

Yellen's Racehorse



The *Sound Advice* Portfolio is up 12.7 percent this year, as compared to 6.1 percent for the S&P 500. We have an average profit of 62 percent based on the prices at which each position was recommended.

As we went to press, the drama over Deutsche Bank was beginning to unfold. We will be watching and advising on this matter with email updates if necessary. This bank has plenty of liquidity, \$223 billion which is 20 percent of assets, a relatively high level that gives it the ability to withstand sudden shocks. In addition, it can draw emergency liquidity from the European Central Bank (at a negative interest rate). However, European banks are not as well capitalized as US banks, and Deutsche Bank is no exception. This has driven the stock price down 50% this year. The IMF says that this bank "is one of the most important net contributors to systemic risks in the global banking system." Accordingly, the relatively large \$14 billion fine recently levied by the US Department of Justice could introduce more jitters for stocks in both Europe and the US.

-- Gray Emerson Cardiff, Editor

Our Diffusion Index of Lagging Indicators (page 11) hit 100 percent again this month, for the fourth consecutive month. These readings tell us that the US economy is strong enough to push up interest rates. This Index is worth noting because it has warned of major past downturns in the stock market, most notably in August 1987, just before the so-called Crash of 1987; again in June 2000, as the market headed into a 50 percent dive; and then again in March 2008, just prior to the 2008-09 meltdown.

Economic strength is being confirmed again by a surge in consumer confidence. This is significant because consumer spending accounts for more than two-thirds of GDP. The September Conference Board Consumer Confidence Index jumped to 104.1 (1985=100) in September, the highest level in 9 years, after jumping to 101.1 in August from 96.7 in July.

Normally these readings would accompany rising interest rates.

A recent issue of *The Economist* has a picture on the cover of Janet Yellen galloping on a racehorse. An emblem of "0.5%" is written on her saddle. The initial image is that she is heading fast for another rate hike from a Federal Funds rate of 0.25% currently to 0.5% in the next December meeting. However, less obvious is the fact that her horse has disproportionately short legs, indicating that it may take her horse longer to get there than she thinks.

The title of the issue is "Living in a low-rate world." The magazine cites the low, and even negative interest rates around the world. The Bank of Japan (BOJ), the European Central Bank (ECB), along with several smaller central banks, no longer pay interest on deposits, but charge a fee to hold cash reserves, which is effectively a negative interest rate. Germany became the first Eurozone country to issue sovereign bonds that mature at an amount less than what is initially invested.

The lead article gives three principle reasons explaining why low interest rates are bound to stay endlessly low.

The first is that working age populations are declining in major industrialized countries outside the US, especially in China and Japan, which means that more money is being saved for retirement, and the increased savings has put downward pressure on interest rates.

The second factor is the integration of China into the world economy, introducing a billion people who save an average of 40 percent of their income, thus exacerbating what Bernanke called "a savings glut".

The third reason cited is the growing income inequality gap within major countries, and higher savings from the wealthy is adding to the savings glut.

While these reasons may be valid, they are long-term in nature, and such macro trends can, and often are dominated by shorter-term swings in business cycles. Monetary expansions have an over-riding and stimulating impact, as evidenced by the boost to the US economy since the 2008-09 melt down.

As we pointed out last month, for the first time in recent history, synchronized massive monetary expansions are in force among the world's largest countries. A



one-horse race has turned into a full-blown Kentucky Derby.

After the 2008-09 meltdown, Europe maintained a relatively tight monetary policy while our Federal Reserve was launching a series of Quantitative Easing (QE) programs. Japan was also hesitant to take action, as was China. Now, all of these countries have launched aggressive monetary expansion policies revealed by stunningly low and negative interest rates.

Japan's Prime Minister Shinzo Abe recently announced a hefty new set of stimulation policies, totaling \$275 billion, which is similar in relative GDP scale to the stimulus applied to the US economy since the 2008-09 meltdown. The BOJ says it will continue to buy bonds at the rate of \$800 billion a year until inflation rises above 2 percent in Japan and stays there for a while.

The Eurozone's "bazooka" QE stimulus package is expanding the amount of the ECB's bond buying from \$60 billion to \$80 billion. The People's Bank of China (PBOC) adopted a new policy aimed at keeping the seven-day repo rate confined to a low and narrow range, and has doubled government spending. Energy-based economies, including Canada and Australia, are strengthening with the stabilization and upturn in commodity prices.

