

Border Adjustment Taxes



The *Sound Advice* Portfolio is up 5.41 percent so far this year, as compared to 7.02 percent for the S&P 500. We have an average profit of 68.9 percent based on the prices at which each position was recommended.

-- Gray Emerson Cardiff, Editor

The recent strength in the stock market has been underpinned by the anticipation of corporate tax reduction. For 8 years, the Republican members of the House Ways and Means Committee have been working on their plan. On the surface there is a lot to like about the Grand Old Party's (GOP) proposed tax plan.

The GOP plan reduces the highest corporate tax bracket from 35 to 20 percent. In addition to lowering the tax burden of US corporations, the plan lines up with the tax plans of virtually all of the US trading partners.

One of the stock market's favorite provisions is to eliminate the corporate tax on dividends paid in the US. This would end the long-standing practice of taxing dividends twice – once at the corporate level because they are not tax deductible to the corporation, and then again when the individual stockholder receives them.

There are no other alternative tax overhaul plans, so the GOP plan is most likely to be the map for the road ahead.

Imports Versus Exports

The GOP plan is proposing a simple flat tax, which would eliminate the current complicated array of tax deductions. However, the way US corporate profits are calculated would change in a significant way.

US corporations would no longer be able to deduct the cost of imports, such as goods brought in from Mexico or China, and that are sold in the US. With a flat corporate tax rate of 20 percent, the effect would be the same as a 20 percent tariff on imports, at least initially.

The 20 percent flat tax would only be on profits earned on goods sold inside the US. This means that profits on exports would not be taxed.

Effectively, imports would be taxed and exports would be subsidized. The relevance of where profits on goods come from, and where they are sold, gives rise to the term "border adjustments". This so-called border adjustment tax is estimated to raise about \$1 trillion which is necessary to help offset the revenue loss from lowering the corporate rate to 20 percent.

Mathematically, the plan is aimed at bolstering GDP growth. When calculating GDP for a given period, the dollar volume of exports is added to domestic production, but imports are subtracted. Accordingly, the incentive to reduce imports and increase exports will add to GDP growth.

The GOP plan lines up with Trump's pro-growth agenda as well as his mantra: "Hire American, Buy American".

The Impact on Trade

The GOP plan clearly raises the cost of imports because they are no longer treated as business expenses. Critics argue that the increase in import costs is directly inflationary. Retailers, for example, import most of their products and fear that the cost increase will hike prices.

Proponents of the GOP plan argue that it will have a neutral effect on trade. They argue that the effective subsidy on exports will make them cheaper, thus adding demand for US exports. They argue further that this added demand for exports will cause an increase in the dollar relative to other currencies. Because a rise in the dollar makes imports cheaper for US companies, the after-tax increase in the cost of imports would be directly mitigated.

The Near-Term Uncertainties

There is agreement among economists regarding the longer-term neutrality on trade. However, nobody really knows what would actually happen in the short run. For the impact to be neutral, the dollar would have to jump by at least 20

percent. Such a sharp rise is far from typical, and would be destabilizing to the rest of the world. The dollar is the basis for global commodity prices (including oil) on world exchanges. The economies of emerging countries with dollar-denominated debts would also be severely impacted. Currency markets are complicated, and are governed by a diverse array of forces coming from other countries, not just those inside the US.

If the dollar did not jump by 20 percent in a short period of time, the result would certainly be highly inflationary. Moreover, an inflationary surge would undermine the dollar which would exacerbate the problem further, and could lead to an inflationary spiral.

To bridge the transition, some experts are suggesting transition rules to protect importers from the effective hike in costs, as well as to protect consumers from an inflationary surge. One idea involves temporary tax credits for importers. Another suggestion is for the Federal Reserve to somehow adjust monetary policy to insure that the dollar appreciates. (That would have to involve a hike in interest rates.) The fact that transitional solutions are being offered, confirms that there is a likelihood of economic displacements in the near term.

As the plan is unveiled in the weeks and months ahead, political debates are bound to arise. As investors, our job is not to be political, but to analyze the most likely impact that such a macro-economic change would have on our investments. The upcoming debates will underscore the near-term uncertainties of such a sweeping overhaul. We know that the one thing that the stock market does not like is uncertainty. Accordingly, we are maintaining our cautions approach, as suggested by the "Caution" signal in force by the *Sound Advice* Diffusion Index of Lagging Indicators (page 11).

