Consilience
Asset Management

May 2, 2016

Consilience Market Notes:

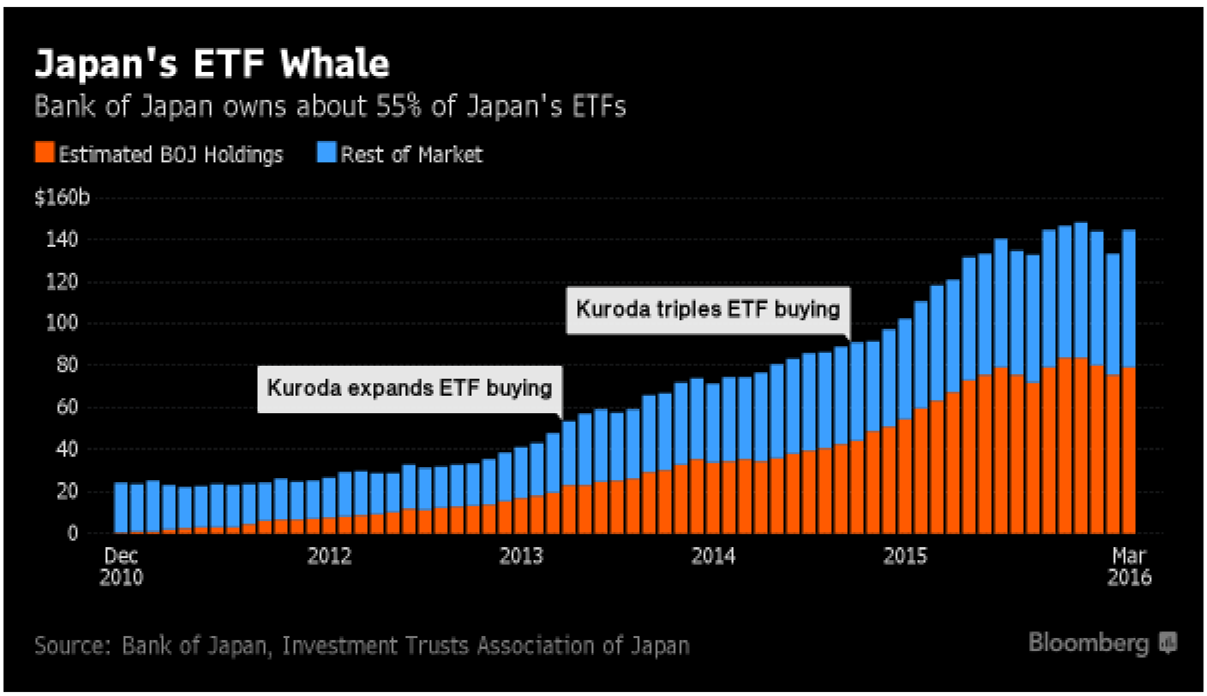
Is it Time to Replace the Artificial with the Real?

First, an update: Our *Global Macro Indicators* remain **neutral*** for U.S. equities. **

Now to this week's report: How far can central banks go with their artificial stock buying activities?

The latest shocking example of just how intertwined central banks have become in not only Treasury and corporate bond markets, but also in stocks can be found in Japan.

The Bank of Japan (BOJ) announced that it intends to double its stock ETF purchases from the current 3.3 trillion yen to 7 trillion yen! This will make the BOJ a top 10 holder in about 90% of all Japanese stocks and the No. 1 shareholder in about 40 of the Nikkei 225's companies.



The BOJ is not alone. The U.S. government spent $245 billion to prop up banks during the global financial crisis in 2008… and these money center banks have added hundreds of billions more from their excess reserves into U.S. stocks.

At the height of the Asian Financial Crisis in August 1998, Hong Kong bought HK$118 billion ($15.2 billion) of local shares to defend its currency peg… And let's not forget the European Central (ECB), the Bank of England (BOE) and the Peoples Bank of China (PBOC).

This is not only troubling but dangerous: the longer such central bank buying persists, the further market prices will detach from fundamentals.

And what happens if/when they sell?

According to a report from Goldman Sachs, these central banks simply have no exit strategy and "in an effort to protect the system" will continue buying risk assets at an ever faster pace…

But, at some point, this charade has to end. Because as I have stated repeatedly in these reports, these purchases are being made with borrowed money!

