Consilience
Asset Management

October 30, 2017

# Consilience Market Notes:

## A High-wire Act a Thousand Feet in the Air…

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

Now to this week's report:

*We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping… I admit to not understanding it*. – Richard Thaler, 2017 Nobel Prize winner in economics.

In the early 70s, there was something called the "Nifty 50…" Avon, Xerox, IBM, Polaroid, etc., and they were stocks that were considered the eternal growth stocks at that time.

And they just never stopped going up. Everything else stopped going up but not those Nifty 50! They would be something like the FANG stocks today, (**F**acebook, **A**pple, **A**mazon, **N**etflix and **G**oogle) or maybe the tech stocks in the late 90s.

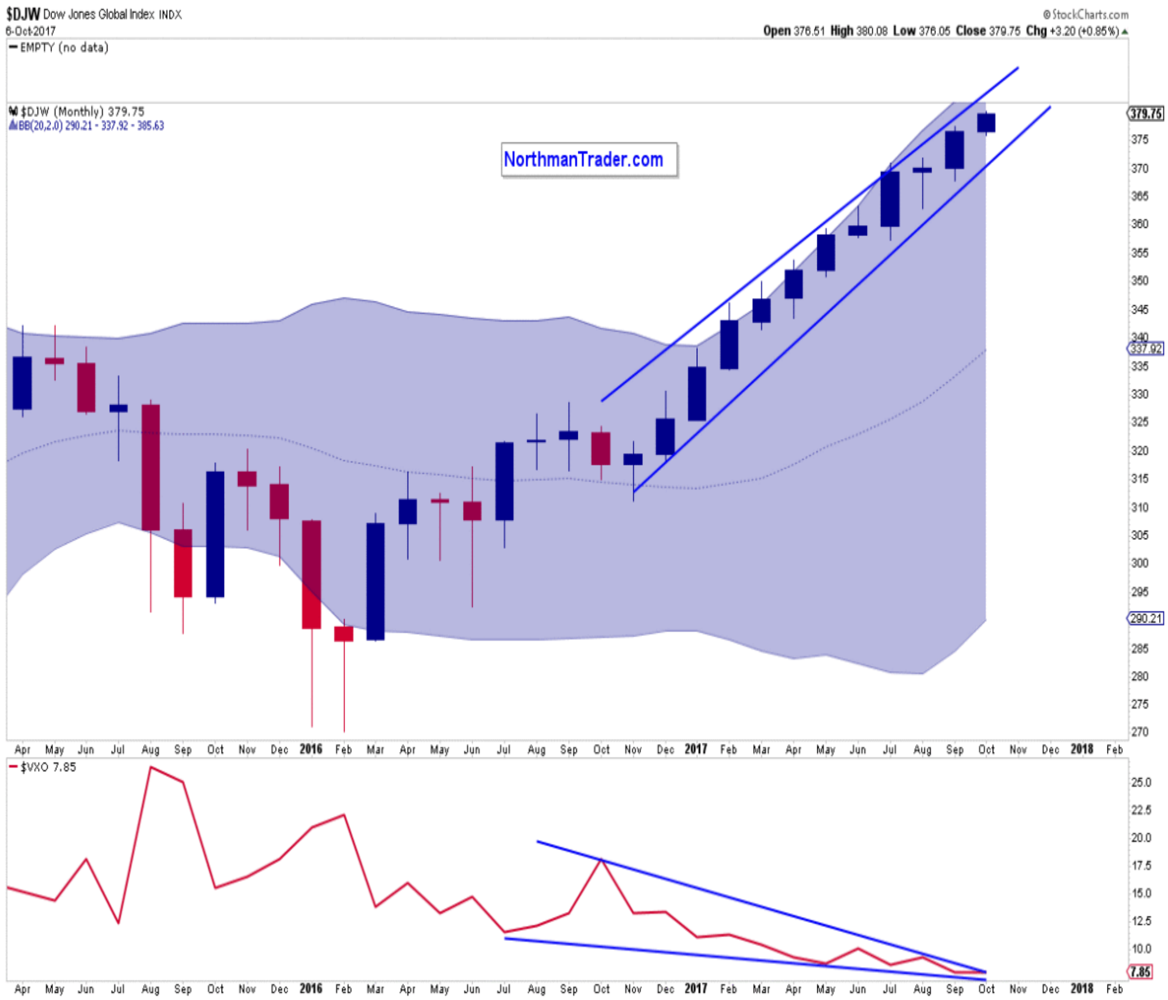
So, this has happened before in market history and as always happen, eventually even these succumb.

Alarmingly, among the companies that make up the S&P 500, there are only about 50 stocks that are actually moving higher… Everything else is in a downtrend. And yet the market is making all-time highs.

