

## What Happened to the Bull Market?



**Gray Emerson Cardiff, Editor**

The *Sound Advice* Portfolio is up by 3.7 percent in 2018. The *Sound Advice* investment returns in prior years have been calculated independently by the Hulbert Financial Group. They are as follows:

From 2000-2017  
**10.08%** Annually vs.  
3.20% from the S&P 500

Our February 2018, issue of *Sound Advice* was published on Friday, February 2 (called Caution: Storm Warning). The S&P 500 closed the previous Friday, January 26, at 2872.87 as exuberance was high. It was bound to be a good year. The corporate tax cuts, coupled with robust economic growth, were going to propel earnings growth to new highs, and stock prices were certain to follow. However, we were not optimistic. We recommended that you should have a substantial amount of cash on the sidelines and wait for a substantial correction. Since that exuberant market close on January 26, the market has been volatile to say the least and is well off that peak.

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

### The Risk Indicator

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

### The Diffusion Indexes

While our Risk Indicator detects the seasons that roll across the market's landscape that we call supercycles, the *Sound Advice* Diffusion Indexes

of Leading and Lagging Indicators detect the more visible business cycles that are the storms which we actually perceive as weather -- the bull and bear markets that fluctuate along the path of Supercycles. On January 25, when the latest leading and lagging economic indicators were released, our *Sound Advice* Diffusion Index of Lagging Indicators switched into a Caution Signal.

### The 2018 Trade War

The first salvo was launched when President Trump signed an executive order on March 8. The second salvo was launched on March 22, when President Trump signed an executive memorandum to impose approximately \$50 billion of regulatory tariffs on Chinese imports.

Just after these salvos were launched, we became more pessimistic. In our April 2 issue, we predicted that the likelihood of further escalation is bound to be negative for the stock market.

China has since threatened to retaliate with \$50 billion of their own tariffs, which provoked the Trump Administration to launch a third salvo -- new tariffs on \$200 billion of Chinese imports. This third salvo included a warning: if China retaliated again, there would be more tariffs on another \$200 billion of Chinese imports. The potential tariffs of \$450 billion is equal to 89 percent of Chinese goods imported to the United States last year. Trump is gambling that China has the most to lose because the US only exported \$130 billion of goods to China last year, so it could not come close to matching America's tariffs on \$450 billion of Chinese imports into the US.

Politically, both sides have everything at stake. To stay in power, the Chinese communist party needs China's GDP to continue growing rapidly and create jobs at a torrid pace for massive employment growth. The government also needs to follow through on its *Made in China 2025* mandate. On the other side of the Pacific, Trump looks at countries with trade deficits as "losers" and those with surpluses as "winners." He also has a loyal base and campaign promises to keep for re-election hopes in 2020. We can see the gravity of the war by looking closely at the resolve of both sides.

### Made in China 2025

China's resolve is evidenced by a mandate it calls *Made in China 2025*, which is aimed at making China independent, without reliance on strategic western products and technology. The mandate prescribes the elimination of foreign suppliers by 2025, with the stated goal that Chinese companies own 80 percent of specific domestic markets. Two requirements are overtly protectionist, and are specifically prohibited by the World Trade Organization (WTO): one is that a large part of a product's value be created in China; the other sets a specific market share for domestic producers.

To do business in China and to avoid steep tariffs, US companies report that they are required to enter into joint ventures with Chinese companies, and are compelled to turn over their intellectual property and technological secrets.

### Made in America - Now

On the campaign trail, Trump promised to avenge China's "theft" of American jobs and technology. The second salvo signed on March 22 was billed as a historic move against Chinese "economic aggression." It specifically ordered US trade officials to provide a list of products Beijing has identified as strategic in the 10 sectors of its *Made in China 2025* mandate.

### Reciprocity

Trump claims that he is not a protectionist. He is quoted as saying, "I'm absolutely a free-trader. I'm for open trade, free trade, but I also want smart trade and fair trade." He says that his aim is to replace "one-sided" existing trade deals with agreements based on "fairness and reciprocity."

The Trump administration is not the first to push for reciprocity in trade. Secretary of State, Thomas Jefferson, also claimed to be a free-trader. However, in 1793 he documented a long list of barriers that foreign countries had placed against American goods. Jefferson's solution to reciprocity was through retaliation.

In 1901, President McKinley was quoted: "*Reciprocity treaties are in harmony with the spirit of the times ...*".

