



The Connolly Financial Advisors Monthly Economic & Market Report

Being nimble in a dynamic world

Equity prices have led economics and it is catch-up time, but what if the economy does not show up? Have the volume of shares bought in rising stocks proven to be the right backdrop for continued confidence in more equity gains? What risk premiums would you attach to this market? Cash, Gold and Crypto-Currencies have been winners this summer, but will that continue? Is it time to batten down the hatches as the horizon shows greater instability with each passing day?

Executive Summary

The year 2017 has seen the DJIA rise by 2,200 points through August 31, 2017. An impressive positive performance. With this magnitude of a gain, over 11%, would you expect the volume of activity in 2017 to confirm the gain by also showing higher volumes and much greater positive volumes, indicating broad participation and engagement in the market? I would want to see that. If we look at the same period in 2016, the DJIA index rose by 1,067 points, roughly half of what we have gained in the YTD 2017 period. Now I really expect the 2017 data to be much better than 2016, given the greater Index gains.

What does the activity on the NYSE reveal?

Shares traded by month on the NYSE for 2016 and 2017 (in billions of shares traded):

	<u>2017</u>	<u>2016</u>
August	17,557	18,295
July	15,910	17,499
June	21,713	23,579

May	19,325	19,860
April	16,106	20,278
March	20,850	23,191
February	16,561	22,727
January	17,252	22,471

It is surprising that in every month the volume of shares traded during 2017 are below the monthly shares traded in 2016.

What about the composition of the shares traded? I would expect that the net volume in stocks that advanced in price for 2017 would be much higher than the net volume in 2016. If this is the case it would make me less concerned about the overall volume decline that we see above. So what happened? In the YTD period through August 2017, advancing volume exceeded declining volume by 2.15 trillion shares. In the YTD period through August 2016, advancing volume exceeded declining volume by 7.5 trillion shares. WOW! There is a disconnect here that is astounding to me.

What happens if we move away from stub periods that are less than 12 months in length, and look at the comparisons between years using the fiscal years September through October, from 2011/12 through where we are in 2017, with one month left to go in the fiscal year? Will that help alleviate the concern that the one-off comparison above revealed? Let's see.

