

Is a Recession Coming?

In August, the yield curve became inverted when long-term Treasury bond yields fell below yields on short-term bonds. Although falling bond yields are generally good for stock prices, the stock market reacted negatively because an inversion is believed to be a reliable indicator that a recession is on the horizon. Of course, recessions are bad for stocks because earnings decline and so do price/earnings ratios, giving stocks a double whammy.

The reliability of this recession indicator is well-founded because inverted yield curves on US Treasuries have preceded every recession since 1956. This phenomenon typically starts when the Federal Reserve tightens monetary policy by raising short-term interest rates in an effort to ring out an inflationary spiral caused by a mature and over-heating business cycle. Investors know that a hike in short-term interest rates will lead to a recession which will undermine inflation. In anticipation, investors rush into long-term bonds because they know yields will drop as inflation wanes. Long-term yields fall below the recently hiked short-term yields, causing an inversion, and a recession has followed an average of 22 months later.

On some occasions, the bursting of an asset bubble is the culprit and not the Federal Reserve's tightening monetary policy. This was the case in 2007. As the wind whistled out of the bloated real estate market, the resulting damage to the economy was anticipated by investors and they rushed into the safety of long-term bonds. The most recent recession of 2008-9 followed.

Is It Different This Time?

As we celebrate the longest economic recovery in modern history, we cannot help but ask those famous last words: Is it different this time?

One clear difference is that we do not have an inflationary spiral that needs ringing out by a tightening monetary policy. Although the Federal Reserve increased short-term interest rates last December, it was not because of runaway inflation. The Federal Reserve perceived a solid economy that no longer



Gray Cardiff, Editor

So far this year, the *Sound Advice* model portfolio is up 2.0 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

needed resuscitating from the last recession and that the “normal” interest rate should be higher. The increase also provided room for lowering to buffer the next recession, whenever that would be. Without the threat of boiling inflation, there is no need for a tight monetary policy. In fact, the primary controversy among Federal Reserve board members is whether to lower them at all.

The other cause leading to recession, asset bubbles, is more of a possibility. Clearly, low bond yields have pumped real estate prices. However, unlike the 2007 bubble, there is not the added zest of subprime mortgage lenders loaning too much money at temporarily-low teaser interest rates to those whose primary qualification was the ability to fog a mirror. As a result of the expiration of teaser rates in the last bubble, defaults mushroomed and the crash became systemic because it compromised the banking system. These days, it takes an honest credit worthy homebuyer to receive a mortgage loan. And the banking system has been bolstered by increased Dodd-Frank capital requirements.

Another difference from past cycles is that there are major distortions in the bond markets. For nearly ten years, the Federal Reserve has been buying massive amounts of US Treasury bonds. Its balance sheet expanded by four-fold during the “quantitative easing” (QE) programs, taking an enormous supply of Treasury bonds off the market. The bulk of the QE purchases were long-term Treasuries, which put significant downward pressure on the long end of the yield curve.

Recently, the Federal Reserve started to sell these QE bonds but stopped short.

To make matters worse, the Treasury is funding the escalating US deficit by issuing a high volume of short-term Treasury bills, which puts upward pressure on the short end of the yield curve.

Also pulling down bond yields are markets outside the US. Close to \$16 trillion in sovereign bonds now have a negative yield. Not only is there no investment return, investors will receive less back than they invested. Of course, this makes no sense and cannot be a lasting situation. However temporary, foreign investors have been a downward force on US Treasury bond yields because US bonds are relatively attractive, even with paltry yields.

So, this time actually could be different. There are new forces putting downward pressure on long-term yields as well as upward pressure on short-term yields. Indeed, these are pressures that are not connected to the usual forces that governed previous inversions. Accordingly, the recession that followed previous inversions may not occur this time -- at least for the same reasons.

We know that a recession is inevitable, we just don't know when. What we do know is that when a recession becomes widely expected, stocks tumble. In the last recession, earnings on the S&P 500 dropped 55 percent from the third quarter of 2007 to the first quarter of 2009. In the previous, more mild recession of 2000-2003, earnings dropped 26 percent.