The most recent full-blown trade war was inaugurated by the passage of the Smoot-Hawley Tariff Act in 1930, which raised duties on hundreds of imports. In 1934, Franklin D. Roosevelt and his Secretary of State, Cordell Hull, convinced Congress to pass the Reciprocal Trade Agreements Act, which marked a major shift away from protectionism and toward reciprocity by giving the President the authority to reduce tariffs and enter into trade agreements with other countries.

The General Agreement on Tariffs and Trade (GATT), was instituted after World War II, which formalized the concept of reciprocity, and targeted discriminatory policies against American exporters. The European Economic Community (EEC) was subsequently formed which removed taxes among members but established a common external

tariff. Negotiations to reduce the external tariff led to the 1967 revisions to GATT.

The next round of negotiations with other countries to reduce the external tariff led to another revision again in 1993 and established the World Trade Organization (WTO) to settle disputes and protect intellectual property rights. However, the WTO has been slow and inefficient. The Trump Administration believes that the WTO has not done its job by preventing unfair trade practices perpetuated by China.

An excerpt from the President in an official Whitehouse statement on June 18 summarizes the Administration's current position:

China apparently has no intention of changing its unfair practices related to the acquisition of American intellectual property and technology. Rather than altering those practices, it is now threatening United States companies, workers, and farmers who have done nothing wrong.

This latest action by China clearly indicates its determination to keep the United States at a permanent and unfair disadvantage, which is reflected in our massive \$376 billion trade imbalance in goods. This is unacceptable. Further action must be taken to encourage China to change its unfair practices, open its market to United States goods, and accept a more balanced trade relationship with the United States.

Therefore, today, I directed the United States Trade Representative to identify \$200 billion worth of Chinese goods for additional tariffs at a rate of 10 percent. After the legal process is complete, these tariffs will go into effect if China refuses to change its practices, and also if it insists on going forward with the new tariffs that it has recently announced. If China increases its tariffs yet again, we will meet that action by pursuing additional tariffs on another \$200 billion of goods. The trade relationship between the United States and China must be much more equitable.

## The Portfolio

As investors, our job is not to be political, but to evaluate the fallout from political events, and to adjust our investments accordingly. There are many reasons to be cautious.

There is no visible end to the escalating trade war.

We also have a rising interest rate environment.

Our *Sound Advice* Risk Indicator (page 10), which measures the struggle for capital between the stock and real estate markets, is still flirting with 2.0, revealing a very high-risk time for stocks.

Our *Sound Advice* Diffusion Index of Lagging Indicators is in a Caution mode.

This bull market will become 112 months old on July 9, making it only one month shorter than the longest in post World War II history, which ended in March 2000, and lasted 113 months. The last two bear markets took prices down 50 percent, which required a 100 percent recovery just to break even.

Our portfolio recommendations are made in regard to the money you have allocated to the stock market, and in accordance with the caution mode currently prevailing the *Sound Advice* Diffusion Index of Lagging Indicators.

### ETFs for Rising Bond Yields

Our recommended ETFs are designed to benefit from an increase in long-term bond yields. They differ in the amount of leverage used. You can choose among them depending on your investment objectives and risk tolerance.

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

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

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

The escalations of the trade war have dampened these ETFs recently. The fear is that tariffs will jeopardize economic growth for both the US and China. Oxford Economics estimates that U.S. growth could slow by 0.3 percentage points next year with the imposition of \$200 billion in tariffs in both China and the US. This fear has exacerbated a very unusual situation. There is currently little difference between the yields on 10-year Treasury and 30-year bonds, offering investors almost no additional return for the additional 20 years. This anomaly makes no sense and is providing a buying opportunity for these ETFs.

When it comes to bond yields, the most powerful factor is inflation. As tariffs go into effect, consumers will pay higher retail prices as companies pay more for imported parts. The first tariffs were imposed in January on washing machines, which have since risen in price by 17 percent. The next rounds of tariffs will impact a wide range of products, including cell phones, computers, apparel, toys, sporting goods, furniture, shoes, and televisions.

As tariffs push up prices of products and commodities, inflation is bound to heat up. As inflationary expectations heat up, Treasury bond yields are also bound to rise from currently historically low levels, particularly on bonds with longer maturities.

### Foreigners Pulling Back

Foreigners hold a substantial amount of US Treasury bonds, \$6.17 trillion in all, out of the total \$14.84 trillion outstanding. As trade tensions escalated recently, Foreign governments began pulling back their purchases of longer-term US Treasuries in April (the latest data available). Russia recently announced that it cut holdings nearly in half from March to April, from \$96.1 billion to \$48.7 billion. China, the largest owner of US debt, reduced its level by \$5.8 billion in April to \$1.18 trillion. Japan, the second largest owner of US debt, cut its holdings by \$12.3 billion to \$1.03 trillion.

