The Connolly Financial Advisors Monthly Economic & Market Report

Being nimble in a dynamic world

Economies across the globe are exhibiting growth, with the EuroRegion accelerating. What are U.S. stock market valuations telling us about growth expectations? To use an Alan Greenspan expression, do we have "irrational exuberance"? Is inflation the next big thing? How should capital be allocated in this environment? Imagining the future looks at the the risk from under-funded pensions and other obligations.

Executive Summary

The headlines that make the most sense for me to highlight are twofold: (1) Where is the growth needed to justify the current equity market valuations going to come from, and; (2) Inflation is revving up and appears to be getting ready to speed down the tracks, and no one seems to be pricing in the slowness of the Central Banks to act and the upcoming speed with which they will act once price increases begin to take center-stage in the discussion of economic risk. There is a boatful load of uncertainty out there, and no one is pricing it into this market.

I have been expecting a significant market decline which has just not played out. The weakness in market internals and the over-valuation of equities observed during the month of August appeared to set the stage for a major bout of selling in September. To my surprise, it simply did not happen. As I look at the market, the economy, and the tone of the market, the right mix for a near-term sell-off has become diluted and no longer appears to be imminent.

The US economy and a majority of the significant global economies are reporting decent economic results, not too fast and not too slow, and while there is nothing to "write home about", modest growth is evident across the board. The U.S. stock market internals were very negative 30 days ago, but rather than follow-through to the downside the internals reversed and advancing issues and advancing volume began to outperform the equity indexes, pointing to a rising market with momentum for September. Interest rates fell during the early part of the month, and towards month-end they staged a reversal and are now back to levels that have been consistent for each quarter-end in 2017. The U.S. dollar has weakened considerably during the second and third quarters and that should help exports and stimulate

a bit of inflationary pricing pressures. This backdrop has caused me to become less pessimistic in the short-term, not because I see buying opportunities but simply because the market does not want to decline and there is enough marginally good news to hold off any material selling pressure.

There are still strong concerns out there, principally stock values are much too high given the growth prospects as currently forecast, and the volume of shares traded is very weak, indicating a lack of broad enthusiasm for stocks at current prices. Couple these market dynamics with the political paralysis in the U.S. and the tensions that exist in the world, and I must conclude that strong sound reasons for a continued equity market advance are lacking. I continue to be heavily weighted toward cash and precious metals in my personal portfolio, and for my client portfolio, less so, but still sizeable.

My investing activity for the nine-months ended September 30, 2017, reveals a gain for the combined client portfolio of 8.4%, and a loss of 1% in my personal portfolio. The loss in my personal portfolio has been driven by my large position in precious metals, the modest short positions I have maintained, and the level of cash at roughly 50% of total assets.

As you read this month's letter, keep in mind my deep concern that a market correction of significance is in the cards. The timing is unknown, but the level of growth needed to justify the equity valuations is not realistic, and as such there will be a re-pricing to the downside once Central Bank policies directed at supporting asset values dissipates and earnings' growth expectations moderate.

Finally, the Future section focuses on the risk from pension obligations that are not supported by available assets and the need for inflation. We are in the queue for the roller-coaster, so buckle up and hold-on.

The Portfolio

The 90 individual securities owned in the combined portfolio of CFALLC and of Thomas J. Connolly as of September 29, 2017, in order of size (with the largest position in U.S. Dollars listed as number 1), are as follows:

Equity Holdings

1. **New Gold Inc**
2. **Twitter**
3. **Amgen**
4. **NY Community Bank Prfd**
5. **JP Morgan**
6. **Merck**
7. **Gold Corp**
8. **Microsoft**
9. **3M**
10. **Chevron**
11. **Hecla Mining**
12. **Pan America Silver**
13. **Biogen**

14 **Time Warner**
15 **General Electric**
16 **Novartis**
17 **Con Ed**
18 **ASA Gold & Precious Metals**
19 **Viacom**
20 **Raytheon**
21 **Brookfield Real Assets**
22 **First Solar Inc**
23 **Zimmer Biomet Holdings**
24 **McDonalds**
25 **Express Scripts**
26 **Ten Cent Holdings**
27 **Wells Fargo**
28 **Yum**
29 **Tetra Technologies**
30 **Alamos Gold Inc**
31 **Exxon Mobil**
32 **Travelers**
33 **Ford**
34 **Norfolk Southern**
35 **Yum China**
36 **Synaptics**
37 **Cheniere Energy**
38 **Pfizer**
39 **BB&T**
40 **Baker Hughes**
41 **Google**
42 **Golar LNG**
43 **Harmony Gold**
44 **GLD**
45 **DBA Food Power shares**
46 **Qualcomm**
47 **XLB SPDR MAT FUND**
48 **DBC Commodities**
49 **Halliburton**
50 **Eastman Chemical**
51 **CISCO**
52 **Hershey**
53 **HDFC Bank**
54 **Anadarko Petroleum**
55 **Ingredion**
56 **Coeur Mining**
57 **Guanhshen Railway Company**
58 **Phillips 66**
59 **China Yuchai International Ltd**
60 **Franco Nevada**
61 **ICIC Bank Limited**
62 **AT&T**
63 **Mathews India Fund**
64 **Disney**
65 **Make MY Trip Ltd**
66 **Union Pacific Railroad**
67 **Bioverativ**
68 **Solar Edge**

69 Reaves Utility Income Fund
70 DJP Bloomberg Comm Index
71 Agnico Eagle Mines Ltd
72 Westinghouse Air Brake Tech
73 Schlumberger
74 iShares India 50 ETF
75 Gilead Sciences
76 iShares Silver Trust
77 CBS
78 Nordic American Tanker
79 Columbia India Infrastructure
80 Fortinet
81 Mahanagar Telephone
82 Nokia
83 Baidu
84 Lowes
85 Rockwell Automation
86 Footlocker
87 UPS
88 Southwest Air
89 American Express
90 Corning Glass

The above is a comprehensive list of all securities that are presently owned, other than Futures positions. Individual client portfolios do not include all of the above securities, as the composition of any single portfolio will inherently be more limited and unique to the risk and reward preferences of each individual client.

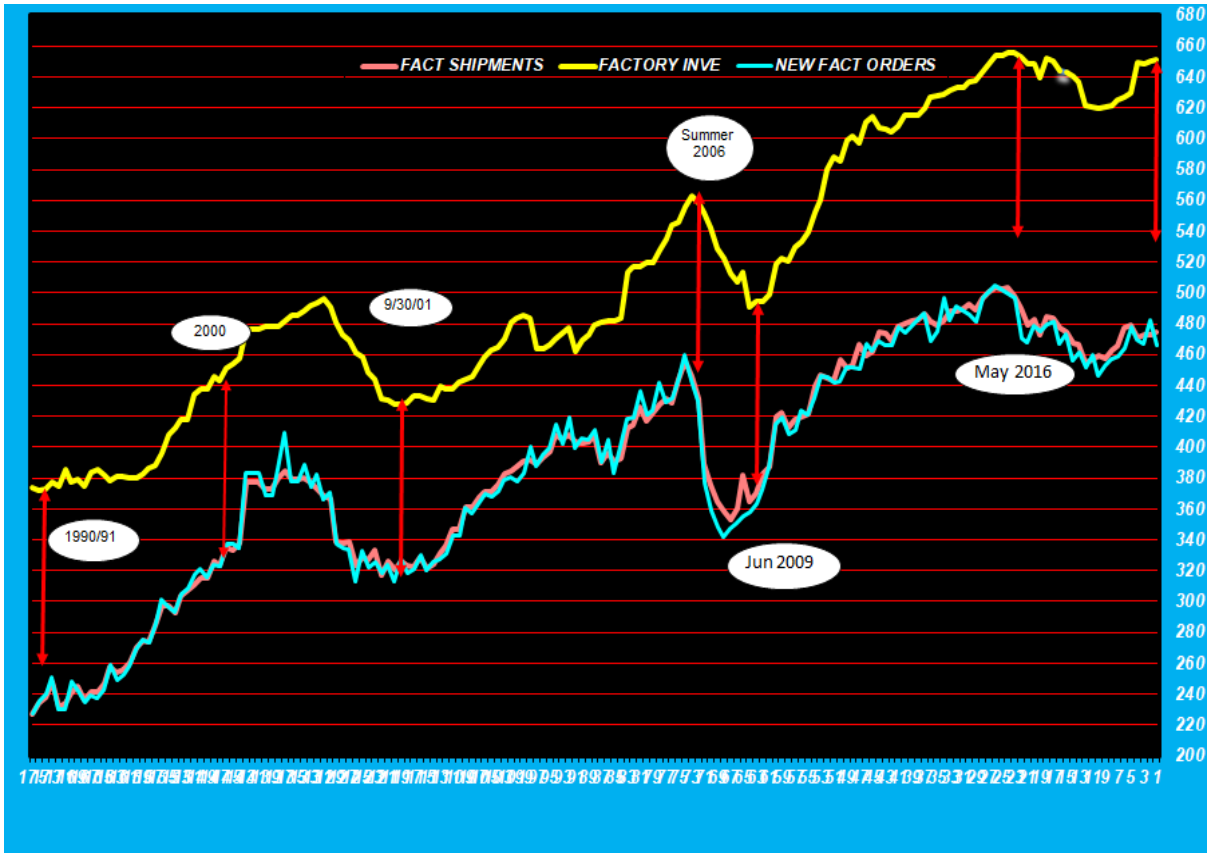
The Economy

The United States economy is expanding at a very moderate rate. While the recent second quarter GDP data release of 3.1% growth was encouraging, it is important to note that some of the major contributors were government spending and inventory build. Given the deficit financing of the U.S. government I am less encouraged by the reported GDP growth. Additionally, the contribution from inventory growth is a double-edged sword, for if future new orders and shipments do not match the growth in inventories, then this positive contribution will turn around and become a negative in subsequent quarters. The NY Fed is showing sensitivity to this in their latest September 29, 2017 release, where they forecast a 4th quarter GDP rate of only 2.0%.

