Consilience
Asset Management

October 01, 2018

Consilience Market Notes:

10 Years Later – Did QE work? Or Has it Created a Bubble?

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

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

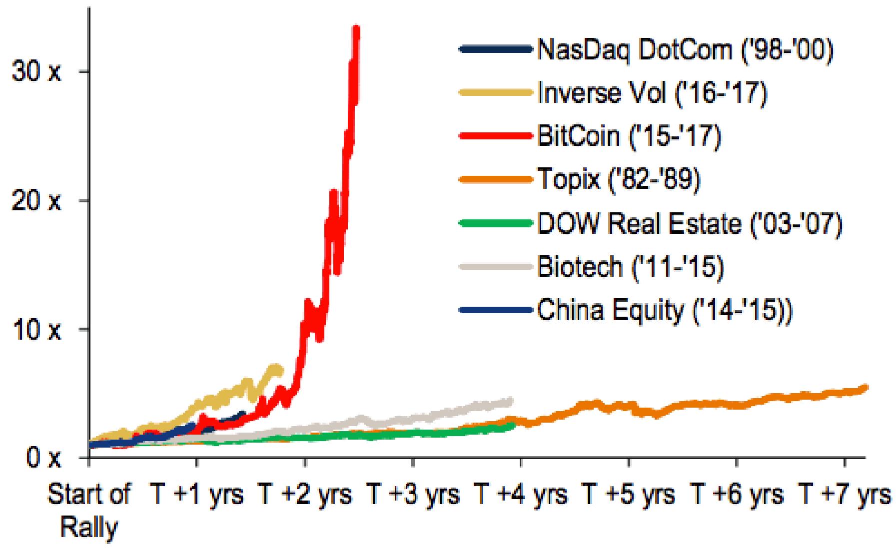
Now to this week's report:

A decade ago, the blue-chip index fell by nearly 54 percent measuring from its record close of 14,164.53 points on Oct. 9, 2007, to rock bottom when the blue-chip index closed at 6,547.05 points on March 9, 2009.

But now the Dow is trading over 26,000. So, the question is: Is the Dow Jones Industrial Average in a bubble?

Do you see it in the "bubble" chart below?

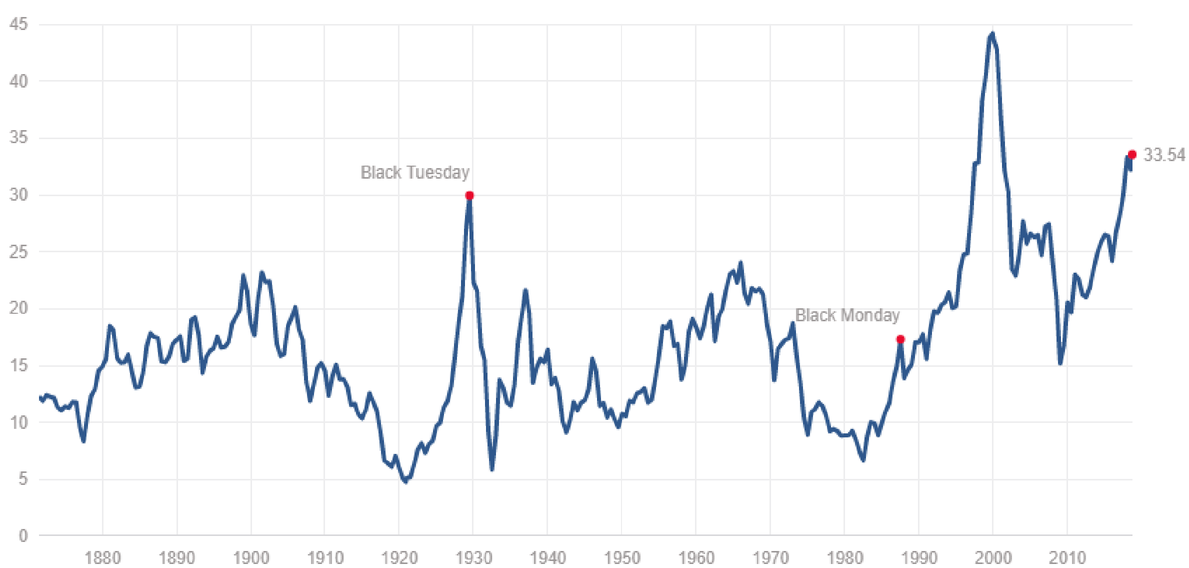
Chart 42: Are bubbles becoming more "bubbly"?



