Consilience
Asset Management

March 26, 2018

Consilience Market Notes:

Follow the Money!

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:

"Things could start to get interesting right about now." - Bob Dylan

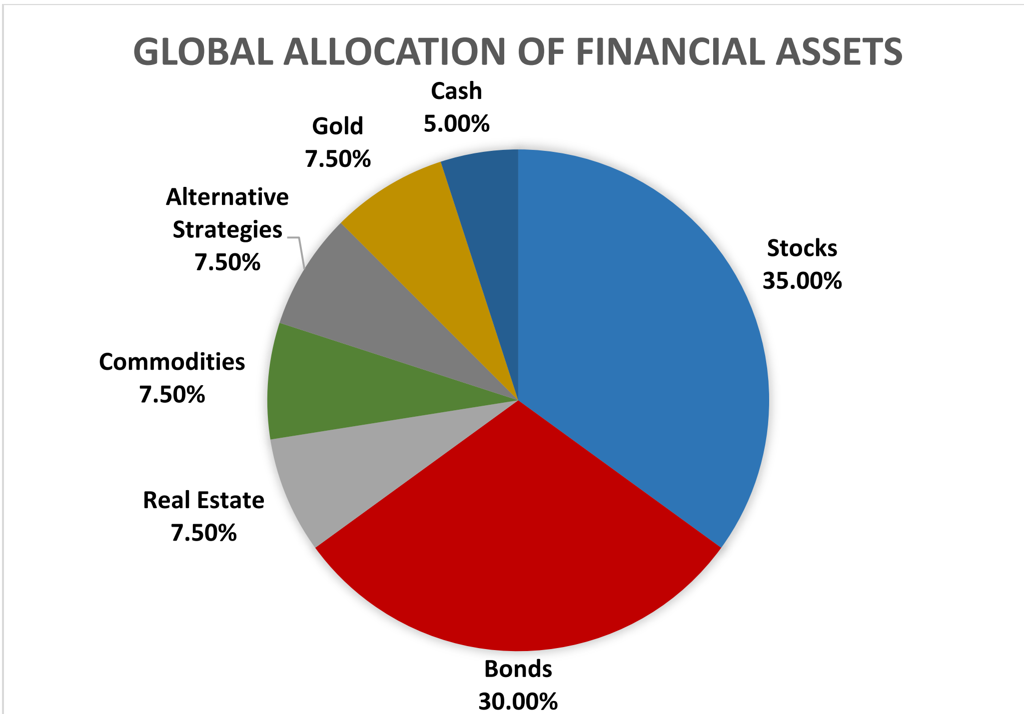
The ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information in a manner that allows one to imagine a plausible world different from today's, understanding how new data points fit (or don't fit) into that world and adjusting accordingly.

Although this is no easy feat, at *Consilience Asset Management* we employ a discipline that we believe circumvents the effects of the uncertainties and disparities between the underlying fundamental changes that occur in financial assets and actual market action. Ultimately, it will be the forces of supply and demand that will drive prices of these 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…

