The Connolly Financial Advisors Monthly Economic & Market Report

Being nimble in a dynamic world

The "To Do" list of matters to research to ensure an educated point of view covers eleven items. Inflation, Taxes and Debt lead the list. Economic growth continues to shine, but is it enough to make sense of stock prices? What are those large point moving days within the stock indexes revealing under the surface? Imagining the Future section discusses Digital currencies, contracts and the "Amazoning" of the global Financial system.

Executive Summary

Inflation, Taxes, Debt, Stocks, Quantitative Easing/Tightening, Bitcoin/Crypto-Currencies, Pension Obligations, Demographics, Employment/Wages, Politics, and Global Tensions seem to consume us every day. The media overwhelms the content we consume with an avalanche of news on the preceding topics. I get the sense that we are nearer to a tipping point where the weight of the risks moves to center stage causing a reassessment of the paths we are on, and that may be discomforting, but necessary to get to a better place.

My suggestion is that for many of us it is time to become simpler, to create a basic "To Do" list that brings order, that prioritizes what is truly important to our day, giving us a focus that lets the noise of the media in, without distracting us from what is truly important. It has been said that if one "Sticks to their Knitting" then their own piece of the puzzle is secure, and when multiple secure pieces are connected, stability and a clearer picture will emerge from the cacophony that bombards us each day.

In terms of creating order for the list above as it relate to implications for return on invested capital, my thoughts are as follows:

- **Inflation:** It is rising across the globe, and one should pay particular attention to Mexico. This is number one on my "To Do" list, coupled with changes in interest rates.
- **Taxes:** The new tax plan exacerbates problems rather than solves them. Projecting where the opportunities and risks will emerge is number two on my "To Do" list.
- **Debt:** There is simply too much debt in the world, and the cost of debt service will become an issue in the future. This is number three.

- **Stocks:** They look more like peak values then buying opportunities. Should interest rates rise the equity fallout could be painful.
- **Quantitative Easing/Tightening:** Reversing the actions of past injections of money into the economy will present hard choices and significant challenges to the sustainability of economic growth. Watch those interest rates across the globe.
- **Bitcoin/Crytpo-Currencies:** These are very much at an unnatural high (BTC = $16,000 per coin as I write this), but do present the evolution of "Amazoning" the banking system leading to future government actions that will eliminate paper currency. Talk about a sign of inflation, just look at the hyper-price change in Crypto-Currencies as priced in Sovereign Currencies.
- **Pension Obligations:** Will not be met in the public sector without large tax increases to fund retirement payments, and this is the definition of a "Hobson's Choice" for our society.
- **Demographics:** The population of the world is aging and the cost of caring for the elderly will become one of the world's greatest issues
- **Employment/Wages:** Technology will continue to displace middle income jobs, resulting in high employment in low income producing areas, and rapid wage growth in the skilled areas which will further skew income disparity in the Developed Economies
- **Politics:** Tribalism has emerged in a way that poses dislocations across societies, and will drive movement to tipping points of conflict that will resolve themselves in not so pretty ways.
- **Global Tensions:** The recurring nature of Global issues move over time between pressing to benign. They are all pressing now.

Well, I am sure the concerns summarized above equate to a wet blanket at the party, however I do believe brighter days are ahead.

Global economic growth continues to improve, with Developed Economies leading the way. The Euro zone, Japan, India, and the United States are all on the upswing. Brazil appears to have bottomed. China is slowing, but still expanding at +6%. The global impacts of monetary easing have taken root in stimulating growth. Unfortunately, it took $15 trillion of stimulus, and the jury is still out as to whether there are longer term consequences from this never before tried way of economic stimulus. But for now, economic growth is very real with consumer and business confidence expanding.

As to tomorrow, I believe in mankind and the positive potential we will tap into. History shows that while we have made missteps along the way, we tend to get things right over the long-term. I believe in that future, and I believe the confluence of today's negatives will become the catalysts that unite us and will bring change that gets the world to a better place, a place of promise, of hope, of goodness. We may have to retrench in the not to distant future before the new dawn arrives, but that is okay, we have done it many times before.

This month, I will be brief on the technical and fundamental side of the equity market as I will cover them in greater detail in my Year-End letter in January. Having said this, there is one technical point I think deserves highlighting in this month's Executive Summary.

On a whim, I decided to look at daily moves in the DJIA that were positive or negative by at least 100 points during the year 2017. I then broke the year into two halves, January 1 thru June 30, and July 1 to the present date. I was surprised by what I saw.

