Consilience
Asset Management

October 3, 2016

Consilience Market Notes:

Are We Headed for a Repeat of the 2008 Financial Crisis?

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 – Neutral,
Gold – Neutral,
Hedge Fund Strategies – Negative,
U.S. Dollar – Neutral,
Real Estate – Positive.

Now to this week's report:

George Soros' former partner of the very successful *Quantum Hedge Fund* is warning that "the next time the world comes to an end, it's going to be a bigger shock than we expect."

The 2000-2003 and 2008 bear markets started with an outlier event that morphed into something much bigger and then spread throughout the entire global financial system.

In 2000 it was fraud and unrealistic valuation levels in the tech sector and in 2008 it was deceptive practices and highly leveraged derivatives tied to mortgages on bank's balance sheets.

Leading up to the 2008 financial crisis, most people thought the banks were safe. This, however, turned out to be an illusion. Banks had rendered themselves completely insolvent.

Bear Stearns, Lehman Brothers, Merrill Lynch, Washington Mutual, Wachovia… some of the most established banks in the U.S. collapsed. And poof!

Ever since then, the banks, the US government, the Federal Reserve, and other financial regulators in the United States have been working to rebuild the illusion of financial safety… or at least give the appearance of safety.

Most notably they introduced numerous laws and regulations like the *Dodd-Frank Wall Street Reform* and *Consumer Protection Act*, signed into law in 2010, designed to make the banks safer…

However, a close look at the current state of the banking industry provides little support for the view that major institutions are safer than they were before the 2008 financial crisis. In fact, it may be instead that **risks have actually increased**.

And it's not just in the US!

Today, the "elephant in the room" may be Germany's largest lender, Deutsche Bank…

Last week, Deutsche Bank plunged to fresh all-time lows on the question as to whether the German government would or would not provide state aid to the bank (if needed).

What was the catalyst for this dramatic share price decline? Their excess leverage and derivatives exposure have been present for quite a while… so why now?

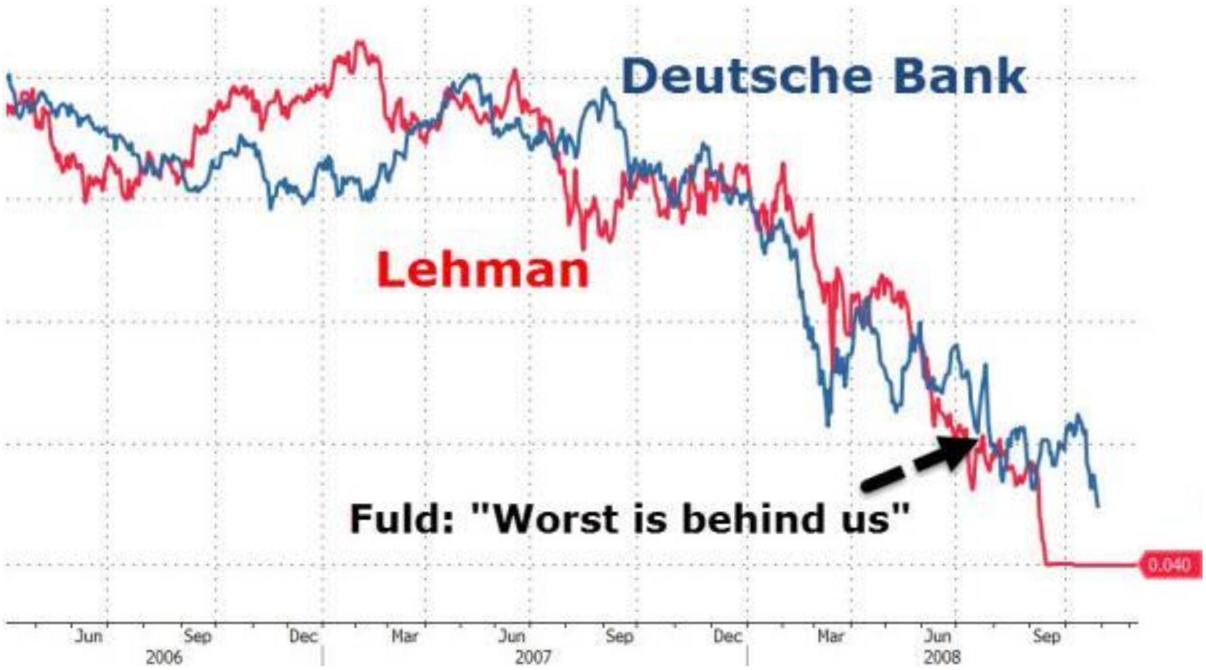
The latest concerns about the bank came after the U.S. Justice Department demanded it pay $14 billion to settle a number of investigations related to mortgage securities. Considering that the bank's total market capitalization is around $16 billion, such a ruling would result in serious liquidity concerns for the bank.

