September 05, 2017

Consilience Market Notes:

Can QE Work Again?

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

Global Equities – **Positive,** (Note: U.S. Equities turned neutral this week),
Global Bonds – Negative,
Commodities – Negative,
Gold – **Neutral,**
Hedge Fund Strategies – Negative,
U.S. Dollar – Negative,
Real Estate – Negative.

Now to this week's report:

QE did wonders for us coming out of 2008 – Warren Buffett

However, we've never gone through a period like this and how it will all work out in the end, nobody really knows.

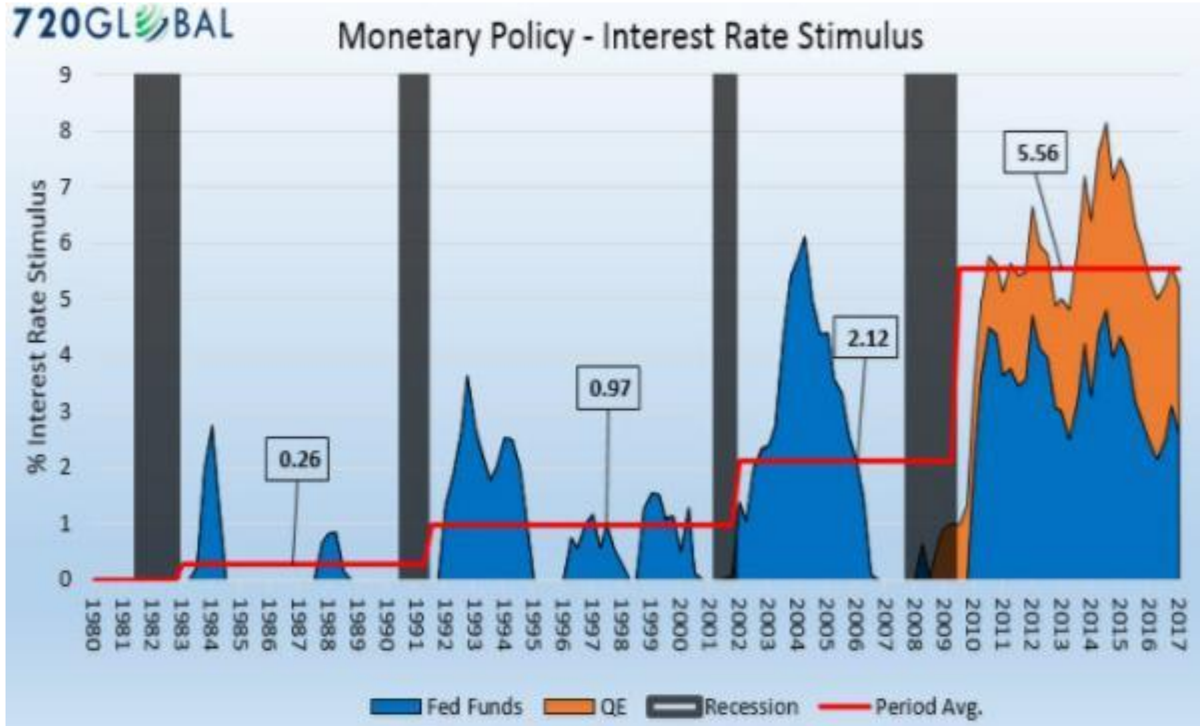
Remember, QE or Quantitative Easing is really just a fancy name for monetary stimulus. And the amount of monetary stimulus imposed on the financial system since 2008 has created false signals about the economy's true growth rate.

Let's delve a little deeper into exactly what the components of QE actually are.

As illustrated in the following graph, monetary stimulus comes in two forms:

First, in the form of targeting the Fed Funds interest rate at a rate below the nominal rate of economic growth (blue).

Second, from the large-scale asset purchases by the Fed (orange).



Data Courtesy: Federal Reserve

When these two metrics are quantified in the form of an equivalent interest rate stimulus quotient, we can see that the Fed has, in effect, applied the equivalent of a 5.25% interest rate reduction to the economy since 2008.

This number dwarfs any similar calculation from that of any prior period.

As this chart shows, the Fed has been increasingly aggressive in both the amount of stimulus employed as well as the amount of time that such stimulus has remained in place.

