August 1, 2016

Consilience Market Notes:

Why are Stocks Rallying?

First, an update: Our *Global Macro Indicators** are as follows for the 7 asset classes we invest in for our clients:

Global Equities – Positive,
Global Bonds – Neutral,
Commodities – Negative,
Gold – Favorable,
Hedge Fund Strategies – Negative,
Global Currencies – Negative,
Real Estate – Favorable.

Now to this week's report:

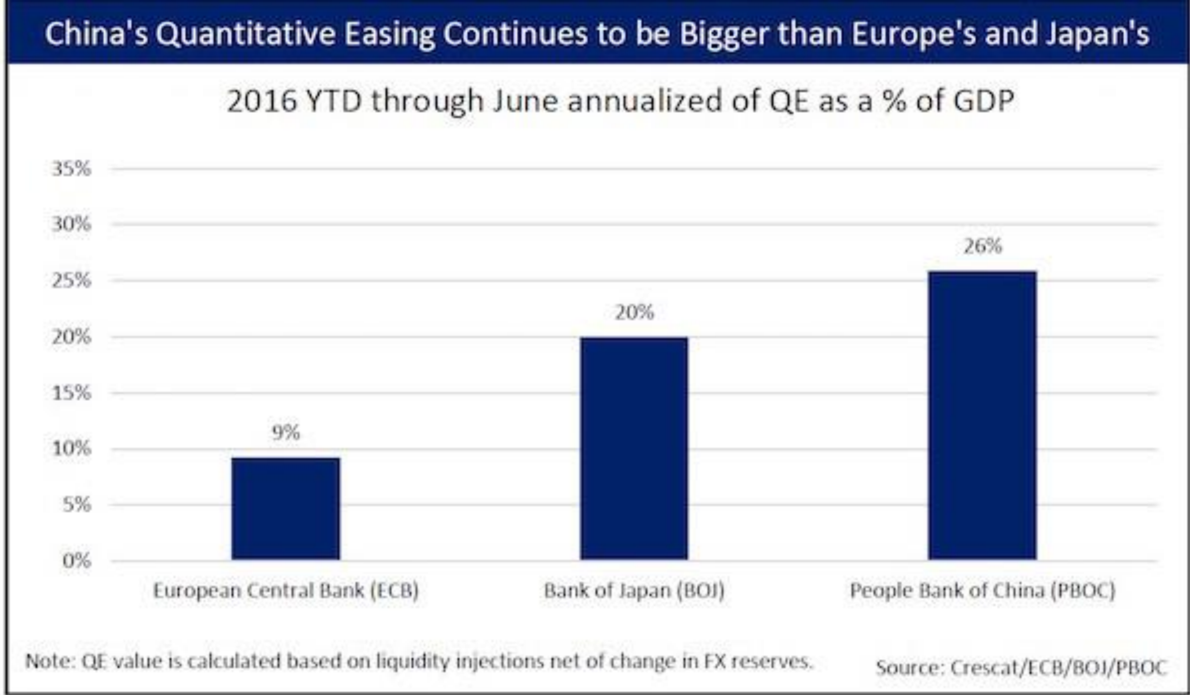
Just a few weeks ago as the uncertainty of a BREXIT loomed, all evidence pointed to a repeat of the 2008 stock market crash. Now, after a quick and nasty decline in prices, stocks have climbed back to record levels. How is this possible?

Answer: Helicopter money and Quantitative Easing!

A quick headline search for the phrase "helicopter money" is all one needs to understand the reason for the latest global stock rally.