Finding buyers for US Treasuries is becoming more important. The US government has been issuing debt heavily because the federal budget deficit is expected to

rise in coming years and surpass \$1 trillion in 2020. So far in 2018, Treasury sales have totaled \$443.7 billion. This is close to a nine-fold increase from the same period a year ago.

This additional need comes at a time when the Federal Reserve has become a seller of Treasuries rather than a large buyer, as it reverses into quantitative tightening from many years of quantitative easing. As a result, the Federal Reserve's portfolio of Treasuries and mortgage-backed securities has declined by \$116 billion. This process has just begun. The Federal Reserve's portfolio of Treasuries swelled by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion during quantitative easing. The Federal Reserve still has a long way to go to get back to normal.

The Federal Reserve's swollen Treasury bond portfolio has a preponderance of longer term bonds. That means that the reduction of its Treasury holdings will add a disproportionate amount of upward pressure to long-term bond yields. This is important because 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 benchmarks will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in their respective benchmarks will cause these ETFs to drop in the same fashion.

### The June Dot Plot

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

The most recent Dot Plot was taken at the June meeting when the Federal Reserve raised the Federal Funds rate another 0.25 percentage point to 1.75 percent. The median prediction was that the Federal funds rate would be 2.375 percent at the end of 2018.

We are using the Fed's dot plots of Federal funds as a means to predict changes in short-term interest rates, and making the assumption that long-term interest rates will move in tandem in order to maintain the same long-term real returns that exist today. This should prove to be a conservative assumption based on today's extraordinarily flat yield curve (the difference between short and long-term interest rates). However, in the spirit of trying to be conservative, we can assume that the yield curve will remain as flat as it is today, which means that long-term Treasury bond yields move in accordance with the Dot Plot target points. Accordingly, long-term Treasury bonds would be yielding 3.62% by the end of 2018, and 4.37% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$19.07 to \$26.39 by the end of 2018, and to \$37.86 by the end of 2019.

TBT would rise from \$35.95 to \$44.65 by the end of 2018,

and to \$56.80 by the end of 2019.

TBF would rise from \$22.64 to \$25.23 by the end of 2018, and to \$28.46 by the end of 2019.

These projections are bound to prove to be conservative. Even prior to recent trade tensions, today's yield curve has been flattening because the Fed has been raising (normalizing) short-term interest rates while a perceived mild inflation rate has kept long-term interest rates low. However, the yield curve is bound to widen as inflation heats up and forces long-term bond yields up from today's historically low levels.

The Personal Consumption Expenditures (PCE) index was released again at the end of June, which is the Federal Reserve's preferred method of measuring inflation. The PCE rose 2 percent year-over-year in May. A 2 percent inflation rate is now the norm. Historically, investors demand a real return in the vicinity of 3 percent. With inflation at 2 percent, and trending upward, yields should be close to 5 percent, giving these ETFs a tremendous upside potential.

### The Erosion Factor

As we point out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.03 percentage points (3 basis points) every day, and thus go nowhere. By the end of 2018, TMV would decline to \$18.38 (3.6%), TBT would decline to \$35.21 (2.0%), and TBF would decline to \$22.45 (0.8%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

### Energy & Natural Resource Selections

In late June, a State Department official announced that the Trump administration expects oil buyers to completely cut off purchases of Iranian supplies by early November. Until recently, Iran has been exporting close to two million barrels a day (MMB/D) of crude oil. Europe has been purchasing one-quarter of that volume but is likely to go along with US sanctions, as it did in 2012 when all of its oil imports from Iran were cut. Japan had already started lowering its purchases from Iran. India's oil giant IOC is now looking for alternative barrels to replace its 140,000 B/D of purchases from Iran. South Korea has also started reducing its purchases from Iran to 300,000 B/D from 360,000 last year and is expected to continue to reduce purchases given its alignment with the US. The curtailment of international investment will lead to significant reduction of Iran's natural gas industry for many years. The US is pressuring the French natural gas company, Total, to back out of its South Pars joint venture with Iran. China, is also an investor but does not have experience developing LNG exporting projects.