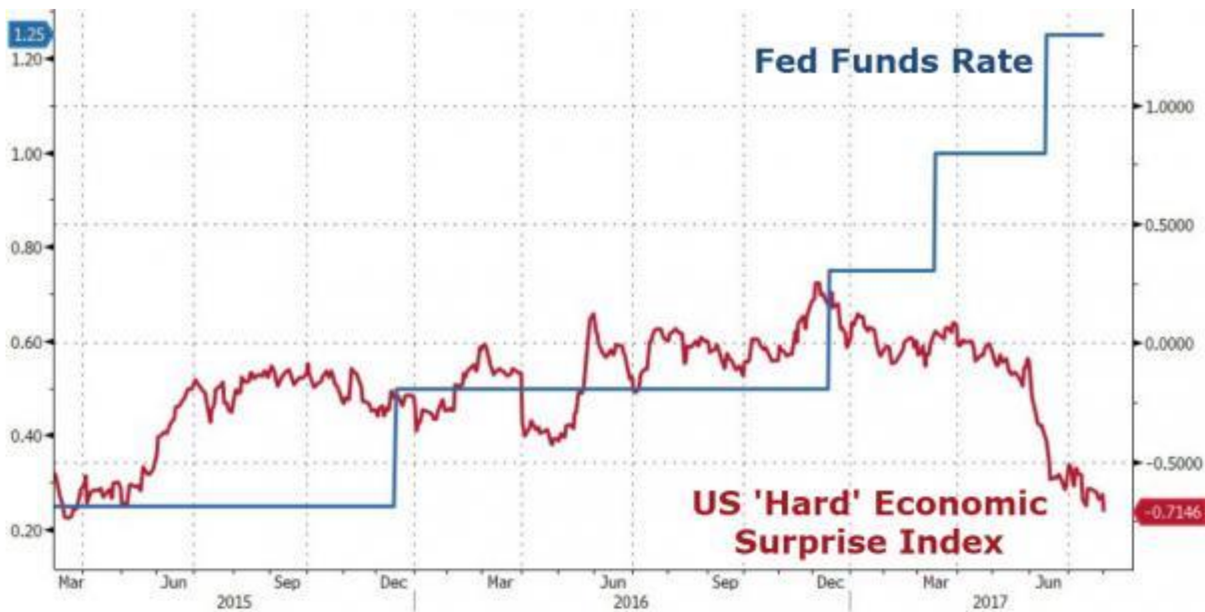
Amazingly few investors seem to comprehend that despite the massive level of monetary stimulus, economic growth is trending well below recoveries of years past. In addition, it appears that they display a total lack of concern for the potential vulnerability for the stock market at current levels.

According to the latest Conference Board survey, only 20% of Americans believe stocks will fall in the next 12 months. As shown in the following chart, the last time investors were so confident was in the fall of 2007.

And we know what happened next… not to mention the previous period of investor complacency - 2000.

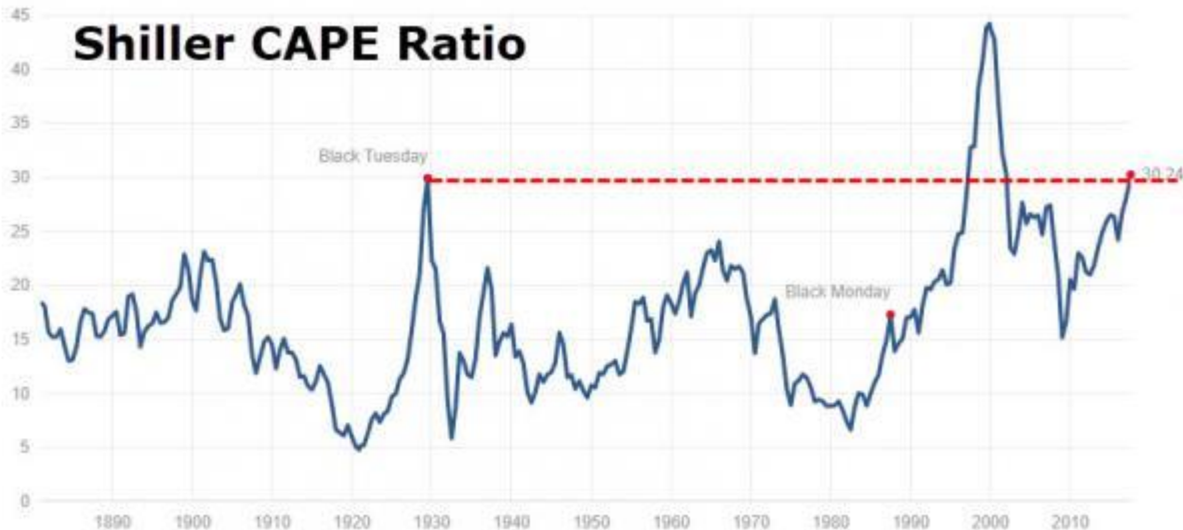
It's not just the sub-par economic growth that should concern investors today, this is one that should be at the top of the list… as total domestic corporate profits have grown at an annualized rate of just .097% over the last five years. Prior to this period and since 2000, five-year annualized profit growth was 7.95%.

