December 01, 2023

# Consilience Market Notes:

## A Summary of Our Major Themes in 2023

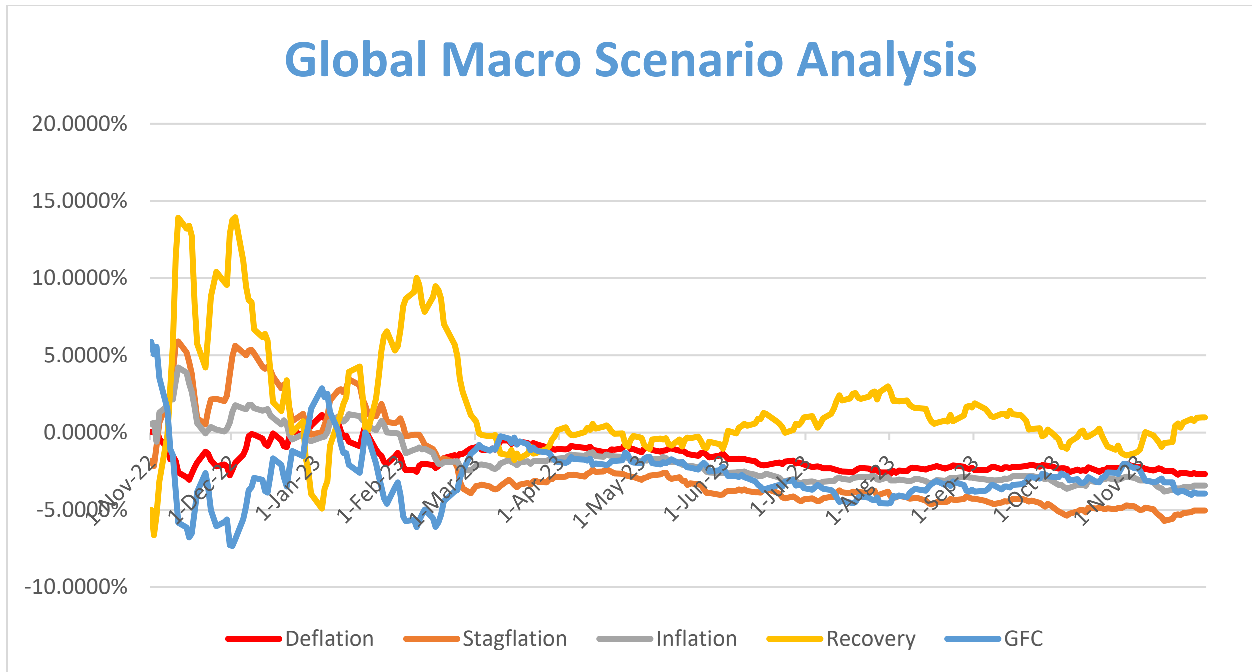
**First, an update**:

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




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

**Now, to this month's report:**

As we enter the final month of 2023, our message remains the same, "manage risk in these very uncertain times."

We are looking at debt at an all-time high, geo-political risks at crisis levels and economic uncertainty with the risk of a recession at cycle highs… yet the stock market has been rallying for much of 2023.

So, it seems that something must give. Either the risks are overstated and will recede, or the stock market will retreat.