In the immediate months ahead, the global synchronization of strong expansionary monetary policies around the world is bound to translate into higher economic growth rates around the world. This will come with mixed blessings. Some sectors of the US stock market will prosper. However, accelerating growth is likely to raise the prospects for rising interest rates and bond yields, and give Janet Yellen's racehorse stronger legs. Certainly, near-zero interest rates have been pumping up the US stock market, and any change could cause the wind to whistle out of stock prices.

Portfolio Updates

We always keep in mind that a 50 percent drop in the stock market requires a 100 percent gain to break even. At times like now, we should stay defensive. Accordingly, we are maintaining our cautious approach, as advised by our Diffusion Index of Lagging Indicators. Our model portfolio is constructed with this overall caution in mind.

Energy Selections

In the final days of September, OPEC agreed to reduce and limit its oil production to 32.5 MMbbl/d (million barrels per day) from 33.24 MMbbl/d. The group said it will agree to set specific levels of production for each country at its next formal meeting in November. Oil prices jumped over 5 percent on the news.

There have been several attempts recently to accomplish this without agreement, and that may happen again. This time however, Saudi Arabia is becoming more desperate and making concessions because its economy is suffering under low oil prices and high debt. Saudi Energy Minister Khalid al-Falih has given in on his insistence that all members must cut production. He now has agreed to let Iran, Nigeria and Libya to produce "at maximum levels that make sense" as part of any output limits which could be set at the next OPEC meeting. Iran has consistently argued that it should be allowed to produce 4 MMbbl/d which was the

level before sanctions were imposed.

CHK jumped more than 8% on the OPEC news, CVX 3%, RIG 6%, and ICNEX nearly 5%.

In the US, commercial crude storage dropped by 1.9 MMbbl/d during the week ending September 23, 2016, according to the latest data from the Energy Information Administration (EIA). US production was 8.497 MMbbl/d during that week, down 1.123 MMbbl/d from the peak of 9.61 MMbbl/d during the week ending June 5, 2015. The fact that production is not down substantially more is because shale frackers have cut the costs of production by as much as 40 percent by negotiating lower prices from suppliers of rigs, pipes and other services. Energy companies have also improved productivity at the wells through improved technology to find the most productive drilling sites. In addition, once the capital expense has been made (at higher energy prices) the marginal cost of operating existing wells can be justified.

On the demand side of the equation, EIA projects that consumption will still rise by 1.2 to 1.5 MMbbl/d in 2016 and 2017 by using low worldwide GDP growth assumptions.

Recoveries in oil and gas stocks have been bumpy in past cycles, but have ultimately translated into stellar profits. This time should be similar. Here are our energy selections.

Chesapeake Energy (CHK) has taken a beating from the crash in oil and gas prices. CHK's debt load makes it an aggressive investment in the current environment of low oil and gas prices, and the risks increase with an extended period of low energy prices. The company has a portfolio of 8 million net acres of oil and gas assets carried at a book value of \$70 billion.

Chesapeake expects to sell more than \$2.0 billion in assets this year, which is above the upper end of the prior \$1.2 billion to \$1.7 billion range of its planned asset sales.

CHK has also announced approval of a \$1.5 billion loan which will be used to pay off other debt maturing in 2017 and 2018, extending liquidity into mid-2020. The company also has a \$4 billion credit facility to tap that matures in 2019. These moves have greatly enhanced CHK's prospects for survival.

Until recently, Carl Icahn held 11 percent of the outstanding shares and has undoubtedly been a strong influence over management. In September, he sold half of his CHK stake at a loss. Icahn said in a statement: "We believe that over the last few years Doug Lawler and his team have done an admirable job, especially in light of the circumstances. We reduced our position to recognize a capital loss for tax planning purposes." Chesapeake said the resignations of Icahn representative Vincent Intrieri, along with John Lipinski, board members since June 2012 and June 2014 respectively, were not due to any disagreements.

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 of \$4.28 per share as "sacrosanct" which provides an attractive yield and limits the downside risk.

Chevron's most significant projects, Gorgon and Wheatstone, both off the northwest coast of Australia, are beginning to come on stream. Both of these projects will boost cash flow substantially.

