The Connolly Financial Advisors Monthly Economic & Market Report

Being nimble in a dynamic world

Economies across the globe are exhibiting growth. What are stock market valuations telling us? Why are we churning each day in a way that leaves us running in place? Are we going through a topping pattern? Where in the market am I allocating capital in this environment? The Imagining the Future section looks into what may be one of the most compelling investment opportunities in the world today.

Executive Summary

Continued positive economic data from across the globe is telling us that growth is more prevalent than it has been in almost nine years. We seem to be at a point in time where key decisions by governments will either derail the growth and green shoots by pursuing controversial and isolationist policies, or we will navigate through this tense period and come out the other side with global accelerating growth and even greater opportunity for investing success.

The US markets are churning, as if in a wait and see mode. This churning began from a very over-valued position posing great downside risk. Some of that over-valuation has dissipated during this churning process, but risk still exists and I am proceeding with caution.

As we wade through the Economic, Fundamental, Technical and Tonal aspects of the markets in this month's essay, all of which confirm the current state of Market Churn and possible topping action, there is a gem hidden within these writings, one that should be pursued in terms of seeking knowledge. That Gem is the country of India. In my closing section, I always try to share where my mind is flowing to in terms of the future. Letting my mind run is one of the most favorite things I do. Sometimes I find real substantive paths to follow, and I follow them with conviction. Other times, I sense good ideas but they are simply good, not revolutionary. In this letter, I am excited, for the idea expressed below in the "Imagining the Future" section may be of incredible value to the world and to those that invest early and correctly, and it just may be revolutionary in its impact.

The Economy

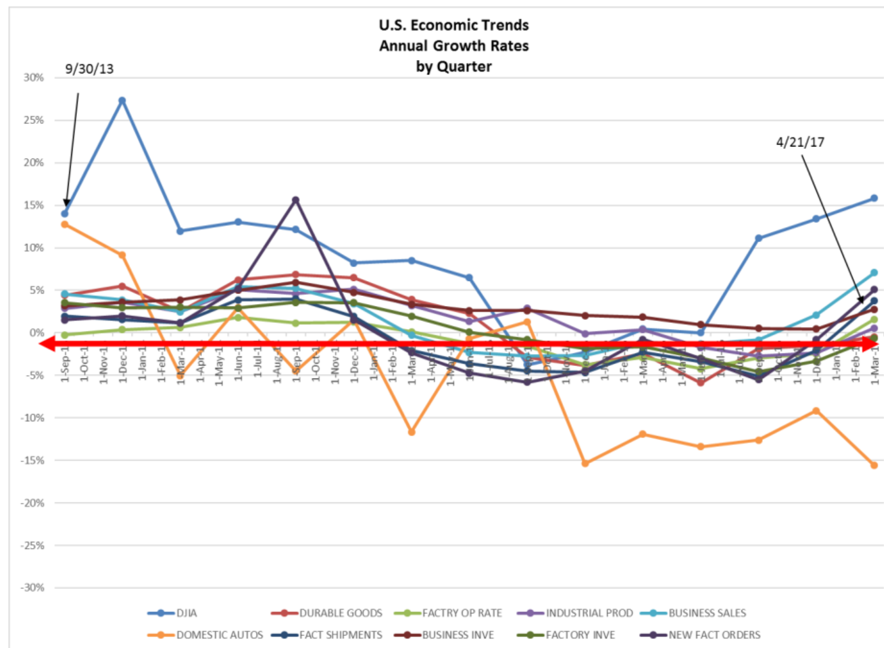
Economic indicators have created a muddled picture.

The Federal Reserve's Beige Book was released on April 19, 2017. This report is defined by the FED as "a publication about current economic conditions across the 12 Federal Reserve Districts. It characterizes regional conditions and prospects based on a variety of mostly qualitative information, gathered directly from District sources". Every district across the US showed economic improvement and prospects for more growth. Economic activity increased, Employment expanded, labor markets are tight, and wage increases broadened. Prices were reported to have risen, and are expected to continue to increase. The Districts reporting are Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

This Beige Book release gives me optimism that sustainable growth is with us. Coupling this with more global economic information, and a sense of real optimism justifiably gains momentum. For example, it was reported on April 20th that construction in the Eurozone rose at the fastest pace in five years. Belgium rose 18.7%, Germany by 13.6% and France by 8.1%. Official figures for overall Euro economic growth during the first quarter will be released on May 3, 2017. Additionally, the IMF raised their Global Economic forecast for 2017 to 3.5% growth up from 3.4% growth. This increase focuses on Japan improvement of 0.4% to 1.2% growth, the Eurozone and China of 0.1%, to 1.7% and 6.6% growth, respectively. To further the growth theme, China reported on April 17th that GDP grew by 6.9%, fixed investment grew by 9.2%, Industrial production rose by 7.6% and retail sales grew by 10.9%, all beating expectations.