Energy & Natural Resource Selections

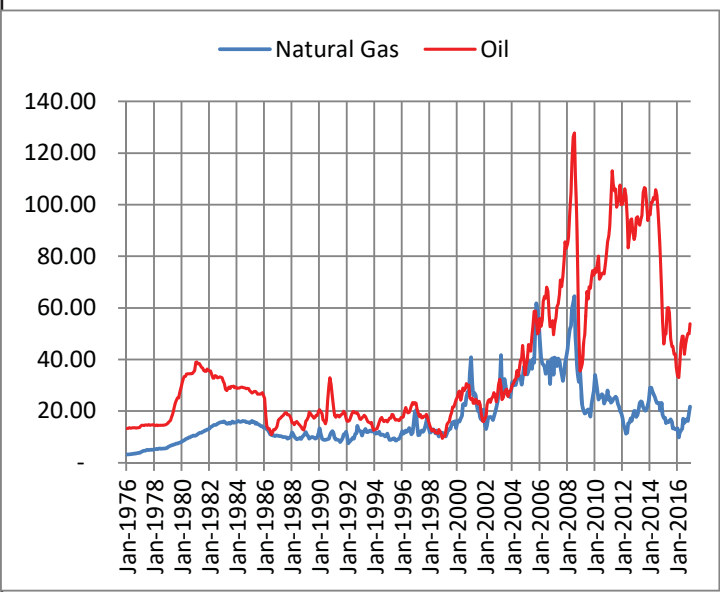
President Trump's "America First Energy Plan" is aimed at giving energy independence to the US by unleashing America's \$50 trillion in untapped shale, oil, and natural gas reserves.

To be completely energy independent, US production would need to essentially double. Trump claims this is achievable because "America has 1.5 times as much oil as the combined proven resources of all OPEC countries; we have more Natural Gas than Russia, Iran, Qatar and Saudi Arabia combined; we have three times more coal than Russia."

Trump's goals provide a generally bullish environment for the oil and gas industry. However, the GOP tax plan would have some mixed side effects.

Imported oil brought into the US for sale would effectively be taxed at a 20 percent rate. This would have the desired effect of increasing demand for domestic oil at the expense of demand for imported oil. However, the additional cost of imported oil would be problematic for refiners because US oil refiners are generally designed to refine heavier grades of crude oil imported from Canada and Saudi Arabia,

The Cost of Energy Equivalents of Oil and Natural Gas



rather than light crude oil that is typically produced inside the US. Refiners on the east and west coasts have less flexibility because they do not have access to US pipelines and need to rely more heavily on supplies of imported oil. As a result, gasoline prices are projected to increase by 30 to 40 cents per gallon as a result of the GOP tax plan. Of course, a sharp rise in gasoline prices would be directly inflationary.

Chesapeake Energy (CHK) has a portfolio of close to 8 million net acres of oil and gas assets inside the US areas called the Haynesville/Bossier, Marcellus, Eagle Ford, Powder River Basin, Utica, and Anadarko Basin regions. As purely a domestic producer, CHK is well situated to benefit from the GOP tax plan or any plan involving border adjustments or tariffs.

CHK made major strides in reducing debt in 2016 by \$2.5 billion to \$10.9 billion which is a 50 percent reduction since 2011. It has also lowered drilling costs by 50 percent since 2011 to \$4.10 per barrel of oil equivalent (BBOE).

In February, CHK reported a profit of 7 cents per share, its first profit since the end of 2014, thanks to low operating expenses and higher oil and natural gas prices. CHK ended 2016 with total proved reserves of 1,708 million barrels of oil equivalent (MMBoe), which was higher than 1,504 MMBoe at the end of 2015. Although CHK is the second largest gas producer (behind Exxon) in the US, CEO Doug Lawler will be directing more emphasis on its oil producing wells because oil brings three times more cash than gas on an energy equivalency basis. (We have been noting this inconsistency in these pages. See the nearby chart.) CHK is planning 320 new crude wells versus 90 for natural gas. The company expects oil output to grow by 10 percent this year with the goal of doubling in 2018. CHK's shift to oil emphasis actually began last year when the company abandoned its Barnett Shale properties and burdensome pipeline contracts.

Chevron (CVX) is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling (upstream), to transporting and refining (downstream). Profits vary from these stages of production, depending on price demand for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. When oil prices are low, profit margins expand from refining. Management has pronounced the annual dividend as "sacrosanct" which provides an attractive yield and limits the downside risk.

Chevron has a huge proved reserve base of 11.2 billion barrels of oil equivalent to tap for growth. Two leading projects began production during the second half of 2016: the Bangka project in Indonesia and the Alder project in the North Sea. One of the large Australian LNG projects, Gorgon, started production in 2016, and the other large Australian LNG project, Wheatstone, is scheduled to commence in mid-2017.