We also know that it is a dangerous time because the stock and bond markets are priced for perfection. The trailing 12-month (TTM) P/E is still close to 19. The average since the bull market began in 2009 has been 17.61. In addition, the TTM P/E is substantially higher than at the peak of the previous bull market when it was 17.09 at the end of the third quarter of 2007. Accordingly, the market is extended and vulnerable by TTM P/E historical standards.

If a recession is not imminent, perhaps an extended period of slow growth is ahead. Then we are also looking at a period of slower growth for earnings, which is not what a high P/E on stocks typically anticipates. Slow growth means lower P/Es on stocks which translates into lower stock prices even if earnings don't change. A prolonged and escalating trade war could be responsible for this scenario. However, even this scenario does not mean bond yields will remain at

today's historic low levels.

Is Inflation Dead?

Of course, yields on bonds can only remain low as long as inflation is low. The latest inflation reading was a 1.8 percent increase of the consumer price index (CPI) for goods and services over the previous 12 months ending in July. However, the inflation that we feel is higher than that because the CPI is not accounting for the rapid rise in the services sector.

The services sector has become far greater throughout the world and now represents a majority of the world's GDP. In the US, the services sector represents **80 percent** of GDP, and in this sector, inflation has been running higher. One of the Commerce Department's economic indicators is the *Change in the CPI for Services*, which has been steadily logging in annual increases of 2.4 to 2.8 percent. The latest reading for July was a 2.6 percent annual increase.

The higher inflation reading for services reveals that the widely reported inflation measure, the CPI for goods and services, is too heavily weighted on goods rather than services. In reality, inflation is higher than the latest reading of 1.8 percent.

Today's absurdly low yields on long-term treasury bonds are not sustainable because they offer 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

We can see from 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 more than 5 percent, not less than 2 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 close to 4 percent. Accordingly, even in a low inflationary environment, the yields on long-term treasuries are way too low and belong much higher. The stock market won't like a rise in bond yields because low bond yields have been propelling the stock market to today's heights.

The Sound Advice Indicators

Our *Sound Advice* Diffusion Index of Lagging Indicators (page 11) is still giving us a Caution Signal. It is telling us that the economy is strong enough to put upward pressure on interest rates.

Our *Sound Advice* Risk Indicator (page 10) was substantially above 2.0 in August, revealing that it is a very high-risk time for stocks.

The Portfolio

Bear Bryant was talking about football when he said, "*Offense sells tickets, but defense wins championships.*" However, his quote also applies to investing. After a 50 percent loss, it takes a 100 percent gain to recover. That 100 percent gain doubles capital if the loss is avoided. The key to superior return is staying out of trouble.

We continue to recommend that you keep a substantial amount of cash on the sidelines. We cannot tell you how much, because we don't know your particular financial situation, but it should be substantial to you.

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 our selections 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

Adams Natural Resources (PEO) is a candidate for steady income because it 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 fund has been in operation since 1929 and has 80+ years of distribution history.

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) is leaving the portfolio. With its high debt load, the company will be put at higher risk with a prolonged period of meandering oil and gas prices which has become the most likely outlook as slow world-wide economic growth dampens demand for energy. The US has become the world's largest oil producer as shale producers continue to frack regardless of prices. The glut in US supplies and over-production is an immediate threat to CHK because of its highly-leveraged financial position and narrow room for declines in cash flow.

Chevron (CVX) reported earnings in early August of \$1.78 per share which was one of the few majors that reported better than expected results. These earnings included Anadarko merger termination fees

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of \$740 million along with some non-cash tax benefits. Removing these special items, earnings were flat. However, flat was encouraging because soft energy prices were offset by the increase in production we have been predicting from the large Australian projects.

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.

