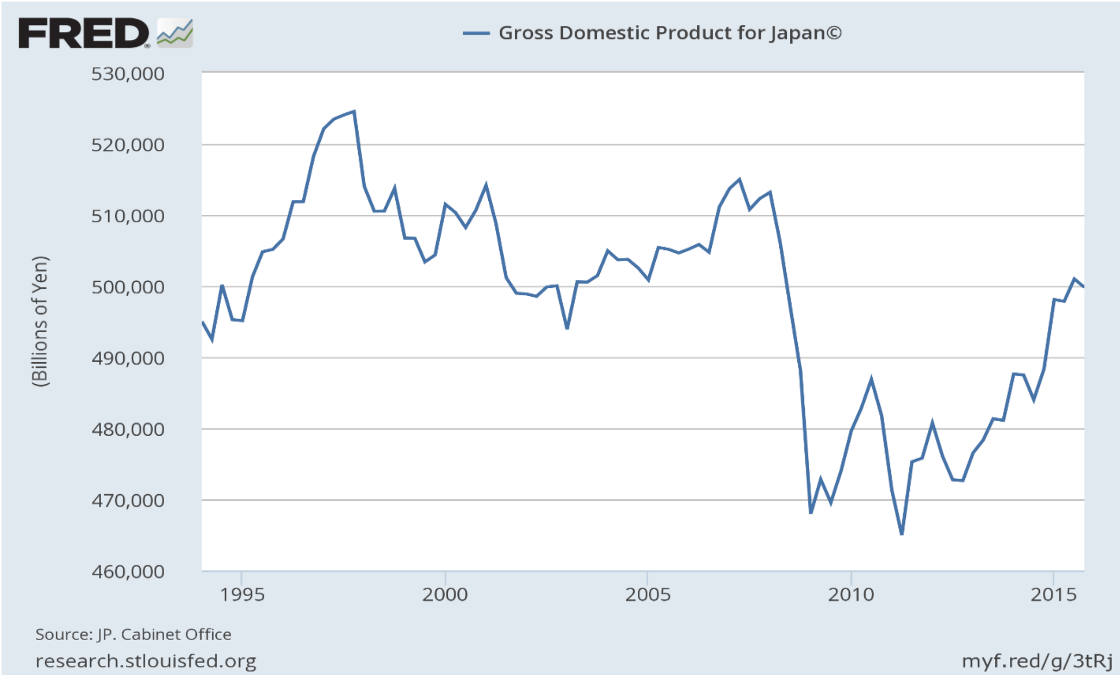
But weren't ultra-low rates and Quantitative Easing supposed to have generated a boom in investment and spending, which in turn would have led to growth and jobs?

Well, back in the mid 1990's, **that's what Japan thought too**. How wrong they were…




In the late-1990s, the Japanese banking system was restructured and with massive balance sheet expansion/*Quantitative Easing* (although this term was yet to be coined) and a clearly-articulated ambition to stimulate economic growth through ultra-low interest rates.

Yet, despite all this, Japan's GDP is currently at about the same level it was 21 years ago!




Two questions:

1. Why?
2. If it isn't working in Japan, will it work in other developing nations?

The answer to question #1 is DEBT. Japan has debt in excess 350% of their GDP! A healthy ratio is closer to 1.5 times GDP.

Developing nations have in excess of $200 trillion dollars in debt. For many countries this represent more than **three** times GDP.

Another round of central bank balance sheet expansion (increasing global debt) will only move the world further away from the reality.

The answer to question #2 is, for it to work, either debt has to come down or income has to rise. Both Quantitative Easing and ultra-low or even negative interest rates can provide more support, however both have their limitations.

Quantitative Easing may have lifted asset prices (stocks and bonds) and stopped a 1930s-style meltdown but households and companies have mostly been unwilling to increase their spending; thus the new stimulus money has never worked its way into the real economy.

The higher values for financial assets has meant that companies which, in other circumstances, would have been under pressure to reduce their costs could now carry on with business as usual.

Put another way, they could happily employ people who might otherwise have lost their jobs.

But… in this case have capital markets distorted the efficient allocation of capital? Yes. In other words, too much capital has stayed in bloated and inefficient companies leaving too little to support the growth of smaller, more dynamic, enterprises.

What's the alternative?

At the beginning of the Great Depression, Andrew Mellon, the US Treasury Secretary, suggested an alternative to Herbert Hoover…

His recommendation was to… *liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate... it will purge the rottenness out of the system.*

To say the least, it probably wasn't the best strategy.

Nevertheless, Mellon still had a point. *Zombie* companies preserve inefficiencies and dampen enterprise. Their preservation limits the *creative destruction* that Joseph Schumpeter famously described in his 1942 book; *Capitalism, Socialism and Democracy*.

