April 01, 2024

Consilience Market Notes:

A Debt-Induced Bull Market

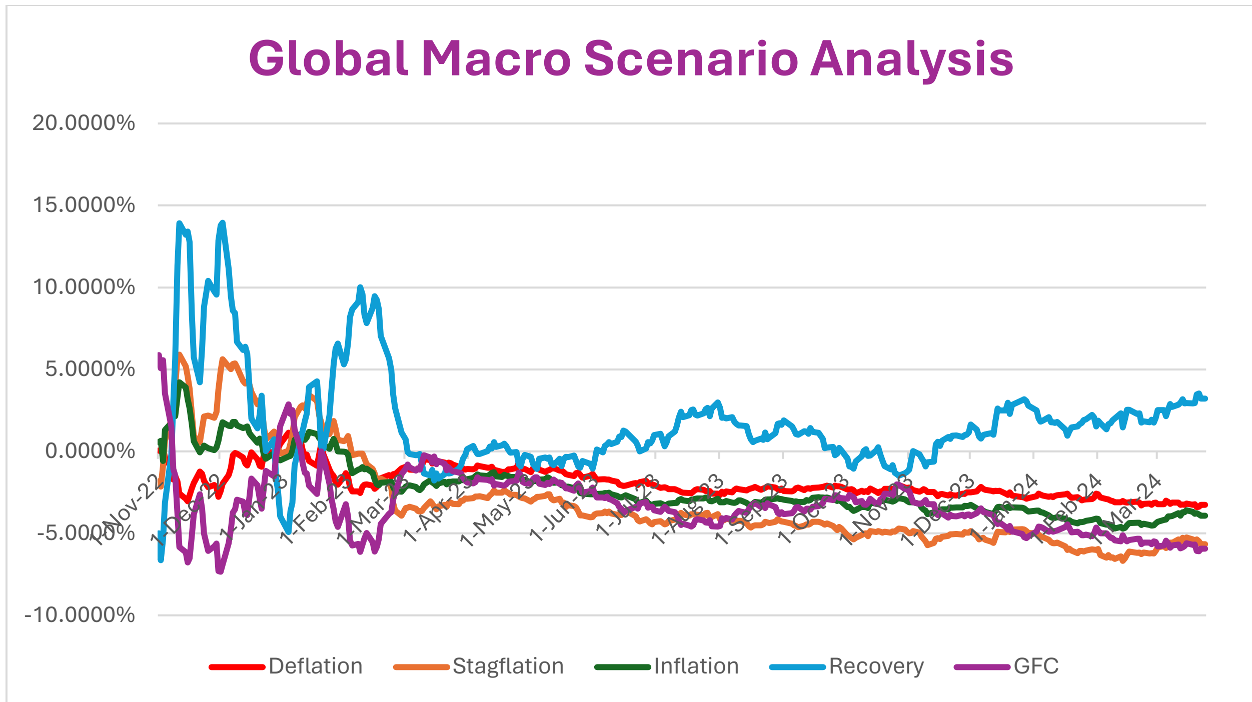
First, an update:

Last year, we at *Consilience Asset Management* added a Macro-Economic component to our *Relative Capital Flow Model**. Using market action, through a process of reverse engineering, we seek to identify which macro-economic climate is being represented in the market at any given time.

This is an important addition to our discipline as central banks across the globe are attempting to unwind decades of monetary expansion. As this unwinding occurs, it could have significant ramifications for the financial market. Thus, there is an increased need to monitor this process and the corresponding macro-economic result.

Below are the ratings of **securities in the five scenarios** that we are monitoring:

Inflation – **Positive,**
Deflation – **Negative,**
Stagflation – **Neutral,**
Recovery – **Positive,**
Financial Crisis – **Negative.**



Source: *Consilience Asset Management*

The above scenarios reflect the current *Capital Flow** composite rating of the securities that have historically generated positive returns in the above economic environments.