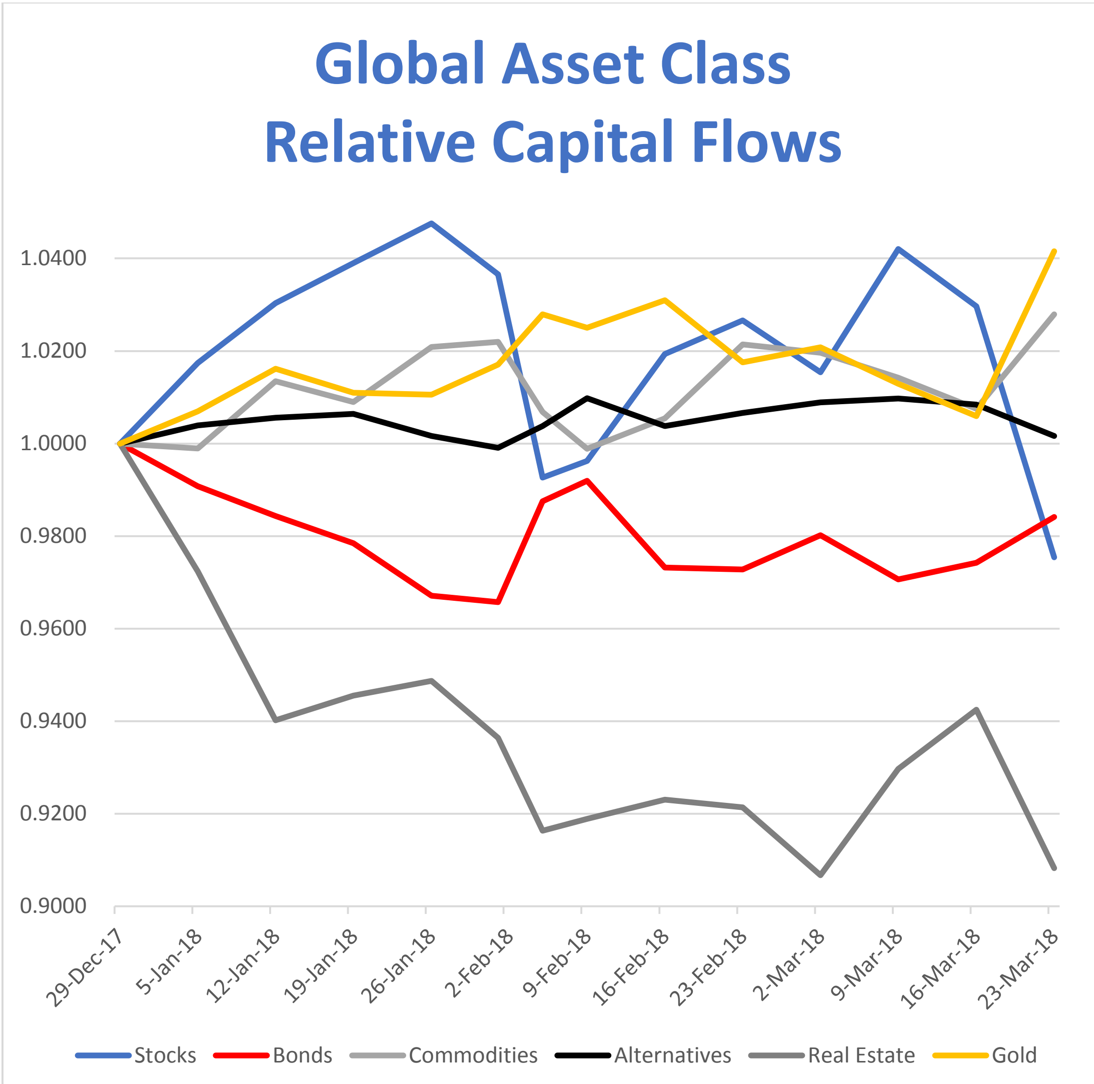


Source: BIS, Thompson Reuters, World Bank, World Gold Council, Financial Analysts Journal, (January 2014).