Meanwhile Venezuela's production has dropped 40 percent since 2014. The former oil czar expects crude production to

continue plummeting in the aftermath of President Nicolas Maduro's re-election. He predicts production will drop to 900,000 B/D from 1.4 MMB/D currently. Major OPEC oil suppliers are announcing larger production to fill worldwide needs. The Saudis intend to hike production 0.8 MMB/D in July. However, these suppliers are not interested in glutting the market. On average, the OPEC countries needed an average of \$77.68 per barrel (weighted by production) to balance their 2017 budgets.

Rising worldwide demand, along with the interference from geopolitical tensions on supplies, and the need for oil prices above \$78 per barrel in OPEC countries, translate to favorable conditions for our selection of energy company investments.

**Chesapeake Energy (CHK)** has its primary natural gas assets located in the Marcellus Shale in the northern Appalachian Basin in Pennsylvania, the Haynesville Shale in northwestern Louisiana and east Texas, and the Utica Shale in Ohio. These large domestic assets make CHK well situated to participate in the resurgence of the US shale drilling. CHK is also in a favorable position to benefit from the secular shift to clean burning natural gas fuel for power generation globally and in the Asia-Pacific region in particular, led by China's transition away from coal.

CHK has climbed substantially since our last issue. The rise was driven primarily by rising oil and gas prices which will help CHK produce positive cash flow. First quarter cash flow was negative, but today's oil and gas prices turn it positive. The company has a rate of return (ROR) of 75% on its Marcellus wells with natural gas prices at \$2.75 per Mcf (thousand cubic feet), and a ROR of 40% on its Haynesville wells.

First quarter earnings of 34 cents per share brought the trailing annual earnings to 94 cents. The P/E is still astonishingly low. The company's debt of \$9.40 billion makes CHK a high-risk investment, but the profit potential is substantial and becomes more certain at today's oil and gas prices.

**Chevron (CVX)** has an attractive dividend that was just increased (again) to \$1.12 per share per quarter. The company's dividend is sacrosanct and has a history of increasing annually through thick and thin.

Production is bound to continue increasing this year, in accordance with our predictions. The two massive Australian projects, the Gorgon and Wheatstone, are swinging into production. Large investments in its 1.5 million acre position in the prolific Permian Basin are projected to boost output by 400,000 barrels of oil per day in the next few years.

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

diversified basis with professional management.

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the growth of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At the current price of \$73 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$2.95 for one million BTUs, 5.8 million BTUs will cost \$17.11. Thus, the same amount of energy is available for approximately 23 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart shows the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. The fact that natural gas provides energy for pennies on the dollar will translate into an expanding natural gas industry.

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

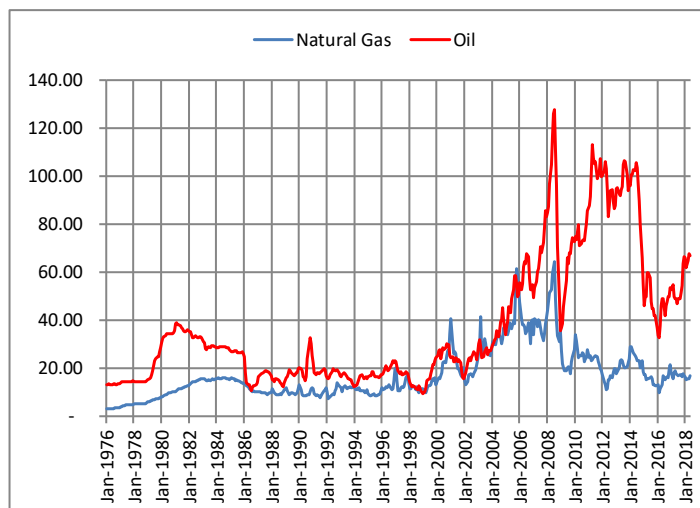
**Valero Energy (VLO)** is in a unique position to benefit from a US conundrum. Prior to the US shale revolution, most US refineries were constructed to process imported crude oil which is a heavy (thick) and sour (high sulfur) grade. The oil from fracking US shale cannot be processed at these refineries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

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

**Real Estate Selections**

Commercial real estate prices are historically high because low interest rates have pushed down real estate capitalization (cap) rates to historically low levels (like bond yields). Our posture is still defensive with regard to real estate stocks. The *Sound Advice* portfolio only includes real

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



estate stocks offering an extraordinary value now. Two REITs currently exist in the hospitality industry along with one mutual fund.

**Hersha Hospitality (HT)** has reported several hotel transactions during the last several years at cap rates ranging from 4.9 to 8 percent. The most recent sales were the Hyatt House in Gaithersburg, MD, for \$19.0 million and the Holiday Inn Express in Chester, NY for \$8.4 million, two older, suburban assets at a combined capitalization rate of 4.9 percent. To be on the conservative side, we can use a cap rate at the high end of this range of 7.5 percent for valuation purposes.