In addition, our *Global Macro Indicators** are as follows for the seven asset classes we invest in for our clients:

Global Equities – **Neutral,**
Global Bonds – **Neutral,**
Commodities – **Neutral,**
Gold – **Positive,**
U.S. Dollar – **Neutral,**
Real Estate – **Neutral,**
Cryptocurrencies – **Neutral.**

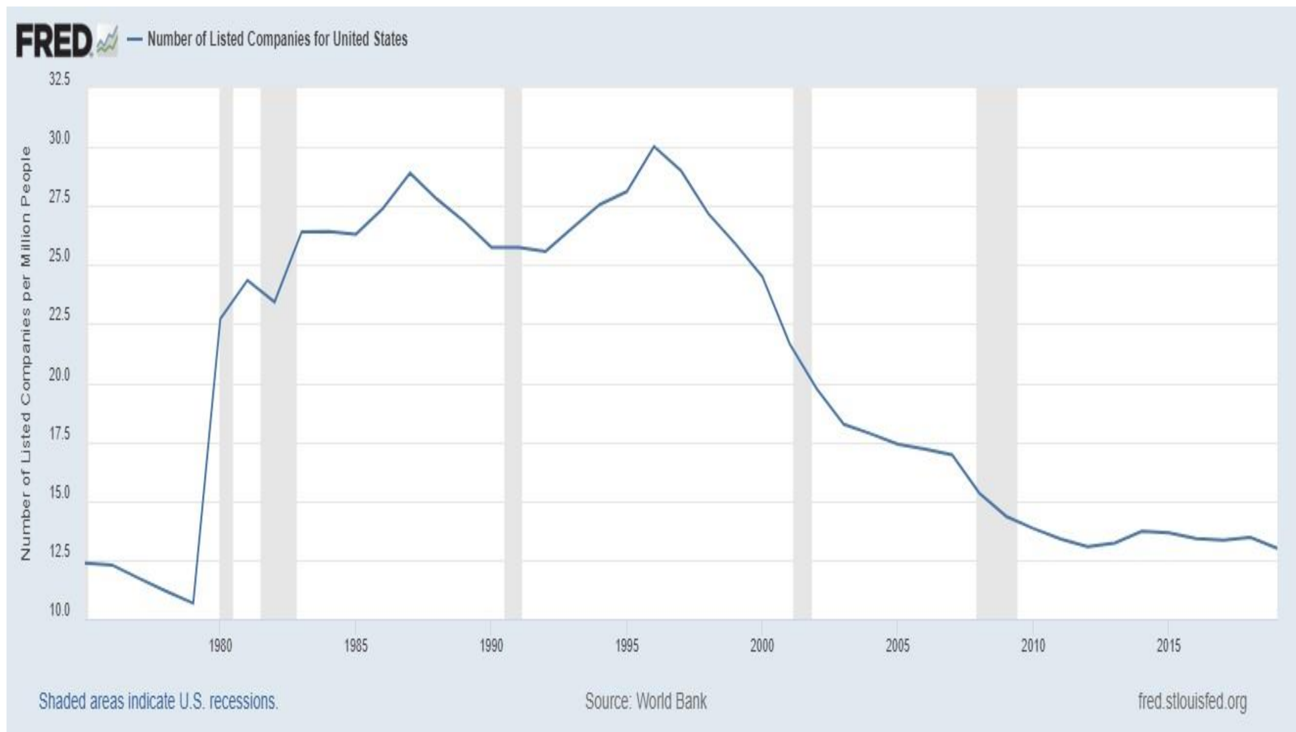
Now, to this month's report:

What's driving the current stock market frenzy?