Not the decline in this economic index as the Fed Funds rate has increased in recent months…



In addition:

The S&P 500 cyclically adjusted price-to-earnings (CAPE) valuation has only been higher on one occasion, in the late 1990s. It is currently on par with levels preceding the Great Depression.



Add to this the fact that at $8.6 trillion, corporate debt levels are 30% higher today than at their prior peak in September 2008.

So, U.S. corporations are simultaneously more indebted, less profitable, and more highly valued than they have been in a long time.

So, what would happen if the Fed continued to raise interest rates and reduce economic stimulus? Is the economy on solid enough footing that solid growth would ensue… without the Fed's assistance? And would corporate profits strengthen enough to justify current lofty valuation levels for stocks?

On the first question, the U.S. Treasury yield curve has been a solid indicator of the over-all health of the U.S. economy. The yield curve is simply a chart showing Treasury yields on the vertical axis and maturity on the horizontal axis.

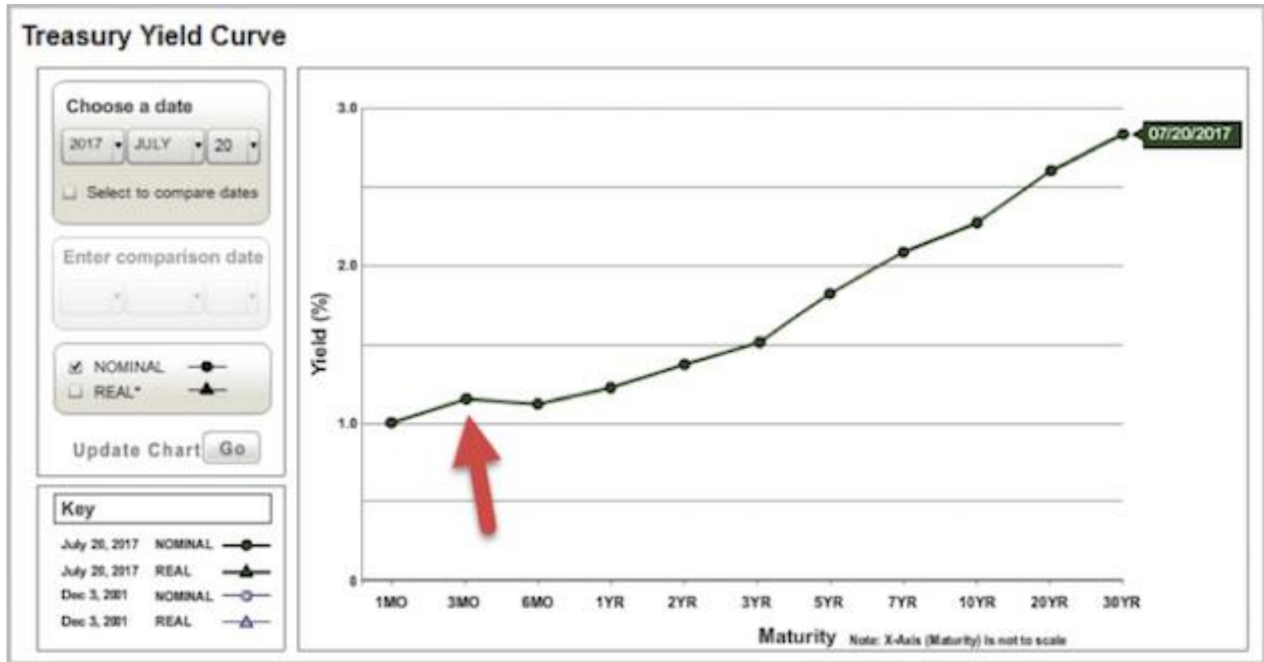
We need to keep a close eye on the yield curve, and especially on changes in its shape. Normally, you would expect interest rates to slope upward as time to maturity increases.