Source: BofA Merrill Lynch Global Research. Bloomberg. Using TPX Index, CCMP Index, DJUSRE Index, NBI index, SHASHR Index, XIV US Equity and XBT Curncy. Data is normalized and rebalanced at 100 at the start date of the rally (lowest data point) and ends at the top of the rally (highest data point).

Interestingly, you do not! So, maybe by comparison to the extreme example of Bitcoin, the stock market doesn't appear to be in a bubble. But does that mean it still "clear sailing" from here?

Although we may not be in a "bubble," most professional observers of financial markets would agree that stocks valuations are extremely high compared to their historical range. This fact is demonstrated in the chart of the Shiller CAPE ratio (Cyclically-Adjusted PE ratio) below.



Source: Robert Shiller, multipl.com. Data through September 21, 2018.

While no single statistic perfectly describes reality, the CAPE ratio highlights how cheap or expensive the stock market is relative to its historical average. Indeed, comparing the current CAPE ratio of 33.54 to its median value of 16.15, stocks would have to fall by more than 50% to be in line with historical norms, ominously similar to the drop a decade ago.

Although current valuation levels are not unprecedented, there is a crucial difference today versus previous stock market declines.

Previous episodes of elevated risk-asset valuations tended to be localized, either by geography or sector: 1990 was focused in Japan; 2000 was focused in the dot-com related sectors; 2008 was focused in the U.S. mortgage and credit markets and preceded the emerging market credit boom.

The post-2008 global experiment with quantitative easing, and zero and negative interest rate policies have boosted the valuations of all risk-assets across <u>all geographies and multiple asset-classes - global equities, global bonds and global real estate.</u>

In addition to elebvated valuation levels, there's the risks posed by the reversal of Quantitative Easing (QE) called Quantitative Tightening (QT) and the likely result: higher interest rates!

Remember, there were basically three objectives of QE:

1. Prevent the collapse of the global economic system,
2. Rescue the banks and financial markets,
3. Re-ignite economic growth.

So… where are we in the process and did QE work… and what are the risks associated with this transition?

Numbers 1 & 2 have been successfully completed. Number 3 appears to be in the early stages of success with solid GDP growth and low unemployment in 2018!

So, as we sit today, it appears that it has worked. And, if in the end it does work, it will be no insignificant feat. In fact, it may be the first successful attempt to rescue a failing economy by printing money and taking on record amounts of debt.

History is littered with examples of countries who attempted this approach and failed miserably with a worthless currency at the end of the process.

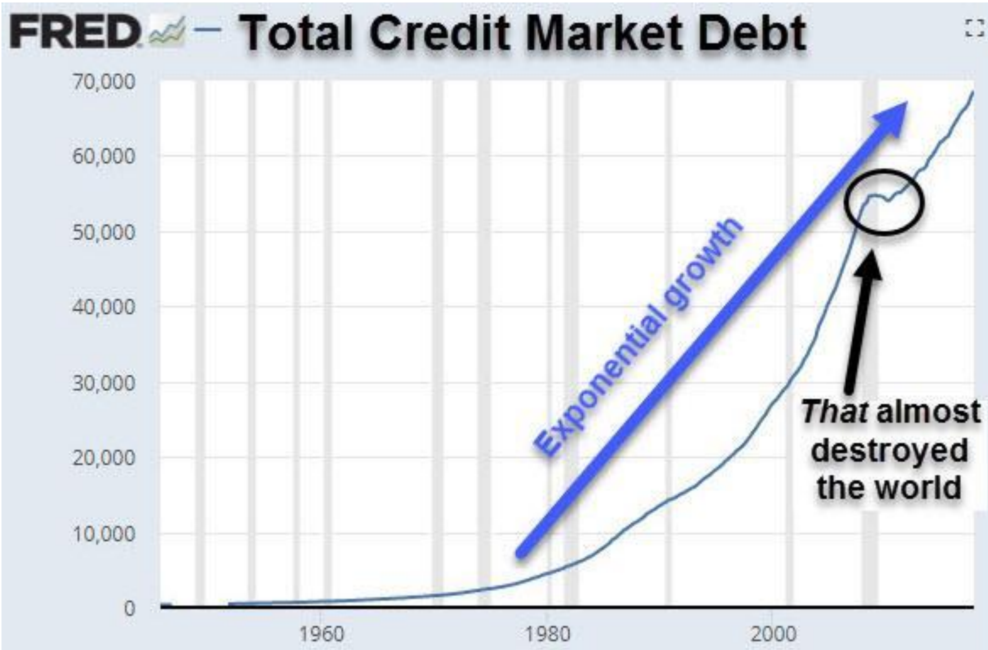
Here are a just a few examples from recent history: Peru in 1989, Nicaragua in 1990, Zaire and Russia in 1992, Yugoslavia, Brazil and Bosnia in 1993, Georgia in 1994, Ukraine and Angola in 1995, Turkey in 1997, Romania in 2001, Venezuela in 2002, and finally Zimbabwe in 2006.

