Consilience
Asset Management

February 26, 2018

Consilience Market Notes:

Trust and Sustainability

First, an update: Our *Global Macro Indicators** are as follows for the 8 asset classes we invest in for our clients:

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

Now to this week's report:

If trust and sustainability were the two conditions that allowed for the transition from physical gold to paper currency almost 50 years ago, it is from this basis that we must start to analyze where we are going today and what the implications of the current monetary policy transition may have on the global financial markets.

More recently, in 2008, it was confidence in central banks that saved the global economy. But as European Central Bank President, Mario Draghi said, "the bazooka of quantitative easing (QE) was fired and a second hit during a crisis would have proved ineffective."

The reason for this is complex and must be clearly explained. Let's begin with a nation's currency. Most people are paid in a currency which is deposited in a bank and which they are then able to withdraw at any time.

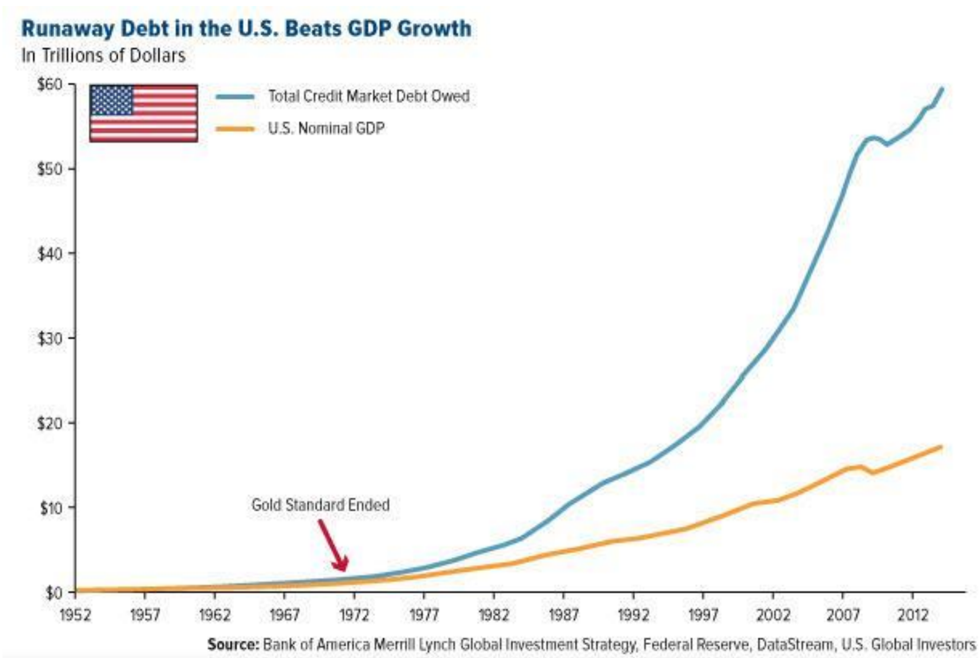
But in the event of an economic crisis, priority is given to the banks, and after that, whatever remaining liquidity there is, is left for the customers. The reason why there was no panic or bank run in 2008, which would have led to the collapse of the global banking system, lies in the trust that ordinary people continued to place in the financial system.

But what if there is another financial crisis? Will this same level of confidence be there to protect the banking system and by extension the global financial system?

If the actions of Russia and China are any indication, the answer is: not necessarily. In both countries, they have been accumulating many tons of gold and are diversifying their assets, by selling U.S. dollars in exchange for tangible goods.

As a result, in the not too distant future, their currencies, the Yuan and Ruble will be backed with gold or other tangible financial assets.

As mentioned above, the exact opposite occurred in the U.S in 1971, when the U.S. went "fully off" the gold standard and the dollar became an unbacked fiat currency. Looking at the following chart, it is easy to see how the start of U.S. debt expansion coincided with the end of the dollar being linked to gold.



Since then, banks have had the ability to increase the supply of dollars with no constraints, i.e., there has been no need to limit their increases to some tangible backing such as gold. This has led to an increase in inflation. Remember inflation is primarily caused by an increase in a nation's currency relative to their available goods and services.

But, why worry now, almost 50 years after the U.S. went off the gold standard?

If we were to have a repeat of the 2008 financial crisis, it would be no surprise if global investors followed Russia and China's lead by dumping their U.S. dollars (or Euro's or Yen) and replaced them with gold or other tangible assets or possibly even into the crypto currency market, as they look for a safe haven against their potential devaluing fiat currency.

In addition, if the U.S dollar loses its status as the main world reserve currency, Washington will be forced to reconcile with the rest of the world. This monetary policy normalization could be a game changer for the financial markets and result in a continuation or even exacerbation of the recent increased volatility in the financial markets.

Meanwhile, interest rates are rising as evidence of inflationary pressures is building. This week, the yield on benchmark 10-year U.S. Treasuries climbed to the highest level since the summer of 2014.

Inflation has already become a key topic this year among the investment community and central bankers. If we get an acceleration in terms of wage inflation, the U.S Federal Reserve, as well as the rest of the world's central banks, could start to get nervous.

We are already entering an environment where monetary policy around the world is starting to reverse course, meaning that the global expansion of unbacked currencies and debt is being reversed. This is both good news and bad news.

It's **good news** in that it represents a prudent step in the management of the supply of each nation's supply of their currency and debt.

Remember, since 2008, the world's central banks have been in a massive expansion phase, this in an effort to prevent a collapse of the global financial (banking) system. This phase was coined (Quantitative Easing, QE) and the result was a world awash in liquidity and all-time low interest rates, resulting in record amounts of debt… (government, corporate and consumer).