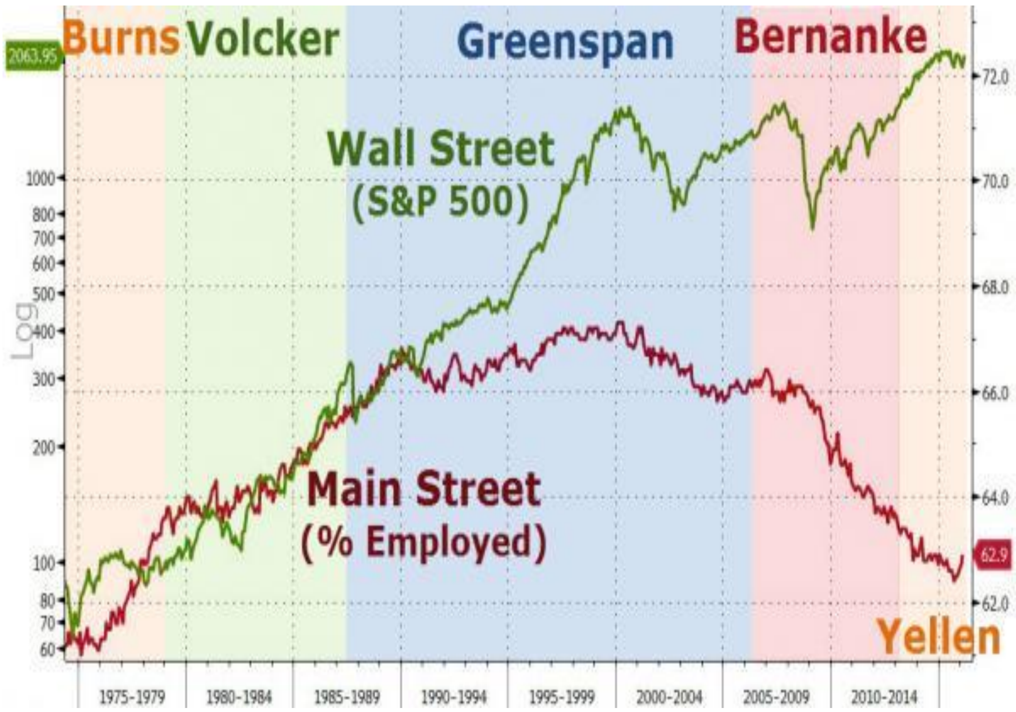
But today we are faced with the same dilemma, but on a much larger, global scale. The economic slow puncture that was initially associated with Japan alone has spread to the rest of the industrialized world.

As more and more countries succumb, so the ability to escape declines… as Japan has discovered in the light of disappointments associated with policies they have initiated over the past three decades.

As Japan's experiments have demonstrated, upping the monetary dosage alone is not enough to cure the affliction. In fact, monetary stimulus only seems to encourage a further wave of risk-taking within financial markets.

As we have seen repeatedly, without central bankers continuously interjecting their willingness, as well as, openness as to do "whatever it takes" the markets will at first vacillate in place until they relent and then plummet in unison causing <u>conciliatory panicked responses</u> from one central banker after another.

In the U.S. this has been going on for almost **thirty years** in one form or another. The question is… how long can it continue?




For example after the stock market crash of 1987, the Federal Reserve announced to the world that they stood ready to provide whatever liquidity was needed by the banking system to prevent the crash from turning into a systemic financial crisis.

Again in September of 1998 when Long Term Capital Management, a highly leveraged high profile hedge fund, sustained losses that threatened its solvency, the Fed stepped in and engineered a bailout… intervening in what, otherwise would have been a market calamity.

