Consilience
Asset Management

January 02, 2018

Consilience Market Notes:

Can the Markets Withstand Quantitative Tightening, Excessive Valuations and Bitcoin?

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

Now to this week's report:

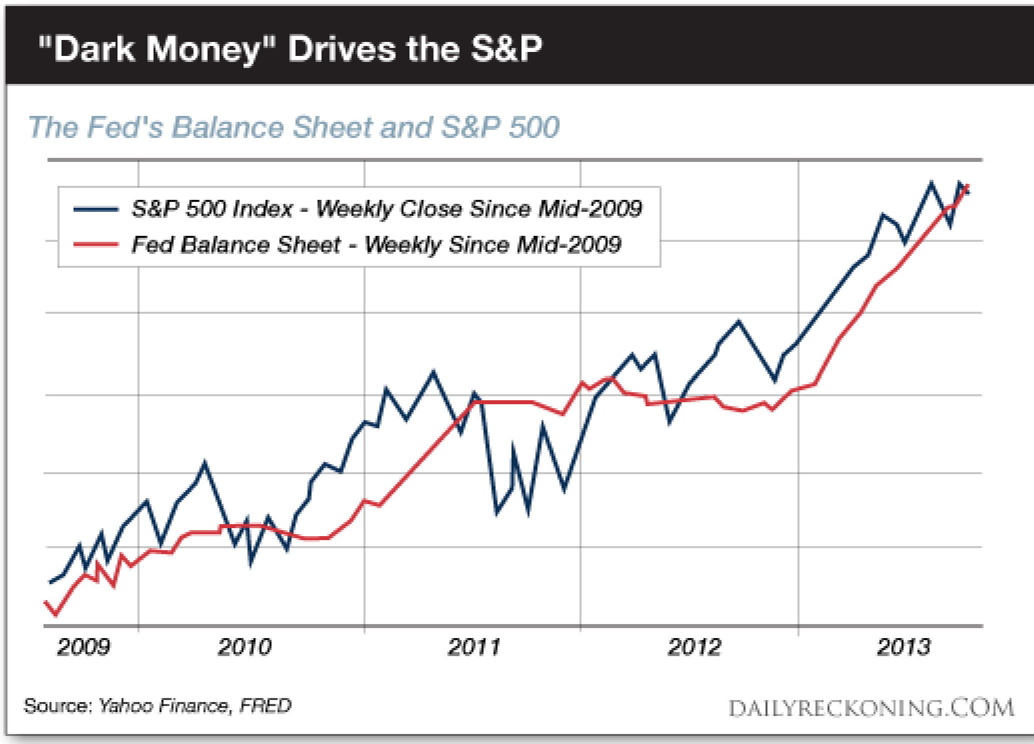
We start the year with the dilemma we left off with in 2017…. Quantitative Tightening. As pointed out in numerous issues of our *Consilience Market Notes*, the primary driver for the post-2009 bull market in stocks has been the rising Fed balance sheet under what has been coined Quantitative Easing (QE).

In essence, under (QE), central banks "print" money or electronically fabricate money by buying bonds or stocks. In addition, they use other tools like adjusting interest rate policy and currency agreements with other central banks to pump liquidity into the financial system.

