The Connolly Financial Advisors Monthly Economic & Market Report

Being nimble in a dynamic world

Developed economies across the globe are navigating an emerging world of less liquidity, and while economic growth is present, is it accelerating? What are fiscal budgets indicating? What happened to capital investment? Do current stock market valuations make sense? Should we be anticipating a continued increase in equity prices? Where in this market am I allocating my capital? Which equities am I tracking for buying and selling purposes? The Imagining the Future section focuses on the world of Digital currencies and attempts to answer the question "Are we interpreting this phenomenon correctly?"

Executive Summary

Yesterday I watched storm clouds move in and out over Manhattan. At times threatening, hinting at a deluge of rain to come, and then sunshine would peek out, the threat would diminish. Coming back from Costco at 3:00 PM, loaded with two weeks' worth of groceries and hoping to get home to unload the bags on 5th Avenue without getting everything, including myself, drenched in rain, the windshield showed the small blasts of rain drops beginning. A bit wet, but not drenched, the unloading completed, and the threat passed. Early evening and plans to dine at an Italian restaurant, a favorite piano player performing, the N.Y. Met game in the 8th inning, and the skies darken once again. The field tarp is unfolded at the game, the rain comes, and dinner becomes a home affair. Sometimes taking conservative steps is the best strategy.

The equity and financial markets are quite a bit like yesterday. Storm clouds are clearly evident, more now than what has been around for the past five years. There is an unsettled nature to the world, with the heaviness of humidity that creates a sticky sluggish feeling reminding me of the economic slowness in the U.S. A storm is on the horizon, a real downpour with lightning and thunder is coming, and this storm is needed to wash away the heaviness in the air, to reveal a new day of lightness and sunshine. I believe, given the real hard facts of the economy and government mismanagement, that a financial correction of a large magnitude is coming, and the decline in the stock market will be dramatic.

What are the signs of this storm?

1. The falling value of the U.S. dollar vs the currencies of other developed markets;
2. There are four U.S. States with no fiscal budgets passed by the June 30th deadlines (Illinois, Maine, New Jersey and Connecticut) and hence must cut back on services to the people of the state;
3. The failing healthcare financial underpinnings of both the private and public sectors;
4. The weakening in the relationship of home prices to income levels that have once again become unsustainable;
5. The decline in the automobile market;
6. Full employment without wage growth;
7. The percentage of the population on government support;
8. The growing burden of ever increasing indebtedness by our society;
9. The decline in capital flows and investment that are inhibiting growth in our economy, leaving us to save more and spend less in complete contrast to what should occur in an environment that is touted as an economic recovery.

We are striving to prepare for a storm, a storm we can sense as the air becomes electric with the attributes of turbulence that is growing month by month. In preparation, we must still sow seeds for the future while conservatively protecting our homes and families through fully informed and aware choices that are more critical today then they have been in the past ten years.

There is a storm coming and too few are appreciating the magnitude of how strong and how close it really is. Below is more color on the points noted above. The confluence of these as matters that are getting stronger not weaker give me great concern. The potential for a major downward correction in our financial markets is too real, and while I cannot say with any degree of confidence that it will be today or tomorrow or six months from now, I do say with confidence that we cannot stay on the path we are on.

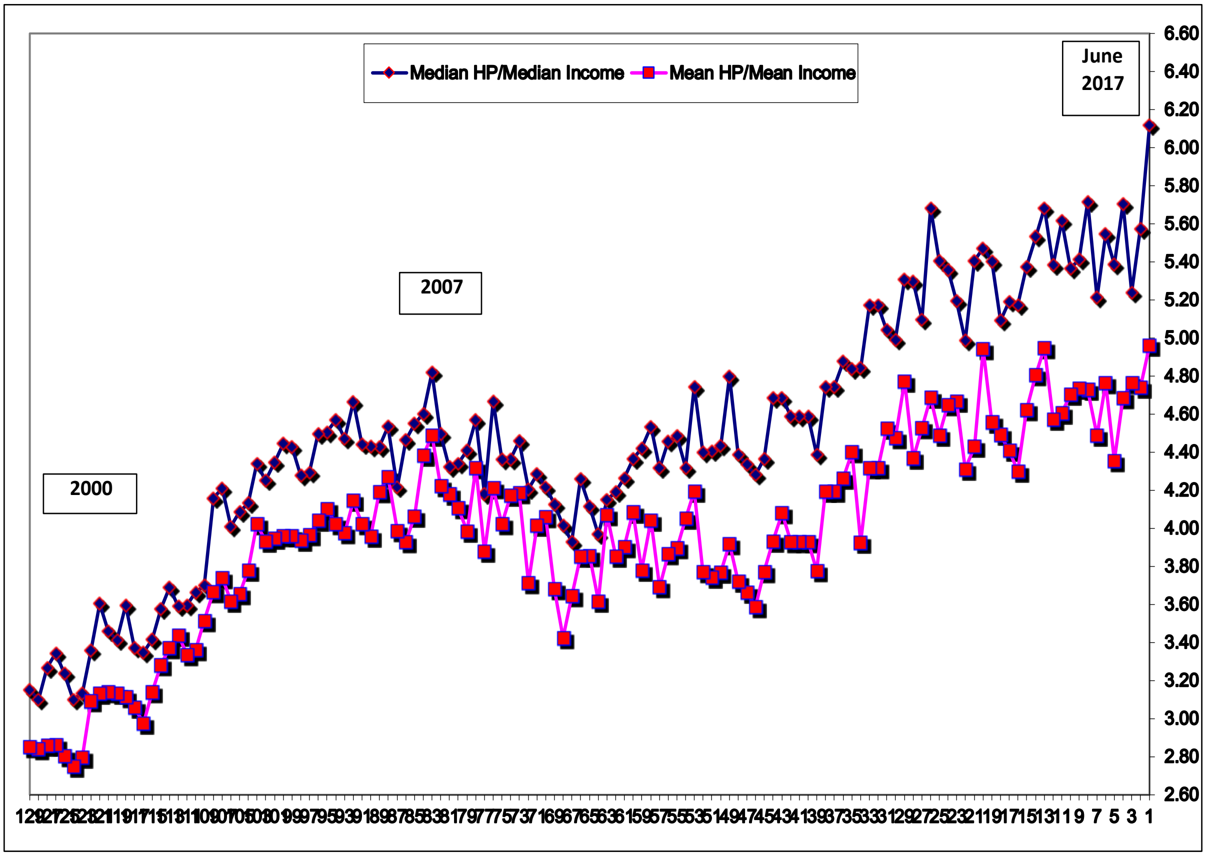
Facts that everyone should consider:

- **The U.S dollar has fallen in value by 6.6% since December 31, 2016.** When capital is flowing into the United States the dollar typically gets stronger as foreign demand for dollars increase to fund the investments in the U.S. When the U.S.

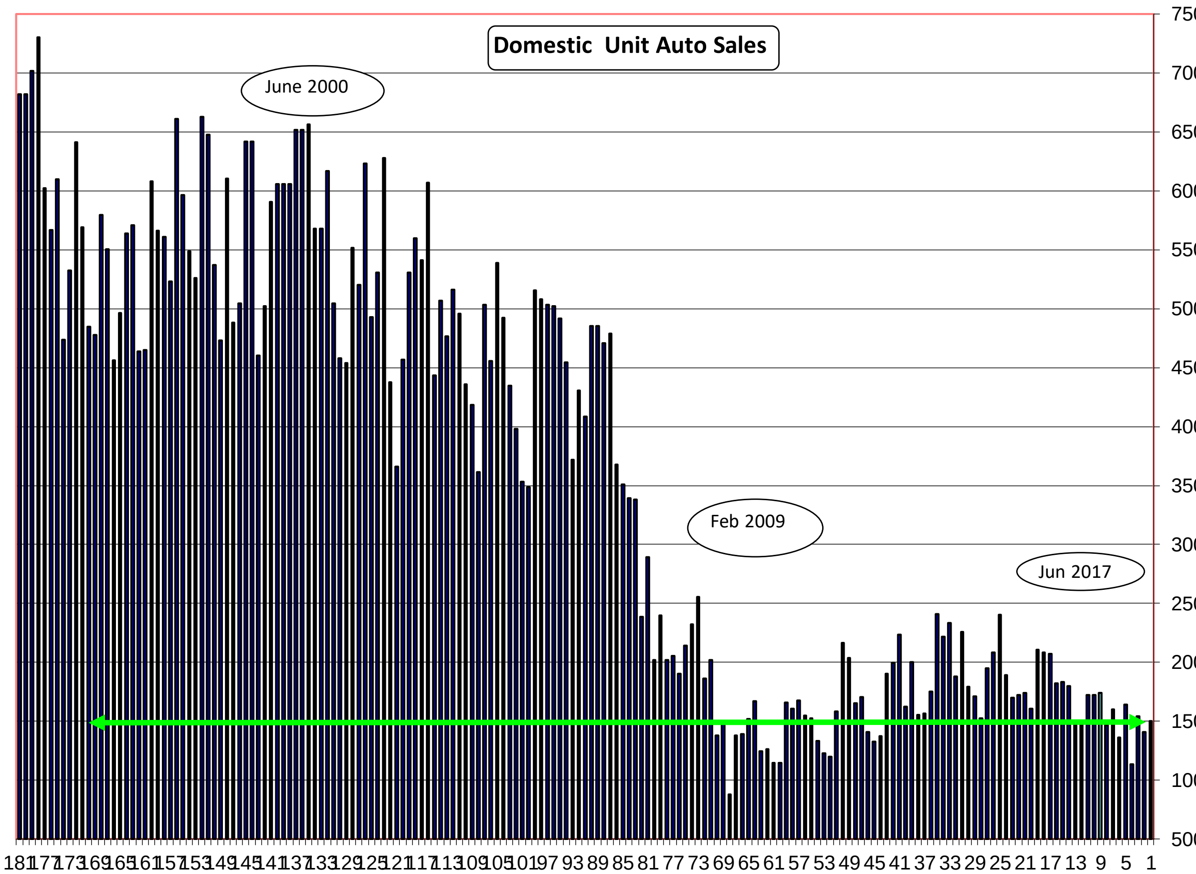
dollar declines in value it is often because foreign investors see better opportunities outside the U.S. and also see greater risks within the United States. The cause for concern here is further heightened as the interest rate environment in the U.S. is heading toward higher rates, hopefully driven by economic strength as compared to other countries, which should typically attract capital and demand for dollars, yet since December 2016 we have a falling dollar environment.