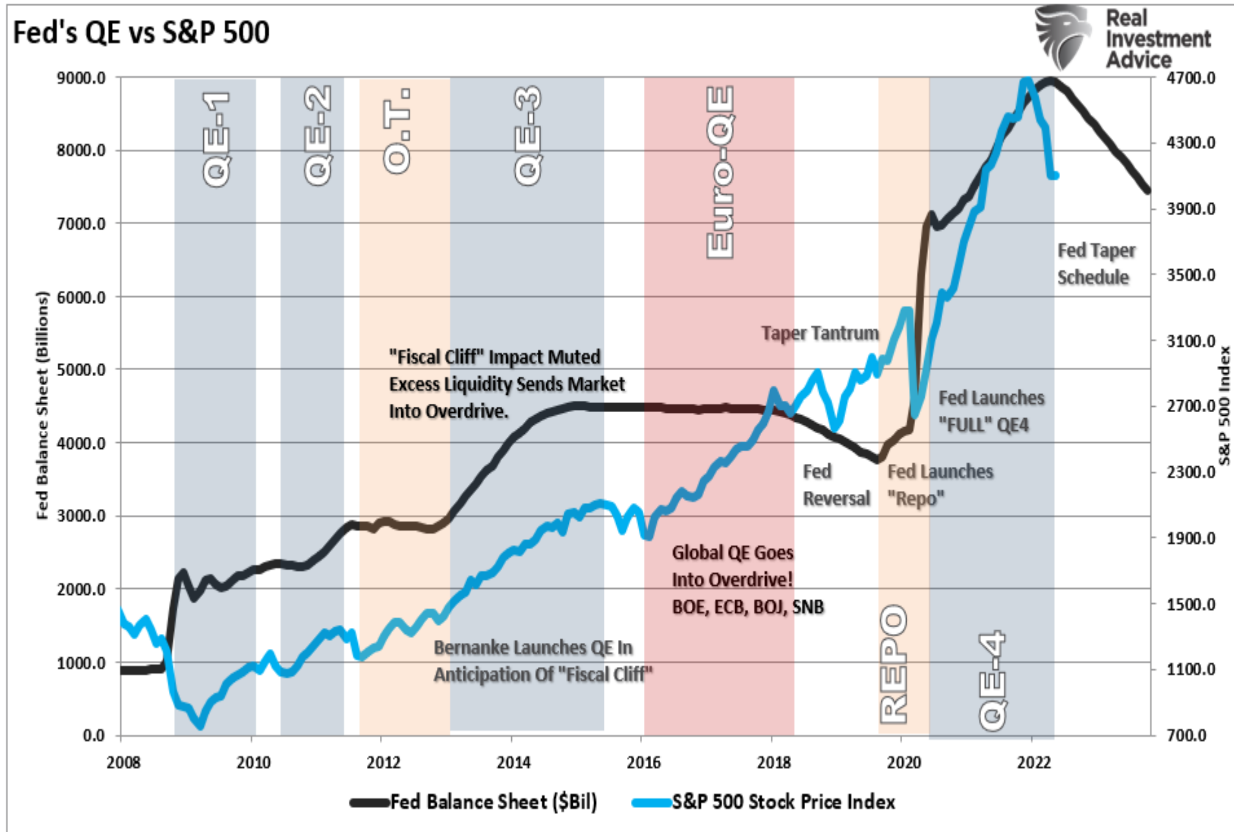
The economy and markets are giving divergent views on US recession risk, with the recent performance of several assets sending out a more negative message than justified by the economic data. Oil has slumped, copper is weak and US interest rates markets now expect almost 1% of cuts next year. But this is all contrary to an abundance of economic data from the National Bureau of Economic Research (NBER) that indicates the risk of a recession is in fact receding.

Which one is right then, the market or economic data? A snapshot of our current indicators above suggests the latter. But as we have found in recent years, things can change very quickly.

In this month's report, I will look back at the year and summarize the highlights from our 2023 *Consilience Market Notes*. Here we go…

<u>From our January 2023 Report:</u>

The primary driver for the financial markets has been, "the Fed's money printing operation… [which has] artificially fueled the stock market to record levels as shown below."




*Source: Standard and Poor's, St. Louis Fed*

<u>From our April 2023 Report:</u>

An introduction to the Fed's dilemma…

First, they printed trillions of dollars following the 2008 Global Financial Crisis in a process called Quantitative Easing (QE) to "save" the economy and financial markets. This excessive capital resulted in inflation (a reduction in the purchasing power of the dollar).

Source: Bloomberg

Next, to fight the inflation that they created, they have attempted to reverse course and reduce dollars and raise interest rates in a process they call Quantitative Tightening (QT).

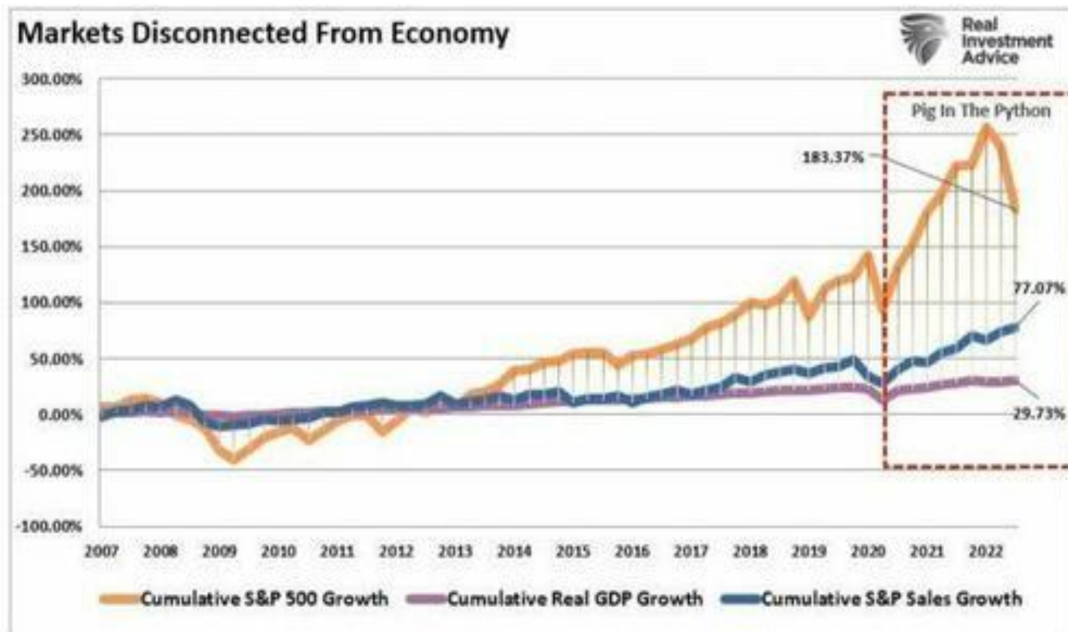
From our February 2023 Report:

Has the Federal Reserve engineered a soft landing for the economy while curbing inflation? Has the current administration introduced a durable plan to address our ever-expanding debt without crashing the economy and the markets?

If not, then what is driving the financial markets higher in recent weeks?

There's an old expression coined by political strategist, James Carville, "It's the economy, stupid." That may have been an astute political observation when he made the statement in 1992, but today, price moves in the financial markets bear no resemblance to the economy. No today, as our statistical work suggests, "it is absolutely not the economy."

For example, while the stock market has returned more than 180 percent since the 2007 peak, that increase in asset prices was more than 6x the growth in real GDP and 2.3x the growth in corporate revenue.




(Source: St. Louis Federal Reserve, Refinitiv, RealInvestmentAdvice.com)

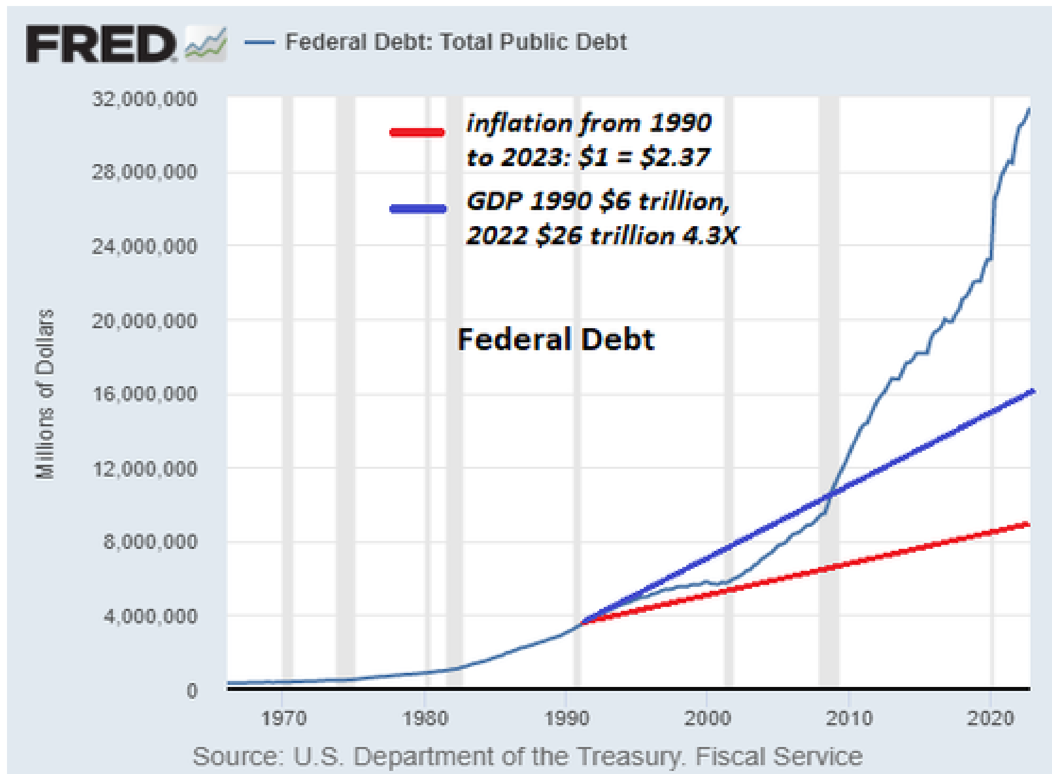
As pointed out on numerous occasions in our *Consilience Market Notes*, rather than the economy, it's been Central Bank money printing or Quantitative Easing (QE), and zero precent interest rates that have been the primary driver for rising stock and bond prices.