However, periodically, an inverted yield curve shows up indicating that either the economy is in recession or soon will be.

It inverted in early 2000, and again in 2006–2007.

Although the yield curve is not presently inverted when viewing its shape from 1-month to 30-years, in our current QE environment, it may no longer tell us what it once did.

In the following chart, direct your attention to the red arrow, where we see a slight inversion forming.



Here, the 3-month Treasury yield currently exceeds the 6-month yield. At first glance, this may not seem terribly relevant, but in our current QE environment this may bear close monitoring.

Why?

Because today, the Federal Reserve is tampering at the short end of the yield curve. This type of activity didn't exist prior to the Fed's unprecedented monetary stimulus following the 2008 financial crisis.

This is a new development… and may presage a weakening economy or even worse, a recession developing. This would of course exacerbate the already troublesome economic conditions relative to current stock market levels and investor confidence.

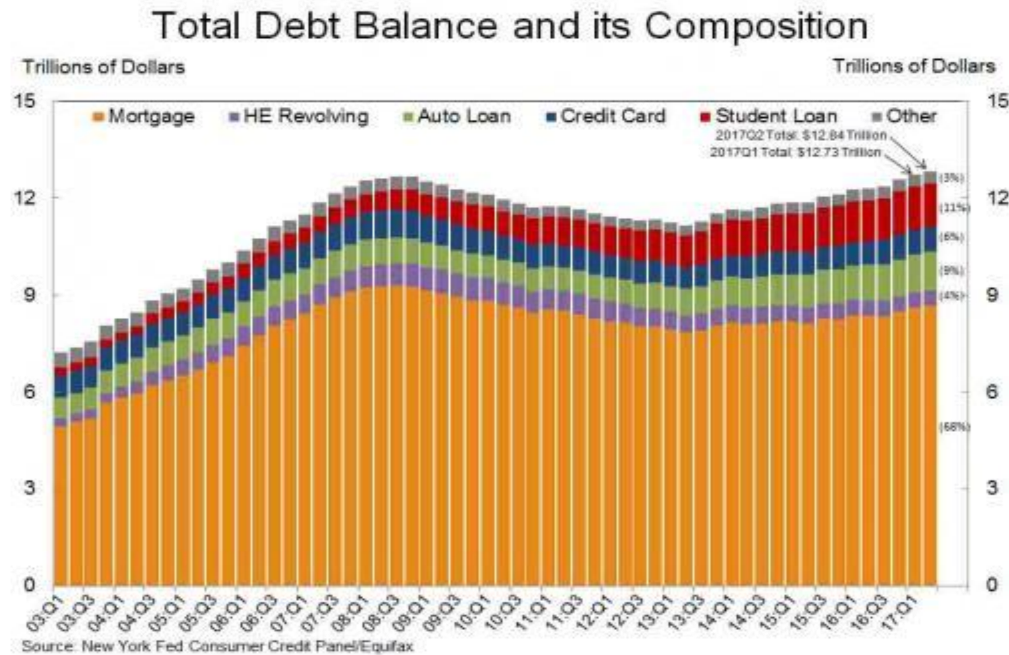
What are the risks if the Federal Reserve continues their tightening monetary policy… i.e., raising interest rates and further reduction in QE?

Unfortunately, we don't have any historical examples to review… we're in uncharted territory here. But logic suggests that such action by the Fed would curb any inflation pressure that exists and potentially push the economy into outright deflation.

Would deflation be all that bad? Doesn't this mean lower prices? Yes, but deflation in an economy <u>as debt-burdened as ours</u> would be catastrophic.

We noted above, that U.S. corporations have amassed $8.6 trillion in debt… but that's not all!

As of June 30, 2017, total household indebtedness was $12.84 trillion, or 69% of US GDP. Put the two together and they exceed 100% of our GDP! (Don't forget there's an additional $20 trillion in government debt)…



So… if deflation were to occur today, we would have to repay debt with cash that is gaining purchasing power instead of losing it to inflation. Americans have not seen this happen since the 1930s.

But, couldn't economic growth still surprise on the upside? And wouldn't that generate additional tax revenues, allowing the U.S. to begin reducing these debt levels? After all, didn't U.S. GDP increase by a very respectable 3% last quarter?