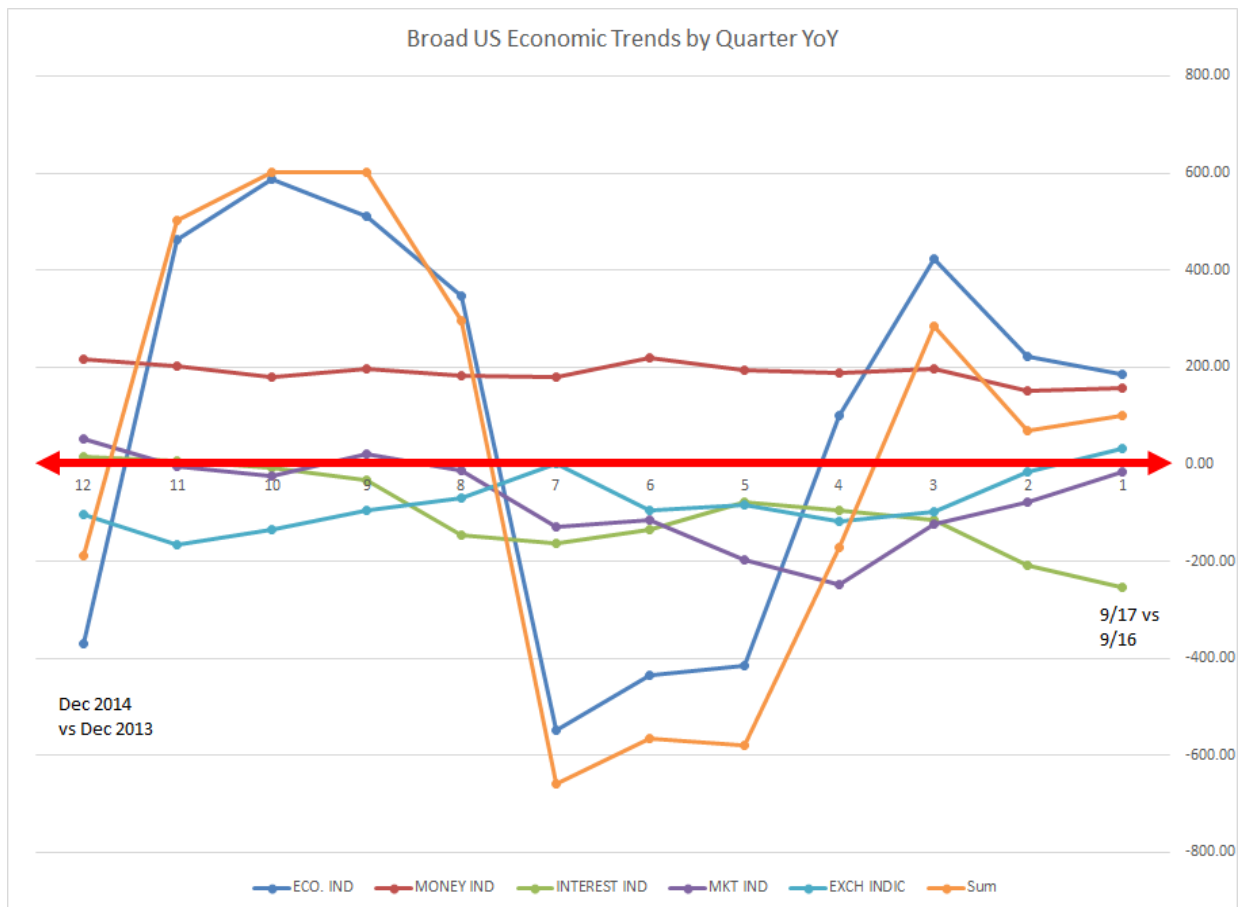
	<u>DJIA Index change</u>	<u>Net Volume</u>	<u>Volume per Pt</u>
2011/12	2,799	+8.7 trillion	3.1 billion
2012/13	1,769	+4.8 trillion	2.7 billion
2013/14	1,760	+5.7 trillion	3.2 billion
2014/15	- 733	- 4.4 trillion	6.0 billion
2015/16	1,974	+7.9 trillion	4.0 billion
2016/17	3,647	+4.1 trillion	1.2 billion

It is clear from the above that the current activity in 2016/17 is an anomaly. The volume of net advancing shares per point change in the DJIA Index is significantly below the historic average, and indicates the weakness of money flows into advancing stocks

