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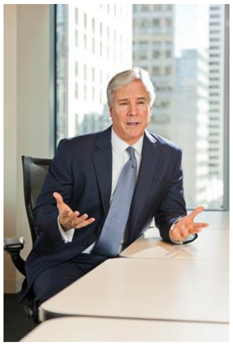


The Connolly Financial Advisors Monthly Economic & Market Report

Being nimble in a dynamic world

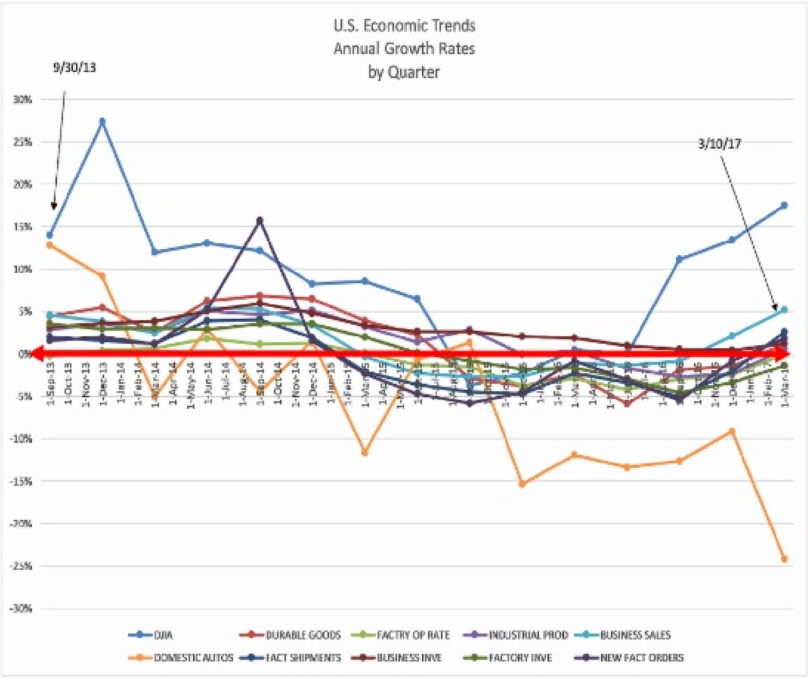
Economies across the globe are exhibiting growth. Do stock market valuations present good investment opportunities in this emerging growth environment or are they ahead of the game? What does the Fed Rate hike mean for the near-term? Where am I allocating capital in this environment?   Imagining the future.

Executive Summary

Economic growth, inflation and interest rates are on the rise across the globe. Fiscal stimulus is beginning to complement/replace monetary stimulus and the impact is giving us economic green shoots, optimism, expanding employment, increases in production and consumption, and the emergence of rising inflation expectations. These factors, along with a pro-business posture in government, have directed the strong monetary flows that have been in the financial system and channeled them with aggressiveness into the equity markets. The result has been a dramatic rise in the equity indexes since November 2016. This rise has been further fueled by the movement of the retail investor out of money markets and into equity index funds. The monetary fuel and the expectations of a struck fiscal matchstick have ignited this fire, and for many it has been a great ride. For others, there is a sense of having missed the parade which is driving a newly inspired desire to join in and to buy stocks. Per the WSJ, Fund tracker EPFR Global reported record net inflows into equity mutual and Exchange Traded Funds during the week of March 1st, clear evidence of the herd moving in one direction. Jamie Diamond of JP Morgan was recently reported to have stated that the animal spirits are back and in play. I wonder if that is good or bad.

A contrary observation to the above is the ratio of company executives buying shares to those selling shares in their own companies. This ratio has slumped to a 29-year low as selling overwhelms buying. That observation more or less aligns with my personal activity in the market. I am not joining the buying parade, for while the reasons for the powerful move higher have substance, the regime of the market in terms of over-valuation, weakening market internals, and the move towards tightening of monetary policy present a real reason to be cautious and conservative until a better entry point appears. That summarizes my current approach.

