Consilience
Asset Management

October 29, 2018

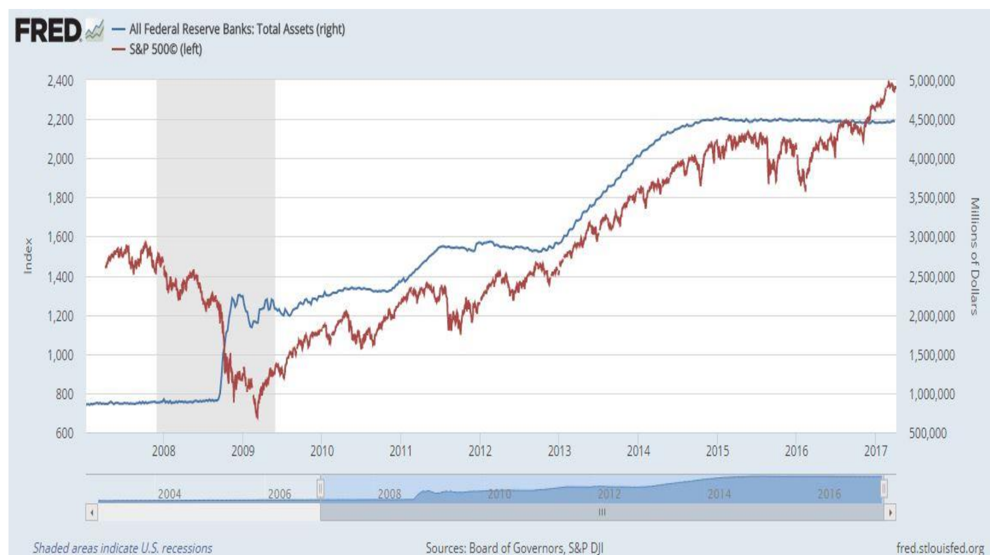
Consilience Market Notes:

So now we have come to the tricky part…

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

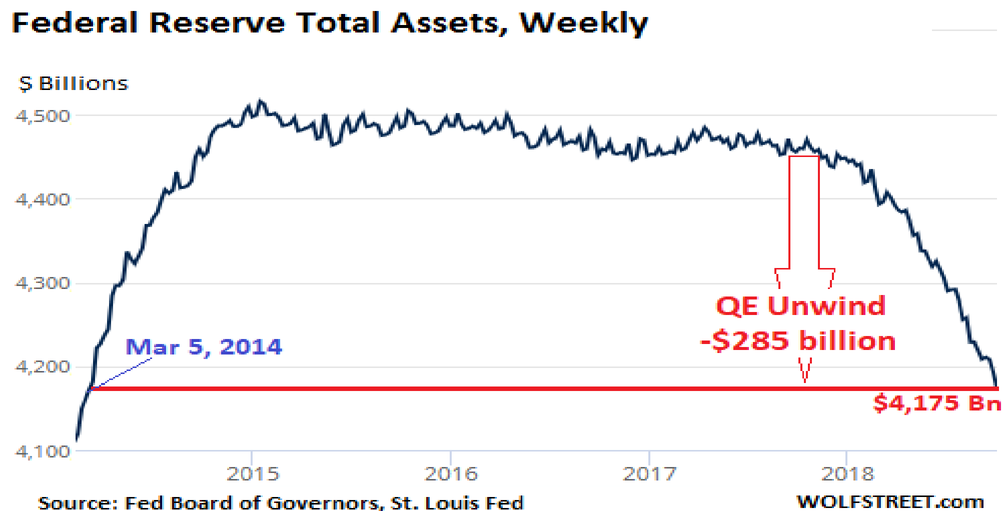
Global Equities – **Negative,**
Global Bonds – **Negative,**
Commodities – **Negative,**
Gold – **Negative,**
Hedge Fund Strategies – **Negative,**
U.S. Dollar – **Positive,**
Real Estate – **Negative**
Cryptocurrencies – **Negative.**

Now to this week's report:
In the past several reports I have pointed out that the future direction of the stock and bond markets will be determined by something called Quantitative Tightening (QT)… just as the direction during the past decade was determined by its counter-side, Quantitative Easing (QE).