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 \$2.20 for one million BTUs, 5.8 million BTUs will cost \$12.76. Thus, with a barrel of Brent crude oil costing \$65, the same amount of energy is available for 21 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 translates 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, which bodes well for the longer term. Valero also has access to the US pipeline network for delivery to its gulf coast locations. This flexibility allows the company 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

The *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. 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).

Our two recommended REITs in the hospitality industry offer value, high dividend yields, and growth trends.

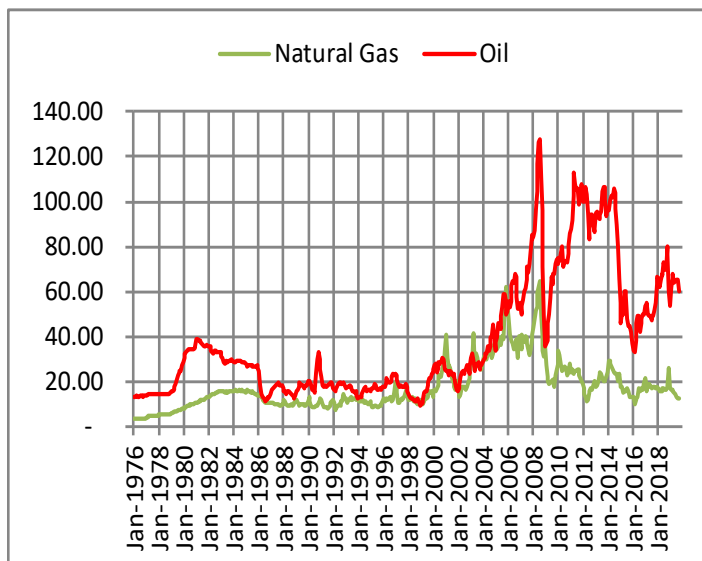
A major drag on the hospitality industry has been the proliferation of Airbnb and similar competition. However, this is changing in major metro areas. New York City is the most recent to pass a measure prohibiting transient rentals of fewer than 30 days at a time without the host being present. San Diego, 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.

They also pay very attractive dividend yields of which also reduces risk by putting a floor under the stock price.

Hersha Hospitality (HT) is worth \$22.23 per share based on the most recent trailing four quarters, and using a 7.0 percent cap rate, which is substantially greater than the current price of the stock.

The Cost of Energy Equivalents of Oil and Natural Gas



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	16.21	8.1%	11.7%	7,636	33.86	-52.1%
Hersha	HT	13.90	8.1%	8.2%	2,418	22.23	-37.5%
Hospitality Properties	HPT	24.14	8.5%	11.1%	12,647	52.66	-54.2%
Host Hotels & Resorts	HST	16.04	5.0%	10.7%	23	26.66	-39.8%
Apple Hospitality	APLE	15.93	7.5%	8.8%	6,372	21.73	-26.7%

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.

The dividend is currently \$1.12 annually, which is in the vicinity of an astonishingly high 8 percent yield. We took a close look at the company’s cash flow to determine the security of this dividend. Over the last four quarters, HT’s funds from operations (FFO) have been \$1.72 per share which is plenty of coverage for the dividend. While FFO is considered the best measure for dividend coverage, it can be misleading if the company has significant capital expenditures (capex), which are normally not included in FFO.

Hersha has had very high capex due to the destruction brought by Hurricane Irma in 2017. The company reported \$65.7 million of capex in 2018. However, \$38.8 million was categorized as hurricane damage, which leaves \$26.9 million as a balance, or \$6.7 million per quarter.

For the first half of 2019, capex was \$21.2 million. It is not clear how much of this is still extraordinary, as part of renovating properties. If we subtract all of it from FFO, along with the final two quarters of 2018, the net cash flow is 92 cents per share, which is less than the dividend.

We can see why the market is nervous about HT. However, even if the dividend were adjusted down to 92 cents per share, the yield would still be more than 6 percent. We don’t see HT lowering the dividend because not all of the recent 2019 capex is “ordinary and necessary” to maintain the company’s properties. The stock price also presents a compelling value, which is bound to increase from increasing net income from major renovations to hotels in Philadelphia, Boston,

and New York, along with the ramp up at Cadillac and Parrot Key after the 2017 Florida hurricanes.