Based on the latest trailing four quarters' financials, including the most recent 2018 first quarter results released at the end of April, and using a 7.5 percent cap rate to evaluate the company's real estate portfolio, Hersha is worth at least \$24.98 per share. We say "at least" because the company's two premier hotels in Miami were closed because of Hurricane Irma, and have not been contributing to income (which is the basis for valuating the company's assets). Hersha management expects the Courtyard Cadillac Hotel to resume operations following its conversion to an Autograph Collection hotel during the second quarter of 2018 while the Parrot Key Hotel and Resort is expected to remain closed for repairs and renovations through the end of the second quarter of 2018. Management sees a recovery in 2018 based on the reopening of the Miami Convention Center and a diminished supply of competing hotels.

The company will be deploying the proceeds of the most recent sales to repurchase more of HT stock. CEO Jay H. Shah considers the stock to be at a deep discount to the market value. HT's attractive dividend provides a nice yield and reduces risk by putting a floor under the stock price.

**RLJ Lodging Trust (RLJ)** is also selling at a steep discount to its hotel assets. Based on the latest trailing four quarters' financials reported, including the most recent 2018 first quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value RLJ at \$28.10 per share which

**Hospitality REITs Comparison Table**

Company	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	22.05	6.0%	8.8%	7351213.33	28.10	-21.5%
Hospitality Properties	HPT	28.61	7.1%	9.5%	10,873.7	42.76	-33.1%
Hersha	HT	21.45	5.2%	9.1%	2,402.9	24.98	-14.1%
Host Hotels & Resorts	HST	21.07	3.8%	8.1%	20.1	22.99	-8.4%
Apple Hospitality	APLE	17.88	6.7%	8.6%	6,156.9	21.19	-15.6%

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

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

is higher than the current price. The high dividend yield is also attractive and lowers the risk profile.

We anticipate improvement in net operating income (and thus the value of the stock) because of the company’s mission to sell its non-core assets since the merger with FelCor. The company is on pace to complete the sale of these assets by the first quarter of 2019. So far this year, RLJ sold two legacy FelCor assets for \$119.2 million and three other properties for \$300 million, the Fairmont Copley Plaza in Boston, the Embassy Suites Marlborough, and the Philadelphia Sheraton Society Hill, for a capitalization rate close to 6 percent. The Philadelphia Sheraton was also sold for \$95.5 million, a 5.6% cap rate. The primary use of the funds continues to be the reduction of debt.

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

This fund is loaded with good values substantially below net

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

**Medically-Related Selections**

The big news in June was that Stryker (SYK) was working on merging with Boston Scientific, our two favorite companies in this sector. It would have been a synergistic merger. Shortly after the rumors, Stryker denied any such efforts to purchase BSX. We would not be surprised to see rumors circulate again. Meanwhile, these two stocks stand on their individual merits.

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

The recent acquisition of Apama Medical will expand BSX’s arrhythmia solutions. To further expand its EP segment, Boston Scientific announced plans to acquire Securus Medical, a developer of thermal monitoring systems for the continuous measurement of esophageal temperature.

**Stryker (SYK)** is best known for its orthopaedic devices for

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artificial knees and hips. The company also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. Recent acquisitions are now paying off. Mako's surgical robots are now being used in the majority of the Mako knee surgeries since the launch in mid-2016. The 2017 acquisition of Novadaq Technologies has enhanced SYK's position in the endoscopy market and expanded Stryker's capabilities in imaging. Stryker's acquisition of Vexim in 2017 expanded SYK's portfolio of minimally invasive technologies and complements Stryker's interventional spine business.

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

## Financials

A less stringent regulatory environment will give banks the ability to shed excess capital and increase leverage. Both of our bank selections will benefit from this regulatory relief as well as reduced tax rates. Rising interest rates also increase spreads on loans. Our two choices are good values now. At the end of June, based on favorable results of the second part of the annual "stress tests", the Federal Reserve approved the plans for 34 of the largest banks to increase dividends and share buy-back programs.

**JP Morgan Chase (JPM)** announced it would raise its quarterly dividend to 80 cents from 56 cents a share and buy back up to \$20.7 billion in stock. JPM is expected to earn \$8.78 in 2018. At a forward P/E ratio of 15, which is below the market average, JPM would be \$131.70 by the end of 2018. JPM is still cheap in comparison to the rest of the market.