As shown in the above chart, as the Fed expanded its balance sheet and bought stocks and bonds, the markets rose! But this is all changing.

Over the past year, total assets on the Fed's balance sheet have dropped by $285 billion to $4,175 billion, the lowest level since March 5, 2014.



Simply put, equity markets have been built on central bank liquidity (QE), over the past 10 years and that is now unraveling as the central banks are attempting to take the "patient off life support."

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

All of the other issues that market commentators are spouting are secondary to the Fed's actions, whether it's the potential trade war with China, a potential default on Italy's debt, high stock market valuations, rising interest rates, slowing economic growth in 2019… whatever.

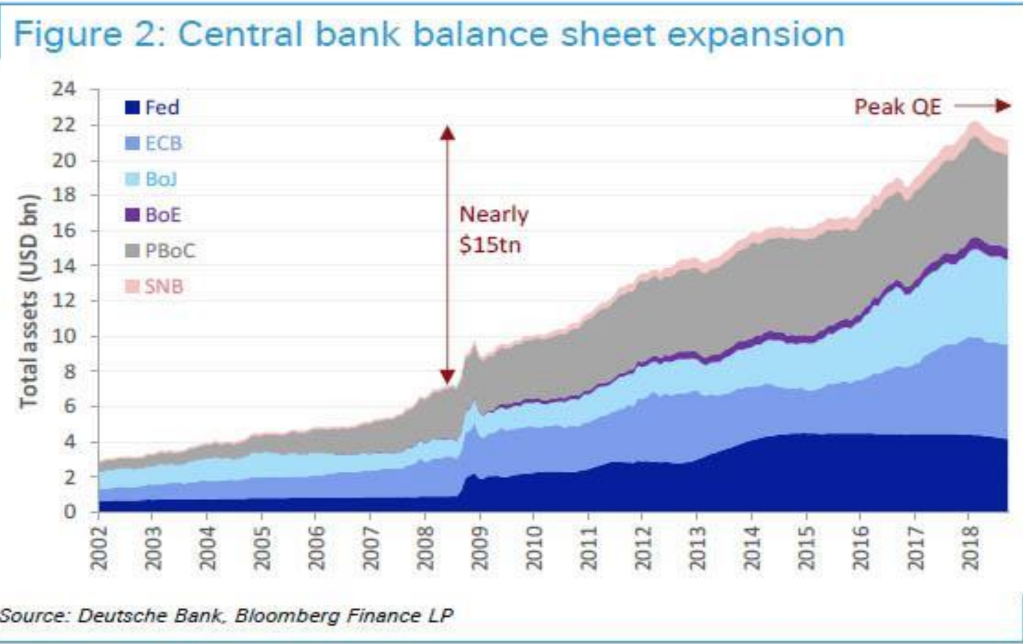
These are important issues and they are certainly responsible for stock market volatility. But, the future trends will not be determined by any of them. Rather, it will be determined by what the Fed does with their over $4 trillion balance sheet.

During QE, the Fed bought Treasury securities, mortgage-backed securities (MBS) and in a rather circuitous manner, S&P 500 futures contracts. Now, the Fed is shedding those securities.