CVX recently announced that it signed a binding agreement with China's ENN LNG Trading Company, one of China's largest gas distribution companies operating in 150 cities serving 12 million residential customers, for the delivery of 650,000 metric tons of liquefied natural gas (equivalent to approximately 512,000 barrels of oil) annually beginning in 2018.

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.

The drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$48 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to \$2.90 for one million BTUs, 5.8 million BTUs will cost \$16.82. So the same amount of energy is available for 35 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. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together, but remain substantially apart. This difference still translates into an expanding natural gas industry.

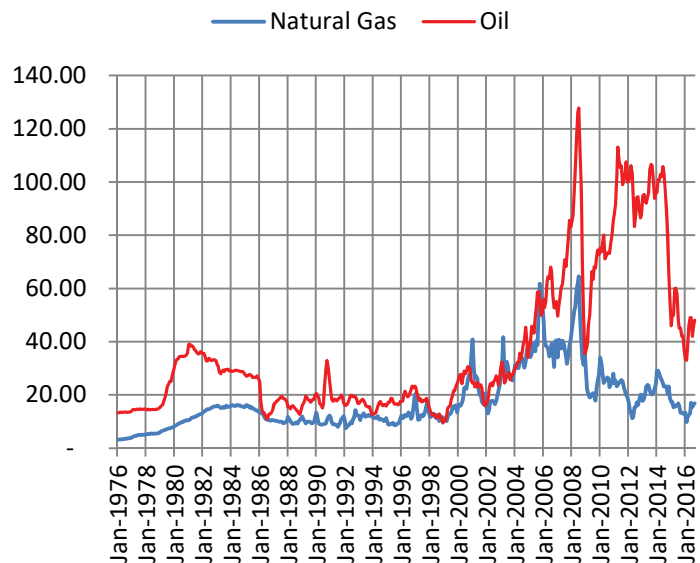
ICON Energy Fund Class S (ICENX) is also a diversified way to participate in the recovery with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sector to capture value, rather than simply depending on rising oil prices. This fund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

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. The company reports a backlog of orders totaling \$14.6 billion, nearly all of which is for ultra-deep water floaters. 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, especially as US fracking drops off.

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 product, which is mostly in the form of gasoline. Fluctuations in these prices compress and expand margins which can make

The Cost of Energy Equivalents of Oil and Natural Gas



refining stocks volatile and somewhat unpredictable in the short run. In the case of Valero, however, the current valuation is compelling for the longer term (and perhaps the short term as well) in view of the fundamental aspects of the company.

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. Valero's refineries are also well positioned geographically, even for accessing the low-cost Maya crude from Mexico, heavy sour oil that Valero buys for an even larger discount than from glutted US oil. Its Gulf Coast refineries make Valero well positioned to capture widening profit margins from refining sour crudes. Gulf Coast volume will also be expanding due to recent expansions of capacity in the region.

As we have mentioned in the past, Valero has the ability to sell (drop down) assets at any given time to its master limited partnership to generate cash for improving growth and shareholder returns.

The prospect of an OPEC agreement and rising oil prices threatens to put upward pressure on the crack spread, which has caused VLO to decline recently, presenting a good buying opportunity for the longer-term. VLO is a great value with a strong balance sheet and solid growth potential. The quarterly dividend was recently increased again to \$0.60 a share, for a yield above 4 percent.

Real Estate Selections

Currently, the average real estate investment trust (REIT) does not present a particularly good value. As in the case of bond yields, low interest rates for so many years have pushed down real estate capitalization (cap) rates (the yield before debt payments are considered) to historically low levels. As a result, commercial real estate prices are historically high. In the longer run, a rising economy will push up rental rates which will more than compensate for added interest expenses caused by rising

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	21.03	6.3%	11.7%	6,436.1	40.40	-46.4%
Hospitality Properties	HPT	29.72	6.9%	10.0%	10,941.6	47.98	-38.1%
Hersha	HT	18.02	6.2%	10.3%	2,341.4	27.53	-34.5%
Host Hotels & Resorts	HST	15.57	5.1%	9.7%	18.6	21.20	-26.6%
Apple Hospitality	APLE	18.51	6.5%	8.4%	4,705.6	21.37	-13.4%

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.

mortgage interest rates. However, this benefit is most likely to translate into profits only on real estate stocks offering an extraordinary value now.

