Consilience
Asset Management

September 5, 2018

Consilience Market Notes:

Dark Money!

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

Now to this week's report:

Well, it happened. Last week the US stock market broke the all-time record for the longest bull market ever.

This means that the US stock market has been generally rising for nearly a decade without a 20% correction.

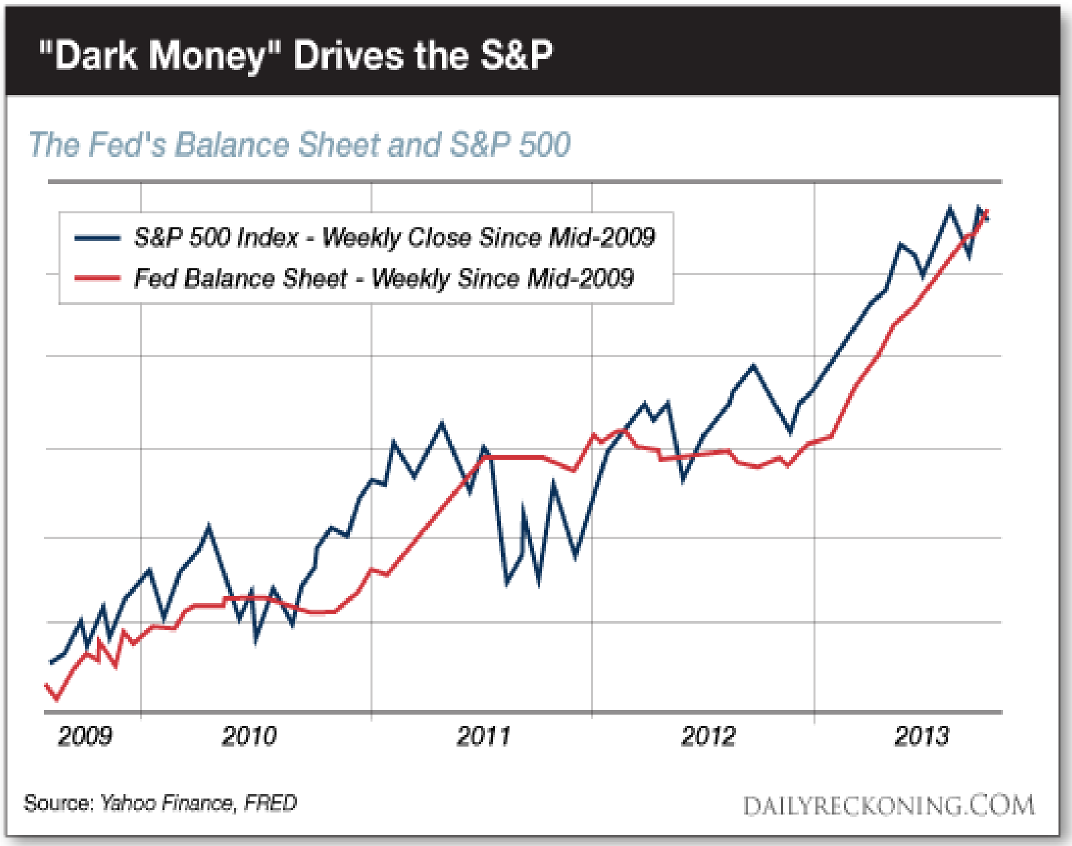
So, is it possible that this market will continue marching higher for the foreseeable future?

The answer lies in the future of what is called: "Dark Money". This is the "life force" of today's financial markets. It represents trillions of dollars per year flowing in and around global stock, bond and derivatives markets.

The "dark money" comes from central banks. In essence, central banks "print" money or electronically fabricate money and from there, it spreads out in seemingly infinite directions and ultimately its used to buy bonds and stocks.

The consequences that follow are foreseeable if you understand how the system works and follow the "dark money" flows.