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

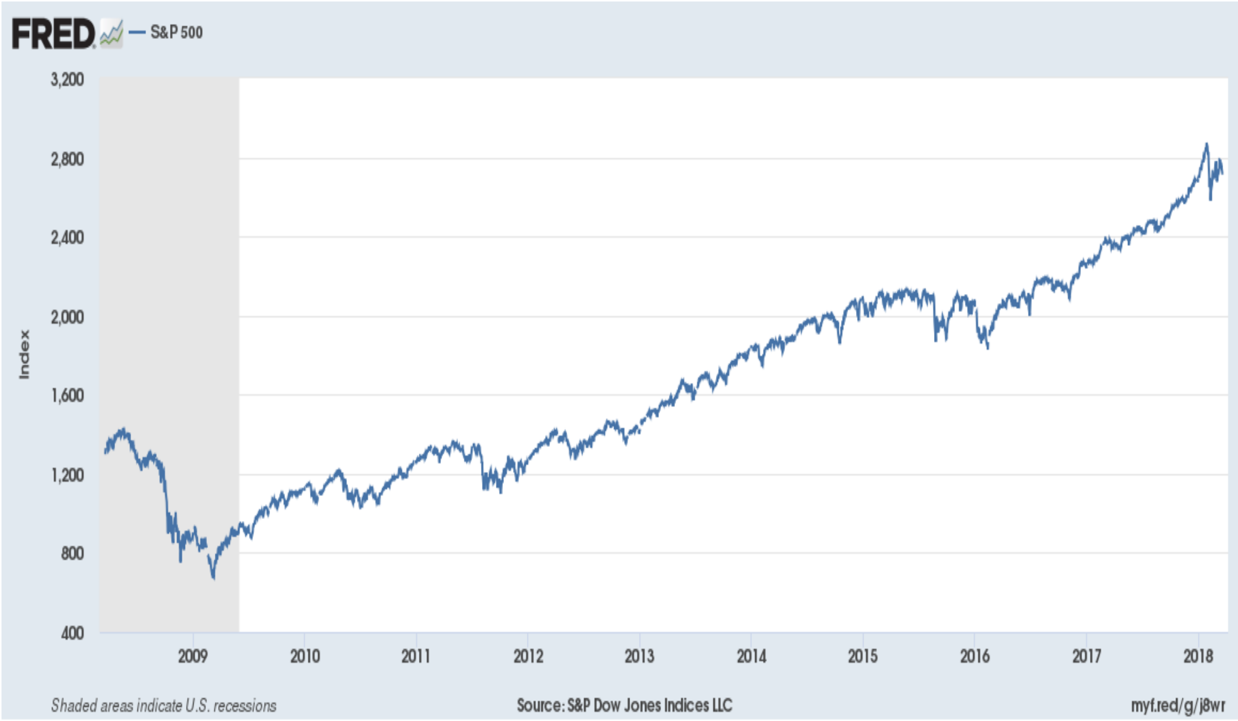
In the following chart, note the changes in capital flows that have occurred since the beginning of 2018. If the recent changes in market leadership persist, this will result in a major sea change in leadership in the markets.

Using a base of 1.000, note the clear delineation of assets classes that have shown positive capital flows and those that have shown negative flows as of Friday's market close.