The common denominator that led to the downfall of each currency above was their own form of QE or printing money and taking on record amounts of debt.

Is this really what the US did? Yes.

During this process, total credit outstanding in the U.S. has far outpaced the expansion of the real economy. Printing money, deficit spending or whatever you want to call it is not a healthy long-term policy. Specifically, debt-based fiat money demands a regime of a continual expansion of debt and the corresponding perpetual growth to support it.

So, each year, as there is more debt in the system than the year before. If economic growth is not there, this high-leveraged system risks collapse, as it threatened in 2008:



As long as you can have endless growth, the system of money we have in place today is perfectly fine. But, once growth slows, the entire system is at risk.

So now we have come to the tricky part… unwinding this process and paying down the enormous debt that was acquired during the past ten years.

Unfortunately, there are no conventional economic tools with historically predictable results that we can point to for comfort.

This is not just a U.S. problem.

Twenty years ago, there was $40 trillion of debt in the world, today there is $250 trillion worth of debt in the world. The leverage of the world has gone from 1.3 times global GDP, which is stable...to 3.3 times.

There is no doubt, this unwinding process is going to create a serious issue for the financial markets. Already globally, numerous markets ranging from China to Germany have entered corrections, if not outright bear markets as a result of the Federal Reserve’s Quantitative Tighten (QT) plan.

Will this eventually spill into the US markets?

We cannot impress enough what a significant impact this has had on the financial markets this year. The Treasury net take-out from the public was net-zero last year. Compare this to the first eight months of 2018, in which the Fed has taken over a trillion dollars from the markets.

In the world of full-blown quantitative easing where central banks were printing reserves to purchase government bonds (among other assets) the effects were trivial, null, nonexistent.

But that has all changed. And it appears that the market has not fully focused on the upward pressure this will have on long-term interest rates.

So, all eyes should be on the Fed and their maneuvers in the transition from QE to QT!

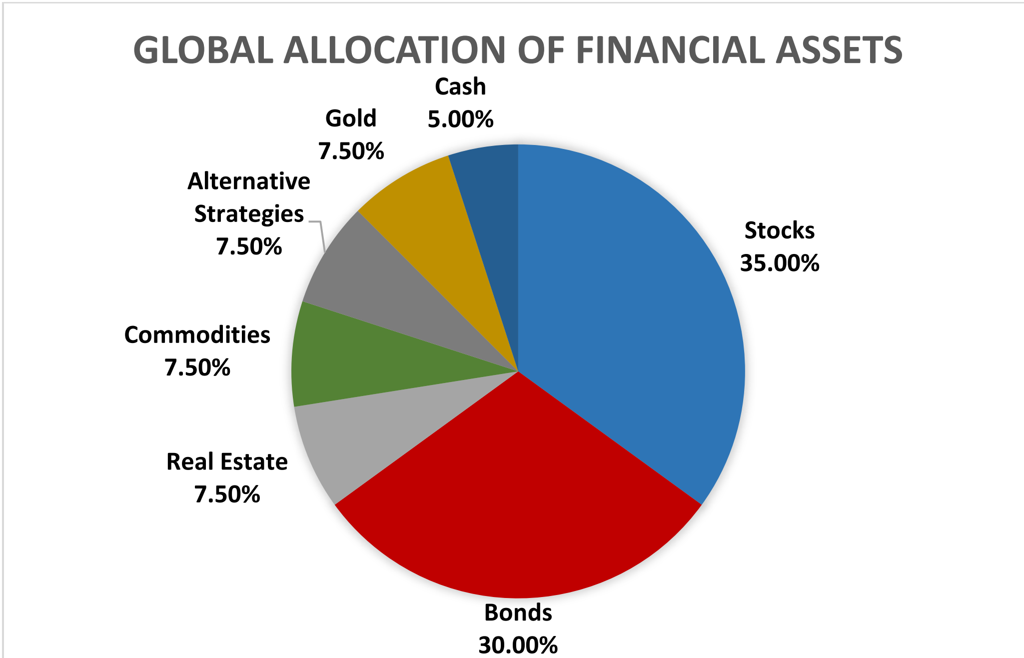
Of course, there is no way to tell in advance exactly how this will unfold. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different from today's,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

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.