July 31, 2017

Consilience Market Notes:

Can You Time the Market?

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

Now to this week's report:

If by "timing the market," you mean being *"all in"* or *"all out"* of the market at any given time… the answer is no!

However, if we're discussing a risk management discipline whereby an asset class is reduced to minimize losses when risk is high, then there are many acceptable methods that can be employed to help protect investors over long-term holding periods.

The key is reducing risky assets at such times and not necessarily eliminating them entirely. Incremental adjustments can have a significant impact over the long run.

To illustrate, let's examine the 4 worst stock market periods over the past 100+ years and calculate the impact these bear markets had on investors if no risk management adjustments were made. Here's the breakdown of each of these periods and more importantly, the length of their respective recovery periods.

Shockingly, although the stock market has returned very favorable returns over the long haul, it has actually been in recovery mode for 74.5 of the past 111 years!

For example, beginning in 1906, it took the S&P 500 index 20 years to get back to its inflation-adjusted pre-crash level.

During the Great Depression, the S&P had fallen so far that it took 26 years to recover.

From 1973 to 1987 it took 14 years.

And following the tech crash (2000-2003) and mortgage crisis (2007-2009), it took 14.5 years to regain its full purchasing power.

It's worth pointing out that the Nasdaq still has not recovered from the 2000-2003 tech crash. It lost 78% of its value in the crash, and adjusted for inflation is still down 17.6% (as of 6-30-17) from its March 2000 peak!

In the following chart, we can see this illustrated by the 4 cut-outs in the midst of an otherwise, long-term rising stock market.

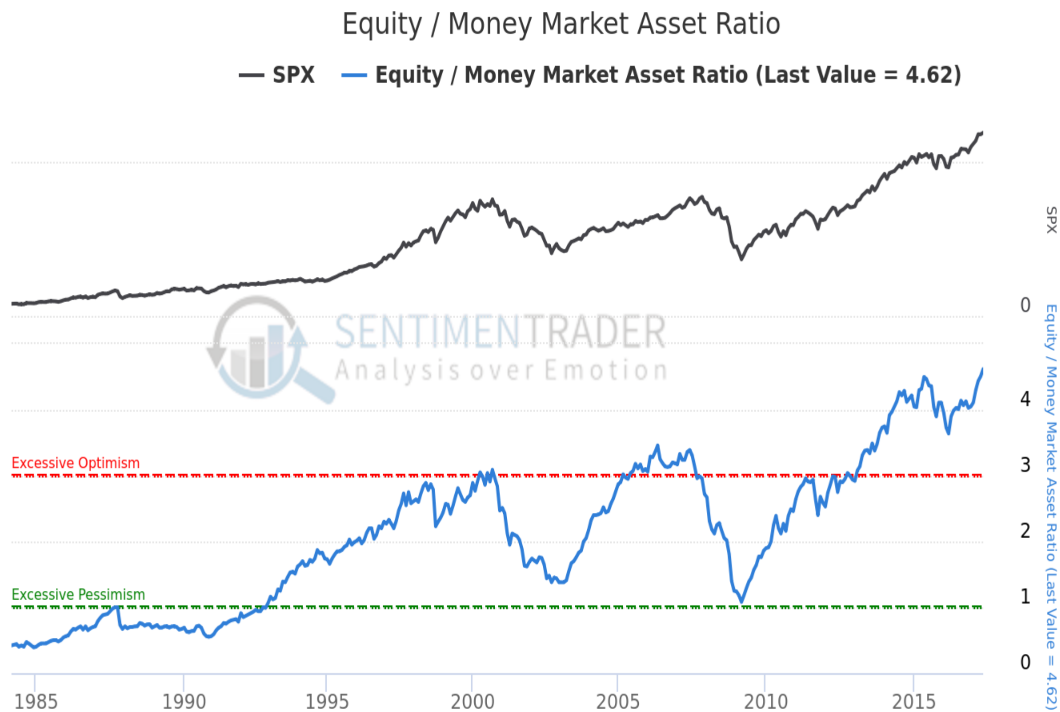
I think it clear from the forgoing that it's critical that every investor has a risk management discipline in place. Otherwise, bear markets and our own behavioral biases will lead to poor investment results.