From January 1, 2017 there have been 52 days where the DJIA moved greater than 100 points. This compares to 91 days in 2016, 125 days in 2015, 85 days in 2014, and 72 days in 2013. Clearly, 2017 has been the least volatile, yet it has been the greatest point gainer of any of the years. It has delivered a persistent and steady move higher with no meaningful pullbacks.

Breaking down the 2017 data further to see how many of those 52 days have been positive +100 point days vs negative +100 point days, we find that there are 34 positive days and 18 negative days. On a percentage basis, 2017 has the largest % of up days when compared to the years noted above.

Now, my curiosity kicked in as to whether there has been any change in trend during 2017 of the character of the 100 point moves. There has been, and it indicates to me that the market is weakening under the surface. For the positive +100 point days between January 1 and June 30, 2017, the average volume was a net positive 430 billion shares per day. Between July 1 and the date of this report, December 8, 2017, the net advancing volume on the positive +100 point days has declined to 293 billion shares per day. For the down days, the volume is consistent between the periods with 348 billion net declining shares on negative +100 point days during the first half of the year vs 326 billion during the second half. So volume is telling us that there is less enthusiasm for positive days, and that is a change in trend.

This observation is further supported when we add the view of advancing vs declining issues on these +100 point day moves. Advancing issues on positive +100 point days during the first half of the year averaged 1,271 issues per day. During the second half of the year, they averaged 890 issues per day. On negative +100 point days, there were 898 net declining issues per day during the first half of the year, and 1,122 net declining issues per day in the second half. Again, the trend change to a more negative tone is building. I would not ignore the substance of what this data is indicating, for it is foretelling an ultimate index decline in the major stock averages.

The Issues and why they are on the top of my List

- **Inflation:** Throughout my life inflation has been something to fear, something that kills the purchasing power of your savings, your money. The Great Recession of 2008/09 raised the specter of deflation, and it made the Central Bankers act. Falling asset prices stymie economic growth as spending is delayed in anticipation of being able to buy assets in the future at lower prices. The CBs' actions halted the decline in asset prices, but did not create economic expansion as fast as they had anticipated. It has now been almost ten years of global monetary stimulus policies with low to negative interest rates on debt. The Central Bankers never perceived their efforts would take so long to produce rising prices. It has, and now we are seeing the bottom form in inflation. Like a curved dish, the rate of inflation in country after country has moved off the bottom, the low point, and is riding the side of the dish upwards. How fast and high will it move? The answer to that is unknown given the lack of history of such vast monetary stimulus being fed into the engine of economies across the globe, but the flooding of +$15 trillion of monetary injections cannot go quietly into the night, and my fear is that when the turn takes place, which it appears to be doing now, it will accelerate rapidly and cause significant economic and social dislocations. Think about the phenomena of Bitcoin, and the incredible appreciation in price over just a few months. That is what hyper-inflation looks like. We all need to be very alert to this. As to the speed of inflation picking up, look at Mexico's increase over just one year from 3.36% to 6.37%, a doubling in the rate of growth in prices:

- **Taxes:** The new tax plan leaves me very uncomfortable. It has been presented as a pro-growth policy that will deliver positive economic benefits. In the world of the 1970s, the 1980s and even the 1990s, this would make sense to me. In today's world, I just do not see this plan working as envisioned. There are a host of reasons why, so let me lay them out for you:
    1. Reducing the Corporate Tax rate to 21% from 35% will add to available cash in the hands of corporate entities. The expectation is that this will stimulate investment in new plant and equipment, drive employment growth, enable wages to rise, and bring foreign investment into the United States as well as off-shore cash held by U.S. multi-national companies. In theory, and in the past, I would have agreed with these assumptions, but not today. Corporate behavior after the Great Recession has been driven to embrace technology, to reduce workforces, and to channel excess cash into higher shareholder dividends and stock buybacks. This has delivered exceptional returns for the executives running corporate America. They will stay on this path, and will NOT become aggressive with expansionary policies, or expand hiring in any significant manner. They will continue to streamline, to reduce costs, to embrace technological efficiencies, and to deliver returns to shareholders. The American worker will not be the beneficiary, and the income disparity that has raised class warfare will only get worse. The tax plan advocates believe the expected economic growth and the greater income and larger tax base will prevent a significant rise in the deficit and debt of the United States from reduced tax rates. If that economic growth does not materialize, this tax rate reduction will drive the National Debt to record levels.

