

## The Titanic Struggle



**Gray Emerson Cardiff, Editor**

The *Sound Advice* Portfolio is up 1.0 percent in 2018. The *Sound Advice* investment returns in prior years have been calculated independently by the Hulbert Financial Group. They are as follows:

From 2000-2017  
**10.54%** Annually vs.  
2.68% from the S&P 500

We published our last issue of *Sound Advice* on Friday, February 2 (called *Caution: Storm Warning*) just as the market was slipping off its peak. We recommended that you should have a substantial amount of cash on the sidelines and wait for a substantial correction in the overall market to restore value to stock prices. Since then, the market has seen some breath-taking downdrafts, with the Dow dropping over 1,000 points in a single day.

Our reasoning for recommending caution came from our *Sound Advice* Risk Indicator (page 10); our *Sound Advice* Diffusion Index of Lagging Indicators (page 11); as well as the lofty level of the S&P 500 index in relation to earnings and revenues of the underlying stocks in the index.

### The Risk Indicator

Our *Sound Advice* Risk Indicator, which measures the struggle for capital between the stock and real estate markets, rose very close to 2.0 in January, revealing a very high-risk time for stocks. There have been only 5 times in the past 100 years that this indicator has risen above 2.0, and it was always prior to major market tops.

### The Diffusion Indexes

While our Risk Indicator detects the seasons that roll across the market's landscape that we call supercycles, the *Sound Advice* Diffusion Indexes of Leading and Lagging Indicators detect the more visible business cycles

that are the storms which we actually perceive as weather -- the bull and bear markets that fluctuate along the path of Supercycles. In January, the *Sound Advice* Diffusion Index of Lagging Indicators switched into a Caution Signal.

### Fully Valued

These scary readings from the *Sound Advice* indicators came at a time when stock prices were very high. The trailing 12 months (TTM) price/earnings (P/E) ratio of the S&P 500 stock index was 21.7 which was in record high territory, well above average, and banking on a 22.5 percent earnings growth rate in 2018.

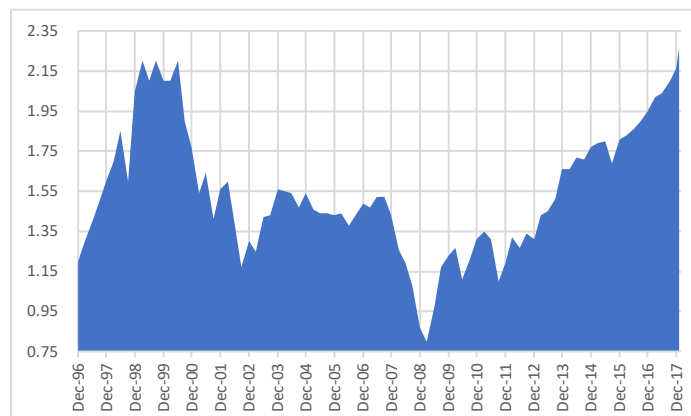
The ratio of the price of the S&P 500 index to the revenue of its underlying companies was also at the lofty level of 2.27, above its peak levels achieved at the top of the bull market in the late 1990s, and considerably higher than the ratio reached in 2006, prior to the peak of the last bull market.

### New Inflationary Trends

Another reason for our caution warning was the growing potential for a lasting rise in the inflation rate. The February 2 robust jobs report showed wages increasing 2.9 percent year-over-year in January, the highest increase since 2009. The 100 percent reading from the *Sound Advice* Diffusion Index of Lagging Indicators confirmed that the US economy was gaining strength, which, as it has in the past, is bound to be a natural upward force on interest rates and bond yields.

In mid-February, the Commerce Department reported that the Consumer Price Index, a key indicator of inflation trends, jumped 0.5 percent in January, well above

### S&P 500 Price to Sales Ratio



expectations. Markets reacted sharply to the news; stock prices dropped and bond yields climbed.

## Capital Flow

Capital markets are in a titanic struggle, in a perpetual competition for capital. In the last several years, bond yields and interest rates have been historically low, offering very little competition, and forcing massive capital flows into the stock and real estate markets. However, all of that is changing now.

In February, the Federal budget was passed which will add to the Federal Deficit. Estimates are that annual deficits will rise above \$1 trillion beginning in 2019. Of course, this increases the need to sell Treasury securities which will add upward pressure on yields.

Another factor adding upward pressure on Treasury bond yields is the fact that quantitative easing (QE) has been reversed into quantitative tightening. In a titanic reversal, the Federal Reserve has started reducing its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities. During the QE programs, the Federal Reserve was buying gargantuan amounts of Treasuries causing the Fed's holdings to grow by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion recently. The Federal Reserve is now reducing its inventory back to more normal levels by methodically selling its massive Treasury holdings.

