Consilience
Asset Management

August 29, 2016

Consilience Market Notes:

Are Interest Rates About to Reverse their 35 Year Down-trend?

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 – Negative,
Commodities – Neutral,
Gold – Positive,
Hedge Fund Strategies – Negative,
U.S. Dollar – Neutral,
Real Estate – Positive.

Now to this week's report:

Did Fed Vice Chairman, Stan Fischer's comments on Friday spoil the party when he said, *"Yellen's comments are consistent with* ***a possible September hike"***

Although the Fed doesn't directly control bond market interest rates, a move to raise the Fed Funds Rate even by as little as ¼ of 1% could have a major impact on the financial markets; especially the bond market… as this suggests a major policy change on the part of the Federal Reserve.

For the past seven years, they have been reducing rates and printing trillions of dollars in an effort to stimulate economic growth. These efforts have resulted in stock and bond prices rising to record levels.

So, what would a modest 1% increase in interest rates do to the value of bonds?

Answer: It would cause a **staggering $2.4 trillion in losses or about 6% for US bonds! (**This is based on a total estimated value of $40 trillion). However, the loss to the average investor could be far greater…

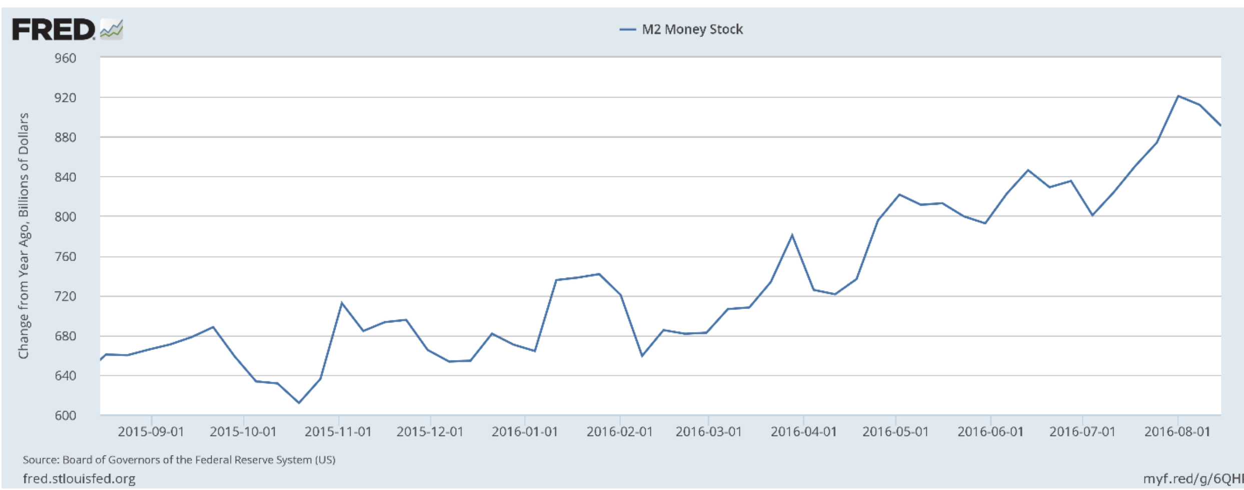
This is due to the fact that the average bond investor has been taking on more risk by extending the maturities of their holdings in an effort to capture higher yields. For example, the average bond maturity is over 16 years today vs. an average of 8.6 years during 1990's. Incidentally, the average yield was 5.6% then vs. 2.2% today.

A loss to a diversified bond portfolio with a 16-year maturity would be approximately 10.7%!