This is what has overwhelmed any hint of investor nervousness… central bank "money printing," and the biggest participant is…

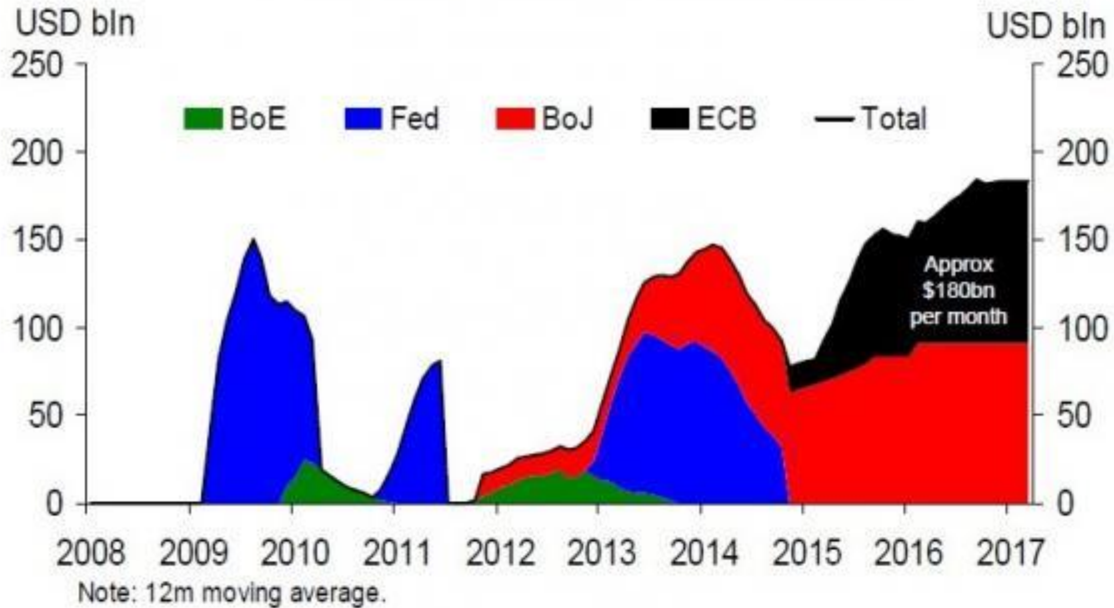
China!



But China isn't alone.

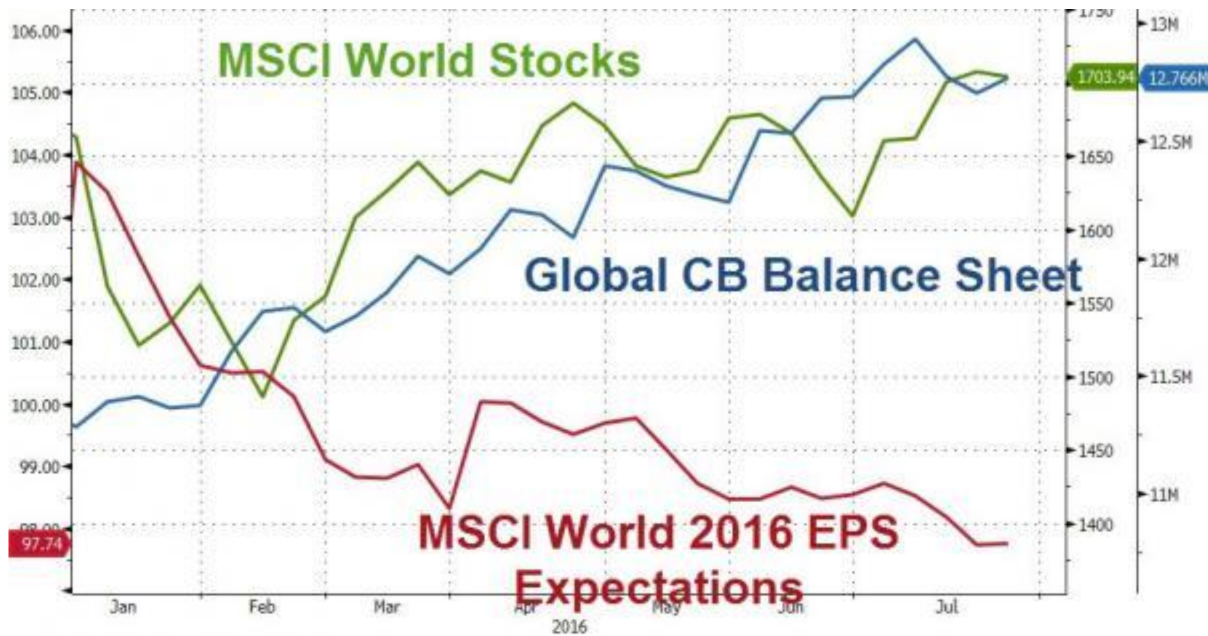
Eight long years after the monetary policy experimentation went extreme, **the amount of QE stimulus being pumped into the world financial system has never been higher**... and it's about to get bigger.