These are encouraging indications that may provide the needed backdrop of support for further improvement in equity markets.

The chart below is very reflective of the turn and direction up of the key economic trends in the United States:



It will be important to pay attention to the reports coming out early this week from the semi-annual gathering of Finance Officials from the IMF, the World Bank and the Group of 20 major economies, to ascertain whether headwinds are of concern in sustaining continued growth or does optimism shine through the communiques that are distributed.

The other economic data and information that is causing me to use the term "muddled" and which creates a sense of unease in fully embracing a growth story are data points such as:

- The Atlanta Fed revised the first quarter U.S. GDP growth down to 0.5%, based on weak personal income and the resulting lower forecast for consumer spending.
- The Federal Reserve Bank of New York released its April 2017, "U.S. Economy in a Snapshot" report, and while it looks for better growth later in the year, it did point out that Real Consumer spending fell in February for the second consecutive month, Auto sales declined 5.4%, Payroll employment growth slowed in March, and Compensation growth remains modest at best. There are positives in the report but the impact of the negatives caused the NY Fed to forecast a decline in GDP growth to 2.6% from above 3% that it reported in February and March.
- U.S Railcar loadings which is an indicator of economic activity is in a declining trend, and has been in this declining trend since 2014.
- One of the highlights of economic improvement has been New Housing starts and sales, yet the just released data on lumber and wood products in Railcar loadings, an economic indicator that historically tracks consistently with New Housing has dramatically disconnected. Lumber and wood product loadings now show a gap with New housing that is larger than at any point since 1990.
- Federal Tax receipts from corporations have rolled over and have been in a steady decline in 2016 and 2017.
- Liquid assets as a percent of the S&P 500 now stands at roughly 55%. The last time this liquid asset ratio was this low was 2007. Meanwhile, Commercial and Industrial loans as of April 5th reached $2.4 trillion, a new all-time high.

- Finally, the Citigroup Economic Surprise Index which has historically been a very good indicator of future economic and equity market performance, declined from a reading of roughly 60 in March to a reading of 10 on April 18th.

I see the muddled picture as one that should add to uncertainty, even at a time where optimism is on the rise. Global expansion feels real, yet the talk of protectionism and of less monetary support must be strongly considered in determining how strongly to embrace the sense of optimism without a blanket of caution.

The Equity Market

The Macro view:

The current equity market in the United States remains highly valued but is not as extreme as it was during the last CFALLC report in March. Two things have occurred that have moderated the level of over-valuation: (1) the market has pulled back a modest amount since March, with the DJIA declining approx. 600 points and the S&P 500 declining by 35 points, and (2) cash flow estimates for 2017 have increased by 7.2% since January. These changes have taken a bit of the froth out of the market but we remain in an over-valued state.

As I indicated in the March Newsletter, I look to three factors in assessing opportunity in the equity market. They are the fundamentals of the market, the technical attributes of the market, and the tone of the market.

What are the three factors of Fundamentals, Technicals and Tone messaging today?

We are in a period of flux with a downward bias.

Fundamentals have improved with the better economic data, yet the advance we experienced during the past six to nine months in equity values has priced in even higher fundamental growth than what is currently projected. So, we remain at risk for a further decline from where we are currently. My analysis indicates a 14.5% decline from current values would bring us back in-line with historic normalized valuations.

The technical attributes have moved away from extreme conditions, but still point to risk to the downside. Relative strength indicators have declined from the mid-80's in February to readings in the 60s now, (based on a scale of 0 to 100, with readings above 66 indicating over-bought conditions and readings below 33 indicating over-sold conditions). The number of issues advancing each week vs the number of issues declining each week became unsupportive of the market index point increases during the first three months of 2017. In April, the advancing issues vs declining issues have stabilized and even outperformed the indexes in the past couple of weeks. I am pondering this, for on one level it is a positive of the market finishing a correction to the downside. However, I remain cautions and concerned with the credibility of this technical indicator given the influence of the Index funds and the amount of money that has flowed in to them. The Index funds buy the broad market, and with the influx of money to them the continued buying creates more advancers than decliners. This makes me skeptical, and so I look to volume to corroborate the issues. Unfortunately, the volume is not ratifying the message from the Issues, as volume in advancing issues continues to deteriorate. A divergence such as this highlights for me what smart early money may be

doing (liquidating positions) vs money of those late to the market (buying what the smart money is selling).

