October 2, 2017

Consilience Market Notes:

A New Term: Quantitative Tightening (QT).

First, an update: Our *Global Macro Indicators** are as follows for the 7 asset classes we invest in for our clients:

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

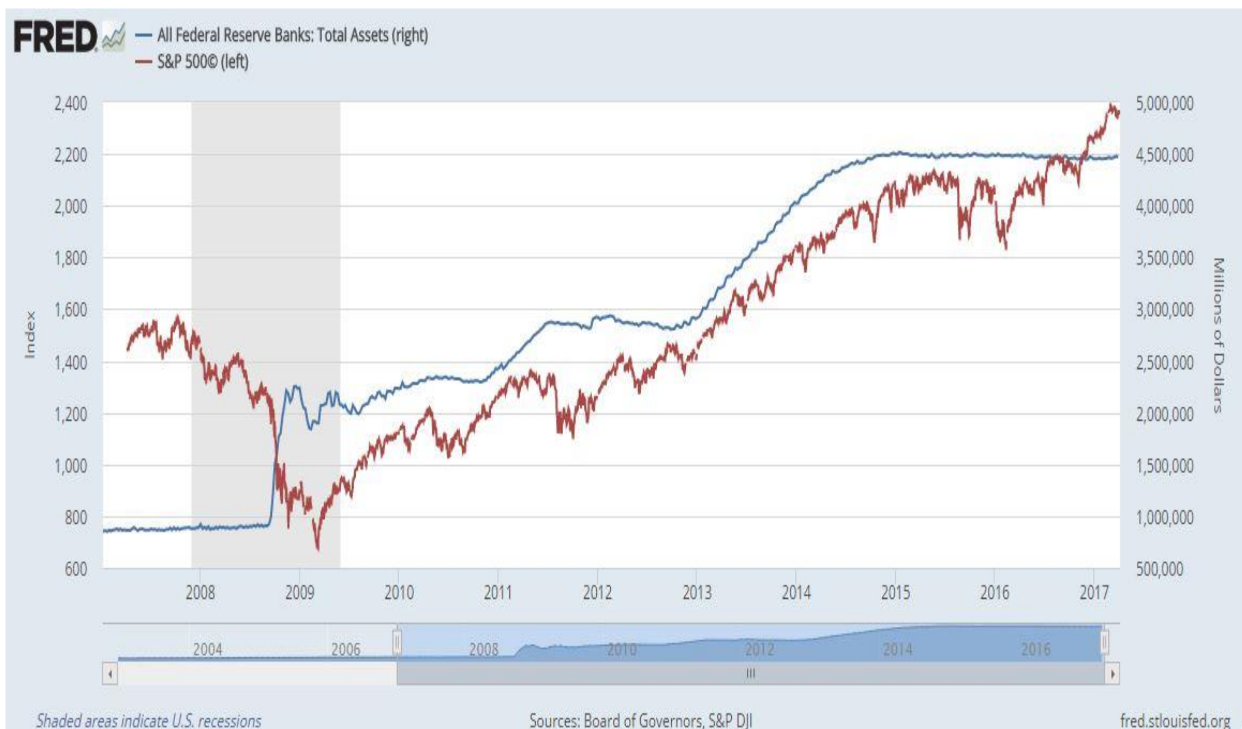
Now to this week's report:

A decade after the onset of the 2008 global financial crisis, central bankers have decided to move the levers of policy off their emergency settings. As the stimulative policy has been coined *Quantitative Easing* (QE), our new term, as the Fed reverses policy, is Q*uantitative Tightening* (QT).

Quantitative Easing (QE)… was implemented in the form of zero interest rates and massive asset purchases to confront the collapse in financial markets and looming implosion of the real economy. The U.S. wasn't alone in these efforts, as the rest of the developed world's central banks followed the Fed's example and engaged in their own versions of QE.

