

Is Inflation Dead?



Gray Emerson Cardiff, Editor

The *Sound Advice* Portfolio is up 8.8 percent so far this year. We have an average profit of 74 percent based on the prices at which each position was recommended. We have been, and remain in a cautious and defensive mode.

In October, an article by Mark Hulbert in USA Today featured *Sound Advice* as one of 6 newsletters to make Hulbert's Honor Roll. Hulbert has independently tracked and ranked newsletters during the last two decades for their performances. To make it into the Hulbert Honor Roll, a newsletter had to perform better in both bull and bear markets than at least half of the US equity mutual funds in Morningstar's database. The data-tracking period was for the last four bull and bear markets through 9/30/2017.

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

18.69% in 2016 vs.
9.54% from the S&P 500

From 2000-2016
10.30% Annually vs.
2.37% from the S&P 500

The rate of inflation is perhaps the most important macro force on our investments. It directly impacts market interest rates because investors want a "real" rate of return – something above the rate of inflation. Historically, the desired real investment return has been in the vicinity of 3 percent. In addition, the Federal Reserve has a dual mandate: to maintain a stable economy with inflation close to 2 percent. When inflation heats up, the reaction will be to tighten monetary policy by raising short-term interest rates (the Federal Funds rate).

We saw the enormously positive impact that historically low interest rates had on the stock market. Of course, the Fed's Quantitative Easing programs were a strong factor, but so was a persistently low inflation rate.

On October 13, the Bureau of Labor Statistics (BLS) reported that inflation was a moderate 0.5 percent for September. The bond market rejoiced by pushing up bond prices and forcing down yields. However, there were significant details that were omitted from the inflation headlines; the moderate 0.5 percent change was only from the previous month. Over the last year, the change was 2.23 percent. This is significant because the Federal Reserve's inflation target is 2.0 percent, above which interest rates deserve to be increased, or at least normalized from the historically low levels that were needed to bail out the economy from the 2008-09 meltdown.

The other detail, usually glossed over, was that the inflation number was based on a seasonally adjusted Consumer Price Index (CPI). Seasonal Adjustments attempt to remove the effects of recurring seasonal influences. For example, oranges can be purchased year-round, but prices are significantly higher in the summer months, between harvests. The seasonal adjustment process is a statistically complicated process. In a perpetual process, the adjustments themselves are tweaked based on changes in the recent past. There are times when the tweaking is not enough, and the seasonal adjustments distort the true picture. We are likely in one of those times now.

According to the BLS, hurricanes Harvey, Irma, and Maria started to affect data collection in September. Because of the lasting damage and distortions caused by these hurricanes, it is certain that seasonal adjustment factors will be unreliable and clouded through the end of the year. To get a clearer picture, we can look at the CPI that is not seasonally adjusted. Here is what the BLS says about the "not seasonally adjusted" CPI:

Who should not use CPI seasonally adjusted indexes?

Those who use the CPI in escalation agreements to adjust payments for changes in prices should typically not use seasonally adjusted indexes. Unadjusted indexes are used extensively for escalation purposes because they measure the change in actual prices consumers pay for goods and services. Many collective bargaining contract agreements and pension plans, for example, tie compensation changes to the Consumer Price Index unadjusted for seasonal variation.

In other words, the CPI that is not seasonally adjusted measures reality -- the prices we are actually paying for goods and services.

CPI - All Urban Consumers, 12 Month Percent Change

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2016 Y/Y %	1.4%	1.0%	0.9%	1.1%	1.0%	1.0%	0.8%	1.1%	1.5%	1.6%	1.7%	2.1%
2017 Y/Y %	2.5%	2.7%	2.4%	2.2%	1.9%	1.6%	1.7%	1.9%	2.2%			
With no change										2.1%	2.3%	2.2%
With 2% change										2.3%	2.6%	2.7%

The table above shows the CPI for all urban consumers – not seasonally adjusted. The first two rows show the percentage increase over the previous 12 months. After dipping below 2 percent in June, July, and August of 2017, the index rose 2.23 percent in September. The red numbers show the percentage increase in the next three months with no change in the CPI from September's reading. Even under this absurd assumption, inflation remains above 2 percent.