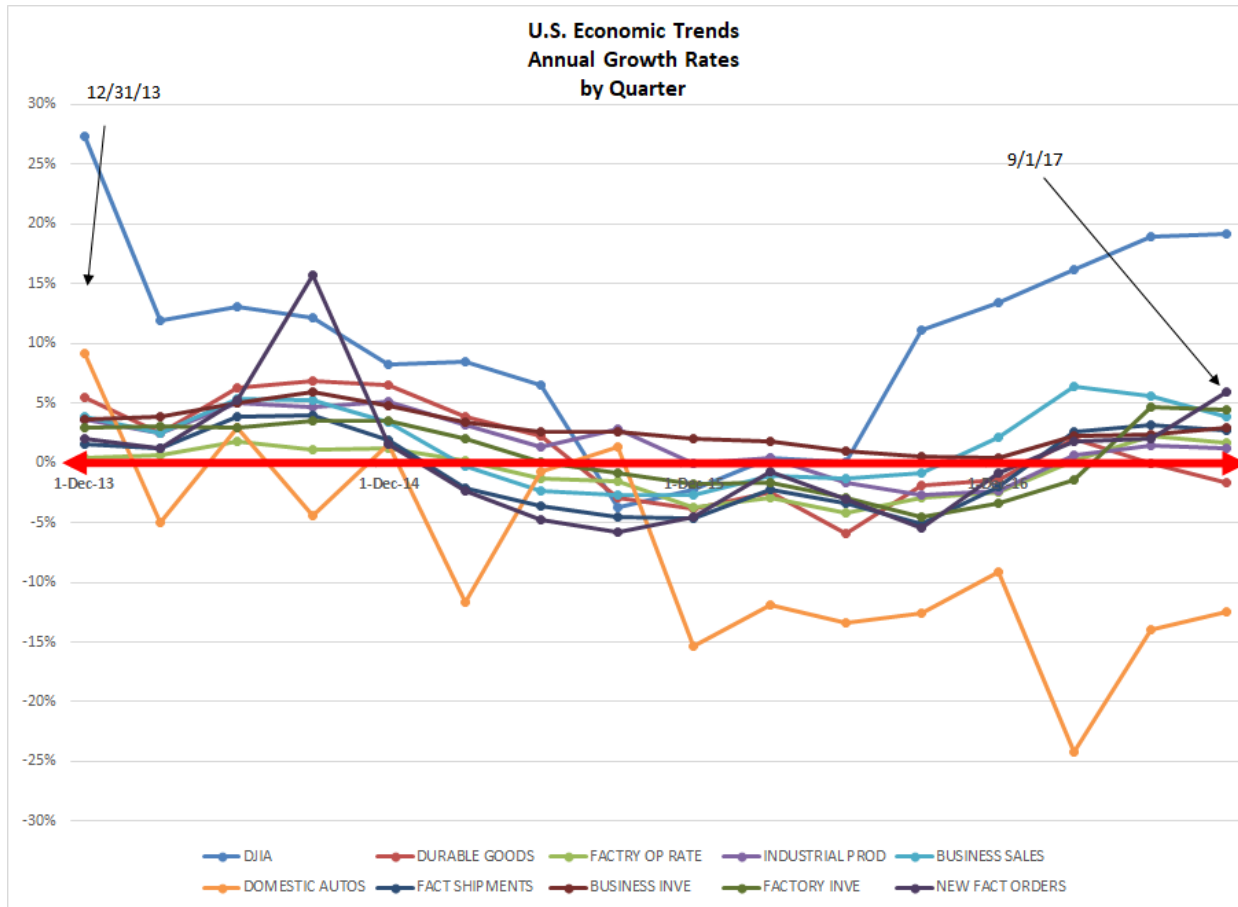
overall during the current period. This is of great concern to me and casts significant doubt as to the equity market's support for current prices.

The Economy

Economically, the data have softened slightly. We are still seeing growth as we enter the second half of the year and hope to see greater expansion in the weeks to come. The five indicators that summarize for me the change in our economy are (1) Economic activity; (2) Money; (3) Interest rates; (4) Equity markets; and (5) Foreign Exchange. Economic, Money, and FX are all positive, with Economic and Money showing decelerating growth. Interest rates and Market indicators are negative, with Interest rates becoming more so while Market indicators are less so. The combination of these data points when summed (the tan line) indicates a loss of momentum that is occurring at a time when equity prices need stronger support. As each week's new data is released I will be very focused on signs of acceleration, but worry about business leaders becoming more conservative in this increasingly uncertain environment. The picture of these five indicators, by quarter, since 2014 is as follows:



The rates of annual change in the components of the Economic Indicator are as follows (note the dramatic fall-off in domestic autos vs the performance of the DJIA Index):



A more detailed assessment by individual category shows positive signs in the majority of areas. The data below compares September 2016 data to the most recent data through the end of August 2017 (it indicates September 2017 at the heading, but the next month's data through September have not yet been released).