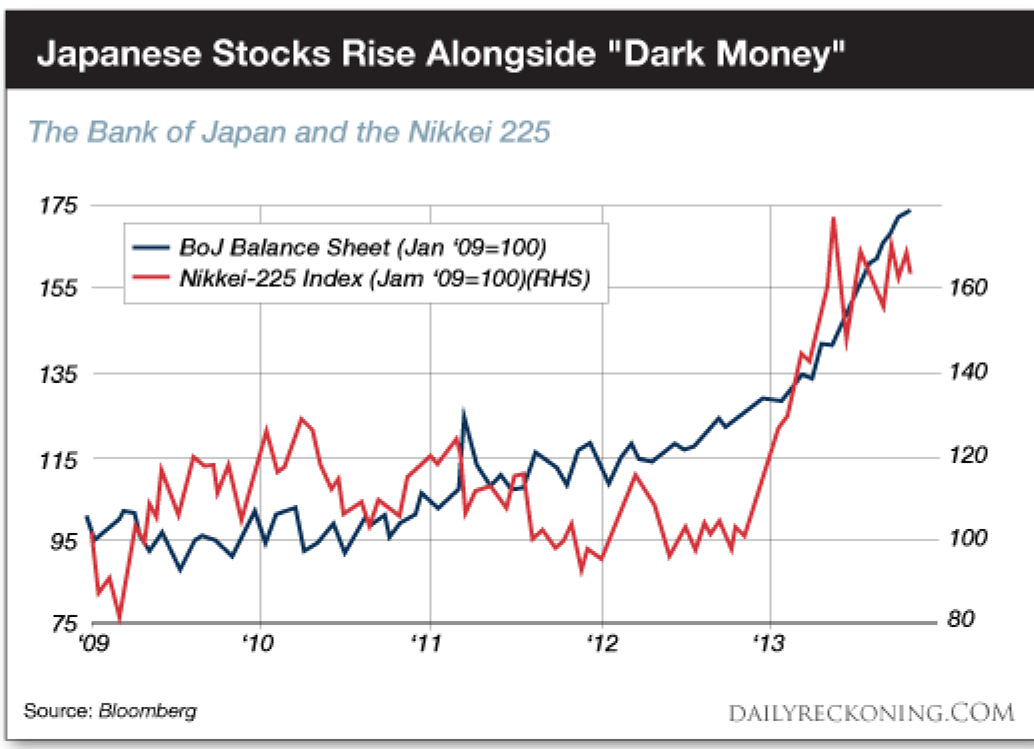
That "dark" money goes to the biggest private banks and financial institutions first. From there, it spreads out in seemingly infinite directions affecting different financial assets in different ways.

As shown in the following charts, global equities have been the primary beneficiary…

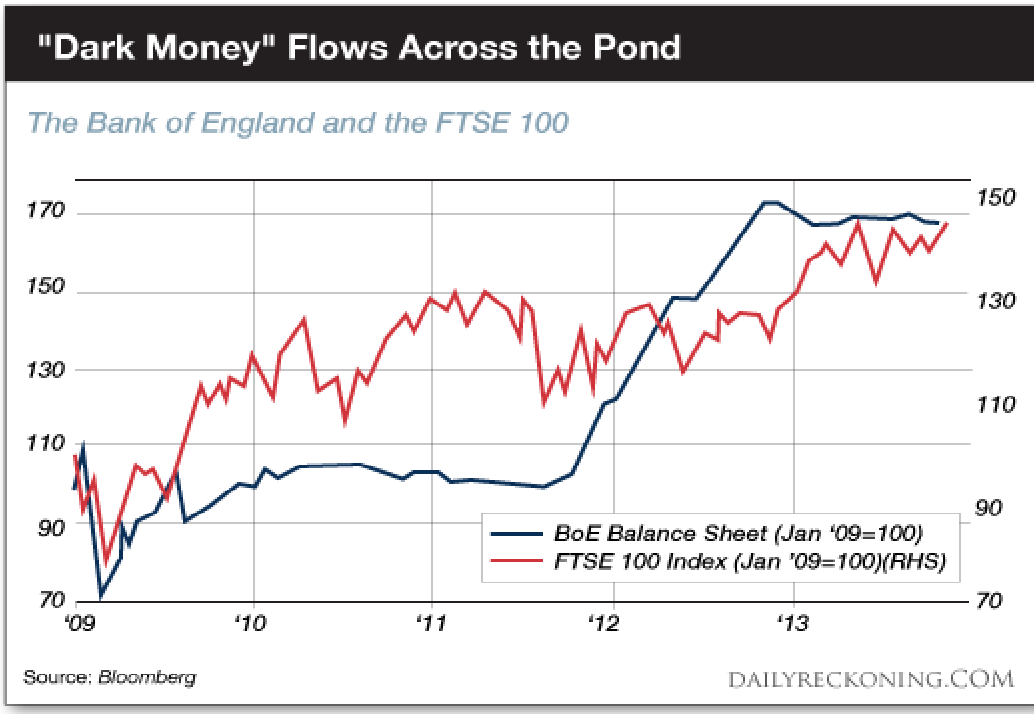
First, the U.S.….