RLJ Lodging Trust (RLJ) is worth \$33.86 per share which is also substantially higher than the current price. 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.

We have been recommending RLJ because the net operating income (and thus the value of the stock) is primed to improve as the company executes its mission to sell its non-core assets since the August 2017 merger with FelCor, and to renovate and upgrade significant properties.

As in the case of Hersha, RLJ is paying a high dividend in the vicinity of 8 percent annually. FFO has amounted to \$2.29 per share which is plenty to cover the dividend of \$1.32. However, renovations of the Felcor properties have required substantial capex which, if subtracted from the FFO leaves \$1.21 in net cash flow, which is slightly less than the dividend but would still provide a 7.5 percent yield.

We don’t see RLJ lowering the dividend because the net cash flow is still close to the declared dividend. The stock price also presents a compelling value, which is bound to increase from increasing net income coming from major renovations.

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.

The fund 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

Both of our selections make medical devices and products which are well-suited for an aging population. They are defensive in nature because they are not largely dependent on economic conditions. They also avoid the current uncertainties over drug pricing and patent expirations facing pharmaceutical companies.

Boston Scientific (BSX) has been a global medical technology leader for three decades by providing a range of high-performance solutions aimed at addressing medical needs and reducing healthcare costs. The company's stream of new inventions acquisitions add to promising growth prospects.

Stryker (SYK) 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. SYK has a very high return on equity which is propelled by its strong balance sheet and its ability to make strategic acquisitions.

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.

ARK Genomic Revolution Multi-Sector (ARKG) is an actively managed biotech ETF investing in companies that are expected to substantially benefit from extending and enhancing the quality of human life by incorporating technological and scientific developments and advancements 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.

Financials

As we all know, such a flat yield curve is very unusual and not a historical norm. Beyond the near term, banks will prosper as interest rates rise from historically low levels, and the yield curve steepens. That eventual return to historical norms is why these stocks present an extraordinary value.

JP Morgan Chase (JPM) is a good value, especially in comparison to the rest of the market. 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 also a good value. 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) represents a good value, especially in view of the \$210 billion in cash in the company's coffers. This amounts to \$48 per share. Subtracting this cash from \$210 per share means we are actually paying \$164 per share for the company. This puts the TTM P/E close to 14, substantially below the rest of the market.

Carnival Cruise Lines (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.

With the stock price at \$44 per share, the P/E is 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.

Intel (INTC) has the size, diversity, and industry dominance, to make 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 12 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) reiterated its earnings guidance of at least \$13.90 in earnings per share for all of 2019. This guidance puts the current P/E under 10, which anticipates little or no growth. However, a strong 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 Red Hat acquisition is bound to be transformative because it launches IBM into the enormous and growing hybrid modern data center market.

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) 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.

Symantec (SYMC) has been volatile recently, climbing in early July on the news of a potential sale to Broadcom and then dropping when discussions halted. President Trump also tried to block the effort on national security grounds, citing how the acquisition could interfere with competition in developing 5G wireless network technologies.

In mid-August, SYMC was back up again on the news that Broadcom is buying Symantec's Enterprise Security segment for \$10 billion. This is Symantec's segment that serves businesses and accounts for roughly half of the company's annual revenue. This segment is an important source of future growth. As we have noted in *Sound Advice*, business enterprises have been increasing their security budgets substantially in recent years to guard against cyber-attacks. On average, corporate security budgets increased by 20 percent in 2018.

Without its business segment, we believe that Symantec's upside growth is limited. Moreover, there is a chance the deal could fall apart again, in which case the stock will drop, as it did the last time the previous talks stalled. The rise in the stock price provides an opportunity to take a profit in this stock and our advice is to sell SYMC.

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.