Then, on Friday, DB stock staged a dramatic rebound, surging from its previous overnight -9% lows.

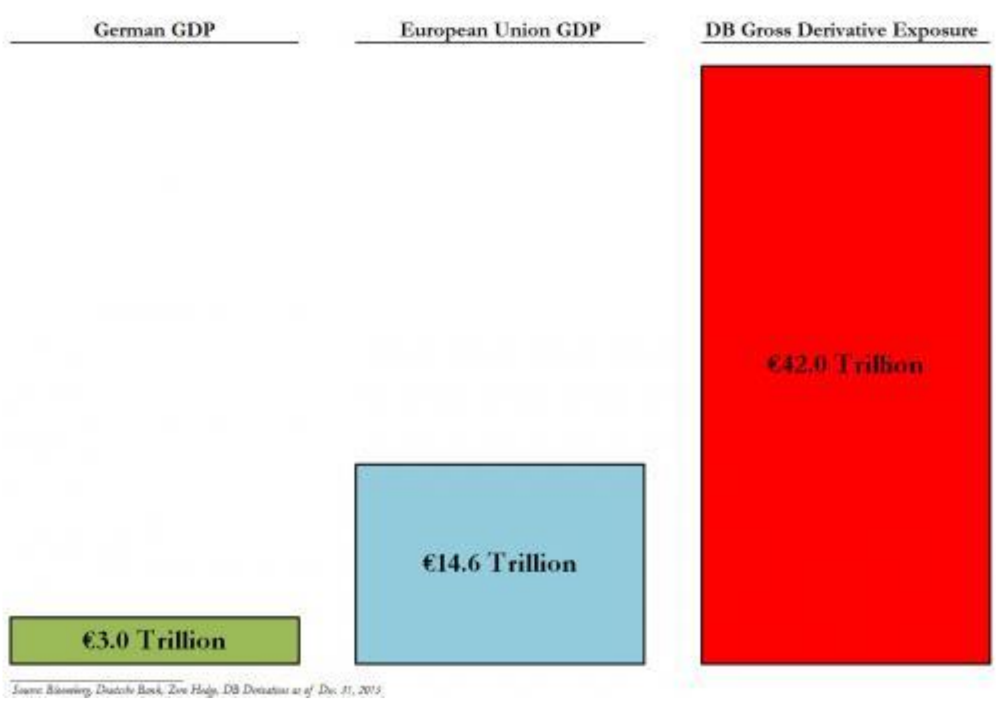
What was the cause? Aside from a trivial "Dick Fuld-esque" letter by John Cryan to his employees blaming speculators for the plunge, there have been rumors that the Department of Justice will significantly reduce the fine. To $5.4 billion. (Fuld was Lehman's CEO and Cryon is Deutsche Bank's CEO).

As a reminder, there were "fixes" galore in 2008 and numerous rumors that sent Lehman stock soaring over 10% in at least 6 weeks during the last few months...

Looking at the following ominous chart brings back terrible memories of the U.S. bank failure that set the stage for the 2008 financial crisis! As shown here the rumors and assurances from Lehman's CEO, Fuld were in vain.