During the first quarter of this year, China generated new debt at a madcap annual rate of $4 trillion or nearly 40% of GDP. This, in addition to the ECB's $90 billion of new debt per month in their latest form of Quantitative Easing (QE)…

These money printing central bankers can't stop.

But, what if they were they to begin reducing their shares and began to allow financial prices to normalize?

It seems that if someone among the 100 or so central bankers knew how to "normalize" and had the will to try, it would have been evident long ago. But they haven't… or maybe they can't. As a result, what they have done, instead, is simply disable and falsify the pricing mechanism throughout the global financial system.

This is especially evident in the U.S. stock market where prices are currently at an excessive 24X corporate earnings (vs. the long-term average of 15X)… that is, 24 times <u>artificially inflated earnings</u>…

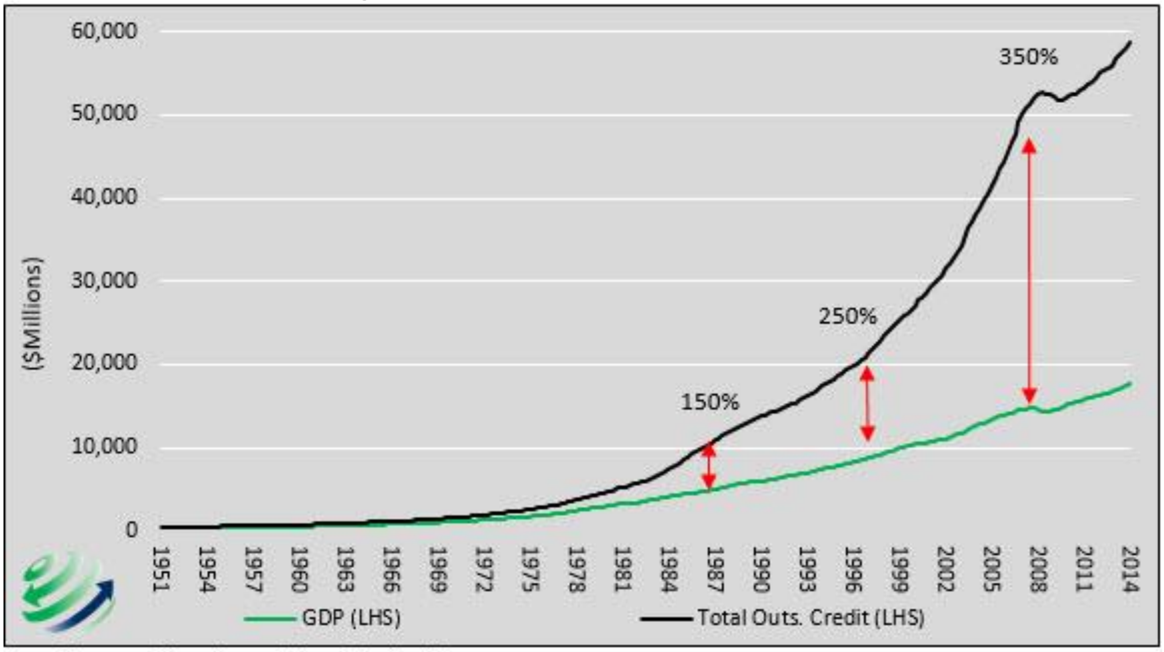
What underlies the market's current fantastic over-valuation besides sheer these central bank's fantastic eruption of debt!

Remember, all of these governments and central banks have driven interest rates not just to zero, but to negative levels in some cases... and simultaneously have been printing up trillions of currency units.

Debt isn't necessarily bad if it is used productively, but the one sure sign of trouble is if your debt burden is growing faster than your net worth. In the case of the United States, our cumulative debt burden is growing at a much faster pace than our gross domestic product.

In hindsight we know these actions have been unproductive as highlighted by the steadily rising debt to GDP ratio as shown below. The increase is stark when compared to the relatively modest level of economic activity that accompanied it (green line). The red arrows highlight the exponential rise in the ratio of debt to economic growth.

