

# SoundAdvice

Advising Investors for 30+ years

July 2019 Issue

July 2, 2019

## A Timeout

In the wake of the G-20 summit in Japan this past weekend, the Trump Administration pulled back on imposing more tariffs. As investors, our job is not to be political, but to realistically assess situations that could have a meaningful impact on our investments. The course of the trade war certainly qualifies as one of those forces.

China believes any new agreement will need to be “evenhanded” -- an equal reduction of tariffs on both sides. However, US officials want more than that. They want structural changes on the Chinese side: no more intellectual property theft, no more forced transfer of technology as a prerequisite for joint ventures, and ways to enforce these structural changes. These views are also supported by private industry as evidenced by the typical response to the weekend’s trade truce:

**U.S. Chamber of Commerce:** *The U.S. Chamber of Commerce is encouraged by today’s announcement by Presidents Donald Trump and Xi Jinping that both governments will return to the negotiating table and refrain from further escalatory actions, including new tariffs that would damage businesses, workers, consumers and the global economy. We hope each side is now prepared to go the last mile to achieve a high-standard, comprehensive, enforceable agreement. China must commit to addressing longstanding unfair trade practices and industrial policies that prevent a level-playing field for U.S. companies. Opening markets, increasing IPR [intellectual property rights] protection, and promoting fair and reciprocal opportunities in trade are in China’s own interest as it works to build a stronger and more innovative economy.*

**National Association of Manufacturers:** *A trade deal, not a trade war, is exactly what manufacturers have advocated over the last year and a half, and today’s meeting brings us closer to that goal. We*



Gray Emerson Cardiff, Editor

So far this year, the *Sound Advice* model portfolio is up 8.1 percent.

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

From 2000-2018	9.5% Annually versus.
	2.8% from the S&P 500

*will continue to seek a new structure for the U.S.– China commercial relationship that eliminates unfair practices and opens China’s market through strong enforceable new trade rules...For too long, manufacturers have paid the price while China has reaped the rewards of its unfair trade practices, intellectual property theft and exploitation of existing trade agreements.*

Last year’s G-20 meeting in Argentina ended the same way, with a 90-day truce. As we know, the lack of structural changes led to a new round of tariffs.

### **The Role of SOEs**

The Chinese communist-based economy has been relying on its 109 state-owned enterprises (SOEs) to provide a substantial portion of employment, especially in areas where the government believes its oversight is necessary, such as defense, energy projects and management, communications, and transportation.

SOEs are highly over-leveraged with debt from preferential access to loans. They also promote legislation to reduce private competition. SOEs would not survive without subsidies and perks they receive, which is acknowledged by the World Trade Organization (WTO) as an unfair trade practice.

Lumbering inefficiencies and lack of incentives make it difficult if not impossible for SOEs to be innovative.

That is why China has been “procuring” technology from the west, either by outright theft or by imposing technology transfers to domestic companies in exchange for access to China’s markets.

SOEs are enjoying increasing support from the Chinese government who want to make them more efficient and a larger force in the economy. The State-owned Asset Supervision and Administration Commission (SASAC), which was established in 2003, is currently concentrating on restructuring SOEs into modern profit-oriented corporations. However, the government insists on holding absolute control over final decisions. Efforts to privatize SOEs have slowed recently as the trade war escalated because the government began focusing on retaining centralized control to better prepare for economic threats.

What does all this mean to us as investors?

The likelihood of an escalating trade war is still present. The Chinese economic situation is difficult and delicate, and its plight will have a major impact on economies around the world. The Chinese government is responding to western markets through a centralized, government-controlled economy. Any structural changes are bound to slow and will not come without nearly unbearable trade pressures. As we have said in previous issues, Chinese leaders may kick the can and hope the US has a new president in 2021, one with whom it will be easier to make a more favorable deal.