The following table shows the impact on the prices of our selected ETFs at the end of next year at various long-term treasury bond yields. The first row shows today's ETF prices with long-term Treasury bonds yielding 1.97 percent. Note that the price of these ETFs would rise dramatically with yields at 4 percent, and even more so at 5 percent.

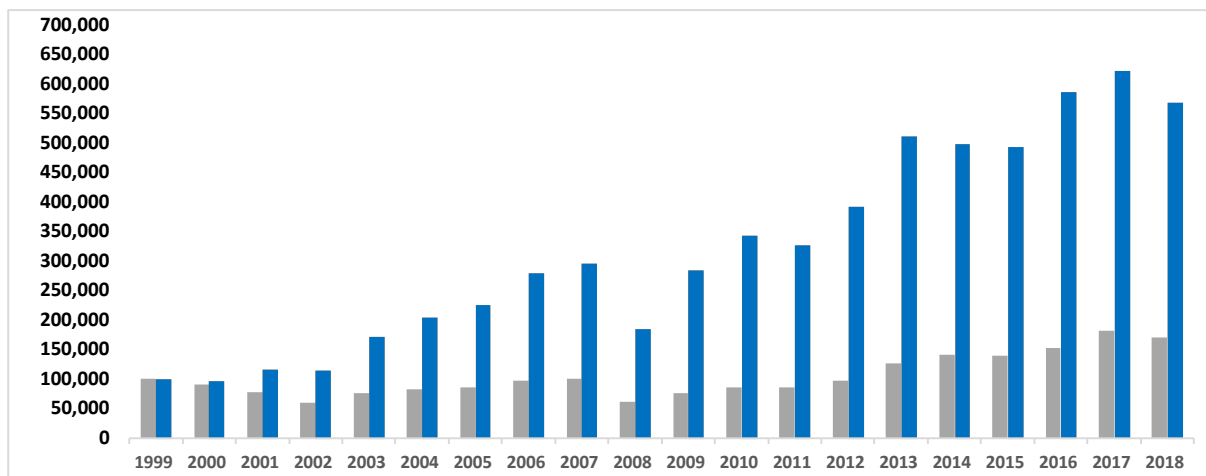
Bond Yields	ETF Prices		
	TBF	TBT	TMV
1.97	18.34	23.29	9.71
3.50	22.71	34.38	16.64
4.00	24.50	39.82	20.60
4.50	26.40	45.99	25.39
5.00	28.40	52.95	31.15

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 \$9.45 (2.6 percent), TBT to \$22.94 (1.5 percent), and TBF to \$18.23 (0.6 percent). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

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.



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Adams Natural Resource Fund	PEO	\$15.10	6.00%	BUY	\$15.86
Chesapeake Energy Corp	CHK	\$1.44	0.00%	SELL	
Chevron	CVX	\$117.72	3.81%	BUY	\$123.61
Fidelity Select Nat. Gas Fund *	FSNGX	\$16.94	0.47%	BUY	\$18.00
Valero	VLO	\$75.28	4.78%	BUY	\$79.04
Real Estate					
Hersha Hospitality Trust	HT	\$13.90	8.06%	BUY	\$14.60
RLJ Lodging Trust	RLJ	\$16.21	8.14%	BUY	\$17.02
Third Avenue Real Estate Value Investor *	TVRVX	\$26.46	1.54%	BUY	\$28.00
Medically Related					
Boston Scientific	BSX	\$42.73	0.00%	BUY	\$44.87
Genomic Revolution Multi-Sector	ARKG	\$31.43	0.00%	BUY	\$33.00
Stryker Corp.	SYK	\$220.66	0.94%	BUY	\$231.69
Virtus LifeSci Biotech Products	BBP	\$37.25	0.00%	BUY	\$39.12
Financials					
JP Morgan Chase	JPM	\$109.86	2.91%	BUY	\$115.35
Wells Fargo	WFC	\$46.57	3.69%	BUY	\$48.90
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$17.58	0.39%	BUY	\$19.00
Special Situations					
Apple	AAPL	\$208.74	1.40%	BUY	\$219.18
Carnival Cruise Lines	CCL	\$44.08	4.54%	BUY	\$46.28
Intel	INTC	\$47.41	2.53%	BUY	\$49.78
International Business Machines	IBM	\$135.53	4.43%	BUY	\$142.31
NCR Corp	NCR	\$31.51	0.00%	BUY	\$33.09
Symantec	SYMC	\$23.25	1.20%	SELL	
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$9.71	0.00%	BUY	\$10.20
ETF - ProShares Short 20+ Year Trsry	TBF	\$18.34	0.00%	BUY	\$19.26
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$23.29	0.00%	BUY	\$24.45
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$30.73	0.00%	BUY	\$32.27