As shown below, while the Federal Reserve was engaged in money printing/expanding their balance sheet, the stock market rose. When they reversed course last year, stocks declined.

From our May 2023 Report:

Remember, when the US prints new dollars, they offset these dollars with new debt.

As the next chart below shows, the increased rate of borrowing has vastly exceeded the increase in the US economic growth. If federal debt had tracked GDP since 1990, it would be around $16 trillion, half of its current $32 trillion.




In 2010, respected economists (Carmen Reinhart and Kenneth Rogoff) concluded that at a government debt to GDP rate of over 90% it becomes exceedingly difficult for a nation to grow its way out of its debt burden.

According to the Bank for International Settlements (BIS), core government debt in the United States, is now 112.6%.

Now that after decades of declining interest rates the long-term trend is once again rising, Reinhart and Rogoff's theories are about to be tested.

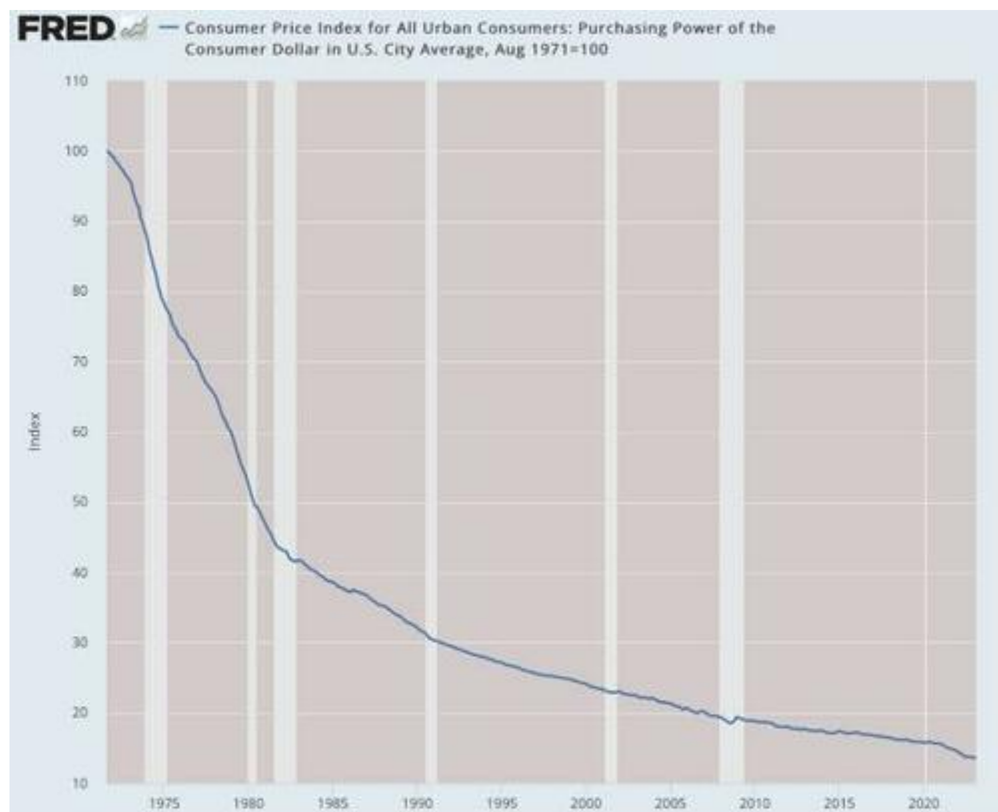
But their theory dealt exclusively with government debt. What about total debt; government, corporate and consumer?

According to the International Institute for Finance, global debt reached almost $300 trillion by the second quarter of 2021. In relation to GDP, this was some 350%, above the 280% before September 2008 Lehman bankruptcy.

The cost of this debt induced increase in the US money supply has been an accelerating currency debasement. This has certainly contributed to the reduction of foreign buyers of US Treasury debt.

Here's a sobering picture of the debasement of the US dollar's purchasing power since we went off the gold standard in 1971 and gave the Fed the ability to print money without the constraints of matching the new dollars with a portion of gold.

The 1971 dollar is now worth about 13 cents!

