

## Hedging Pays

The best performing position in our portfolio since the last issue was the **ProShares UltraShort S&P 500 (SDS)**, our recommended ETF that essentially short-sells the S&P 500 and acts as a hedge against our other holdings. SDS was up 14.3 percent since our last issue.

Our February 2018, issue of *Sound Advice* was published on Friday, February 2 (called Caution: Storm Warning). The S&P 500 closed the previous Friday, January 26, at 2,872.87. Exuberance was high because the corporate tax cuts, coupled with robust economic growth, were going to propel earnings to new highs, and stock prices were certain to follow. However, we were not optimistic. We recommended that you should have a substantial amount of cash on the sidelines and wait for a substantial correction. Since that exuberant market close on January 26, the market has been volatile to say the least and is well off its peak.

Our reasoning for recommending caution came from our primary *Sound Advice* indicators: the Risk Indicator (page 10) and our *Sound Advice* Diffusion Index of Lagging Indicators (page 11).

### The Risk Indicator

Our *Sound Advice* Risk Indicator, which measures the struggle for capital between the stock and real estate markets, was close to 2.0 in January, revealing a very high-risk time for stocks. Then in July, our Risk Indicator climbed over 2.0. It had only happened five times in the last 123 years. In each of the five previous times, this Risk Indicator has marked the beginning of a major peak in the stock market – in 1906, 1928, 1937, 1965, and 1998. Stock prices often stayed high for many months, sometimes even a couple of years. However, in all cases, it was the beginning of a major top.

### 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. Signals from our Diffusion Indexes usually come at times when they are least

After the October slaughter in the stock market, the *Sound Advice* Portfolio is still up by 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

**9.6%** Annually vs.

3.2% from the S&P 500



**Gray Emerson Cardiff, Editor**

expected. The most recent signal was no exception. The leading and lagging economic indicators were released on January 25, the day before the market peaked. As a result, our *Sound Advice* Diffusion Index of Lagging Indicators switched to a Caution Signal.

## The Portfolio

The concurrence of these two reliable indicators tells us that the risk in the market is higher than normal. This bull market will become 116 months old on November 9, making it longer than the longest bull market in post World War II history, which ended in March 2000, and lasted 113 months.

We are continuing to recommend that you have a substantial amount of cash on the sidelines. Our portfolio recommendations are made regarding the money you have allocated to the stock market, and in accordance with our current cautionary mode. We believe that they are exceptionally strong values, trading at a significant discount to the rest of the market, which should give them buoyancy in both good and bad market conditions over the longer term.

### Hedging the Portfolio

While we are in a Caution mode, we continue to recommend hedging your portfolio with the **ProShares UltraShort S&P 500 (SDS)**. This 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.

### ETFs for Rising Bond Yields

The second-best performing positions since our last issue of *Sound Advice* were our recommended ETFs designed to benefit from an increase in long-term bond yields. They 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 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 benchmark bond indexes will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent.

### The Dot Plot

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 26 meeting. The median prediction from the members was that the Federal funds rate would be 2.375 percent at the end of 2018 and increase to 3.125 by the end of 2019.

We are using the Fed's dot plots of Federal funds as a means to predict changes in long-term interest rates under the assumption that long-term interest rates will move in tandem with them. This should prove to be a conservative assumption because today's yield curve (the difference between short and long-term interest rates) is relatively flat, offering very little additional yield on longer term bonds. 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, and will not rise any faster. Accordingly, long-term

Treasury bonds would be yielding 3.515% by the end of 2018, and 4.625% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$22.85 to \$24.37 by the end of 2018, and to \$35.15 by the end of 2019.

TBT would rise from \$40.69 to \$42.47 by the end of 2018, and to \$54.23 by the end of 2019.

TBF would rise from \$24.13 to \$24.65 by the end of 2018, and to \$27.86 by the end of 2019.

These projections should prove to be conservative for other reasons as well. Wages and material costs are rising, which should add to inflationary pressures and add upward pressure to bond yields. Additionally, the Federal Reserve has become a seller of Treasuries rather than a large buyer, as it reverses into quantitative tightening after many years of quantitative easing. During quantitative easing, the Federal Reserve's portfolio of Treasuries swelled by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion. The Federal Reserve has a long way to go to get back to normal.

