Consilience
Asset Management

May 29, 2018

Consilience Market Notes:

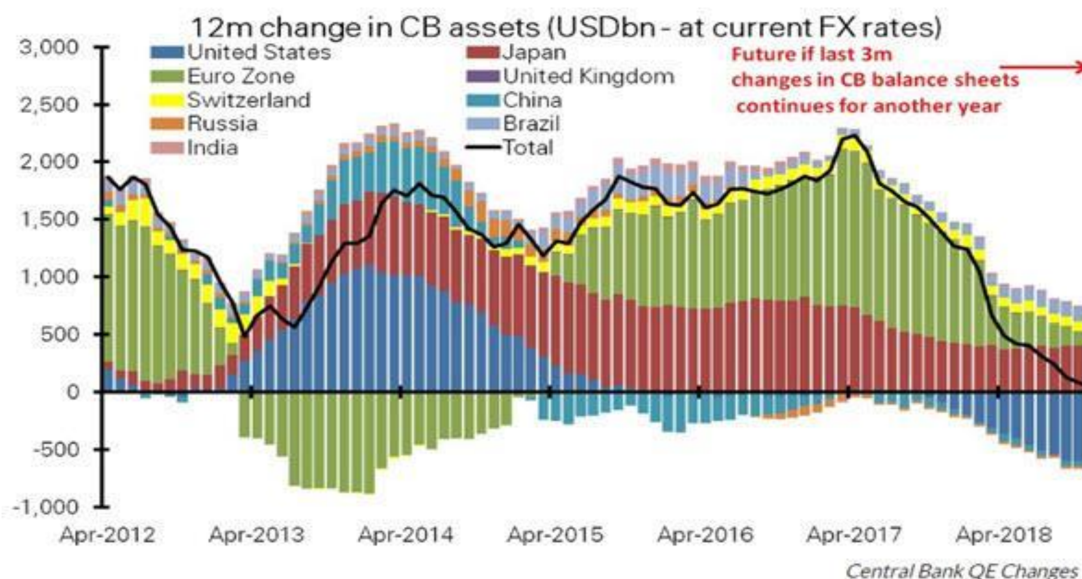
Corporate Earnings Up 24%, Stock Market Up 2%. Why?

First, an update: Our *Global Macro Indicators** are as follows for the 8 asset classes we invest in for our clients:

Global Equities – Negative,
Global Bonds – Negative,
Commodities – **Positive,**
Gold – Negative,
Hedge Fund Strategies – Neutral,
U.S. Dollar – Neutral,
Real Estate – Negative,
Cryptocurrencies – Negative.

Now to this week's report: Traders, analysts and strategists have been stumped by a market paradox in recent weeks: despite earnings that have been off the charts, the S&P is up only 2% so far this year.

To explain, the chart below is probably **the most important one in existence**…



Globally, central banks have deployed $21 trillion worth of fiat money in return for stocks and corporate bonds around the world.

So, what will happen if central banks stick to their stated plans to reduce their levels of money printing/balance sheet expansion.

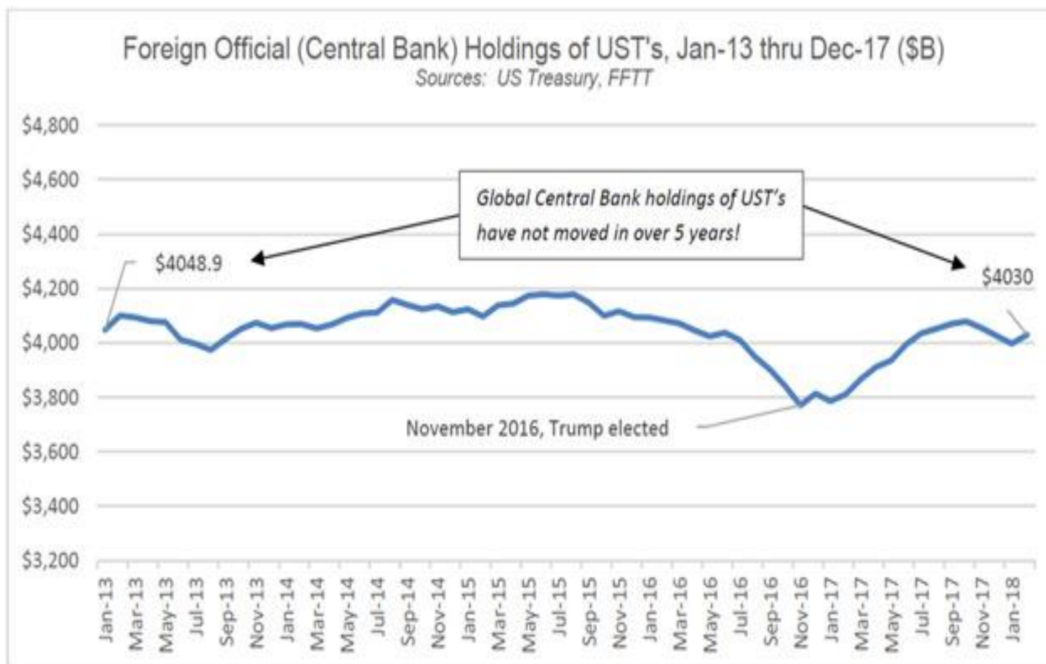
As shown in the above chart, they are on track to end worldwide stimulus in early 2019, when their collective net change in assets will dip below $0!