## The Portfolio

We continue to recommend that you keep a substantial amount of cash on the sidelines. In the midst of potentially lingering trade uncertainties, stock prices are historically high and vulnerable. Our *Sound Advice* Risk Indicator (page 10) is still over 2.0, revealing that it is a high-risk time for stocks. In addition, our *Sound Advice* Diffusion Index of Lagging Indicators (page 11) is still giving us a Caution Signal.

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 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. To add downside protection, we continue to

recommend hedging your portfolio.

**ProShares UltraShort S&P 500 (SDS)** 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.

### Energy & Natural Resource Selections

The US became a net exporter of oil late in 2018, which is supporting oil prices. We are still importing nearly half of our oil needs because most US refineries were constructed prior to the US shale boom and designed to process imported crude oil which is a heavy (thick) and sour (high sulfur) grade. 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 supplies. Meanwhile, America’s light sweet crude is now available for exporting.

**Adams Natural Resources (PEO)** is a candidate for steady income. This fund has been in operation since 1929 and has 80+ years of distribution history. PEO has an objective and recent history of making quarterly distributions that add up to at least 6 percent annually. These distributions are usually a mix of dividends and long-term capital gains.

This is a closed-end fund, which means it trades like a stock and can be bought and sold during market hours. The price of PEO is not tied directly to the NAV of the underlying portfolio, so it can trade at a discount or a premium. This is an advantage now because PEO is currently trading at a substantial discount to its NAV. In addition, PEO also has a lower expense ratio of 0.78 percent, versus the industry average of 1.14 percent.

**Chesapeake Energy (CHK)** has come out of the red in the last three years and become a profitable company with a respectable return on equity that is higher than the industry average. The recent WildHorse acquisition is delivering cost efficiencies while increasing oil production and is on track to

The Cost of Energy Equivalents of Oil and Natural Gas

deliver 30+ percent oil growth this year.

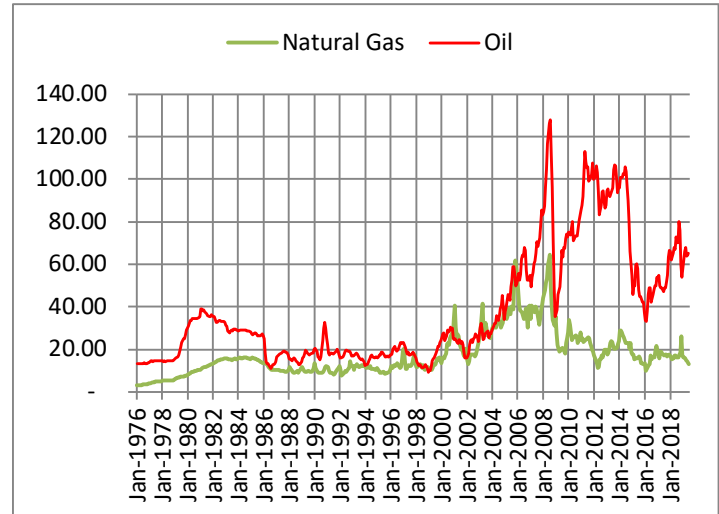
**Chevron (CVX)** has had strong earnings growth in recent years despite a volatile oil market. That trend has been bolstered by the fact that Chevron is an integrated oil company, which means it has operations in production as well as refining. This gives CVX diversification because the company’s oil and gas production (upstream) benefits from rising oil and gas prices while the refining operations (downstream) tend to benefit from lower oil prices. This diversification adds financial stability during times of volatile oil prices. CVX has an attractive and sacrosanct dividend that provides an attractive yield and puts a floor under the stock price.

**Fidelity Select Natural Gas Fund (FSNGX)** is an open-end fund which means it trades at the NAV of its portfolio set at the close of the market each day. It 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 \$2.23 for one million BTUs, 5.8 million BTUs will cost \$12.93. Thus, with a barrel of Brent crude oil costing \$65, the same amount of energy is available for 20 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 green 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.

**Valero Energy (VLO)** 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

Commercial real estate prices remain historically high as low interest rates have pushed down real estate capitalization (cap) rates to historically low levels (like bond yields). Accordingly, the *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now.