There is plenty of foreign demand and existing contracts for these foreign sources of production, and oil or gas sold outside the US would not be impacted by the GOP plan. Inside the US, the company's 2 million acres in the prolific Permian Basin will be an important area of focus in 2017.

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the recovery 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 \$55 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$2.70 for one million BTUs, 5.8 million BTUs will cost \$15.67. So the same amount of energy is available for approximately 28 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.

ICON Energy Fund Class S (ICENX) is also a diversified way to participate in the recovery 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.

Freeport-McMoRan (FCX) is the world's largest copper producer. Copper prices typically rise during economic expansions because of the wide use of copper for new construction. Low copper prices in recent years have forced miners to cut back on exploration and development which

has been reducing supplies. Projections from industry analysts call for shortages to begin appearing from as early as this year to the next few years. Trump's infrastructure spending will be a large boost, and the amount and timing of the actual spending will play a significant role.

FCX acquired substantial oil and gas assets at the top of the market in 2013 and took on close to \$20 billion of debt to do so. To survive the downturn, the company has been selling assets to reduce its debt burden. FCX sold \$6.6 billion in non-core assets in 2016, and reduced debt by \$8 billion down to \$11.8 billion. The company states that there are no additional asset sales required.

FCX is also negotiating with the Indonesian government regarding the ability to export out of the country from the Grasberg mine. This has interrupted production. Resolution is expected soon which would be in the interests of all parties.

Transocean (RIG) makes deep-water drilling rigs and leases them to major oil producers around the world. RIG has been sharply impacted because the utilization of its rigs has fallen along with the drop in oil prices. We continue to recommend RIG because of its prospects for survival. Although down substantially in recent years, RIG still has a backlog of orders that is significantly higher than its peers totaling \$12.2 billion, nearly all of which is for ultra-deep water floaters. Transocean currently has a fleet of 56 drilling rigs, most of which are deep-water floaters.

The company completed the construction of three new ultra-deep-water rigs in 2016 and will complete two more by early 2018. These additions mean that the company has one of the newest fleets in the industry with the ability to be most competitive. The long-term profit from RIG should be very good from here. Deep-water drilling is still a necessary source for the US and the world's oil needs.

In mid-February, Transocean issued a quarterly fleet status report that showed the company's contract backlog for new rigs was \$11.3 billion. On December 31, 2016, the company's new *Deepwater Conqueror* commenced operations on its 5-year contract in the U.S. Gulf of Mexico at a day rate of \$589,000. *The Dhirubhai Deepwater KG2* was awarded a three well contract offshore Myanmar.

In late February, Transocean reported fourth quarter earnings of 63 cents per share, surprising analysts who were expecting a loss of 4 cents per share.

Valero Energy (VLO) is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US, Canada, UK, and Ireland. Profitability in refining is a function of the so-called "crack spread", the difference in the amount a refiner pays for crude oil and the amount for which it sells the resulting refined products such as gasoline and jet fuel. Fluctuations in these prices compress and expand margins which can make refining stocks volatile at times. Valero is the most complex refiner in the US, which allows it to purchase lower quality crudes when they are priced at the most advantageous discounts. This flexibility allows VLO to capture the highest margins among its competitors.

Unlike most of its peers, Valero's refineries have access to US crude supplies and the flexibility to refine 600,000 to 1 million barrels per day of light domestic crude. With regard to refining imported oil, Valero CEO Joe Gorder said, "If it [the GOP tax plan] were to pass, we'll be able to be flexible. We'll be able to move the price onto the consumer."

While the GOP tax plan would introduce negative cross-currents for VLO, we are still recommending this stock because it is a solid value with a good yield. Valero's refining flexibility, gulf coast locations, and access to US pipelines give it an advantage over its peers.

ETFs for Rising Interest Rates

The combination of corporate tax cuts, infrastructure spending, deregulation, and repatriation of capital trapped overseas is bound to stimulate significant economic growth. This stimulation is bound to boost inflationary pressures.

In addition to the upcoming inflationary forces from Trumponomics, we have confirmation from the **SoundAdvice Diffusion Index of LAGGING Indicators** (page 11) which is telling us that the US economy is already strong enough to prompt a rise in inflation and interest rates.

After 7 years of economic expansion thanks to historically low interest rates, today's unemployment rate is below 5 percent which is considered full employment. Most economists agree (and worry) that stimulating a fully-employed economy will be inflationary.