The Federal Reserve's swollen Treasury bond portfolio has a surfeit of longer-term bonds. That means that the reduction of its Treasury holdings will add a disproportionate amount of upward pressure to long-term bond yields.

### 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 \$22.33 (2.3%), TBT would decline to \$40.12 (1.4%), and TBF would decline to \$23.97 (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

US sanctions on Iran's oil sector are set to take effect November 4. They bar companies from buying Iranian exports. Analysts project that these sanctions will remove from 1 million to 1.5 million barrels a day from global oil markets. The curtailment of international investment will lead to a significant reduction of Iran's natural gas output for many years because Iran does not have the expertise to develop its resources alone.

The Cost of Energy Equivalents of Oil and Natural Gas

Meanwhile, the economic meltdown in Venezuela (which has the world's largest oil reserves) has seen its production fall to 1.2 million barrels a day today from 3.2 million barrels in 2006, under President Nicolás Maduro.

Although major OPEC oil suppliers have increased production to fill worldwide needs, they are not interested in glutting the market. On average, the OPEC countries needed an average of \$77.68 per barrel (weighted by production) to balance their 2017 budgets. Saudi Arabia needs \$83 a barrel to pay for its 2018 public spending.

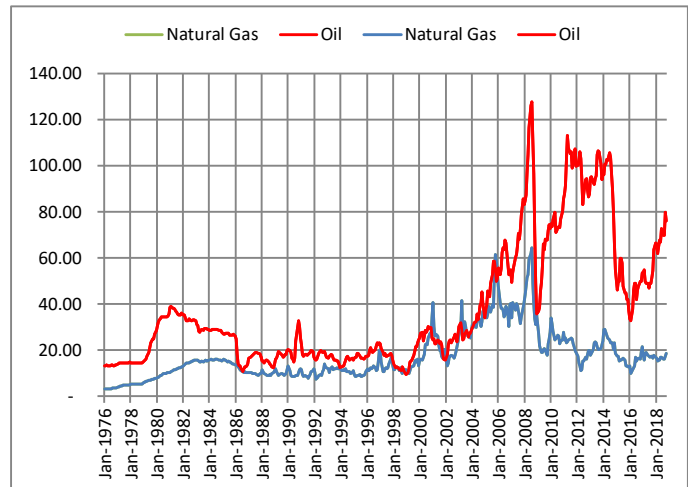
Strong global economic growth has been increasing energy demand. According to International Energy Agency, oil demand has grown annually by 1.5 million barrels a day since the end of 2011. Rising worldwide demand, along with the potential for interference from geopolitical tensions on supplies, translate to favorable conditions for our selection of energy company investments.

**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. However, with the current market price for natural gas at \$3.21 for one million BTUs, 5.8 million BTUs will cost \$18.62. Thus, with a barrel of oil costing \$76, the same amount of energy is available for approximately 24 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 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.

The Energy Information Association (EIA) predicts global demand for natural gas will grow from 340 billion cubic feet per day (Bcf/d) in 2015 to 485 Bcf/d by 2040. China's transition away from coal will account for most of this increase.

**Chesapeake Energy (CHK)** announced at the end of October that it would acquire WildHorse Resource Development Corporation for \$3.9 billion. WildHorse stockholders can trade each of their shares for either 5.989 shares of Chesapeake stock or a combination of 5.336 shares of Chesapeake stock and \$3 in cash. Chesapeake plans to finance the cash portion of the



deal, which is expected to be between \$275 million and \$400 million, through its revolving credit facility. The deal is expected to close in the first half of 2019 and is subject to shareholder approval.

The stock market reaction to the announcement was negative because the purchase price was a 21 percent premium over the current value of WildHorse stock. This move was also a reversal for Chesapeake from its years of consolidation and paying down debt. Chesapeake will assume the \$930 million of WildHorse debt, adding to \$9.2 billion of existing debt (which is down from \$16 billion in 2012). The number of CHK shares outstanding will increase by 90 percent.

The added value of the acquisition is projected by management to more than offset the dilution from the increase in CHK shares. The deal would add 420,000 acres in the prolific Eagle Ford and Austin Chalk formation, almost tripling CHK's assets in Texas, and help save between \$200 million and \$280 million in annual costs over the first five years. The added acreage will increase CHK's oil production and put it back in the growth mode again.