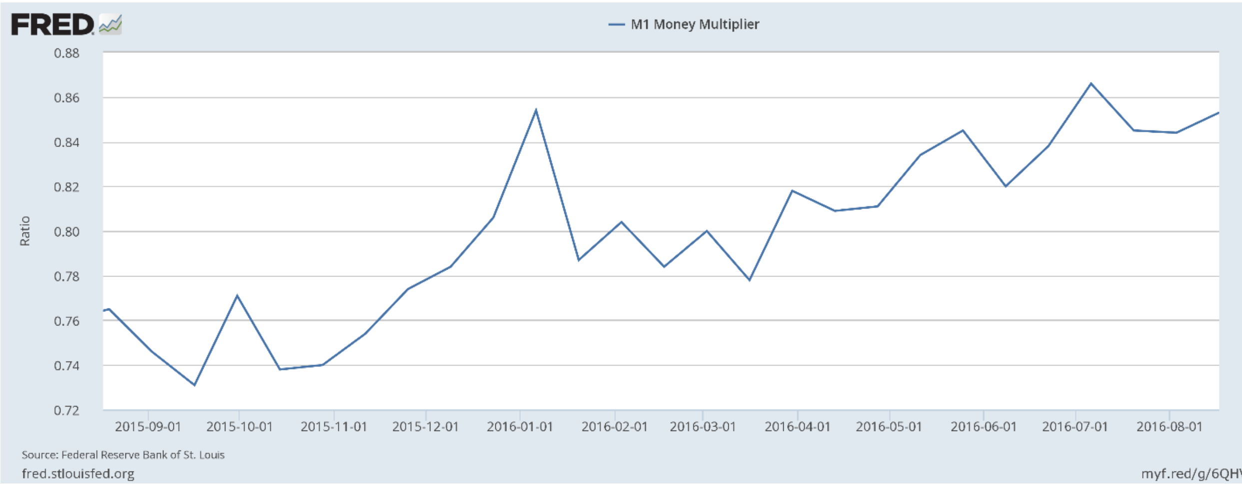
Historically, a rise in interest rates is due to a rise in inflation. Is there any evidence of this?

A major component of the inflation calculation is labor… and we're beginning to get a pickup in wages beyond the rate of growth of productivity, and that is usually a pretty good indicator.

But, more importantly, it is growth in the money supply that causes inflation. And as we see here… money supply has been increasing.



And banks are lending this newly created money!

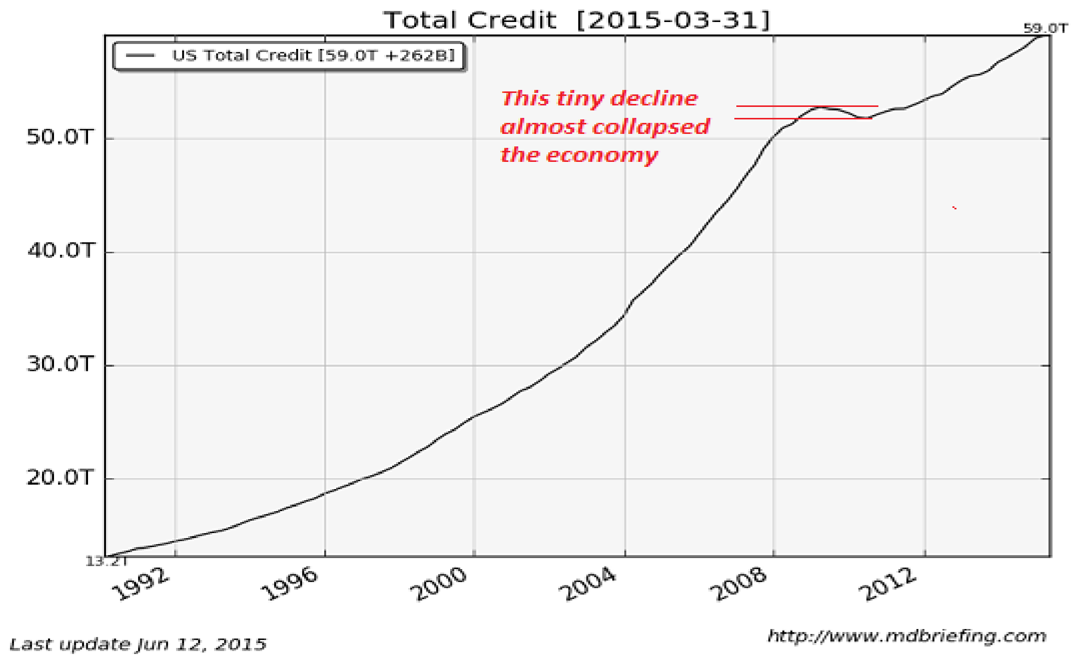


If this trend in money growth persists and leads to inflation… the last place an investor will want to be is in bonds! Remember bonds prices move inversely to inflation and interest rates. Thus, a modest rise in rates would cause U.S. bonds to lose trillions of dollars in value!

On top of this, what if at some point in the future, investors wake up and realize that lending money to fiscally challenged "investment-grade" sovereign entities for 30 years at 1.5% probably isn't adequate compensation for the risk being taken?