It is also hard to imagine how the GOP "border adjustment" tax plan will not be inflationary, at least initially. Gas prices are certain to rise, and costs will increase on a wide range of imported goods that are imbedded in the fabric of the US economy.

The era of historically low-interest rates is clearly over.

Our recommended ETFs, designed to benefit from the normalization of interest rates and long-term bond yields, differ in the amount of leverage used, and you can choose among them depending on your investment objectives and risk tolerance.

The **Direxion Daily 20 Plus Year Bear 3 Shares (TMV)** uses 3:1 leverage.

The **Proshares UltraShort Lehman 20 Plus Year Treasury (TBT)** uses 2:1 leverage.

The **Proshares Short 20 Plus Year Treasury (TBF)** uses no leverage.

The price action of these ETFs is based on the changes in long-term treasury bonds, as measured by benchmark bond indexes, only in the opposite direction, and then multiplied by the leverage each ETF uses. For example, a decline of say, 1.0 percent in their respective benchmarks will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in their respective benchmarks will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based

on any given scenario. We have been using the Federal Reserve's prediction, which was as good as any. As part of the Federal Reserve's quarterly Federal Open Market Committee (FOMC) meetings, each of the 17 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 December meeting. As usual, there was a wide difference in the predictions among this group of informed experts. The median prediction was that the Federal funds rate would be 1.375 percent at the end 2017, 2.125 percent at the end of 2018, and 2.875 percent at the end of 2019.

FOMC Members base their opinions on the most recent data available, and use older data for context. Accordingly, monetary policy is generally a reaction to recent and past conditions. This is why the Federal Reserve is usually "behind the curve" when major economic shifts take place, and this time appears to be no exception.

With the Federal Reserve behind the curve, it is probable that the December Dot Plots will likely end up to be low. However, in the spirit of being conservative, we can use the December Dot Plots as a basis of a forecast. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same as today's real return), long-term Treasury bonds would be yielding 3.89% by the end of 2017, and 4.64% by the end of 2018, and 5.39% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$22.09 to \$34.70 by the end of 2017, to \$49.40 by the end of 2018, and to \$68.24 by the end of 2019.

TBT would rise from \$38.73 to \$52.34 by the end of 2017, to \$66.24 by the end of 2018, and to \$82.17 by the end of 2019.

TBF would rise from \$23.35 to \$27.15 by the end of 2017, and to \$30.54 by the end of 2018, and to \$34.01 by the end of 2019.

The Erosion Factor

As pointed 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, 0.04 percent (4 basis points) every day, and thus go nowhere through the end of 2017. Here is what would happen to each ETF:

TMV would decline to \$20.75 by the end of 2017 (6.1%).

TBT would decline to \$37.56 by the end of 2017 (3.3%).

TBF would decline to \$23.12 by the end of 2017 (1.0%).

While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Real Estate Selections

Most real estate is immune to the cross-currents that would be introduced by the GOP border adjustment tax plan. The exception would be retail shopping centers whose tenants are

Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	23.35	5.7%	12.2%	6,558.5	43.84	-46.7%
Hospitality Properties	HPT	32.00	6.4%	10.1%	11,184.6	50.14	-36.2%
Hersha	HT	19.70	5.7%	9.3%	2,237.9	23.23	-15.2%
Host Hotels & Resorts	HST	18.39	4.4%	9.5%	20.7	24.19	-24.0%
Apple Hospitality	APLE	19.79	6.1%	7.6%	5,212.2	20.26	-2.3%

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.

likely to be adversely affected by the hike in import costs. Last month we sold **Retail Opportunities Investment Corp (ROIC)** partially for this reason. The stock price was also paying a lofty 5 percent capitalization (cap) rate for the underlying portfolio. (The cap rate is the cash yield before debt payments are considered.) As in the case of ROIC, the average real estate investment trust (REIT) does not present a particularly good value. Low interest rates have pushed down real estate cap rates to historically low levels (like bond yields). As a result, commercial real estate prices are historically high.

Accordingly, the *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. Two currently exist in the hospitality industry.

The table above shows the comparative values of other hospitality REITs. **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. **Apple Hospitality (APLE)** is trading at a slight premium.

Hersha Hospitality (HT) is a real estate investment trust which owns and operates high quality upscale hotels in

urban gateway markets. The Company's 55 hotels totaling 8,654 rooms are located in New York, Boston, Philadelphia, Washington DC, Miami, and select markets on the West Coast. Many of HT's major properties have been undergoing renovations and not producing their full income potential. As renovations are completed and rooms are put back on line, revenue and FFO should climb substantially higher. New acquisitions will also contribute to growth, along with sales of less-attractive properties.