## The Portfolio

The investment landscape is changing. Last month's wild correction exposed the risk in the market, and has tainted the full-throated optimism that was blinding investors to the risks they were taking. Our portfolio recommendations are made with the changing landscape in mind, in accordance with the caution signal recently given from the *Sound Advice* Diffusion Index of Lagging Indicators.

This bull market became 107 months old on February 9, making it one of the longest in post World War II history. Only the bull market that ended in March, 2000, lasted longer -- 113 months -- which ended with a bear market that took prices down 50 percent. Past bear markets become a fading memory with time, but we should keep in mind that a 50 percent loss requires a 100 percent gain to break even. We continue to recommend that you should have a substantial amount of cash on the sidelines.

## ETFs for Rising Bond Yields

The Federal Reserve's swollen Treasury bond portfolio has a preponderance of longer term bonds. That means that the reduction of the its Treasury holdings will add a disproportionate amount of upward pressure to long-term bond yields. This is important because our recommended ETFs are designed to benefit from an increase in long-term

bond yields.

Rising inflation will also push up long-term bond yields in order to furnish investors with a real return in the vicinity of 3 percent. With inflation pushing above 2 percent, yields should be close to 5 percent, giving these ETFs a tremendous upside potential.

Our recommended ETFs differ in the amount of leverage used. You can choose among them depending on your investment objectives and risk tolerance.

The [Direxion Daily 20 Plus Year Bear 3 Shares \(TMV\)](#) uses 3:1 leverage.

The [Proshares UltraShort Lehman 20 Plus Year Treasury \(TBT\)](#) uses 2:1 leverage.

The [Proshares Short 20 Plus Year Treasury \(TBF\)](#) uses no leverage.

The price action of these ETFs is based on the changes in long-term Treasury bonds, as measured by benchmark bond indexes, only in the opposite direction, and then multiplied by the leverage each ETF uses. For example, a decline of say, 1.0 percent in their respective benchmarks will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in their respective benchmarks will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. We have been using the Federal Reserve's prediction, which was as good as any. As part of the Federal Reserve's quarterly Federal Open Market Committee (FOMC) meetings, each of the committee members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot".

The most recent Dot Plot was taken at the December meeting when the Federal Reserve raised the Federal Funds rate another 0.25 percentage point to 1.25 percent. The median prediction was that the Federal funds rate would be 2.125 percent at the end of 2018, and 2.69 percent at the end of 2019. The FOMC is predicting that the Federal funds rate will rise in the months ahead because the Federal Reserve wants to bring short-term interest rates back to more normal levels from the extremely low levels used to stimulate the economy out of the 2008-09 crash.

We are using the Fed's dot plots of Federal funds as a means to predict changes in short-term interest rates, and making the assumption that long-term interest rates will move in tandem in order to maintain the same long-term real returns that exist today. While this should be a reasonable guide, it will be changes in inflation expectations that will ultimately govern long-term interest rates and the behavior of these ETFs. Recently we have

seen a flattening of the yield curve (the difference between short and long-term interest rates) because the Fed has been raising (normalizing) short-term interest rates while a perceived mild inflation rate has kept long-term interest rates low. We are predicting that this flat condition will change as inflation heats up, and forces long-term interest rates up from historically low levels.

However, in the spirit of trying to be conservative, we can assume that the yield curve will remain as flat as it is today, which means that long-term Treasury bond yields move in accordance with the Dot Plot target points. Accordingly, long-term Treasury bonds would be yielding 4.00% by the end of 2018, and 4.57% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$21.22 to \$33.72 by the end of 2018, and to \$42.78 by the end of 2019.

TBT would rise from \$38.38 to \$52.27 by the end of 2018, and to \$61.26 by the end of 2019.

TBF would rise from \$23.35 to \$27.25 by the end of 2018, and to \$29.50 by the end of 2019.

### The Erosion Factor

As we point out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.03 percentage points (3 basis points) every day, and thus go nowhere. By the end of 2018, TMV would decline to \$20.49 (3.4%), TBT would decline to \$37.72 (1.7%), and TBF would decline to \$23.22 (0.6%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

### Energy & Natural Resource Selections

The table nearby shows the price of oil OPEC countries needed to balance their 2017 budgets. On average, the OPEC countries needed \$77.68 per barrel (weighted by production). With oil prices below the necessary price, OPEC countries will continue to urge for oil production cutbacks wherever they can exert pressure. These cutbacks and resulting price stability are advantageous for US oil and gas companies.