As shown below, it's easy to see how this "dark money" affects the stock market…



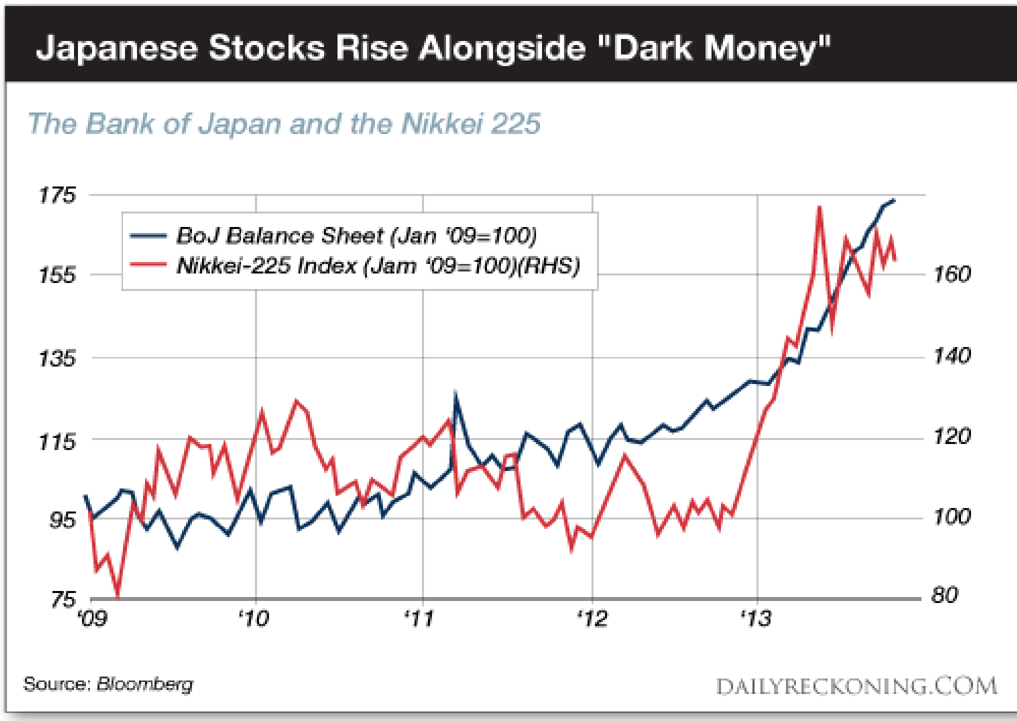
The red line shows you how much "dark money" the Federal Reserve has printed since 2008.

The black line shows the price movement of the S&P 500.

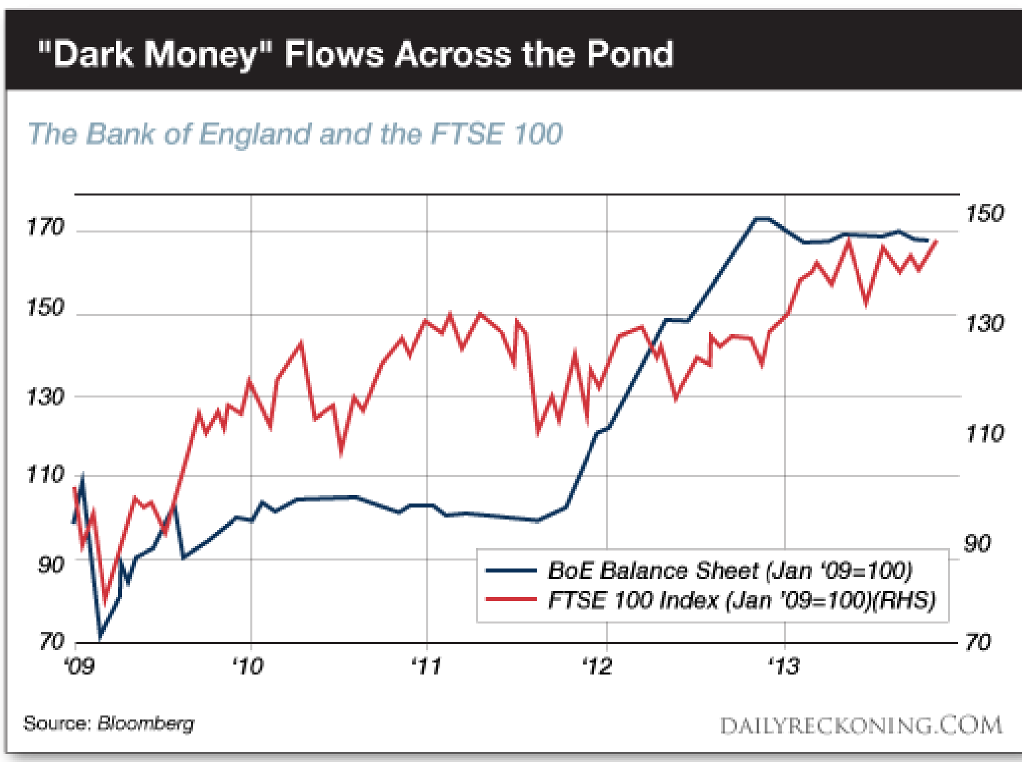
They move together… more dark money drives the market higher.