The Economy



We are witnessing for the first time in a long time a global improvement in economic activity. This improvement is feeding optimism among business executives and consumers. This is critical if we are to realize continued economic growth. Expectations about the future are vital to the re-enforcing feedback loop that builds momentum in further positive behavior and removes the conservatism of the past. These are key elements for sustained growth. It is still early in the U.S., Japan, and Europe so it is important to keep in mind that this emerging confidence is fragile, but it does feel good to be able to embrace a growing sense of coordinated economic expansion.

In China, there may be a bit too much enthusiasm in the housing sector and the government is tightening access to credit. For example, the value of homes sold in January and February of 2017, rose 23% compared to the prior year. Financing this activity saw 45% of new loans in China going to the property sector. This is a very heated market and the potential overbuild is real as unsold inventory of homes is expanding for the first time since March 2016. Couple this with tightening access to credit and China may truly be caught in a contracting growth story for 2017 in a way that the market does not yet reflect.

Focusing on the United States, the above chart measures annual growth rates in various U.S. economic categories. The recent improvement is in key areas such as housing, manufacturing, lending, and business sales. Of particular note in the Manufacturing sector are the increase in New Orders which were up for the sixth month out of the last seven and Shipments which were up in ten of the last eleven months. Data is soft in the domestic automobile industry and bears watching. This general overall upturn has provided a positive backdrop to the business friendly political atmosphere that the new U.S. Administration holds. Couple these economic friendly observations with the liquidity fuel from easy monetary policies that have been a key to the past stimulus efforts, and the explosion in equity values is truly not a surprise. Accompanying this rise in economic optimism is the forward expectation of greater inflation. Inflation is expanding in individual product and service categories, as well as in a broad based global geographic sense (while relatively low, inflation readings are upward trending in the USA, Canada, China, Germany, Japan, France, the UK, Italy and others). It will pay to watch this closely. One other note that deserves to be mentioned is the observation of the two soft data points within the bevy of economic statistics provided by the U.S. Census Bureau. In the Service side of the US economy, while expansion was present in almost every statistic, there was a quarter over quarter decline in Transportation revenues (Air, Ocean, and Truck). Freight rail car loadings are slowing, and a particular decline was evident in the lumber and wood products sector, which may point to a softening in US new housing development. Keep an eye on this.

With no desire to dampen the enthusiasm, there is a note of real caution that should be considered in this discussion. That caution is the level of debt within the global system at the start of a positive economic cycle. This high level of debt may curtail and even hamper further growth. If we see signs of slowing in the future, the negative impact on equity values could be dramatic. To drive this point home, the OECD (Organization for Economic Cooperation and Development) released their latest global economic forecast on March 7, 2017. Their report projects modest global economic growth and increased confidence, with significant risks from high corporate debt levels, rising non-performing loans, and vulnerabilities to external shocks. At this juncture, the words of caution are highlighted in this quote from the report "Confidence has improved, but consumption, investment, trade and productivity are far from strong, with growth slow by past norms".

Additionally, the pressure on interest rates in an expanding economic environment is also problematic to the cost of capital and in the allocation of resources to service debt. With debt levels at record levels, both at a consumer and governmental level, a focus on continued growth and sustainability of growth is of the highest importance to the proper allocation of investment resources. To make the point on debt levels, it is worth noting the level of consumer debt. Looking at the Federal Reserve report from February 2017, we find that consumer debt has risen to $12.6 trillion, roughly equal to the peak we hit in the 3rd quarter of 2008. That is troublesome, particularly in a rising interest rate environment. The Fed's decision on Wednesday to raise the Fed Funds rate by .25%, and to forecast two more rate rises in 2017, is not only a challenge for the credit markets but also will present a challenge to the consumer. One last point of concern here is the level of debt pertaining to autos. The year 2016 proved to be the highest auto loan origination year in the 18-year history of the Federal Reserve tracking this data. I am concerned, for debt poses a limit on growth when it is too high, and it is too high.