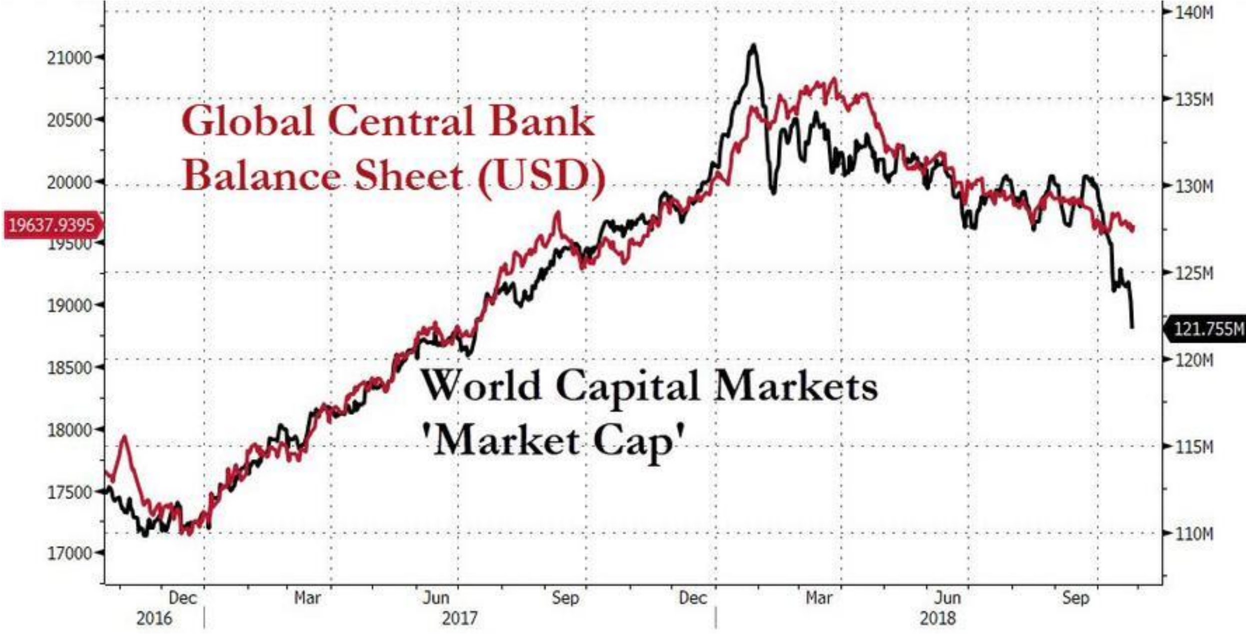
And, as the Fed sells $billions of stocks and bonds, it should not be unexpected that their prices decline and bond yields rise.

This phenomenon is not a U.S. exclusive. Between mid-2008 and early 2018, foreign central also expanded their balance sheets by nearly $15trillion.

As shown below, these central banks, including the Fed, are now collectively holding over $20 trillion of securities accumulated through their asset purchase programs**.**



And as shown in the next chart, the international stock markets have been under pressure since the beginning of the year as the balance sheet expansion phase has ended. And the U.S. markets have followed suit during the past few weeks.