The assumption is absurd because even a low inflation rate will push up the CPI by at least a little. Even if the (not seasonally adjusted) CPI were to rise at a 2 percent annual rate in the next 3 months, the year-over-year readings would be 2.3 percent for October, 2.6 percent for November, and 2.7 percent for December (the blue numbers). This coincides with the forecast from economists at JPMorgan Chase who are among those predicting inflation will approach 3 percent in the fourth quarter.

It is reasonable to expect the unseasonally adjusted CPI to increase in the months ahead because several near-term factors are bound to add to inflation. Gas prices will likely increase because, according to Goldman Sachs economists, Hurricane Harvey shut down over 16.5 percent of US refining capacity. In addition, Houston was already facing a shortage of construction workers, and it will pull from other states. The added competition for workers is likely to lead to higher wages, especially with the US unemployment rate at an historically low 4.2 percent. Moreover, a surge in demand is expected for autos to replace those lost in floods. Likewise, there will be an increase in demand for building materials.

Longer term, it was noted at the recent International Monetary Fund's annual meeting that the industrialized world is undergoing the healthiest and most synchronized global economic expansion in a decade. Also, central bankers see normal business finally resuming and are counting on improving demand to translate into higher inflation.

Yellen said she assumed "these soft readings will not persist" and that "the ongoing strength of the economy will warrant gradual increases" in interest rates. Mario Draghi, president of the European Central Bank (ECB) said that he is "confident" inflation will soon pick up. He subsequently announced the beginning of a tapering of purchases of

bonds in the ECB's quantitative easing program. The head of the Bank of England, said that he may need to raise rates from a record low in "coming months" as the U.K. economy is "running out" of spare capacity. Britain is facing inflation already above the target largely because the decision to leave the European Union has weakened the pound substantially.

Getting Back to Normal

If the world is getting back to normal from the 2008-09 meltdown, so must inflation, along with the financial markets.

The Federal Reserve's three massive rounds of "Quantitative Easing" (QE) programs, employed to pull the economy out of the 2008-09 melt-down, involved buying large quantities of Treasury bonds and mortgage-backed securities. In addition to pumping new money into the economy, these purchases pushed up the prices of these securities which forced their yields down. The downward pressure on bond yields and interest rates also stimulated financial markets. As the Federal Reserve purchased these Treasury bonds and mortgage-backed securities, they were added to the Fed's balance sheet as assets. The Fed's assets grew by more than 5 times, from under \$900 billion in 2008 to \$4.6 trillion. All of that is about to be reversed.

In late September, the Federal Reserve announced that, in October, it would start reducing its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities. This is a reversal of quantitative easing, and will amount to quantitative tightening.

Reasons to be Cautious

We always keep in mind that the market delivers returns in waves, and not in measured doses. The end of all bull markets have one thing in common -- rising interest rates. The current bull market has already had a long wave up. It will turn 104 months old on November 9. It is close to double the average length of the 12 bull markets in modern history (since WW II), and second to the longest of 113 months, which lasted into March 2000. If our current bull market is to become the longest in history, we have another 9 months to go. Of course, we cannot bank on that.

The *Sound Advice* portfolio is currently designed with a cautious approach. The price/earnings ratio of the S&P 500 currently 24.08 based on the trailing 12 months (TTM)

of earnings of the stocks in this index. Since the current recovery began in 2009, the TTM P/E ratio of the S&P 500 has averaged 19.0, with a high of 24.34 and a low of 13.01. We are clearly at the high end of the range, which is telling us that the market is already anticipating strong earnings growth as well as good news on tax reform.

Moreover, the *Sound Advice* Risk Indicator (page 10) has risen to 1.96, very close to the 2.0 mark, which reveals a high-risk time for stocks.