Chesapeake's management believes that the WildHorse assets will enhance the company's existing Eagle Ford position and will give Chesapeake another powerful oil growth engine, along with the company's Powder River Basin assets. CEO Doug Lawler said that the acquisition would allow Chesapeake to generate free cash flow much sooner.

Separately, Chesapeake also announced third quarter net profit of \$60 million, following a loss of \$41 million a year earlier. Earnings per share were 19 cents, beating expectations of 15 cents. Revenue rose to \$2.42 billion from \$1.94 billion one year ago.

For 2018, CHK is now expected to earn 79 cents per share. At the current stock price, the price/earnings P/E ratio is astonishingly low. The drop in the stock price over the WildHorse news looks like an over-reaction, and therefore is presenting a buying opportunity.

**Chevron (CVX)** has been increasing production from the Gorgon and Wheatstone, its two massive Australian projects. Large investments in its 1.5 million acre position in the prolific Permian Basin in Texas are projected to boost output by 400,000 barrels of oil per day in the next few years, especially as new pipelines come on stream.

CVX has an attractive annual dividend that was increased (again) this year to \$4.48 per share. The company's dividend is sacrosanct and has a history of increasing annually through thick and thin. Chevron is buying back its stock with \$3 billion per year.

**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.

**Valero Energy (VLO)** has declined recently which is providing a buying opportunity. The decline started in mid-October and coincided with the announcement that the company is buying Valero Energy Partners (VLP) for a purchase price that is close to seven percent over the prevailing stock price. However, this news did not account for the drop in the stock because the premium is relatively small and VLP will only account for approximately 20 percent of Valero's earnings.

A more likely reason is because of the international rules that begin in January 2020. Vessels in international waters will be required to burn low-sulfur diesel fuel which is more expensive, and more profitable for refiners to sell. This expectation adds favorably to the outlook for the refining industry in general. Late last week, there was news that the Trump Administration is pushing to postpone that requirement, which was negative news for refiners and exacerbated the sell-off.

The good news is that it is highly unlikely that the Administration will be able to postpone the requirement because it does not have the authority to do so. So, the mini-panic we saw in the sell-off does not appear to be warranted.

To add to positive news, this morning, VLO reported earnings of \$2.10 per share, surpassing expectations. Higher refining volumes and capacity utilization were

behind the robust earnings. The longer-term outlook remains solid, and remains a "Buy" recommendation.

On a longer-term basis, Valero 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

In general, commercial real estate prices are historically high because low interest rates have pushed down real estate capitalization (cap) rates to historically low levels (like bond yields). We are selective when choosing real estate stocks. The *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now.

Our two recommended REITs in the hospitality industry offer an excellent value. Both have new growth trends and pay attractive dividend yields which also reduces risk by putting a floor under the stock price. A major drag on the industry was the proliferation of Airbnb and similar competition but is changing in major metro areas. New York City is the most recent to pass a measure prohibiting transient rentals of fewer than 30 days at a time without the host being present. San Diego, Los Angeles, San Francisco, Boston, Washington DC, Philadelphia and Miami have also passed similar measures.

Both hospitality REITs have reported several hotel transactions during the last several years at cap rates ranging from 4.9 to 6 percent. Hershah recently sold the Hyatt House in Gaithersburg MD, and the Holiday Inn Express in Chester NY, at a combined capitalization rate of 4.9 percent. So far this year, RLJ sold three legacy

FelCor assets: the Fairmont Copley Plaza in Boston, the Embassy Suites Marlborough, and the Philadelphia Sheraton Society Hill, for a capitalization rate close to 6 percent. The Philadelphia Sheraton was also sold for \$95.5 million, a 5.6% cap rate.

To be conservative and to anticipate a rise in capitalization (cap) rates along with interest rates in general, we use a cap rate of 7.0 percent for valuation purposes.

**Hersha Hospitality (HT)** is worth \$29.63 per share which is substantially greater than the current price of the stock. This value should be a conservative estimate because Hersha's two premier hotels in Miami were closed because of Hurricane Irma and have not been contributing to income during the last 4 quarters. The Courtyard Cadillac Hotel, following its conversion to an Autograph Collection hotel, is now open. The Parrot Key Hotel and Resort is scheduled to open in the fourth quarter. Both hotels will offer enhanced quality in a strong market.