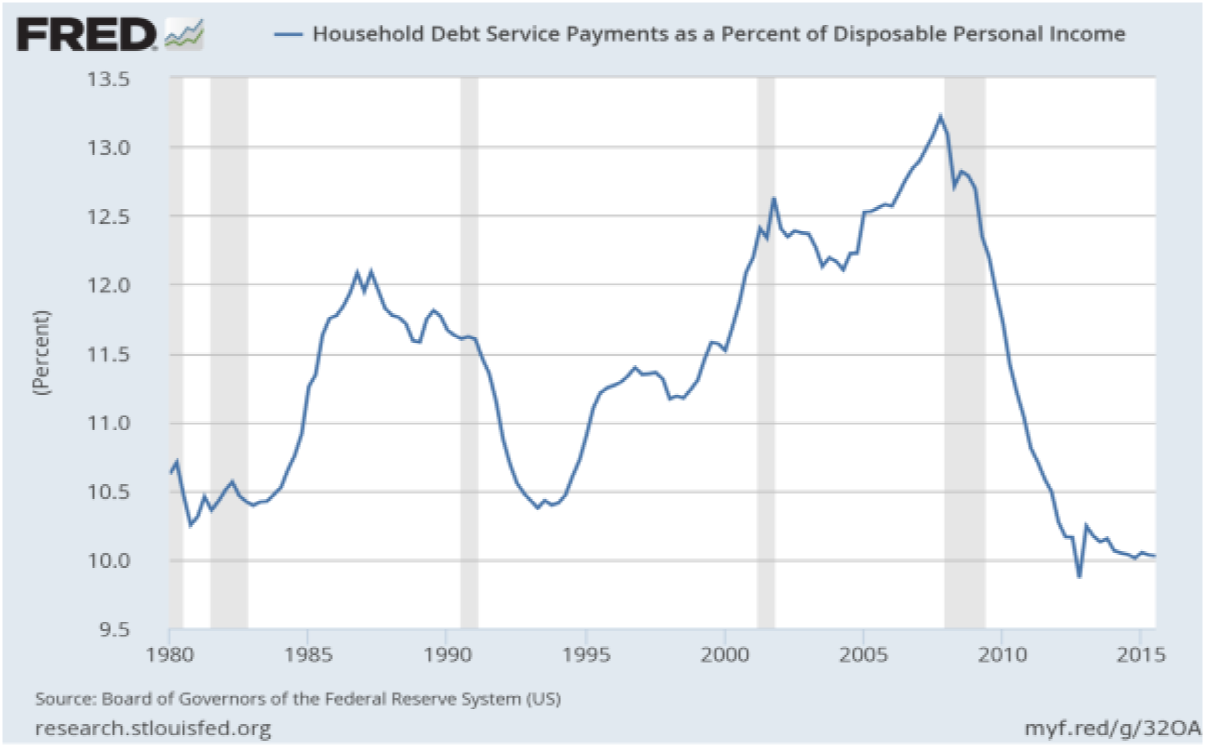
In December of 1999, the Fed injected enormous amounts of liquidity into the banking system to fend off any potential problems from the Y2K problem.

That extra banking liquidity found its way into the stock market and sent the tech bubble into overdrive. Yet, when the Fed withdrew this excess liquidity, the tech bubble peaked in March 2000 and then collapsed.

Now the Fed worried that the crash in technology stocks would cause a systemic financial crisis so they embarked on an interest rate cutting program that saw the Fed Funds Rate drop from 6.5% to 1% from 2000 to 2003.

This in effect morphed the tech stock bubble into a housing bubble as adjustable rate mortgage yields plunged and further accelerated a housing boom that was already in progress.

Note the sharp decline in debt service payments as a percent of income that occurred during this period.




Once again the planet was borrowing from future growth to propel current growth. This was indeed a short sighted solution to an existential crisis faced by the world. And what is this existential crisis? Over $200 trillion in global debt!

So in effect after 1987 the Fed was acting as a giant put** or protective lower limit for the stock markets. Today the rest of the world has caught on as similar action is occurring in unison with the Bank of Japan, European Central Bank, Peoples Bank of China and Bank of England to name just a few.

This is the most precarious moment in financial market history because as the world potentially slides into recession, global central banks believe that they have no alternative to softening such an event other than more debt creation.

But, can the world service an ever expanding supply of new debt? Or are central banks being backed into a corner where the cure is worse than the disease?

The alternative is to **deleverage** and get on more solid financial footing.

But… the last time the world deleveraged was during The Great Depression. The defining quality of The Great Depression was the destructive deflation that gripped the economy.

Evidence suggests that central banks of the world will not sit idly by and allow this to happen again. In fact they appear to be poised to move into a new and unexplored terrain in an effort to defer the inevitable.

Also, don't forget that without further central bank action, a major decline in asset prices would ensue which would likely crush consumer confidence and push the economy further to the edge of the feared deflation that gripped the world during the Great Depression.

Yet further monetary policy accommodations risk a further surge in asset prices that will expand the current over-valuation of markets and potentially magnifies the eventual reversion. They truly appear to be “between a rock and a hard place” as they attempt to accomplish several goals simultaneously.

With the market’s having recovered from the recent January sell-off, their talk of lower/negative interest rates and even the possibility of more Quantitative Easing appears to suggest they are prepared to *kick the can further down the road* and allow investors to maintain and even <u>expand further their artificially earned gains</u>!

These are clearly unprecedented times and it is important for the astute investor to be nimble and pay close attention! We are not calling for an end to the bull markets, but are cognizant of the inconsistencies and irrationalities of the current levels relative to their underlying fundamental values.

At *Consilience Asset Management* we are employing 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.

**In finance a put or put option is a contract to sell an assets at an agreed price on or before a particular date.