So far this year, moves to upgrade the portfolio include the January sale of the 203-room Courtyard by Marriott in Alexandria, VA, and its 120-room Residence Inn in Greenbelt, MD for \$62.0 million. The sales were based on a 7.4 percent cap rate. This sale funded the February purchase of the 115-room Ritz-Carlton in Coconut Grove, FL for \$36.0 million as part of a tax-deferred, like-kind exchange.

Also in February, Hersha acquired the 153-room Pan Pacific Hotel in Seattle. This acquisition is expected to be part of another tax-deferred exchange in connection with the sale of the company's suburban West Coast portfolio which is anticipated to close in July, 2017.

In the fourth quarter, the Company repurchased approximately 167,000 common shares which completed the purchased of 2.8 million common shares in 2016 (6.2% of the common shares). Hersha announced a 2017 share repurchase program of up to \$100 million of the outstanding



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common shares. During the last several years, Hersha has reported several hotel transactions it made at cap rates ranging from 5.4 to 8 percent. To be on the conservative side, we can establish a main street cap rate at the high end of this range, of 7.5 percent for valuation purposes.

Based on the latest trailing four quarters' financials, including the most recent 2016 fourth quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value HT at \$23.23 per share which is significantly higher than the current price. The dividend yield is attractive and lowers the risk profile.

RLJ Lodging Trust (RLJ) is also currently selling at a steep discount to its hotel assets. RLJ has a large, geographically diversified portfolio of 125 hotels, branded by Marriott, Hilton, Hyatt, and Embassy Suites with over 20,000 rooms. Rather than traditional full service hotels, RLJ emphasizes "focused-service" or "compact full service" hotels, where only specially chosen services important for guests are offered. The most important amenity is an attractive, modern room offering quality features for the basic necessities – sleeping, bathing, and working. Minimized are amenities such as large restaurants, spas, and meeting rooms. Overall, the hotels are mid- to up-scale, but with reasonably-priced rooms. This concept translates into a larger portion of revenue from the rooms.

The company is on a mission to upgrade its assets by purchasing properties in high growth markets with barriers to entry. The company is also seizing opportunities to sell at high prices, such as the recent sale of two of its New York City hotels at a lofty 4.7 percent cap rate.

Based on the latest trailing four quarters' financials reported, including the most recent 2016 third quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value RLJ at \$43.84 per share which is considerably higher than the current price. The high dividend yield is attractive and lowers the risk profile.

Third Avenue Real Estate Value Investor Fund (TVRVX) is loaded with good values substantially below 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. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams in order to come up with their estimates of intrinsic 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.

TVRVX has a number of distinguishing characteristics.

This is a global real estate fund. 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

Trump is after pharmaceutical companies to lower prices. He also appears favorable to repeal the law that forbids Medicare from negotiating drug prices. For these reasons, our portfolio is conspicuously void of pharma stocks.

The repeal of the Affordable Care Act (Obamacare) was first on Trump's agenda but specific proposals have yet to be revealed. These sweeping changes also need Congressional approval which adds further uncertainty. How this will all shake out is anyone's guess, which means it is too early to look for new investments in this area. We are comfortable with our current recommendations in this sector based on their own individual merits.

Boston Scientific (BSX) produces medical products well suited for an aging population. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. 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.

In February, BSX reported fourth quarter sales of \$2.2 billion, a growth of 11 percent over the prior year period. This translated into earnings of 30 cents per share versus 26 cents a year ago. For 2016, earnings per share were \$1.11 compared to \$0.93 in 2015.

Stryker (SYK) provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products, although SYK is best known for its orthopedic devices for artificial knees and hips. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase (and obesity trends continue), more and more hip, knee, and spinal procedures will be needed. Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions.

Tekla Life Sciences Investors (HQL) is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10

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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. This fund is an excellent way to invest in this sector.

Small Caps

Small caps tend to be domestic companies without substantial overseas exposure. They are typically not buffeted by the currency fluctuations that often haunt larger companies. The Trumponomics benefit is evident by the rise since election-day in the Russell 2000 Index, which is oriented toward small caps.

Numerous studies show that small caps perform better over the long run than the market as a whole. They 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. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), 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.