- **The financial soundness of State and Local governments in the United States is not healthy**. The latest US Census bureau data published for the year 2015 shows total State expenditures were above revenues by $88 billion, which missed the projected surplus that was forecast by $354 billion. Illinois is the most critical patient in the country, with its Comptroller stating on Friday that "the state's finances went from horrific to catastrophic". Illinois has $15 billion in unpaid bills, is being reviewed by the credit rating agencies for a debt rating downgrade to "Junk Status", and in the past year alone saw expenses exceed revenue by $6 billion. Above and beyond this, the Illinois payments to address healthcare through Medicaid are $2 to $3 billion in arrears. Illinois is not alone, and the issues are growing for many states throughout the country. Total State and local debt is now $3.1 trillion, a 150% increase since 2000, and this excludes pension and retirement obligations (Federal Reserve data).

- **The cost of Healthcare is problematic, and for all of us the cost of healthcare is taking more and more of our take home pay.** This leave less in a stagnant wage growth environment for investment and purchases that drive economic growth. Jim Chanos, one of the world's very successful investors, commented during a recent interview that **"**Americans are getting unexpectedly higher copay and deductible expenses. They're shouldering more and more of the health care obligation themselves, and that's something a lot of families haven't budgeted for. It was already a growing trend in our employer-based system at the time of Obama's election — remember, about 50 percent of us get health care through our employers. But now it's also happening in Obamacare's individual and small group markets. That means people have less money to spend even if their income isn't shrinking."



- **Home prices have risen to the point where the price of a home is at the highest level when compared to income since I began tracking this data (since the year 2000).** Today, the median home price in the United States is 6.1 times the median income in the United States. In the last housing peak period of 2006/2007 the relationship topped out at 4.82 times. This cannot bode well for new home purchases and in fact the recent decline in New Housing starts is a serious concern (New Housing Starts are 10% lower in June 2017 vs June 2016).



- **Domestic Automobile sales have been in a decline over the past three years and the sales level in June 2017 vs June 2016 was down 15%.** Autos and housing are key economic drivers for the United States. This decline in sales is impacting production and is a drag that should not be ignored. General Motors, which not too long ago was in bankruptcy, and emerged with a restructured set of obligations, just announced they need to raise $3 billion in debt to fund their European pension liabilities (a total underfunded European plan of $6.5 billion). This is not a borrowing to expand investment. It is a debt to fund the past and will take away from any productive future.

- **Wage growth of 3.4% as recently reported by the Federal Reserve based on data from the Bureau of Labor statistics is below the level of growth of past economic recoveries by 1 to 2%,** at a time when we are deemed to be at Full Employment. The low level of wage growth is a problem for the U.S. economy, particularly when productivity improvements are absent. The increasing impact of technology in terms of efficiency and cost reduction for employers will further weaken wage rates and related worker productivity levels. This places more burden on the government to add to debt to supplement the economic needs of the population. This is like chasing your tail, and that will not lead to sustainable economic growth.

- **The last reported statistic of the percentage of the US population receiving public assistance from the government stood at 21.3%.** The cost that this represents requires the government to borrow money. With close to $20 trillion in federal debt, an amount that is 170% higher than it was in the year 2000 and which is growing at an 8.7% annual rate with no end in sight of an ever-expanding obligation for Healthcare and Social Security, the drag on economic stimulus from debt financing grows. It seems it is not possible for the U.S. economy to expand above 2 to 2.5% given the constraints that exist, and presently the Fed is forecasting sub 2% growth through the 3rd quarter of 2017.

- **Investment spending that is the mother's milk of growth is too low.** This fact is seen across the investment spectrum, including investment in Intellectual Property as well as Equipment and Structures. Growth is dependent on investment, and we have seen more capital spent on share buybacks vs productive assets. A key measure of this is the level of investment compared to the depreciation of prior investments. In a growth environment, we should see investment occurring at a rate that far exceeds depreciation. Today, investment as a multiple of depreciation is 15 to 20% below the levels of prior expansionary periods. We will not grow at the rate needed to expand the economy with this lack of new investment.

These are the headlines that I want my readers to focus on. They are facts and not biased interpretations. I do not know when the storm will arrive, but I do believe it is not something to toy with, just as dancing in the rain during a lightning filled thunder storm is something to be avoided.

Good luck out there, and stay dry.