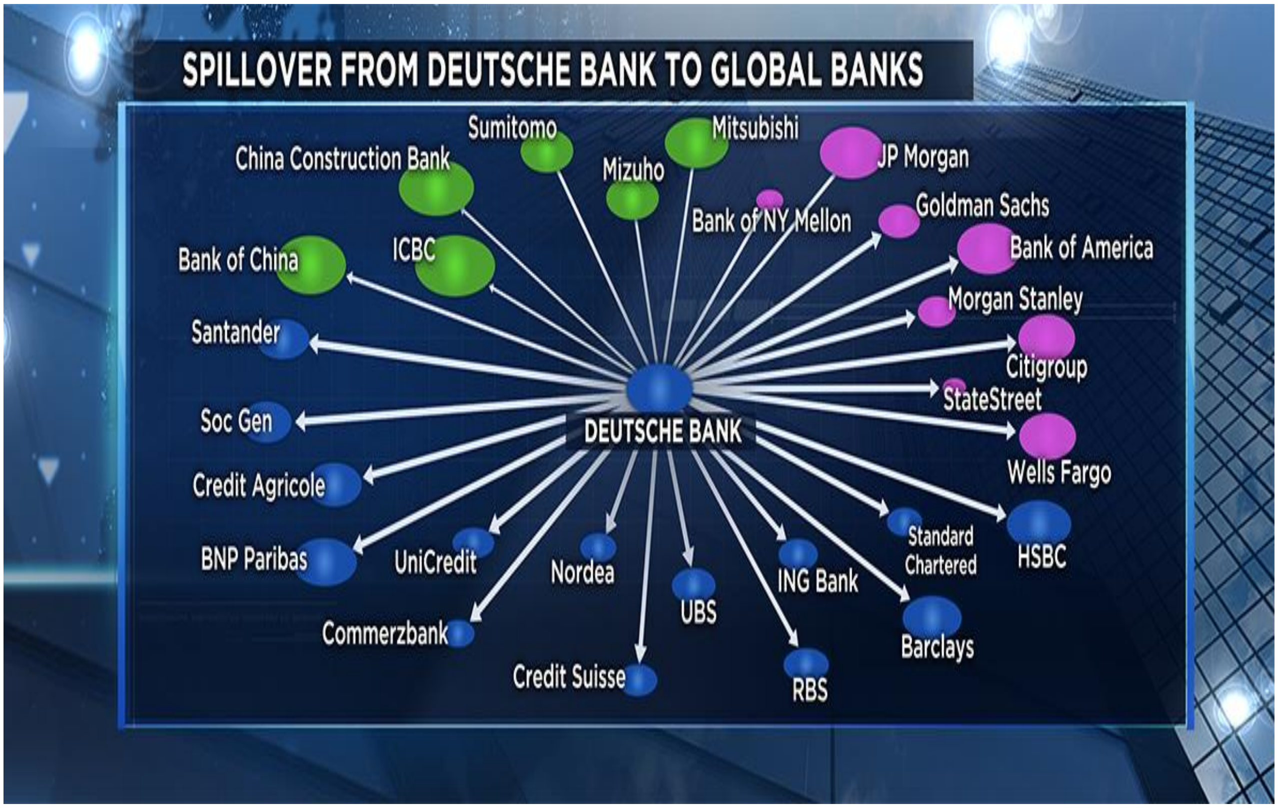


And as with Lehman, this isn't just a simple case of a large bank failing. Deutsche has gross derivatives exposure that is 14 times larger than Germany's GDP and almost 3 times larger than the entire economic output of the Eurozone.



This is more than just Deutsche Bank's problem; more than just Germany's problem. If something bad happens to Deutsche Bank, it is a **global** problem.

The *International Monetary Fund* sees Deutsche Bank as the "most important net contributor to systemic risks in the global banking system!"



If Deutsche Bank went down, and the German Government didn't step in with a rescue, no one really knows where the losses would end up, or what the global impact would be.

What we do know is that if some €42 trillion in derivatives were to suddenly lose their counterparties links, the systemic damage would be unprecedented.

And just like that, Germany finds itself in the same position the Fed and US Government were in September 2008: let the bank fail and deal with the devastating consequences, or inject billions to keep the bank alive.

Indeed, the politics of a rescue are terrible, but the economics of a collapse may be even worse… although we don't really know what a collapse would look like, as each time we've seen a crisis brewing, the "cavalry has come running to the rescue"!

I don't know if Deutsche Bank will fail or whether they will be saved by a bailout. But due to its complexity, I'm not even sure it's analyzable.

But, the question that should be on every investors mind is: How are you preparing for the possibility of its failure and the dire implications this would have for the global financial markets?

For many, the answer is simply; diversification.

Let me take you back to school for a minute and review the "standard bearer" theory on diversification.

In the 1950's, Harry Markowitz developed what has been coined, *Modern Portfolio Theory (MPT).* Simply put his theory argues that portfolio risk can be reduced by holding combinations of different securities and asset classes that are <u>not positively correlated</u>. (Correlation means the degree to which they move in relation to each other).

I agree with the theory in that there are benefits to diversification… but there is a problem with the belief that <u>this alone</u> will protect an investor during a crisis.

