Consilience
Asset Management

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Consilience Market Notes:

Have World Stock Markets Become Engines of Obfuscation?

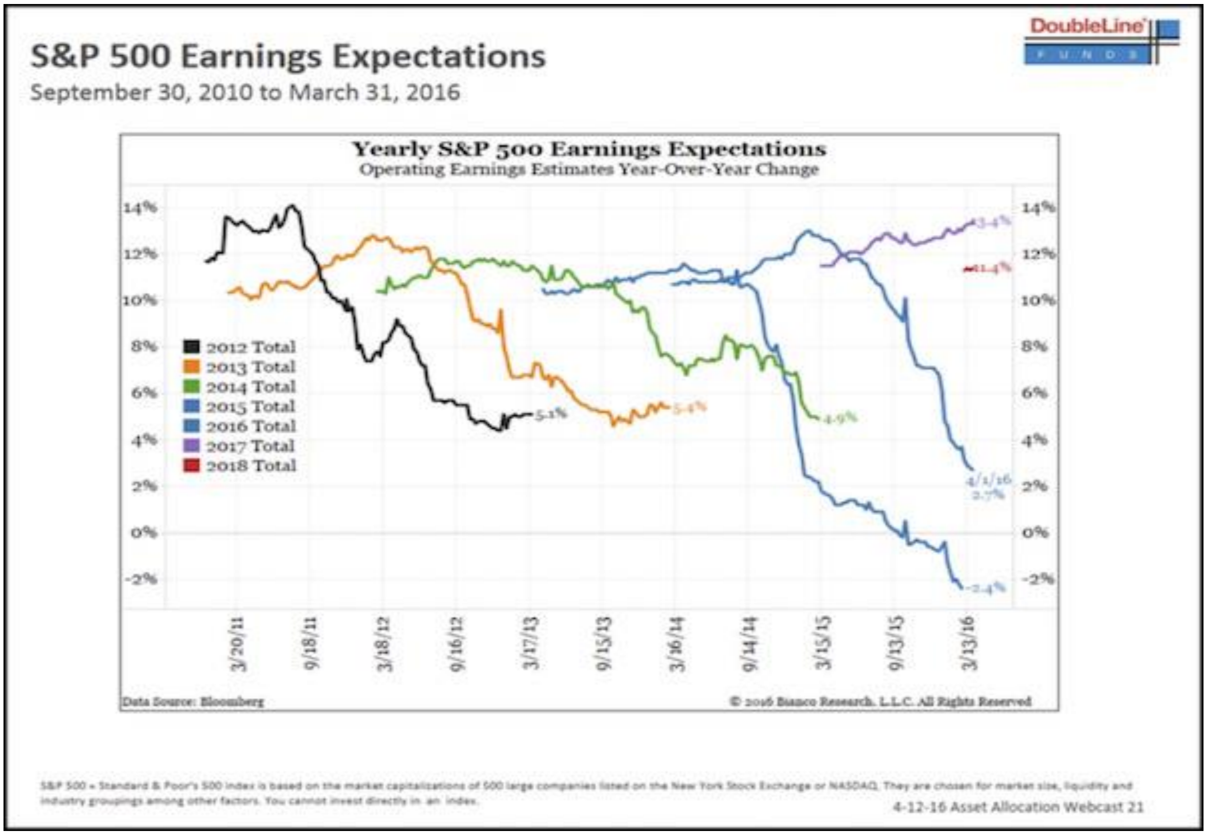
First, an update: Our *Global Macro Indicators* remain **neutral*** for U.S. equities. **

Now to this month's report: Once upon a time stock markets were essential avenues for raising capital, valuing corporations and providing a gauge of a nation's economic health. Then along came central bankers!

Now amazingly under their care and feeding, we have witnessed seven years of rising stock prices, yet missing are the accompanying increasing company earnings and economic growth. In fact, for seven years the rising markets have coexisted with an anemic rebound in the world's economies.

As evidenced by company earnings estimates, this trend does not appear to improving.