According to the Bank for International Settlements, central banks' combined asset holdings in the major advanced economies (the US, the Eurozone, and Japan) expanded by $8.3 trillion over the past nine years, from $4.6 trillion in 2008 to $12.9 trillion in early 2017.

As shown in the following chart, in the U.S. alone, the Federal Reserve expanded its balance sheet from less than $800 billion in 2008 to $4.5 trillion today! And the markets correspondingly advanced in lock-step with the Fed's liquidity injections.



Now, the Federal Reserve has decided to reverse course and begin letting assets roll off its balance sheet and as a result, no longer inject new capital into the financial markets.

This means that the balance sheet will begin to shrink in size! Imagine if the correlation between the central bank's balance sheet and the stock market remain in place as the **blue line** in the above chart begins it decent?

This withdrawing $3-4 trillion, which has been the driving force for the stock market advances during the past 9 years, will certainly create serious challenges for stock prices going forward.

Either the **red line** will decline in lock-step or other market participants will be forced to step in and offset the corresponding selling of securities that will occur during this "unwind."

It's not just stocks that will be impacted, but more directly it will be the debt that has been created during this massive buildup. With the central bank no longer engaged in buying bonds, will investor's purchases be enough to absorb the supply of new issuance of treasury and mortgage backed bonds?

If not, the result will be declining bond values and rising interest rates. And, without low interest rates, what will happen to the already lackluster economic growth of the past eight years?

Let's look at the numbers.

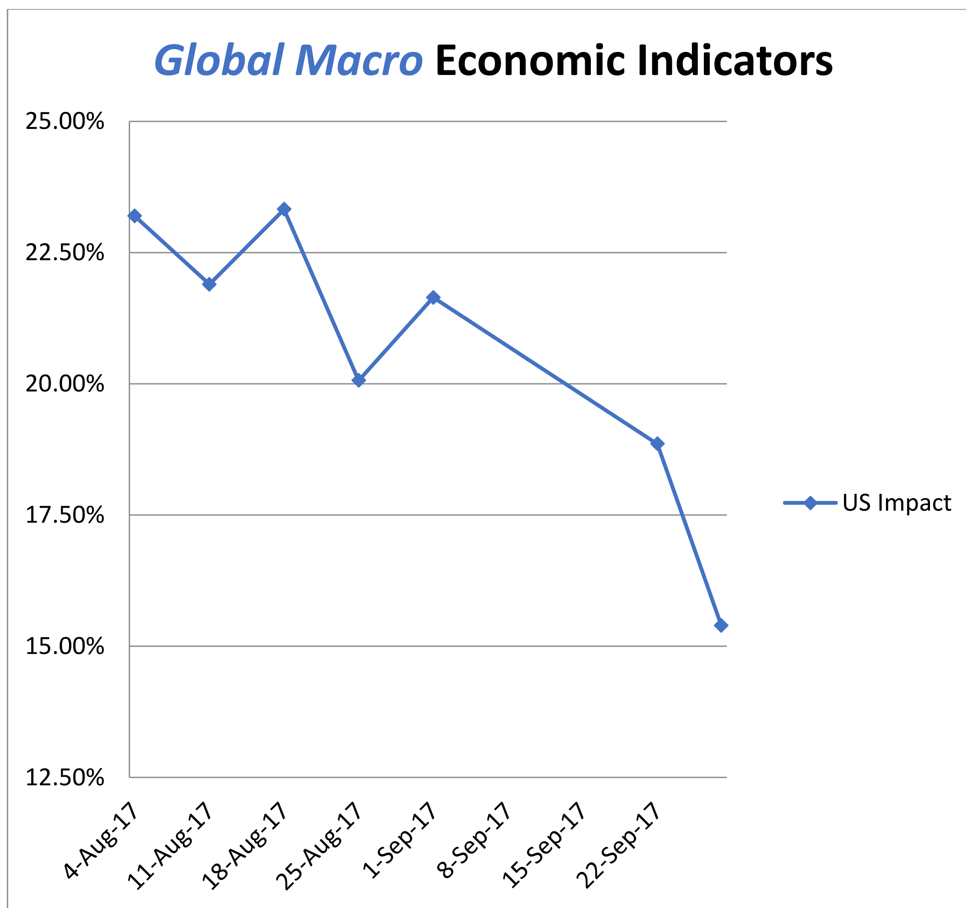
Under this new policy of QT, the Fed is going to fully reverse course by eliminating the purchase of new bonds (money printing) to the tune of $10 billion, $20 billion, $30 billion, etc. per month over the next five years. And all of this will need to be absorbed by the markets!