2. Eliminating the State and Local income tax deduction from the individual tax calculation is an effort to eliminate the Federal subsidy to State economies. It is expected to raise Federal Tax collections from individuals by eliminating this income reduction on the Federal Tax Return. It is also a political goal of the Republican party, as it puts great pressure on State and Local politicians who have large income tax levies on their residents. The pressure to change (reduce) their social welfare and income support structures is the unstated target. There will be pressure to reduce the State and Local tax burden or face the risk of seeing current tax paying residents leave for lower income tax States. The States with the largest social programs and the highest tax rates are predominantly run by the Democratic party. This will further isolate and divide our country, as the Tax Plan will drive economics that become defining factors in the decision of where to live within the United States. It is a dangerous path that fails to recognize the concentration of large groups of people who live close to the poverty level within our urban centers. People who rely on the social benefit programs that are financially supported through the higher incomes and resulting taxes of middle to upper income workers who live and work within the urban centers will become the victims of this new tax policy. Eliminating the State and Local Tax deduction may have very far reaching implications that have negative unintended consequences on the broader society.

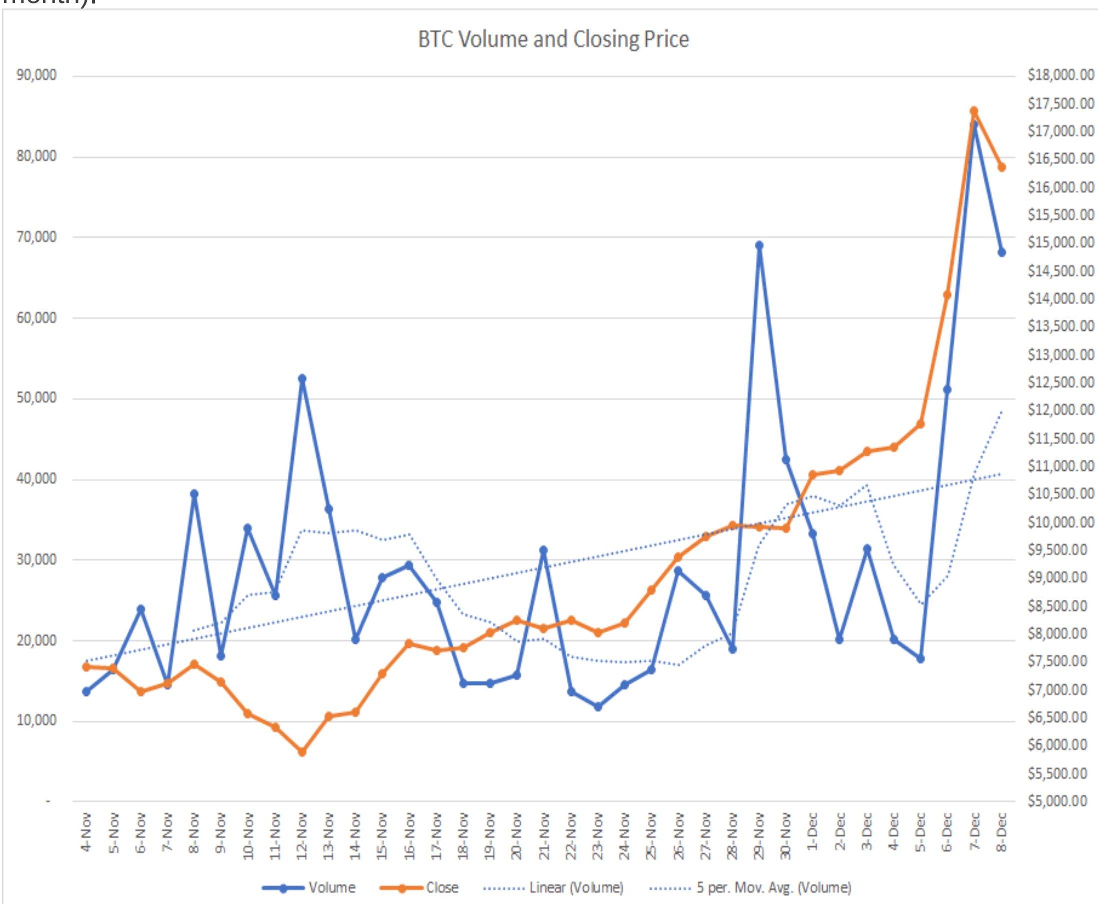
- **Debt:** The expansion of debt levels in the United States and throughout the world is breathtaking. Who would have thought that the need to address a world with too much bad debt in the year 2008 was to add more debt obligations to an already over-indebted world? At the public (government) and private level, debt has soared since 2008. This is not only investment grade debt, but also high yield debt (junk debt). One would think that with higher debt burdens, creditors would demand higher interest rates to compensate for the higher potential for default. Yet, we live in a world where interest rates have never been lower, and the spread between Investment grade and high-risk debt is lower than ever. It is clear to me that there is a mispricing of risk present in the market, with the clearest example being the debt markets. This cannot end well, for the level of defaults will rise significantly when it is not anticipated.