**Wells Fargo (WFC)** said it would more than double its stock buybacks to \$24.5 billion and raise its quarterly dividend to 43 cents a share from 39 cents. WFC is expected to earn \$4.71 in 2018. At a P/E ratio of 15, WFC would be \$70.65 in 2018. WFC is also currently cheap in comparison to the rest of the market.

## 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)** is a premier growth stock and carries the highest A++ financial rating, with a pristine balance sheet showing as much cash as long-term debt.

AAPL's P/E is still close to the rest of the market. With this first quarter report, the trailing four quarters of earnings add up to \$10.38. At \$185, AAPL has a trailing twelve-month (TTM) P/E ratio of 17.8 which is slightly below the market as a whole. However, estimates are that AAPL's fiscal year (ending September 30) will show earnings of \$11.42 per share. That would put the P/E ratio at 16.2, which is substantially below the market average.

**Intel (INTC)** can leverage new technology into its existing large platform without introducing unacceptable risks. A history of established cash flow and an attractive dividend, along with the currently low P/E ratio, diminishes the risk profile of the stock. The company expects its 2018 earnings to be \$3.85 per share, which makes the P/E ratio close to 14, substantially below the rest of the market. The company has the size, diversity, and industry dominance to offer a relatively safe investment in a high-growth, and often high-risk business.

Stronger growth prospects make INTC under-valued at its current price because it deserves a higher P/E. Recent acquisitions are contributing to growth, including the 2017 Mobileye acquisition which added \$151 million in revenues during the first quarter. The Mobileye acquisition launched Intel into the burgeoning assisted-driving and autonomous vehicle arena, and extends to markets for autonomous ships, planes, drones, and a wide range of weapons.

At a P/E of, say 18, which is still below the market, the stock price would be close to \$70. The current dividend yield is also attractive, with an annual dividend of \$1.20 a share which was just increased by 10 percent.

**International Business Machines (IBM)** expects its 2018 earnings to be "at least \$13.80 per share", giving the stock a price/earnings ratio of less than 11, far below the rest of the market. The \$6.00 per share dividend now provides a yield of 4 percent.

IBM is turning into a growth stock but is not priced like one. The growth portion of the company was 47 percent of first quarter earnings, its so-called "Strategic Imperatives" which includes cloud-computing revenue,

analytics, mobile and security. Within those imperatives is IBM's cognitive-solutions segment, which includes software, analytics and its artificial intelligence platform, it calls Watson, which can "think" like a human. In the first quarter, IBM's Strategic Imperatives grew 15 percent.

In Mid-June, IBM demonstrated Project Debater, the first artificially intelligent (AI) system capable of debating with a human being by pulling information from over 300 million indexed news articles and academic papers.

The first quarter was the second consecutive quarter for revenue growth after 22 consecutive quarterly declines. This is a good time to invest in this long-term growth company at a stunningly good value.

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

The company expects operating earnings to be \$3.30 to \$3.45 in 2018, before non-recurring paper changes for its transformation plan. Thirty-five percent of annual earnings are expected in the first half of the year with the balance in the second half. This makes NCR an outstanding value, with a P/E less than 10, a considerable discount to the rest of the market. With its new growth prospects, NCR deserves a much higher P/E. At a P/E ratio of, say 15, which is still a discount to the rest of the market, the stock belongs above \$50 per share.

NCR owns nearly three-quarters of the burgeoning self-checkout market and is well-positioned to benefit. Using their smartphones, or a handheld scanner provided by the store, customers scan items from the shelves as they add them to their cart. At checkout, they input either device into the register, and it spits out the tally. This technology is driving the new Amazon Go store, which is bound to drive the entire supermarket industry to implement self-checkout technology. Amazon Go, Kroger, and Walmart are leading

the cutting edge of grocery stores, but NCR is the power behind the trend.

**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."

Symantec's recent acquisitions of LifeLock and Blue Coat have refocused the company and provided a broader suite of products. Symantec is bound to benefit from LifeLock's wide subscription base and allow it to cross-sell Norton and LifeLock services. The Blue Coat assets should enhance Symantec's enterprise business with top-line growth and margin expansion with protection services for both cloud and mobile customers.