The just released IHS Markit PMI for the United States (October 2, 2017), noted that production rose modestly and new order growth softened. Interestingly, employment expanded at the quickest pace over the past nine months and input prices increased at the fastest pace since December 2012. The Chief Business Economist at IHS noted "…details of the survey are more worrying. Output growth was unchanged from August's 14-month low, and translates into stagnation at best in terms of the official manufacturing output data. Firms' expectations of future output growth also slipped to a four-month low."

My concern for inventory growth is best exhibited by the chart below that shows growth in Factory Inventories (the yellow line) vs growth in Factory Shipments (the flesh colored line)

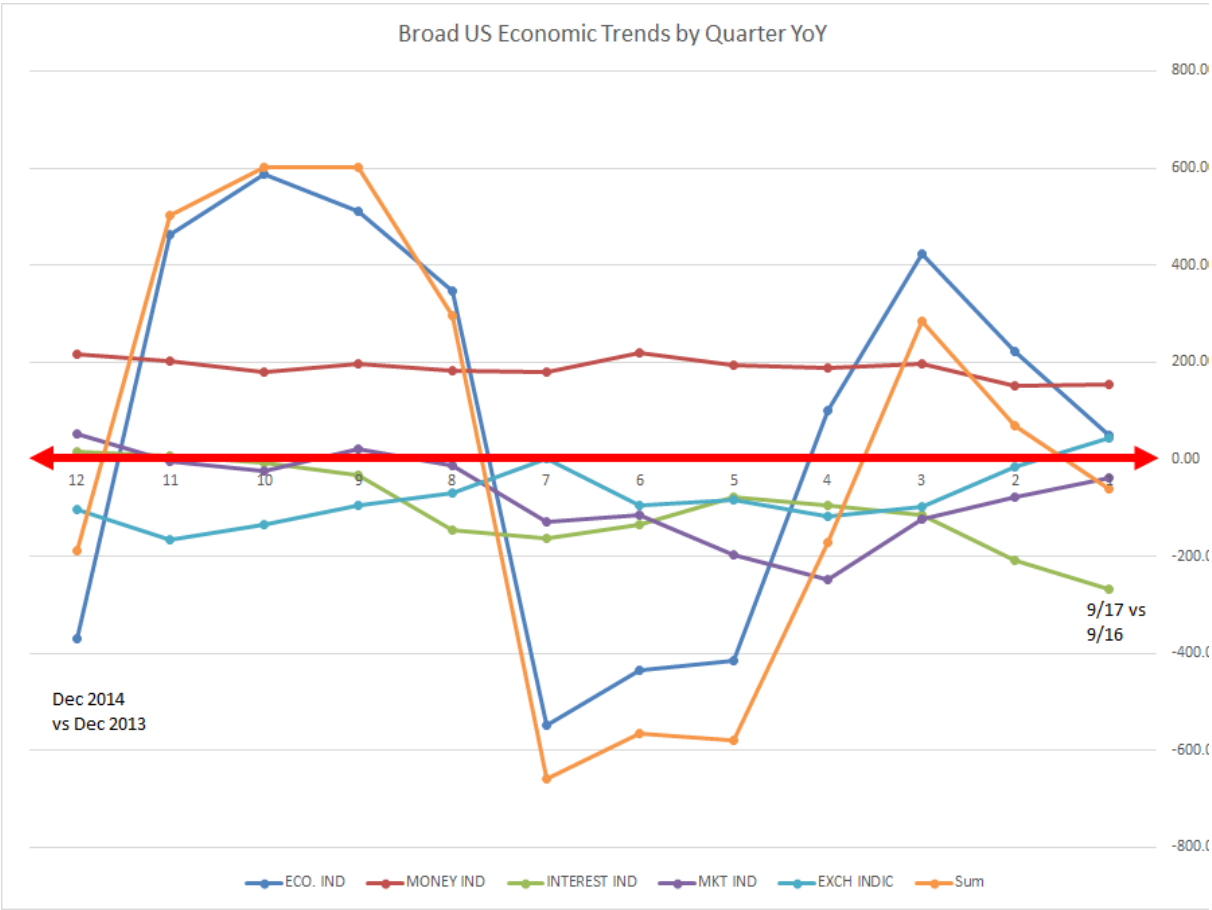
and New Factory Orders (the blue line). Note the spread between the measures as shown by the red arrowed lines. The gap that presently exists is troublesome for it is historically large, and the New Orders have turned lower.



It is very confusing to take the IHS Markit report information and contrast that with the ISM report on U.S. manufacturing (both were released on October 2, 2017). As discussed above, the IHS report is raising come cautionary flags in the U.S., whereas the ISM report is robust in its reporting of growth across the board, with supply constraints pushing pricing higher. How does one reconcile the two reports? I tend to lean toward the IHS report for direction when the two reports diverge. The reason for my bias toward IHS is two-fold: first, it follows the ISM structure and data, but weighs the information in a different way. IHS only measures Private Company data, vs ISM which is influenced by the inclusion of government spending; and IHS weights the importance of data based on reporting entity size/significance to the overall industry vs ISM's equal weighting of respondents reported data. Finally, IHS utilizes a different seasonal adjustment factor that segregates underlying changes in economic conditions from simple seasonal variations, and has shown itself to outperform the seasonal factor used by ISM. For me, I place more emphasis on IHS Markit reporting, and as it covers the world with separate reports on each region of the world (ISM only focuses on the U.S.), it allows for apples to apples comparisons on a worldwide basis.

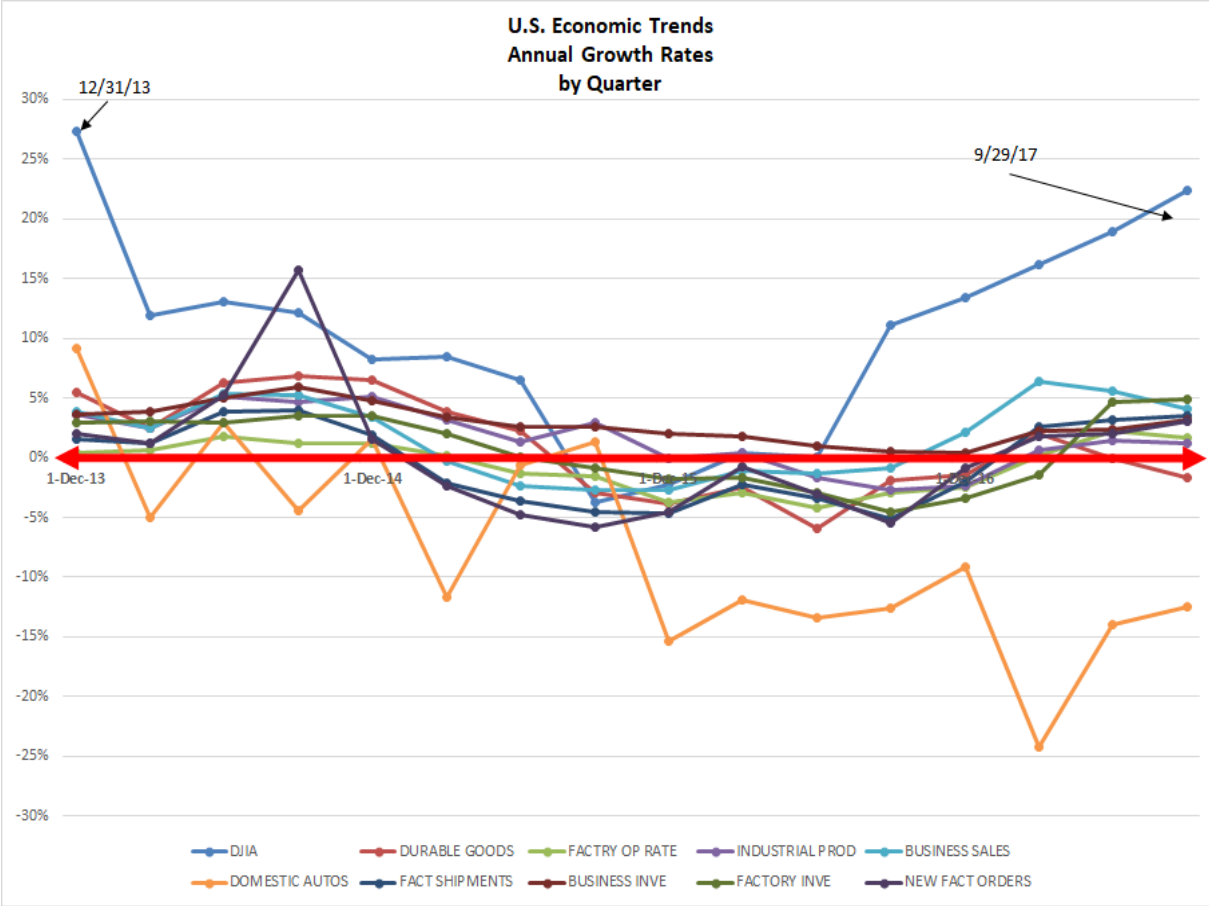
Taking a more broader view of the U.S. economy, my **Laboratory Report,** which utilizes the latest published data across 58 financial metrics, indicates a deceleration is taking place. Whether this persists or not remains to be seen. On a positive note, Japan and Europe are reporting solidly good economic news and that helps the U.S. from an export perspective, but also increases competition in foreign markets. China, Japan, and Europe IHS manufacturing information are presented further down in this section.