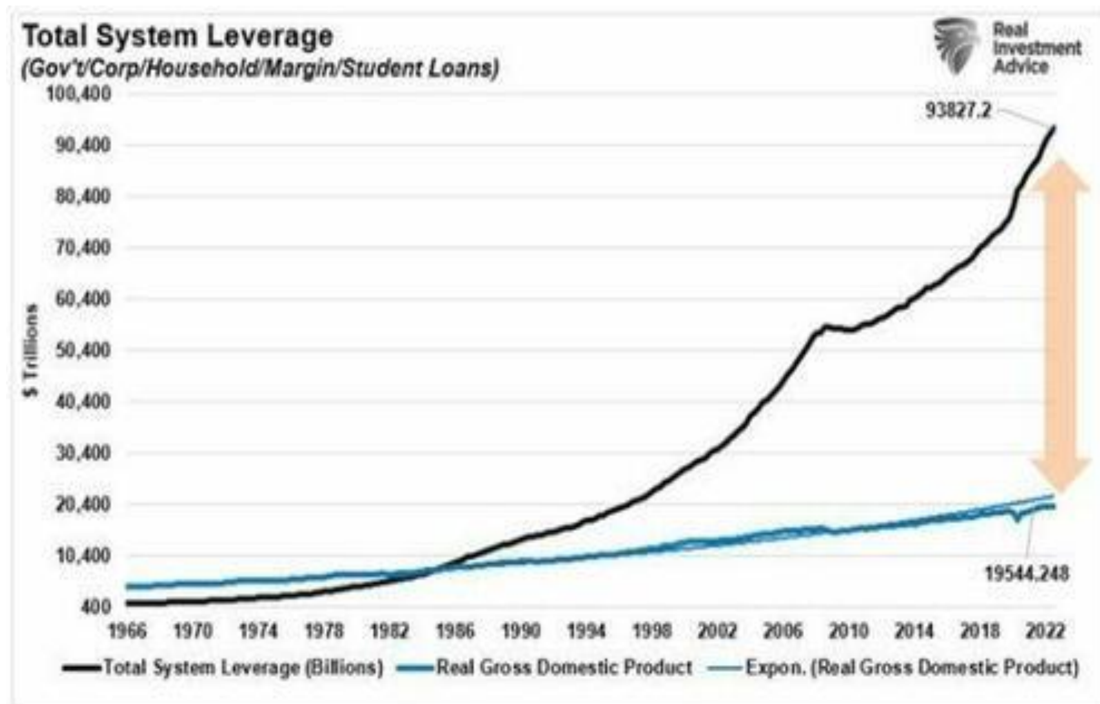



(Data: Federal Reserve Economic Data)

From our June 2023 Report:

Since 2009, there has been more than $43 trillion in various liquidity supports. To put that into perspective, the inputs exceed underlying economic growth by more than 10-fold. (Source: *Federal Reserve Bank of St. Louis*)

Keep in mind, "liquidity supports" means debt!




*(Source: Federal Reserve Bank of St. Louis / RealInvestmentAdvice.com chart)*

And as shown above, although that $43 trillion has supported a multi-decade bull market in stocks, it hasn't translated into a corresponding boon for the economy. But that hasn't mattered to the stock market. Stocks rose regardless of the lackluster economy as newly printed money created greater demand for stocks.

From our August 2023 Report:

And financing these deficits is becoming enormously expensive as the Fed raises interest rates to attempt to ward off inflation.

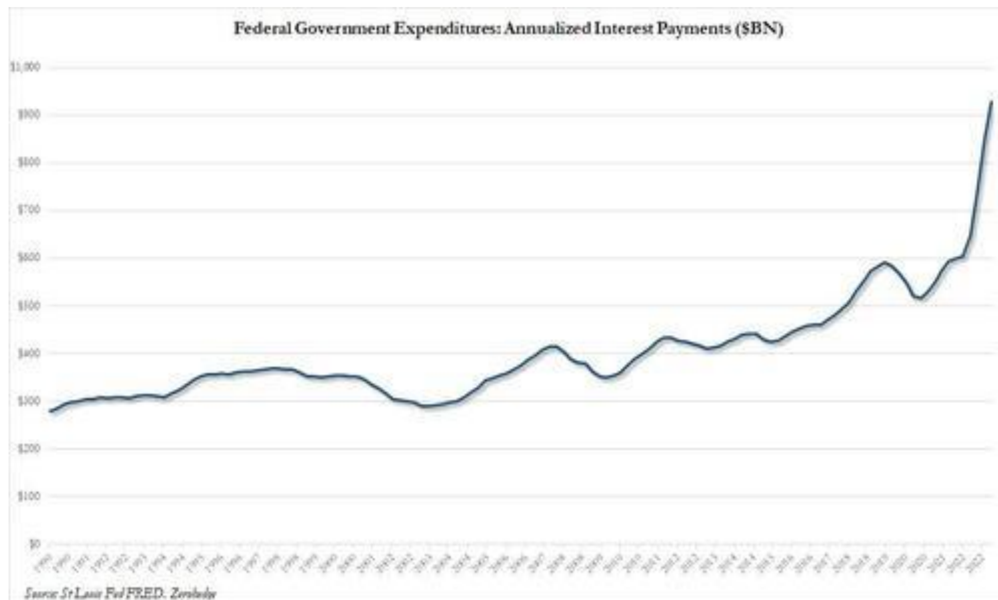
According to Bloomberg, the five-year Treasury yields are now about 3.96%, versus 1.35% at the start of last year. And according to the St Louis Fed's FRED and

the BEA, the interest payments by the Federal Government have now surpassed $900 billion for the first time ever.