**Chesapeake Energy (CHK)** reported very favorable earnings in the last week of February of 33 cents per share for the fourth quarter, substantially above expectations of 24 cents. Behind the robust earnings was a surge in revenue of 25 percent which came from a combination of growth in production along with the company's ongoing cost-cutting programs. For the year, CHK swung into a profit, with revenue climbing 21 percent and earnings logging in at 90 cents per share. The stock climbed over

25 percent on the news. The earnings report confirms our predications and that this stock was (and still is) incredibly cheap with a trailing P/E under 4.

Chesapeake reduced its debt by \$1.3 billion in 2017, down to \$9.9 billion. To lower its debt burden further, the company is currently selling \$2 to \$3 billion of assets. After adjusting for these asset sales, the company expects production to rise by about 3 percent in 2018, even under its cost-cutting efforts. The company also expects new wells to be "a lot more economic" as it tests new well designs. CEO Robert Lawler said on a conference call, "We will continue to drive costs out of our operations, improve margins and utilize advancing technologies to create value across our portfolio."

The company has a large US portfolio of oil and gas properties -- in the Powder River Basin, Eagle Ford, the Marcellus and Utica shale, the Haynesville/Bossier, and in the Anadarko Basin regions. These large domestic assets make CHK well situated to participate in the resurgence of the US shale drilling. CHK is also in a favorable position to benefit from the secular shift to clean burning natural gas fuel for power generation globally and in the Asia-Pacific region in particular, led by China's transition away from coal.

**Chevron (CVX)** is set to see an increase in production

## Requisite Oil Prices

### Prices Needed to Balance 2017 Budgets

OPEC Country	Balancing Price	2016 Oil Production
Algeria	63.80	1,348,361
Angola *	83.00	1,769,615
Ecuador *	78.00	548,521
Libya	102.00	348,686
Iran	54.70	3,990,956
Iraq	54.10	4,451,516
Kuwait	46.50	2,923,825
Nigeria *	127.00	1,999,885
Qatar	46.80	1,522,902
Saudi Arabia	73.10	10,460,710
United Arab Emirates	68.00	3,106,077
Venezuela *	216.00	2,276,967
Weighted Average	77.68	34,748,021

Competing Country	Price	Production
Russia	49.90	10,551,497
US	n/a	8,856,809

Source of Oil Production: US Energy Information Administration  
Source of Balancing Prices: International Monetary Fund

\* Estimated figures provided by RBC Capital Markets

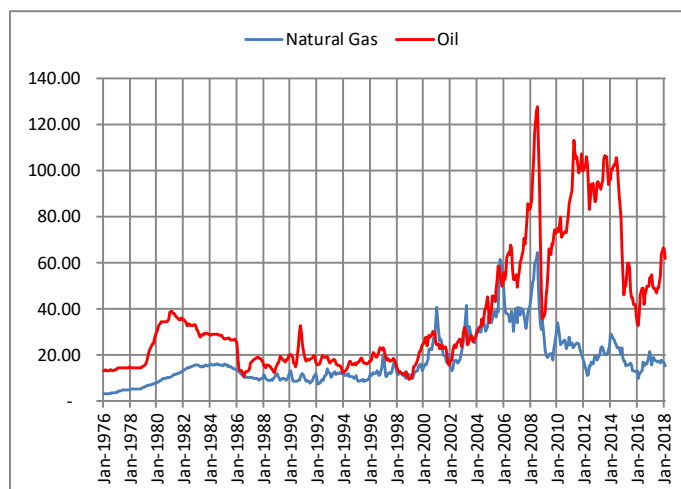
and revenue in 2018, including the two massive Australian projects, the Gorgon and Wheatstone, both of which had required large capital outlays that are no longer needed in CVX's forward-going cap-ex budget. The company is making large investments in its 1.5 million acre position in the prolific Permian Basin to boost its output by 400,000 barrels of oil per day in the next few years. CVX is well-positioned to see earnings growth in the years ahead, along with an attractive dividend that was just increased (again) to \$1.12 per share per quarter, up 4 cents from the previous quarter.

**ICON Energy Fund Class S (ICENX)** is a diversified way to participate in the expansion of the energy sector with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sector to capture value, rather than simply depending on rising oil prices. This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis with professional management.

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the growth of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At the current price of \$62 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$2.67 for one million BTUs, 5.8 million BTUs will cost \$15.49. Thus, the same amount of energy is available for approximately 25 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart shows the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to

### The Cost of Energy Equivalents of Oil and Natural Gas



approximate the same amount of energy contained in a barrel of oil. The fact that natural gas provides energy for pennies on the dollar will translate into an expanding natural gas industry.