ETFs for Rising Interest Rates

The Fed's swollen bond portfolio has a preponderance of longer term bonds. That means that the upcoming reduction of the Federal Reserve's long-term bond 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 September meeting. As usual, there were differences in the predictions among this group of informed experts. The median prediction was that the Federal funds rate would be 1.375 percent at the end of 2017, 2.125 percent at the end of 2018, and 2.69 percent at the end of 2019. Assuming long-

term Treasury bond yields move in accordance with these target points (to preserve the same yields as today's real return), long-term Treasury bonds would be yielding 3.25% by the end of 2017, and 4.01% 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 \$19.15 to \$23.3 by the end of 2017, to \$34.0 by the end of 2018, and to \$44.1 by the end of 2019.

TBT would rise from \$35.59 to \$40.6 by the end of 2017, to \$52.3 by the end of 2018, and to \$62.1 by the end of 2019.

TBF would rise from \$22.42 to \$23.9 by the end of 2017, to \$27.2 by the end of 2018, and to \$29.6 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 \$18.3 (4.5%), TBT would decline to \$34.8 (2.2%), and TBF would decline to \$22.3 (0.7%). 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

Barring any geopolitical disruptions restricting supplies, the US Energy Information Administration (EIA), the agency in charge of collecting data, projects that increasing worldwide demand through 2018 will absorb supplies, including increasing production in the US oil patch. This outlook translates to flat oil prices for the foreseeable future. However, there are trends that should be beneficial to certain sectors of the industry, and our portfolio selections are selected with these in mind.

[Chesapeake Energy \(CHK\)](#) has a portfolio of close to 8 million net acres of oil and gas assets inside the US, in the Powder River Basin, Eagle Ford, the Marcellus and Utica shale, along with the Haynesville/Bossier and Anadarko Basin regions. These large domestic assets make CHK well situated to participate in the resurgence of the US shale drilling boom. CHK has reported total earnings of 57 cents per share for the previous four quarters. The consensus is that CHK will earn 80 cents per share during the next four quarters, starting with 12 cents for the third quarter. Based on the current price of CHK, the forward P/E ratio is close to 5 – very cheap. A forward P/E ratio of 10 puts the stock at \$8.00, more than double the current price.

[Chevron \(CVX\)](#) reported third quarter earnings at the end of October of \$1.03 per share, which was 50 percent larger

than the same quarter last year. Chevron's holdings are set to increase production and revenue, 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 management says is "sacrosanct."

Chicago Bridge & Iron (CBI) reported low third quarter earnings of 10 cents per share after deducting restructuring charges of 17 cents and an excess interest expense of 14 cents for accelerated amortization of debt issuance costs. The charges relate to Patrick Mullen's goal of "resetting" the company culture by enhancing efficiency and risk management, optimizing interface management, and accelerating innovation. Mullen took over as CEO on July 1. He said the company has made significant progress on the decisive actions announced last quarter, including a cost reduction program as well as the continued improvement of project execution and risk management processes. The benefits of these programs are expected to be realized next year.

Mullen also said that he is pleased with the progress of selling the company's Technology Operations business which is expected to produce sale proceeds in excess of \$2 billion. After taxes, the sale proceeds could be used to eliminate the company's \$1.8 billion of debt. The intent is to negotiate a long-term strategic alliance with the ultimate buyer because the engineering and techniques developed by that division are still useful to CBI.

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 \$51.50 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$3.00 for one million BTUs, 5.8 million BTUs will cost \$17.40. Thus, the same amount of energy is available for approximately 34 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart to the right 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 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.