The summary picture of the United States based on a composite of the 58 metrics is shown below. It is clear from the chart that the rate of change early into 2017 was on the upswing and peaked in the March 2017 quarter. The deceleration in the key metrics of the Economy, Interest rates, and Money are troublesome as they exhibit two consecutive quarters of slowing. The positive Foreign Exchange metric is helpful and a reflection of the weakness in the U.S. Dollar versus other major currencies, particularly the EURO and the Chinese Yuan.



A more granular look at some of the components contribution to the Economy Summary Metric is revealing. There is a general flattening to a potential decline in many of these sensitive economic categories. Of note, is the inability to rise above the 5% growth level while

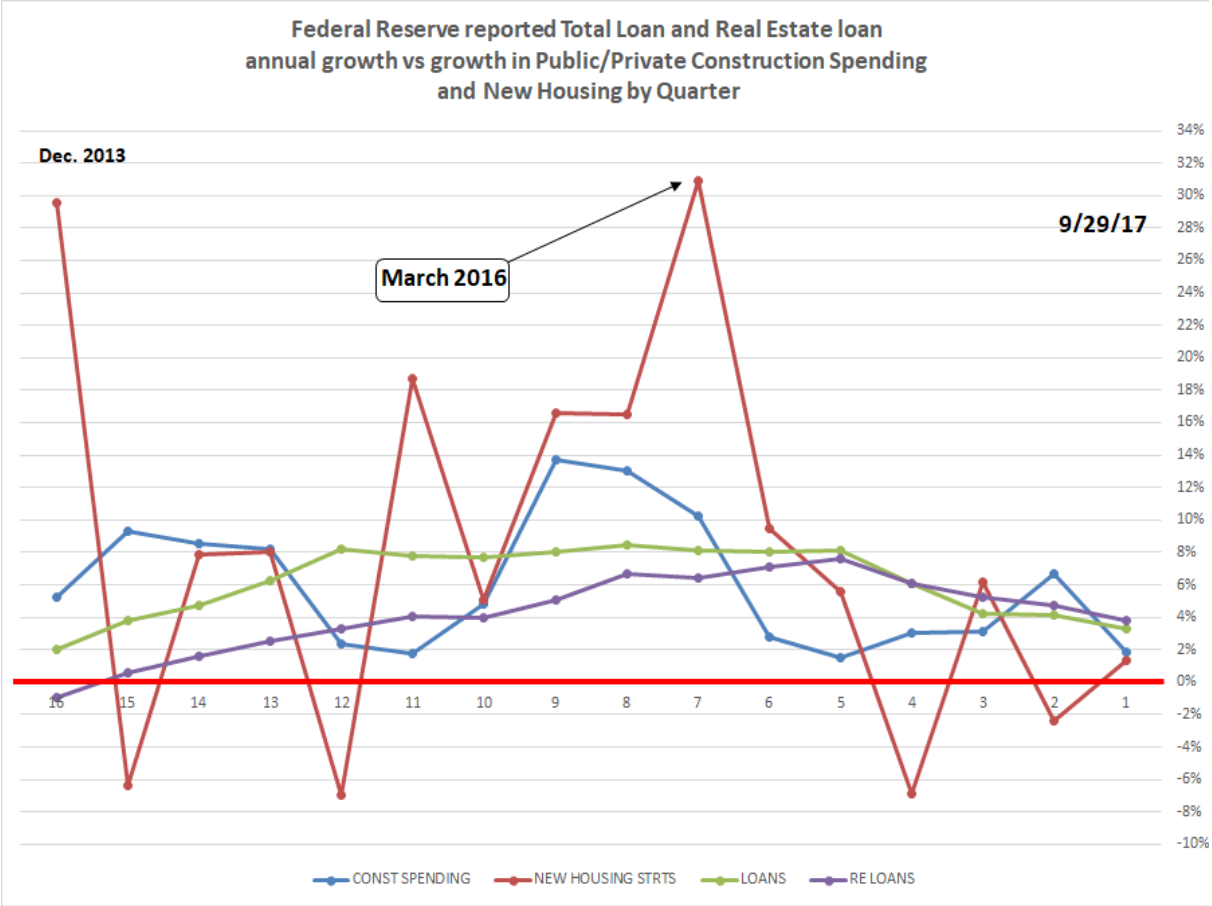
the DJIA Index soars to new highs (along with the S&P 500 and the NASDAQ). Couple this with the dramatic decline in U.S. Domestic Auto sales and it would be wise to temper any over-enthusiasm for acceleration in earnings beyond what has already been forecast (please note that S&P earning forecasts have been coming down and is discussed later in the letter).



Finally, on the U.S. economic front, the growth rate/decline in key public and private construction, new housing starts and the overall loan and real estate loan growth activity is turning to the downside or is negative. We have been a debt driven economy for a long-time, and this decline in the growth in leverage tracks the decline in growth of construction spending and actual decline in New Housing Starts. We need to see this turn upward if we are to see greater expansion in the overall U.S. economy.