I've added behavioral biases, because humans are hard-wired to become more optimistic (bullish) following market advances and pessimistic (bearish) following market declines.

Because of this, investors tend to be fully invested at market tops, which only magnify their losses and under-invested when stocks are cheap at market bottoms.

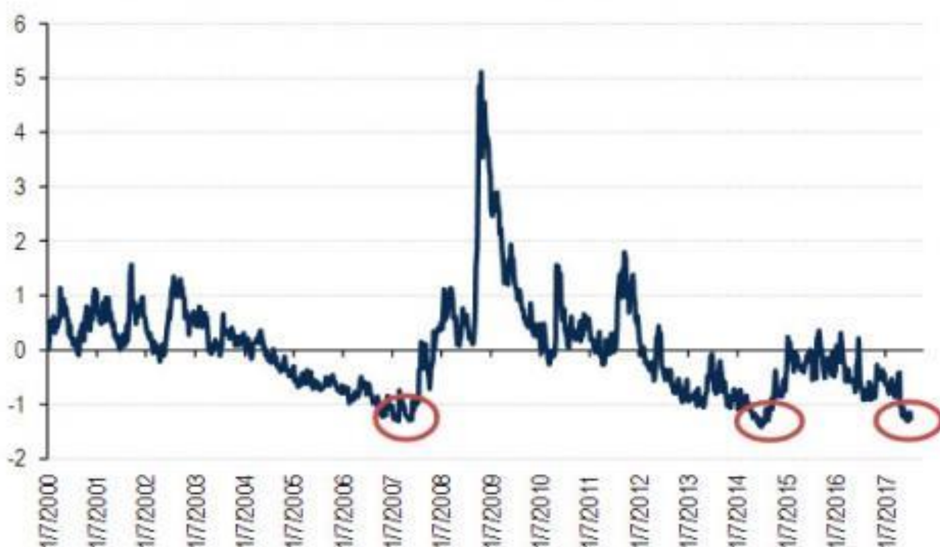
Therefore, as shown in the following chart, investor psychology tends to be a contrary indicator… That is, optimism is bearish and pessimism is bullish!

And as can be seen here, investors are currently very optimistic!



There is another statistical measurement of investor behavior worth considering here. It's called the VIX, which measures volatility or investors perception of market risk and is also a contrary indicator. This volatility measurement is near its lowest level in twenty years.

Chart 1: The average of z-scores across MOVE, VIX and 3-month EUR/USD implied vol



Source: BofA Merrill Lynch Global Research

Put these two charts together and the implication is that investors today, are extremely over confident as well as extremely complacent!

So, the important question is; do the economic, geo-political and stock market fundamentals warrant such enthusiasm for the stock market today?

You may be surprised, but my answer is yes… and therefore, from a "market timing" standpoint, a portfolio should favor equities.

But wait! Didn't I just present a convincing argument for investors to be very cautious based on overly optimistic sentiment indicators?

Hold that thought for a moment and I'll address the risk management method that we use at *Consilience Asset Management*… but first a word of caution here: The correct allocation would vary from investor to investor based on one's risk tolerance.

For example, let's say that you are someone with a moderate risk tolerance and short-term time horizon. In this case it might be appropriate to have a balanced portfolio comprised of growth investments that are tempered with income oriented investments. In an environment where equities are favored, it would be appropriate to tilt the allocation to the equity side while still maintaining a healthy percentage in income securities.

Conversely, when the environment is not as favorable toward equities, one might tilt the allocation in favor of income oriented investments. So, as pointed out above, you not "*all in*" or "*all out*," rather you are over-weighted or under-weighted relative to your core asset allocation objective which is based on your tolerance for risk.