**Valero Energy (VLO)** is in our portfolio because it is in a unique position to benefit from a US conundrum. Prior to the US shale revolution, most US refineries were constructed to process imported crude oil which is a heavy (thick) and sour (high sulfur) grade. The oil from fracking US shale cannot be processed at these refineries because it is light and sweet. Additionally, refineries on the east and west coast do not have access to the US crude oil pipeline network, so they must rely on imported oil arriving in US ports for their feedstocks. This is evidenced by the fact that we are still importing nearly half of our oil needs, while US storage tanks in Cushing, Oklahoma, are brimming with the light sweet crude fracked from US shale.

Valero is well-positioned to take advantage of this conundrum because it has the flexibility to refine substantial quantities of both US light sweet as well as heavy sour crude. It also has access to the US pipeline network for delivery to its gulf coast locations. This flexibility allows VLO to capture the highest margins among its competitors because it can take advantage of the temporary local gluts of crude, whether it's low or high-quality crude, or light sweet or heavy sour, and receive the best discounts for its feedstocks.

### Real Estate Selections

Our posture is still defensive with regard to real estate stocks. Commercial real estate prices are historically high because low interest rates have pushed down real estate cap rates to historically low levels (like bond yields). The *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. Two REITs currently exist in the hospitality industry along with one mutual fund.

**Hersha Hospitality (HT)** has reported several hotel transactions during the last several years at cap rates ranging from 4.9 to 8 percent. To be on the conservative side, we can use a cap rate at the high end of this range of 7.5 percent for valuation purposes.

Based on the latest trailing four quarters' financials, including the most recent 2017 fourth quarter results released at the end of October, and using a 7.5 percent cap rate to evaluate the company's real estate portfolio, we value HT at \$21.70 per share which is higher than the current price. This valuation is low for several reasons.

The 2017 net operating income was impaired because the company was forced to close six south Florida hotels in September because of Hurricane Irma. Management sees a recovery in 2018 based on the reopening of the Miami Convention Center and a diminished supply of competing hotels. In the fourth quarter, the strength in the South

## Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	19.81	6.7%	11.5%	9413.79	38.21	-48.7%
Hospitality Properties	HPT	25.44	8.0%	11.0%	11,616.3	48.11	-47.1%
Hersha	HT	16.80	6.7%	9.5%	2,402.9	21.70	-22.6%
Host Hotels & Resorts	HST	18.56	4.3%	10.0%	21.6	25.75	-27.9%
Apple Hospitality	APLE	16.99	7.1%	9.1%	6,114.9	21.86	-22.3%

The table above shows the “Stock Market Cap Rate” (what the stock price is paying for the underlying real estate portfolio) for several comparable hospitality stocks. The “Stock Value” column shows the current value of the stock assuming the underlying portfolios are valued using a cap rate of 7.5 percent, which is close to the average cap rate on recent hotel transactions. The last column shows the discount or premium at which the stock is trading based on a 7.5 percent cap rate valuation of each company’s real estate portfolio.

**Hospitality Properties (HPT)** has the second largest discount. However, this company is externally managed by RMR which charges high fees and suppresses value. As long as RMR continues to externally manage HPT, we do not expect to see significant growth. **Host Hotels and Properties (HST)** is very small, with only 749 thousand shares outstanding, which may lead to excessive volatility. Growth may be limited by its small capitalization.

Florida market from hurricane related recovery efforts and the abatement of Zika fears allowed HT to exceed the high end of the company’s 2017 financial guidance range.

There were also some significant new acquisitions in the fourth quarter that were only adding to income late in the year. The company is also divesting of its non-core, underperforming properties. In February, HT announced the sale of the Hyatt House in Gaithersburg, MD, for \$19.0 million and the Holiday Inn Express in Chester, NY for \$8.4 million, two older, suburban assets at a combined capitalization rate of 4.9 percent. The company will be deploying the proceeds of this sale to repurchases of HT stock, which CEO Jay H. Shah considered to be at a deep discount to the market value. In the fourth quarter, Hersha’s Board of Trustees approved a new share repurchase program of up to \$100 million of the Company’s outstanding common shares in 2018. Since January 1, 2014, the Company has repurchased \$232.3 million in common shares, representing 21.8% of the January 1, 2014 float.

The net operating income of HT’s properties is bound to be improving in 2018. With a reduction in the amount of stock outstanding, the increase in the income per share will be even greater, resulting in an increase in the value of the stock. Meanwhile, an attractive dividend provides a nice yield and reduces risk by putting a floor under the stock price.