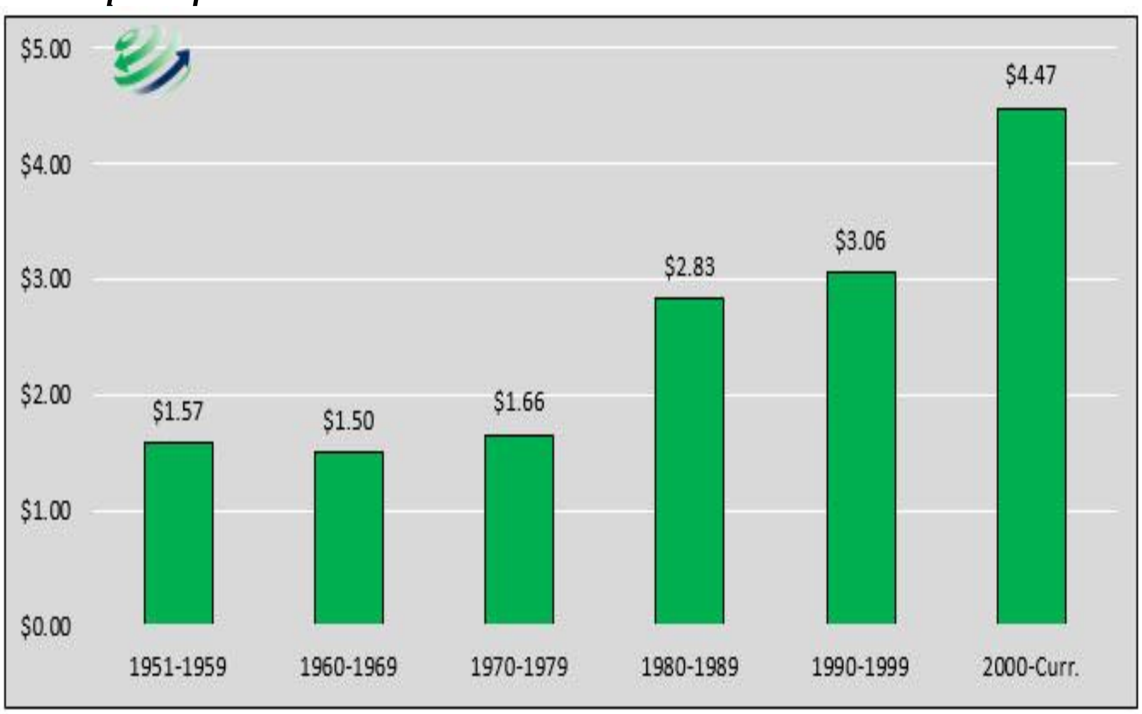
Total Domestic Outstanding Credit vs. U.S. GDP



Data Courtesy: Bloomberg, St. Louis Federal Reserve

The graph below tells the same story in a different manner, plotting the amount of debt required to generate $1 of economic growth.

Debt Required for Economic Growth



However, with rare exceptions, monetary policy has been the only policy in the last seven years to support any amount of economic growth.

But here's the thing… Debt undermines growth and the world has never been more indebted.

Reinhart and Rogoff's 2010 research on the topic concluded that growth is about 1 percentage point lower in the long run when sovereign debt is 90% or more of GDP.

Debt levels of many countries have reached levels far higher than 90%. In the U.S, government debt-to GDP is 104% (not including unfunded entitlement liabilities which many argue will reach levels greater than $100 trillion in the next 10 years).

Loose monetary policy is supposed to provide cheaper funding for investment into capital projects that ultimately spur economic growth.

Yet, a massive amount of borrowing has taken place. Unfortunately, the proceeds of the huge corporate debt issuance have been used for share buybacks and dividend increases.