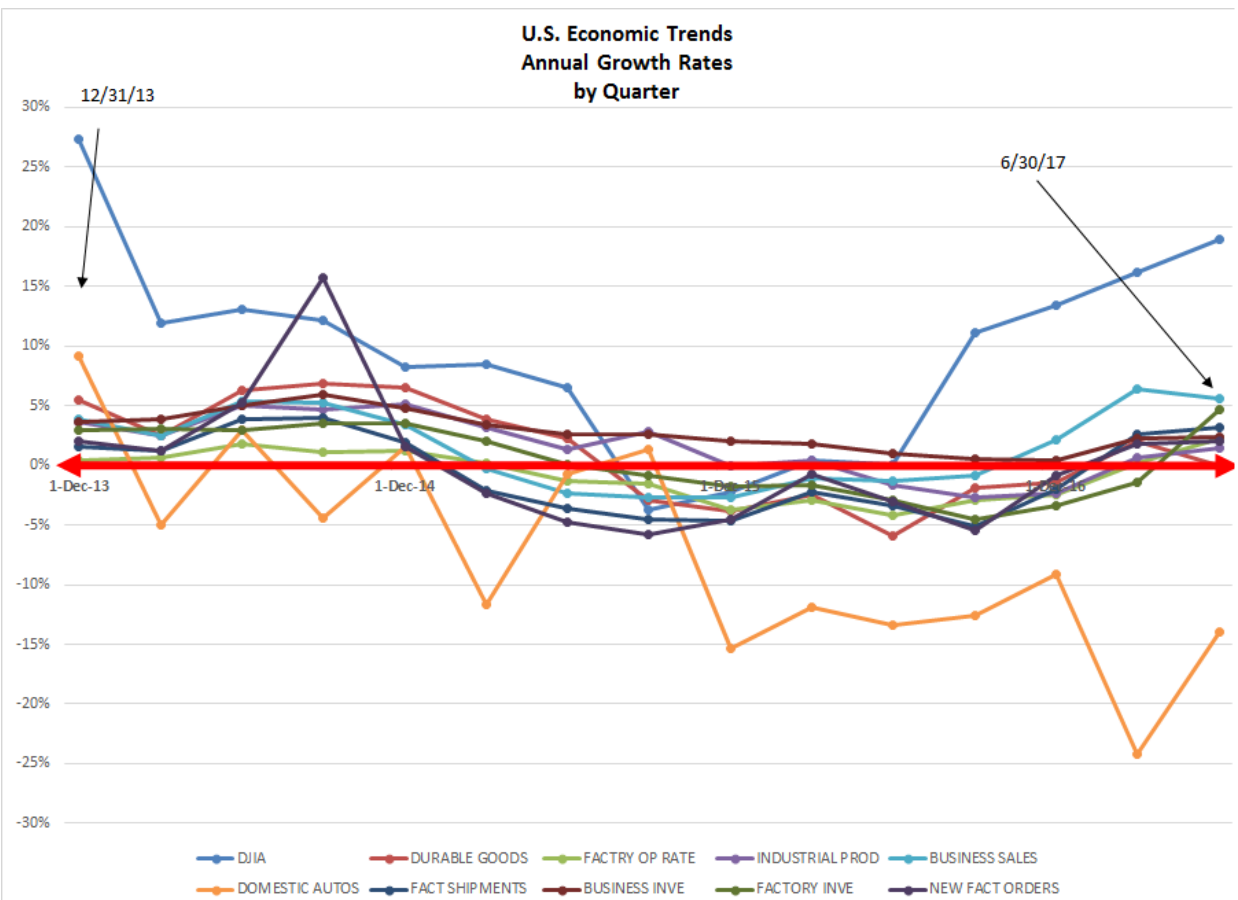
The Economy

Economic indicators have been decelerating, and the leading indicators are contracting for the United States. Growth in France and Germany are bright spots, but the recent strength in the EURO and a less accommodative European Central Bank will likely curtail this current expansion. China is tightening and reducing liquidity, and Japan appears to be moving from new growth and Central Bank accommodation to a deceleration of growth.

In the U.S., the Federal Reserve Bank of New York "Nowcasting" report for June forecast a second quarter GDP growth of 1.9%, down from the over 3% growth forecast in February, and the third quarter growth forecast is now set at 1.6%. The weak economic expansion is in complete contrast to the equity values that exist in the current market.

The most recent Business Leaders Survey for New York was less than what was hoped. The business activity index fell 3 points and the business climate index fell 18 points into negative territory. The outlook for the balance of the year is still optimistic but at much lower levels of optimism as compared to the May report.

The chart below continues to reflect U.S. economic growth that is at a subdued level vs the growth in the Dow Jones Industrial Average:



In addition to the US economic data noted above, on June 23rd, the IHS Purchasing Manager Index reports for the United States, the Eurozone and Japan were issued. The reports are all less positive as compared to last month and reveal the following:

- **United States:**
    - The Composite Index fell in June to a 3-month low
    - The Services Index fell in June to a 3-month low
    - The Manufacturing Index fell and is at a 9-month low
    - The Manufacturing Output index fell and is at a 9-month low

  The Chief Economist for IHS reported "The economy ended the second quarter on a softer note indicating the second-weakest expansion of business activity since last September. The PMI is running at a level broadly consistent with the economy growing at a 0.4% quarterly rate."