Our two recommended REITs in the hospitality industry offer excellent values, high dividend yields, and new growth trends. They also pay attractive dividend yields which also reduces risk by putting a floor under the stock price.

A major drag on the hospitality industry has been the proliferation of Airbnb and similar competition. However, this 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,

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### Hospitality REITs Comparison Table

Company	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	17.71	7.5%	12.3%	9,462	41.26	-57.1%
Hersha	HT	16.43	6.8%	8.5%	2,624	27.21	-39.6%
Hospitality Properties	HPT	24.79	8.2%	11.2%	12,776	53.91	-54.0%
Host Hotels & Resorts	HST	18.71	4.3%	9.7%	23	27.34	-31.6%
Apple Hospitality	APLE	15.65	7.7%	9.4%	6,734	23.26	-32.7%

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.

Los Angeles, San Francisco, Boston, Washington DC, Philadelphia and Miami have also passed similar measures.

Both of our selected hospitality REITs have reported several hotel transactions in recent years. Hersha sold 20 properties from 2016 through 2018 for an average cap rate of 6.5 percent. In the spirit of being 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)** has a bi-coastal portfolio of 48 high-quality hotels. Based on the trailing four quarters, and using a 7.0 percent cap rate, HT is worth \$27.21 per share which is substantially greater than the current price of the stock. This value is bound to increase due to the ramp up at Cadillac and Parrot Key after the 2017 hurricanes along with increasing net income from major renovations to hotels in Philadelphia, Boston, and New York. The Company is also repurchasing significant amounts of its own stock.

**RLJ Lodging Trust (RLJ)** is worth \$41.26 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) as the company executes its mission to sell its non-core assets since the merger with FelCor, and to renovate and upgrade significant properties.

RLJ has a large and diversified portfolio, with 151 hotel properties with 28,800 rooms located in 25 states and the District of Columbia. The majority of the hotels are located in business districts within major metropolitan areas where business travelers represent the majority of the demand.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** is loaded with good values substantially below their net asset values (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.

This 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.

## Medically-Related Selections

**Boston Scientific (BSX)** has made acquisitions that have added numerous products with significant growth potential, including Claret Medical, VENITI, and Augmenix.

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, and the company's stream of new inventions acquisitions add to promising growth prospects. The company

**Stryker (SYK)** has a very high return on equity which is propelled by its strong balance sheet and its ability to make strategic acquisitions. Demand for Stryker's products will grow as America and the rest of the world ages. The company provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. Its orthopaedic devices for artificial knees and hips lead the industry.

## The Best in Biotech ETFs

Biotech companies offer the most explosive profits in the healthcare industry. Over the last 15 years, biotechnology has become a major industry and the source of the world's top breakthrough drugs. However, stocks of individual biotech companies are often volatile and can have unforeseen risks, which makes diversification essential. This diversification can be accomplished by investing in a diversified biotech electronically traded fund (ETF) investing exclusively in a portfolio of biotech companies. We are recommending two top performers.

**Virtus LifeSci Biotech Products (BBP)** seeks investment results that correspond to the price and yield performance of the LifeSci Biotechnology Products Index, which tracks the performance of biotechnology companies, and covers companies that design drugs ranging from entrepreneurial start-ups to global giants that have completed multiple human clinical trials and have received FDA approval to sell and market at least one drug.

This is a passively managed biotech ETF that weighs the portfolio selections essentially equally, as opposed to weighing selections according to market

capitalization. This is an important point because biotech ETFs weighing their portfolio selections essentially equally have been the best performers by far because they have larger investments in smaller biotechnology companies which are acquisition targets for large pharmaceutical companies looking for ways to revitalize their drug portfolios by scooping up smaller companies.

**ARK Genomic Revolution Multi-Sector (ARKG)** is an actively managed biotech ETF focusing on the revolution stemming from mapping the human genome. Breakthroughs and advancements have cut the cost substantially of mapping the human genome which is opening up new opportunities and making this sector the cutting edge of new innovations. This ETF invests in companies that are expected to substantially benefit from extending and enhancing the quality of human and other life by incorporating technological and scientific developments and advancements in genomics into their business.