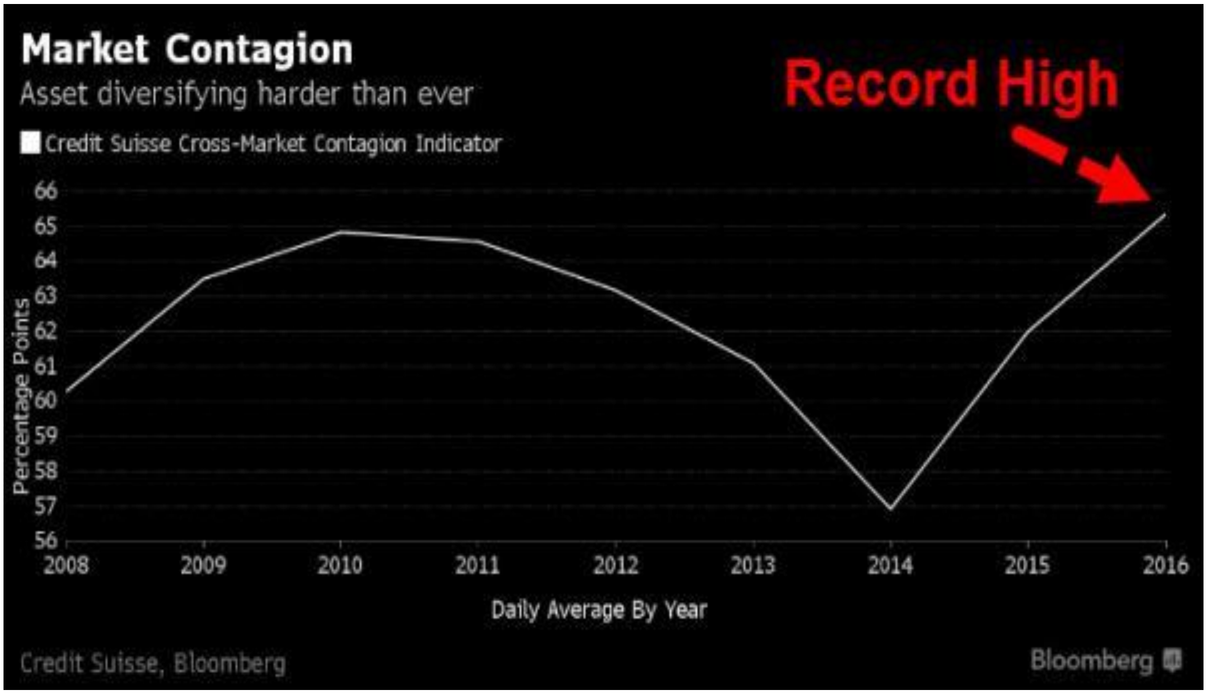
Diversification makes sense when you buy uncorrelated assets to reduce a portfolio's volatility during fairly stable market environments. But buying assets for the sake of diversification to protect against a potential future crisis is fraught with risk regardless of how many different securities and asset classes one may hold.

Why?

Answer: Contagion. During a crisis, the risk from one asset class spreads to others as the need for more and more liquidity is needed. As more liquidity is needed to keep financial institutions solvent and investors meeting minimum equity requirements in margin accounts, they all begin to sell at the same time.

In the panic to raise capital, all types of financial assets are sold, driving their prices lower in tandem. Thus there is no diversification protection. In financial jargon, "<u>correlations all go to one!</u>"

Here's a chart from Credit Suisse that illustrates this risk.



Here, the Credit Suisse data, which tracks price relationships in equities, credit, currencies and commodities, shows that different markets are influencing each other in 2016 at a higher rate that any time since the measure was invented in 2008.

As we have noted in previous issues of the *Consilience Market Notes*, all asset classes are now largely moving in the same direction as markets have become more and more driven by central bank's monetary policies, leaving investors with no place to hide.

Massive central bank stimulus with below zero rates and quantitative easing has led to increasingly dysfunctional markets, with even the historic negative correlation between stocks and bonds breaking down.

Modern Portfolio Theory was created in 1952   But in today's investment climate, I think a MPT type diversification strategy is going to become problematic.