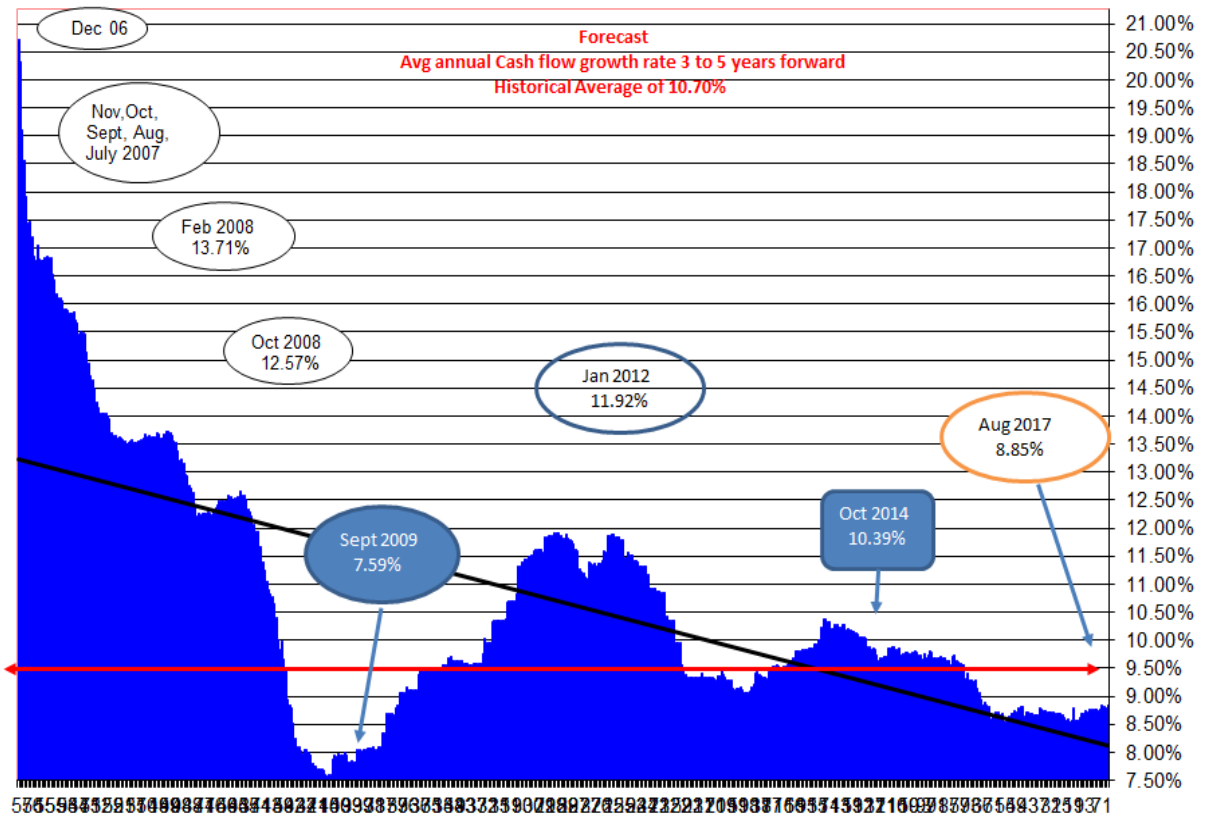
Connolly Financial Advisors, LLC August 2017 Newsletter

	Annual % change 9/30/2017
Year over Year Change	
Dow Jones Industrial Avg	19%
Durable Goods	-2%
Factory Op Rate	2%
Industrial Prod	1%
Business Sales	4%
Domestic Auto Sales	-12%
Factory Shipments	3%
Business Inventoris	3%
Factory Inventories	4%
New Factory Orders	6%
Producer Price index	2%
Construction Spending	2%
New Housing Starts	10%
Fed Funds Rate	190%
Total Loans Outstanding	3%
Total Real Estate Loan	3%
M2 Money Supply	4%
Free Banking Reserves	8%
Interest Confidence Index	12%
Gov't Corp Yield Spread	-31%
Stock/Bond Yield Gap	-83%
DJ P/E	0%
Personal Income	3%
Personal Consumption	3%
Pounds per Dollar	0%
YEN per Dollar	-9%
3-month T Bills Auc	308%
10 year Treasuries	36%
Dollars per EURO	6%
Consumer spending	5%
Durable consumption	2%
Durable orders	0%
Non Borrowed Reserves	8%
Average NHome price	7%
Median NH Price	5%
3 mo-10 yr spread	-15%
Steel Production	6%
Exports	3%
Imports	5%
Initial Jobless claims	-9%
Continuing claims	-10%
Avg weeks unemployed	-11%
U-6	-11%
Median Household incom	0%
Mean Household income	3%
Total Banking reserves	8%
Discount window borrow	0%
Mining	7%
Petroleum Capacity	4%
Rigs running	80%
Retail Sales	4%
Wholesale sales	5%
Wholesale inventories	2%
Building Contracts	24%
Consumer Confidence	21%
Leading eco indicators	3%