The Equity Market

When writing about the overall equity market and individual companies within the market, I take a macro and a micro view to help make sense of what I see. The macro view focuses on the broad stock market, looking at its current position against history and the trends that are evident from its recent behavior. This view is also heavily reliant on three factors: the market's technical signals, the market's fundamental attributes that speak to relative value, and the tone of the market in terms of its participants' psychology. This perspective provides me with a broad directional sense of where the market is tracking and the tools to form an opinion on its momentum and staying power. It impacts the degree to which risk is weighted in actions under consideration.

The micro view focuses on a unique portfolio of equities that I created to specifically track the performance of companies that were and are of interest to me. This portfolio consists of 187 companies that range in value from small cap to large cap. The breadth of industries is such that a window to the broader economic strength or weakness of the overall economy is possible from analyzing this portfolio. In addition to the overall assessment, this portfolio permits me to weigh the attractiveness of each company against the overall portfolio and against each company within the portfolio. The filters that I utilize and the weighing of attributes are all proprietary and yield for me the basis from which to buy, sell or hold the investments that comprise my investing and trading efforts.

The Macro view:

The current equity market in the United States is presently at an historic extreme valuation. It would take a greater than 20% decline to return the market to its mean valuation metrics. This high valuation level has been present for the better part of 2016 and into the early part of 2017. This **fundamental condition** as part of the three-part factor assessment offered and offers a signal to pause in committing new capital to equities. However, for most of 2016 and the early part of 2017, the **technical factors** of the market indicated strength and a level of upward participation that was broad, presenting a tide one did not want to swim against. So the first two factors were in conflict for most of 2016 into 2017.

The **tone of the market**, the third leg of the factor tool, which reflects the psychology of the market's participants showed comfort, knowing there existed the backing of an easy monetary policy and a low cost of capital. This low interest rate environment became the trump card (no pun intended). Re-enforcing this policy across the Global Central Banks was further evidenced after the G-20 meeting in Shanghai, China that took place in February 2016. If you remember, at that time the equity markets were in freefall, and after the meeting the markets rebounded and never looked back as they advanced consistently up to today.

Today, that chapter in the market's history is past and a new chapter is to be written. There is a new G-20 meeting this weekend, and the consensus that will emerge will be critical. I will not predict how this meeting will evolve, or bet on a particular path, but the world is now more attuned with a tighter monetary policy given economic strength that is emerging and the desire to slow the acceleration of debt creation and budding inflation. This alone should give a reason to reassess current capital allocations and to give greater weight to the messaging coming from the three factors.

What are the three factors messaging today? They are more in concert. Fundamentals remain stretched to the upside. Technicals have switched from being indicators of higher prices to now being indicators of lower prices. The tone is more uncertain, and like a cat on a hot tin roof, is jumpy with the changing landscape. With these factors lining up the result is a very bright yellow line, and for me it is actually a red line as I expect a meaningful fall in equity values. This is contrary to investor sentiment readings that are extremely bullish and to the flow of funds into Exchange Traded Equity funds. Something has to give at some point.

What are those Macro details that are the foundation of the above three factors? They are as follows:

Fundamental measures provide context as to where the market is valued at a point in time. On a relative and absolute basis is the market 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 March 16, 2017. I come to that conclusion based on the following:

1. One of the attractive features of owning stocks is the dividend stream of payments that a holder may receive. The strength of the attraction is very much a function of the dividend yield based on the price of the stock and the alternative cash streams available from interest payments realized by buying bonds. This comparison is quickly assessed from looking at the markets Current Interest Yield Gap. That Gap is presently 1.29%, which means on average the interest rate on bonds is 1.29% points higher than the dividend yield on stocks. Historically, that is a modest spread, for the long-term average difference is 2.42%. Of note here is the trend since December 2015, where we touched a low of .39% and now sit at the recent high, a message that the return from bonds is getting better as compared to the dividend returns from owning stocks. Pension and Institutional buyers of income producing assets pay close attention to this relationship and will reallocate funds away from equities to bonds as the spread grows.
2. The Price Earnings ratio of the S&P 500 is above 26 times. This tells us that on average, a company producing $1 in earnings has a stock price of $26. This is a very high relationship based on historic standards. The historic average is in the 15 to 16 times range. There are times when the future earning potential is so great that the price paid today should be high when compared to current earnings because of the anticipation of rapid and large growth in the future. Unfortunately, the forecasts in the market for earning growth for the S&P 500 basket of stocks shows insufficient growth at this time, and in fact the growth forecast for 2017 and 2018 are being reduced week in and week out as the year 2017 unfolds. The trend here is not supportive of current stock prices. In late 2016, the forecast for 2017 earnings showed a 14% growth over 2016. Today that growth rate has been reduced to 11%.
3. The strength or weakness of the U.S. Dollar is important to earnings of U.S. companies and to the ebb and flow of trade into and out of the United States. A very strong dollar tends to slow exports as goods priced in US dollars become more expensive to foreign trade partners, and for the US company operating in foreign markets and pricing their goods in local currencies, the foreign exchange impact of converting those foreign sales to US dollar based financial statements results in lower US dollar revenues and earnings due to the unfavorable strength of the US

Dollar vs the local sales currencies. Today the U.S. Dollar is 6.6% higher in value then it was a year ago. This poses a risk to foreign sales and to earnings comparisons between the years.

4. Money Supply growth in the United States has been steady and somewhat robust over the past years. This was reflective of the Federal Reserve's policies to ensure ample liquidity was in the financial system to encourage investment and growth. As the Fed's policy moves from easing to tightening, a decline in the money supply measure will typically dampen the level of investment. On average, the quarterly growth in the M2 money supply has been roughly 2% per quarter (8.25% per year) for the past ten years. I point this out as the growth over the past 12 weeks is now running at 0.7%. 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 have become very unfavorable in terms of supporting a continued advance in the price of stocks. This statement is made when the collection of underlying market attributes indicates a lack of support for the direction of the price of the market. This lack of support became visible during the latter part of January and has continued through today. What are the technical measures that cause me to make the above statement? They are as follows:

1. The number of companies whose stock price is rising vs falling each day and each week has been negative. On a weekly basis for the NYSE 1,750 more stocks went down in price then rose for the week ended March 10th. For the week ended March 3rd, down stocks led up stocks by 200 issues on the NYSE during a week when the S&P 500 index rose by 16 points to a new all-time weekly closing high. On a daily basis, the underlying turbulence is even more troublesome. For example, since January 31, 2017, the Dow Jones Industrial Average has advanced by approximately 1,000 points to get to the closing price on March 14, 2017. During this time-frame there has been no net increase in the cumulative measure of stocks advancing vs declining. The market internals of advancing stocks over declining stocks has made no progress while the DJIA has increased by 13.25%. A clear disconnect and a sign of the lack of broad based support for the index point gain.
2. Coupling the information embodied in the number of stocks advancing in price vs declining is the trend in companies making new 52 week highs in price vs new lows in price. Again, we find a deterioration that is counter to the index point move up in prices. On a weekly basis, net new highs for the NYSE reached a positive 457 companies for the week ended January 27, 2017. Since that date through last Friday, the DJIA is up 900 points and the S&P 500 is up 80 points, yet the net new highs and lows for the week ended March 10, 2017 showed a negative 7, with 162 new highs and 169 new lows. There is an underlying turn to the downside in the market that has not yet shown itself in the Index averages.
3. The trend of the indexes is an area I try to be very sensitive to. The market is an objective yet emotional indicator. The ebb and flow over time is a reality that history has validated time and time again. Believing this, I look to DJIA and the NASDAQ for trend length and trend change dynamics. To do this, I set 3% as a meaningful indicator of trend stability or trend change. When there is a change in the market direction by 3% or more, I view this as a new trend pattern and based on that track the length of the trend and the magnitude of the change in the index over the new trend period. Historically, when in an uptrend the DJIA has averaged a positive return of 9.2% that trends for 9 weeks before a 3% reversal to the downside occurs. For the NASDAQ the historic average return is 12.6% that trends for 11 weeks before a 3% reversal to the downside occurs. Presently, we reached a new high in both the DJIA and the NASDAQ on March 3, 2017. As of that date, the DJIA was up 16.31% over 17 weeks and the NASDAQ was up 15.41% over 17 weeks. Both of these trend indicators are in the late stages of an advance based on historic averages. In terms of context, since 2004 there are on average 3.5 trend changes in any given year. We are now in week 17, or a third of the way through a year without a trend change. Couple this with the relatively few periods that have had such a percentage and period change and we are in rarified air. For the DJIA the current readings fall outside 92.2% of the historic results. For the NASDAQ the current readings fall outside 86.7% of the historic results.
4. Finally, staying with the theme of trends, the Relative Strength of the equity markets as measured by the point changes in those indexes over time as compared to recent activity provides a sense of momentum and changes in momentum. I look at the