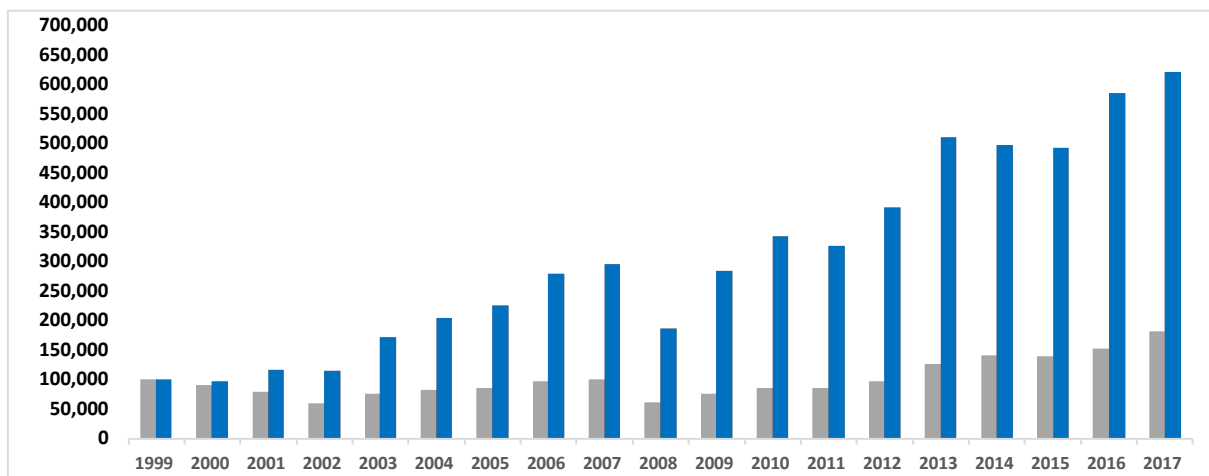
**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation. The company's record high of \$2.5 billion backlog reveals a robust pipeline with major governmental organizations like the US Department of State, Environmental Protection Agency (EPA), US Army Corps of Engineers, and the US Air Force. The company has a very healthy balance sheet.

### Hedging the Portfolio

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

## Sound Advice vs the S&P 500

This chart shows the growth of \$100,000 invested in the S&P 500 (in gray), which would have grown to \$181,977, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$620,555.



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$5.24	0.00%	BUY	\$5.60
Chevron	CVX	\$126.43	3.54%	BUY	\$129.00
Fidelity Select Nat. Gas Fund *	FSNGX	\$21.65	0.57%	BUY	\$23.00
ICON Energy Fund Class S *	ICENX	\$11.27	0.48%	BUY	\$12.00
Valero	VLO	\$110.83	2.17%	BUY	\$125.00
Real Estate					
Hersha Hospitality Trust	HT	\$21.45	5.22%	BUY	\$23.00
RLJ Lodging Trust	RLJ	\$22.05	5.99%	BUY	\$25.00
Third Avenue Real Estate Value Investor *	TVRVX	\$33.08	0.49%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$32.70	0.00%	BUY	\$36.00
Stryker Corp.	SYK	\$168.86	1.01%	BUY	\$180.00
Tekla Life Sciences Fund	HQL	\$18.79	0.00%	BUY	\$20.00
Financials					
JP Morgan Chase	JPM	\$104.20	2.15%	BUY	\$112.00
Wells Fargo	WFC	\$55.44	2.81%	BUY	\$59.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$20.25	0.32%	BUY	\$22.00
Special Situations					
Apple	AAPL	\$185.11	1.58%	BUY	\$194.00
Intel	INTC	\$49.71	2.41%	BUY	\$59.00
International Business Machines	IBM	\$139.70	4.29%	BUY	\$150.00
NCR Corp	NCR	\$29.98	0.00%	BUY	\$33.00
Symantec	SYMC	\$20.65	1.36%	BUY	\$23.00
Tetra Tech	TTEK	\$58.50	0.82%	BUY	\$59.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$19.07	0.00%	BUY	\$23.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$22.64	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$35.95	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$38.22	0.00%	BUY	\$41.00

**Notes to the table:** The right hand column is the highest recommended price limit for purchases. See our website for live pricing and buy limits: <http://www.soundadvice-newsletter.com/members>  
 \* It is not possible to offer live pricing on our recommended mutual funds.

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

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

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

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

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

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

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

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

What is too high? When stock prices are very high relative to house prices, the SoundAdvice Risk Indicator will rise over the

line marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the SoundAdvice Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$15.9 million in stocks and to \$1.78 million in houses.