If they pulled that plug, if they were to take down any of the $21 trillion, even a little bit . . . it could begin to create a major rupture in the financial system… because the central banks are the market!

So far, the shift in this direction has been modest. The European Central Bank (ECB) and the Bank of Japan (BoJ) have still been putting chairs into the game even as the Fed has begun taking them out, and there are times when the music is playing that it's tempting to overlook the markets' vulnerabilities.

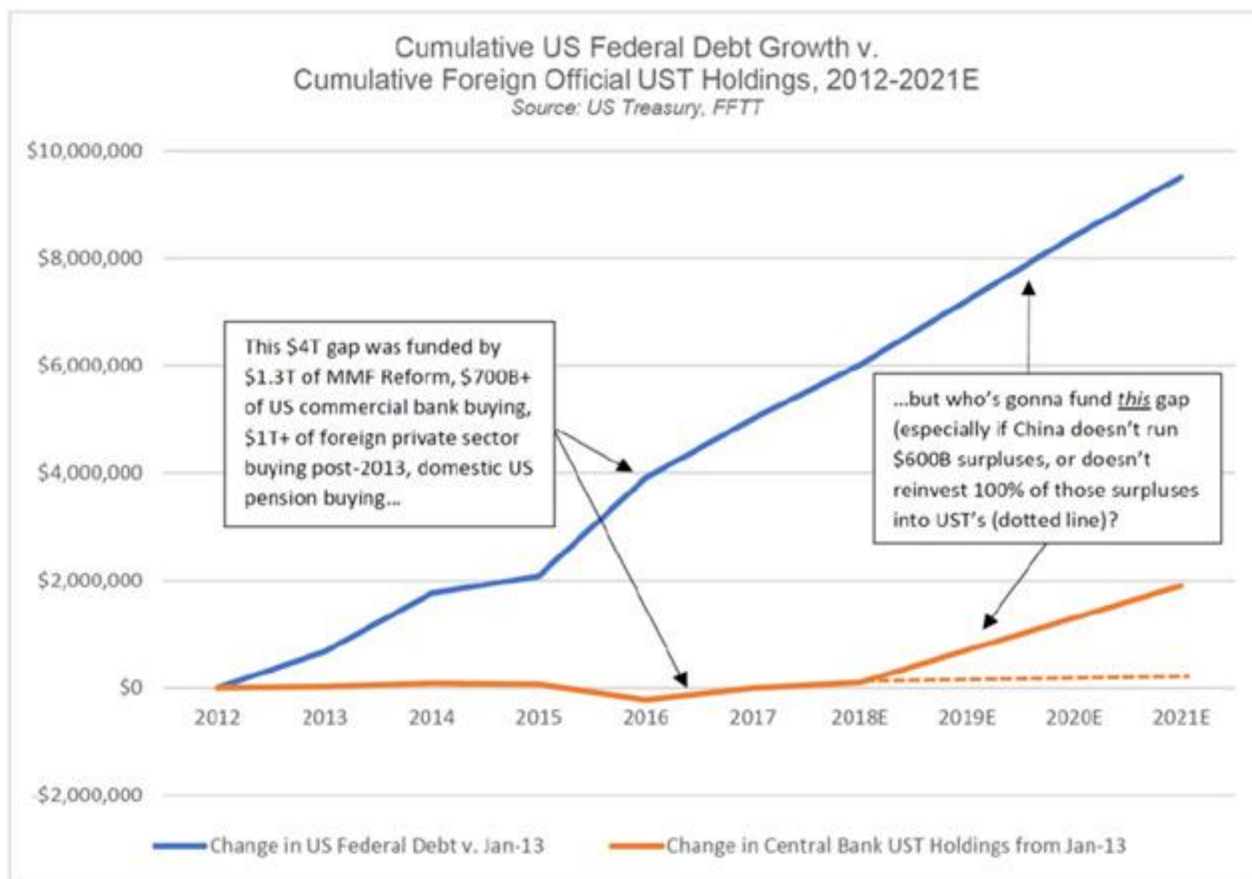
But, the inflows to the world's stock markets from central banks have basically stopped. This explains why the stock market's upward trajectory has stalled… in spite of strong corporate profits.

