January 30, 2017

Consilience Market Notes:

What if Bad News Becomes Good News?

(Remember: for 8 years, stocks have risen as bad news was considered good news for the markets).

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

Now to this week's report:

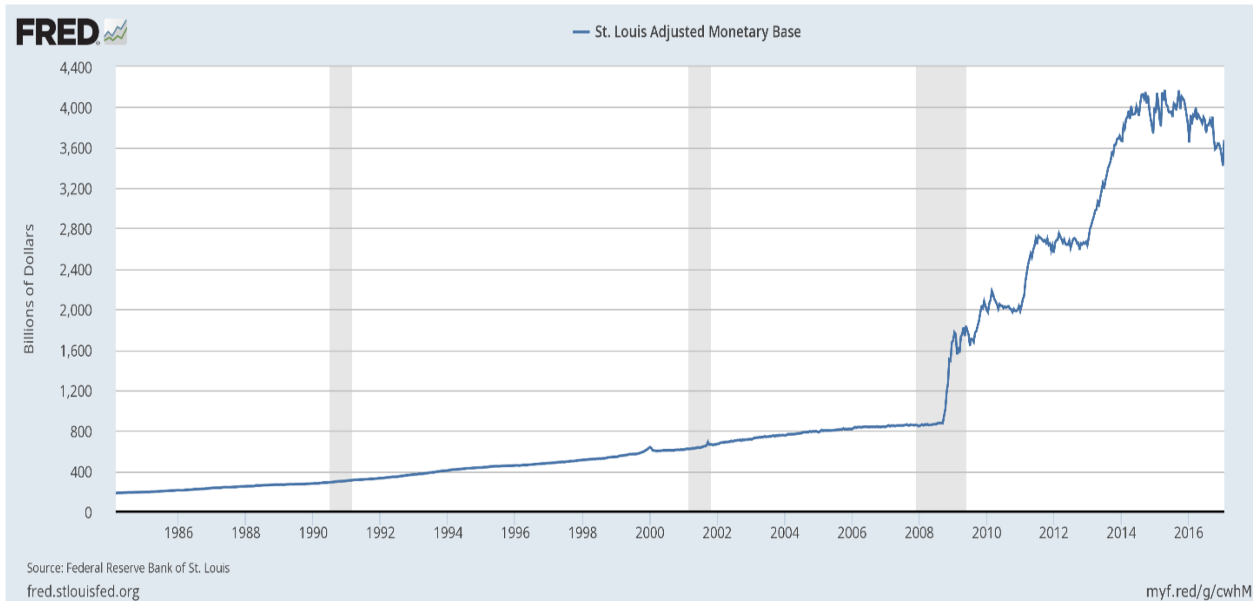
My biggest fear: What if good news now becomes bad news? For eight years, bad economic news has been good news for the markets as it indicated that another dose of monetary stimulus was just around the corner. And stocks rallied.

But now the Fed feels that the worst is behind us and we are beginning to see positive signs that the economy is improving. Good news… right? Well, not necessarily. Because of the perceived strength, the Fed is discontinuing its stimulative monetary policy. This is referred to as "tightening." By tightening, I mean raising interest rates and paying down the $trillions of debt on their balance sheet.

Without Fed support, stocks would once again be dependent on rising earnings and increasing profit margins in order to advance from their current levels.

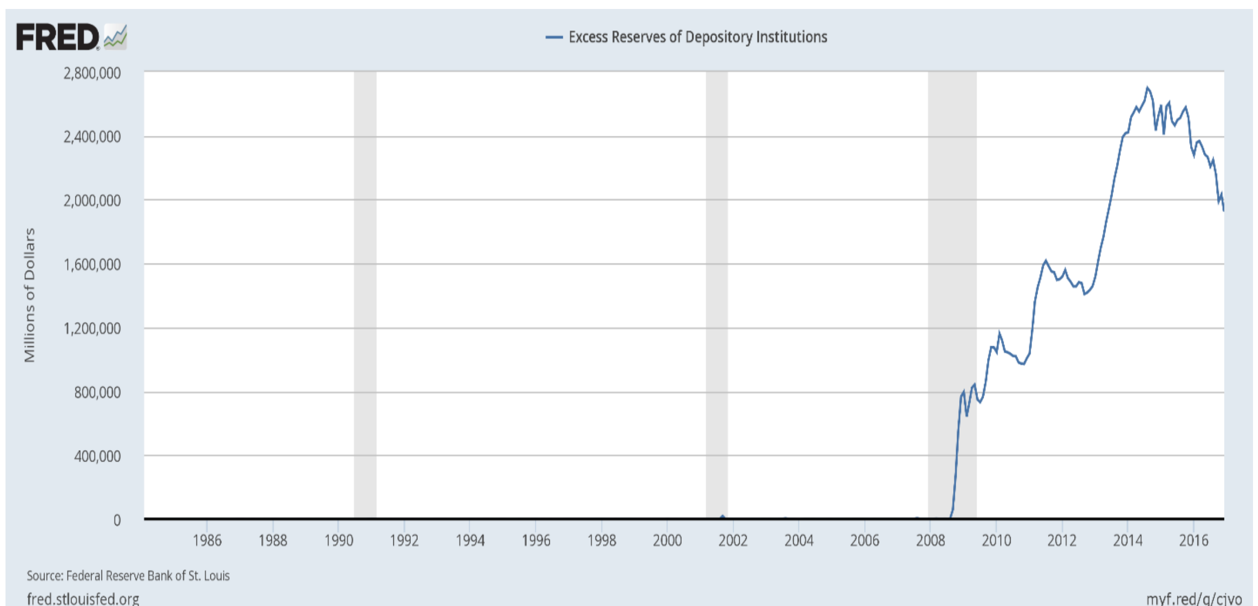
But now, as the Federal Reserve has begun to raise interest rates and is expected to continue tightening in 2017, liquidity growth is likely to slow markedly.