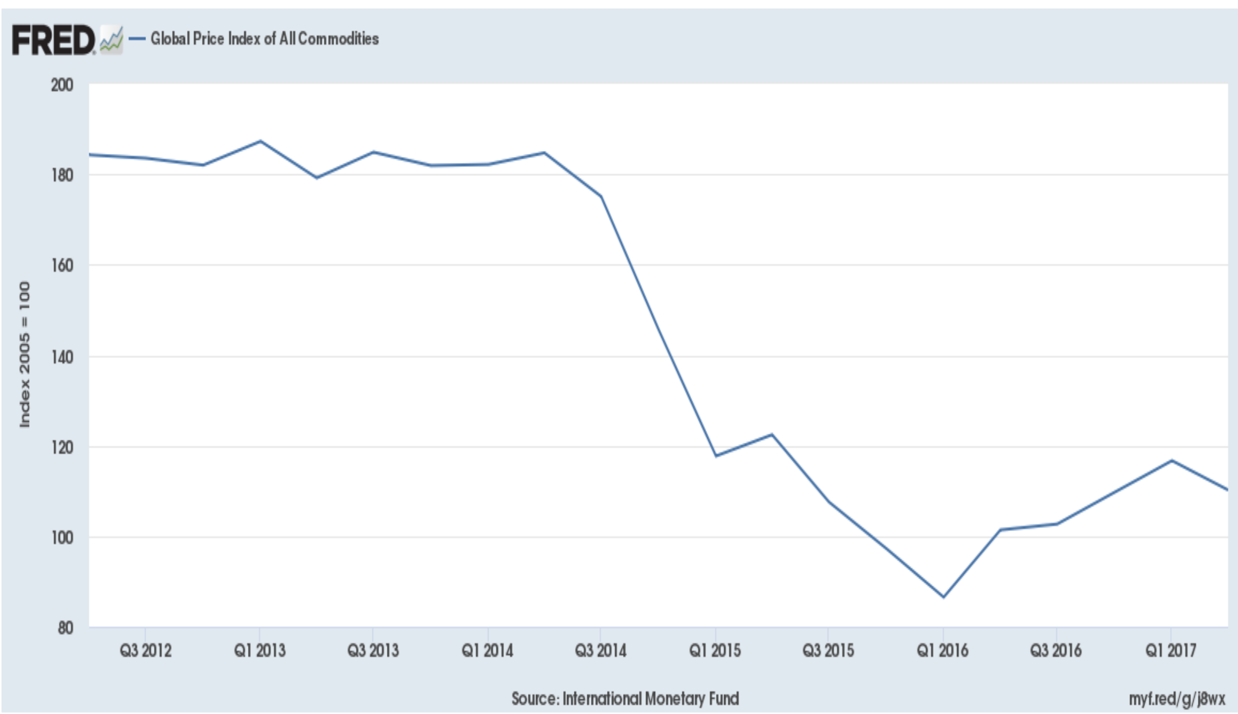


The biggest change in capital flows (and price movement) has been in financial assets (stocks and bonds) which have moved below 1.000 vs. hard asset (gold and commodities) with a calculation above 1.000.

This is occurring after a 9-year bull market in stocks that has propelled them to their highest prices in history…



While, relative to financial assets, commodities are at one of their lowest points in history…



Why?

The reasons for the recent market instability and possible change in leadership may not be what the headlines are suggesting.

Rather than a volatility problem or a trade problem, the recent market turbulence may more likely be the result of years of pent up ultra-low interest rates, central bank money printing and other forms of market manipulation, that has resulted in its finally manifesting itself.

It is important to remember that global central banks have been the largest purchasers of stock and bonds. Now, the Fed has ended Quantitative Easing (QE) and is reducing its balance sheet. This means they will be selling financial asset (stocks and bonds) by the trillions!