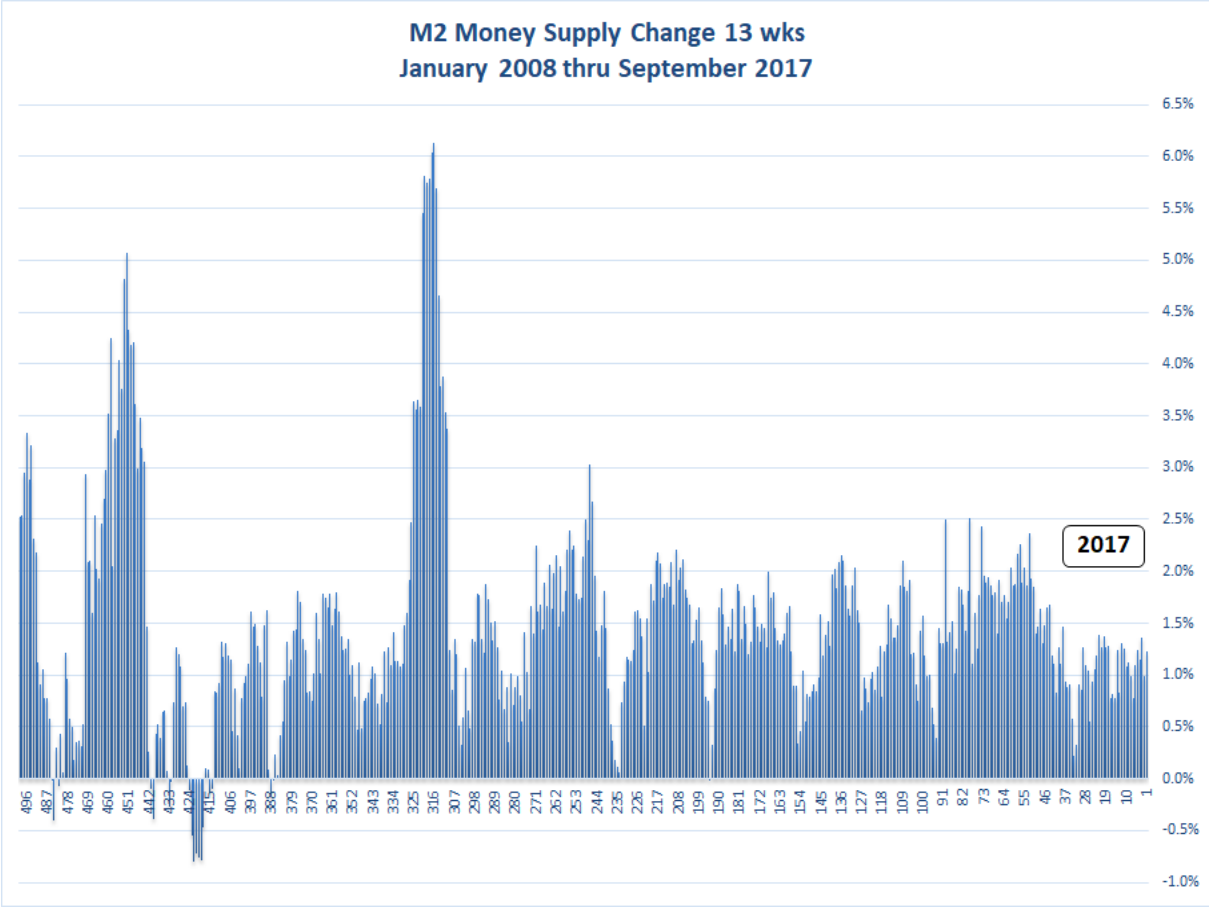
The October 2, 2017 U.S. Census bureau report on Construction spending showed a Y-T-D 4.7% increase over the prior year (+$36 billion, not seasonally adjusted). This was driven by construction in the Residential sector which was up 12.3% (+$38 billion), and reflective of the profit margins on what is the highest New Home selling prices in the history of the United States. While residential construction has grown, it is important to note that Private Manufacturing construction is down 11.6% Y-T-D, Power is down 4.3%, and Roads are down 4.4%. Public construction was down 5.3%, or $10 billion. Overall, take away New Home construction and the new investment in infrastructure is lacking to drive further economic

growth, particularly if lending activity growth is declining and government spending is caught up in deficit battles in Washington.



One consistent theme that is being seen in every report I read, other than what the OECD data shows, is that prices are rising across industries on almost all raw materials. I know for me it is very true in my personal life. For example, my home insurance renewal invoice arrived this month. The annual premium was 16.4% higher than last year. I did not change the policy or file any claims, it was simply a pure price increase. In other areas of my home life, I see property taxes, broadband services, varied subscription based services, and food all rising more than 5% year-over-year. Inflation is alive and well. A single slice of pizza cost me $3.50 last week. New home prices are now greater than they were in 2007. With rising prices evident and more anticipated, I must ask, where is the income growth to meet the rising expense growth? From my vantage point, U.S. household incomes have just recovered to the level that existed in the year 2000. Leverage and Central Bank Quantitative easing have fueled price increases, but the flow-through to incomes is generally lagging, and with the CBs reducing their monetary accommodation, a large and unknown outcome exists, which is what happens when the historic monetary stimulus is no longer there as a support after trillions of dollars have been pumped into the world economies. Present expectations for the Federal Reserve tightening are focusing on a reduction of reinvestment in debt assets over the next twelve months to the tune of $300 billion; split $180 billion in treasury securities and $120 billion in Mortgage Backed Securities.

Continuing with the comments on the Fed, a look at the money supply growth and the velocity of money show tightening that the market has ignored. Consider the downward trajectory of M2 money supply growth over time and the recent inability to break above 2% growth for the past 52 weeks as measured in quarterly change:



This impact of this reduction in growth in the M2 Money Supply is further demonstrated by the loss of momentum in the velocity of money circulating in our economy. Before the 2008/09 financial crisis, the velocity of money was greater than 8X (meaning the M2 Money supply was 8X as large as the Monetary base of the U.S. Banking system). This velocity measure, which indicates how vibrant our economy is running, fell to under 3X as we struggled to exit the global economic slowdown. With the stimulus added by the Central Banks of the world, the velocity improved to close to 4X. That was approximately 40 weeks ago. Since then, velocity has been contracting, and we are presently in the 3.5X range. If we do not see a further acceleration in velocity then the likelihood of a sustained economic expansion is unlikely.

In addition to the US economic data noted above, the IHS Purchasing Manager Index reports for the Eurozone, China and Japan were issued on October 2, 2017. The EURO region report is very positive, the Japan report is generally positive, and the China report is the least enthusiastic of the three. The reports reveal the following:

- **Eurozone:**
  - Stronger output growth and capacity constraints drive job creation to survey-record highs
  - Final Eurozone Manufacturing PMI at 58.1 shows increased growth
  - The Manufacturing Output and New Orders expanded across all nations.
  - Germany and France are at a 77-month highs; Greece is at a 111 month high, and the Netherlands are at a 79 month high.
  - Purchase price inflation is at a five-month high. All of the nations surveyed recorded steeper increases in input costs. Average selling prices rose for the twelfth consecutive month, and at the fastest pace since April 2017.

  The Chief Economist reported "The Eurozone manufacturing boom kicked into an even higher gear in September, with the PMI rising to a level surpassed only once in the past 17 years. Surging order book growth has encouraged manufacturers to take on extra staff at a rate never previously seen in the 20-year history of the PMI survey. The stronger Euro has so far barely dented export growth. With the upturn being accompanied by rising inflationary pressures, expectations of an imminent announcement from the ECB in relation to tapering of policy stimulus will intensify."

- **Japan:**
  - Production and New orders increase at accelerated rates
  - Employment growth weakest since November 2016.
  - Cost pressures intensify. The rate of inflation reached a five-month high.

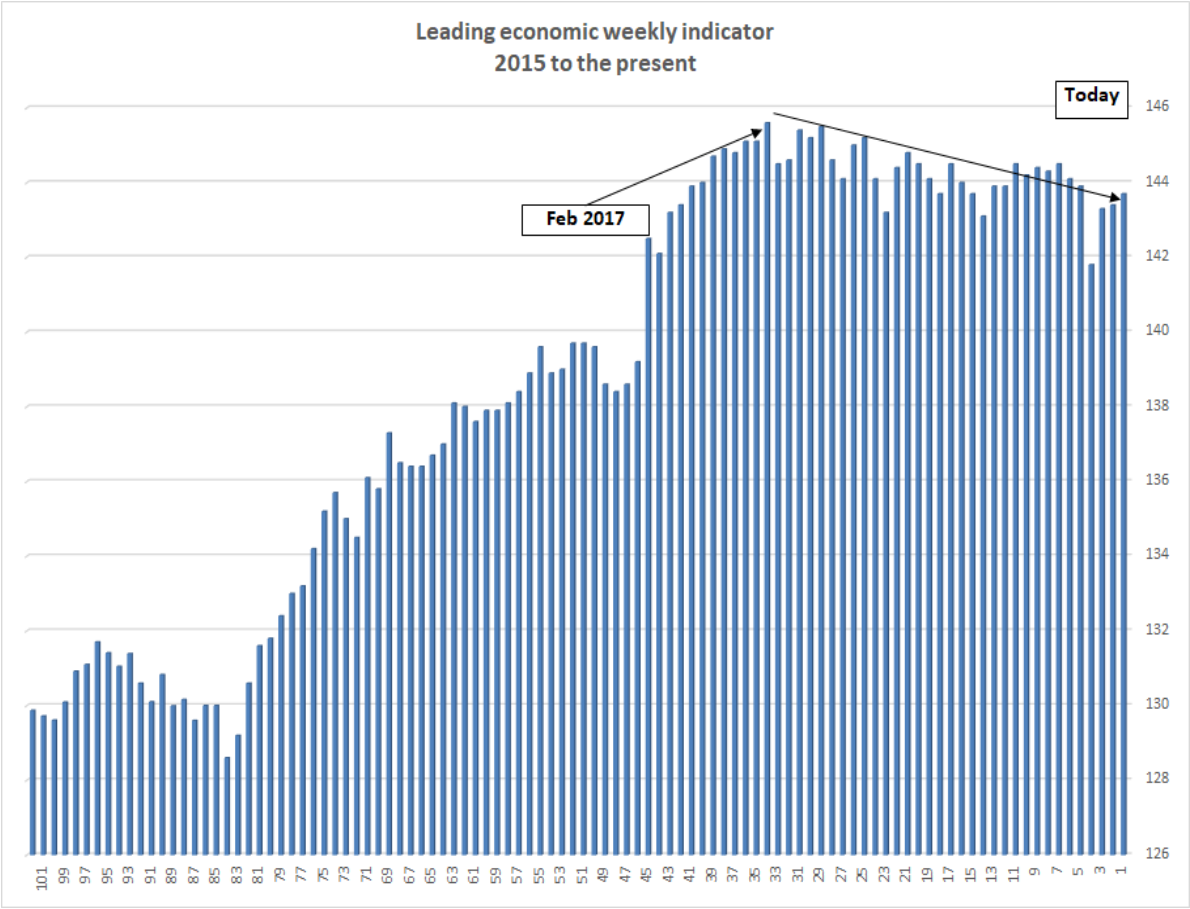
  The Chief Economist reported "September data signaled further improvement to the Japanese manufacturing sector. Stronger international client demand provided a key source of growth, as shown by export sales expanding at the quickest pace in seven months. Data suggests hikes in raw material prices are driving up cost burdens."