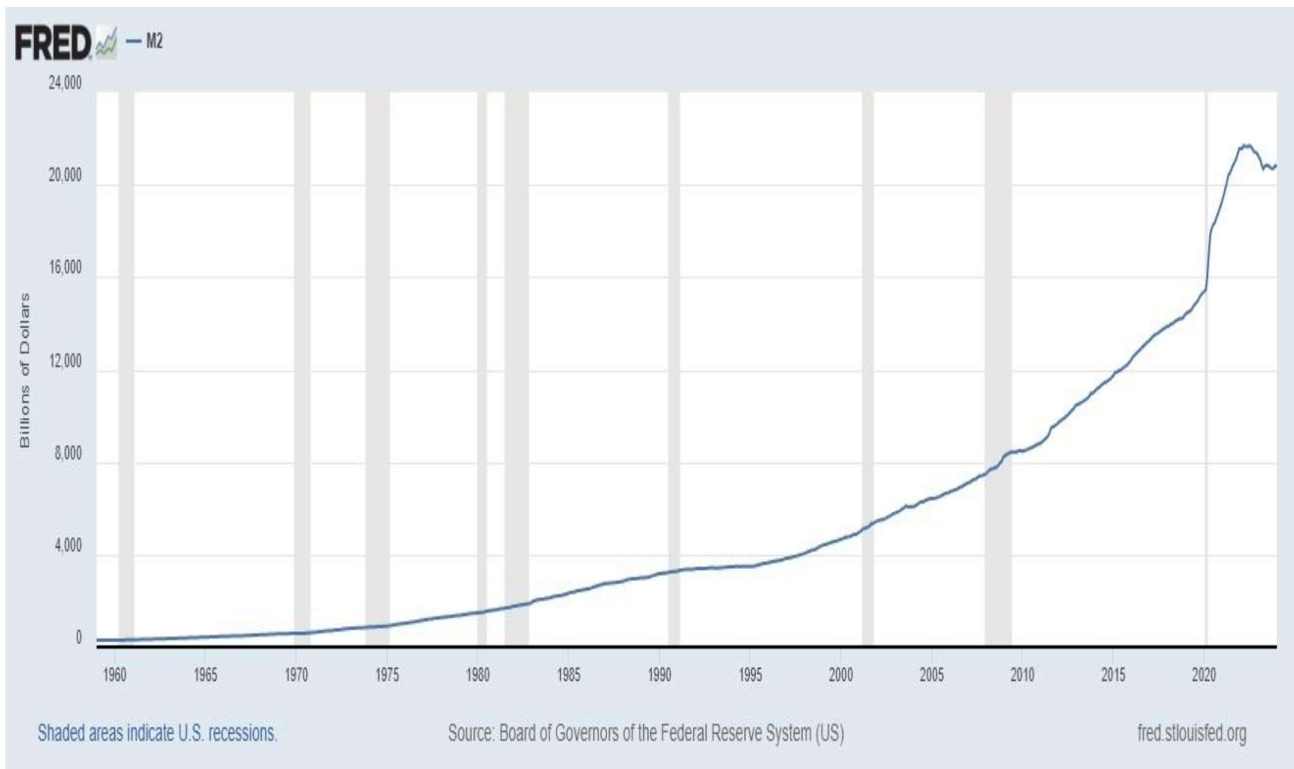
Is this a new bubble pure and simple? Is it driven by fundamentals? Does the Fed play an important role?

Here is a simple supply vs. demand visual that helps explain the stock market's long-term advance.

First, here is a chart showing the trend in the number of US public companies. Since the mid-1990's it has been down by more than half.



This has happened when total money supply has also exploded:



So, a simple conclusion is that if the Fed continues to expand the money supply, stocks should continue to rise. But can they continue this practice indefinitely?

The obvious answer is, of course not.

Trends in stock prices over the past year have largely been a function of market expectations about Fed… that they will continue to expand the money supply, masking a much more troubling economic reality.

But wait, didn’t the US experience stronger-than-expected GDP growth in Q4 2023? Isn’t that an important catalyst for rising stock prices?

Yes, but… the strong GDP growth has been powered not by productivity gains or private-sector investment but as shown above, by government spending. During this recent stock market rally, growth in GDP has only been about 40% of growth in the national debt.