The European Central Bank and Bank of Japan are **buying around $180 billion of assets a month, a larger global total than at any point since 2009**, even larger than when the Federal Reserve's QE program was in full force.



And if market consensus proves accurate, that total is about to rise by billions more -- with the European Central Bank, Bank of Japan, Bank of England and the Peoples Bank of China all expected to expand their QE programs soon in an effort to bolster fragile growth and lift stubbornly low inflation.

And this explains why stock markets around the world have soared since February in spite of a collapse in everything fundamental... as shown in following chart. Here stocks are rising along with Central Bank balance sheet expansion or QE/money printing vs. the underlying earnings for the world's largest companies.



Charts: Reuters, DB, and Bloomberg

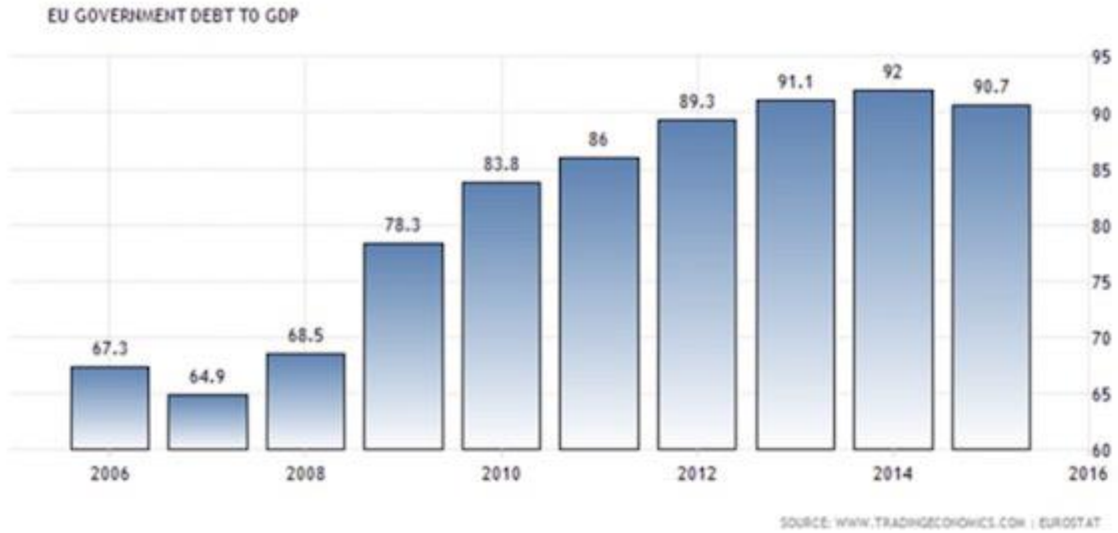
It's this accommodative central bank stance that is trumping any fears investors may have concerning global growth! The resulting low interest rates cause money manager's stock market valuation models to project higher potential P/E ratios and make corporate borrowing for share buy-backs attractive.

In addition, central banks are buying stocks (either indirectly or directly). All of these factors result in rising stock prices in spite of dismal economic data.

But unfortunately, these are all artificial forces and they don't begin to address the long-term structural issues that we should be very concerned about!