- **China:**
  - September data signals weaker increases in output and new orders
  - Manufacturing operating conditions improved marginally
  - Production and new orders expanded at softer rates, with firms signaling slower growth in export sales.
  - Employment continues to decline, marginally
  - Inflationary pressures picked up, with average input costs and output prices both rising sharply

  The Director of Macroeconomic Analysis at the CEBM Group said: "Output prices and input costs increased further, both hitting their highest level seen this year. The Chinese economy was stable in the third quarter, but the outstanding price pressure from upstream industries will be a drag on the continued improvement of companies' profitability."
  An additional point of importance is the downgrade by Standard & Poor's of China's sovereign debt rating this month, the first time it has done so since 1999.

> The IMF warned in August that Beijing's reluctance to rein in borrowing was dangerous. Debt is currently 268% of GDP.

Another indicator of economic softening is 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:



Given the above, I remain hopeful that economic expansion will accelerate in the United States, but the data series that have emerged, although rear-view mirror based, leaves me cautious and hesitant in an environment where market participants are exceptionally enthusiastic in their expectations of higher earnings beyond what has already been forecasted.

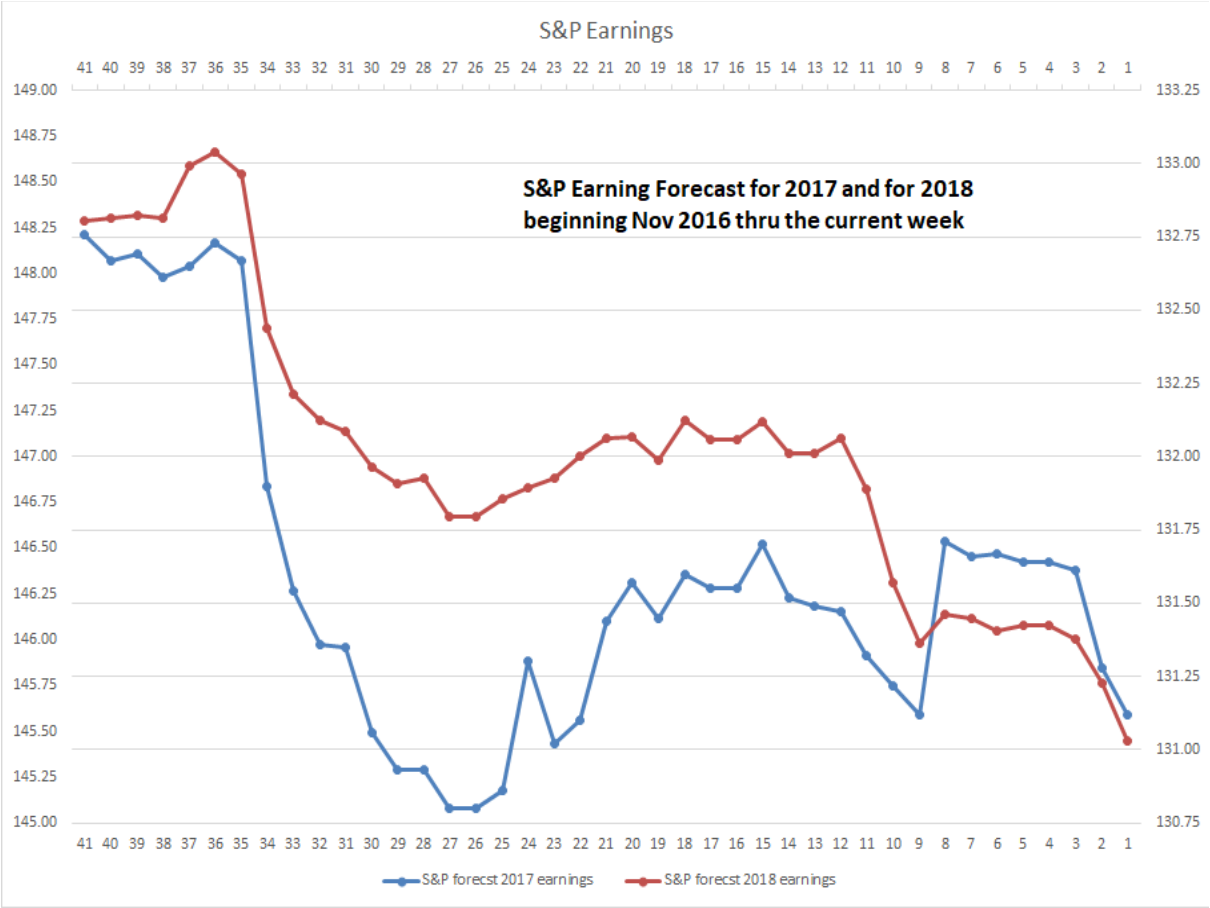
The Equity Market

The Macro view:

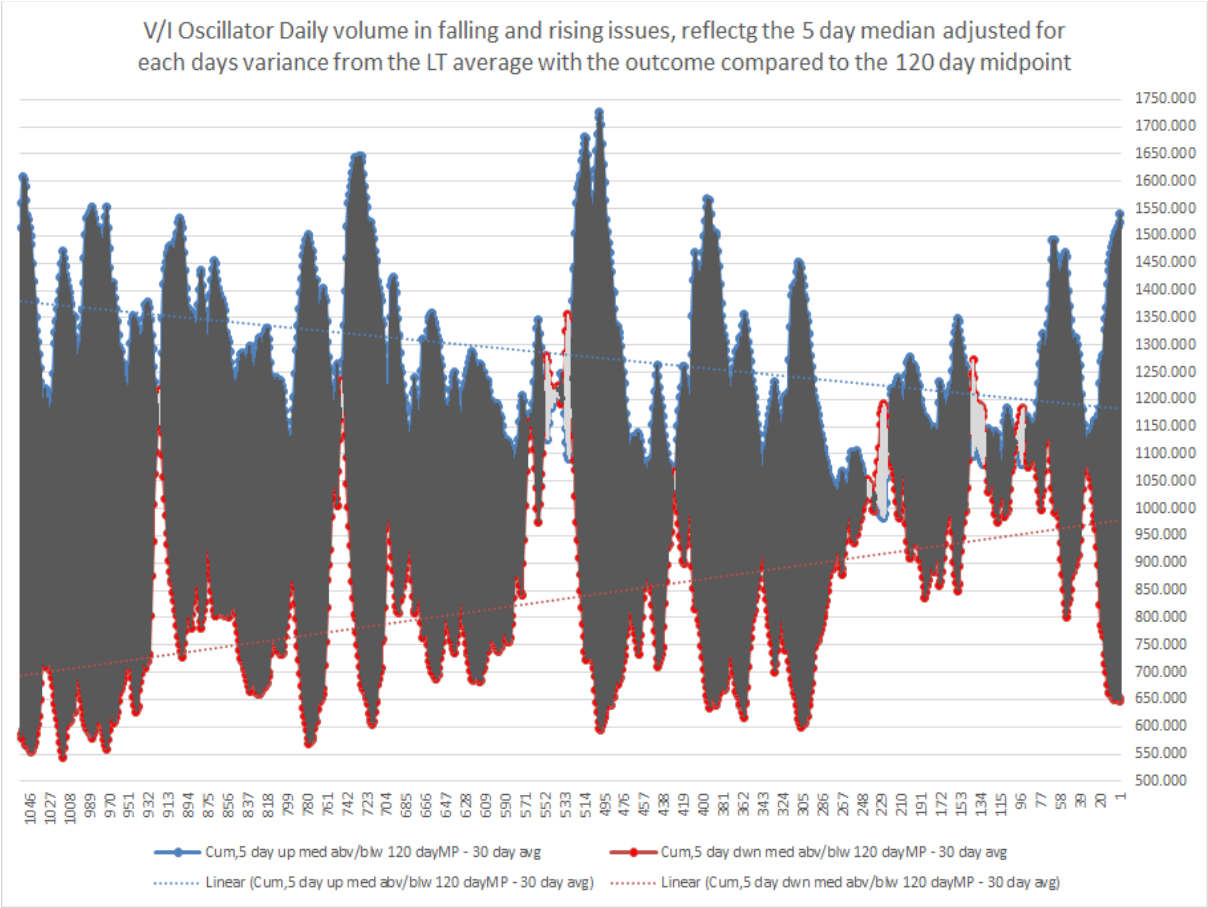
The current equity market in the United States is exceptionally over-valued based on existing cash flow forecasts for 2017 and 2018. At the market close on September 29, 2017, my readings for price as a multiple of 2017's forecasted cashflow per share sat at 24.14X. This is a record high. The price to cash flow multiple based on 2018's forecasted cashflow per share was 21.28X. These measures are significantly above the long-terms medians of 17.7X and 16X, respectively. The cashflow growth rates for 2017 over 2016, and 2018 over 2017, based on current forecasts, reflect 9.84% and 13.41% growth. To bring the price to cashflow multiple back to the historic median level for 2018, the 13.41% growth would have to rise to 24.11%. Think about that. From an investment perspective, given the 10% growth in 2017, how comfortable should you be to pay a price today that assumed a 24% growth rate beyond 2017? Further, the number of stocks trading today at prices above their discounted cash flow values represent roughly 50% of the market. I can come to no other conclusion that fits with the facts, but that the equity market today is grossly overvalued.