The Fed suggests that QT will not have any impact on the financial markets… I'm not so sure about that.

Are economic and the current market conditions sustainable when the money printing policy is discontinued?

Let's start with the economy. Retail sales, real incomes, auto sales and even labor force participation are all declining. In fact, almost every important economic indicator shows that the U.S. economy is slowing right now.

This is also evident in our *Global Macro Econometric Model*. This is a time-weighted, GDP-weighted calculation that shows the trend in 500 monthly economic reports from 41 major economies that trade with the U.S.



The current percentage of 15.39% represents the number of the above-mentioned indicators that are currently favorable. A move below 20% (our current level) moves our economic rating from favorable to neutral. Although we're still above a minus reading, a move below 0%, would turn our economic rating from neutral to negative.

So, it seems logical to me that if the Fed aims to tighten monetary conditions, reduce the money supply and increase interest rates, there is a significant risk that this will cause the economy to weaken further.

In addition, as shown on page 2, as loose monetary policy, expanding money supply and declining interest rates have been the primary catalyst for rising stock prices, won't a reversal potentially spell trouble for the equity markets?

For the sake of clarity, let's go back and deconstruct the volatile engagement between equity markets and central banks for the last ten years for an understanding of where we stand today.

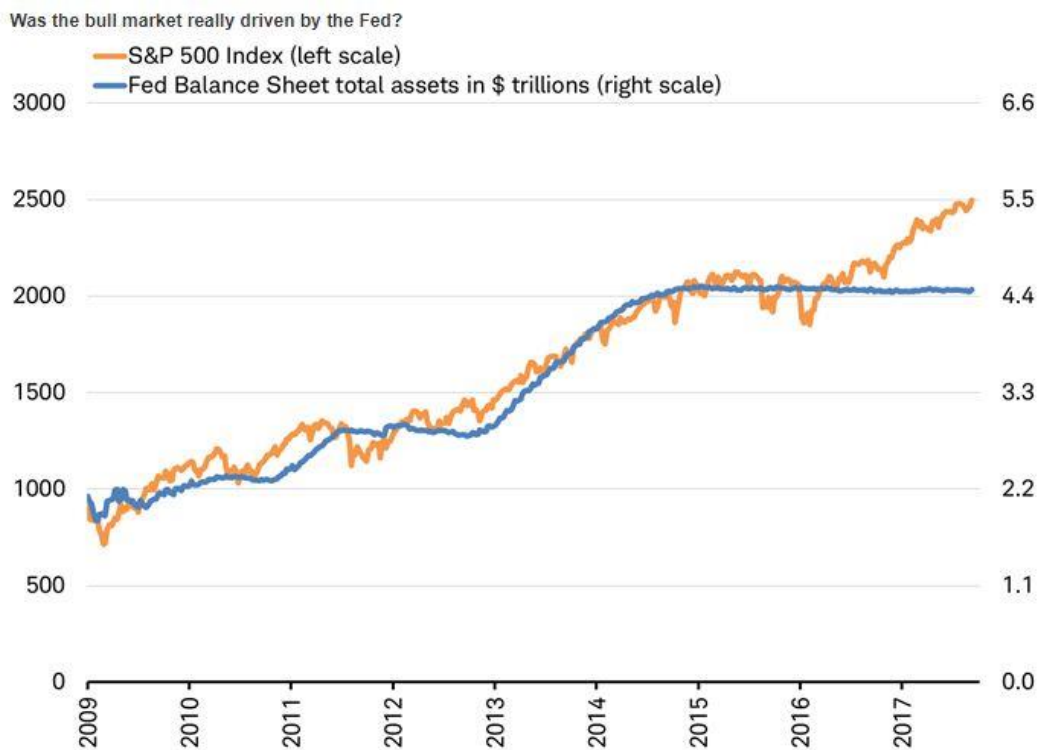
As stated above, QE rescued the financial system as trillions of dollars were funneled into U.S. banks to stimulate lending and thus economic growth. However, the expected stimulative borrowing never materialized and those liquidity injections came to be stored rather than multiplied by the banking system.