As lower-yielding securities mature, the Treasury faces even further increases in the rates it pays on outstanding debt.

The department's data show the Fed's blended rate on the debt will surpass 4% in one year.

That would mean that interest payments on total US debt of $32.3 trillion would hit $1.3 trillion within 12 months, potentially making interest on the debt the single biggest US government expenditure and surpassing social security!




As a result, an ominous trend is unfolding. The world is not unaware of the fiscal condition in the US and as a result, appears to be in the process of moving away from the dollar, thus chiseling away at the dollar's reserve status.

As tensions with Russia and China escalate, the so-called BRICS countries (Brazil, Russia, India, China, and South Africa) are they preparing to strike a blow against U.S. dollar hegemony?

In the first of the two most recent examples of how non-western nations plan to avoid the dollar, late last week Argentina made a loan repayment to the International

Monetary Fund worth the equivalent of $2.7 billion “without using dollars” on Friday, using Chinese yuan and special-drawing rights notes instead, Reuters reported.

Indian refiners have also begun paying for some oil imports from Russia in Chinese yuan, Reuters also reported citing "sources with direct knowledge of the matter" as Western sanctions force Moscow and its customers to find alternatives to the dollar for settling payments.

The former Credit Suisse economist, Zoltan Poszar explains that the traditional idea of a unipolar world dominated by the US dollar is shifting, and we are entering an era where multiple currencies will play a significant role. Simply put, he notes, the global financial system is going through a "monetary divorce" from US dollar hegemony and becoming more multi-polar.

Such moves are weakening the purchasing power of the US dollar… which is the true definition of inflation. And although the financial markets, especially stocks have been in a strong recovery so far this year, a re-acceleration in inflation is a primary endogenous risk for stocks and bonds.

From our September 2023 Report:

Remember, the US dollar is the reserve currency for global trade. This creates a continual demand for dollars, thus propping up its value. Any challenge would potentially result in a reduction of the dollar’s value and even higher inflation and interest rates in the US.

As it stands, the majority of global oil sales are priced in dollars. This ensures a constant demand for the greenback since every country needs dollars to buy oil. This helps support the US government’s “borrow and spend” policies, along with its massive deficits.

This means that as long as the world trades in dollars the Federal Reserve can keep printing dollars to monetize the debt.

But this is all beginning to change.

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For example,  China has been pushing for oil trade to be denominated in yuan, and that Saudi Arabia's acceptance into BRICS could bolster this ambition, potentially shifting the dynamics of global oil trade away from the US Dollar.

Recently, according to Bloomberg, the Chinese central bank revealed that in July it increased its gold reserves for a ninth straight month as it continues to diversify its reserves away from the US dollar.

In another blow to dollar dominance, according to Bloomberg, India and the United Arab Emirates settled an oil trade without converting local currencies to dollars for the first time on Monday, as India's top refiner made a payment for oil in rupees.

From our October 2023 Report:

Years of distorted, rigged and entirely reckless debt-and-print polices have made global economies and currencies weaker, not stronger and have made the entire financial system vulnerable to additional shocks, and crisis.

As pointed out in last month's *Consilience Market Notes*, the expansion of Brazil, Russia, India, China, and South Africa (BRICS) has made it clear that the de-dollarization of the international finance system is inevitable.

A larger BRICS will mean the world will increasingly use U.S. dollars less, thus potentially driving the dollar even lower, inflation higher and less demand for our Treasury bonds, resulting in even higher interest rates.

This does not appear to bode well for economic growth and likely result in headwinds for stock and bond prices.