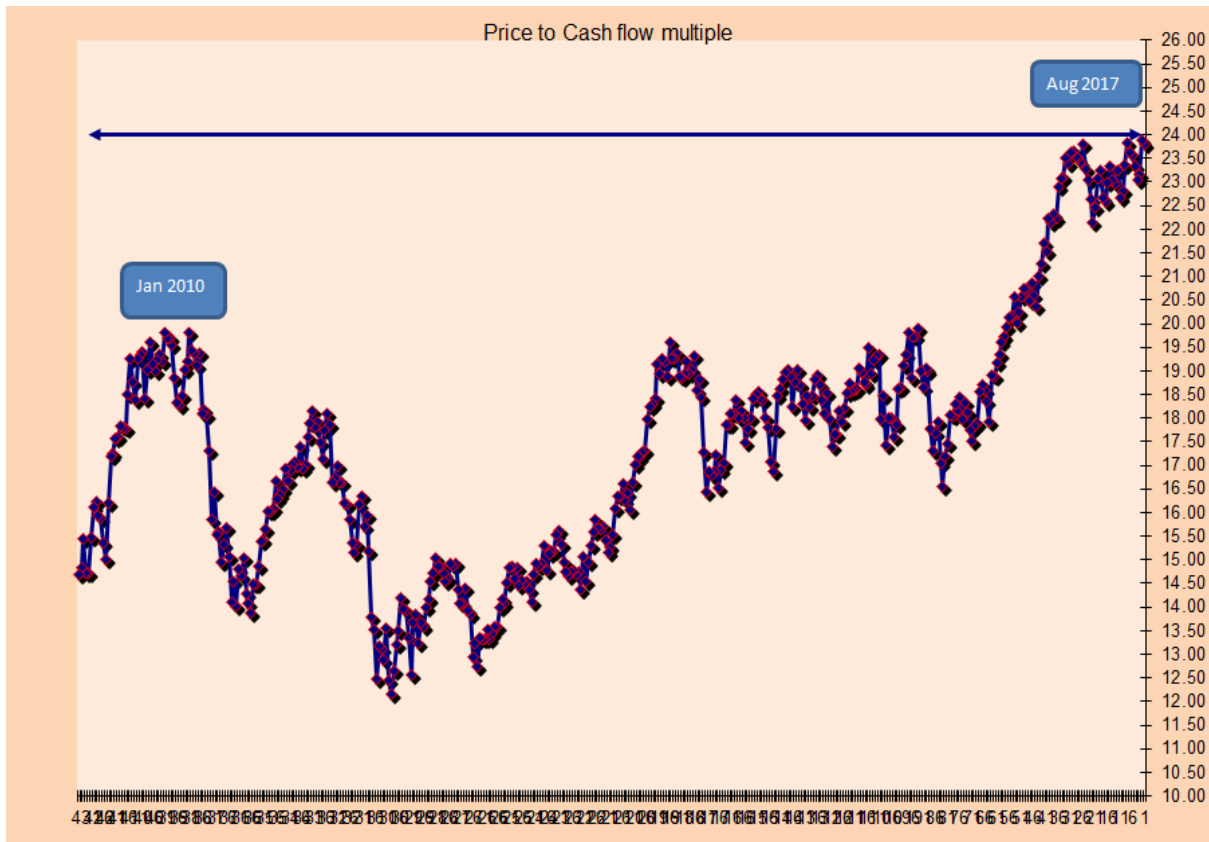
The Equity Market

During the month of August 2017, the equity market has been very Jekyll and Hyde. The DJIA was up 58 points in the month. The S&P 500 was up by just 4 points. Interestingly, 8 of the trading days individually had greater point moves than the entire month. We were basically running in place, one day up and the next day down. However, during the month there were a cumulative net 630 billion NYSE shares that traded to the downside in a month where the index was up. The clear lack of conviction to advance or decline is the nature we find ourselves in. This strikes me as a period of exhaustion, of topping, of those that want higher prices hanging on, while those that foresee lower prices unable to commit to selling, so the market meanders. This wandering market has as its backdrop a host of fundamental concerns, as well as environmental concerns. Previously, the market internals brushed aside valuation concerns, and the buying activity followed the trend up, paying little heed to the expensiveness that was being created. In a way, it sounds like Bitcoin and the overall rise in price of cryptocurrencies, without any appreciation of the valuations that are being created. Environments like this can run for quite a while, but it is the signs of fatigue and the loss of internal support that must be monitored if we are to escape the danger of buying high and selling low. The activity in 2017, and the activity in August, are warning signs that should be monitored to see if they persist as September unfolds. If they do persist, then the feared dramatic decline in equity prices may be closer in time, and actions should be considered to protect the wealth that may have been generated over the past year's exceptional return environment from holding equities.

On a fundamental level, the picture has not brightened. **Cash flow projections for the 187 Portfolio have been coming down since June.** In June, the projected growth in cash flow for 2017 over 2016 was 10.53%. As we enter September, that growth rate has been revised downward to 8.98% for 2017, and over the next three to five years the annual growth is forecast to be in the 8.85% area, which reflects a continued contraction (see chart below). Further downward revisions will act as a catalyst for equity prices to move lower. S&P 500 earnings' estimates projected growth of 12.42% in January, which has been revised downwards to 11.49% in August. Same valuation concern exists here if there are any further reductions in projected earnings' growth.



The current valuation of the 187 Portfolio based on cash flow is at 23.80 times. That is a record high for the year 2017, and is also higher than at any point in the last seven years.



Context is important, and aligning prices with cash flow since the year 2007 remains a powerful sign of over or under-valuation. Creating an apples-to-apples comparison of where we are in each year since 2007 for the month of August, reveals a market that may be viewed as being ahead of itself, over its tips from a skiing analogy. Consider the data of price change and cash flow change for the period from August of 2007 to today, and ask yourself if the correlation is at an outer-bound that remains sustainable.