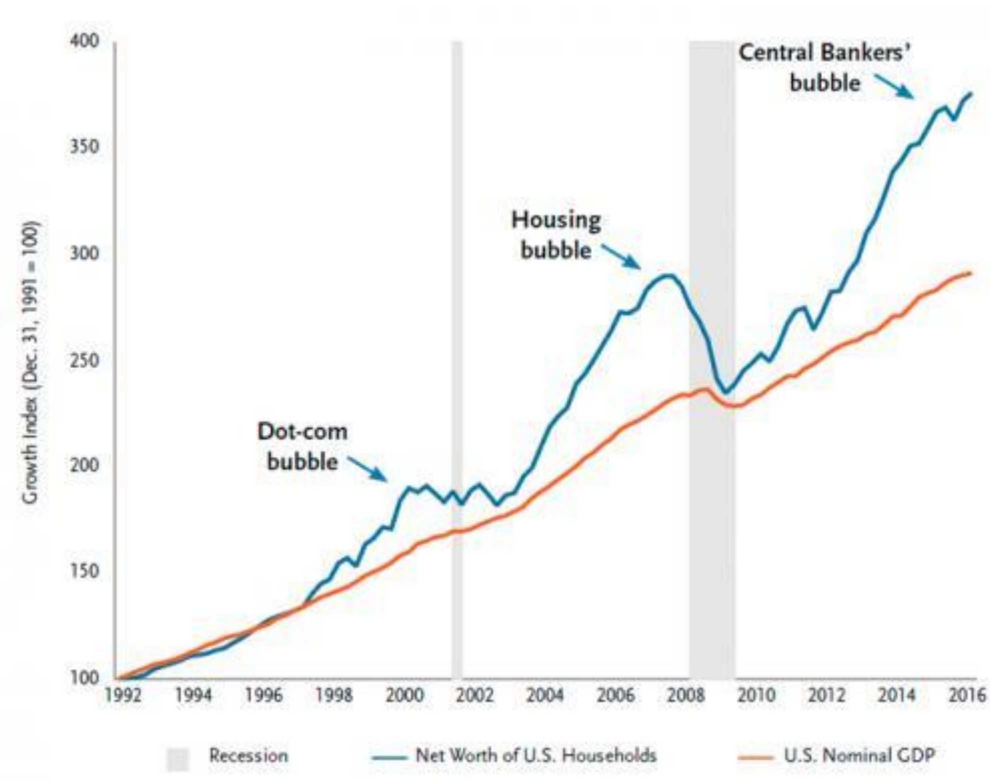
The major investor class today is comprised of Global Central Banks. We have never seen anything like this in history. Their balance sheets are up from $6 trillion in 2007 to $21 trillion today and they are still being expanded at the pace of $200 billion each and every month.

What's happening is that the robo-traders, the algorithms, the frontrunners on Wall Street and around the world are just gaming the system, looking for the next increase in central bank credit to take their collateral to the *European Central Bank* or to the *Bank of Japan* or to the *Fed* and buy more stocks and bonds.

This, in addition to direct buying of stock, bonds and other financial assets by these very same central banks!

We currently face a monumental dilemma. How do we extract ourselves from all this excessive debt without crashing the world economy?

Consider the chart below which plots the trajectory of cumulative asset prices (stocks, bonds, real-estate) against that of aggregate income (GDP):



The chart reveals something rather extraordinary: over the course of the past 25 years, <u>the traditional business cycle has been replaced with an asset price cycle</u>.

Rather than let recessions run their painful but necessary course, central bankers have intervened and disrupted the natural forces of the free markets.

But in the next crisis, can the Fed hold back the tides of de-leveraging when **even a hint that it might end sends the entire investment community scampering for the door**.

I suspect that they, like their "comrades in arms" at the *European Central Bank*, the *Bank of Japan* and the *Peoples Bank of China* will keep trying.

To illustrate how challenging these time are for investors, 2016 has been disastrous for hundreds of hedge funds, as is confirmed by the unprecedented number of shutdowns even as the S&P 500 (supported by central banks) is just shy of its all-time high.

Why? Aren't these funds made up of the smartest and most prominent investors on Wall Street? Well, yes! So why have so many been swept away this year?

In the words of one CEO, who closed his fund this year:

"It is more difficult than ever before for us to accurately forecast macroeconomic and corporate variables. [There is a risk of us] suffering substantial capital loss simply because we could be caught up in a [central bank induced] <u>erroneous market trend</u>, which could then persist for far longer than we could take the pain."

"It is therefore time to accept that what we have done has worked brilliantly for twenty years but <u>does not work anymore</u> and move on."

So, if hedge funds managed by the best and brightest on Wall Street are "throwing in the towel," what is the average investor to do?

Our answer involves a *consilient* approach to managing investments. By *consilient*, I mean an entirely different approach than is commonly practiced in the investment management world today.

This approach requires diversifying beyond stocks and bonds only and does not rely on economic forecasting or any Wall Street research. Rather, it relies on <u>tracking extremes in global capital flows reinforced by economic, monetary and behavioral data in real time</u>.

Our mission is to help investors get to the other side of any impending financial crisis, because if there is one with the current global debt levels, it is likely to be of a magnitude that will exceed previous financial crisis'.

And you really do want to get to the other side, because on the other side we have the potential to participate in what could be an enormous bull market!

Just think about opportunities that could be presented at such a time for the astute investor.

But first, you have just got to get your assets from here to there!

For more information, please visit our website: consilienceassetmanagement.com, where we present a video presentation of our risk management process on the opening page as well as a graphic illustration of our discipline under the tab *Our Process*.

As we navigate through these volatile times, our admonition remains: Stay vigilant and nimble.

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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.