**RLJ Lodging Trust (RLJ)** is selling at a steeper discount to its hotel assets than HT. Based on the latest trailing four quarters’ financials reported, including the most recent 2017 third quarter, and using a 7.5 percent cap rate to

evaluate the company’s portfolio, we value RLJ at \$38.21 per share which is considerably higher than the current price. The high dividend yield is also attractive and lowers the risk profile.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** is a global real estate fund which means it is not confined to US real estate with low cap rates. Management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business. Management also searches for opportunities in different aspects of a real estate company’s capital structure by investing in senior debt in addition to equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities.

This fund is loaded with good values substantially below net asset value (NAV) with strong growth prospects. Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value. Just as we do at *Sound Advice*, they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

### Medically-Related Selections

The healthcare industry is still blanketed by uncertainty over future Congressional efforts to repeal and replace the Affordable Care Act (Obamacare). The entry of Amazon into the healthcare and pharmaceutical industries is also a disrupting force that is changing the landscape. We

are comfortable with our current recommendations in this sector based on their own individual merits.

**Boston Scientific (BSX)** has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs. BSX's medical products are well suited for an aging population, and the company's stream of new inventions and products add to promising growth prospects.

For example, late last year, **BSX** launched the latest version of its implantable cardioverter defibrillator (ICD) and cardiac resynchronization therapy defibrillator (CRT-D) systems. The devices were approved last year by the FDA and received the CE Mark in Europe. Last month, BSX received FDA approval for its Vercise Deep Brain Stimulation (DBS) System to treat the symptoms of Parkinson's disease. The company also received FDA approval for the Spectra WaveWriter Spinal Cord Stimulator System.

Boston Scientific has impressive growth in all of its segments and plans to launch key innovative products to capture untapped growth opportunities in high-growth markets.

**Stryker (SYK)** provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products, but is best known for its orthopaedic devices for artificial knees and hips.

Stryker's healthy balance sheet has allowed it to make many acquisitions in the recent past which are now paying off, such as Mako whose surgical robots are now being used in the majority of the Mako knee surgeries since the launch in mid-2016. The 2017 acquisition of Novadaq Technologies has enhanced SYK's position in the endoscopy market and expanded Stryker's capabilities in imaging. Stryker's acquisition of Vexim in 2017 expanded SYK's portfolio of minimally invasive technologies and complements Stryker's interventional spine business.

**Tekla Life Sciences Investors (HQL)** is a good way to invest in the most explosive profits in the healthcare industry with a portfolio of biotech companies. Over the last 15 years, biotechnology has become a major industry and the source of the world's top breakthrough drugs.

Biotech companies tend to be high risk and high reward investments which makes diversification essential.

## Financials

Both of our bank selections will benefit in 2018 by reduced tax rates, and both will benefit from rising interest rates. Our two choices are good values now.

**JP Morgan Chase (JPM)** will benefit from a reduction in its effective tax rate in 2018 to 19 percent, and the tax savings will provide a significant boost to earnings. The company stated that it will use the tax savings to invest across all of their business sectors which will accelerate growth.

The consensus is now \$8.78. At a forward P/E ratio of 15, which is substantially below the market average, JPM would be \$131.70 by the end of 2018. JPM is still cheap in comparison to the rest of the market.

**Wells Fargo (WFC)** also expects its 2018 effective tax rate to drop to 19 percent. WFC is now expected to earn \$4.71 in 2018. At a P/E ratio of 15, WFC would be \$70.65 in 2018. WFC is also currently cheap in comparison to the rest of the market. As a parting shot as she exited her position of Federal Reserve chair, Janet Yellen penalized WFC for the account opening scandal by restricting its growth through September. The stock dropped on the news but has since been recovering.

## Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. Small Caps are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger, which is usually quite profitable.

**Third Avenue Small-Cap Value Investor Fund (TVSVX)** invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund (TVRVX). Management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value, and the ability to consistently grow NAV, with an initial targeted holding

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period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

### Special Situations

The rest of our portfolio falls into other market sectors, with companies that are presenting extraordinary values within their respective industries. Here they are in alphabetical order.

**Apple (AAPL)** has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial rating. Although this is a premier growth stock, its P/E is still at a discount to the rest of the market. AAPL has \$216 billion of overseas cash which is 25 percent of its market capitalization. A repatriation of that cash hoard is likely to spur investment in growth avenues inside the US as well as share buy-backs and dividend increases.

Although the number of iPhones being sold has been disappointing, the high margins have not. Fourth quarter revenue and profit hit record highs, with record sales of \$88.3 billion (up 12.7%). In addition to higher unit prices from selling higher priced iPhones, revenue rose 18 percent from its software and services to \$8.5 billion. The App Store, Apple Music, iCloud and Apple Pay all had their biggest quarters ever from the 1.3 billion active devices in the hands of customers.