In the chart below, note the rapid expansion of the Fed's balance sheet since 2008 which provided a significant pool of liquidity, which then cascaded into stocks. Next notice the contraction during the past year.



As liquidity ebbs, will conditions be ripe for an increase in corporate capital investment that will result in growing productivity. In other words, will money flow from the bank's balance sheets back into the real economy?

Note the massive excess reserves that piled up on bank's balance sheets…



This too has reversed from its massive increase since 2008. Therefore, it seems that for stocks to continue their advance, it must be driven by an expansion of corporate earnings, rather than excess liquidity in the banking system chasing stocks.

The good news is… there is evidence of that happening!

In the above chart, the money multiplier increase is evidence that banks are lending, thus moving money off the bank's balance sheets into the real economy. This is encouraging.

However, a large portion of this money has not necessarily been sitting idly on bank's balance sheets; rather a significant amount has been used as collateral either directly or indirectly for stock and bond investments. Thus, the artificially driven rise in stocks and bonds during the past eight years, in spite of poor economic fundamentals.

And if this "easy" money is moving out the bank's reserves it will require that stock and bond investments that banks have been made, be sold. This would be the equivalent of a major sell-off in stocks. This is, unless new money comes in to offset these sales.

Without a new source of demand, stocks will decline! As liquidity is withdrawn from the stock market by central banks, it will be imperative that corporations deliver much better earnings to attract new individual and professional investors into the market.

As the new administration in Washington delineates its policies in areas such as taxation, trade and infrastructure investment, this may reduce some of the uncertainty that has been an impediment to capital investment and thus solid earnings by U.S. corporations.

So… if corporations “deliver,” good news could be good news for investors once again!

But what if this doesn’t occur? Can bad news still be good news for stocks? Maybe…

There has certainly been a lot of excitement around the potential for accelerating growth in the U.S economy, but how much money from investors has **really** moved off the sidelines into the market in the past 8 weeks? Has it been enough to account for and more importantly, sustain this spectacular rally?

In other words, has this really been the driving force for this rally in stocks? Or is there another explanation?

Remember the U.S. markets started 2016 with a 10% drop. In fact, it was the U.S. stock market’s worst 10-day start to a year **since 1897**. And other global stock markets fared even worse.

Then following this volatile start, the markets rebounded. Not because fundamental economic conditions of the world’s major countries improved instantly or geo-political tension declined. Rather, even as the U.S. Federal Reserve began to tighten or reverse its stimulative monetary efforts (as shown above); other major central banks took over the cheap money mantle.

The foreign cavalry appeared.

The Bank of Japan initiated a negative rate policy in January, 2016. Then the European Central Bank adopted negative rates in March, 2016. As a result of these major central banks equalizing the cost of global money back to zero, (even less than zero), the stock market rally marched on.

And if that wasn’t enough, both central banks introduced additional manifestations of quantitative easing during the year. Included in these manifestations were central bank direct purchases of common stocks.

According to a recent study by Invesco on central- bank investment which polled 18 reserve managers, **more than 50% of the respondents to questions on asset allocation said they planned to invest more in stocks!**

We’ve seen a major central planning shift in the past decade. Where they once engaged exclusively in monetary policy, the world's central banks now appear to be more focused first on "investment management".