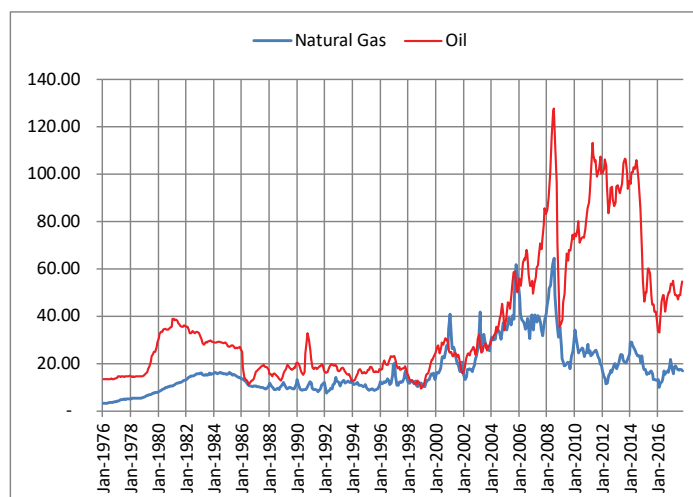
ICON Energy Fund Class S (ICENX) is also a diversified way to participate in the expansion of the energy sector with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sector to capture value, rather than simply depending on rising 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.

Valero Energy (VLO) reported strong third quarter earnings at the end of October of \$1.91 per share, despite the shutdown of 5 refineries due to Hurricane Harvey. VLO realized \$23.6 billion in revenue, a substantial increase from \$19.6 billion in the comparable quarter one year ago.

As we noted in last month's issue, VLO began to climb as Hurricane Harvey approached the Gulf coast and threatened the domestic hub of refineries located there. Although Valero has refineries in the region, the market saw a greater benefit to VLO coming from the damage to other refineries and the likelihood of widening crack spreads – the difference between the price of oil and the price of gasoline and other refined products. In the wake of the storm, crack spreads did indeed rise steeply (by 50 percent).

For the longer run, Valero continues to enjoy a unique position to benefit from a US conundrum. Prior to the US shale revolution, most US refineries were constructed to process imported 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 sweet crude. 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.

The Cost of Energy Equivalents of Oil and Natural Gas



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	21.66	6.1%	10.9%	9413.79	38.62	-43.9%
Hospitality Properties	HPT	28.58	7.1%	10.2%	11,445.5	47.26	-39.5%
Hersha	HT	17.69	6.3%	8.9%	2,257.6	19.19	-7.8%
Host Hotels & Resorts	HST	19.56	4.1%	9.7%	22.2	26.30	-25.6%
Apple Hospitality	APLE	18.94	6.3%	8.0%	5,862.4	20.62	-8.1%

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.

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. It can take advantage of the best discounts for its feedstocks, whether it’s low or high-quality crude, or light sweet or heavy sour.

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 completed its upgrading cycle. As future quarters are included, the trailing income will include upgrades to the portfolio, which is bound to cause the net operating income and the net asset value to increase.

During the last several years, Hersha has reported several hotel transactions at cap rates ranging from 5.4 to 8 percent. To be on the conservative side, we can establish a “Main Street” 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 third 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 \$19.19 per share which is higher than the

current price. The dividend yield is attractive and lowers the risk profile.

Funds from Operations (FFO) in the third quarter 2017 totaled \$0.61 per share, which was 16.0 percent below the FFO in the third quarter 2016. CEO Jay H. Shah stated that improved results from the New York City and West Coast portfolios were not enough to offset the disruption from Hurricane Irma to their south Florida properties, which led to the closure of six hotels in September. Following the dissipation of the storm, the company’s primary focus was devoted to resuming operations at four of those least impacted by the storm. The disruption was more significant at the Cadillac Miami Beach and Parrot Key hotels where more substantial reparations are required. Looking into 2018, the company sees a recovery in the region based on the reopening of the Miami Convention Center and a diminished supply of competing hotels. Meanwhile, HT saw healthy revenue growth in its eight hotels on the West Coast and its 10 New York City hotels.

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 second quarter (the third quarter results are not yet reported), and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value RLJ at \$38.62 per share which is considerably higher than the current price. The high dividend yield is 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.

TVRVX 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 cloud of uncertainty still blankets the healthcare industry now that the repeal and replacement of the Affordable Care Act (Obamacare) is dormant. We are comfortable with our current recommendations in this sector based on their own individual merits.