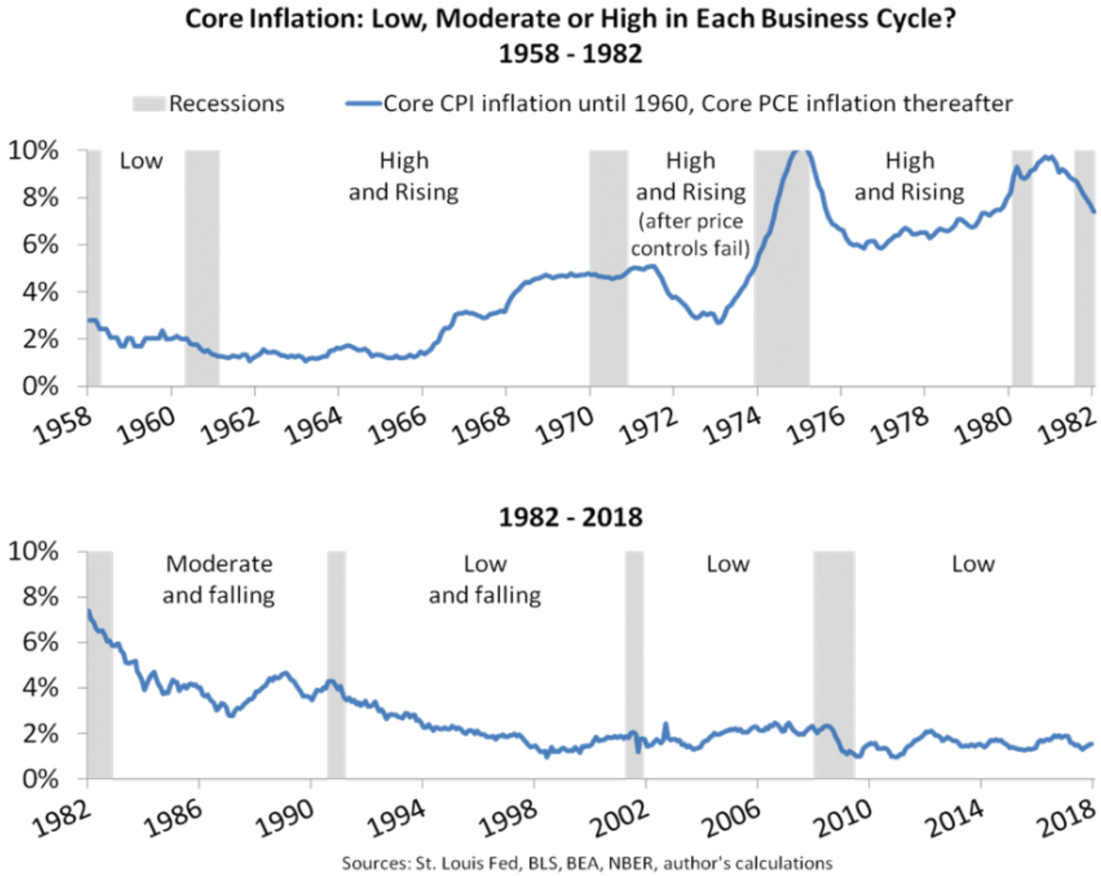
This is not just a U.S. phenomenon, but in addition, beginning next September, the European Central Bank (ECB) will be concluding their asset purchases too. The result will be that the aggregate balance sheets of the main central banks in the world will start contracting after nearly a decade of expansion… thus global selling pressure is a natural outcome.

On top of this, we find ourselves in a unique historical situation with the Fed stepping away from the market while simultaneously, the U.S. government is significantly increasing its bond auction sizes.

For context, keep in mind that we're in the third-longest period of economic expansion in history, which began from a crisis low in 2008. None-the-less, the U.S. has passed a tax cut and a spending bill, which together could result in a budget deficit of 5% of GDP.

This would be unprecedented in peacetime outside of recessions. So… are policymakers setting the stage for accelerating inflation, similar to the late '60s. If so, what the markets are signaling make sense.

Here's an interesting picture of the historical trend in inflation since 1958…



So, is the long-term trend reversing? If so, the market's recent action make sense.

Finally, are adverse valuations are becoming more glaring? Valuation levels haven't been that relevant in recent years because of central bank manipulation. But with the Fed in motion and the US economy expanding, they may start to matter a lot. Especially with measures such as the stock market's Price-to-Sales ratio at record highs...

Conclusion:

1. With low interest rates, low inflation, low volatility and Central Bank money printing (QE) likely behind us… (all of which added liquidity to the stock markets and are stimulative to the economy)…

2. … and rising rates, rising inflation, high volatility, Central Bank monetary contraction (QT) likely in front of us… *headwinds* for the stock market may very well accompany these actions and thus a shift to real assets (gold and Commodities) may be appropriate, as our indicators* are presently suggesting.

One caveat to this outlook: If rising interest rates and inflation begin to impede economic growth and resurrect deflationary concerns, expect central banks to re-emerge with new rounds of QE… which will create an environment where, once again, financial assets will be favored over "hard" assets!

How will we know which scenario is unfolding?

As stated at the outset, 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.

We are closely monitoring the unprecedented developments that are presently unfolding and are cognizant of the challenges inherent due to the 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 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.

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