In addition, as the following chart exposes all too well, estimates of earnings have been falling dramatically in real time since 2012… and falling earnings – especially when they go negative, as they have for the last few quarters – are not typically associated with rising markets.



Yet markets are rising! And as mentioned at the outset of this month’s report, our *Global Macro* indicators remain neutral for U.S. equities. How is this possible?

Answer: Central Banks and an unprecedented distortion of corporate earnings calculations.

First, let’s examine earnings. Evidence suggests that world stock prices are no longer being driven by company earnings. In fact, they haven’t been a particularly helpful gauge since the beginning of the first post-crash rebound in 2003, nor since the second post-crash rebound in 2009.

Why? Because under the extremely loose Generally Accepted Accounting Principles (GAAP) guidelines, companies are given significant leeway and are allowed aggressive interpretation of their numbers.

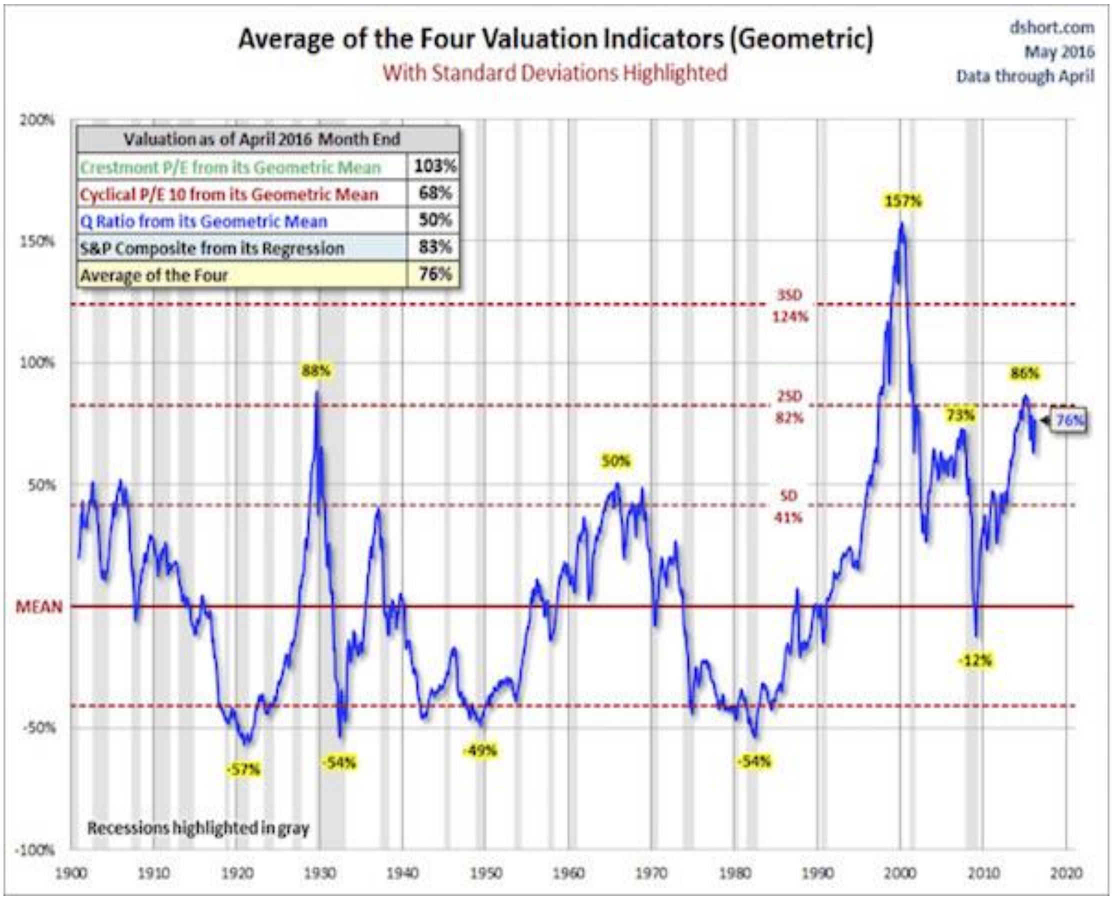
But doesn’t his mean that valuations are higher than officially stated and therefore stock are even riskier? Yes… if investors were buying stock based on their earnings. But are they?