**Intel (INTC)** can leverage new technology into its existing large platform without introducing unacceptable risks. A history of established cash flow and an attractive dividend, along with the currently low P/E ratio, diminishes the risk profile of the stock. Yet, substantial growth prospects have been introduced that now justify a higher P/E and thus, a higher stock price.

INTC has been making significant acquisitions that are now leading to renewed growth. The 2017 Mobileye acquisition is a prime example, which has launched Intel into the burgeoning assisted-driving and autonomous vehicle arena, and extends to markets for autonomous ships, planes, drones, and a wide range of weapons. Tesla recently shifted to using Intel's chips from those made by NVIDIA to power its massive infotainment console. The upcoming Model 3 and new versions of Tesla's Model X and Model S will rely on the Intel chips. Intel is also a supplier to Google's (Alphabet's) Waymo self-driving car unit. Fiat Chrysler has joined Intel's automotive partner base. The company's team also includes BMW.

These stronger growth prospects make INTC undervalued at its current price. The company has the size, diversity, and industry dominance to offer a relatively safe investment in a high-growth, and often high-risk

business. Even at \$50 per share, the forward P/E is 14, substantially below the rest of the market. At a P/E of, say 18, which is still below the market, the stock price would be close to \$64. The current dividend yield is also attractive, with an annual dividend of \$1.20 a share which was just increased by 10 percent.

**International Business Machines (IBM)** is turning into a growth stock but it is not priced like one. Watson, IBM's super computer, is at the heart of IBM's new growth business which the company calls "Strategic Initiatives" which will soon account for one-half of the company. Watson is the closest thing to artificial intelligence because it can "think" like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient. Watson is behind IBM's booming cloud business, which had revenue growth of 24% in 2017.

IBM took one more step in February to grow Watson by partnering with video game engine developer Unity Technologies and launching the IBM Watson Unity software development kit (SDK) which allows developers to integrate Watson services into their games and applications. After providing the SDK for free, IBM charges for each call to a cloud-based Watson service. Watson is already being used in the virtual reality game, *Star Trek: Bridge Crew*, where Watson allows players to talk to artificially intelligent characters. Watson's text-to-speech service goes beyond gaming, where it is used to build business applications virtual reality (VR) and augmented reality (AR). This Watson-Unity collaboration won't move the needle for IBM on its own, but it is another step transforming IBM into a cognitive computing powerhouse.

IBM is a good value now. The company expects 2018 earnings to be at least \$13.80 per share. The stock is still selling at a P/E ratio substantially below the market. At \$160 per share, the stock is only 11.6 times earnings. A P/E ratio of 15 puts IBM above \$200 per share.

While we are waiting for growth, the \$6.00 annual dividend provides an attractive yield. IBM has increased its dividend each year, for the past 22 years. IBM still generates over \$12 billion of free cash flow each year, which can be used for continued investment, as well as share buybacks and dividends.

**NCR Corp (NCR)** makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world.

The “self check out” market is growing rapidly and NCR, which owns nearly three-quarters of the self-checkout market, is well-positioned to benefit. Using their smartphones, or a handheld scanner provided by the store, customers scan items from the shelves as they add them to their cart. At checkout, they input either device into the register, and it spits out the tally.

For example, Kroger is leading the new technology race by rolling out its “Scan-Bag-Go” technology to over 400 stores this year. Walmart, which already has the technology in some stores is now testing the service in 120 more this year, and already has it in its 600 Sam’s Club stores. B.J.’s Wholesale Club has launched the service in a handful of stores and plans to add it to about 100 clubs this year.

This technology is driving the new Amazon Go store, which is bound to drive the entire supermarket industry to implement self-checkout technology. Amazon Go, Kroger, and Walmart are leading the cutting edge of grocery stores, but NCR is the power behind the trend.

NCR is an outstanding value, with a P/E currently below 12, which is a considerable discount to the rest of the market. With its new growth prospects, NCR deserves a much higher P/E. At a P/E ratio of, say 16, which is still a discount to the rest of the market, the stock belongs above \$50 per share.

**Symantec (SYMC)** is the world’s leading cyber security company offering organizations strategic, integrated solutions to defend against sophisticated attacks across endpoints, cloud, and infrastructure. Symantec operates one of the world’s largest civilian cyber intelligence

networks, allowing it to see and protect against the most advanced threats. Our mantra with this stock has been, “If there ever was a more certain growth industry, protection from cyber espionage is it.” Fourth quarter operating gross profit was up 15.5 percent and operating income surged 40 percent.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation. The company’s record high of \$2.54 billion backlog reveals a robust pipeline with major governmental organizations like the US Department of State, Environmental Protection Agency (EPA), US Army Corps of Engineers, and the US Air Force. TTEK has a very healthy balance sheet.