## Financials

**JP Morgan Chase (JPM)** raised its quarterly dividend by 13 percent to 90 cents a share from 80 cents a share after passing the most recent Federal Reserve "stress test. The bank can now repurchase up to \$29.4 billion in stock under a new program, compared to \$20.7 billion last year.

JPM is a good value, especially in comparison to the rest of the market. At \$113 per share, the P/E is 11.37. At the relatively modest P/E ratio of, say 14, JPM would be \$139 which is substantially above the current stock price.

**Wells Fargo (WFC)** is raising its quarterly dividend to 51 cents per share from 45 cents and increasing stock buybacks up to \$23.1 billion.

WFC is also a good value. At \$48 per share, the forward P/E is 10. At a P/E ratio of 14, WFC would be \$67.20, substantially above the current stock price.

## 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)** introduced a glucose monitor in June, called OneDrop, in some of its retail locations to continue expanding into health care. The monitor integrates with the iPhone to give people with diabetes a way to track their blood sugar through Apple's Health app. The OneDrop kit includes a year of free coaching from a certified diabetes educator along with other coaching programs that can help with carbohydrate counting.

To continue exploring the potential market for robotic vehicles, Apple announced in June that it purchased Drive.ai, which had been operating self-driving vans between Arlington and Frisco in Texas.

AAPL has been buoyed in June by the expectation that the US will hold off on the additional \$325 billion worth of tariffs. Even after rising from \$180 to nearly \$200 a share, the stock still represents a good value, especially in view of the \$245 billion in cash in the company's coffers. This amounts to \$51 per share. Subtracting this cash from \$200 per share means we are actually paying \$149 per share for the company. This puts the TTM P/E close to 12.5, substantially below the rest of the market.

**Carnival Cruise Lines (CCL)** announced earnings in June for its fiscal second quarter ending May 31. The results were better than expected and the company said it expects to earn between \$4.25 and

\$4.35 per share for the fiscal year that runs through next February.

With the stock price at \$47 per share, the P/E is slightly under 11. During the last 5 years, the median P/E has been 19, so CCL is currently priced at a bargain in comparison to its own history as well as at a bargain to the rest of the market.

For the longer run, CCL has strong growth prospects because of the company's dominance in the industry, efficiencies of scale, and favorable demographic trends driving a lasting increase in demand. It is also cheap, especially when compared to the rest of the market.

**Intel (INTC)** announced in June the acquisition of Barefoot Networks, which specializes in network silicon switches and software for data center cloud networking to deliver higher workloads, and capabilities. This acquisition enhances Intel's size, diversity, and industry dominance, which makes 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.

At \$48 per share and earnings of \$4.35, the stock is trading at a P/E ratio of 11 which anticipates very little or no growth. While that may be the case this year, it is not the longer term outlook.

**International Business Machines (IBM)** launched in June an upgraded version of its blockchain platform available to businesses. Blockchain is a simple way of passing information through the internet in a fully automated and safe manner that is impossible to corrupt or hack. Google spreadsheets are an example, where two people on separate computers are looking at the same spreadsheet at the same time while both have editing capabilities. Two or more people could also be editing the same text document instead of waiting for one to edit and transmit the document for the other to edit.

IBM announced earlier this year its *Q System One*, the world's first quantum computer available to businesses. This has given IBM an early lead in quantum computing, a game-changing technology

that offers exponentially more computing power to crack currently unsolvable problems. IBM says it has customers lining up for this technology for use in a wide range of industries.

Another driver of growth is the company's so-called "Strategic Imperatives" which offers cognitive solutions through its artificial intelligence platform, it calls "Watson", which can "think" like a human.

The company believes it will earn at least \$13.90 in earnings per share for all of 2019. This guidance puts the current P/E close to 10, which anticipates little or no growth. Any reported growth will be a beneficial surprise and gives IBM stock large potential upside. Even at a modest P/E of 12, the stock would be over \$167 per share. The \$6.00 per share dividend provides an attractive yield and puts a floor under the stock and reduces risk.