The U.S. isn't alone. Look at Japan…

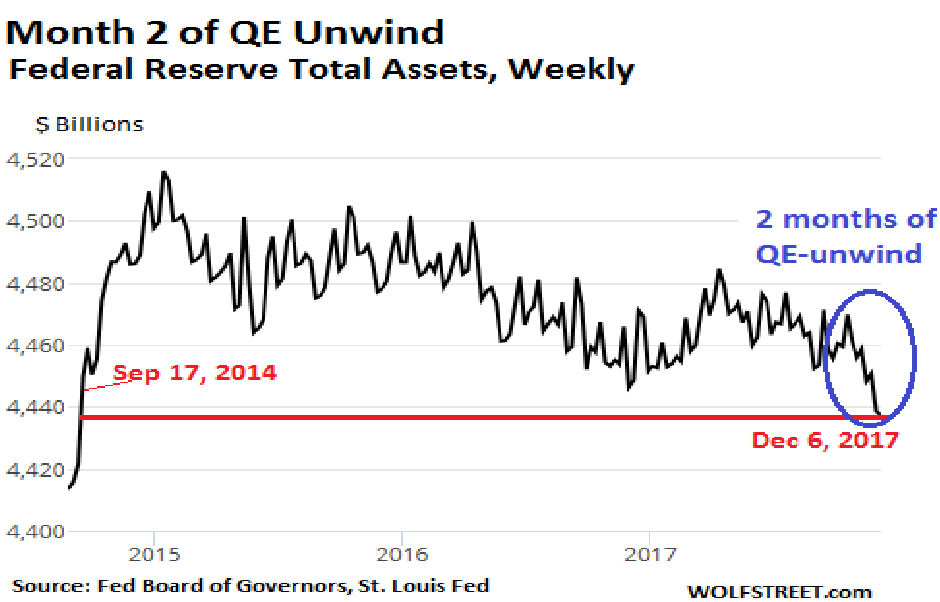


Or, look at this "dark money" chart from the U.K…



The question that we need to ask is, what can drive stocks higher from record levels; both, in terms of price and valuation metrics, at a time when these primary buyers of stocks (Global Central Banks) are entering a phase where they will be net sellers to the tune of $15 trillion over the next several years.

Although you won't see a chart that shows the actual amount of stock selling that occurs as a result of Central Bank's balance sheet unwinding or Quantitative Tighten (QT), we can provide a chart that shows the recent selling of U.S. Treasuries and mortgage-backed securities which have provided the collateral for the leveraged buying of S&P 500 index futures contracts in the U.S.



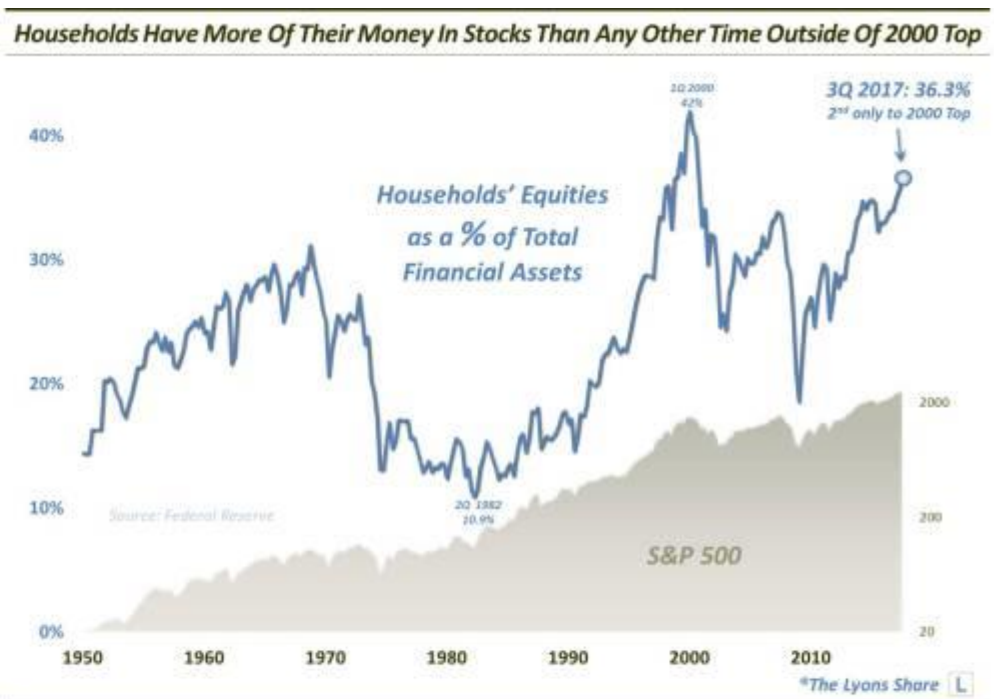
In reality, QE has been all about pushing the central bank induced, artificial liquidity into riskier investments.