Two examples currently exist in the hospitality industry: Hersha (HT) and RLJ Lodging (RLJ). Both are selling at deep discounts to their net asset values and pay high dividend yields above 5 percent. As investors continue to search for high yielding investments, which are becoming scarce, these represent a solid choice with outstanding value, and are likely to benefit in the near term. The table above shows the comparative values of hospitality REITs.

Hersha Hospitality (HT) is a real estate investment trust in the hospitality sector, 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. HT is selling at a discount to its hotel assets.

Many of HT’s major properties have been undergoing renovations and not producing their full income potential. Even with ongoing renovations in 2015, the year saw an 18.7 percent growth in funds from operations (FFO). Both the first and second quarters saw strong growth as well. 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.

In September, Hersha announced the sale of a 5-hotel suburban portfolio for \$185 million. The sale of these underperforming properties will improve the performance of the company’s portfolio. The sale prices work out to an 8 percent capitalization (cap) rate on the trailing 12 months of net operating income (NOI) from the 5 hotels.

With part of the sales proceeds, HT is planning to develop a 7-story, 135-room hotel in Coral Gables (one of South Florida’s wealthiest cities) next to a site being developed into an upscale shopping mall by General Growth Properties (GGP-NYSE).

During the last 2 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.

Based on the latest trailing four quarter’s financials, including

the most recent 2016 second quarter, and using 7.5 percent cap rate to evaluate the company’s portfolio, we value HT at \$27.53 per share which is 53 percent higher than the current price. The dividend yield of 6.2 percent is attractive and lowers the risk profile. Hersha has repurchased \$186.6 million of its common stock during the last three years.

RLJ Lodging Trust (RLJ) was added to our portfolio in early July. 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. Excluded or 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 has been upgrading its assets by purchasing properties in high growth markets with high barriers to entry. Management expects a significant “ramp up of growth from recent acquisitions”.

As in the case of Hersha (HT), RLJ is also selling at a discount to its hotel assets. Based on the latest trailing four quarter’s financials, including the most recent 2016 second quarter, and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value RLJ at \$40.40 per share which is 92 percent higher than the current price. The high dividend yield is attractive and lowers the risk profile.

Retail Opportunities Investment Corp (ROIC) is a real estate investment trust (REIT) that specializes in the acquisition, ownership and management of grocery-anchored shopping centers located in densely-populated, metropolitan markets across the West Coast. The dividend yield is attractive which lowers its risk profile.

ROIC began as an IPO 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. As new properties are added, along with tenant upgrades, FFO is bound

to continue rising.

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, when making decisions on whether to buy, hold, or sell a particular company. 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 in distressed times.

Medically-Related Selections

This sector is defensive because medical needs persist regardless of financial conditions. The world's demographic aging trends, and the commensurate increase in medical care needs, translate into strong growth prospects for this industry.

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. BSX has more than 900 US patents.

In September, BSX announced European approval for its LOTUS Edge Valve System, the company's next generation transcatheter valve implantation used for aortic valve replacement. Similar to earlier versions, the system accurately relocates the device and prevents leakage but with a more

flexible and lower profile catheter. It also includes *Depth Guard* technology, which reduces the need for pacemakers. The heart valve market is a relatively untapped and growing market. This device gives BSX significant growth opportunity for its interventional cardiology segment.

Pfizer (PFE) has an arsenal of new pharmaceutical products, with 88 in clinical development and 30 in late stage development or registration. PFE has rebuilt its pipeline and transformed its R&D approach. PFE has agreed to purchase AstraZeneca's antibiotics business for \$1.58 billion in order to boost PFE's stable of older products that are losing patent protection. In September, the anti-trust waiting period expired with respect to Pfizer's pending acquisition of Medivation, Inc., which means the acquisition can proceed.

Medivation, is a biopharmaceutical company that focuses on the development of medical therapies including *Xtandi* for the treatment of metastatic prostate cancer; *Enzalutamide* which is in clinical trials for the treatment of non-metastatic prostate cancer, as well as for hepatocellular carcinoma, and breast cancer; and *Talazoparib* which is also in clinical trials for treatment of HER2 normal breast cancer.