**RLJ Lodging Trust (RLJ)** is worth \$33.88 per share which is also substantially higher than the current price. We anticipate improvement in net operating income (and thus the value of the stock) because of the company's mission to sell its non-core assets since the merger with FelCor.

**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**

**Boston Scientific (BSX)** reported third quarter earnings in October of 35 cents per share, up 12.9% from the year-ago quarter. Revenues in the third quarter were up 7.7% year over year. Growth was worldwide. In addition to 9.4% growth in the United States, revenue grew 5.1% in Europe, the Middle East and Africa region; 6.2% in the Asia Pacific region, 3.7% in Latin America and Canada and 11.1% in the emerging markets.

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

**Hospitality REITs Comparison Table**

Company	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	19.44	6.8%	10.1%	8,246	33.88	-42.6%
Hersha	HT	17.56	6.4%	10.0%	2,575	29.63	-40.7%
Hospitality Properties	HPT	25.26	8.1%	10.2%	11,748	47.78	-47.1%
Host Hotels & Resorts	HST	19.11	4.2%	9.0%	22	25.75	-25.8%
Apple Hospitality	APLE	16.17	7.4%	9.4%	6,783	23.80	-32.1%

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 7.0 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 7.0 percent cap rate valuation of each company's real estate portfolio.

**Hospitality Properties (HPT)** is trading at a large 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.

costs. BSX's medical products are well suited for an aging population, and the company's stream of new inventions acquisitions add to promising growth prospects.

**Stryker (SYK)** reported third quarter earnings in October of \$1.69 per share, 11 percent higher than the \$1.52 per share a year ago.

Stryker is best known for its orthopaedic devices for artificial knees and hips. The company also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. The company's strong balance sheet allows it to make strategic acquisitions. The most recent was Inuity, the leader in advanced photonics and single-use, lighted instruments that deliver enhanced visualization for in a variety of surgeries. Other acquisitions are paying off. Mako's 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

Our two choices are still good values. A less stringent regulatory environment will give banks the ability to shed excess capital and increase leverage.

**JP Morgan Chase (JPM)** reported third quarter results in October of \$2.34 per share, versus expectations of \$2.25. Revenue came in at \$27.8 billion, slightly higher than expectations of \$27.5 billion. JPM is now expected to earn \$9.26 in 2018. JPM is still cheap in comparison to the rest of the market. At the relatively modest P/E

ratio of, say 15, JPM would be \$139.

**Wells Fargo (WFC)** also reported third quarter earnings in October of \$1.16 per share, slightly lower than expectations of \$1.17 per share. Revenue of \$21.9 billion was slightly higher than expectations. Net income of \$6 billion was 33 percent higher than the same period last year.

WFC is also currently cheap in comparison to the rest of the market. WFC is expected to earn \$4.50 in 2018. At a P/E ratio of 15, WFC would be \$67.

## 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 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)** reported third quarter earnings in October of \$2.34 per share, exceeding expectations and 40 percent higher than one year ago. Revenue grew by 17 percent year-over-year.

We added AAPL to the portfolio at \$116.30 and have continued recommending its purchase until recently. As the stock rose above 215, we switched from a "buy" to

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a “hold” because the trailing twelve-month (TTM) P/E ratio was rising above that of the market as a whole. In addition, the ongoing trade war with China makes us nervous because much of Apple’s supply chain is in China. Apple reported \$9.55 billion in third quarter revenue from greater China. Although this was an increase of 19 percent year over year, it was a drop of 29 percent from the previous quarter. Mainland China is Apple’s second-largest source of revenue, behind the US.

**Carnival Cruise Lines (CCL)** was added to the portfolio recently because it is a good value, especially when compared to the rest of the market. Growth prospects are strong because of the company’s dominance in the industry, efficiencies of scale, and favorable demographic trends driving a lasting increase in demand.

The consensus is that CCL will earn \$4.52 during the next year, which puts the forward price/earnings (P/E) ratio close to 14. During the last 5 years, the median P/E has been 19.

CCL has traded at an average enterprise value multiple of 11 during the last five years. A common practice is to multiply a company’s EBITDA (earnings before interest, taxes, depreciation, and amortization) by such a multiple to calculate its enterprise value. Based on the most recent four quarters of EBITDA, an enterprise value multiple of 11 puts the enterprise value at \$87 per share, which is substantially above the current stock price.