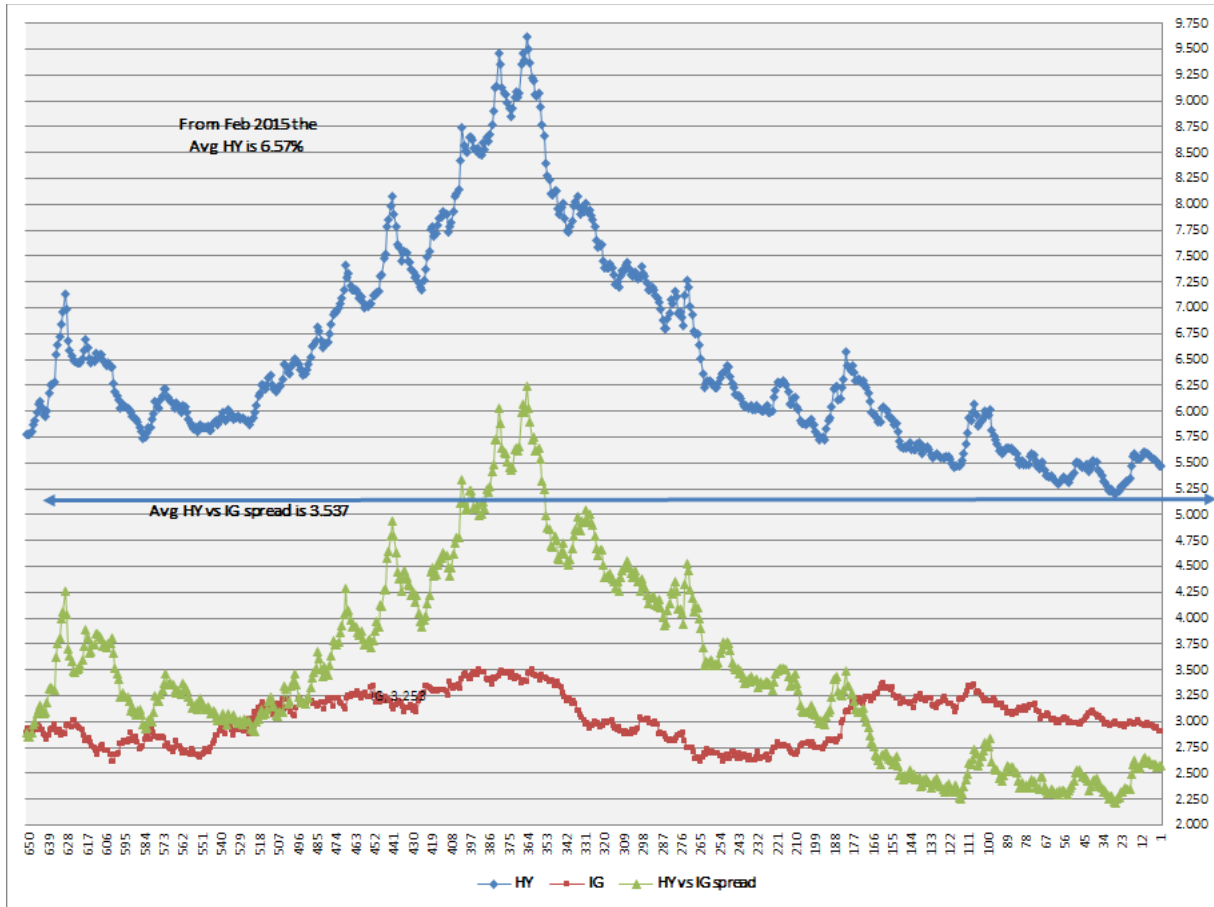
<u>Current mkt price and cash flow vs Prior Years</u>			
		price	cash flow
		<u>% change</u>	<u>% change</u>
	vs 2007	106.73%	73.32%
	vs 2008	196.20%	65.45%
	vs 2009	177.97%	114.82%
	vs 2010	137.28%	53.60%
	vs 2011	150.71%	27.92%
	vs 2012	101.96%	23.92%
	vs 2013	67.90%	21.07%
	vs 2014	48.18%	10.83%
	vs 2015	39.52%	4.66%
	vs 2016	21.61%	5.93%

The year 2007 to today always attracts my attention. In 2007, we had a market that was highly valued amidst the Private Equity buying and the huge leverage that was available to buyers. To take that 2007 data and see the rise in price from that point to today outstrip the rise in cashflow, indicates we are more highly valued today than we were at the height of the market in 2007. Do the prospects for 2018 and beyond warrant such a rich current valuation? I think not.

Given the high valuation, **the discount rate needed to equate current prices with future price projections** based on cash flow and cash flow growth is now at 8.66%. That is the lowest discount rate since 2007, and while we are in a low interest rate environment, the lack of risk being priced into the market is what being blinded by the light means. The discount rate should be closer to 10-11%, which would require a 17.5% decline in equity prices. With the 17.5% decline, we would only get close to a more reasonable but still highly valued environment.