  I remember when the financial panic was all around us in 2008 – 2010. The financial service professionals were nervous, looking out at the wall of debt that would need to be refinanced two to five years out, and all anyone could see were bankruptcies, debt restructurings, and the kind of outcomes that history taught us were inevitable in a highly indebted world. It did not happen, because the Central Banks came to the rescue in ways that no one anticipated. Today, no one is talking about defaults. No one sees a world of impending financial restructurings. When no one is talking about it is when it will emerge to strike fear into the financial and industrial community. We are close to that time when complacency, coupled with the huge debt, economic, political and global tensions that are churning under the surface, will write the next chapter in the business and political cycle of the world.

- **Stocks:** The current valuation levels of stocks in the United States are record setting. They are higher than at any time in modern history. There is an old adage on Wall Street, “Bulls make money, Bears make money, and Pigs get slaughtered”. It sure feels like piggy time to me.
- **Quantitative Easing/Tightening:** Other than Japan, the world is moving toward a more restrictive monetary policy. China, the United States, the Euro Zone and the UK are all following through with liquidity reduction plans. The fuel that fed the fire of

asset price growth in the financial sector is being taken away. The punch bowl is being emptied. The effects of this are not apparent yet, but they will become apparent as the tightening policies continue. Interest rates will rise. Inflation will become its old self, an enemy of value retention and something to be fought, bond yields will increase, and bond prices will fall, debt refinancing will be more expensive, and economic contraction will follow.

- **Bitcoin/Crytpo-Currencies**: These digital currencies are at an unnaturally high price (BTC = $16,000 per coin as I write this), but they do represent: (1) the evolution of "Amazoning" the banking system, and (2) where future government actions will develop to eliminate paper currency. Digital "money" will expand and paper money/coinage will become a relic of the past. As to the current prices of the various digital currencies, in a way they represent a sign of inflation. Just look at the hyper-price change in Crypto-Currencies as priced in Sovereign Currencies as demonstrated by the price action in Bitcoin over the past month (tan line shows a tripling in one month).



- **Pension Obligations:** The promises to financially support our aged and retired citizens will not be met without large tax increases to fund retirement payments. This is the definition of a "Hobson's Choice" for our society. If we fail to meet the agreed obligations we will experience domestic and social turmoil, and if we meet these obligations it will have to be through higher tax burdens on property ownership and income. Higher tax burdens will damage our economy, so there is no good choice, only a single choice to honor the commitments made. Of course, there is always inflation as a way out. Fixed pension liabilities that are unaffected by inflation can be met by rising tax collections due to inflationary impacts on earnings. As I said, a Hobson's Choice, with inflation as the savior. Below is an interesting quote I read this week:

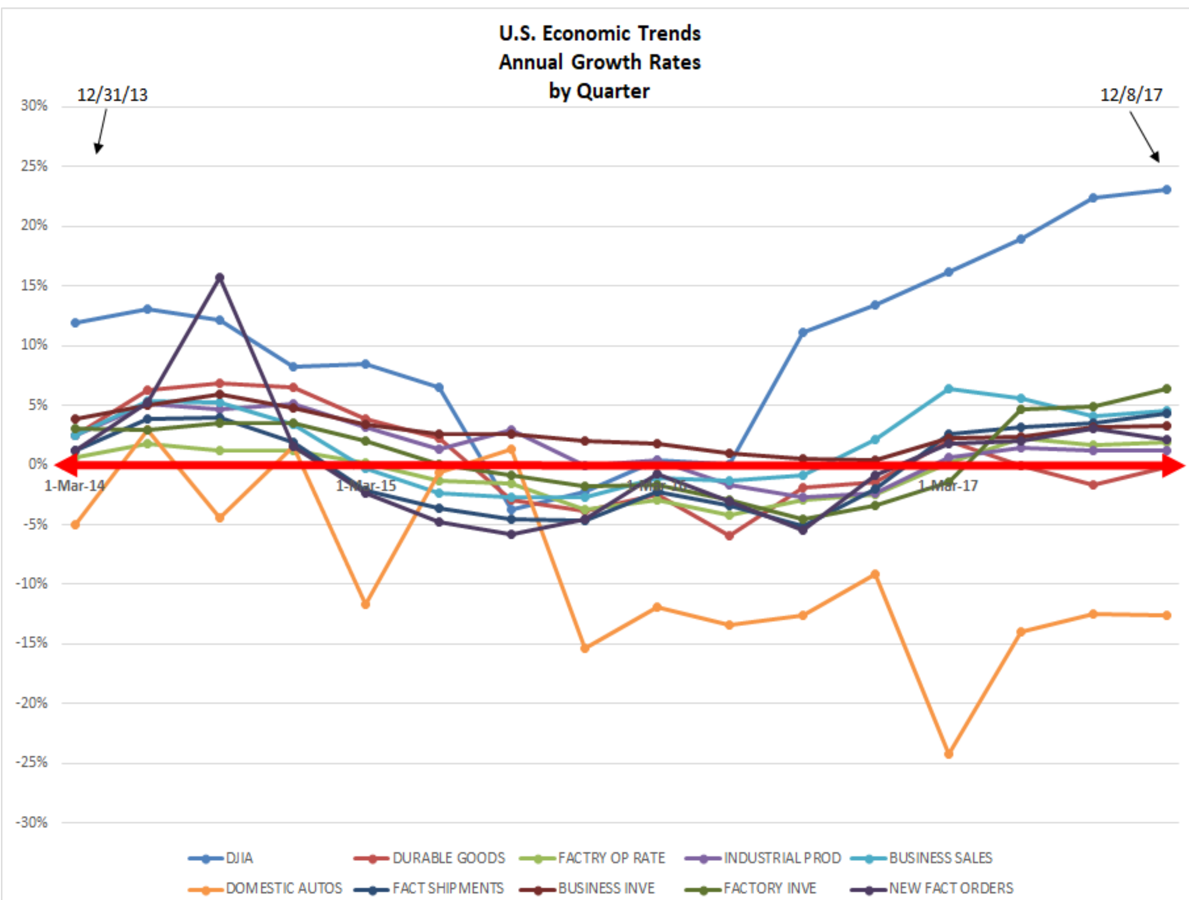
- The founder of Vanguard Group thinks a conservative portfolio of bonds will only return about 3 percent a year over the next decade, and stocks won't do much better, with a 4 percent annual gain over a similar period. **This is "totally defeating" for pensions, which "are not going to be able to meet their 7.5 percent or 8 percent obligations,"** Bogle said in a Bloomberg Radio interview that aired Thursday."The only return you get on a bond is from the interest coupon," with fluctuations in prices eventually evening out and becoming relatively negligible over the longer term, he said. **Given a portfolio of about half corporate bonds and half U.S. Treasuries, the blended yield is about 3 percent today.**"So that's what you get over the next decade," he said.**It is almost a given that it will end badly,"** he said

- **Demographics:** The population of the world is aging and the cost of caring for the elderly will become one of the world's greatest issues. The income generating demographic is declining as a percentage of the overall population, which undermines the premise on which retirement and elderly care is based on. We need more babies, lower cost care solutions, and higher incomes.
- **Employment/Wages:** Technology will continue to displace middle income jobs, resulting in high employment in low income producing areas, and rapid wage growth in the skilled areas which will further skew income disparity in the Developed Economies. Given the cost of living continues to rise, the lack of broad and substantial income growth is placing a greater percentage of the population at economic risk. The full employment goal in the United States appears to be at hand, yet wage growth is sluggish. Without wage growth there has been an increase in debt burdens as purchasing is realized through financing. This unsustainable growth in consumer debt will be resolved either through restructuring or greater income growth, ie. Inflation. Absent inflation, the future poses a very hard set of choices.
- **Politics:** Has it ever been this nasty? With rhetoric at its most offensive, we are seeing change vs stagnation in the policies that are being put forth, and in some cases implemented. In a way that is a good thing, for we are no longer stuck in a "do nothing and offend no one" mindset. That is what change is all about, creating discomfort by engaging in efforts to change course. This creates tension, tension that will need to be resolved, and that will bring about a new chapter in our history. I do not know whether we are approaching a good or bad piece of history making, but I do believe the status-quo is done. Across the world change is happening, and in many cases it is picking up speed. With speed comes risk, and with risk comes volatility. It will be an unsettling time for most, and I recommend we all pay attention and be involved.
- **Global Tensions:** Go back and watch the television show "West Wing" from the 1990s, and watch as the show plots address North Korea, the Middle East, Jerusalem, Terrorism, Trade with China, the economy, the environment, alternative energy sources, etc, etc. The issues today are the same, and in so many ways we have seen the ebb and flow of these move throughout our past. Presently, it feels as though we are reaching a point where the Leaders of the World must unite to collectively and jointly address the issues with calmness and care, or participate in a spiraling down of global coordination and peace. We are in a period of rapid and discomforting change, and keeping our heads about us is critical. The unanticipated Black Swan is out there, and it will take a collective effort to minimize the turbulence that it will bring when it