**NCR Corp (NCR)** is continuing its cost saving initiatives, which are expected to result in savings of about \$100 million in 2019.

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. 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.

NCR remains a good value with a P/E close to 11, a considerable discount to the rest of the market. Earnings per share are expected to be between \$2.75 and \$2.85 in 2019.

**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. On average, corporations increased budgets by 20 percent in 2018 to shield against cyber-crime. Symantec also increased its share buyback authorization to \$1.3 billion.

At \$22 per share, the P/E is under 13, still very modest both historically and compared to the S&P 500.

### **ETFs for Rising Bond Yields**

Even without an increase in interest rates or inflation in the foreseeable future, long-term Treasury bond yields are absurdly low, both from a historical perspective and from just plain common sense. Thirty-year treasury bonds have close to the same yield as short-term treasury bonds.

Our recommended ETFs are essentially short-selling bonds and will prosper from rising 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.

Long-term treasury bonds offer almost nothing in real terms (after adjusting for inflation). This has not been the case historically, as can be seen from the following table.

Years	30 Yr Note (Avg. Yield)	CPI Annual Increase	Real Rate
1980-84	12.0	7.6	4.4
1985-89	8.4	3.6	4.8
1990-94	7.7	3.7	4.0
1995-99	6.3	2.4	3.9
2000-04	5.7	2.6	3.1
2005-09	4.5	2.6	1.9
2010-14	3.6	2.0	1.6
2015-18	2.9	1.9	0.9
Average			3.1
			Current Inflation Rate 2.0
			Theoretical Target Yield 5.1
			Average Since 2000 1.9
			Current Inflation Rate 2.0
			Theoretical Target Yield 3.9

Bond Yields	ETF Prices		
	TBF	TBT	TMV
2.60	20.64	29.59	14.01
3.50	23.62	38.12	20.07
4.00	25.47	44.10	24.79
4.50	27.42	50.86	30.49
5.00	29.47	58.47	37.34

The table above shows the impact on the prices of our selected ETFs at various long-term treasury bond yields. The first row shows today's ETF prices with long-term Treasury bonds yielding 2.6 percent. Note that the price of these ETFs would rise dramatically with yields at 4 percent, and even more so at 5 percent.

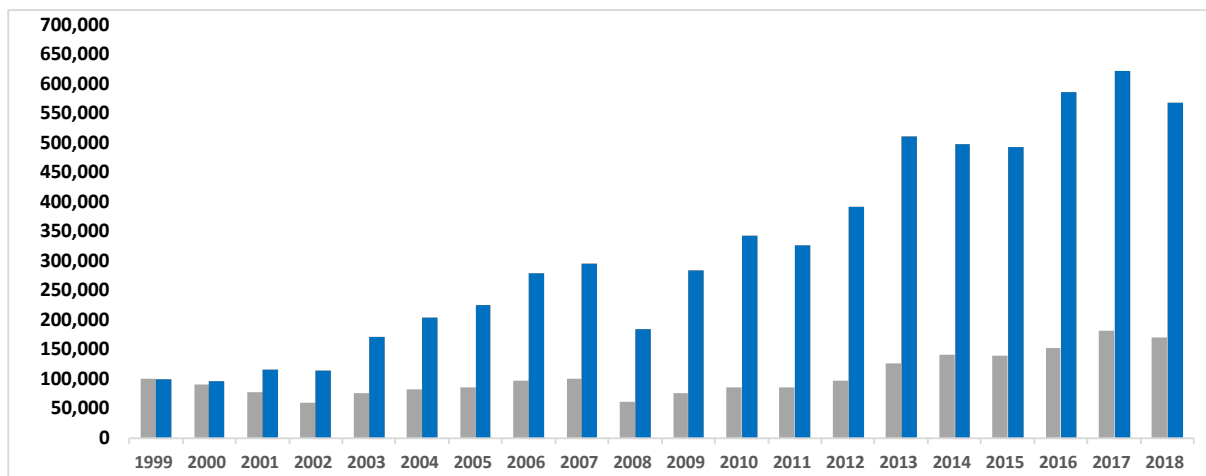
**The Erosion Factor**

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 2019, TMV would decline to \$13.72 (2.1 percent), TBT to \$29.30 (1.0 percent), and TBF to \$20.58 (0.3 percent). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