Another data point that is worth noting relates to the **change in cash, debt and market value**. It is clear that with the low interest rate environment many CFOs have led the charge in creating capital structures that take advantage of the low cost of debt capital. Since 2013, to the latest set of available financial statements, debt has grown by 42%. Interestingly, cash has grown by 26%. The big winner is the outsized gain in market value which has grown by 63%. Of great interest to me is the historic relationship of net debt to market value. On average, net debt has approximated 23.4% of market value. If we were to return to this relationship, the market would require a 17% decline in market value. I find the similarity of reasonable decline here (17%) to the required decline noted above in the discount rate discussion (17.5%) to be further supportive of the likelihood of a market correction in the future.

The discussion of debt levels must be complimented with a data comparison of where we are in **pricing investment grade debt and high yield debt**. In an uncertain world, the spread between IG and HY debt should be wider than a calm predictable world. In a world where the trend governs, the events in the world are often ignored or discounted in a way that preserves the trend, even in the face of expanding risk. Today, and over the past 163 trading days, we find that the spread between IG and HY debt is under 2.83%. In fact, during this 163-day period the spread has bottomed at 2.25% and has been trading sideways between these two marks. The differential is very narrow, pricing riskier debt with little premium for the risk accepted for making the loan. To give you an idea of how potentially mispriced this is, consider that the spread was 6.24% in February 2016 when concerns over the price of oil created uncertainty for loans to the oil patch. From \$30 oil to \$48 oil today, the reduction in risk premium for drillers and others strikes this investor as too much, and at some point HY debt will be priced more in line with the real default risk to protect investors/buyers of these financial instruments. That debt repricing will have a dramatic impact on equity prices.



So how close are we to a significant decline in equity prices? Closer than we have been in a long time. I just do not see the equity market with all of the factors lining up against a continued advance continuing with an upward trend. At some point, it will give to the downside if for no other reason than buyers are no longer willing to buy at levels that pose greater downside risk than upside reward. I think the action in 2017 shows us this is happening now, with the lower volumes overall, the balance that is emerging between advancing volume and declining volume, the continued decline of stocks making new highs vs new lows, and the general Central Bank tightening of market liquidity, the intensity of the market's dynamics is waning. Higher interest rates as risk premia becomes a greater concern to lenders is in the cards and this will be a trip wire that ignites a reset of values in a reversion to the mean. The lining up of market negatives is growing.

As to timing, I often point to the length and magnitude of the equity market advance in terms of 3% reversals. Reversals of 3% are a normal recurring event that has been absent in the current environment for a record breaking period. As I write this newsletter, we have seen the NASDAQ advance for 43 straight weeks without a 3% decline. The advance over this period is 24.86%. Think about that. The time span and magnitude of

the gain has never happened during my tracking of this data, and that covers 13 years. My fear is that when it breaks to the downside, it will be dramatic, scary, large, and punishing to the economy and the country. Just as the pressure of the earth's plates pressing against one another lead to earthquakes, to go for so long a period of time without a stock market correction in an environment where prices are rising faster than earnings and cashflow, is one where the pressure is building in an increasingly uncertain environment that must find a way to blow off steam. We are closer to that time of a correction, and being ready will be very important to those that wish to preserve their wealth.

In closing, I am increasingly concerned with the potential loss in equity values that I believe is likely to occur in the near future. I am searching for better news and data to encourage me to be more heavily invested in equities. I do not find enough positive data to justify greater equity exposure. The performance in Precious Metals has been exceptional over the past few months, as has been the performance in the more established Crypto-currencies. Cash is highly desirable to me. Fixed income does not offer enough of a return for the risks. Commodities have been good performers, and warrant attention. Foreign equities are selectively attractive, and I remain focused on India and China. From a portfolio allocation perspective, I remain heavily weighted to cash (50%), followed by equities (22%), gold (20%), commodities (2%), Bonds (2%), and crypto-currencies (4%).

I expect Gold and Silver to continue to be the best performer of the group. Crypto-currencies are anyone's guess from a valuation perspective, but the platforms continue to gain acceptance and deeper penetration into the commercial markets. I remain positive on Bitcoin and Ether, and have sought opportunities in other platforms (LiteCoin and Ripple).

Until next month, invest well and stay alert!

All the best,

Tom