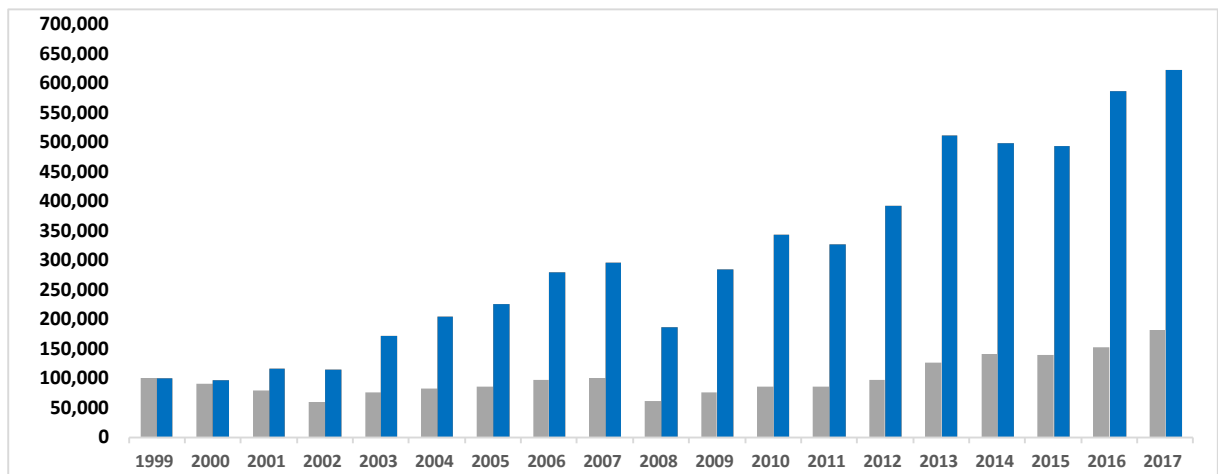
The company’s Water, Environment and Infrastructure segment revenues continued on a solid growth trajectory, benefiting from strong US federal and Infrastructure projects. Fiscal first quarter (fourth quarter calendar) reached a record high, and operating earnings per share of 81 cents were up 33 percent from a year ago.

**Hedging the Portfolio**

The **ProShares UltraShort S&P 500 (SDS)** is a reverse ETF that essentially short-sells the market and will benefit from down-drafts in the S&P 500. It is designed to produce two times the daily fluctuations of the S&P 500 index. A decline of say, 1.0 percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it is performing as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

**Sound Advice vs the S&P 500**

This chart shows the growth of \$100,000 invested in the S&P 500 (in gray), which would have grown to \$181,971, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$620,567.



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$2.82	0.00%	BUY	\$3.40
Chevron	CVX	\$111.92	4.00%	BUY	\$125.00
Fidelity Select Nat. Gas Fund *	FSNGX	\$23.73	0.52%	BUY	\$25.00
ICON Energy Fund Class S *	ICENX	\$11.21	0.44%	BUY	\$13.00
Valero	VLO	\$90.42	2.65%	BUY	\$99.00
Real Estate					
Hersha Hospitality Trust	HT	\$16.80	6.67%	BUY	\$19.00
RLJ Lodging Trust	RLJ	\$19.81	6.66%	BUY	\$23.00
Third Avenue Real Estate Value Investor *	TVRVX	\$32.95	0.47%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$27.26	0.00%	BUY	\$30.00
Stryker Corp.	SYK	\$162.16	1.05%	BUY	\$170.00
Tekla Life Sciences Fund	HQL	\$19.27	0.00%	BUY	\$22.00
Financials					
JP Morgan Chase	JPM	\$115.50	1.94%	BUY	\$122.00
Wells Fargo	WFC	\$58.41	2.67%	BUY	\$64.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$20.30	0.28%	BUY	\$22.00
Special Situations					
Apple	AAPL	\$178.12	1.28%	BUY	\$185.00
Intel	INTC	\$49.29	2.43%	BUY	\$53.00
International Business Machines	IBM	\$155.83	3.85%	BUY	\$166.00
NCR Corp	NCR	\$33.00	0.00%	BUY	\$38.00
Symantec	SYMC	\$26.29	1.22%	BUY	\$29.00
Tetra Tech	TTEK	\$48.95	0.82%	BUY	\$53.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$21.22	0.00%	BUY	\$24.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$23.35	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$38.38	0.00%	BUY	\$43.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$39.26	0.00%	BUY	\$43.00

**Notes to the table:** The right hand column is the highest recommended price limit for purchases.

See our website for live pricing and buy limits: <http://www.soundadvice-newsletter.com/members>

\* It is not possible to offer live pricing on our recommended mutual funds.