A large percentage of these dollars worked their way directly into the stock market providing an artificial dose of demand and thus rising stock prices.

As a result, the macro and even micro data as well as news-flow mattered increasingly less and less, and the only thing that really has mattered was the expansion of the Fed's balance sheet.

So, the big question is: Will these incremental reductions in the Fed's balance sheet and thus the reversal of the artificial demand for stocks, be absorbed without any disruption to the financial markets?

The early evidence is in… as the Fed's Quantitative Easing and corresponding growth in their balance sheet ended about a year ago.

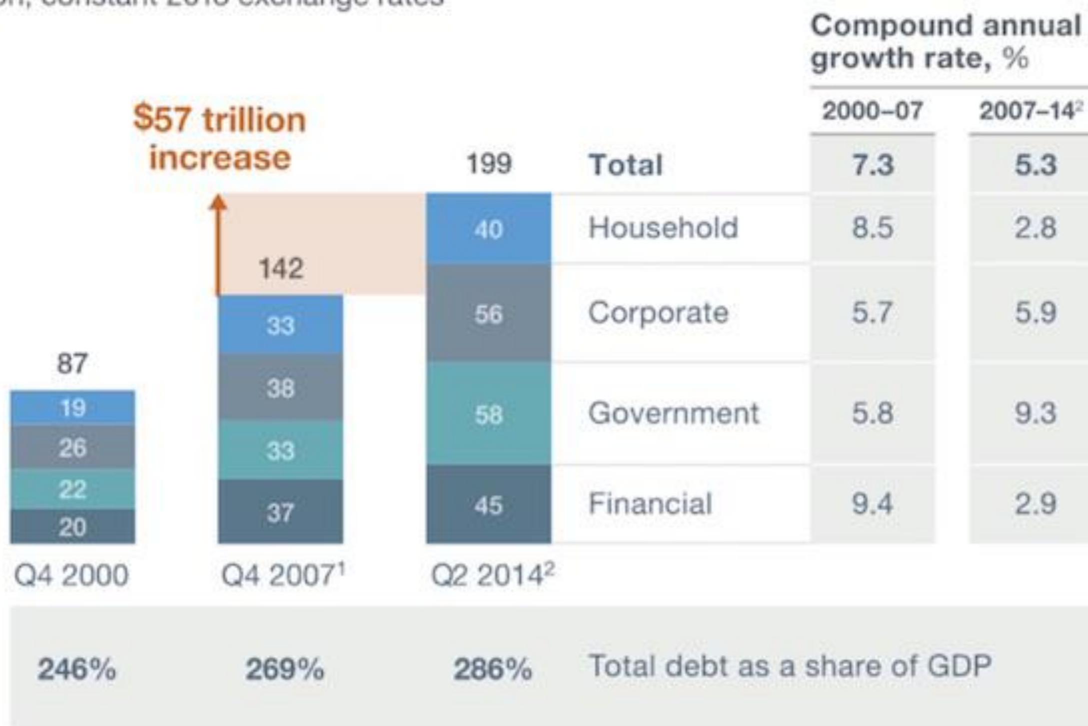


The good news… thus far, as shown above, individual and institutional investors have stepped up to provide the much-needed demand to keep stocks rising during the past year.