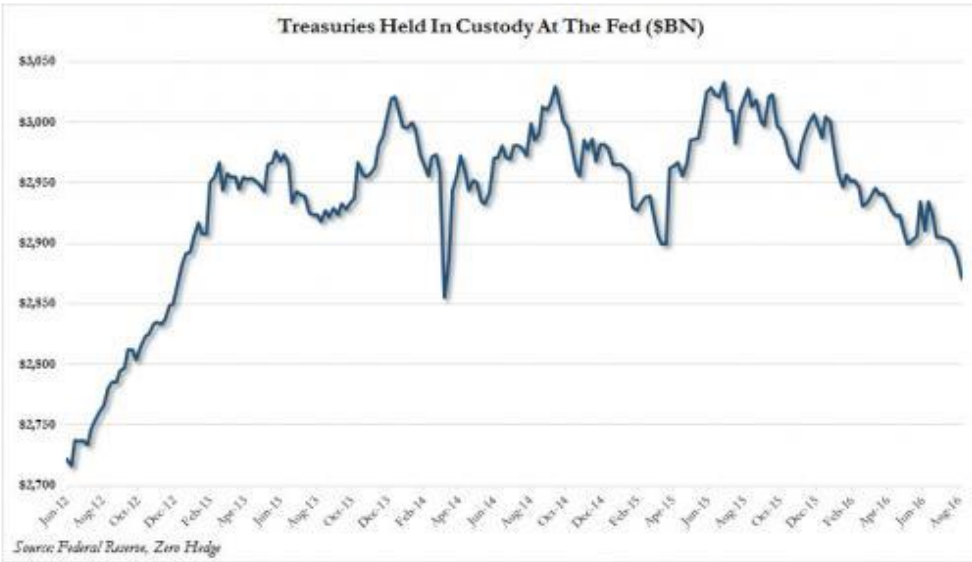
A further decrease in the demand for bonds due to credit risk concerns on top of inflation concerns would only exacerbate further any decline in bond prices.

Recall that a very modest drop in new borrowing (demand for bonds) very nearly collapsed the global financial system in 2008-09, as the whole system depends on a permanently monstrous expansion of new borrowing to fund consumption, student loans, taxes, etc.



Is there evidence that this is already occurring?

Last week's *TIC data*** confirmed something the Fed's Treasury custody account has indicated for the past several months: foreign demand for U.S. government bonds has not only tumbled, but there has been aggressive selling.



So much so, in fact, that in the past 12 months, foreign central banks have sold a gargantuan $335 billion in US Treasuries plus $242 billion when looking at ***all*** foreign transactions including private ones.

The alarming fact is that bond prices will decline significantly and rates will rise further if this trend continues.

But we appear to be between “a rock and a hard place” as the alternative is equally as bad… that is, taking on even more debt. The modest economic expansion of the past decade and the robust growth of the 1980’s and 90’s was primarily fueled by this rapid expansion of debt and strong demand for U.S. bonds.

The strong demand for these bonds plus accommodative monetary policy by the Federal Reserve have resulted in the lowest interest rates in history! Who could have imagined that today we would be in a world where there is nearly $14 trillion in negative yielding bonds?

As a result, this low interest rate policy has rendered the system profoundly fragile and continuing this policy would further distort and corrode the economic structure.

And now investors are resorting to alternative strategies in an attempt to counter these unattractively low bond yields that would have been unthinkable just a few years ago.

A *Wall Street Journal* article last week titled; *In Scramble for Yield, Pension Funds Will Try Almost Anything!* That "anything" is a risky option put-selling strategy. That's right, option trading in lieu of conservative bonds.

And, this strategy would have lost them 27% during the 2008 financial crash… I'm not sure this is a good idea.

So how then do we invest with rates at unattractively low levels and risk of loss to principal extremely high in alternative strategies?

Our answer is to move beyond traditional portfolio management theory which simply posits investing passively in an asset allocation model comprised exclusively of stock and bonds. Although we haven't discussed the implications for stocks, they too tend to decline in a rising interest rate environment.

Many investors are under the false impression that their portfolios are diversified, thus less risky with a conservative mix of stocks and bonds.

Why? Because historically during times of uncertainty, bonds have provided a hedge or buffer against declining stock markets. But with interest rates at all-time lows, correlations between stocks and bonds are likely to converge if interest rates begin to rise, meaning that they will move together… thus such a diversification posture will be futile.

This is especially true with more debt than we have ever seen in history!

Our 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 requires moving beyond stocks and bonds only and 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 previous 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

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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.

*** Treasury international capital (TIC) is used as an economic indicator that tracks the flow of Treasury and agency securities, as well as corporate bonds and equities, into and out of the United States.*