**General Comments:** Our statistics are based on the assumption that \$10,000 is invested in each position. When a new position is added, we assume the same \$10,000 amount is invested in the new recommendation. When we recommend adding to a particular position, as we have done over the years, we assume another \$10,000 is invested again in that position.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

As always, broad diversification will temper volatility, add to safety, and improve long-term performance.

## Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool the **SoundAdvice** "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and are on the verge of declining or under performing the other market.

What is too high? When stock prices are very high relative to house prices, the **SoundAdvice** Risk Indicator will rise over the line marked 2.0, revealing a high-risk time for stocks. In contrast,

when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the **SoundAdvice** Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$15.96 million in stocks and to \$1.79 million in houses.

But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the **SoundAdvice** Risk Indicator he would have made \$635 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the **SoundAdvice** Risk Indicator would have provided.

The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6. **Based on the latest median house price of \$343,000 for November, and with the S&P 500 at 2713.83 at the end of January, the SoundAdvice Risk Indicator reads 1.85, which reveals that it is a high-risk time for stocks.** If house prices remain the same, and the S&P rose to 2920, the **SoundAdvice** Risk Indicator would hit 2.0.

**The New York Times**  
*"Cardiff's equation reveals an elegant financial minuet as each market takes turns outperforming the other."*

### The SoundAdvice Risk Indicator



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

If the Supercycles identified by our Risk Indicator are the solemn, inexorable seasons that roll across the market's landscape, business cycles are the highly visible, sometimes serene but frequently blustery fronts and storms that we actually perceive as weather. The Risk Indicator has given us a reliable tool to determine the investment season in the stock market. This information is all-important; there will be no heat waves in January, no blizzards in July. But in our search for fair winds, we need to know more than the season. We also must be able to predict the shorter-term weather -- the bull and bear markets that fluctuate along the path of Supercycles.

The data we need is contained in the leading and lagging economic indicators published monthly by The Conference Board. We have hand picked the most sensitive of these economic indicators to produce our "Diffusion Indexes" which function with amazing accuracy as predictors of the birth of cyclical bull and bear markets in stocks.

To construct our **SoundAdvice** Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period, and take the percentage of those increasing.

When the **SoundAdvice** Diffusion Index of **LEADING Indicators** drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the soft economy is providing an atmosphere for stable or declining interest rates.

This Diffusion Index gave us a zero reading in April, 2009, close to the bottom, officially giving us an "Aggressive" signal. That signal came at a time when the Risk Indicator was below 1.0, which revealed that Supercycle 5 came to an end, and that Supercycle 6 was born.

The **SoundAdvice** Diffusion Index of **LAGGING Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reading reveals that the US economy is strong enough to put upward pressures on interest rates.

Most of the time, this Diffusion Index has been a timely indicator of oncoming bear markets because a rising interest

rate environment is a dangerous time for stocks. The times when this Index has not performed in a timely fashion is when monetary policy has been established and enforced, regardless of fluctuations in economic strength. A prime example is the quantitative easing (QE) programs that were used to bail out the economy from the 2008-09 meltdown. In recent years, the economy has strengthened, sufficiently at times to push the Sound Advice Diffusion Index of Lagging Indicators to 100 percent. However, interest rates were held artificially low by the QE program. That has changed now. What was once quantitative easing has been reversed into quantitative tightening because the Federal Reserve has started reducing its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities. This is a titanic reversal. The Fed's assets grew by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion, and now it is being reversed back to more normal levels. This means that we will no longer have a QE program holding interest rates artificially low.

### Current Status

The **SoundAdvice** Diffusion Index of **LEADING Indicators** dropped to zero in September because of weakness in the employment and building permit components caused by the temporary impact of the hurricanes. While this was an official reversal of our Caution Signal, we did not change our cautious approach to the market because it is likely that this **Aggressive** signal will be reversed soon, as the affected area began to rebuild and hire the massive number of workers needed for rebuilding. Indeed, the leading indicators rebounded, pushing this Diffusion Index to 100 percent for January (the latest data).

As a result of this strength, the **SoundAdvice** Diffusion Index of **LAGGING Indicators** climbed to 100 percent for December, giving us a new Caution Signal in January. The lagging indicators continued to show strength in January, causing another 100 percent reading in February.

### Track Record of the SoundAdvice Diffusion Indexes

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Sep-17	2,492.8	Jan-18	2,823.8
Ave +/-	30.5%		3.3%

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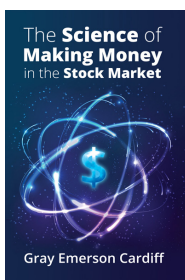
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