However, there is one main factors that is imposing itself on the world and the markets: the bubble of global debt.

There is considerable debate over the exact amount of global debt. Global debt is about 325% of GDP, and likely over $225 trillion.

The following chart, although almost three years old, does show the growth of debt over time. And, since then, it is estimated that global debt has grown by an additional $26 trillion.



A few observations...

First, notice that the growth of household and financial debt has decelerated. Corporate debt continues to grow at roughly the same pace as before. The real acceleration of growth in debt is coming from government borrowing.

This may actually be good news as it at least appears that there is a desire to address this problem, as we witness the reduction in government debt as a result of QT.

Although this will be no easy feat, the fact that the stock market is hitting one all-time high after another, despite all the economic headwinds and geopolitical uncertainties, appears to show that the investment public is confident that we are on the right track so far. And most importantly, they are stepping in to offset the reduction in stock and bond buying by central banks.

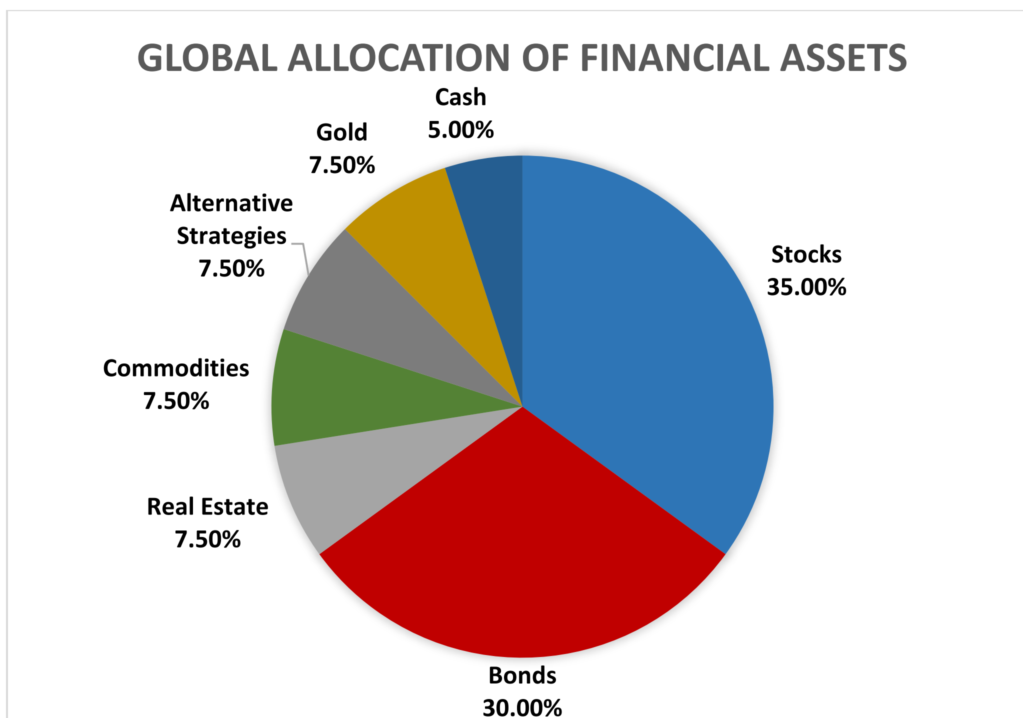
Will this trend continue as the Fed moves forward with their credit tightening policy of QT and increases further the size of new assets for the markets to absorb… from $10 to $30 billion per month?

Our answer as Investment Advisors is to employ a discipline that we believe circumvents the effects of these 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 2014).

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 inconsistencies and irrationalities of their current levels relative to their underlying fundamental values.

Several catalysts exist today that suggest that investors should remain vigilant and keep the following concerns in mind as they invest.

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

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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.