The tone is more uncertain given the global political dynamics and risks that appear to be increasing. These events are creating concerns that are more external in nature. Optimism about the economy supports a positive tone and increased investing, but the near-term disruptions of North Korea, Russia, Syria the French elections, the Trump agenda challenges and uncertainties, etc, have made each day directionless in terms of the markets behavior. This argues for a market that will not in the near-term unify and move in a clear trend direction to either the upside or downside. The greater bias may be for a quick and sharp move lower, one that flushes out more of the froth and puts fear into the market, creating some buying opportunities.

Macro Details

Fundamental measures and their importance were discussed in detail in March, and will be again discussed in detail in June. For April, the following high level commentary is relevant:

1. The markets Current Interest Yield Gap (the difference of the avg return on Bonds vs Dividends from stocks). That Gap is presently 0.90%, which means on average the interest rate on bonds is 0.90% points higher than the dividend yield on stocks. Historically, that is an exceptionally small spread, for the long-term average difference is 2.42%. Such a low difference makes stocks a more attractive income vehicle, particularly given the lower tax rate applied to qualified dividends vs interest income.
2. The current Price Earnings ratio of the S&P 500 is 24.8 times. The historic average is in the 15 to 16 times range. Given the forecasted earnings for 2017, the forward PE ratio for the S&P 500 is a more modest 17.9 times. Based on this measure the level of over-valuation has been reduced compared to where we were last month, and while still at the high-end, the global reflation that is anticipated is providing support to current high expectations. I think the muddled economic picture should act as a deterrent at this juncture to committing new capital to the market.
3. The U.S. Dollar has been volatile this past month. The basket measure of the US Dollar vs other currencies has ranged from 99 to over 101 since our last report. Volatility here makes hedging programs more challenging, as the longer-term direction of the dollar is uncertain. I am presently short the U.S. Dollar as technical measures point to a decline, the Trump Administration is talking the dollar down, and improvement in the economy of the Eurozone should add strength to the Euro against the U.S. Dollar.
4. Money Supply growth in the United States has decelerated during 2017, and that continues to be evident since our last report. The M2 Money supply has shown no growth in the past month. A clear sign of Fed tightening and a precursor to the raising of the Fed Funds rate. Tighter money reduces flows into the stock market.

Technical Indicators which were very negative when discussed in the prior month's report have become less so.

1. Since March 1, 2017 through April 21, 2017, the DJIA has declined by 570 points. Yet that decline has not been validated by the number of NYSE issues declining in price. In fact, during this period there are in the aggregate a net increase of the

number of NYSE advancing issues over declining issues by close to 2,000 issues, even though the Index fell. As I noted earlier, I am suspicious of the impact of the Index fund phenomena on advancing vs declining issues, but cannot ignore this divergence.

2. New 52 week highs vs lows on the NYSE remain consistent, with daily and weekly highs exceeding lows. This has surprised me given the recent declines in stock prices and the calendar movement away from February 2016, the last substantive market low. I expected to see a broadening of new lows after February, and that has not happened. This is supportive of current market prices.
3. The 3% market change indicator that assesses turning points in the market and the exhaustion potential of the most recent trend does indicate a topping scenario in the market. 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 warranted, yet we are at most only 2% down on the DJIA from its most recent high, and roughly at a new high for the NASDAQ. The NASDAQ move higher reflects a 24-week run with a return of over 16%, and that is an up-move duration that is extended and in rarefied territory.
4. Finally, the Relative Strength of the equity markets as noted at the beginning of this discussion has cooled-off. The measures of Standard Deviation from the mean for the Relative Strength indicators have returned to more normalized levels, and are no longer beyond one standard deviation from the mean. This has become a more neutral indicator at this time.

The Micro View:

The importance of the Micro view of the 187 company portfolio is discussed in detail in the March report.

Today, the fundamental picture presents valuation variances from historic norms that have meaningfully changed. We were at extreme levels of 25% over-valuation in February and March, whereas today we are over-valued in the 15% range. A correction lower is still warranted.