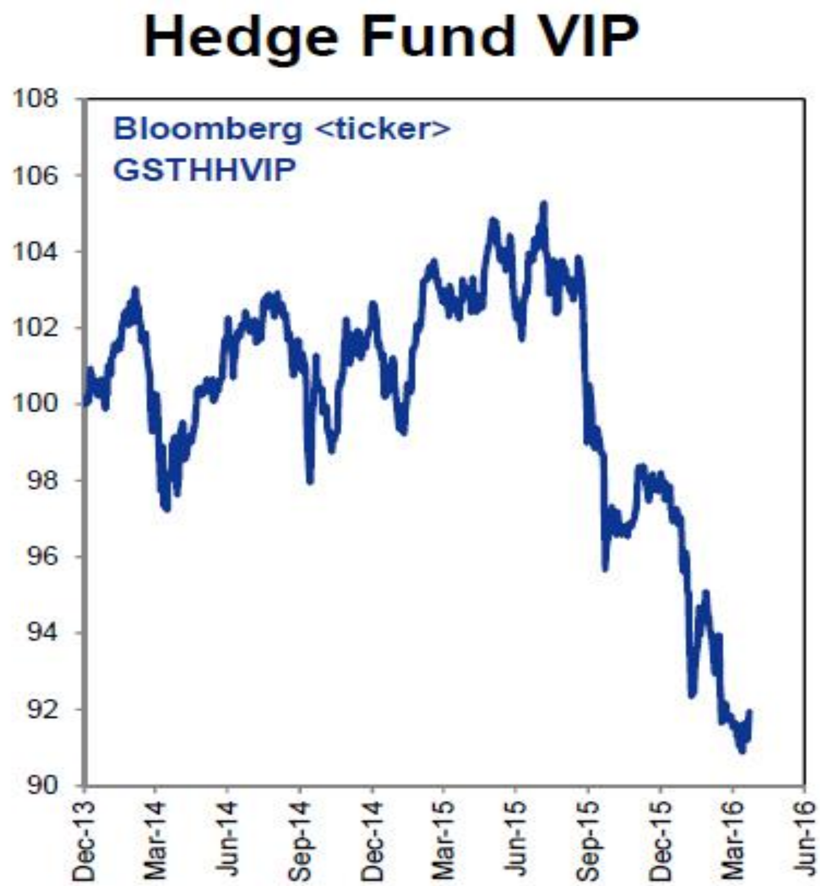
To make things look 'less bad', corporate executives have made efforts to increase earnings per share (EPS) ratios by making sure that the share count (S) falls faster than the earnings (E).

Thus, as a result of this activity, higher asset prices increasingly diverge from underlying economic fundamentals.

No surprise then that the average investor is tasked with an uncomfortable dilemma. How to sensibly invest when all prices have been distorted and no prices can be taken at face value?

But it's not just the average investor who is struggling… even the "best and the brightest" are in a quandary. Yes, even Hedge Fund managers; the most sophisticated and highest paid investors, are faring poorly in this environment.

Note the dismal performance of Goldman Sach's own Hedge Fund...



As central banks continue to take over capital markets it makes fundamental-based investing <u>nearly</u> impossible. But not <u>entirely</u> impossible…

As most investors have been caught off-sides at some or multiple points over the past several years, the impulse to do little is understandable. I am of a contrary view that this period of excess volatility is creating excellent opportunities.

I believe increasing complexity is here to stay and now is a more important time than ever to employ active portfolio management to take advantage of this volatility.