And to state that they are the major “player” in the financial markets is an understatement. According to the International Monetary Fund, in the third quarter of 2016, global foreign-exchange reserves totaled $11 trillion, up from $1.4 trillion at the end of 1995.

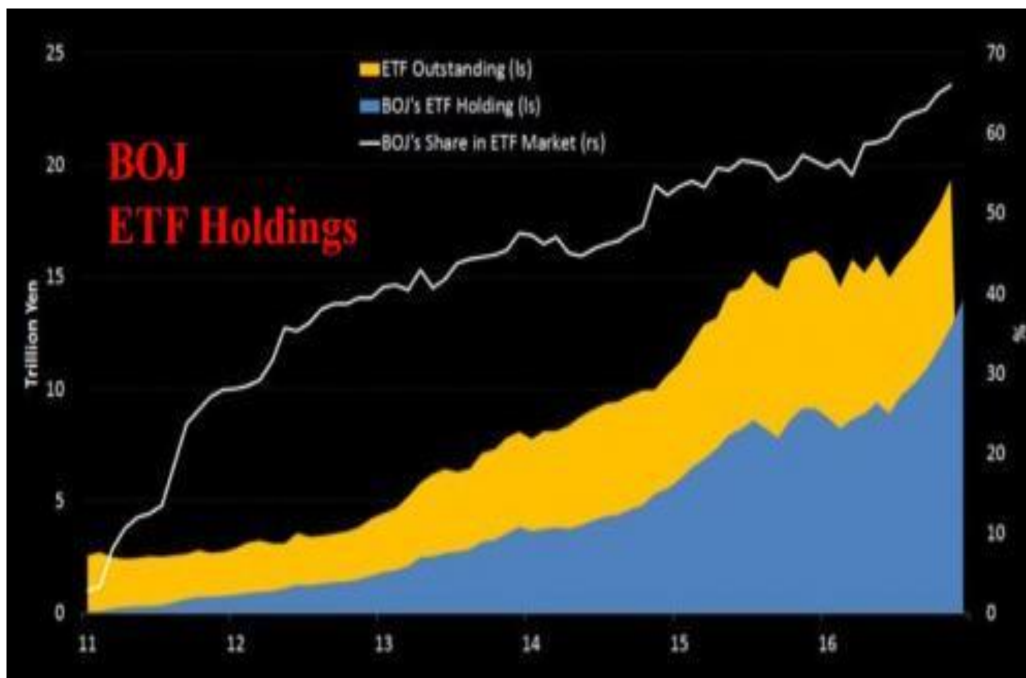
Illustrative of the new activities that these banks are engaged in with their newly minted $trillions, we can take a look at the Swiss National Bank (SNB), which has taken investing in the stock market to a whole new level.

The SNB now manages a mammoth $643 billion in foreign reserves. In 2009, equities only made up 7% of the SNB's reserves. According to the third-quarter Securities and Exchange Commission filings, **they are now at 20%.**

Their holdings include investments of $1.7 billion in Apple Inc., $1.08 billion in Exxon Mobil Corp., and $1.2 billion in Microsoft Corp.

This shift comes with its risks as is illustrated buy another central bank. The Czech National Bank started buying stocks in June 2008 just before the financial crisis. The subsequent stock market crash wiped out a third of its equity investment that year…

Let's look again at Japan. As a result of their modified policies, the Bank of Japan now owns **two-thirds** of all Japanese exchange traded funds (ETFs)...



Keep in mind, we're not talking about hedge funds or investment management firms, we're talking about central banks!

And at the current rate of expansion, within a few years, the world's monetary authorities who are tasked with "financial stability" will potentially have acquired a majority of the world's equities! This would effectively nationalize the world's stock markets.

So… as I stated above, the strong stock market recovery in 2016 was not because fundamental economic conditions of the world's major countries improved instantly or geo-political tension declined, but rather it was because major foreign central banks aggressive bought stocks!

Although the narrative is still focused on growth/earnings and politics and the gap between expectations/enthusiasm and reality is large, it's still central banks that will ultimately "move the needle."

Conclusion:
Although a somewhat oversimplification… as I see it, during the next several years we will face one of three scenarios with the following corresponding implications for the stock markets:

1. Strong U.S. economic growth, tightening Fed policy and stimulative foreign central banks – very bullish,
2. Anemic U.S. economic growth, neutral Fed policy and stimulative foreign central banks – bullish,
3. Anemic U.S. economic growth, neutral Fed policy and neutral or tightening foreign central banks – bearish.

As we navigate through these uncertain times, we will be paying very close attention to our *Global Macro Indicators*** for evidence of which of these scenarios will be the primary driving force for the financial markets.

Our admonition remains: Stay vigilant and nimble.

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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.