The Micro fundamental indicators are as follows:

1. Of the 187 companies, 84 are priced today above their Discounted Cash Flow value. Historically, roughly 62 of the companies would be above their DCF values and would be candidates to be considered for sale or shorting. Over the past two months, as many as 106 companies have crossed this threshold, setting new overpriced records for the overall 187portfolio, but that has moderated to a more reasonable but still over-valued number of 84.
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 22.47 times the forecasted 2017 full year cash flow. When this measure is below 17 times, the profit opportunity has been realized through buying equities. Above 18 times, the loss avoidance opportunity has been to sell equities. This is not an absolute rule given the potential for future accelerated earnings and cash flow growth in later years and the weighing of the technical underpinnings of the market that may conflict with a sale decision.
3. The measure of cash flow growth for the 187 companies shows a 2018 growth rate over projected 2017 cash flows of 13.07%. Projecting this level of cash flow at

current prices produces a price multiple of cash flow of 19.88 times which is still above the historic average of 17.3. It would seem that the current valuations assume few missteps in the future and may even be assuming performance above the current analyst projections.

4. As to cash flow growth projected out to the year 2022, the current projections indicate an annual growth rate over the next five years of 8.54%. This is below the single year projection for 2017 and 2018, and in fact is lower than any annual projection other than in the midst of the financial crisis (in 2009 the five-year cash flow growth projection was 7.59% per annum).
5. As a litmus test, I compare the current price of the overall portfolio of 187 companies to the price projected by the Value Line service three to five years out. On average, the historic Value Line future price projection for the187 portfolio has exceeded the current price by $28.54. In the current environment, the VL composite price is only $22.38 above the current price. The implication is that current prices do not offer the future appreciation that typically justifies the risk of investing at today's prices.
6. Throughout January and February 2017, on average 25% of the 187 companies were down in price compared to December 31, 2016. Presently, that number has increased to 34% of the portfolio. Under the surface, the market broad averages are being supported by some of the larger companies' price moves as compared to the overall market. This is typically a sign of topping in the market and should be watched carefully,

Investment Categories

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

1. **Cash:** A very attractive asset for me in today's environment. I am not a risk averse person, but the flexibility that cash provides me is of great value in a market that I view as being in the midst of an identity crisis (uncertainty as to whether the equity markets will continue to rally or will reverse and head lower).
2. **Equities:** The recent minor decline in equity prices coupled with a clear upturn in economic data, although muddled, and the raising of company cash flow projections has made some equities more attractive than they were two months ago. I have stopped reducing my portfolio of stocks (after reaching all-time lows as a % of my portfolio), and in fact during April I added to a few positions and initiated some new positions in a minor way. Those buys were: Ford, AT&T, Cheniere Energy, Golar LNG, and a number of companies based in India, including: ICICI Bank, Make My Trip, HDB Bank, Mahanagar Telephone Nigam, and Mathews India Fund.
3. **Foreign exchange**: In the last letter I indicated I was on the FX sidelines absent some opportunistic event. During April I became active in the currency markets by taking positions in the British Pound and the EURO, and in shorting the U.S. Dollar. The sell-off of the UK Pound due to Brexit, the decline in the EURO prior to the French election, and the strength in the U.S. dollar at a time when the U.S. President states it is over-valued, presented for me triggers to closely monitor these currencies. At various points, I established what struck me as valuations that if hit would prompt a trade. These caused me to enter positions, and in the case of the UK Pound to buy low and to exit within the month given the rapid strength after Theresa May called for new elections to solidify her political party. The Pound

rallied hard, and I profited nicely. I am still long the EURO and short the U.S. Dollar. I should also comment that digital currencies deserve a small place in my asset mix, if for no other reason than to make me pay attention to them. Bitcoin and Ether serve that purpose for me. Bitcoin as I write this is valued at $1,250 per coin and Ether at $48 per coin. Both have experienced gains in excess of 100% over the past year. Each week new announcements by governments and merchants validate the existence and viability of these digital currencies. There is no guarantee that some country will not ban these new currency platforms, but at the moment the momentum remains to the upside with new adopters rising.