At the top of the list is DEBT!

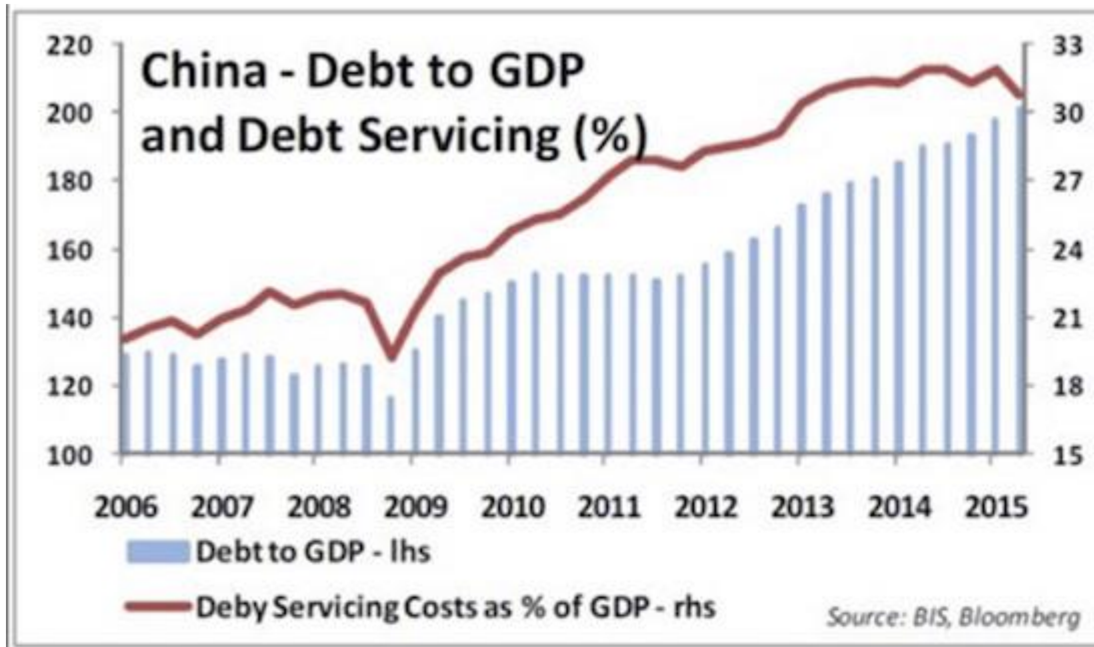
Beginning with Europe, the debt-to-GDP ratio is about 90%.



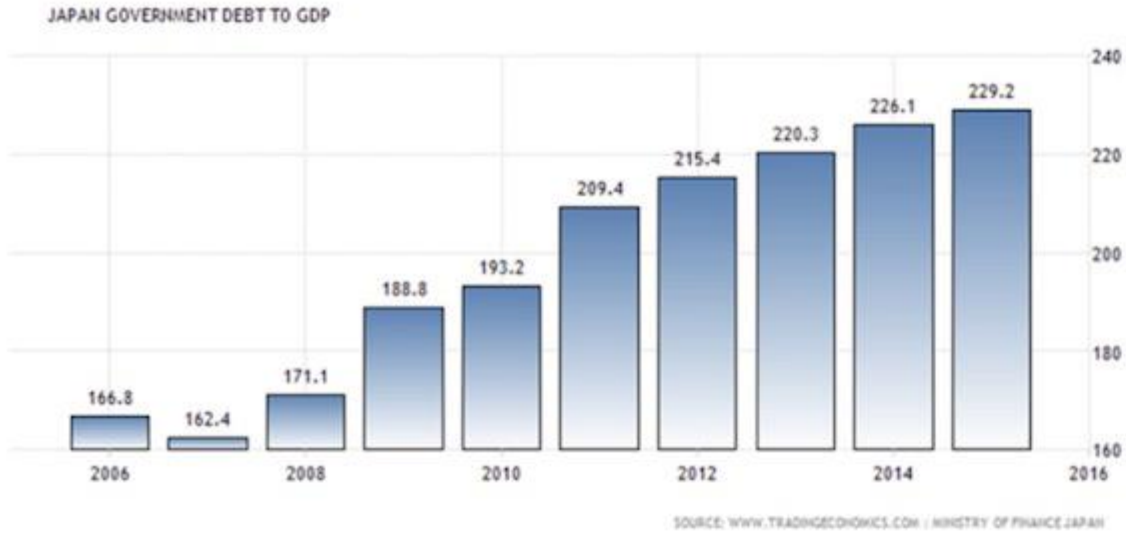
There are theories warning that at this level, the risk of an impending financial crisis is high. Although some experts have suggested that the number is higher…