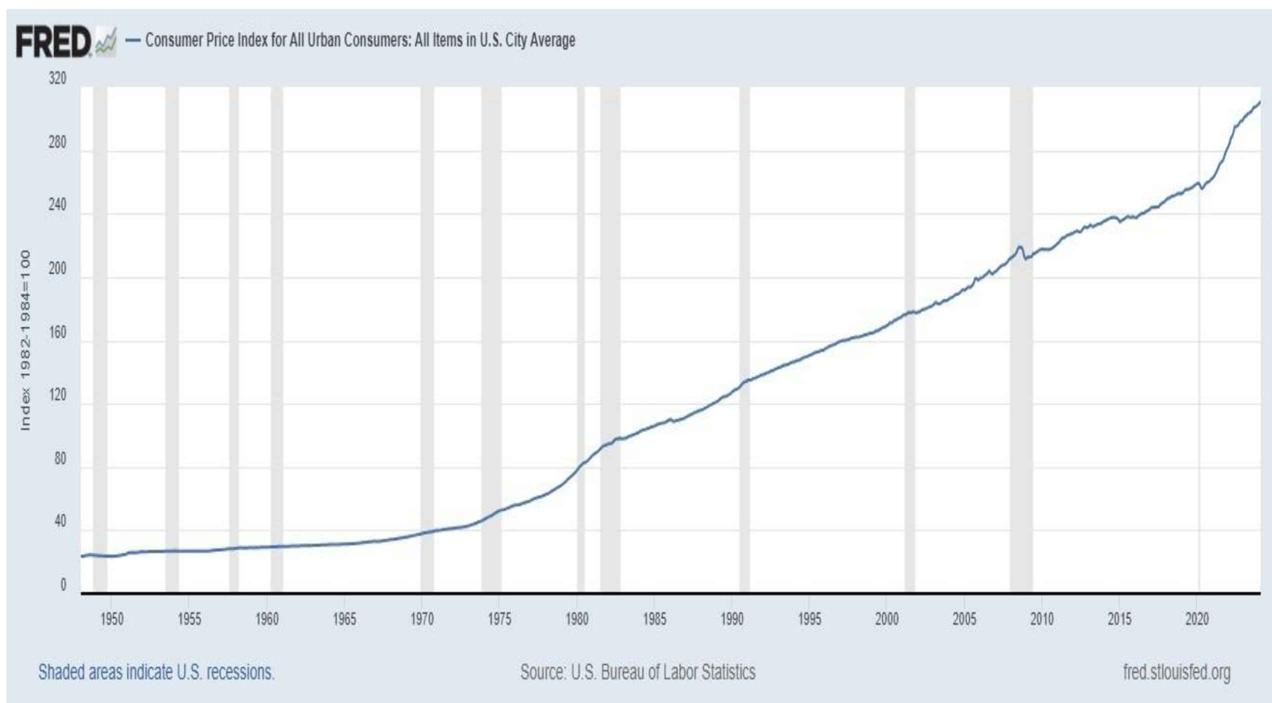
Put differently, this means a multiplier of 0.40%.

With a 0.40% multiplier, you borrow a dollar, spend a dollar, and get only $0.40 of growth. In short, your debt is growing faster than your economy, a completely non-sustainable situation.

It is this excessive amount of debt that has been supporting our economy and asset valuations. Therefore, the Fed has no choice but to keep the liquidity pumps flowing to support the leverage.

But the long-term result of monetary expansion is inflation/currency debasement.

After troughing back in June 2023, US headline/core CPI is again trending higher. Is there any real evidence that the Fed is serious about fighting inflation/currency debasement?



Rather the evidence is that the Fed is tolerating higher inflation (which also eases the record US debt burden at $34.5 trillion) and has tacitly accepted a higher inflation target than the historical 2%.

Since it now appears that the Fed is telegraphing higher inflation, that would suggest a weaker currency as well.

This is nothing new. Nations have engaged in monetary expansion at the cost of currency debasement for millenniums.

Debasement refers to the action or process of reducing the quality or value of something. When talking about paper/fiat currencies, debasement traditionally refers to the practice of reducing the value or purchasing power of a currency — such as when central banks increase the supply of money, in the process lowering the nominal value of each unit.

In previous times, nations engaged in the practice of mixing the precious metals that backed their currencies with a lower-quality metal enabling them to create additional coins with the same face value, expanding the money supply for a fraction of the cost compared to coins with higher quality metals like gold and silver.

Today, currency can be debased by increasing the money supply, lowering interest rates, or implementing other measures that encourage inflation; they're all "good" ways of reducing the value of a currency.

In addition to stimulating economic growth and supporting rising asset values, governments debase their currency so that they can spend without raising taxes.

History offers us poignant reminders of the perils of monetary expansion. Once-powerful empires from Rome to Weimer Germany, all serve as cautionary tales for the modern fiat system. As these empires expanded their money supply, devaluing their currencies, they were, in many ways, like the proverbial lobster in boiling water. The temperature — or in this case, the rate of monetary debasement — increased so gradually that they failed to recognize the impending danger until it was too late.

Is the US really heading down the same path as these other nations? By 2023, the monetary base had surged to 5.6 trillion dollars, representing an approximate 69-fold growth from its level of 81.2 billion dollars in 1971.

Higher inflation rates are the most immediate and impactful effects of currency debasement. As the currency's value decreases, it takes more units to purchase the same goods and services, eroding the purchasing power of money.

Yet, despite the recent surge in money printing, according to Federal Reserve reports, the consumer confidence index, labor participation, and unemployment-to-population ratios, as well as real wage growth, remain significantly below the pre-pandemic level, and this after $6.3 trillion in new monetary expansion/debt.