What are the three key investment timing factors of Market Fundamentals, underlying Technical support, and Participant Tone messaging today? They are in conflict.

Fundamentals are stretched to what many consider to be the breaking point. Equities have continued to rise in value while earnings and cash flow forecasts have moderated. S&P 500 earning forecasts for 2017 and 2018 hit highs of 132.73 and 148.66, thirty-six weeks ago. Today they are at 131.12 and 145.45, respectively (see chart below). No signs of improvement, and in fact a modest decline, yet stock prices have soared during this period with the S&P 500 index moving from 2,294 on January 27, 2017 to 2,519 on September 29, 2017, a 10% increase. The S&P 500 price to earnings ratio based on 2017 forward earnings was 17.29X in January, and now sits at 19.21X. This high valuation could be more understandable if in addition to growth considerations we had a high dividend yield compensating for the additional price risk. However, the current dividend yield of 1.90% is more aligned with the 2007 market peak where the dividend yield was 1.87%. Buying equities at today's prices does not strike me as prudent investing, and I urge caution in allocating greater capital to the stock market.



The technical attributes are a bit confusing and pose a challenge in realizing solid guidance. As we closed August 2017, there was a marked deterioration in the level of advancing volume and issues, lower new highs, and weak overall volume for 2017. The indicators pointed to a market sell-off. Interestingly, as we entered September the internals started to provide support, with advancing characteristics improving every day. This surprised me and I watched with a very skeptical eye, but throughout the month and now into October the internals continue to point higher (although the last two days (October 2nd and 3rd) are showing some indecision). My key indicator that measures 5-day patterns of internal strength has been strong, and is presented below. It does appear to have peaked and so I am watching it carefully to see if the market has reached a minor or major inflection point.



The one major technical indicator that is forcing me to view the index advances as suspect is overall NYSE volume. Last month I indicated that every month in 2017 had lower volume than the corresponding month in 2016. This has continued in September. To give you an idea of the trend, the 2017 and 2016 data is once again presented below. To further drive home the point, if we look only at the month of September we find that the NYSE volume for 2017, 2016 and 2015 dramatically emphasizes the lack of current participation in a market that is making all-time highs. The September volumes for 2017, 2016 and 2015 are 17.4 trillion, 20.0 trillion, and 21.4 trillion, respectively.

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

	2017	2016
September	17,391	20,007
August	17,557	18,295
July	15,910	17,499
June	21,713	23,579

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

An additional data set that I track covers the fiscal year from October 1 to September 30. I do this to recognize that analysts' estimates for the next calendar year begin to gain attention in the fourth quarter and impact prices and volume based on the next year expectations. Ending the year from a tracking perspective in September eliminates some of the forward-looking bias. I like to compare the DJIA point change for the fiscal year, the supporting net volume for the fiscal year, and the resulting volume per point of change in the DJIA Index. The data for 2017, appears to be an outlier that should not be ignored, as the net positive or advancing volume is low compared to the magnitude of the Index point change.

	DJIA Index change	Net Volume	Volume per Pt
2016/17	4,101	+6.7 trillion	1.6 billion
2015/16	1,974	+7.9 trillion	4.0 billion
2014/15	- 733	- 4.4 trillion	-6.0 billion
2013/14	1,760	+5.7 trillion	3.2 billion
2012/13	1,769	+4.8 trillion	2.7 billion
2011/12	2,799	+8.7 trillion	3.1 billion

The tone of market participants has been very positive. The bullish/bearish sentiment is clearly weighted toward the Bulls. Optimism over accelerating global economic growth is providing a strong backdrop in building confidence in the equity markets.

Globally, the macro-environment tone is more uncertain given the domestic and geo-political dynamics and risks that are increasing. These events are creating concerns that are more external in nature. Optimism about the economy supports a positive tone and increased investing, while the disruptions from North Korea, Spain, Brexit, and the stagnation of the Trump agenda are dismissed. Enthusiasm that climbs a wall of worry works for me, but enthusiasm that starts to ignore the global negatives troubles me. I remain cautious.

The Trend of the equity markets has been challenging and setting historical highs. The DJIA, the Dow Jones Transports, the Dow Jones Utility Average, the S&P 500, the S&P 100,

and the NASDAQ have all reached new highs in 2017, and are at or near them as I write this newsletter. One of the things that surprises me is the longevity of this equity market advance without any form of a price correction. On one level this is a positive as it reflects sustainability of the advance, however the general lack of investor uncertainty or appreciation for and the pricing of changing levels of risk, attributes that should be part of a normal and healthy market where all of the participants are not on one side of the boat, appears to be absent from this market. Consider these two factors:

1. 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 9.3% that trends for 9.6 weeks before a 3% reversal to the downside occurs. For the NASDAQ the historic average return is 12.9% that trends for 11.5 weeks before a 3% reversal to the downside occurs. Presently, we reached a new high in both the DJIA and the NASDAQ on September 29, 2017. As of that date, the DJIA was up 22.87% over 47 straight weeks and the NASDAQ was up 25.82% over the same 47 weeks. In terms of context, since 2004 there are on average 3.5 trend changes in any given year, and we are tracking to not have a single one. This is of great concern to me, for as an Earthquake arises from the build-up of tension, and as a volcano erupts suddenly to relieve the internal pressure, we are in the process of building a market value that has not had any release valve tapped for almost a year. At some point the market will correct this, and the longer we go before that occurs feeds my fear that the correction when it comes will be dramatic and painful.
2. Finally, staying with the theme of trends, the Relative Strength of the equity markets provides a sense of momentum and changes in momentum. The DJIA, the S&P 500, the NASDAQ, and the Dow Jones Transports are all at inflection points. For each, the RS reading is above 70, which points to an over-bought market. Of greater concern is the lack of accumulated downward index points over the past and rolling twelve-week periods. We are now approaching levels that reflect a dearth of down point moves, and this absence of down points which would normally offset some of the strength of the upward move, points to a lack of sustainability of the upward move as it is too biased to the upside to maintain its momentum.