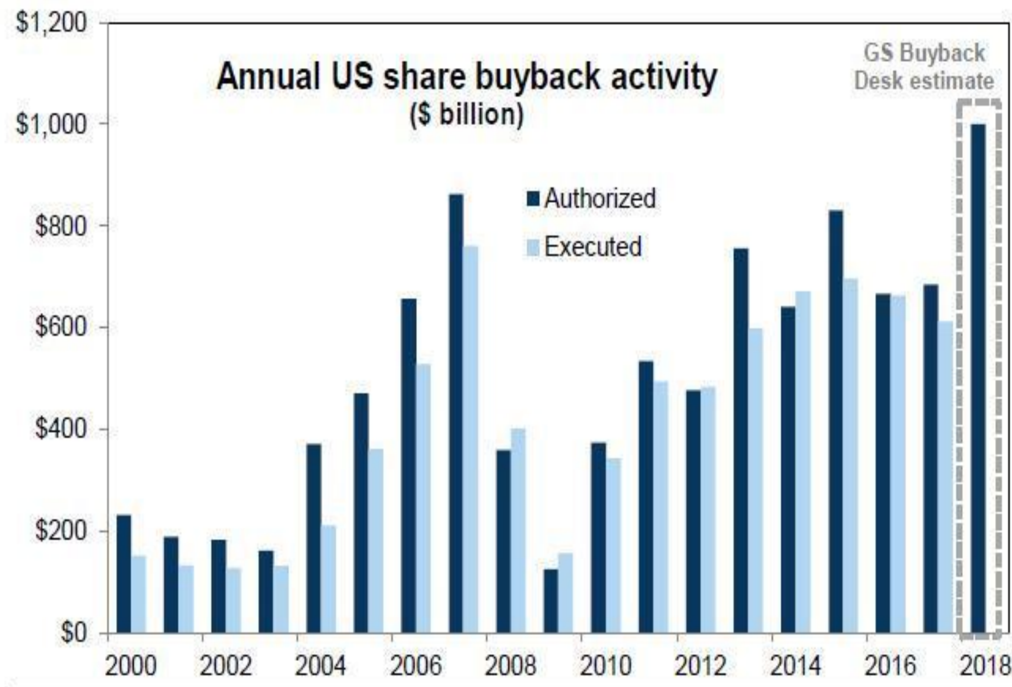


Is there anything that can prevent this from becoming an all-out "bear" market? In the short run, yes.

Interestingly, if we go back to February and the 11% correction that shook the stock market, we find an immediate likeness to today's weakness. Both have occurred during a "blackout period,"

which is a period that occurs before quarterly earnings are released and companies are prevented from buying their own shares to prevent inside trading on shares of their own companies.

This is significant because it has affected 86% of S&P components and these companies have been buying back their own shares at record levels this year and are expecting total buybacks to reach a total of $1 trillion for the year.



And not surprising, as their buying stopped, the markets corrected.

The one bright spot going into the end of this year is that this “blackout” period for buying back their own shares will be lifted as we go into the month of November.

Will this be enough to offset central bank selling?

Well, keep in mind, we are now in one of the longest running bull markets in history and whether this market resumes its upward trajectory and continues for a few more years, or rolls over into a much larger correction, no one knows.

But the important thing is that you have a **risk budget** and a **plan** that is automatic and quantifiable.

With regard to a **risk budget**, on our website: www.consilienceassetmanagement.com, you will find a link to our risk tolerance questionnaire on the home page. By completing the 10 questions, we will be able to help you identify what your maximum portfolio risk level should be and your appropriate asset allocation.

With regard to an automatic and quantifiable **plan,** please refer to the "**Our Process**" tab.

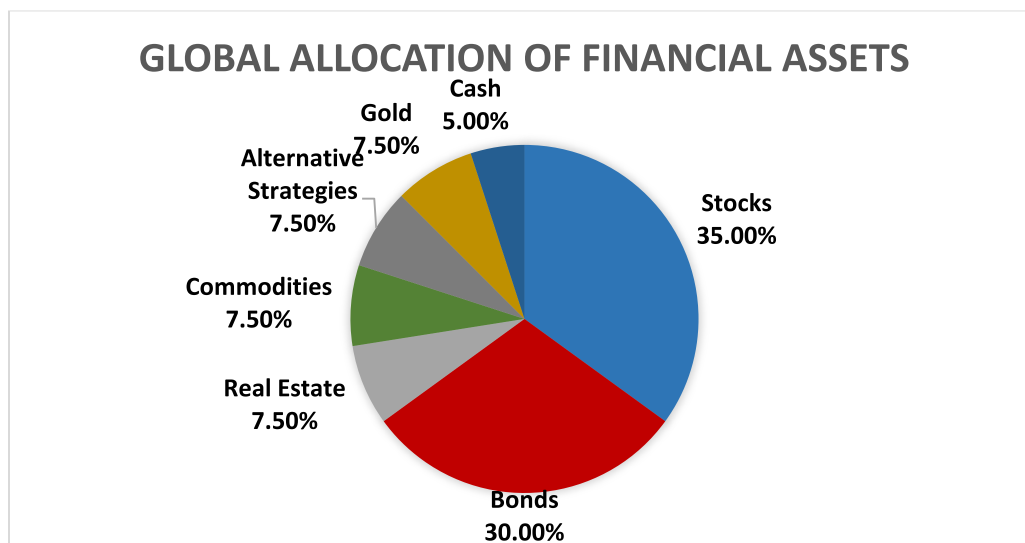
Of course, there is no way to tell in advance exactly how the future will unfold. But in the current transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different 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, at *Consilience Asset Management* we 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.

Based on this, the ratings for each of the eight asset classes that we monitor are included each month at the beginning of this report.

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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*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.