market strength using Oscillators and measures of Standard Deviation. Without getting too bogged down in the details of how these calculations are done, the importance here is that the DJIA, the S&P 500, the NASDAQ, and the Dow Jones Transports are all at inflection points representing the reaching of maximum values with each exhibiting the beginnings of a down trend. They point to markets reaching exhaustion, in need of a break, to find a point of reset to reassess new investment choices.

The Micro View:

The Micro view all starts with the data base 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 purchased, taken private or otherwise become uninteresting they have been replaced by new additions. The changes are infrequent and have not substantially altered the relative ability to make historic comparisons based on treating the portfolio as a single stock.

Today, the fundamental picture presents valuations that are historic. Absent support from the technical indicators and market tone, I would have sold and or shorted many of the high flyers over the past six or so months. The technical and market tone stopped me from making decisions that if acted upon would have resulted in losses. As discussed above, it is my opinion that the market technicals and tone are changing and this now puts these extended fundamentals in play as I weigh decisions on how to maximize my returns.

The Micro fundamental indicators are as follows:

1. Of the 187 companies, 100 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. Today, and over the past two months, as many as 106 companies have crossed this threshold, setting new overpriced records for the overall 187portfolio.
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 23.52 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 growth in later years and 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 2017 of 14.45%. Projecting this level of cash flow at current prices produces a price multiple of cash flow of 20.56 times which is still above the historic average of 17.3. Think about that. What must go right to get a 14.45% growth in cash flow in 2018 on top of the growth projected in 2017? Keep in mind that this 2018 growth comes off of a cash flow decline in 2016 of 2.7%, and a forecasted growth of 10% for 2017. It would seem that the current valuations assume no 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 of 8.68%. This is below the single year projection for 2017 and 2018, and in fact is lower than any 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 $28.61. In the current environment, the VL composite price is $20.37 above the current price. The implication is that current prices do not offer the future appreciation that justifies the risk of investing at today's prices.
6. Often the overall price of the portfolio may be moving based on a few large movers versus the overall portfolio. For example, there were times when the FANG stocks were all in vogue (Facebook, Amazon, Netflix, and Google), and the portfolio would rise in price even though other stocks were not participating in the price increases. To judge this I look to see what percentage of the portfolio is rising and declining in price from the prior year end. Throughout January and February 2017, on average

25% of the companies were down in price compared to December 31, 2016. Presently, that number has increased to 33%, and this is when the market is close to all-time highs. Underneath the surface, this is troubling. Couple this with the fact that of the individual company projections received since January 1, 2017, 37.6% of the companies are showing a year-over-year decline in cash flow per share. The level of caution for a market move to the downside must be increased in this type of environment.