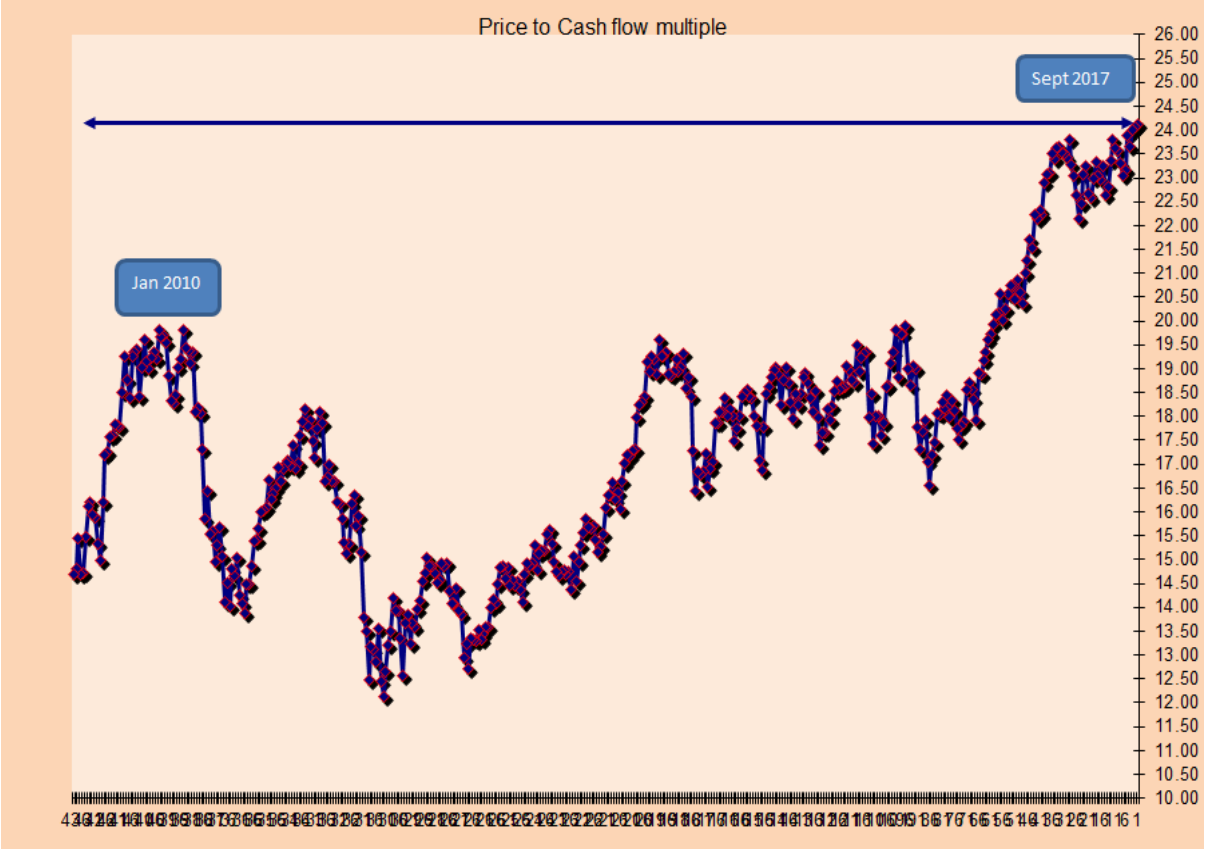
The Micro View:

The Micro view presents details of the 187-Company Portfolio that forms the bedrock of my market and company analysis.

Today, we are at an extreme level of over-valuation. My models indicate a 19% decline in the equity market would be needed to simply realize a reversion to the historic mean based on current earnings and cash flows.

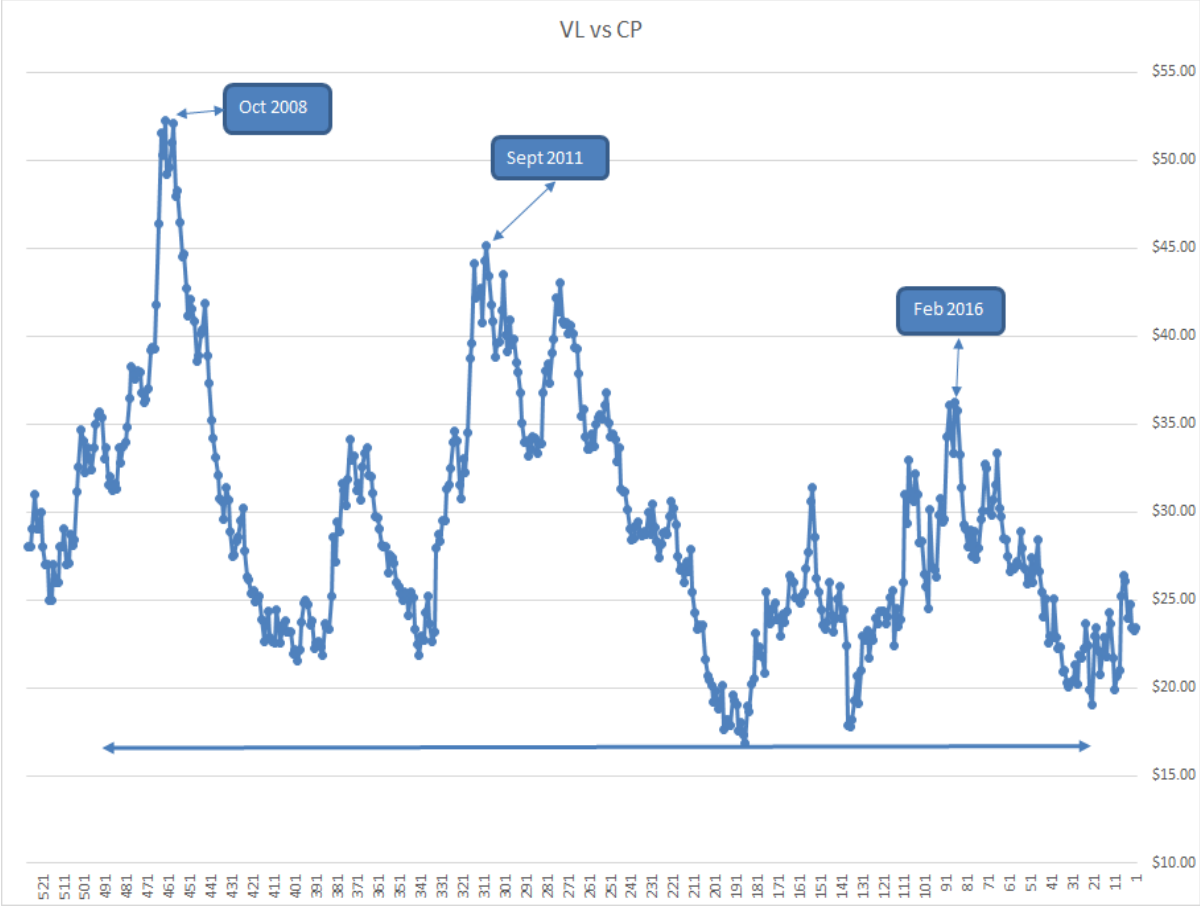
The indicators from the 187-Company Portfolio are as follows:

1. Of the 187 companies, 92 are priced today 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.
2. Assuming the 2018 forecasted cash flow growth is a lock at 13.41% over 2017, and calculating an overall 187-Company Portfolio price based on future cash flows beyond 2018 at a growth rate of 8.91% in cash generated, the 187-Company Portfolio falls short of today's actual pricing by $3.12. This is important as it indicates today's stock prices are only a good investment choice if growth materially exceeds 10% per year for the foreseeable future. In the economic environment we live in, I cannot justify a sustained level of growth north of 10% per year for the next ten years that is assumed in today's stock prices.
3. 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 24.14 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.



4. The measure of cash flow growth for the 187 companies shows a 2018 growth rate over projected 2017 cash flows of 13.41%. Projecting this level of cash flow at current prices produces a price multiple of cash flow of 21.28 times which is still above the historic average of 17.3.
5. As a litmus test, I compared 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 $28.14. In the current environment, the VL composite price is only $23.58 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. The chart below shows that we are close to the low area of price appreciation forecasted by the Value Line Service, providing another source of concern for risking capital in today's equity market.



Investment Categories

My assessment of the current attractiveness of a variety of investment choices is 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 mispricing risk.
2. **Equities:** I am not committing any new investment capital to the equity markets (except for precious metals, and small additions to certain high dividend paying stocks).
3. **Foreign exchange**: I remain on the FX sidelines, absent some opportunistic event.

4. **Crypto-Currencies**: Digital currencies have been a small part of my portfolio since 2015. Bitcoin, Ethereum, and LiteCoin represent my holdings. Bitcoin is currently valued at $4,300 per coin, Ether at $290 per coin, and LiteCoin at $54 per coin. All have experienced gains 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 (China is the most limiting at the moment), and so caution and a willingness to act quickly in both selling and buying is critical to protecting your investment capital.
5. **Commodities:** Trending patterns and relevant economic news govern my involvement here. I utilize various technical tools to time my entry and exit. At present, supply and demand factors favor higher prices in crude oil. The price oscillator indicated a bottom 13 weeks ago, and was very accurate in catching the move higher. It still is heading to the upside, but is approaching an apex that may indicate a decline is near at hand. Cocoa and precious metals round out my focus here. The inflationary pressures that I note this month are setting up Gold and Silver for strong moves. Monitoring CB tightening actions is critical at this juncture. Commodity ETFs are a mainstay of my portfolio in this environment.
6. **Precious Metals**: Gold has rallied nicely this year and recently pulled back from $1,350 per ounce to $1270. Silver is just under $17 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. Inflation is becoming part of the story, and that is new.