In addition, one of the least-noticed recent developments is that foreign central banks stopped net purchases of U.S. government debt about five years ago.



Source: Forest for the Trees, LLC

This is important because someone has to fund our deficit spending, and the job is not getting easier as the next chart shows.



Source: Forest for the Trees, LLC

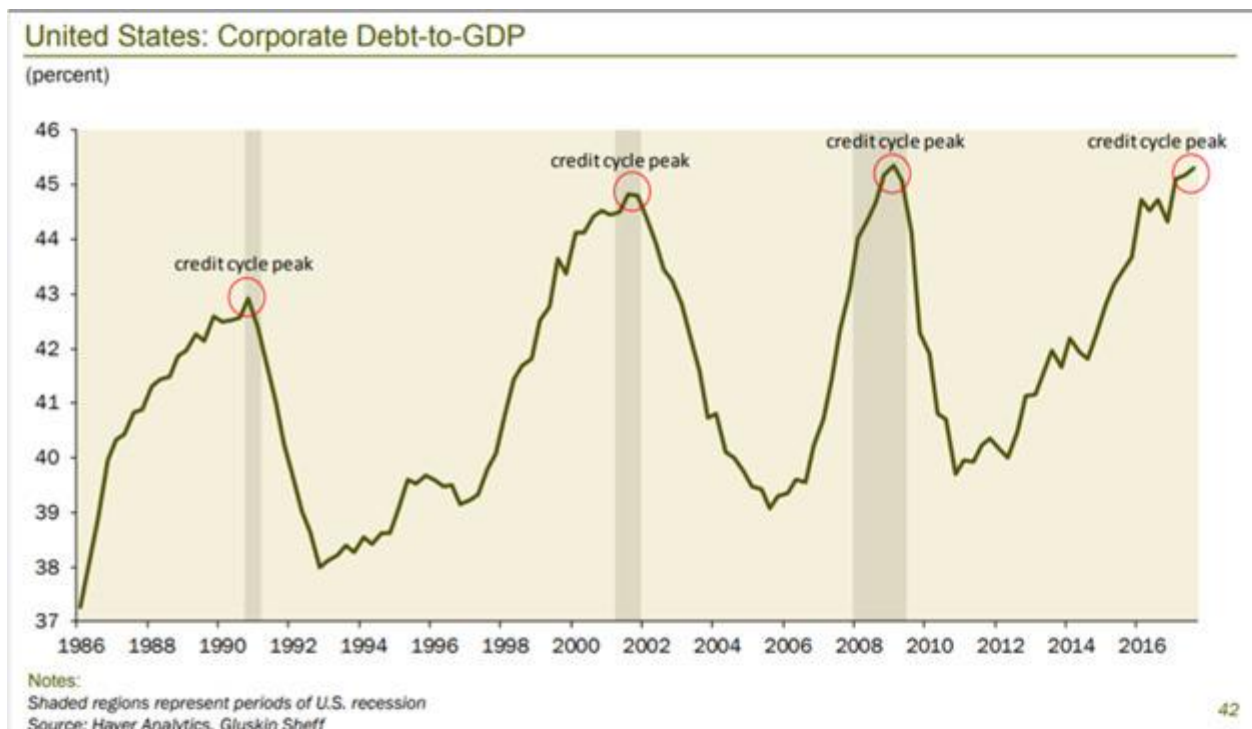
So, on the one hand, central banks are paying down the existing debt created through (QE) and on the other hand, new debt is being created by deficit spending!

By the way, this gap is conservative. It assumes the US will have no recession by 2021 and that foreign central banks will hold their U.S. Treasury securities to maturity.