Investment Categories

My investing activity revolves around a portfolio that includes cash, equities, foreign exchange, commodities, and precious metals. I utilize direct purchases of equities and some commodities, and I am also active in the futures and option markets. I do at times allocate capital to fixed income funds, but rarely invest in specific bond issues. 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: I have been reducing my equity ownership level over the past three months, selling into strength with the hope that I will be able to repurchase shares at lower prices.
3. Foreign exchange: Long-term trends in currency relationships have been historically reliable. However, the Central Bank monetary activism and the publicly stated preferences of politicians have made FX a very volatile arena. The US dollar has been strong over the past year, but that is more of a view that compares single points in time. If one looks at the comparison of the current 52-week average U.S. dollar value to the prior 52 week average, we find that the difference between the two is only 0.08%. Neither strengthening or weakening. For me it is best to be on the sideline here unless some truly opportunistic moment emerges, such as last June when Brexit occurred. 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 it. Bitcoin serves that purpose for me.
4. Commodities: Trending patterns is the rule that governs my involvement here. Looking for moments when trends change and news supports the change is important. For example, there has been a stalemate in the shipment of Cocoa out of Africa due to local levies placed by the government. The price of Cocoa had fallen to recent multi-year lows. It seemed to me that the supply and demand equation would push cocoa higher, and so I took a small position. I was rewarded for paying attention to this commodity.
5. Precious Metals: I have never been a big fan of investing in Gold and Silver. Non-productive assets that do not pay a dividend has kept me away. However, the dramatic rise in global debt since the 2008 financial crisis has caused me to rethink that stance. I view ownership of Precious Metals as a safety source for the preservation of capital, and in the debt laden environment we are in, a certain level of PMs is a nice compliment to my asset mix. I also take a bit more risk here by investing in the equities of certain PM Mining companies, as these move in price at a multiple of the physical commodity. This is a double-edged sword, for the ride up is dramatic but the ride down can be very painful. Caution governs my actions here, and a focus on miners in friendly geographies is a good rule of thumb.

CFA Portfolio Allocations and possible future actions

My current asset mix, given all of the above reflects 27% in equities, 21% in Precious Metals, 1% in Bitcoin and 51% 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. Diamond Offshore
2. Oxford Industries
3. Tesoro Corp
4. Antero Resources
5. Golar LNG or Cheniere Energy

From the sale or short side:

1. Amazon
2. Netflix
3. Nvidia
4. Rockwell Automation
5. Thomson Reuters

As to foreign equities, I own and continue to monitor the Chinese company TenCent Holdings.

In regard to Commodities, my attention has been on Cocoa, Gold and Silver. In regard to Gold and Silver Mining companies, I own and watch closely the companies New Gold, Gold Corp., and Hecla Mining.

In regard to FX, my attention is focused on Bitcoin (may lighten-up position), and on potentially shorting the U.S. dollar.

Imagining the Future

Investing for the long-term should involve using our imagination to dream about the potential of tomorrow.

Technology has dramatically changed the lives of all of us. That change continues to happen and is doing so in a more and more accelerated manner. Change is often disrupting, even painful for some, and it does make us vulnerable to that feeling of longing for the past, for a time when our lives felt more certain, more predictable. This longing may cause us to embrace views and politics that promise a return to better times, but in all likelihood, there will be no return. Technology marches on, and with it the walls of isolation crumble as the world gets smaller and the reach of ideas from all parts of the globe bring faster and faster change.

I see a world of tomorrow where we will battle resistance in order to enable seamless and easy movement of trade, commerce, currency, people and less borders rather than more. In that, the opportunity for investments in those companies that are positioning themselves for this world is paramount. Companies like Alphabet, Amazon, Microsoft, and a host of new emerging companies will be important leaders in the future. That is not to say I would buy them today at current prices, but it is to say that my judgement of what investment to make for the long-term will have a filter that seeks an answer to the question of "where will you be in a borderless world of frictionless commerce and a global currency". Assessing new long-term investments against that thought should be fun............and maybe leave my children with something to treasure and enjoy long after I am too old to write this monthly missive.

Stay Safe.

Tom

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