Boston Scientific (BSX) reported third quarter earnings in late October of 31 cents per share, which was in line with expectations. The earnings were solid because there was growth among all seven segments, including its largest Cardiovascular segment where revenue grew 4.1 percent. Boston Scientific 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.

Stryker (SYK) comfortably beat expectations in late October with its third quarter earnings report of \$1.52 per share. SYK jumped 11 percent on the news. Earnings were driven by increases in revenue and unit volume across all major company segments. Orthopedics sales increased 5.1% year over year, MedSurg sales increased 6.7%, and Neurotechnology and Spine sales increased 6.9%.

For the full year, the company expects earnings to be within the range of \$6.45 to \$6.50 on organic sales growth of 6.5% to 7.0%.

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

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

Banks will benefit from rising interest rates. The Federal Reserve's most recent "Stress Test" on US banks revealed that US banks have sufficient levels of capital to weather severe situations similar to those of the 2008-09 melt-down. Our two recommended banks were given a clean bill of health.

JP Morgan Chase (JPM) reported earnings in mid-October of \$1.76 per share, beating the consensus expectation of \$1.65. Strong growth in core banking, credit card sales, and asset management was partially offset by a decline in trading revenue. The company bought back 1.7 million shares in the third quarter at an average price of \$92.02. This follows purchases of 35 million shares in the second quarter at an average price of \$86.05.

The earnings estimate for 2017 is \$6.89 per share. Strong growth is expected in the immediate years ahead. JPM is expected to earn \$7.68 per share in 2018. At a forward P/E ratio of 15, JPM would be \$102 by the end of 2018. JPM is still currently cheap in comparison to the rest of the market.

Wells Fargo (WFC) also reported earnings in mid-October. Earnings per share during the third quarter were \$1.04, in line with expectations. Wells Fargo will repurchase \$11.5 billion worth of stock over the next year, about four percent of the company's market capitalization. Earnings are expected to be \$4.05 per share in 2017, and \$4.32 per share for 2018. At a P/E ratio of 15, WFC would be \$65 in 2018. WFC is also currently cheap in comparison to the rest of the market.

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

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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 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) introduced the iPhone 8 and 8 Plus in September, aimed at the mainstream market. These new iPhones inaugurated a badly-needed upgrade cycle. The iPhone 8 will likely account for most of the customer upgrades in the coming quarters, both in the US and in the Chinese market.

Apple's premium smartphone, dubbed the iPhone X, is to be introduced in November. It retails at a relatively high price point, beginning at \$999. Initial reports are that demand is overwhelming supply, and this phone is likely to be one of the hottest holiday gifts.

Earnings are widely estimated to grow at double-digit rates for the next few years, stemming from direct iPhone sales, a booming services business, along with new additions to the Apple Watch and Apple TV programs.

The company has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial rating. Earnings growth should also lead to dividend increases and more stock buy-backs.

Intel (INTC) jumped 7 percent when it reported earnings in late October, the highest closing price for the stock since Nov. 7, 2000. The company reported earnings of \$1.01 a share, significantly above the expectation of 80 cents a share. The company also forecasts full-year earnings of \$3.25 a share; above expectations of \$3.01 a share. The current price/earnings (P/E) ratio is still modest and considerably below the rest of the market. The current dividend yield is also attractive which lowers the risk profile

Longer term, the Mobileye acquisition launches 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 has announced that it will be using Intel's chips instead of those from Nvidia to power its massive infotainment console. The new Model 3 and new versions of Tesla's Model X and Model S will rely on the Intel chips. Tesla is also considering switching to Intel's chips for its Autopilot system.

As in the Altera acquisition, Intel is planning to leverage Mobileye's technology with Intel's, providing a boost to most of Intel's business sectors. In addition to its acquisitions for synergistic technology, Intel is investing

heavily in artificial intelligence (AI), and has begun offering products from its AI Products Group.

The size, diversity, and industry dominance of Intel offers a relatively safe investment in a high-growth, and often high-risk business. Intel 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.