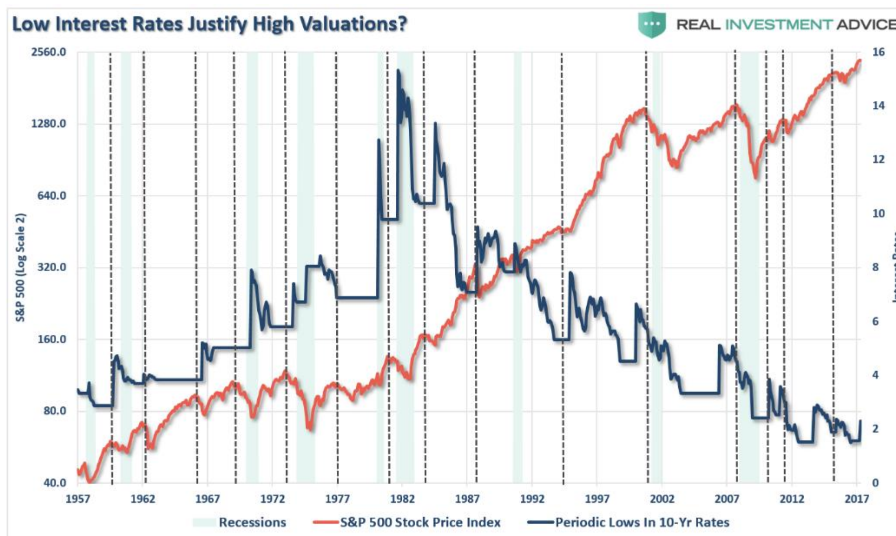
And, of course, for an investor with a longer time horizon and greater tolerance for risk, their core or target allocation may have a higher percentage allocated to growth investments and then adjusted accordingly based on market risk.

Before describing some of the tools that we use at *Consilience Asset Management* to determine when such adjustments should be made, let's delve further into the basis for my statement that an over-weighted position in equities is warranted today.

Right now, the consensus is that inflation will remain low. As a result, investors are anticipating a continuation of low interest rates. In addition, if we are in a low inflationary environment or even a period of global deflation, this would suggest that the central banks may continue their stimulative policies.

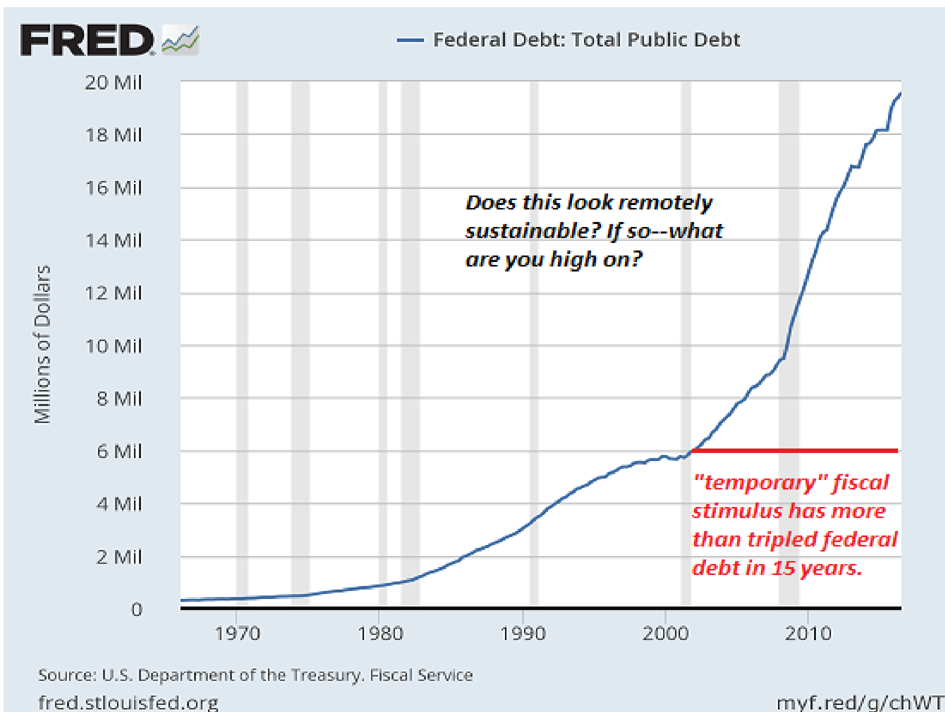
This is important because these policies have been the main driving force behind the historically low interest rates and the spectacular rise in equities during the past eight years.