Before I answer that, let’s look at some numbers.

As expected, there is a significant difference between the P/E ratios based on the (GAAP) approved or "adjusted" earnings, versus earnings before these allowable adjustments.

Therefore, stock market valuation levels are rather remarkably high. Based on some estimates, the current P/E surpasses 92% of all historical P/E data. Only multiples from the 2000 and 2008 bubble periods were higher than today.

This can be clearly illustrated in the following chart which has been compiled by taking the average of four different P/E calculations that attempt to more accurately reflect what real earnings might be on the S&P 500.



By almost any measure, we are at very high valuations. But what about central banks? How do they play into this narrative?

Well, first, they have been keeping interest rates artificially low in an effort to stimulate the economy. Although this hasn't exactly resulted in the growth they had hoped for, it has forced investor into riskier investments than they otherwise would have been in; i.e. stocks, to potentially increase their returns.

In addition, low interest rates make stock valuations look more attractive as there has historically been an inverse relationship between interest rates and valuation levels. Therefore, institutions appear justified in increasing their allocations to stocks.

On top of this, low interest rates have created an attractive environment for corporate stock buy-backs with borrowed money… adding additional demand for stocks.

And it gets even better…

One month ago, the "junk" bond issued by French telecom company Numericable would become the largest high yield bond issuance on record. This was a direct consequence of the unprecedented intervention by the European Central Bank (ECB).

And today we find an even more striking example as the German multinational chemical and pharmaceutical company, Bayer AG, may also receive financing from the ECB to help fund its takeover of US-based Monsanto.

This means that, in theory, the ECB could buy debt issued by Bayer, which will finance its cash bid for Monsanto with a combination of debt and equity with preferential terms.

Is this the beginning of a surge in ECB-funded merger and acquisition (M&A) deals unleashed by European corporates eager to sell billions in debt?

Maybe… Currently, the ECB is buying 80 billion euros ($90 billion) worth of assets every month in an effort to revive economic growth in the euro zone.

And, might the Fed might imitate the ECB and act to fund merger deals?

Although there is no explicit permission in the Federal Reserve Act that authorizes open market corporate bond purchases, the Fed has emergency power provisions, that if invoked, allows for purchases of almost any security!

If they were to act on this provision, it would add even greater fuel which would spur further advances in stock prices in spite of the aforementioned acknowledgment that **stocks' recent advances aren't based on any favorable shift in market fundamentals**.

And, this in spite of the fact that this runs contrary to the instincts and training of any astute investor.

BUT if P/E ratios and company's earnings are no longer a reliable measure of a company's worth and by extension the attractiveness of stock indexes, how is an investor to make an intelligent decision? And how are we at *Consilience Asset Management* able to make a determination that stocks are **neutral** at their current process?

We do this based on the movement of global capital flows among liquid financial assets. There are estimated to be $200 trillion in stocks, bonds, commodities, gold, currencies, hedge funds and money market alternatives that are currently being traded around the world.

Our models track the movement of these asset classes in real time, allowing us to identify trends based on supply and demand. Once a favorable trend is identified, we augment our analysis based on by our Behavior, Economic, Monetary and Stability indicators.

Thus, our process is not impacted by the accounting irregularities allowed by GAAP standards or the distortions in market prices created by central bank activities.

Our current reading indicates that forces, primarily driven by central bank activities, have the potential to drive stock prices even higher.

The risk, of course, is that a day of reckoning will come when central banks will no longer be able to prop up asset prices and investors will withdraw from markets. But evidence suggests that we're not there yet!

But along the way, it is imperative that investors remain diligent and nimble as such market advances are without precedence in modern history.

Consilience Asset Management

Roger Faulring – Partner/Portfolio Manager

Michelle Malone – Partner/Investment Advisor

Donna Stone – Partner/Investment Advisor

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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.