We can see from the history since 1980, that investors have demanded a real return of 3.1% on long-term treasury bonds. With today's inflation rate in the vicinity of 2 percent, 30-year treasury bonds should be yielding 5.1 percent, not 2.6 percent. If we only look at recent history, since 2000, a low inflationary period, investors have demanded a real return of 1.9 percent. This would put the yield on long-term treasury bond yields at 3.9 percent. Accordingly, even in a low inflationary environment, the yields on long-term treasuries are too low and belong much higher, even without a rising interest-rate environment.

**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 \$170,645, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$561,174.



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

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Adams Natural Resource Fund	PEO	\$16.54	6.00%	BUY	\$17.37
Chesapeake Energy Corp	CHK	\$1.95	0.00%	BUY	\$2.05
Chevron	CVX	\$124.44	3.60%	BUY	\$130.66
Fidelity Select Nat. Gas Fund *	FSNGX	\$20.00	0.40%	BUY	\$21.00
Valero	VLO	\$85.61	4.21%	BUY	\$89.89
Real Estate					
Hersha Hospitality Trust	HT	\$16.54	6.77%	BUY	\$17.37
RLJ Lodging Trust	RLJ	\$17.74	7.44%	BUY	\$18.63
Third Avenue Real Estate Value Investor *	TVRVX	\$27.76	1.47%	BUY	\$29.00
Medically Related					
Boston Scientific	BSX	\$42.98	0.00%	BUY	\$45.13
Genomic Revolution Multi-Sector	ARKG	\$34.47	0.00%	BUY	\$36.19
Stryker Corp.	SYK	\$205.58	1.01%	BUY	\$215.86
Virtus LifeSci Biotech Products	BBP	\$41.05	0.00%	BUY	\$43.10
Financials					
JP Morgan Chase	JPM	\$111.80	2.86%	BUY	\$117.39
Wells Fargo	WFC	\$47.32	3.63%	BUY	\$49.69
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$18.09	0.38%	BUY	\$19.00
Special Situations					
Apple	AAPL	\$197.92	1.48%	BUY	\$207.82
Carnival Cruise Lines	CCL	\$46.55	4.30%	BUY	\$48.88
Intel	INTC	\$47.87	2.51%	BUY	\$50.26
International Business Machines	IBM	\$137.90	4.35%	BUY	\$144.80
NCR Corp	NCR	\$31.10	0.00%	BUY	\$32.66
Symantec	SYMC	\$21.76	1.29%	BUY	\$22.85
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$13.56	0.00%	BUY	\$14.24
ETF - ProShares Short 20+ Year Trsry	TBF	\$20.39	0.00%	BUY	\$21.41
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$28.94	0.00%	BUY	\$30.39
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$30.72	0.00%	BUY	\$32.26