Agrium (AGU) has been in the portfolio for many years, and we have ridden this stock for a 10 fold profit. **However, we are now taking our profit in AGU.**

Agrium is a Canadian company offering a broad mix of agricultural products, from wholesale fertilizers to retail farm products for sale in the US. In February, AGU reported disappointing earnings of 60 cents a share, which compares to \$1.52 a share a year earlier. Agrium expects to make \$4.50 to \$6 a share in 2017, compared with the \$4.29 a share it made in 2016. Expectations were of \$5.83 for 2017.

At over \$100 per share, AGU now has a relatively high price/earnings ratio, especially for a company in a slump. The protectionist attitude from Washington also adds uncertainty regarding a Canadian Company making profits from goods it sells in the US.

Arconic (ARNC) is the spin-off of the downstream operations of value-added products from Alcoa (AA). We recommended selling AA and investing the proceeds in ARNC. Since then, ARNC has had a stellar rise.

Arconic manufactures specialty metal products for aerospace and defense, building and construction, and automotive industries. Arconic is one of only a few companies with the expertise and assets to use uniquely advanced metallurgical techniques to produce metals that can withstand harsh environments, such as within a jet engine, as well as in other vital uses in products that must not fail.

In February, Arconic (ARNC) announced that it sold 60% of the stake in Alcoa (AA) that it received on the spin-off for close to \$900 million, very close to Alcoa's recent highs. Arconic still holds an 8% stake in Alcoa.

Elliott Management, an activist investment firm, recently raised its investment in ARNC to 13 from 11 percent of ARNC's shares, and believes ARNC is "dramatically undervalued." Elliot Management wants to oust Alcoa's current chief executive officer Klaus Kleinfeld and replace him with Larry Lawson, the former CEO of aircraft parts maker Spirit AeroSystems Holdings. Elliot Management wants a "proven operator" as CEO.

Apple (AAPL) has a pristine balance sheet, with as much cash as long-term debt, with the highest A++ financial ratings. The stock market has been giving APPL a below-average price/earnings (P/E) ratio because of slow and even negative growth prospects. However, the demise of Samsung's latest Galaxy Note 7 phone has flung open the doors for a significant new growth path. Samsung has been Apple's fiercest competitor, with 22.4 percent of the market share of smart phones – nearly double that of Apple's 11.8 percent share. Slightly more than one-half of Apple's revenue comes from its iPhones, so a gain of just one percent in market share translates to 14 million iPhones, which would add 7 percent to revenue. In addition, the new *iPhone 7* and *7 Plus* have been well received which is inaugurating a long-awaited upgrade cycle.

In February, Apple announced all-time record quarterly revenue of \$78.4 billion during the fourth quarter and earnings of \$3.36 per share. The company sold more iPhones than ever before and set all-time revenue records for iPhone, Services, Mac and Apple Watch. Revenue from Services also grew strongly led by record customer activity on the App Store.

The GOP tax plan would raise the cost of Apple's products brought into the US (along with its competitors). On the positive side, much of Apple's potential for growth is outside US borders. Additionally, lower corporate tax rates would be a large benefit to the company's massive tax burden. Apple has more than \$200 billion stored offshore, and Trump's repatriation tax break gives Apple the opportunity to potentially repatriate 37 percent of its market capitalization.

International Business Machines (IBM) was introduced in our January 24, 2017, email update called *Introducing Watson*. IBM is turning into a growth stock, thanks to the growth of its artificial intelligence division based on Watson, the Company's super computer that can think like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient. We have only begun to see

and imagine the uses of artificial intelligence. IBM is the leader in that field and on a solid path to provide a growing abundance of opportunities in the months and years ahead.

We can simply look at IBM's current P/E of 14 to see the profit potential. For example, if the P/E of IBM increases to 17, which is still below the average of the overall market, the price of IBM would reach \$234 per share.

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.

In February, NCR reported fourth quarter earnings of 43 cents per share, up from 27 cents from the prior year. Full year 2016 earnings are \$3.02 per share, up from \$2.76 in 2015. NCR showed top-line growth in every business, especially in software where revenues continued to expand, particularly for cloud and software license offerings.

The company expects 2017 earnings to be \$3.25 to \$3.35 per share, and plans to repurchase \$300 million of shares in 2017. We added NCR to the portfolio when it was close to 10 times earnings. NCR has climbed substantially, but it is still selling below the market average price earnings ratio.