So, what will happen now that this tide of the artificial liquidity recedes? Is there a source of new capital that can prevent an all-out collapse of global stocks?

Maybe! Take a close look at the next chart… it shows an increasing demand source with a trajectory that potentially offsets the previous chart of a decreasing demand from the central banks.

As demand has been **decreasing** from central banks, as shown in the above chart, demand has been **increasing** in household's stock holdings!

Although the last entry on the following chart is 2010, it is clear that there has been a significant increase, from approximately 30% in 2014 to 36.3% in the 3rd quarter of last year. This helps explain the rise in stocks since 2014, even in the face of central bank's withdrawals.



Do individual investors have the necessary buying power to propel stock prices to even higher levels from here?

To answer, compare the blue line (household holdings) with the grey highlight at the bottom of the chart during the period from 1982 – 2000.

As the blue line shows, it was the individual investor that had a major part in driving the stock market to record levels from 1982 to 2000.

Since 2014, the bull market in stocks has accelerated as individual investors have re-entered the market in earnest. I believe it helps explain the rising stock market values against the headwinds of the Federal Reserve's unwinding of their balance sheet.

But, the drama doesn't end here! As we head into 2018, there are two additional forces that we must contend with:

1. Extreme stock market valuation levels and
2. The introduction of cryptocurrencies like Bitcoin.

Let's look at the second challenge first. You may be wondering what Bitcoin has to do with the stock market.

The answer is, that in 2018, Bitcoin and other cryptocurrencies have the potential to become the largest international currency by market capitalization. This event, together with the global nature of cryptocurrency's 24/7 trading access, has gotten the attention of even the head of the International Monetary Fund.

Managing Director, Christine Lagarde recently warned central banks that Bitcoin and other cryptocurrencies have the ability to cause massive disruptions in their ability to manage their foreign reserves as monetary policy tool.

This is because it will be nearly impossible, due to their size and scope, to avoid including them as part of their balance sheet reserves. However, due to the fact that these cryptocurrencies exist outside of their control, they can severely disrupt the planned orderly unwind that they envision.

Some wonder if monetary policy is even achievable for a global market that includes such a large component in cryptocurrencies!

At the very least, an introduction of cryptocurrencies into central bank's reserves will potentially have an accelerating effect on the current 5-year plan to unwind their balance sheets… meaning the unwind (selling of stocks and bond) will occur much faster and less orderly than anticipated.

Our final consideration for 2018 deal with extreme market valuations. As we have pointed out on numerous occasions, stocks are trading at extreme levels based on just about any metric one chooses to use; price to earnings, price to book value, price to sales, price to GDP, price to just about any **tangible** denominator.

However, what if the **tangible** component is no longer the relevant factor that it once was in determining a company's intrinsic value?

As an example, consider what occurred after the emergence of the semiconductor.

Starting in the early 1980s, investment in traditional, tangible assets (structures, factories, machinery, inventory), considered assets by accountants and reported accordingly on the balance sheet, dropped precipitously from 15% of gross added value in 1977 to 9% in 2014, a 40% drop.