And as shown below, the resulting low interest rates have justified the high valuation levels for stocks.



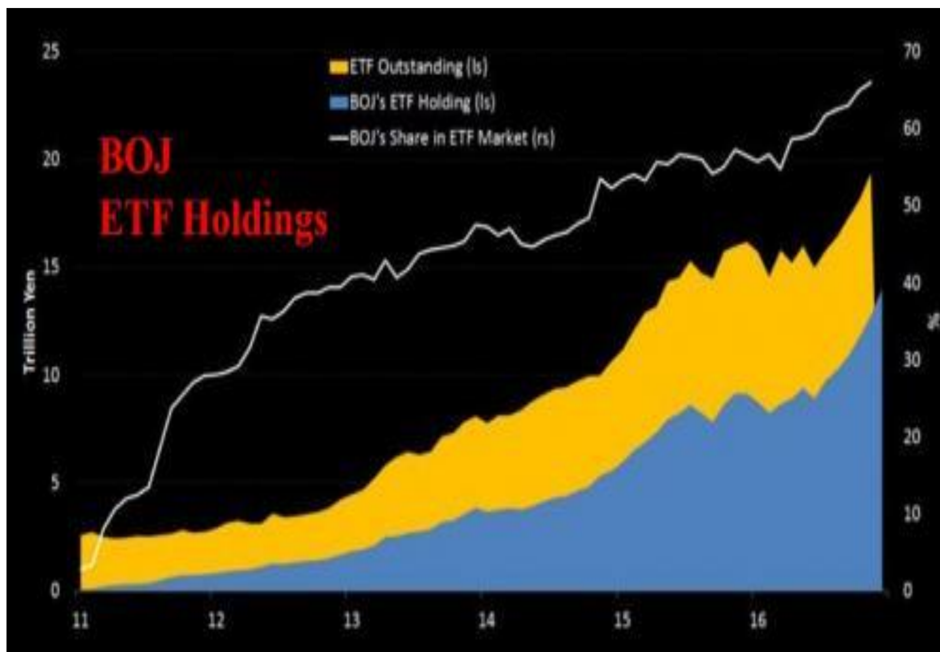
But is this a sustainable force for future advances in stocks? If the answer is no, then we must be on alert to adjust our equity weighting accordingly.

Even if the answer is yes, there is a disconcerting component of these central bank stimulative policies. Although, their policies have resulted in low interest rates, this feat has required massive buying of government bonds with <u>borrowed money</u>…



As we've pointed out regularly in our *Consilience Market Notes*, during the past eight years, central banks have not only been buying government bonds, but they have also been buying stocks with borrowed money. This has been done, not only to improve returns on their balance sheets, but also to intervene and prop up markets in order to maintain confidence in the global financial system.

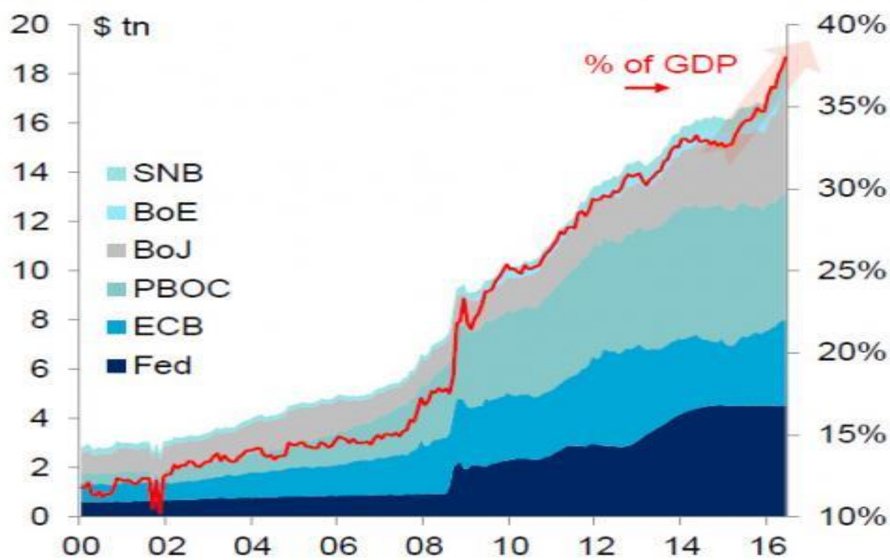
The most vivid and recent example is the Bank of Japan (BoJ), which, as a result of their stock buying through ETF's, now own two-thirds of all Japanese ETFs!