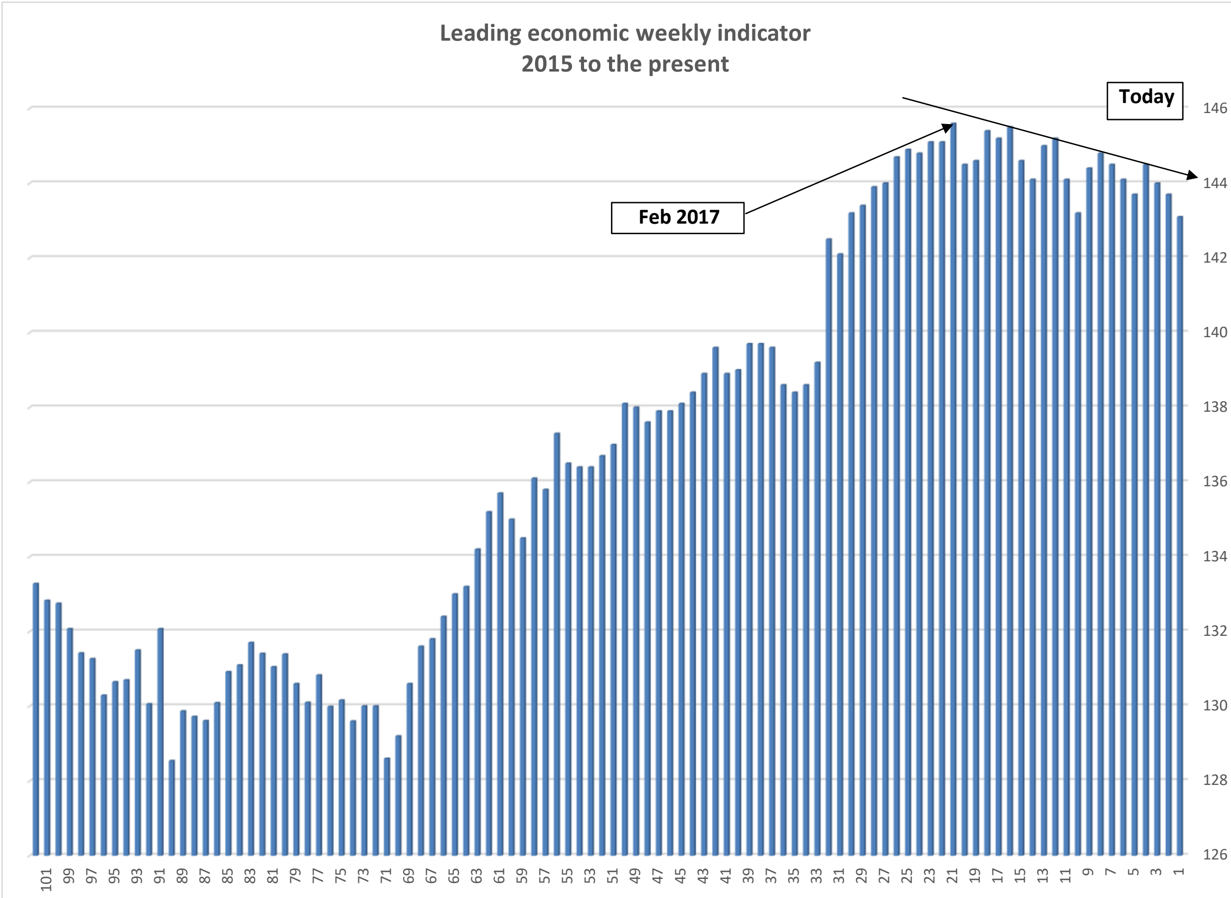
- **Eurozone:**
    - The Composite Index declined from May to a new 5-month low
    - The Services Index declined from May to a new 5-month low
    - The Manufacturing Index rose to 57.3 from 57.0, a 74-month high
    - The Manufacturing Output Index rose to 58.5 from 58.3 and is at a 74-month high

  The Chief Economist reported "Although the PMI data point to some loss of growth momentum in June, the upturn remains broad-based signaling an acceleration of GDP growth in both France and Germany. GDP growth is expected to increase from 0.6% to 0.7%."

- **Japan:**
    - The Manufacturing PMI declined from May and now sits at a 7-month low
    - The Manufacturing Output index declined from May and showed its slowest growth in nine months.
    - Exports rose.

  The Chief Economist reported "Slower growth was signaled in June, with growth in both orders and output rising at the weakest levels since last year."

Another indicator of economic softening is the the Leading Economic Indicator from "ECRI" (the Economic Cycle Research Institute). The Weekly Leading Economic Indicator (WLEI), uses 50 different time series from various categories, including the Corporate Bond Composite, Treasury Bond Composite, Stock Market Composite, Labor Market Composite, and Credit Market Composite. The weekly tracking of the LEI topped out in February 2017 and has been in decline since:



The Equity Market

The Macro view:

The current equity market in the United States remains at what I consider to be a very overvalued level. My market models point to a 17% decline. The recent declines in the NASDAQ Index since June 2, 2017 reflect a 2.60% decline. Clearly, some of the excesses in the high flyers is being taken out. There is much more needed in terms of lower prices to reflect the economic and political risks that exist today.

Fundamentals have improved and current forecasts for higher operating performance persist. For example, projected cash flows for 2017 are now at 10.53% higher than 2016 cash flows. The projected cash flows for 2018 are 12.02% higher than the projected 2017 cash flows. These are very strong forecasts that have given momentum to the upside. My concern at this stage is the sustainability and realizability of these improved cash flow projections given the slowing economic data. As revisions come out during the balance of the year, it will be important to assess whether the forecasts remain solid, increase or decrease. The risk is high, for if revisions are to the downside the market may react quickly and significantly to let some air out of the inflated values that presently exist.