In contrast, the investment rate in intangible capital (R&D, patents, information systems, brands, media content, business processes), mostly expensed in corporate income statements, increased continuously from 9% to 14% of added value, a 56% increase.

This radical business model transformation came to be known as the knowledge, or information revolution, an irreversible trend in developed economies.

Source: We thank Professors Carol Corrado and Charles Hulten for providing us with this figure.

As a result, for companies, the only way to survive and prosper in such a competitive environment is through constant product and process innovation, achieved primarily by investing in **intangible** assets.

Therefore, "earnings' usefulness to investors declines sharply for companies that increasingly rely on intangible value-creating assets.

For these reasons, GAAP-based reported earnings no longer reflect the periodic value changes (growth) of most business enterprises, and thus conventional earnings-based security analysis has lost much of its usefulness for investors in recent years.

Therefore, one must ask, are high valuations due to an outdated earnings number being used as the denominator in the PE calculation? If so, the high PE ratios that are being touted as evidence that the stock market is in a "bubble" that will burst any day now, are severely overblown!

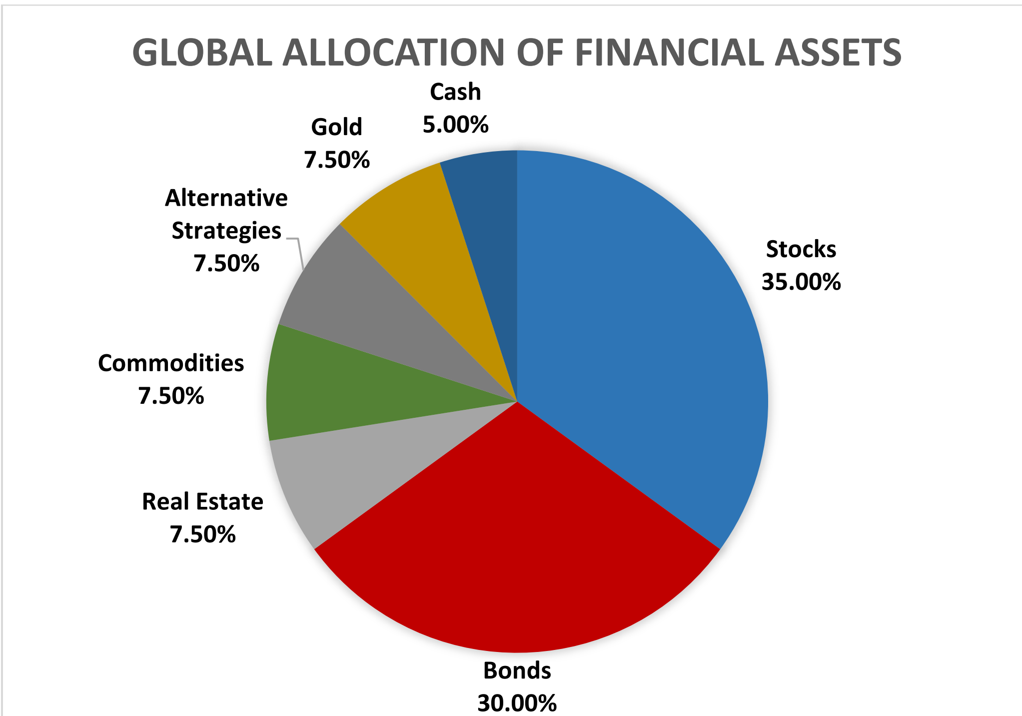
The ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different from today's, understanding how new data points fit (or don't fit) into that world and adjusting accordingly.

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 2014).

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

Roger Faulring – Partner/Portfolio Manager

Michelle Malone – Partner/Investment Advisor

Donna Stone – Partner/Investment Advisor

Roger Faulring is an Investment Adviser Representative (IAR) with and offers Investment Advisory Services through United Advisors Services, LLC ("UAS"), an SEC Registered Investment Adviser (RIA). UAS and Consilience Asset Management are not affiliated.

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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.