Pfizer is well positioned with several break-through drugs and treatments.

Pfizer has several oncology recipes for treating cancer, including *Ibrance* for treating metastatic breast cancer which has exceeded expectations in treating 28,000 patients. In September, the Committee for Medicinal Products for Human Use (CHMP) of the European Medicines Agency (EMA) adopted a positive opinion recommending that *Ibrance* be granted marketing authorization in the European Union (EU). The opinion will now be reviewed by the European Commission (EC). If approved, *Ibrance* would be the first medicine in a new class of anti-cancer treatments.

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

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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 (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still 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 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last one, five, and ten year periods.

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

Numerous studies show that small caps perform better over the long run than the market as a whole. This is especially true during a recovering economy. Small-cap stocks perform better than large-cap stocks because 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. They also tend to be domestic companies without substantial overseas exposure, and therefore are not buffeted by the currency fluctuations that currently haunt larger companies. Here more than ever, attention to value is paramount.

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) is a Canadian company offering a broad mix of agricultural products, from wholesale fertilizers to retail farm products, aimed at increasing the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while population and per-capita income increases. This translates into a need for greater crop output per acre through the use of AGU's products.

Most of AGU's earnings come from its retail stores, offering

farm products with the balance coming from its wholesale sales of fertilizers, mostly nitrogen-based but also from potash and phosphates. This diversification protects AGU from swings in the markets and brings steady sources of free cash flow for future growth.

During September, Agrium and Saskatoon-based Potash Corp continued merger talks. The all-stock deal would combine the world's largest crop nutrient production capacity from Potash, with North America's largest farm retail network from Agrium. The combined company should be able to realize higher food and grain prices while also yielding stronger fertilizer margins, as well as having greater financial might to accelerate Agrium's strategy to boost its US market share among farm retail providers, which is currently less than 20 percent.

Alcoa Aluminum (AA) is splitting its upstream and downstream operations into two separate companies. The upstream operations of mining bauxite, alumina, aluminum, along with cast products and rolling mill operations retain the Alcoa name and the stock symbol "AA".

The new downstream company will be called Arconic, with the stock symbol of "ARNC" and will combine its value-added businesses to precision engineering along with advanced manufacturing of aerospace structures, jet engines, automotive and commercial transportation markets.

The split is expected to occur in the last half of this year, pending a favorable IRS ruling. Splitting will enhance management's ability to focus on core operations, allocate capital, target investment opportunities, and customize employee incentives and recruitment.

Disney (DIS) has built an empire in family-oriented entertainment with its charming film characters, consumer products, and theme parks. The problem is that these segments only provide for half of the company's earnings. The other half comes from its cable TV channels, predominantly ESPN. Despite valiant effort to combat the trend away from traditional cable TV platforms (cord-cutting), it appears that Disney is fighting an uphill battle with half of its revenue, a battle that is bound to continue to chip away at growth prospects for the whole company as the cord-cutting trend continues and new competitive streaming services proliferate (such as Sling TV). **Accordingly, we are recommending selling DIS.**

As we noted in our September 27 email update, aside from erosion from cord-cutting, ESPN is fighting the tsunami of increased costs for sports programming. The most recent is the renewal of its NBA contract which begins with the upcoming season. The new nine-year contract is close to three times more expensive than the expiring nine-year deal, which will cost DIS an additional \$700 million annually.

For this year's Monday Night Football package, ESPN is

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paying \$1.9 billion, or \$111 million per game, about \$32 million per hour. There is also the added cost of 150 people for the production.

We based our initial recommendation on the premise that the charming half of the company would compensate with blockbuster movies. However, it doesn't appear that is happening in view of the strengthening trends in cord-cutting and rising ESPN costs. Uncertainties are too great for the cable side of DIS, for a stock with a relatively high price/earnings ratio which is already anticipating strong and steady growth.

Ford (F) is in our model portfolio because it is an extraordinary value. Ford's new all-aluminum F-150 truck, which gets close to 30 miles to the gallon, has been Ford's best-selling vehicle in the US for 34 consecutive years, and the company's most profitable product. On the cost side, Ford has been reducing the number of platforms it uses to produce its models, from 27 in 2007 to 9 by the end of 2016, which will continue to save billions through economies of scale and give Ford more agility to adapt to changes in demand.