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

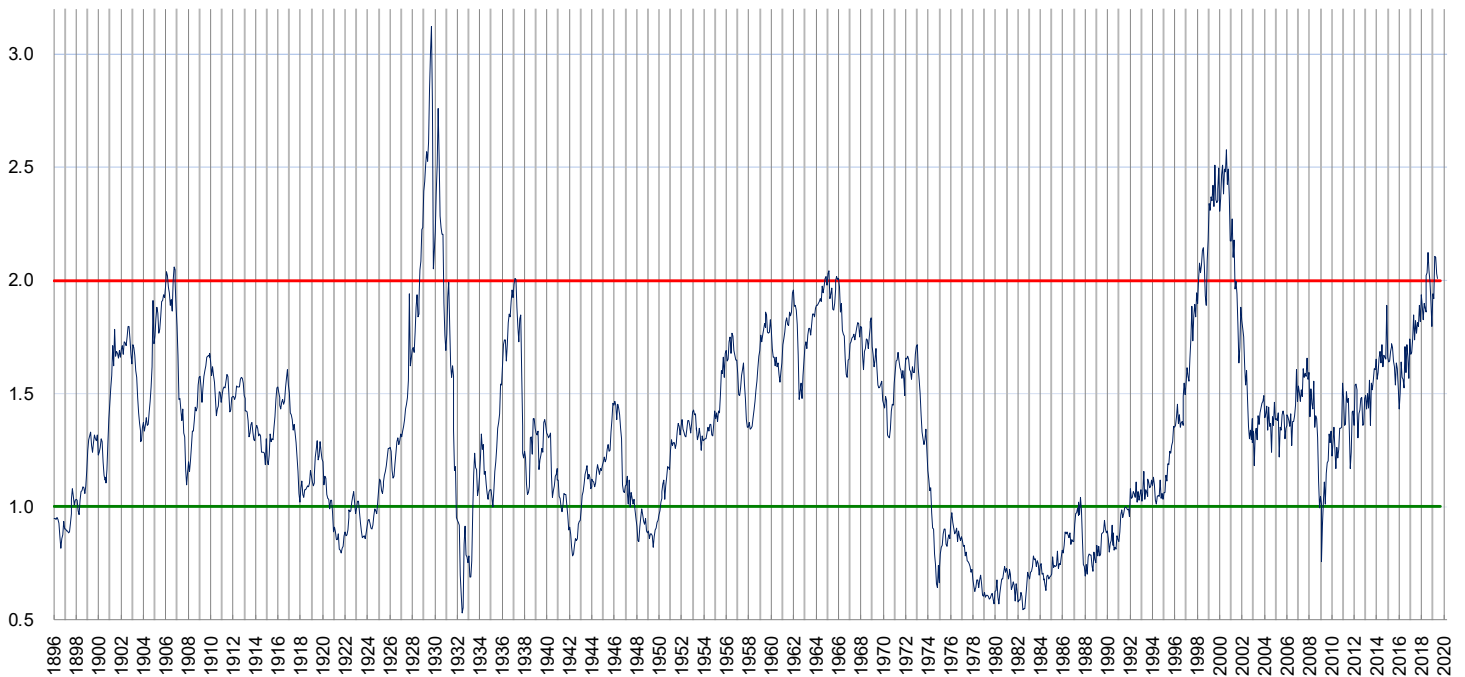
\* It is not possible to offer live pricing on our recommended mutual funds.

**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 **Sound Advice** "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 **Sound Advice** 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 **Sound Advice** 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 **Sound Advice** Risk Indicator he or she would have made \$429 million, or 26.5 times more money than by simply holding stocks though 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 September of 1906. 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 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

**The New York Times**

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

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 after 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. **For the sixth time in the last 123 years, the Risk Indicator rose above 2.0 again in July 2018.**

**With the latest median house price at \$335,100 in April and with the S&P 500 at 2,942, the Sound Advice Risk Indicator reads 2.01, revealing the risk in stocks is high.**

As remarkable as the **Sound Advice** 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 after the zenith to as much as four 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

### Track Record of the SoundAdvice Diffusion Indexes

After each "Aggressive" signal, the S&P 500 climbed an average of 30.0 percent. During "Caution" signals, the S&P 500 either crashed, meandered, or climbed, recording an average increase of 3.3 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 +/-	30.8%		3.4%

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 **Sound Advice** 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 **Sound Advice 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 **Sound Advice 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.

### 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 May 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 **Sound Advice** 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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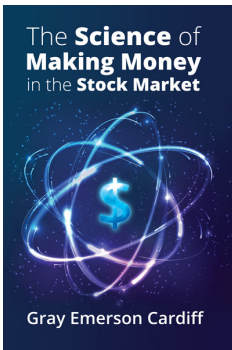
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