At 90%, Europe is a weak link – but maybe not the weakest… How about China?

Their debt has just ballooned to 200% of GDP!

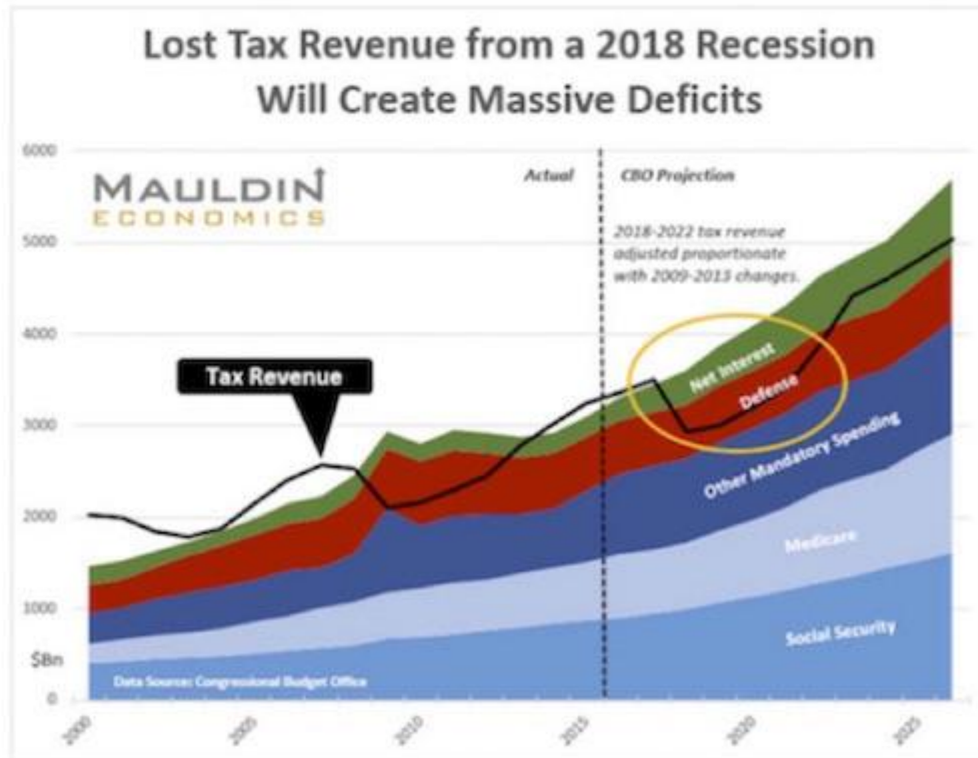


Then there is Japan at just under 230% of GDP.



And… let's not forget the U.S….

U.S. total debt will be rising at over $2 trillion per year… on top of an already huge total national debt.



Although our current total public debt is only 105% of GDP, ($19.2 trillion vs. GDP of $18.2 trillion), it is estimated that in five years our debt will grow to $30 trillion! That will be fine if our GDP grows at a corresponding rate… but what if it doesn't?