From our November 2023 Report:

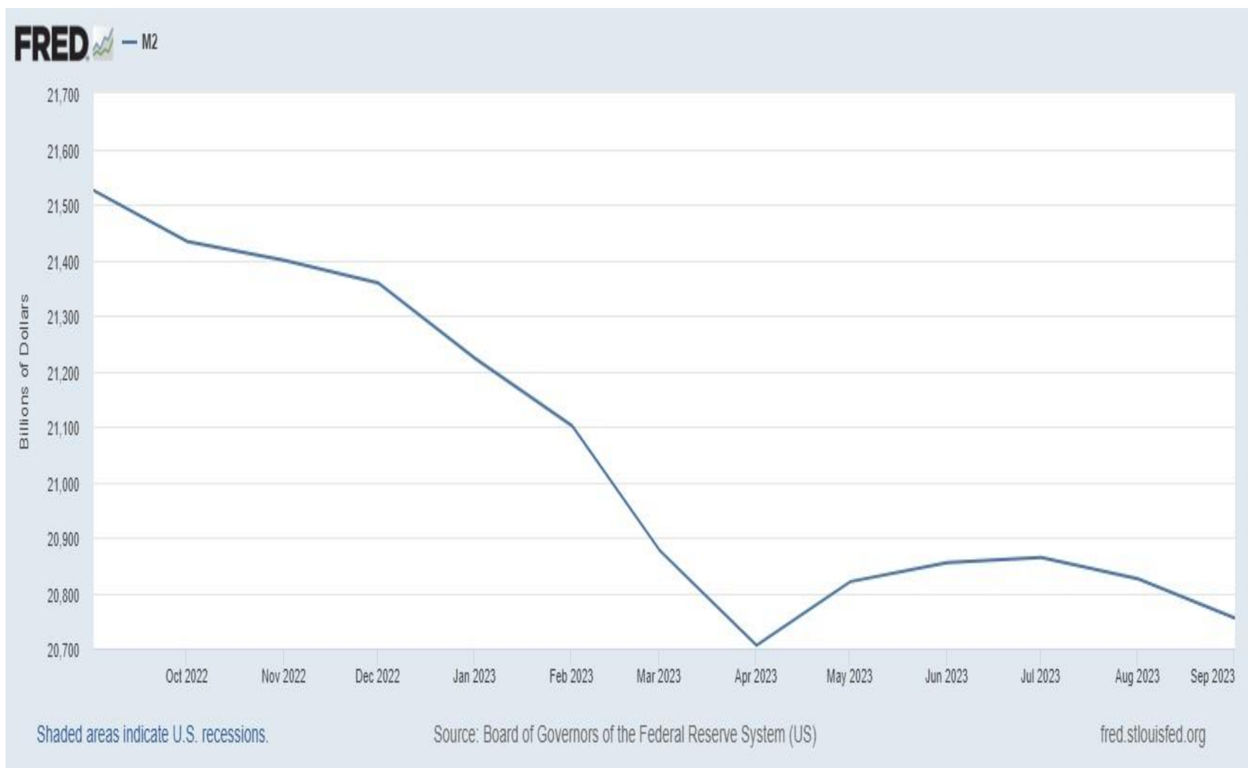
In addition to financing the existing debt of over $33 Trillion, future deficits will be added to this. And if, as shown above, the BRICS nations reduce their need for US

dollars, it may require even higher interest rates to attract buyers of U.S. Treasury obligations.

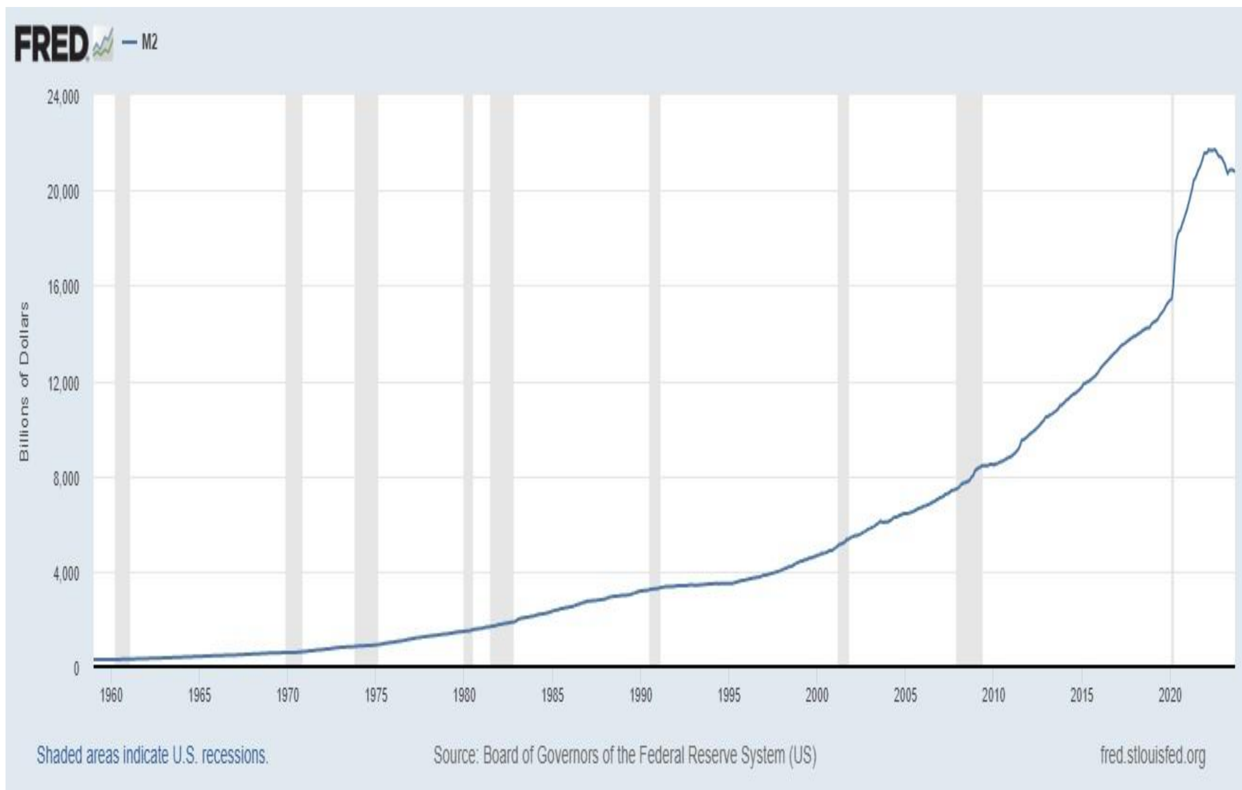
If there still are not enough buyers, the U.S. will need to print new dollars to buy the unsold bonds. These newly printed dollars will further debase the purchasing power of the dollar resulting in even higher inflation.