Symantec (SYMC) is the dominant supplier of software for computer security and protection against viruses and other nuisances. Nearly all of the Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

In February, Symantec completed the LifeLock acquisition. The company says that as an integrated firm, it is more than twice as big as the next largest security business: the enterprise security segment inside Cisco Systems.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets. Two recent acquisitions of Coffey and INDUS corporations have swelled TTEK's backlog of contracts and increased prospects for more Federal contracts in the IT sector. The company's backlog is now \$2.3 billion, which reveals a robust pipeline with major government organizations like the US Department of State, US Army Corps of Engineers, and the US Air Force, which should continue to bolster growth.

In February, TTEK reported first-quarter fiscal 2017 adjusted earnings from ongoing operations of 49 cents, beating expectations. Year over year, earnings were up 17 percent.

Water, Environment, and Infrastructure revenues continued solid growth, climbing 12.4% year over year, benefiting primarily from US Infrastructure projects. The company

is hopeful that the new administration will unlock additional opportunities for Tetra Tech in all areas of the US infrastructure.

Wells Fargo (WFC) will be a beneficiary of rising interest rates, and deregulation could expand business opportunities. WFC has lagged in the bank rally due to last year's scandal regarding unauthorized account-opening practices. While there may still be some fall-out, management has changed and the issue is basically history. The relatively low price of WFC makes it a strong value and a timely investment.

Under conservative assumptions, 2017 earnings are expected to be \$4.45 per share. Even with no expansion in the current price/earnings (P/E) ratio, the stock would be \$62 based on 2017 earnings. However, we expect more upside because the P/E ratio should expand due to brighter growth prospects. At a P/E ratio of, say 18 which is still below the overall market average, WFC would be \$80 per share – 45 percent more than it is now.

Xerox (XRX) spun off its business services unit in early January to a separate new public company called **Conduent (CNDT)**. You received one share of CNDT for every five shares you owned of XRX on December 15, 2016. This is the event we had been waiting

for, and we recommend keeping both for now. Both of these new companies should benefit from the split in their expenses, new separate leadership and goals, and the ability to focus and execute their respective plans for growth. Carl Icahn holds 9.77 percent of the stock of both companies.

XRX will now pay a 25 cent annual dividend for a 3+ percent yield. As part of the spin-off, XRX received \$1.8 billion in cash which will be used to pay off debt. Xerox also has a new CEO, John Jacobson, who is bringing a new enthusiastic corporate culture and a three-year strategy for renewed growth.

Conduent is the consulting and outsourcing company and was the growth side of the old Xerox, with expertise in transaction-intensive processing, analytics, and automation. This side of the business has had an 86 percent contract renewal rate.

Hedging the Portfolio

Our **SoundAdvice Diffusion Index of LAGGING Indicators** (page 11) is warning us to be cautious. Accordingly, we are also recommending a reverse ETF that essentially short-sells the market and will benefit from down-drafts in the S&P 500.

The **ProShares UltraShort S&P 500 (SDS)** 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 performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

SoundAdvice Investment Returns
Calculated Independently by the Hulbert Financial Digest
SoundAdvice in 2016 = 18.69% vs. S&P 500 = 9.54%
SoundAdvice from 2000-2016 = 10.30% Annually vs. S&P 500 = 2.37% Annually

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$5.57	0.00%	BUY	\$6.50
Chevron	CVX	\$113.88	3.84%	BUY	\$120.00
Fidelity Select Nat. Gas Fund	FSNGX	\$28.45	0.45%	BUY	\$32.00
Freeport-McMoRan	FCX	\$13.99	0.00%	BUY	\$15.50
ICON Energy Fund Class S	ICENX	\$13.19	0.42%	BUY	\$14.50
Transocean	RIG	\$14.05	0.00%	BUY	\$15.00
Valero	VLO	\$68.48	3.53%	BUY	\$69.00
Real Estate					
Hersha Hospitality Trust	HT	\$19.70	5.74%	BUY	\$21.50
RLJ Lodging Trust	RLJ	\$23.35	5.80%	BUY	\$26.00
Third Avenue Real Estate Value Investor	TVRVX	\$32.34	0.51%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$24.96	0.00%	BUY	\$27.00
Stryker Corp.	SYK	\$131.05	1.32%	BUY	\$135.00
Tekla Life Sciences Fund	HQL	\$18.94	0.00%	BUY	\$21.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$22.10	0.30%	BUY	\$24.00
Special Situations					
Agrium	AGU	\$97.13	3.62%	SELL	
Apple	AAPL	\$139.79	1.66%	BUY	\$145.00
Arconic	ARNC	\$29.54	1.25%	BUY	\$31.00
Conduent	CNDT	\$16.31	0.00%	BUY	\$18.00
In't Business Machines	IBM	\$181.95	3.11%	BUY	\$185.00
NCR Corp	NCR	\$49.59	0.00%	BUY	\$50.00
Symantec	SYMC	\$29.09	1.12%	BUY	\$30.00
Tetra Tech	TTEK	\$41.45	0.89%	BUY	\$43.00
Wells Fargo	WFC	\$59.73	2.63%	BUY	\$62.00
Xerox	XRX	\$7.39	3.76%	BUY	\$8.50
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$23.21	0.00%	BUY	\$27.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$23.72	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$40.07	0.00%	BUY	\$44.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$13.12	0.00%	BUY	\$15.00