Because the S&P 500 is a capitalization weighted index, those 50 stocks, are driving the index to all-time highs.

This condition or "lack of breadth" has historically been an ominous sign for the overall health of the market… and often has presaged a bear market.

Yet, since January, the S&P 500 has rallied over 14% percent and recorded over 40 record high closes.




As mentioned above, we've been here before. Here's a chart of the Technology heavy NASDAQ index prior to the bear market that began in 2000.


It looked fantastic… until it didn't!

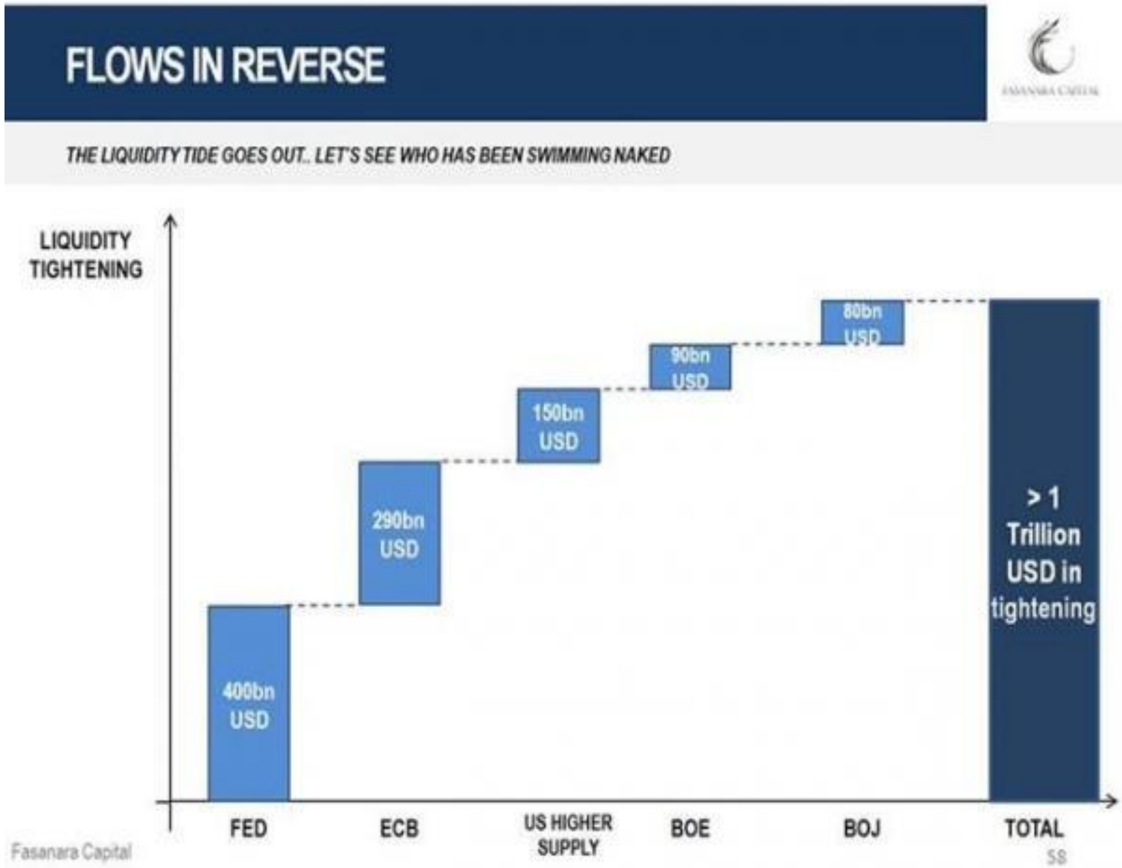
I would argue the stock market's advance since 2009 has been paid for with an over-abundance of unprecedented and unsustainable artificially created capital.

Global central banks have added $15 trillion dollars to their balance sheets, thereby providing excess capital that has been allocated to the global stock markets. As the vast majority of these funds are invested in index funds or index futures contracts, as shown above, it magnifies the returns of those companies with the highest market capitalization.

This trend has continued as $1Trillion has been added since the first of the year…


But, here's the bad news. Central banks have announced that they will begin shrinking their balance sheets next year! By "shrinking their balance sheets" the markets will begin to see a reversal of the capital that has been their lifeblood since 2009.

The undoing of loose monetary policies and the transitioning from Quantitative Easing (QE) to Quantitative Tightening (QT), will create a liquidity withdrawal of over $1 trillion in 2018 alone.




With central banks preparing to put an end to ultra-loose monetary stimulus, and with inflation recently seeing a pickup, there are concerns for stock prices. In addition, bonds could lose value quickly in an environment of rising interest rates and rising inflation.