The technical attributes from a momentum and relative strength perspective show a higher risk level for a correction in the Major Equity Indexes. All of the Relative Strength indexes are in overbought territory, with the NASDAQ showing the signs of rolling over.

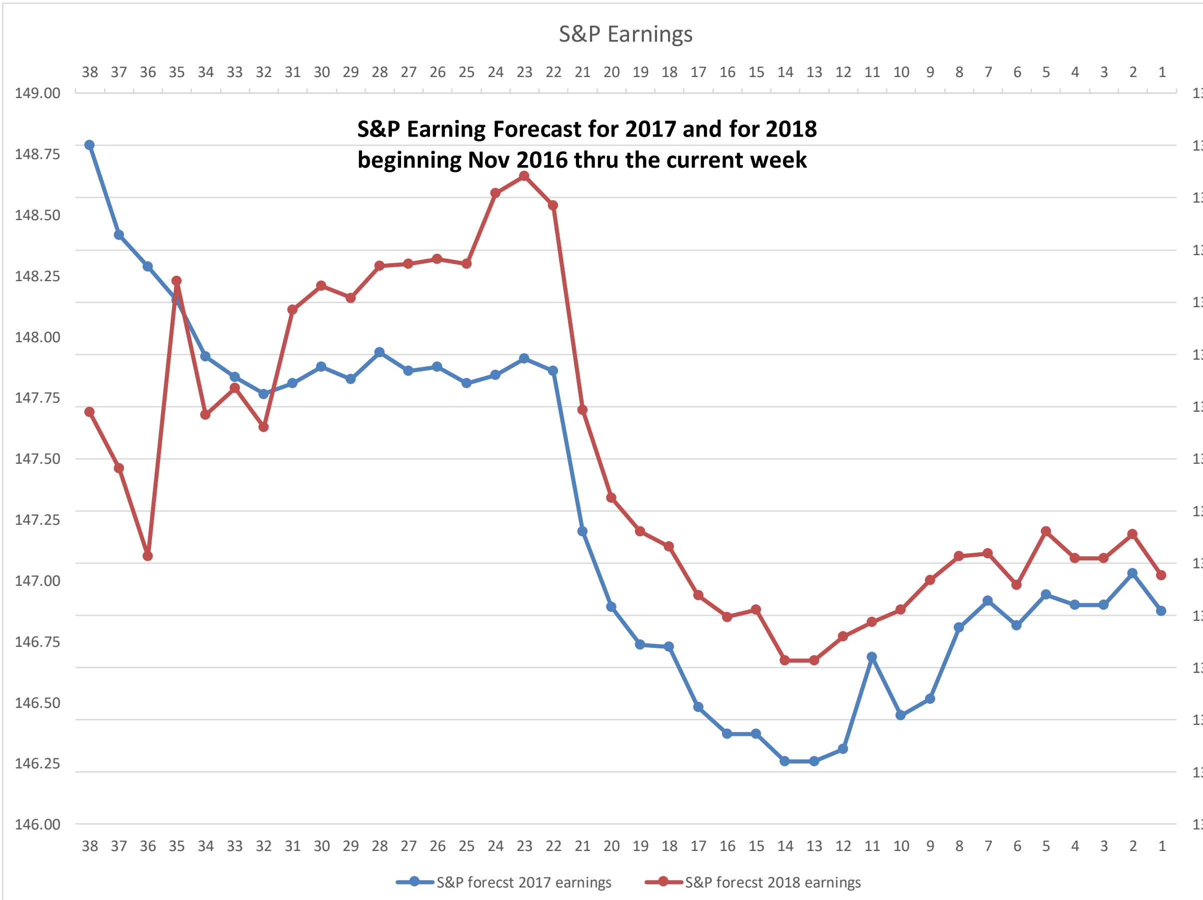
From an internal perspective, we are seeing volatility. Volume was much higher during June then would normally be expected and the price swings on individual stocks was much more exaggerated. This volatility is also present in commodities and currencies, as well as the bond market. Uncertainty is gaining momentum and that poses higher risks to equities.

The tone is more uncertain given the global political dynamics and risks that appear to be increasing. Softening optimism about the U.S. economy and instability from externalities are powerful ingredients that will feed market turmoil.

Macro Details

Fundamental measures provide context as to where the market is valued at a point in time. On a relative and absolute basis I try to answer whether the market is highly valued, normally valued or undervalued when contrasted to history and other investment alternatives? I have concluded that the market is exceptionally over-valued as of this writing on the morning of July 1, 2017. I come to that conclusion based on the following:

1. The markets Current Interest Yield Gap (the difference of the avg return on Bonds vs Dividends from stocks) is presently 0.89%, which means on average the interest rate on bonds is 0.89% points higher than the dividend yield on stocks. Historically, that is an exceptionally small spread, for the long-term average difference is 2.42% from the year 2005 to today, and 3.55% going back to the year 1988 to today. Such a low difference makes stocks a more attractive income vehicle, particularly given the lower tax rate applied to qualified dividends vs interest income. This is also a sign of the material distortive impact that the Central Banks have played in market pricing, and as the Fed moves to unwind its influence, the repricing risk is very extreme.
2. The Current Price Earnings ratio of the S&P 500 is 25.6 times (price divided by earnings). The historic average is in the 15 to 16 range. The forward PE ratio based on anticipated growth for the S&P 500 is18.4 times. Based on the current and forecasted level of earnings at today's price, the degree of over-valuation remains high. Additionally, the earnings forecast for the year 2017 and for the year 2018 have declined since the end of 2016.