**Intel (INTC)** reported third quarter earnings in October of \$1.40 per share, sharply above the expectation of \$1.15 per share. The stock rose during a downdraft in the overall market.

Intel’s earnings were boosted by the acquisition of all of Apple’s modem business. Apple was already using Intel modems for some of its 7, 8, and X iPhones, but it was sourcing modems from both Qualcomm and Intel. However, this year’s iPhones use exclusively Intel’s modems. The third quarter’s earnings reflected a 130 percent jump in Intel’s cellular modem sales over the same quarter last year.

Intel has the size, diversity, and industry dominance to offer 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 this stock.

Stronger growth prospects make INTC under-valued at its current price because it deserves a higher P/E.

The company is projected to earn \$4.16 per share in 2018. At \$45 per share, the P/E is less than 11 which is very modest. At a P/E of say, 15, the stock price would be \$62.4 per share.

**International Business Machines (IBM)** reported third quarter earnings in October of \$3.42 per share, slightly higher than expected. Revenue of \$18.76 was slightly lower than expected, and was 2 percent lower than one year earlier, which sent a shock wave into the stock price. The company reiterated its previous guidance of at least \$13.80 in earnings per share. IBM stock is now trading at less than a P/E of 10. Such a low P/E is normally assigned to companies with little or no growth prospects.

Late in October, IBM announced the acquisition of the leading hybrid cloud computing firm Red Hat. The initial stock reaction was negative because of the premium price paid. IBM CEO Ginni Rometty and many analysts believe the acquisition will be transformative because it launches IBM into the enormous and growing hybrid modern data center market, which means offering cloud computing services for both public data centers, such as those offered by Amazon’s AWS and Microsoft’s Azure, as well as data centers that are private for regulatory reasons.

IBM and Red Hat have been working together for some 20 years on various projects, so the integration should be smooth. The acquisition is not scheduled to close until late 2019.

While expensive, the Red Hat acquisitions adds to the growth portion of IBM which was already more than half of revenue, from its so-called “Strategic Imperatives” which includes cloud-computing revenue, analytics, mobile and security. Within those imperatives is IBM’s cognitive-solutions segment, which includes software, analytics and its artificial intelligence platform, it calls Watson, which can “think” like a human.

The \$6.00 per share dividend now provides a yield of greater than 4.5 percent. This is a good time to invest in this long-term growth company at an excellent value.

**NCR Corp (NCR)** reported third quarter earnings in October of 57 cents per share, in line with expectations. Michael Hayford, President and Chief Executive Officer, said, “During the quarter, we made notable progress realigning our organization and addressing critical execution areas. Our evaluation of our business has uncovered significant cost reduction opportunities in areas targeting spend optimization to improve margins. Moving forward, we will drive operational efficiencies through a targeted plan that we expect will result in at least \$100 million cost savings in 2019. At the same time, we are enabling higher quality and faster

deployment of solutions across our markets while remaining committed to becoming a leading software and services-led enterprise provider of vertical industry solutions. This is demonstrated through our pending acquisition of JetPay, which will enable NCR to fully integrate NCR Payments with our point of sale and capture this recurring revenue stream.”

NCR remains a good value. The Company confirmed its 2018 earnings per share estimate of \$2.55 to \$2.75. This puts the current P/E under 10, a considerable discount to the rest of the market.

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.

NCR owns nearly three-quarters of the burgeoning self-checkout market and 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.