But hasn't the Federal Reserve taken steps to reduce the money supply, thus helping to offset the above stated risks?

If we look at a chart of the steps taken by the Fed during the past year, it appears to be encouraging…




They have clearly taken steps to reduce the U.S. money supply. But is this enough? Let's look at the picture in its larger context…




You may likely conclude that they have a long way to go to seriously address the problem. Keep in mind, the money supply and our debt are tightly linked as every new dollar printed equals a new dollar of debt. Thus, the debate in congress over the debt ceiling.

In light of these facts, what should an investor do?

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 next month's special report, I will provide simulations on several possible scenarios that we may be facing in 2024. In these simulations you will see the statistical downside risks and potential opportunities as well.

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.

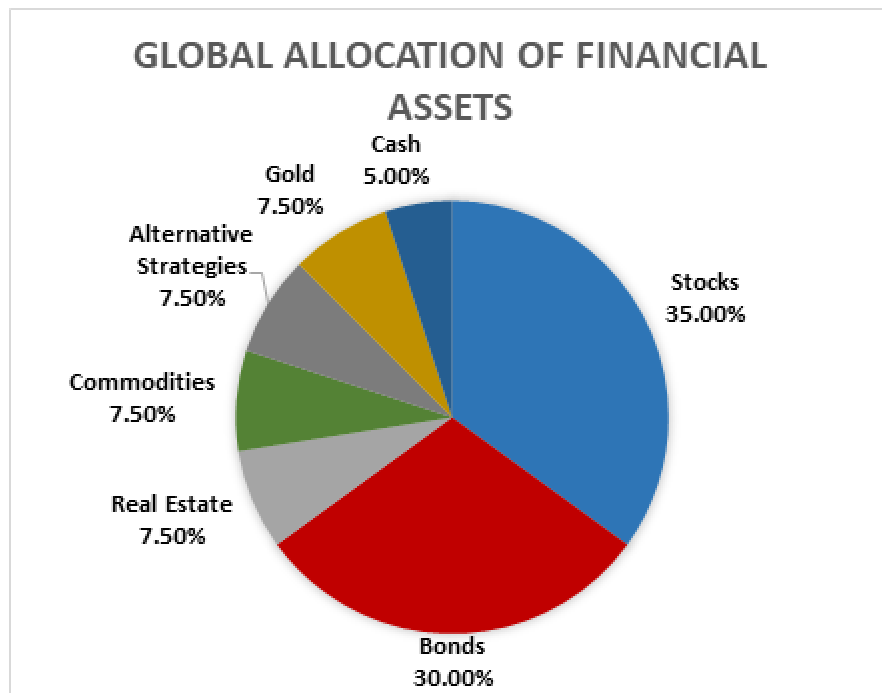
**Conclusion:** Recognizing that we are in uncharted waters with multiple moving parts, we must admit that there is no way to tell in advance exactly how this will unfold. But in such a transitionary environment, the ability to properly anticipate change is predicated upon a detached analysis of information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