And so you have to ask the question; how long can this continue? And more importantly, what are the Federal Reserve and the rest of the world's central banks going to do about it?

The problem starts with the fact that their core belief, their presupposition, is that debt and consumption are the key drivers of the economy… which is how got to the place we are at today!

But what if their wrong? What if the policies that they have put into practice to create economic growth have been based on an incorrect presupposition?

That would certainly explain the stagnant economy in the U.S. and the multi-decade recession in Japan in spite of Herculean efforts by our respective central banks.

Keep in mind that the lion's share of the debt has been accumulated as the result of central bank activities. **What if now, on top of this, businesses and households were to resume borrowing in earnest and the supposition that this will stimulate economic growth is wrong?**

Answer: Debt will continue to expand and GDP will remain stagnant!

As a direct result, U.S. money supply could balloon to 15 times its current size or more, based on the multiplier effect of our fractional reserve banking system. (Excess reserves created by the Fed currently amount to some 15 times the level of required reserves).

Therefore, unless the Federal Reserve takes aggressive steps to reduce these excess reserves, **inflation could quickly spiral out of control as new borrowing is added to these reserves,** creating a huge increase in the amount of money in circulation relative to the quantity of goods.

Isn't that the classic definition of inflation?

This is not just a U.S. phenomenon. The corresponding ratios are 28 times for Japan and Switzerland, five times for the Eurozone, and 11 times for the UK.

The catch 22 is that the extreme reduction in reserves without a corresponding pick-up in economic growth, **would be a nightmare for the economy.**

Or, on the other hand… what if, as we have seen in Japan for over two decades, loan demand doesn't recover any time soon? In that case there would be no need for central banks to reduce these excess reserves. and consequently no need to worry about inflation. Rather, the worry would be **deflation!**

It is extremely difficult to project if or when the private sector will overcome its debt trauma and resume borrowing, inasmuch as **there are few historical instances in which an economy has emerged from what has been coined** a *balance sheet recession*. This type of recession is caused by high levels of private sector debt rather than fluctuations in the business cycle.

Central banks and their governments appear to have painted themselves into a corner and they are going to paint themselves into more corners if their presuppositions are fundamentally wrong.

So how then do we invest? Our answer is to move beyond traditional portfolio management theory which simply posits investing passively in an asset allocation model comprised of low and non-correlated asset classes.

Why? Because historically during times of uncertainty, correlations among all asset classes tend to converge, meaning that they all move together… thus diversifying among asset classes will be futile.

In such a scenario, traditional portfolio management approaches are unlikely to produce results you will be happy with. Especially if the failed central bank policies result in another financial crisis… but this time with more debt than we have ever seen in history!

I believe the answer involves a *consilient* approach to managing investments. By *consilient,* I mean an entirely different approach than is commonly practiced in the investment management world today.

This approach does not rely on economic forecasting or any Wall Street research. Rather, it relies on tracking extremes in global capital flows reinforced by economic, monetary and behavioral data in real time. (For a complete explanation of this process, please visit our website: consilienceasssetmanagement.com and open the "Our Process" tab).

Our mission is to help investors get to the other side of any impending financial crisis, because if there is one with the current global debt levels, it is likely to be of a magnitude that will exceed all past financial crisis'.

And you really do want to get to the other side, because on the other side we have the potential to participate in what could be an enormous bull market!

Just think about opportunities that could be presented at such a time for the astute investor.

But first, you have just got to get your assets from here to there!

For more information, please visit our website: consilienceassetmanagement.com, where we present a video presentation of our risk management process on the opening page as well as a graphic illustration of our discipline under the tab **Our Process**.

As we navigate through these volatile times, our admonition remains: Stay vigilant and nimble.

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

All opinions and estimates included in this communication constitute the author's judgment as of the date of this report and are subject to change without notice. This communication is for informational purposes only. It is not intended as an offer or solicitation with respect to the purchase or sale of any security. This information is subject to change at any time, based on market and other conditions.

*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.