3. The U.S. Dollar has been volatile. The basket measure of the US Dollar vs other currencies has fallen meaningfully. We closed this past Friday at 95.66, down from 103. The next level of support is at the 93 level.
4. Money Supply growth in the United States has decelerated during 2017, and that continues to be evident since our last report. During June, M2 has actually declined. The M2 Money supply has shown under 2% growth for the year. A clear sign of Fed tightening. Tighter money reduces flows into the stock market, and the overall velocity of money remains very subdued.
5. Lending activity in the United States is decelerating. Over the past year, the rate of loan growth in the United States was running at an 8% annual clip. That growth has dipped meaningfully, and presently shows a sub 4% growth rate. This is important given the role that financing plays to drive investment and economic growth, and the absence of more meaningful loan growth going forward is a warning sign of economic malaise.

Technical Indicators are inconsistent.

1. Since the May report, the DJIA has risen by 140 points, which is a significant slowing in its advance. The net issues advancing per point higher and the net

advancing volume per point higher are static at very weak levels in a manner that indicates distribution and a weaker commitment by sophisticated investors to equities.

2. New 52 week highs vs lows on the NYSE remain consistent, with daily and weekly highs exceeding lows. There is no strong message coming from this, as both new Highs and New Lows are staying in a range that is unremarkable.
3. The 3% market change indicator that assesses turning points in the market is in record breaking territory. The age of the up-move is stretched when compared to history, as well as the magnitude of the move. History would indicate a decline greater than 3% is currently warranted. The NASDAQ move higher reflects a 30-week run with a return of over 22.5%, and that is an up-move duration that is extended and in rarefied territory (only one other time since 2003 has this length of time been met or exceeded). The DJIA has gone 33 weeks without a 3% move lower, and that has never happened during the period from 2003.
4. The Oscillator and Standard Deviation indicators indicate a plateauing is underway at market highs, and point to a next move that is to the downside.

The Micro View:

The Micro view all starts with the database I created of 187 companies. These companies are found in the DJIA, the S&P 500, and the NASDAQ. They were selected roughly ten years ago based on my preliminary assessment of them as being attractive buys for my portfolio. Over time, as companies have been acquired, taken private or otherwise become uninteresting they have been replaced by new additions. The changes are infrequent and have not substantially altered the ability to make historic comparisons based on treating the portfolio as a single holding.

Today, the fundamental picture presents valuation variances from historic norms that have meaningfully changed since the beginning of the year. We were at extreme levels of 25% over-valuation in February and March, whereas today we are over-valued in the 17% range as fundamentals have improved during the first six months of 2017. It will be critical to assess whether the growth in forecasted company operating results remain strong as the rest of the year unfolds. A correction lower at the current levels is still warranted, and should future results miss the forecasts then the decline will be more severe.

The Micro fundamental indicators are as follows:

1. Of the 187 companies, 85 are priced above their Discounted Cash Flow value. Historically, roughly 63 of the companies would be above their DCF values and would be candidates to be considered for sale or shorting. This current level of 85 companies is an extreme level of over-valuation given the assumption inherent in the valuation of cash flow growth of over 10% in 2017 vs 2016, and a forward annual growth rate of 8.7%.
2. The measure of price to cash generated per share has been a reliable identifier of value. On average, over the past ten years, the price to cash flow multiple has equaled 17.3 times. Today we are at 22.65 times, a clear rich valuation level.

3. The measure of 2018 cash flow growth over projected 2017 cash flows is 12.02%. Projecting this level of cash flow at current prices produces a 2018 price multiple of cash flow of 20.22 times which is meaningfully above the historic average of 17.3. There is little room for error in current pricing.
4. As a litmus test, I compare the current price of the overall portfolio of 187 companies to the price projected by the Value Line Investment Service three to five years out. On average, the historic Value Line future price projection for the187 portfolio has exceeded the current price by $28.42. In the current environment, the VL composite price is only $24.26 above the current price, reflecting a sub-par expected return. The implication is that current prices are at historic highs and therefore do not offer the future appreciation that typically justifies the risk of investing at today's prices.
5. Presently, the number of companies within the 187 Portfolio that have a lower price today vs December 31, 2016 is at 31% of the portfolio. Yet the overall portfolio value is 12.59% higher in price. Clearly there are very strong winners in the portfolio to realize the overall gain. This is of concern for it indicates a heavy concentration of winners drawing the largest capital flows which creates the appearance of a healthy overall market when in fact the health is supported by a small number of stellar performers that mask the breadth of the underperformers.