Ford stock is selling at a huge discount to the rest of the market. The dividend yield is close to 5 percent which lowers the risk.

Freeport-McMoRan (FCX) is the world's largest copper producer. It also has significant oil and gas assets in the Gulf of Mexico which it acquired at the top of the market in 2013. This was particularly unfortunate because FCX took on a large amount of debt to make the acquisition. The added leverage, along with sinking prices on these commodities, decimated FCX. However, the production from these wells is now increasing.

This year, the company has made significant progress recently in selling non-core assets to reduce its debt. In addition to selling its stake in its African copper operation to a Chinese mining firm for \$2.65 billion, Freeport also sold a \$1.5 billion stock offering to reduce debt further. CEO Richard Adkerson says that these moves clear the path for Freeport to get its balance sheet in order without being forced to sell its highest quality assets. Carl Icahn remains the largest FCX shareholder with 88 million shares, which means moves are being made under his supervision.

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.

Blackstone's recent \$820 million investment in NCR preferred stock that is convertible into NCR stock at \$30 is evidence that this savvy private equity and advisory firm sees that NCR has significant value above \$30.

In September, NCR launched its Business Banking Mobile, a secure and easy-to-use account management platform that community banks can offer their business customers, allowing them to better compete with larger banks.

We have noted that NCR is an undervalued stock. NCR expects its 2016 earnings to be in the range of \$2.90-\$3.00. The current stock price puts it close to 12 times earnings, far below the market average.

Symantec (SYMC) is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. 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.

Earlier this year, Symantec sold its subsidiary Veritas to the Carlyle Group. The sale transformed Symantec into a pure-play security vendor with fresh capital for acquisitions and R&D to bolster growth.

Recently, cybercriminal networks attacking Internet of Things (IoT), devices controlled through the Internet or are internet-accessible, ranging from cars to home networks because they generally lack sophisticated security. Cybercriminals are taking advantage of lax IoT device security to spread malware, create zombie networks, and botnets, in an effort to stitch together a large web to attack more profitable targets like substantial companies.

According to Symantec's IoT research, more than half of all IoT attacks originate from China and the US. Substantial numbers of attacks also emanate from Germany, the Netherlands, Russia, Ukraine and Vietnam.

SYMC has furnished a good investment return this year, especially considering its \$4.00 dividend paid earlier this year.

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 Corp. of Engineers, and the US Air Force, which should continue to bolster growth.

Xerox (XRX) is continuing to transform from a seller of printers and copiers to a company providing information technology (IT) services and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenues. XRX will be splitting into two companies by the end of the year; one with the printers and other equipment and the other offering the IT services. The company predicts that the split will save \$2.4 billion during the first 3 years. Carl Icahn, who holds 82 million shares, believes XRX is undervalued and believes the split will improve management's efficiency and focus.

At close to 10 times earnings, we continue to emphasize that XRX is very cheap relative to the rest of the market.

ETFs for Rising Interest Rates

We have been recommending three ETFs designed to benefit from the normalization of interest rates and long-term bond yields. These ETFs 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. Both TBF and TBT are based on the Barclays US 20+ Year Treasury Bond Index, TMV is based on the Intercontinental Exchange (ICE) US Treasury 20+ Year Bond Index. (We have compared these benchmark indexes with others, including BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which was previously used as a benchmark, and found that using any of these benchmarks produces negligible difference in our projections.) The prices of these ETFs fluctuate in accordance with the daily fluctuations of their benchmark 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.

At this writing, long-term Treasury bond yields are currently 2.34 percent, up slightly from 2.23 percent at the end of last month. The current prices of these ETFs are historically low and present compelling long-term investments, even if we may need to wait a couple of years.

The global synchronized concert of new stimulus packages is bound to lead to more vibrant economic growth around the world. This, along with continued improvement in the US economy, will ultimately lead to increases in inflation over the longer term. In addition, the string of 100 percent readings from the **SoundAdvice Diffusion Index of LAGGING Indicators** (page 11) is telling us that a rise in interest rates is on the horizon.

We can project the movements of these ETFs based on any given scenario. Using the Federal Reserve's prediction is 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 September 21 meeting. There was a sharp difference in the predictions among this group of informed FOMC experts. The lowest prediction was that the Federal funds rate would end 2016 at 0.375 percent. The highest was 1.0 percent.