This is not a phenomenon exclusive to the U.S., Central banks around the world are engaged in the same activity. And with similar results… their stock markets are being artificially driven higher too.

Look at this "dark money" chart from Japan, for example…

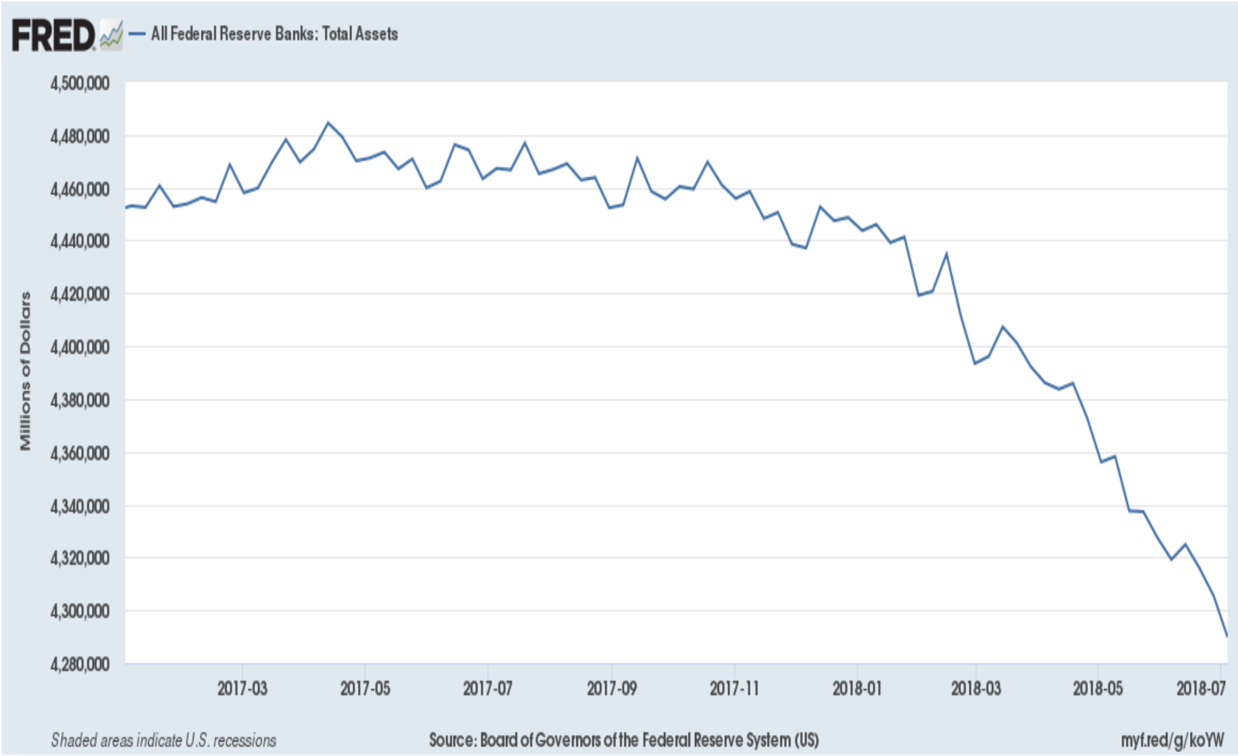


Or, from the U.K….