To make matters worse, based on the relationship between short-term and long-term interest rates, there is evidence of a recession brewing. The US is currently experiencing an inverted yield curve. This is when short-term rates are uncharacteristically higher than long-term rates.

After the 2-year Treasury rate declined below the 10-year at the end of March 2022, it has now been continuously inverted for 625 days since July 5th, 2022. That exceeds the 624-day inversion from August 1978, which previously held the record.

An inverted yield curve has been the best predictor of a US downturn of any variable throughout history. The yield curve has always inverted before all of the last 10 US recessions, with a lag that is usually 12-18 months.

Thanks to a historic flood of fiscal stimulus and record debt levels, such an event has thus far been postponed… But how much longer can an artificially debt induced policy support the economy and financial markets?

The good news is that there are asset classes that can perform favorably under multiple scenarios. Historically stocks do well when rates are declining, and money supply is expanding. Commodities and Gold have performed well when the increased money supply has resulted in inflation and Bonds have performed well during a contracting economy and declining interest rates.

In the meantime, my advice is to pay close attention to our *capital flow* indicators as summarized at the beginning of this report and described below, and as they change, so should the asset allocation of your portfolio.

In our seven asset classes listed, there are both inflation and deflation sensitive options. It is my belief that it would be prudent for investors to allocate a portion of their assets outside the traditional markets of stocks and bonds (paper assets) and into alternative asset classes (hard assets). Some of these are included in our seven assets listed on page 1 of this report.

It is important to note that alternative investments can result in increased portfolio volatility and as with traditional investments like stocks and bonds, are not guaranteed and can decline in value.

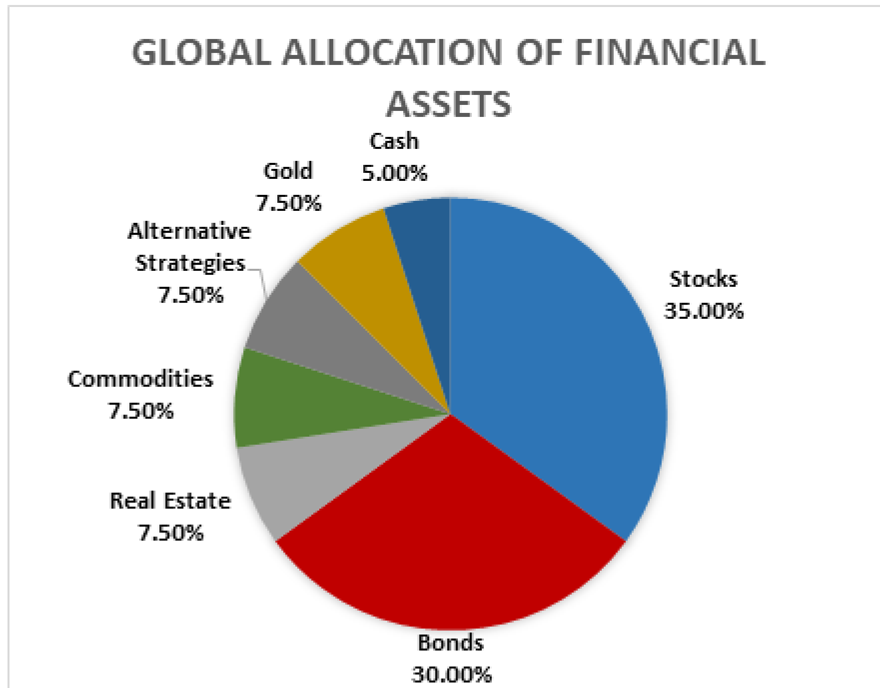
Conclusion: Recognizing that we are in uncharted waters with multiple moving parts, we must admit that there is no way to tell in advance exactly how this will unfold. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of information from multiple sources, 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 has the ability to circumvent 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 $250 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 $300 trillion total…



Source: BIS, Thompson Reuters, World Bank, World Gold Council, Financial Analysts Journal, (January 2019).

(The performance quoted herein represents past performance. Past performance does not guarantee future results)

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 eight asset classes that we monitor are included each month at the beginning of this report.

We are entering a new phase, as the decade-long bull markets for stocks appear to be winding down. We are cognizant of the new challenges inherent due to the structural

changes noted in this report, as they will 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.

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