In fact, recently, Bank of America calculated that in addition to the Bank of Japan, the European Central Bank has joined them and together they have purchased $1 trillion of financial assets just in the first four months of 2017. This amounts to $3.6 trillion annualized, "the largest central bank buying on record."

The good news for equity investors is that according to a recent study by Invesco on central-bank investments, 80% said they planned to invest more in stocks.

And the result…



The bad news is that this buying spree indicates, as stated on page 2, that central banks believe we are still in "a continuation of a global deflationary period."

And deflation implies slow economic growth and therefore the need to "prop up markets in order to maintain confidence in the global financial system."

Which is exactly what they have been doing during the past eight years… they have stepped into **every single market correction** during this post-financial crisis period to provide what they believed was the necessary liquidity to the financial markets to prevent a repeat of 2008.

Therefore… the global markets really all come down to central banks. Although this is a little counter-intuitive… so far as equity investors are concerned… it's working!

Even with rising geopolitical uncertainty, high valuations and slow economic growth, one would think these issues might put a dent in markets, but surprisingly, they have not!

Now, back to our market timing question…

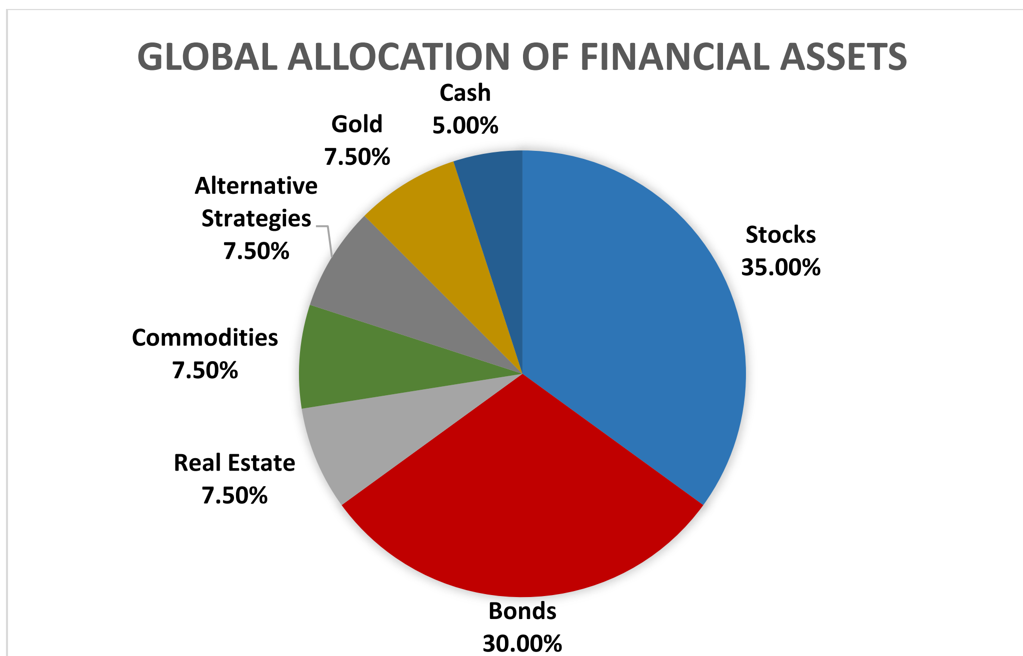
No one has a crystal ball that allows them to see into the future. As such, the best tools we have are those which allow for common sense and analytical rigor applied to historical data.

Our answer as Investment Advisors is to employ a discipline that we believe circumvents the effects of these disparities between the above noted risks and actual market action. Ultimately, it's 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 inconsistencies and irrationalities of their current levels relative to their underlying fundamental values.

Several catalysts exist today that suggest that investors should remain vigilant and keep the following concerns in mind as they invest.

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.