Where do things stand today?

As of last October, the Fed has been reducing its balance sheet as shown here…



Although at first glance this chart looks ominous, in reality the Fed's balance sheet is barely $200 billion lower than its peak of $4.5 trillion. That's basically a drop in the bucket, not much more than a rounding error… so far.

But what if the decline in the Fed's balance sheet continues to decline? Won't that be an ominous sign for the stock market?

Maybe.

The Fed's plan is to reduce the balance sheet by $50 billion a month for the next five years. That's $600 billion per year, which will take a big chunk of money out of the stock market each year. Supply and demand would dictate that, without any new source of capital coming in, stocks would reverse course and follow the same trajectory as the chart above.

The good news is that it is estimated that there will be as much as $1 trillion in corporate buybacks this year. So, if these buybacks occur, the supply/demand dynamics suggest that stocks have the potential to rise further this year!

But during this transition, the underlying distribution of rising versus falling stocks has changed dramatically as the Fed is no longer the primary driver. The vehicle of choice as the Fed expanded it balance sheet was the S&P 500 index, primarily via futures contracts. That meant that the market favored a fairly diverse group companies that make up of this broad-based index.

As the Fed's "Dark Money" slows, the disparity of market winners and losers widens. And if you're on the wrong side, you could be very disappointed.

For example, Greenlight Capital's hedge fund legend, David Einhorn, reported that his fund, lost another 7.6% last month, leaving the fund down 25.1% for the year. Yikes!

How is this even possible with the S&P 500 up over 8% so far this year?

Einhorn said that "this has been a frustrating environment for us and for value investing styles…"

For example, the iShares S&P 500 Value ETF is up a mere 1.49%, while the iShares S&P 500 Growth ETF is up 10.74%. As for Einhorn, he evidently made some very bad selections among the value group.

But my point is this, security selection is critically important in today's environment.

Switching gears for a moment, there are many other forces that are creating volatility in the markets, such as trade wars with china… or maybe even Canada. More recently the mainstream media has been awash lately in talk over the danger of economic "contagion," primarily due to lack of dollar liquidity in emerging markets.

This lack of liquidity, with particular focus on events in Turkey, is being pegged as a trigger for instability in stocks and bonds around the world.

But as pointed out at the beginning of this report, the issue of contagion (as with other issues making front page news today) must be examined through a different set of parameters.

When we look at the true causes of numerous economic and political crises around the world, we usually find central banks right at the center. And it's their *"Dark Money" that is the "life force" of today's financial markets. It drives whole markets up and down.*

But let's assume for a moment that after 2018, stock buyback wane and we are unable to identify any other significant new sources capital coming into the stock market. If the Fed continues to engage in their balance sheet reduction activities, won't this cause stocks to reverse course?

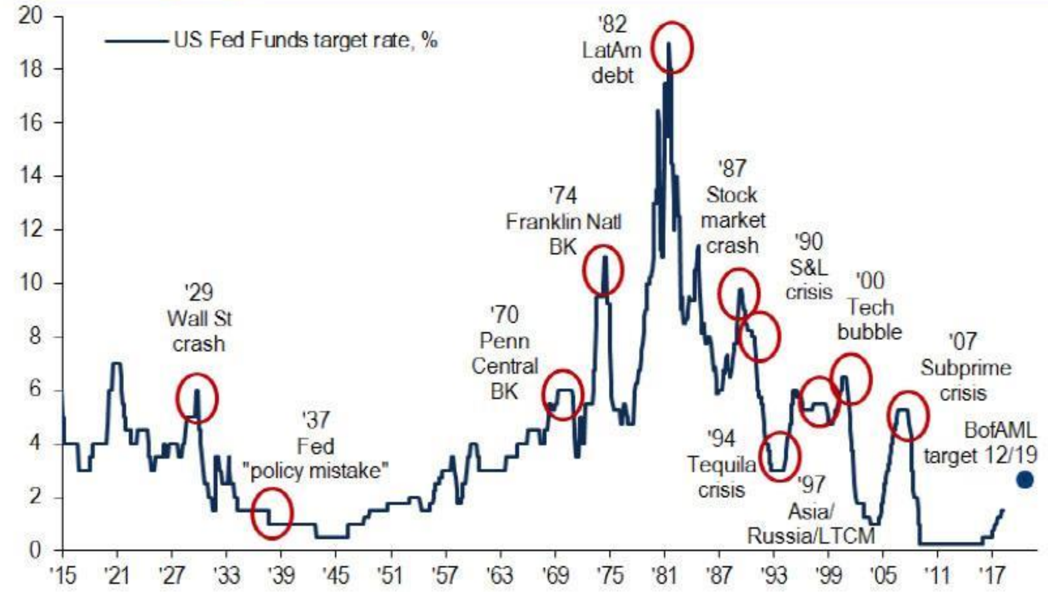
Yes… unless the Fed reverses course! Would they? To answer, take a close look at the next chart…