Notes to the table: The right hand column is the highest recommended price limit for purchases. Prices are as of 3/1/2017. See our website for live pricing and buy limits:

<http://www.soundadvice-newsletter.com/members>

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

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

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

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

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

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

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

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

are on the verge of declining or under performing the other market.

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

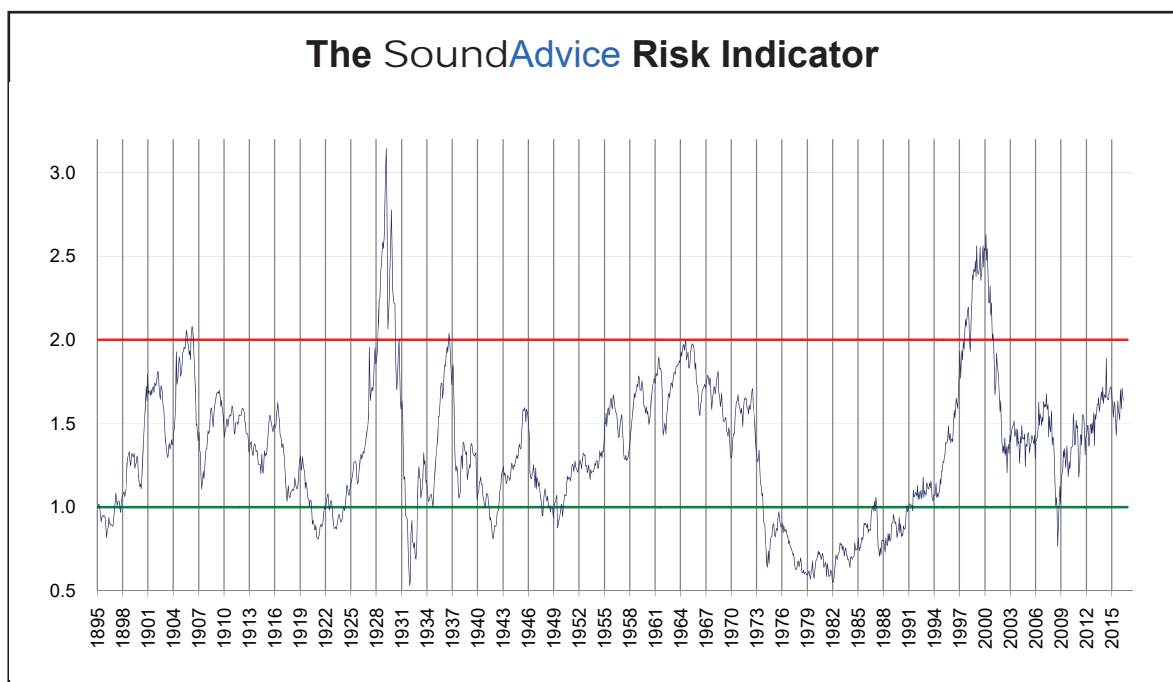
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$13.9 million in stocks and to \$1.6 million in houses.

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 \$554 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.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

The latest reading for the SoundAdvice Risk Indicator is 1.74. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in the Stock Market* for a complete explanation of the SoundAdvice Risk Indicator and its track record.



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. For every indicator that is unchanged from its value during the six-month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be (1.5)/3 or 50 percent.

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

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

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

We have been operating under a "Caution" signal since the June 2015 release of the May lagging economic indicators.

The SoundAdvice Diffusion Index of **LAGGING Indicators** was **67.7 percent** in January (the most recent data).

Our next signal will come from the SoundAdvice Diffusion Index of **LEADING Indicators** when it drops to zero. The latest reading for January was **100 Percent**.

Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32.1 percent. During "Caution" signals, the S&P 500 increased an average of 3.4 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
Ave +/-	32.1%		3.4%

See *The Science of Making Money in the Stock Market* for a complete explanation of the SoundAdvice Diffusion Indexes and their track records.

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