CFA Portfolio Allocations and possible future actions

My portfolio's current asset mix, given the above, reflects: 20% in equities, 21% in Precious Metals and Commodities, 2% in Fixed Income, 2% in Bitcoin/Ether/LiteCoin and 55% in cash. The asset mix of all portfolios combined reflect: 35% in equities, 17% in Precious Metals and Commodities, 5% in Fixed Income, 1% in Bitcoin/Ether/LiteCoin and 42% 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. Discovery Communications
2. Cleveland-Cliffs Inc
3. General Electric (I am long this equity)
4. Lam Research
5. Nabors Industries

From the sale or short side:

1. RBC Bearings Inc
2. Netflix
3. Ansys
4. Rockwell Automation (I am long this equity)
5. YELP

As to foreign equities, I own shares in the Chinese company TenCent Holdings and Guangshen Railway Company, in Singapore based China Yuchai International Limited, and I have positions 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.

In regard to Commodities, my attention has been on 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, Franco Nevada, Agnico Eagle Mines, Alamos Gold, Coeur, Harmony, and Hecla Mining.

In regard to currencies, I have closed my FX positions and look to short the EURO and the Chinese Yuan when indicators support this trade. Crypto-currencies remain a highly volatile and unproven asset class. The potential is significant as are the risks. I remain committed to this asset class but trade around a base position given the volatility that is quite dramatic.

Imagining the Future

I normally focus on upbeat investment opportunities that have meaningful future value when writing here. This month I feel compelled to write about the darker side, the Black Swan. That subject is pensions, and the under-funded nature of these obligations. I believe it is a huge issue that does not have a solution that is without pain and economic contraction.

I believe one of the goals of the Central Bank easing was to raise asset prices. Pension plans are a key beneficiary of the equity indexes hitting new highs. Absent the appreciation of asset values, both in the equity and fixed income categories, the under-funded pensions of both public and private institutions would have torn the economy and the social support nets into fragmented pieces. From an asset perspective, they have realized the value they sought. Unfortunately, the recovery or improvement in the under-funded state of retirement plans and other social support plans has not been enough to solve the future issue of economic risk from higher tax burdens and insufficient assets to meet commitments to retirees and those dependent on public support. Consider the chart below from Mercer Analysis that was part of

the World Economic Forum report on pensions. The headlines from that report read as follows:

New York, 26 May 2017 — The world's six largest pension systems will have a joint shortfall of $224 trillion by 2050, imperiling the incomes of future generations and setting the industrialized world up for the biggest pension crisis in history. To alleviate the looming crisis, governments must address the gaps in access to the pensions system and ageing populations as they are the key sources of the widening pension gap. These are the main findings of the new World Economic Forum report.

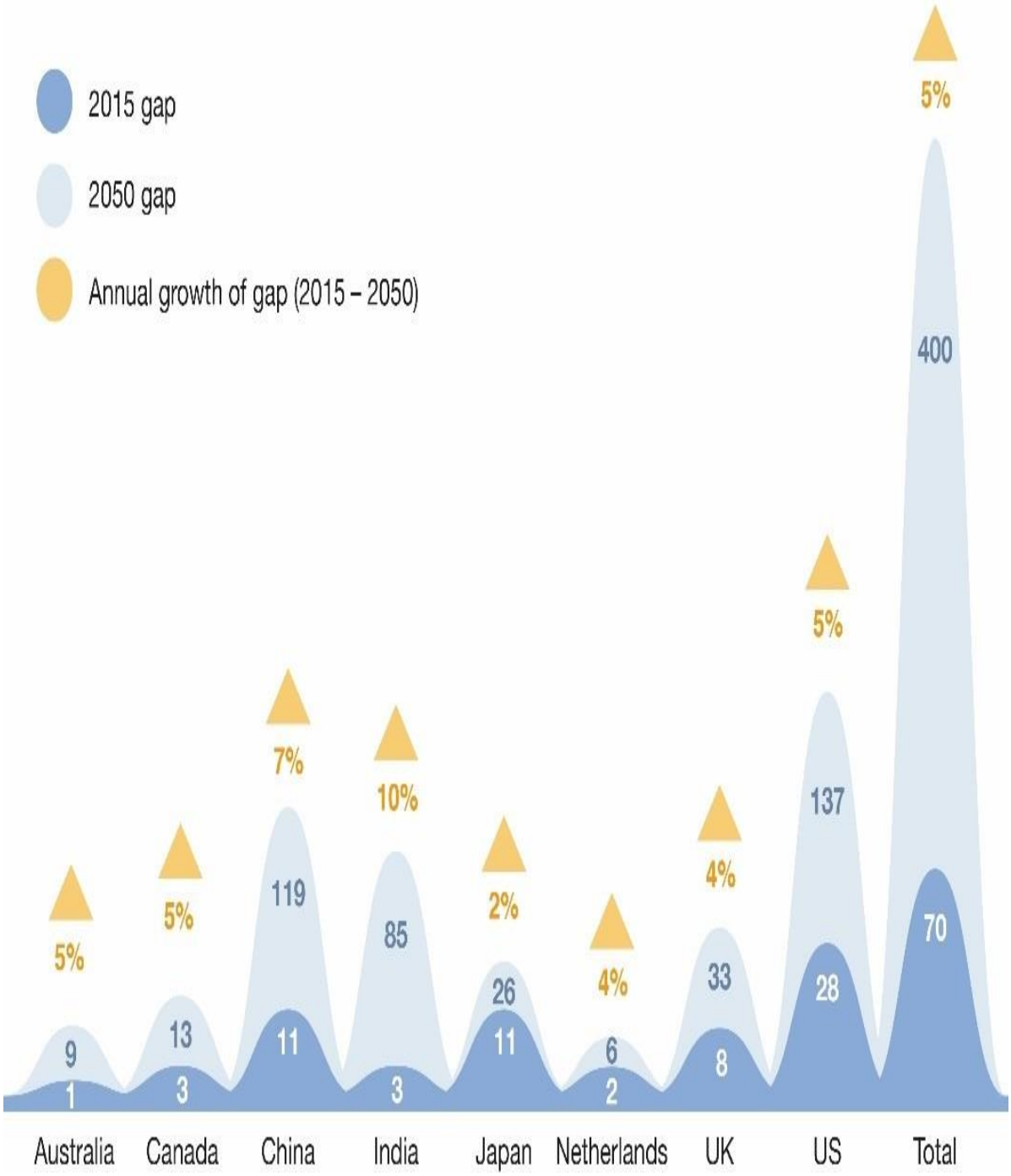
- The world's six largest pension saving systems – the US, UK, Japan, Netherlands, Canada and Australia – are expected to reach a $224 trillion gap by 2050, a new study by the World Economic Forum shows
- Adding in China and India, which have the world's largest populations, the combined savings gap for the eight countries reaches a total of $400 trillion by 2050, a sum five times the size of the current global economy

The savings gap resembles the amount of money required in each country (including contributions from governments, individuals and employers) to provide each person with a retirement income equal to 70% of their pre-retirement income. Outgoings such as personal savings and tax are often reduced in retirement and targeting 70% of pre-retirement income, in line with OECD guidelines, is a crude guide to provide people with a similar standard of living in retirement as they had before retirement.

For low-income earners the 70% target will not be sufficient and could result in poverty unless savings are increased. The funding gap will continue to grow at a rate higher than the expected economic growth rate, often 4%-5% a year, driven in part by ageing population effects: a growing retiree population who are expected to live longer in retirement.

"The retirement savings challenge is at crisis point and the time to act is now," said Jacques Goulet, President, Health & Wealth at Mercer, the lead collaborator for this initiative.

The visual of the present and future under-funded state by major territory and in the aggregate is as follows:



In the United States, the commitments to public workers, such as police, firemen, teachers, etc., will only be honored through large tax increases on property and other assets. The impact of honoring the commitments will be economic contraction in an aging population. The turmoil from not honoring these commitments would be devastating.

There is no magic cure for the current state and future state that is before us. Our debts/obligations are rising across the world. Asset appreciation has been dramatic in 2017, but this appreciation lacks fundamental future investment return to garner new committed capital for expansion. So what is in the cards?

Many steps will need to be taken, but the one dramatic change for which the groundwork has been laid is inflation. Satisfying obligations that are relatively fixed in their calculation as dollars that are reduced in value because of the effect of inflation enables debt to become serviceable as tax collections in nominal dollars rise simply because earnings rise to keep up with inflation. I cannot see any other way to look at the future. Those in positions of economic and political influence know they need inflation, and are doing everything they can to see prices rise. We are now at the point where raw material prices and prices for all goods and services across the world are showing signs of pressure to increase. The genie appears to be leaving the bottle, and with over $13 trillion of Central Bank stimulus having been added to the world since 2008, the ability to slow this train but not stop it will become the focus of the future. If this is correct, then owning assets that rise in inflationary environments will be critical to the protection of your portfolio.

Stay Safe and invest well.

Tom