Yes, they could… but current equity valuation levels leave little room for error today.

Or… assume for the sake of argument that we find out in early 2018 that the U.S. economy is, in fact, in recession. Wouldn't the Fed do what it has always done: cut interest rates and implement another round of QE to stimulate economic activity? And hasn't that action been very favorable for stock prices?

Yes… but, doing the same thing this time would put the federal funds rate well below zero. That's right – negative interest rates!

Here's the conundrum: Up to this point, central bank stimulus has been extremely bullish for stocks. But would QE that resulted in negative interest rates still be bullish?

The historical record for this assumption is quite thin. It is remarkably easy to assume that the recent past should continue indefinitely, but it is an extremely dangerous assumption when it comes to asset prices that are already extremely over-valued.

As shown on page 2, the scope and degree of this last eight years of Federal Reserve monetary stimulus is historically unprecedented and by many accounts, unconventional in approach.

Globally, central banks have added an estimated $10 trillion of assets/debt to their balance sheets, bringing the total to a staggering $14 trillion of assets. This is equivalent to a staggering 17% of all global GDP.

The European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England are still collectively adding $200 billion of new debt to their books each month.

And, as we approach the 10th anniversary of the beginning of central bank stimulus since the financial crisis, there has been – no change – in global G7 central bank monetary policy.

Thus far… they have stepped into **every single market correction** to provide what they believed was the necessary liquidity to the financial markets to prevent a repeat of 2008.

Therefore… the global markets really have, up to this point, all come down to central banks. Although this is a little counter-intuitive… so far as equity investors are concerned… it has worked… thus accounting for the lack of concern among investors, as shown on page 3.

Even with rising geopolitical uncertainty, high valuations and slow economic growth, one would think these issues might put a dent in markets, but surprisingly, so far, they have not!

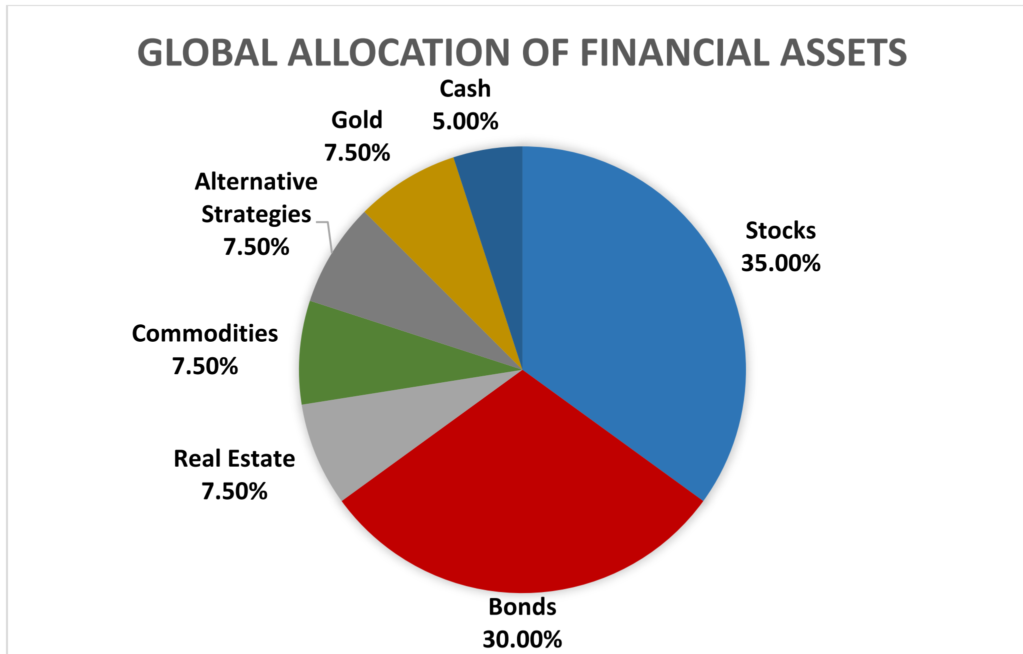
So, what is the prudent stance for investors in light of today's challenging market conditions?

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's 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 aforementioned 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

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.

All opinions and estimates included in this communication constitute the author's judgment as of the date of this report and are subject to change without notice. This communication is for informational purposes only. It is not intended as an offer or solicitation with respect to the purchase or sale of any security. This information is subject to change at any time, based on market and other conditions.

*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.