In the spirit of being conservative, we can use the average of the lowest half of the predictions of the September Dot Plots (8 of the 17). These averages predict that the Federal funds rate will be 0.625% by the end of 2016, 1.125% by the end of 2017, and 1.875% by the end of 2018. 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 bond yields would be yielding 2.715% by the end of 2016, 3.215% by the end of 2017 and 3.915% by the end of 2018.

Here is what would happen to each ETF:

TMV would rise from \$16.51 to \$20.76 by the end of 2016, to \$27.34 by the end of 2017, and to \$38.60 by the end of 2018.

TBT would rise from \$31.60 to \$36.82 by the end of 2016, to \$44.24 by the end of 2017, and to \$55.67 by the end of 2018.

TBF would rise from \$21.00 to \$22.67 by the end of 2016, to \$24.85 by the end of 2017, and to \$27.88 by the end of 2018.

The Erosion Factor

As 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, 0.04 percent (4 basis points) every day, and thus go nowhere for the next two years. Here is what would happen to each ETF:

TMV would decline to \$15.78 by the end of 2016 (4.4%), and to \$14.74 by the end of 2017 (10.7%).

TBT would decline to \$30.80 by the end of 2016 (2.5%), and to \$29.84 by the end of 2017 (5.6%).

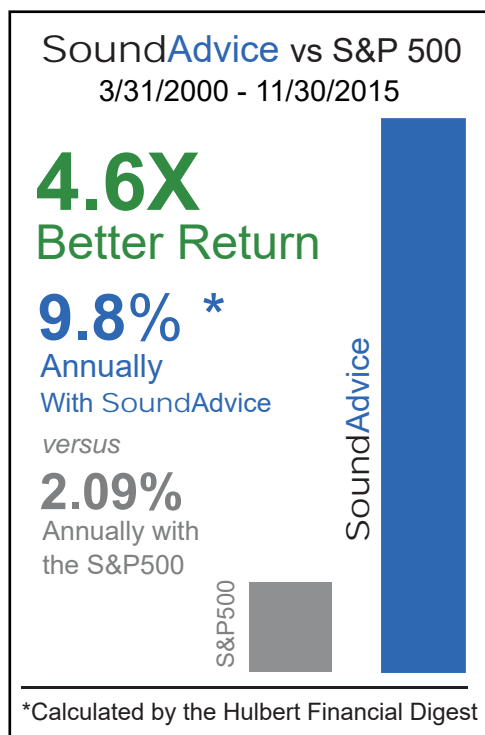
TBF would decline to \$20.78 by the end of 2016 (1.0%), and to \$20.60 by the end of 2017 (1.9%).

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

Hedging the Portfolio

Adding to our overall caution, 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.



Income With Growth	Symbol	Price / NAV	Yield	Action	Limit
Hersha Hospitality Trust	HT	\$18.02	6.22%	BUY	\$21.00
Retail Opportunity Investment Corp	ROIC	\$21.96	3.28%	BUY	\$24.00
RLJ Lodging Trust	RLJ	\$21.03	6.28%	BUY	\$25.00
Diversified Growth					
Agrium	AGU	\$90.69	3.86%	BUY	\$105.00
Alcoa	AA	\$10.14	1.18%	BUY	\$11.00
Boston Scientific	BSX	\$23.80	0.00%	BUY	\$25.00
Disney	DIS	\$92.86	1.48%	SELL	
Ford Motor Company	F	\$12.07	5.80%	BUY	\$15.00
NCR Corp	NCR	\$32.19	0.00%	BUY	\$36.00
Pfizer	PFE	\$33.87	3.54%	BUY	\$37.00
Stryker Corp.	SYK	\$116.41	1.31%	BUY	\$122.00
Symantec	SYMC	\$25.10	1.27%	BUY	\$28.00
Tekla Life Sciences Fund	HQL	\$18.73	0.00%	BUY	\$20.00
Tetra Tech	TTEK	\$35.47	1.01%	BUY	\$37.00
Third Avenue Real Estate Value Investor	TVRVX	\$30.55	1.44%	BUY	\$32.00
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$21.54	0.00%	BUY	\$22.00
Xerox	XRX	\$10.13	2.76%	BUY	\$11.00
Energy/Natural Resources					
Chevron	CVX	\$102.92	4.16%	BUY	\$110.00
Fidelity Select Nat. Gas Fund	FSNGX	\$26.94	0.00%	BUY	\$29.00
ICON Energy Fund Class S	ICENX	\$12.66	0.00%	BUY	\$13.00
Transocean	RIG	\$10.66	0.00%	BUY	\$11.00
Valero	VLO	\$53.00	4.53%	BUY	\$60.00
Aggressive Growth					
Chesapeake Energy Corp	CHK	\$6.27	0.00%	BUY	\$8.00
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$16.51	0.00%	BUY	\$19.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$21.00	0.00%	BUY	\$22.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$31.60	0.00%	BUY	\$35.00
Freeport-McMoRan	FCX	\$10.86	0.00%	BUY	\$12.50
S&P 500 ProShares Ultra Short ETF	SDS	\$16.39	0.00%	BUY	\$18.00