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

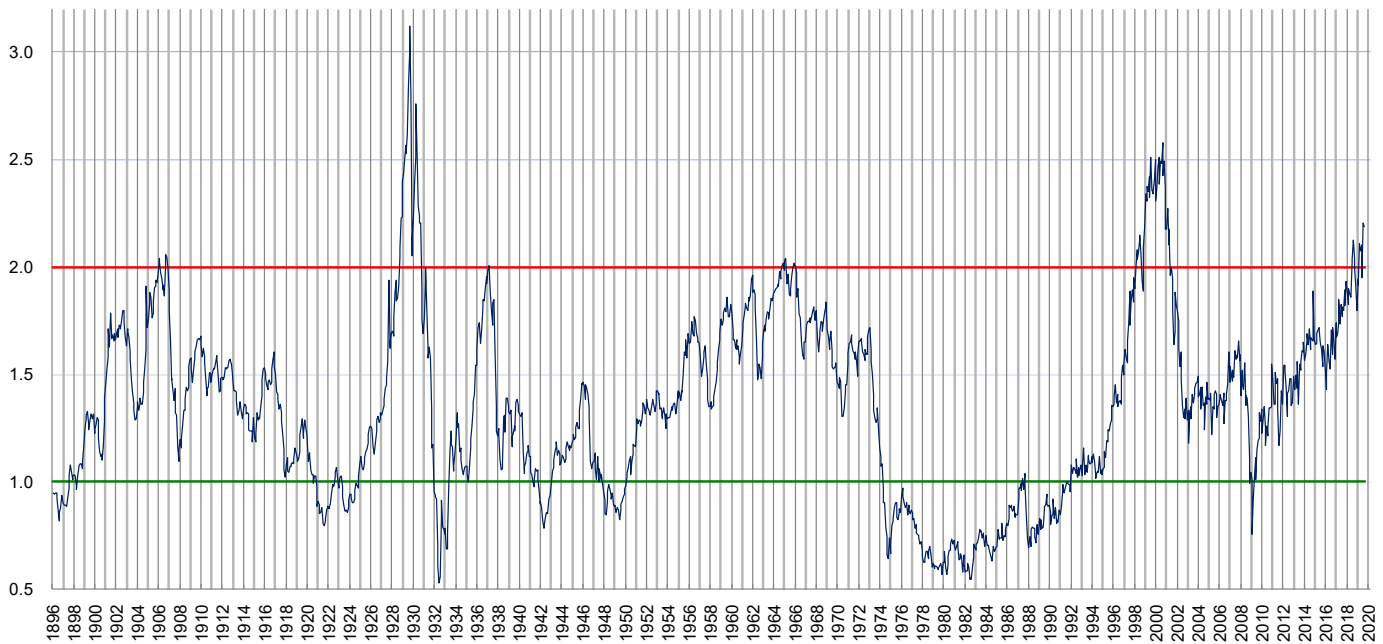
* It is not possible to offer live pricing on our recommended mutual funds.

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 \$446 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 \$306,000 in June and with the S&P 500 at 2,926.46, the *Sound Advice* Risk Indicator reads 2.19, 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 31 percent. During "Caution" signals, the S&P 500 either crashed, meandered, or climbed, recording an average increase of 3.5 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%		3.5%

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.

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 July caused a 83.3 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 66.7 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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