International Business Machines (IBM) reported earnings in mid-October. The stock rose in after-hours trading and soared the following by more than 14 points, nearly 10 percent. As one of the 30 stocks in the Dow-Jones average, IBM's move added more than 90 points to the Dow. (A \$1.00 move in any one of the Dow's 30 components adds 6.89 points to the average.)

Third quarter revenue was up 10 percent to \$19.2 billion. There was double-digit growth in "strategic imperatives", which include businesses like cloud computing, analytics, mobility, and security. This growth is significant because this 100 year-old legacy technology company has been reorganizing around its strategic imperatives, which have grown into 45 percent of total revenue.

IBM is in our model portfolio because it is not priced like a growth stock, but it is turning into one. Watson, the Company's super computer, made a significant contribution to third quarter's earnings progress. 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.

IBM is still a good value now. Along with the earnings report, the company confirmed that it expects 2017 earnings to be \$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, as compared to the overall market of 24. 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 of 3.75 percent.

NCR Corp (NCR) reported earnings of 93 cents in October for the third quarter, slightly ahead of expectations. However, the company trimmed its estimate for the fourth quarter to range from 83 to 93 cents, which disappointed the market. This reduced the company's 2017 earnings guidance to be in the range of \$3.10 to \$3.20 per share, down from \$3.32-\$3.42 per share. The P/E is currently below 11, a considerable discount to the rest of the market. At a P/E ratio of 15, the stock belongs close to \$47 per share.

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.

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."

Tetra Tech (TTEK) won a \$24 million contract in mid-October from the US Agency for International Development (USAID) to support the Agency in strengthening the capacity and efficiency of energy services in Central Asia. In late October, TTEK was granted a \$950 million contract with the US Army Corps of Engineers to provide comprehensive environmental remediation services to the Department of Defense outside the continental United States.

Tetra Tech is a leading company in water technologies and environmental remediation. The company's backlog is now a record-high \$2.5 billion, which 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, which should continue to bolster growth. TTEK has a very healthy balance sheet.

Xerox (XRX) beat expectations with its third quarter earnings of 89 cents per share announced at the end

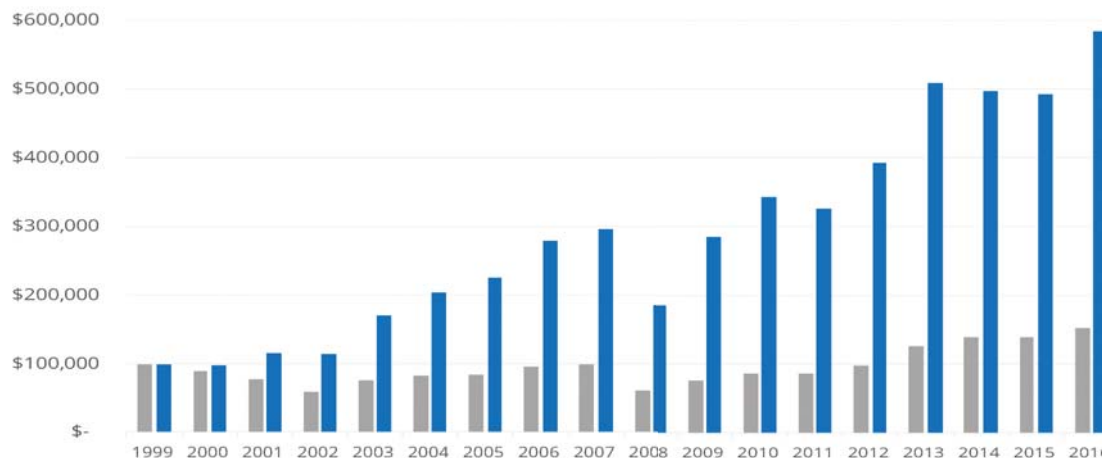
of October. Consensus expectations were for 79 cents. Along with the earnings report, the company increased its 2017 earnings guidance to be in the range of \$3.28 to \$3.44 (compared to \$3.20 to \$3.44 previously). Based on this guidance, XRX is below 10 times earnings - very cheap, especially in comparison to the rest of the market. The dividend yield is also attractive.