It also assumes China will keep running a $600B yearly current account surplus with the U.S. and buy U.S. Treasury securities with all of it. Those aren't guaranteed either and will certainly change if the U.S. succeeds in reducing the U.S.-China trade deficit.

That leaves one option: higher interest rates. People will loan their money to the government if it gives them enough incentive, and higher yields will do it.

And to complicate matters further, there is going to be competition for the funding of all this debt! Corporations will need to refinance an estimated $4 trillion of bonds over the next five years, about two-thirds of all their outstanding debt…



Source: Gluskin Sheff

… and many of these lenders are highly leveraged. They bought their corporate bonds with borrowed money, confident that low interest rates and defaults would keep risks manageable.

And there's still more…

One conspicuous consequence of post-crisis evolution is that trading volumes in many markets are now dominated by high-frequency traders (HFTs).

Regulators and researchers increasingly warn that HFT strategies can contribute to breakdowns in market quality during periods of distress.

The big question is what happens when the "market", which in the past nine years has been centrally-planned by central banks and hardly if ever "allowed" to drop, is pushed into a mode of forced price discovery, especially if HFTs no longer provide the much-needed liquidity.

What happens in a world where the very core of the capital markets system is gradually deleveraging to a point where maintaining a liquid and orderly market becomes extremely challenged?

Will the resulting liquidation of these accumulated assets (stocks and bonds) cause a steep decline in prices? Or…

If the unwinding results in severe weakness in the economies and/or financial markets, will central banks resume their stimulative policies thus providing the necessary catalyst for the markets to resume their upward trajectories?

The central banks have proven to be weak-kneed at every moment of market wobbliness. To date, they've chosen to print (and then print some more), whenever the "markets" are vulnerable to any significant sell-off.

To illustrate this point, let me take you back to 2016…

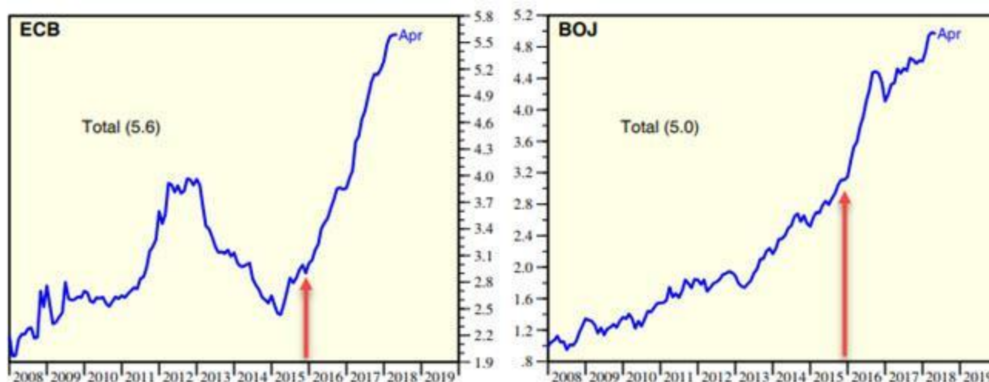
Back in January of 2016 we saw large, highly-leveraged institutional investors, who had been borrowing heavily in stocks and high-yield bonds begin to reverse their trades.

The stock markets rapidly fell into correction territory… until, very early one morning in February of 2016 everything U-turned and rocketed higher. Suddenly and magically, the panic was over.

This wasn't the invisible hand of the market at work; it was the very-visible hand of central bank intervention.

With the benefit of hindsight, we now have a clear picture of what happened. The central banks of the world put their printing presses into overdrive.

In the months to follow, the U.S Federal Reserve, the European Central Bank (ECB) and the Bank of Japan (BoJ) went on a record-breaking money printing spree:



Source: Federal Reserve Bank

The red arrows in the charts above mark this moment when the "markets" were saved by the central banks printing money out of thin air:

So, what caused the weakness in early 2016 that spooked the system so much? The central banks themselves.