arrives. The world is "smaller" as communication flows effortlessly across the globe, as finance and economies begin to move more seamlessly, and unfortunately, weapons realize greater reach, making distance less of a protective shield. Reaching hands across the table, across the oceans, is more important today than it has ever been. Isolationism is a mistake, and I cannot see it as being a positive path in a world that is interconnected and mutually dependent. If we are to realize the potential greatness that is within the destiny of this world, everyone must seek to engage selflessly in resolving the tensions that do not advance peace and prosperity.

The Economy

The economic backdrop in the US and the major economies of the world continue to display improving growth rates, backstopped by low interest rates. Consumer Confidence is high, and future expectations are also high. Improvement in the key metrics of our economy are consistently running positive, with steady improvement toward the 5% period over period growth level.



The Equity Market

The equity market in the United States is exceptionally over-valued. It is hard to make sense of a stock market price that is up by +25% this year, when the cash produced by the companies within the stock market is up only 9%. Fundamental analysis of what something is worth indicates that the stock market is not worth its current price. The average multiple of cash produced by the companies within the stock market to the current price of the stock market indicates we are paying 25.8 times the cash produced. Think about that. A company generates $1 in cash this year, and the price to buy that $1 in cash is $26. Now with the price paid there is the right to be an owner of future cash that is generated, which supports paying more than $1 for the current year's performance. Historically, the price paid for the cash generated has been 18.3 times the cash. Today, we are given the opportunity to pay $8 more for the cash that is generated than the historic average. Why? Is the future growth in the economy and in the prospects for business success dramatically higher than historic rates of economic growth? All of the data that is available, including forward projections of next years growth do not point to exceptional and unusual growth. In fact, cash growth for next year, 2018, is projected to be 13.8% higher than 2017. That is strong growth, but interestingly it is consistent with the projected growth rates that have historically been put forth every year for the following year during the past ten years. Further interesting is that every year over the past ten years the actual results for the year have always been lower than the projection. For example, in 2016 the projected growth in cash flow for 2017 called for a 14.29% rate of growth. Actual cash growth for 2017 is 8.90%. Every year shows this. At some point the price of stocks will have to recognize that the growth in prices paid for stocks has grossly exceeded the growth in the cash the businesses produce, and when that fact begins to resonate, there will be a decline in prices that will be very significant. How significant? I estimate a 25% price decline is in order to align cash produced with the price paid to own that cash and future cash. This makes sense if you acknowledge that since 2008, due to the compounding of the price growth vs the cash flow growth, we now find that prices have tripled while cash flow is only up 77%. What you pay for the stock today is clearly reflective of inflated prices.

Coupling this overvalued state with the trend change in the technical indicators that was discussed in the beginning of this month's newsletter is a serious sign of storm clouds on the horizon.

Imagining the Future

Digital money and the Blockchain represent tectonic shifts in the world of finance. Careful and persistent attention should be paid to the developments and rates of adoption in this area. I believe it represents the evolution of banking, finance, and contractual structures into a new world. Paper currencies, fiat currencies, will have a limited remaining life. The benefits from moving to a digital architecture for value transference will dominate the future. The rise in capitalization of these various digital tokens is astounding, with Bitcoin at $276 billion, Ethereum at $45 billion, and the rest rounding out to a total market cap of $441 billion. Yes, this feels like a bubble, but the price is not the point today. The point today is the meaningfulness of the move that is happening and that will continue to happen. Governments will push for digital currencies, as it will capture greater tax dollars and get at the underbelly of the hidden economy. Foreign exchange will change dramatically as easier and less cumbersome ways of transacting across the globe emerge. Remember that Amazon began selling books online. Today, it has changed the retail industry in ways that no one appreciated back in the 1990s. Bitcoin, Ethereum, the Blockchain, etc, are doing the same. This is a tsunami that is real, and it too will not go quietly into the night. Pay attention is my strongest advice.

Stay Safe and invest well.

Tom