XRX has new separate leadership and goals which is bound to translate into better focus execution. CEO, Jeff Jacobson, is bringing a new enthusiastic corporate culture and a three-year strategy for growth by rolling out 29 new products aimed at mid-size companies which are stronger growth targets than large-scale businesses. An area of focus is "smart-label" technology directed at food and drug companies. Smart labels are printed electronic circuits that allow items to be identified and tracked in real time. They can be produced for a fraction of the cost of silicon sensors and used on small packages. This is a wide-open and high-growth market.

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 \$152,379, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$584,161.

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$3.90	0.00%	BUY	\$4.50
Chevron	CVX	\$115.89	3.73%	BUY	\$120.00
Chicago Bridge & Iron	CBI	\$13.94		BUY	\$17.00
Fidelity Select Nat. Gas Fund	FSNGX	\$23.73	0.52%	BUY	\$25.00
ICON Energy Fund Class S	ICENX	\$12.41	0.44%	BUY	\$14.50
Valero	VLO	\$78.89	3.04%	BUY	\$82.00
Real Estate					
Hersha Hospitality Trust	HT	\$17.69	6.33%	BUY	\$19.19
RLJ Lodging Trust	RLJ	\$21.66	6.09%	BUY	\$24.00
Third Avenue Real Estate Value Investor	TVRVX	\$34.35	0.47%	BUY	\$37.00
Medically Related					
Boston Scientific	BSX	\$28.14	0.00%	BUY	\$30.00
Stryker Corp.	SYK	\$154.87	1.10%	BUY	\$160.00
Tekla Life Sciences Fund	HQL	\$20.34	0.00%	BUY	\$22.00
Financials					
JP Morgan Chase	JPM	\$100.61	2.23%	BUY	\$105.00
Wells Fargo	WFC	\$56.14	2.78%	BUY	\$59.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$23.30	0.28%	BUY	\$25.00
Special Situations					
Apple	AAPL	\$169.04	1.35%	BUY	\$174.00
Intel	INTC	\$45.49	2.40%	BUY	\$49.00
International Business Machines	IBM	\$154.06	3.89%	BUY	\$165.00
NCR Corp	NCR	\$32.09	0.00%	BUY	\$35.00
Symantec	SYMC	\$32.50	0.98%	BUY	\$35.00
Tetra Tech	TTEK	\$49.25	0.73%	BUY	\$52.00
Xerox	XRX	\$30.31	0.92%	BUY	\$33.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$19.15	0.00%	BUY	\$22.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$22.42	0.00%	BUY	\$24.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$35.59	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$44.60	0.00%	BUY	\$48.00

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>

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 \$15.1 million in stocks and to \$1.6 million in houses.

The New York Times

"Cardiff's equation reveals an elegant financial minuet as each market takes turns outperforming the other."

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 \$602 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 latest preliminary data for September, the median house price is \$319,700. With the S&P 500 at 2575, the our Risk Indicator is 1.96.**

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.

We have been operating under a "Caution" signal since June 2015. Since then, the Fed's Quantitative Easing program has been keeping interest rates artificially low. However, that program has been reversed now that the Fed is selling its bonds to reduce its balance sheet.

The SoundAdvice Diffusion Index of LAGGING Indicators was 66.7 percent in September (the most recent data).

The SoundAdvice Diffusion Index of LEADING Indicators dropped to zero in September due to weakness in the employment and building permit components caused by the temporary impact of the hurricanes. While this is an official reversal of our Caution Signal, we are not changing our cautious approach to the market because it is likely that this Aggressive signal will be reversed soon as the affected area begins to rebuild and hire the massive number of workers needed for rebuilding.

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		
Ave +/-	30.2%		3.8%



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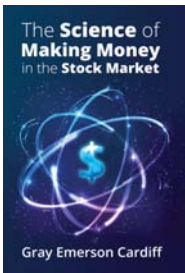
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