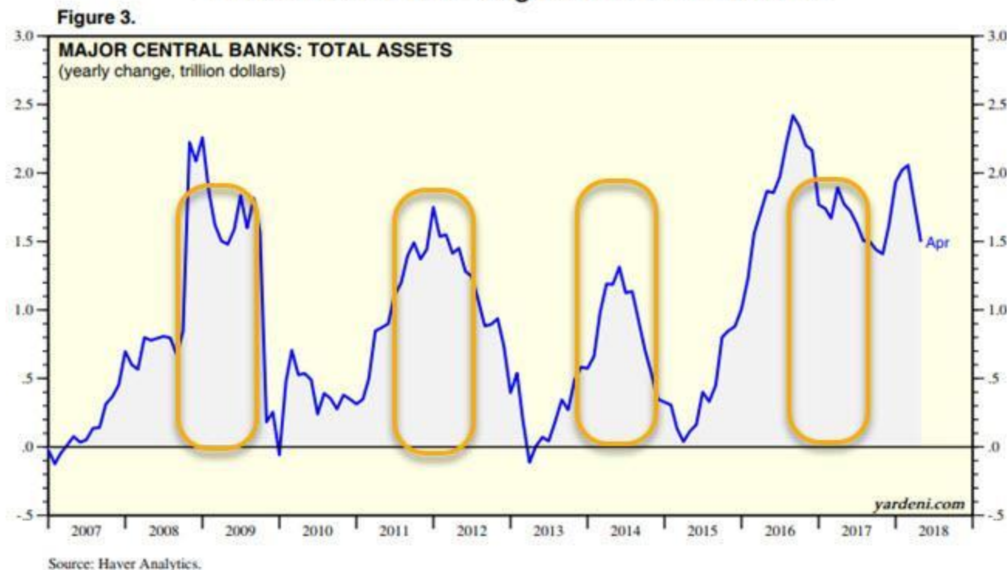
In late 2015, the banks took their feet off of their monetary gas pedals for a bit, hoping that the markets could be gradually weaned off of their stimulus dependence with few ill effects.

That didn't happen. As markets began collapsing, the central banks came to the rescue with a new dose of stimulus (newly printed money).

This is the strategy that has been engineered repeatedly since the 2008 financial crisis… in what has been coined: Quantitative Easing (QE).

Note the chart below, showing the yearly change in world central bank balance sheets.

Total Assets of MajorCentral Banks



The risk is of course, what if central banks don't intervene, allowing this process to run its course in reverse, leaving asset prices unsupported?

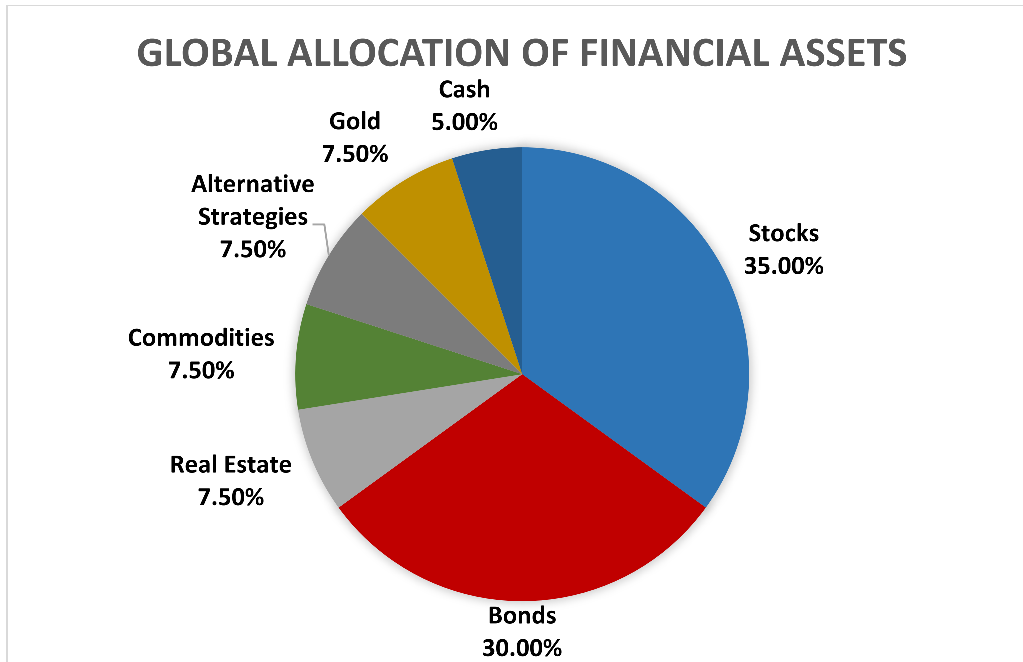
There is no way to tell in advance exactly how this will unfold. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different from today's, understanding 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 2017).

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!

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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.