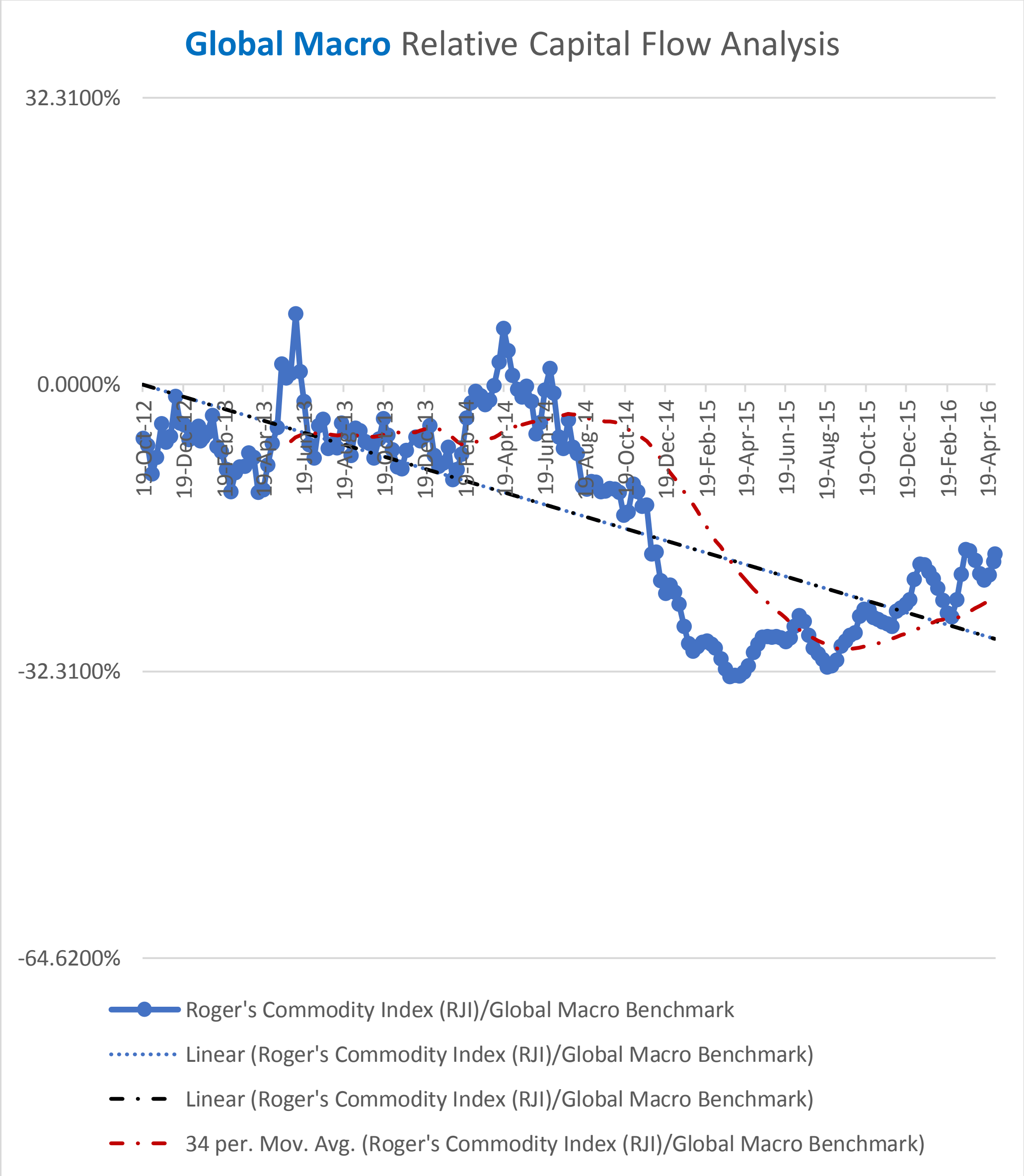
As central banks are forced to continue and many instances <u>accelerate their bond buying</u> programs under the guise of Quantitative Easing, the resulting unfavorable risk-reward of government bonds near the point of zero yields will likely prevent asset managers from increasing holdings of government bonds.

If there are no private buyers, governments will be forced to place their bonds with central banks. This trend is of course already in place – for instance, the Fed's holdings of U.S. Treasuries increased from approximately 18% in 2008 to 34% today.

As history has shown, this will eventually result in the <u>devaluation of all currencies</u> against real assets such as energy, agriculture, gold and other metals.

As financial assets have outperformed during this period of money printing, real assets have suffered in a prolonged "bear" market. Based on our *Global Macro Relative Capital Flow Models* **, this trend appears to be changing.

Note the reversal in capital flows in the *Roger's Commodity ETN* from an extremely depressed 3-Standard Deviations below its mean (zero line). Interestingly, this is the level where we found most major stock markets following the 2008-2009 financial crisis.



As central bank capital has flowed into the world's stock markets, prices have risen to extremely over-valued levels based on historical comparisons. As stocks have stagnated at these elevated levels during the past 15 months, reversals are beginning to occur in real assets.

This has been the result of every money printing experiment since the days of the Roman Empire… as currencies are devalued and real assets appreciate.

At *Consilience Asset Management* we employ a process that monitors the flow of global asset purchases and sales. As part of our risk management process, when capital flow trends reverse, asset classes to avoid are identified as well as asset classes that provide future opportunity.

Along the way, our goal is to employ all of the tools at our disposal to manage client assets through these volatile times.

Consilience Asset Management

Roger Faulring – Partner/Portfolio Manager

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*At a **neutral** rating, our equity allocation is at "target weight". Each client's target weight is determined by their investment objective and risk tolerance.

**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.