**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.”

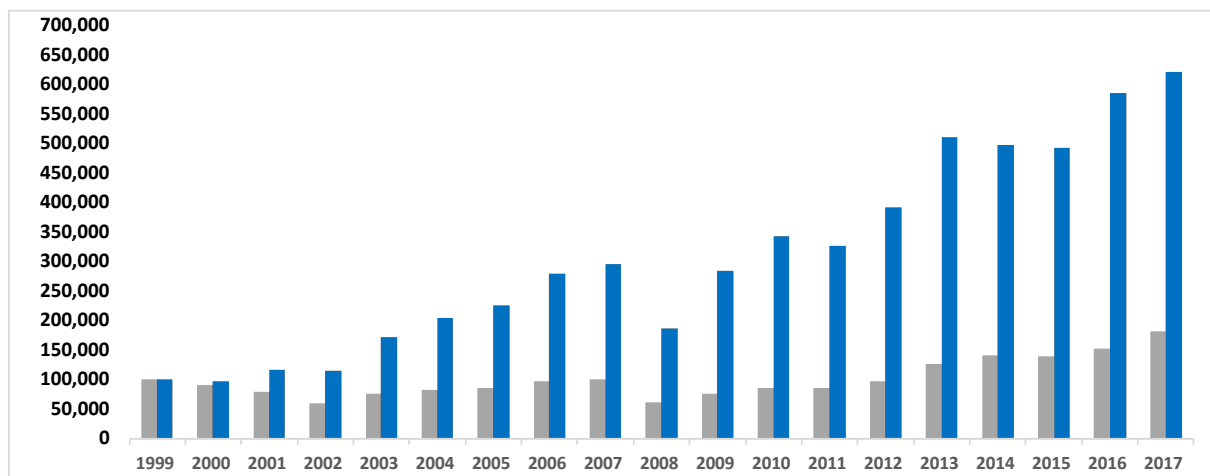
**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation. We added this stock many years ago at \$16.67 per share. Regardless of your purchase price, **we believe it is time to sell this stock** because the risk/reward ratio has become unfavorable. The P/E ratio is now very high, well above 25, which makes it vulnerable.

A storm of potentially bad news is gathering around TTEK regarding the former Navy site of Hunter’s Point in San Francisco. As usual, the old military base was heavily contaminated. For decades, Hunters Point was used to decontaminate Navy ships with radioactive material that ended up in the storm drains and sewers.

Tetra Tech had the contract to clean up the Naval shipyard. Since the cleanup began in 2012, Tetra Tech whistle-blowers have claimed they were instructed to swap contaminated soil samples with clean ones. There have been several suits filed since 2013. Two former Tetra Tech supervisors were recently sentenced to prison for falsifying soil sample reports. In October, the Department of Justice announced it will pursue the matter. That means potentially bad news for many months to come.

### 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 \$181,977, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$620,555.



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

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$3.51	0.00%	BUY	\$3.90
Chevron	CVX	\$111.65	4.01%	BUY	\$119.00
Fidelity Select Nat. Gas Fund *	FSNGX	\$21.93	0.57%	BUY	\$23.50
ICON Energy Fund Class S *	ICENX	\$11.24	0.48%	BUY	\$13.00
Valero	VLO	\$91.09	2.63%	BUY	\$99.00
Real Estate					
Hersha Hospitality Trust	HT	\$17.56	6.38%	BUY	\$20.00
RLJ Lodging Trust	RLJ	\$19.44	6.79%	BUY	\$22.00
Third Avenue Real Estate Value Investor *	TVRVX	\$28.68	0.57%	BUY	\$31.00
Medically Related					
Boston Scientific	BSX	\$36.14	0.00%	BUY	\$38.00
Stryker Corp.	SYK	\$162.22	1.05%	BUY	\$170.00
Tekla Life Sciences Fund	HQL	\$17.73	0.00%	BUY	\$19.50
Financials					
JP Morgan Chase	JPM	\$109.02	2.05%	BUY	\$112.00
Wells Fargo	WFC	\$53.23	2.93%	BUY	\$55.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$20.04	0.32%	BUY	\$22.00
Special Situations					
Apple	AAPL	\$218.86	1.33%	HOLD	\$210.00
Carnival Cruise Lines	CCL	\$56.04	3.57%	BUY	\$65.00
Intel	INTC	\$46.88	2.56%	BUY	\$49.50
International Business Machines	IBM	\$115.43	5.20%	BUY	\$126.00
NCR Corp	NCR	\$26.85	0.00%	BUY	\$29.00
Symantec	SYMC	\$18.15	1.54%	BUY	\$19.50
<b>Tetra Tech</b>	<b>TTEK</b>	<b>\$66.04</b>	<b>0.73%</b>	<b>SELL</b>	<b>\$60.00</b>
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$22.85	0.00%	BUY	\$24.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$24.13	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$40.69	0.00%	BUY	\$44.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$37.83	0.00%	BUY	\$41.00