Notes to the table:

Prices are as of 9/30/2016. See our website for live pricing and buy limits:

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

The right hand column is the highest recommended price limit for purchases.

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. The table above divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

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.

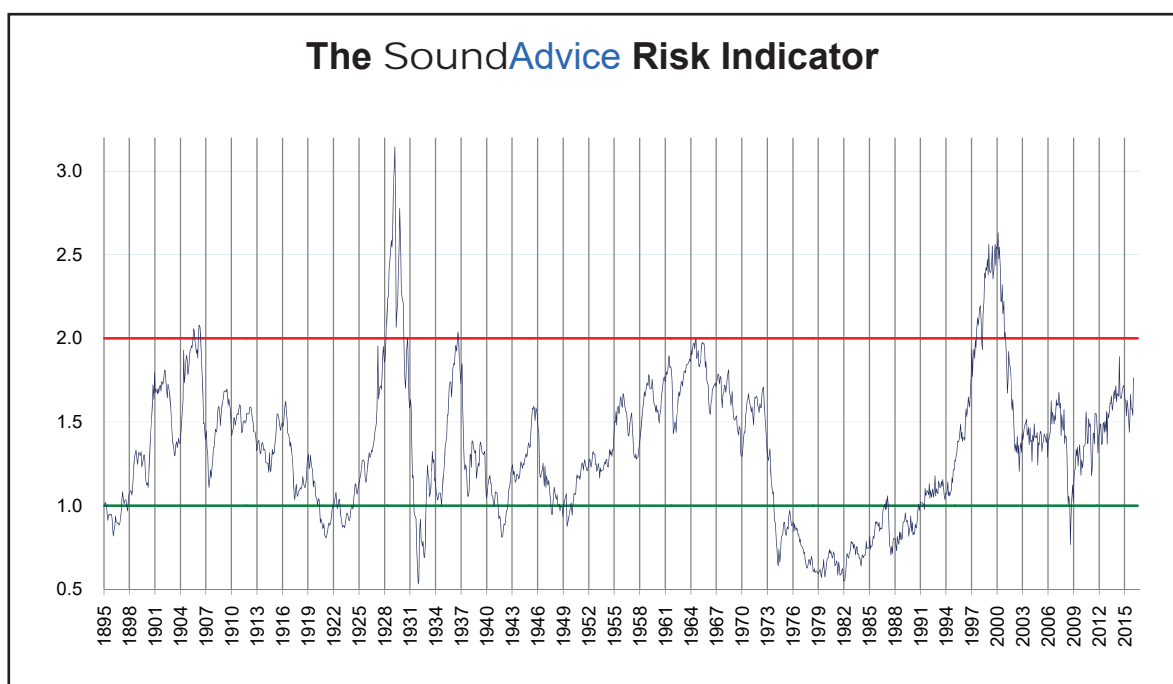
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$12.8 million in stocks and to \$1.6 million in houses.

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 \$508 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 1.73. 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. This was just after the S&P 500 peaked at 2,130.82 on May 27, 2015.

It is worth noting that the SoundAdvice Diffusion Index of **LAGGING Indicators** hit 100 percent again in August (the most recent data), and will continue to do so in September unless there is a significant decline in the underlying lagging economic indicators. This string of 100 percent readings is confirming our caution signal.

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 2.7 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%		2.7%

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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