The big change this year is that central bankers are reversing course and moving toward a policy of "normalization" or contraction (Quantitative Tightening, QT).

The **bad news** is that the net effect is that interest rates are on the rise and the stock markets are experiencing a significant increase in volatility as stocks and bonds that were purchased by these banks are now being liquidated.

The U.S has already begun to unwind its $4.5 trillion balance sheet and the European Central Bank (ECB) has announced that they will be done with their QE by the end of the year.

Elsewhere, it looks like that the Bank of England, the Bank of Japan, the Bank of Canada and the Reserve Bank of Australia will all be following suit this year as well.

One of the biggest unknowns is what this normalization ultimately does to financial markets. No one really knows. The balance sheet reduction at the above noted central banks will be a big change for the global stock and bond markets.

In just the past two years alone, we have had in excess of two trillion dollars in annual global quantitative easing by the major central banks. But this year that all changes: We go from a two-trillion a year to zero!

It's unlikely that you can go from a two-trillion dollar, QE run rate down to zero and not expect an impact.

But hasn't the Fed been engaged in this "tapering" or unwinding process for over a year now? And except for the recent stock market correction, things have been doing fine. So why the worry now?

The reason is that as the Fed was unwinding… (selling stocks and bonds), the rest of the world's central banks were offsetting it with monetary expansion and their corresponding purchases of stocks and bonds.

The difference is, this year none of the major central banks will be offsetting. They're all going into same direction.

Two weeks ago, the Fed sold $22 billion of assets. Is it a coincidence that stocks sold off? Not likely.

Such a transition doesn't necessarily have to be dramatic, but it will look a lot different than the past few years and investors need to understand it. If central banks are selling, this doesn't mean there will be no buyers. Traditional investors; institutions, individuals, and corporations who are engaged in buying their own shares, have the potential to pick up this slack.

Will this be enough to fully offset central bank selling?

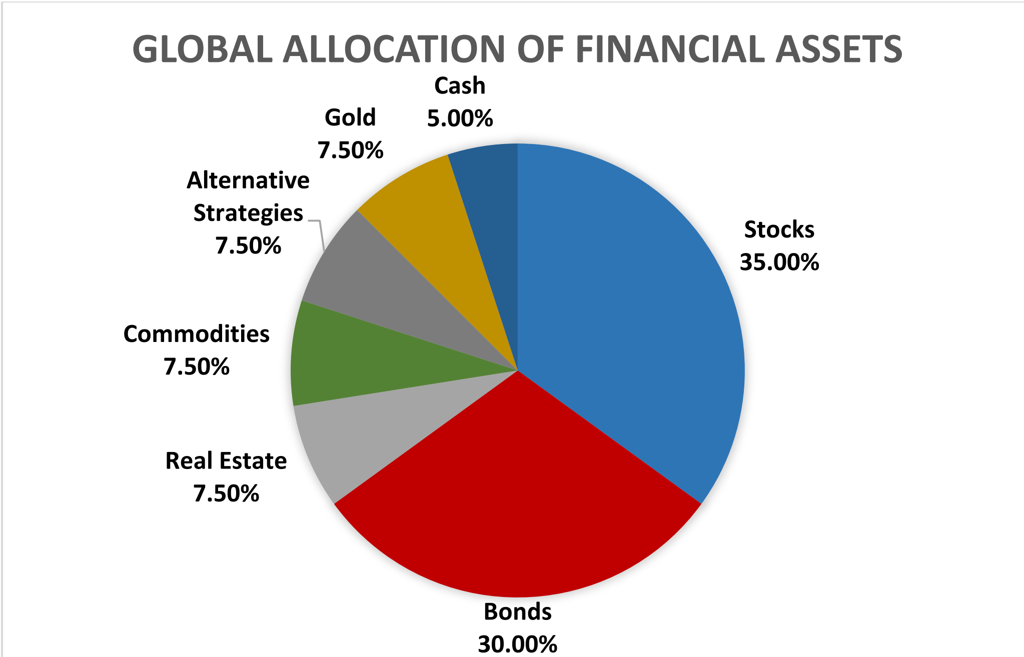
There is no way to tell in advance. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different from today's, understanding how new data points fit (or don't fit) into that world and adjusting accordingly.

Although this will be no easy feat, our answer at *Consilience Asset Management* is to employ a discipline that we believe circumvents the effects of these uncertainties and disparities between the above noted risks and actual market action. Ultimately, it will be the forces of supply and demand that will drive prices of financial assets higher or lower, regardless of the fundamental, geopolitical or economic circumstances.

The cornerstone of our process is our *Global Macro Capital Flow Model.*

In this model, we monitor the movement of capital among the approximately $225 trillion of tradable global financial assets. Here, market trends can be identified regardless of their driver; debt, geopolitical, economic or other…

Below is a picture of the distribution of the world's liquid investment assets as a percent of the $225 trillion total…



Source: BIS, Thompson Reuters, World Bank, World Gold Council, Financial Analysts Journal, (January 2017).

By measuring the capital flows of each of these categories relative to the total, both favorable and unfavorable investment trends are identified.

At *Consilience Asset Management*, we employ this process in deploying client assets.

A more complete description of our model and process can be found on our website: www.consilienceassetmanagement.com under the tab **"Our Process."**

Based on this, the ratings for each of the seven asset classes that we monitor are included each month at the beginning of this report.

And although we are not calling for an end to the current bull markets for stocks, we are cognizant of the challenges inherent due to the two structural changes noted in this report, as they could have a huge impact on the current supply/demand dynamics in the global marketplace.

As such, we realize that these are clearly challenging and unprecedented times and therefore it is important for the astute investor to be nimble and pay close attention!

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.