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

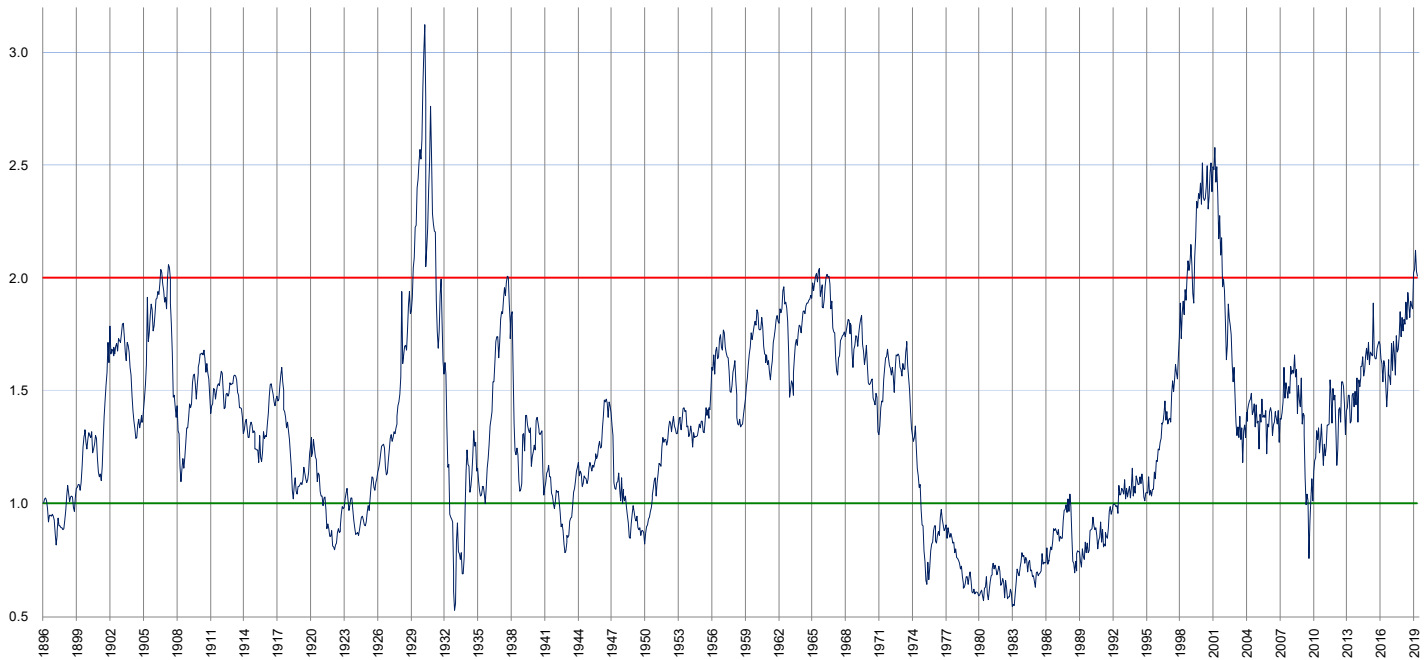
\* It is not possible to offer live pricing on our recommended mutual funds.

**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 120+ 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 based on the ratio of the S&P 500 Stock Index to median price of new houses 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 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.

But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing, had an investor followed the signals of the **SoundAdvice** Risk Indicator he or she would have made \$452 million, or 26 times more money than by simply holding stocks through the ups and downs.

A brief walk through history shows just how reliable this indicator is.

The first recorded time the Risk Indicator rose above 2.0 was in February 1906, after the eight-year-old Dow-Jones average doubled since 1903. The market peaked in the first quarter of 1907. A massive sell-off in October would later be labeled the Panic of 1907. Stock prices trended downward for 14 more years until the end of 1921 while, searing inflation after World War I boosted house prices 48 percent. The combination of falling stock prices and rising real estate prices forced the Risk Indicator to fall below 1.0 in 1920, just in time

**The New York Times**

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

for the Roaring 20's when stock prices tripled. Then, in October 1928, the Risk Indicator rose above 2.0 again. On Tuesday, September 3, 1929, the Dow peaked at 318.17. The October crash marked the beginning of a decline that lasted until July 8, 1932. Houses had declined only by 15 percent compared with the 85 percent loss in stocks. The relative superior performance of houses caused our Risk Indicator to fall below 1.0 at the beginning of 1932.