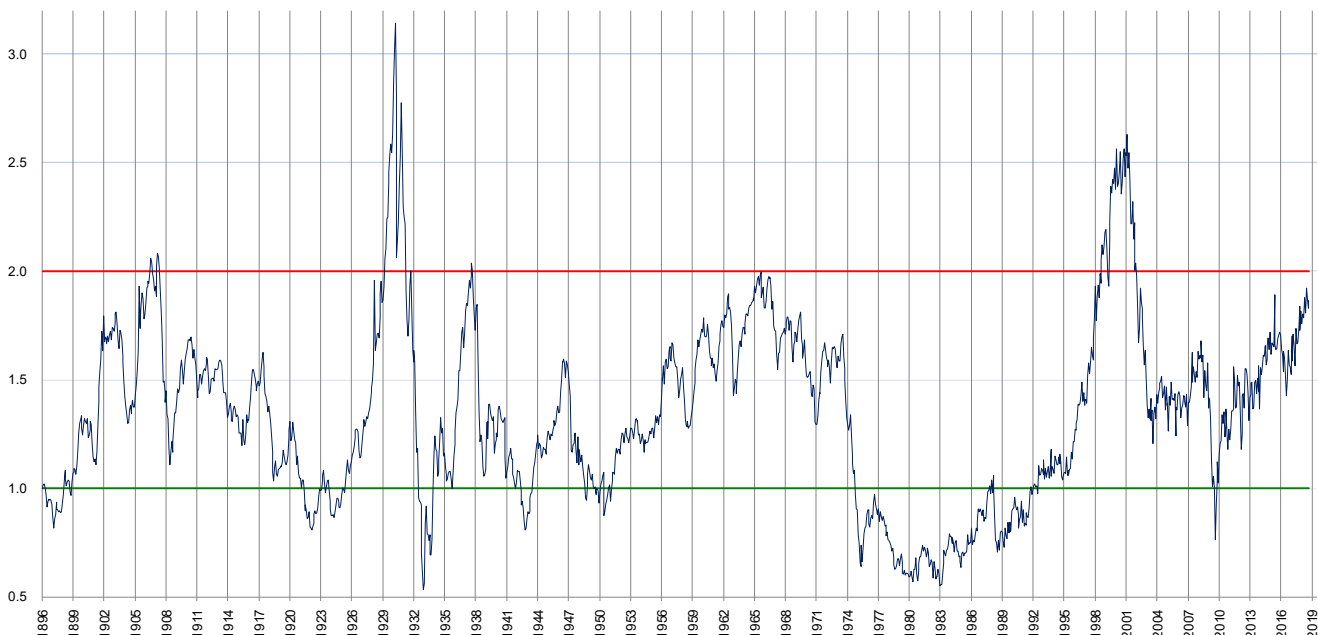
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$632 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the SoundAdvice Risk Indicator would have provided.

The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6. Based on the latest median house price of \$318,500 for April, and with the S&P 500 at 2718, the SoundAdvice Risk Indicator reads 1.96, which reveals that it is a high-risk time for stocks.

**The New York Times**

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

### The SoundAdvice Risk Indicator



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

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

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

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

Most of the time, this Diffusion Index has been a timely indicator of oncoming bear markets because a rising interest rate environment is a dangerous time for stocks. The times when this Index has not performed in a timely fashion is when monetary policy has been established and enforced, regardless of fluctuations in economic strength. A prime example is the quantitative easing (QE) programs that were used to bail out the economy from the 2008-09 meltdown. In recent years, the economy has strengthened, sufficiently at times to push this Diffusion Index to 100 percent. However, interest rates did not rise because they were being held artificially low by the Fed's massive QE bond-buying activities. During the QE programs, the Fed's assets grew by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion.

That has changed now because quantitative easing has been reversed into quantitative tightening. Instead of buying, the Federal Reserve has started reducing its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities. This means that we will no longer have a QE program holding interest rates artificially low.

### Current Status

The **SoundAdvice 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. This Diffusion Index has continued to show strength. The latest data for May caused a 66.7 percent reading.

Our next signal will come from the **SoundAdvice Diffusion Index of LEADING Indicators**, when it drops to zero, which would take a surprising softening in the US economy. This Diffusion Index reads 66.7 percent.

### Track Record of the SoundAdvice Diffusion Indexes

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Sep-17	2,492.8	Jan-18	2,823.8
Ave +/-	30.3%		3.3%

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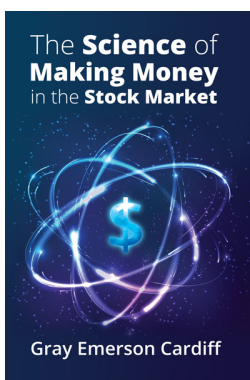
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