4. **Commodities:** Trending patterns is the rule that governs my involvement here. Cocoa reached above $2,000 per ton which caused me to exit my long position at a gain. Subsequently it pulled back to the $1,780 area, which was a 5 year low, and I established a new long position. Currently Cocoa is at $1,850. Looking for moments when trends change and news supports a price change is important. I am looking for Cocoa to once again reach for the $2,000 area. Crude Oil pulled back to the $49 area from $53, and that enabled me to close my short position. The growing US supply that is filling the void of OPEC production cuts seems to portend price weakness. Trading this commodity requires being careful due to the political influences of the major participants. Below $50 I look to find reasons to go long, and above $50 I look for reasons to go short.
5. **Precious Metals**: Gold has rallied nicely this year and now sits close to $1,290 per ounce. Silver is just under $18 per ounce. Political uncertainty, economic uncertainty, currency volatility and global debt levels have supported the prices. The price increases have occurred with minimal fanfare, and that is encouraging for even higher prices. I have a sizeable position in Gold and Gold Miners. For both Gold and Silver I have increased my exposure through new Futures positions. The Gold Miners have not performed as well as the metal and this warrants attention. Either the stock prices of the Miners point to a decline in the Precious Metals or they are poised for a large move higher to catch up to the rising price of the metals. I am positioned for the Miners to play catch-up and to appreciate meaningfully.

CFA Portfolio Allocations and possible future actions

My current asset mix, given the above reflects 9% in equities, 32% in Precious Metals, 1% in Fixed Income, 1% in Bitcoin/Ether and 57% 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. Xperi
2. Diamond Offshore
3. First Solar (Added to portfolio)
4. Tesoro Corp
5. Golar LNG or Cheniere Energy (added both to my portfolio)

From the sale or short side:

1. Amazon
2. Netflix (Short via Put Options)
3. Nvidia (Short via Put Options)
4. Rockwell Automation (short via Put Options)
5. Thomson Reuters

As to foreign equities, I own and continue to monitor the Chinese company TenCent Holdings. As you will see below, I am focusing in on India with new investments.

With regard to Commodities, my attention has been on Cocoa, Crude Oil, Gold and Silver. In regard to Gold and Silver Mining companies, I own and watch closely the companies New Gold, Gold Corp., Pan American Silver and Hecla Mining. I have open long future positions on Cocoa, Crude, Gold and Silver.

In regard to FX, my attention is focused on Bitcoin (I increased my position on a pull back to the low $1,100 area), on Ether (opened small position at prices under $50 per unit), and I have added to a short dollar position and a long EURO position while closing at a profit on a long GBP position.

Imagining the Future

Changes taking place in India have caught my attention. These are short-term initiatives that have long-term implications. My focus on India began with the November 2016 government decision to eliminate the paper money denominations of 500 and 1,000 Rupee notes. Overnight this created great stress on the population and had a dramatic and immediate slowdown effect on the Indian economy. I kept asking why would the government do this? It was easy for me to see the potential target of reigning in the Black Market and to increase tax revenues, but there had to be more.

There is more, and I am excited about what I am learning. I am so excited that I have made initial investments in companies that operate in India, investments designed for the purpose of generating long-term gains. Why am I so excited?

It is called Aadhaar. Aadhaar is a breathtaking plan to modernize and bring technology to the hidden, to the ghosts of India, to its over 1 billion people, half of whom have no formal

identification with the government. Babies born in the rural areas of the country are never registered as being born. Lacking ID, they never obtain bank accounts, struggle to participate economically, and place burdens on the country that are incredibly hard to measure. The current leaders of India understand that their countries future must fix this crippling state. And they are.

India has developed a technological infrastructure that the rest of the investing world is not paying attention to. They have built, and it is operational, a technological infrastructure that is digital and national. In 2009, they launched Aadhaar, a biometrical database system that authenticates citizens of India through finger prints and retina scans. As I write this, 1.1 billion people in India have become registered through the system. It gives them authorized access to governmental support such as food and healthcare, which drives more people to be a part of it and which creates an accountability that has never existed before. The next step is to link the system to the banking system to enable people to create bank accounts, to secure life insurance, and to become part of the informational age. Add to this the overlay of placing the platform on mobile devices, enabling transactional commerce, banking transactions, governmental support transactions, tax collections, higher education opportunities, etc, and the speed with which India may advance could be breathtaking. Stop and think about the progress to date, as over 1 billion people have been registered since 2009, that is 1 billion people who have biometric IDs, verification capability based on retina scans, and eager participation in government programs that historically never recognized all its people's existence.

I sense that this may be one of the most significant investment opportunities that exists today. I strongly encourage you to research matters on this, and when right for you, to include India as a part of your portfolio.

Stay Safe.

Tom