Imagine an environment where the two primary asset classes, stocks and bonds, lose market value at the same time. Historically, bonds have been considered a "safe haven" during periods when stocks are under pressure. But this time investors may be faced with an extremely challenging dilemma.

In addition to Quantitative Tightening (QT), there is a second source of concern that could result in a further drain on liquidity in the financial markets.

A bit of history is in order here…

In the summer of 1974, Treasury Secretary William Simon traveled to Saudi Arabia and struck a momentous deal whereby the U.S. agreed to purchase oil from Saudi. In return, the kingdom agreed to invest the dollar proceeds of its oil sales in U.S. Treasuries.

Soon, other members of the Organization of Petroleum Exporting Countries (OPEC) followed suit, and the U.S. dollar became the standard by which oil was to be traded internationally.

This agreement enabled the U.S. to print dollars with little adverse effect on interest rates; an arrangement that was very helpful as the Fed began their money printing operation under the guise of Quantitative Easing (QE) in 2009.

Recent developments in technology and geopolitics, however, have already ignited a process to bring to an end the financial system predicated on these petrodollars, which could also have a profound impact on global financial markets.

For example, the global penetration rate of electric vehicles is showing signs of reducing gasoline demand and international oil revenue to a degree that would seem unfathomable just a few years ago

In addition, alternative energy sources (solar power and wind) also are well into their exponential growth curves, and are even ahead of electric vehicles in this regard.

The growth of U.S. oil production due to new technologies such as hydraulic fracturing and horizontal drilling has both reduced the U.S. need for foreign sources of oil and has already led to lower global oil prices.

But there's a catch for the U.S.  A U.S. economy more self-reliant for its oil consumption would reduce purchases of foreign oil, leading to a drop in the revenues of oil-producing nations and by extension, lower international demand for Treasuries and U.S. dollars… further exacerbating the risk of rising interest rates, a lower dollar and higher inflation.

This combination of lower demand for U.S. bonds by OPEC and central bank "tightening" may be likened to a high-wire act a thousand feet in the air without a safety net.

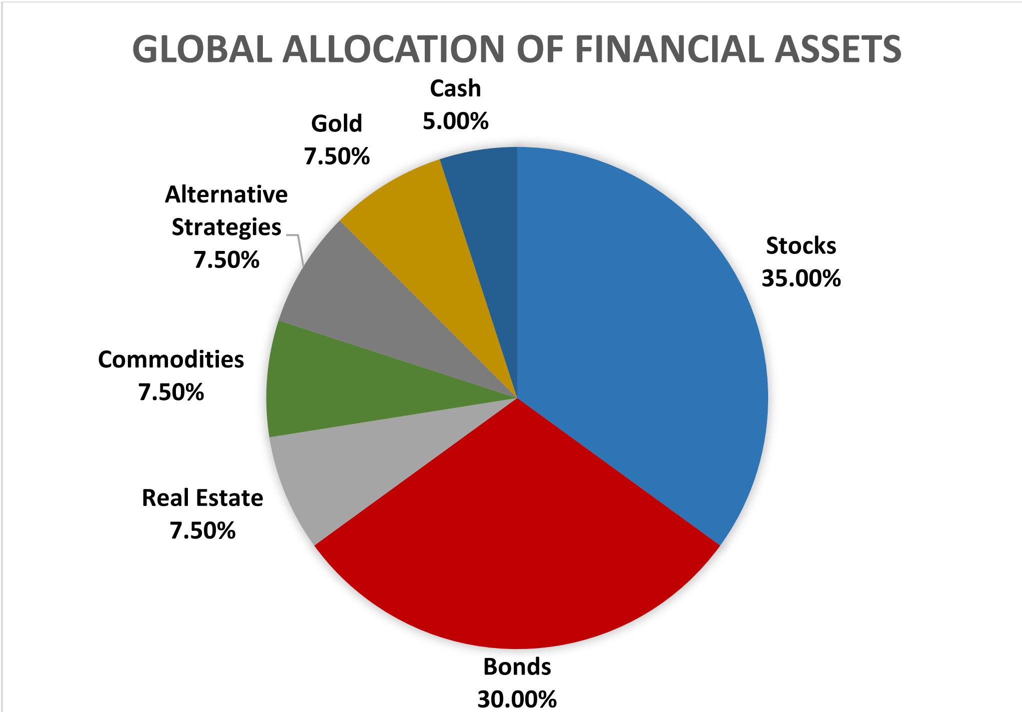
The ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different from today's, understanding how new data points fit (or don't fit) into that world and adjusting accordingly.

Although this will be no easy feat, our answer as Investment Advisors 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 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 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!

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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.