(A little explanation may be in order: When the Fed expands its balance sheet and buys bonds, yields on the Fed Funds Rate decline. Conversely, when the Fed contracts its balance sheet, bonds are sold and yields on the Fed Funds rate rise.)

So, looking at this chart, the red circle represents a peak in the Fed Funds rate or a period where the Fed engage in a period of balance sheet contraction, resulting in, or a coincident with a crisis.

What follows?

Chart 25: How Fed tightening cycles end



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

The Fed capitulates and quickly reverses course and resumes their balance sheet expansion. Will this happen again if the markets face a period of unpleasant turbulence and an impending crisis?

There is clearly historical precedent for them to do exactly that!

This knowledge alone should be incrementally bullish and relieve some of the pressure resulting from concern that adequate demand for stocks may not be available to keep the market from crashing during a Fed unwind of its balance sheet.

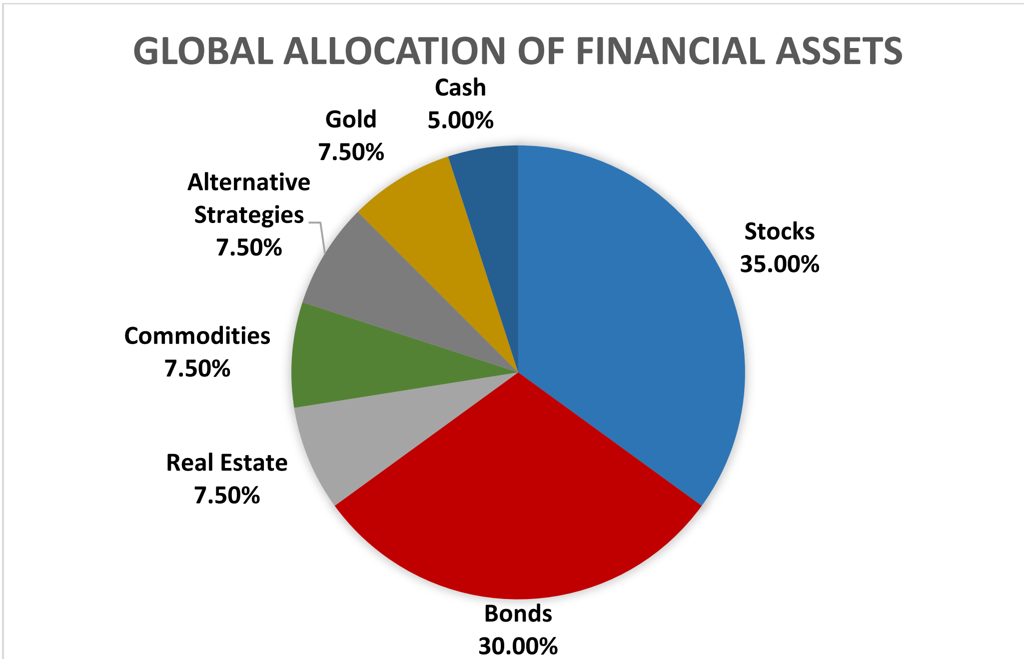
Of course, there is no way to tell in advance exactly how this will unfold. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of fundamental information, applying that information to imagine a plausible world different from today's,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