Investment Categories

My assessment of the current attractiveness or lack thereof of these investment choices are as follows:

1. **Cash:** Remains a very attractive asset for me in today's environment. The flexibility that cash provides is of great value in a market that has increasing levels of uncertainty.
2. **Equities:** I am buying only those equities that fit with a longer-term investment plan.
3. **Foreign exchange**: Given the US Dollar weakness I am looking for an entry point on the long side. I view the GBP as a potential short candidate, and the EURO as a long candidate. I am short the Chinese Yuan.
4. **Commodities:** The CRB index has just reached new two-year highs. While trading in individual commodity futures is a part of my investment strategy, I presently only hold a number of commodity index funds.
5. **Precious Metals**: Gold has rallied nicely this year, but has recently pulled back by 3% and now sits close to $1,241 per ounce. Silver is at $16.57 per ounce, falling sharply from over $18. Political uncertainty, economic uncertainty, currency volatility and global debt levels should be supportive of precious metal prices. I own long-term positions in Gold and Silver and in the equities of Gold/Silver Miners.

CFA Portfolio Allocations and possible future actions

My current asset mix, given the above reflects 22% in equities, 17% in Precious Metals, 1% in Fixed Income, 2% in Crypto-Currencies and 58% in Cash.

As I contemplate future decisions on contemplated long and short positions, the following equity positions have risen to the level of warranting attention. In order for a stock to rise to this level it must be rated across five metrics and stand out from the pack. These metrics or filters are:

1. Projected cash flow growth in 2018 that is above or below the portfolio median by double digits plus a current price to cashflow multiple that differs from the median by a degree that shows enthusiasm or neglect
2. Must be ranked in the top or bottom 25 of the 187 companies based on a collective measure of (a) operating margin; (b) price to cash flow; (c) cash flow growth rate projected out 3 years; and (d) multiple of enterprise value to EBITDA
3. Net debt to market capitalization that indicates expansion potential or lack of resources to grow
4. Enterprise Value to EBITDA
5. A Value Line price projection that forecasts the highest price appreciation/depreciation over the next three to five years

Based on these filters I am watching:

From the buy or long side:

1. First Solar
2. Diamond Offshore
3. Discovery
4. Tesoro Corp
5. Tetra Technologies Inc
6. Southwest Airlines
7. Schlumberger
8. STMicroelectronics
9. Viacom

From the sale or short side:

1. PTC Inc
2. Amazon
3. Nvidia
4. Rockwell Automation
5. Synopsis
6. YELP!
7. Ultra Tech Inc
8. RBC Bearings
9. Fiserve

As to foreign equities, I own shares in the Chinese company TenCent Holdings and Guangshen Railway Company. I recently opened a position in Singapore based China Yuchai International Limited. Additionally, I have positions established in a number of Indian companies and related funds, including HDFC Bank, ICICI Bank Ltd., IShares India 50, Columbia India Infrastructure Fund, Mathews India Fund, Make My Trip Ltd, and Mahanagar Telephone Nigam Ltd.

My precious metal holdings are both in physical and equity form. The Gold and Silver Mining companies I own include New Gold, Gold Corp., Coeur Mining, Pan American Silver, Franco Nevada, Alamos Gold and Hecla Mining. I have open long future positions in Silver.

In the world of currencies, my long investments are in Bitcoin, Litecoin and Ether, with a short on the Chinese Yuan.

Imagining the Future

There is much debate and skepticism over the value and price expansion of Crypto-Currencies. A few years back I recognized the potential benefits of realizing greater efficiency from the underlying technology of the Block-Chain to the world of finance. Without a great understanding, my intuition told me to begin buying Bitcoin in 2015. Subsequently I added Ether and then Litecoin. The early decisions that I made were done to make me pay attention to this new platform. With capital at risk, I would read often and much about these new “Digital Currencies” (“DCs”), and I have done so.

As I imagine the future, my view of the DCs is changing. I do not view them as I once did as simply a frictionless form of capital movement without Central Bank control to devalue their worth. I sense something more important, and if I am right, then the value proposition is greater than I imagined.

My advice is to STOP thinking of these DCs as currencies. Think of the units as shares and not coins. Think of the ownership as being the ownership in a new technology platform. If you were given the opportunity to own shares in new companies: Bitcoin, Ethereum and Litecoin, that were valued at $41 billion (largest), $27 billion (2nd largest), and $2.5 billion (4th largest), respectively, would you take the leap? (note I do not own Ripple at this point, but this platform is the third largest valued at $9.8 billion).

Think of the platform they represent and their applications that are being embraced by corporations, financial institutions, governments, and technology savvy entrepreneurs. There is a gamble here, given the newness of the technology, but then again so was there risk in buying Microsoft back in 1975.

I am willing to embrace these platforms. There is something there, and the general public has not yet formed a belief in them. It is early, and it may be the investment of a lifetime, if in fact the units known as Bitcoin, Ether, Litecoin, and Ripple are representative of ownership interests in the platforms. Given the ownership that “miners” receive for operating the platforms, ownership in the form of coins or units, I am willing to take the leap of faith that these units are effectively equivalent to stock ownership in what is a private market offering of entities before they go public.

Until next month, stay safe and invest wisely,

Tom