As America's GNP began posting positive gains and with 46 percent growth in three short years, stock prices would triple. Then the Risk Indicator crossed 2.0 in March 1937. This time, the signal came only one month before the zenith in stock prices. As stock prices retreated 50 percent, house prices remained relatively steady, causing the Risk Indicator to fall below 1.0 again in June 1941, within 9 months from the bottom.

As U.S. corporations expanded to meet growing demand, and the economy came to a rolling boil during the Eisenhower years, the stately rise would multiply stock prices by ten times until November 1964, when the Risk Indicator crossed over 2.0 again. The stock market would continue to climb into 1968, and then crash in 1975, wiping out the inflation-adjusted gains scored by investors since 1954. However, a switch to an investment in houses would avoid all that and double in price by the time the next signal came for stocks in May 1974, as the Risk Indicator fell

below 1.0 again, as the Dow careened below 700.

It would not be until March 1998 when the Risk Indicator would cross 2.0 again, after stocks were up by more than tenfold. The Dot-Com bubble would push stocks higher into early 2000, but then began another 50 percent retracement. A switch to houses would produce a 44 percent gain through the end of 2008 while stock prices were lower by 17 percent. In February 2009, with the Dow careening down through the 700s once again, the Risk Indicator quietly dropped below 1.0 to 0.77 as the S&P tumbled under 700. Since then, the stock market has delivered stunning gains as the S&P 500 has quadrupled.

**Based on the latest median house price of \$319,200 for August, and with the S&P 500 averaging 2,785.46 n October, the SoundAdvice Risk Indicator reads 2.01, revealing a historically high-risk time for stocks.**

As remarkable as the SoundAdvice Risk Indicator has been, it does not pinpoint the exact time. In the past 123 years, its signal has ranged from being only one month before the zenith to as much as two years early. While the Risk Indicator has been early, it has never been wrong. An expensive crash was inevitable. A 50 percent decline took a 100 percent recovery just to break even.

To help us narrow down the timing as well as gage the potential severity of an upcoming decline, we have our Diffusion Indexes.

## 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

### Track Record of the SoundAdvice Diffusion Indexes

After each "Aggressive" signal, the S&P 500 climbed an average of 31.0 percent. During "Caution" signals, the S&P 500 either crashed, meandered, or climbed, recording an average increase of 3.8 percent.

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 +/-	31.0%		3.3%

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 this Diffusion Index to 100 percent. However, interest rates did not rise because they were being held artificially low by the Fed's massive QE bond-buying activities. During the QE programs, the Fed's assets grew by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion.

That has changed now because quantitative easing has been reversed into quantitative tightening. Instead of buying, 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 means that we will no longer have a QE program holding interest rates artificially low.

### Current Status

The Diffusion Index of LAGGING Indicators climbed to 100 percent for December, giving us a new Caution Signal in January, very close to the peak in the market. The latest data for September caused a 33.3 percent reading.

Our next signal will come from the Diffusion Index of LEADING Indicators, when it drops to zero, which would take a surprising softening in the US economy. The latest reading for this Diffusion Index is 33.3 percent.

### Concurrence

There are times when signals from the Risk Indicator and the Diffusion indexes are out of sync, when one is signaling caution and the other is not. This occurred in August 1987, when the Diffusion Index of Lagging Indicators switched into caution mode, just prior to the October 1987 Crash that took stocks sharply for a brief period. Non-concurrence also occurred in March of 2008, when the Diffusion Index of Lagging Indicators switched into caution mode, just prior to the 2008-09 bear market crash. Both of these crashes were brutal, but relatively short-lived. Once the Risk Indicator plunged below 1.0, a very profitable bull market followed.

Then there are times when both indicators concur, signaling the same thing at roughly the same time. This happens when the Risk Indicator is above 2.0, indicating the end of a supercycle, and the Diffusion Index of Lagging Indicators switches into caution mode, indicating the end of a business cycle. Of course, this concurrence indicates that a more vicious and potentially longer-lasting bear market, or series of bear markets, is bound to follow, eventually taking stock prices down substantially – usually by 50 percent -- until the Risk Indicator falls below 1.0 again. We have this concurrence today.

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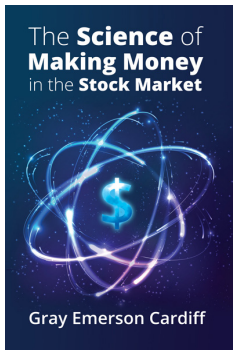
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