

## Brexit Backlash



The *Sound Advice* Portfolio is up 8.5 percent this year, as compared to 2.7 percent for the S&P 500. We have an average profit of 55 percent based on the prices at which each position was recommended.

-- Gray Emerson Cardiff, Editor

Whee! What a ride. The Dow dropped 900+ points during the 2 days following the Brexit vote and then recovered 799 points during the next three days. Is Brexit a big deal or is all of this an overreaction?

Brexit is not the seed of another melt-down. In his speech addressing Parliament the day following the Brexit vote, Prime Minister (PM) David Cameron said that the UK banking system is substantially more resilient than it was before the banking crisis, with capital requirements now 10 times higher than then.

The governor of the Bank of England added that stress tests show that banks have more than enough capital and liquidity reserves to withstand a scenario worse than the one the country currently faces. And the Bank of England can make available 250 billion pounds if it needs to support banks and markets.

While not the seed of a melt-down, a withdrawal from the European Union (EU) is bound to cast a pall of uncertainty over the UK and the EU. It would mean the passport to preferential free trade would be lost. Currently, close to half of the UK's current exports go to the EU.

The pound would likely suffer, making it more expensive for UK residents to travel and do business in EU countries. UK airlines could be locked out of the EU's "easy sky" agreement, making it harder to establish new routes, set prices, and deal with regulations. The UK airlines along with other UK

industries could suffer tariffs and other protectionist trade measures in dealing with EU countries. The UK would have to revert to trading with EU countries under the World Trade Organization rules, in the same fashion as do America, China and India, which would likely introduce trade barriers on pharmaceuticals and automobiles as well.

It would also make it harder for EU countries to do business in London, a perception evidenced by the plunge in London property stock prices after the Brexit vote. Without the EU passport and free access, businesses are less likely to expand into the UK.

The biggest EU industry located in the UK is the headquarters of EU's FDA (the European Medicines Agency). The vote introduced calls to move the headquarters to an EU country, opening up uncertainty regarding prioritizing approvals and pricing of British drugs and treatments, all of which would impact R&D programs.

EU countries would also be impacted by the exit of the UK, one of its largest members, as evidenced by a less dramatic but substantial drop in the euro. Only half of EU company revenues are generated domestically, which makes the EU heavily dependent on foreign business and investment.

It would also set a precedent of leaving the EU, which is already stressed by poor economic growth. Many EU members are having difficulty dealing with a single currency that is too strong for their less productive economies, especially Greece, Spain, and Italy. The most dreaded fear is that Brexit will lead to a disintegration of the EU altogether.

At any rate, it would be a big mess to sort out.

### Article 50

It is up to the UK, not the EU, when to start the process for exiting the EU. The process starts when the UK invokes Article 50 of the Lisbon Treaty. PM David Cameron, resigned on the day the Brexit vote results were tallied. He said he will not invoke Article 50 because that action will be more appropriate for the next prime minister. Cameron said he will stay on until October, until a new PM takes over. If and when Article 50 is invoked, a 2-year negotiation period begins. If no agreement is reached within 2 years, the UK would leave the EU without any new agreement being in place. (The

2 year period could be extended but only by a unanimous vote from the 28 Heads of State from the EU countries that make up the European Council.)

Negotiations are expected to extend for most or all of the 2-year period due to the complexity of the issues and the various potential impacts regarding the other 27 EU countries. The negotiated agreement would need to be adopted by 72% of the remaining 27 EU countries representing at least 65% of the EU population.

The final agreement would also need to be approved by the European Parliament which would require a majority of its 751 members. Each EU country has a certain number of members. The table shows the number for each country.

From the table, it is evident that the largest countries wield the largest voting power. (British countries would not be allowed to vote.) The self-interests of the other 27 countries are bound to play a part. Some will likely propose tariffs on goods coming from the UK to make their own products more attractive. No EU country will be interested in giving the UK a better deal than it has now.

Once Article 50 is invoked, the uncertainty will not stop. Just the negotiation process is bound to provoke a great deal of uncertainty over an extended period, undermining consumer confidence and investment -- the pillars of economic growth. The GDP of the EU is close to that of the US, so the effects will be felt around the world and reduce global growth expectations.

As the negotiations continue, news of various proposals will likely cause ripples in the world's financial markets. The US will be least affected because 70 percent of its company revenues are produced domestically. This compares to 58 percent for Japan and 49 percent for Europe.

## Portfolio Updates

Our model portfolio selections reflect the "Caution" signal in force issued by our Diffusion Index of Lagging Indicators (page 11). With the overall market fully valued, and new Brexit concerns, we have more reason to be cautious.

### Energy Selections

The fracking boom added nearly 5 million barrels a day to world supplies and brought US production close to 10 million barrels per day (MMbbl/d), in line with that of Saudi Arabia. As an oil glut appeared, Saudi Arabia launched a price war aimed at forcing the price of oil down below the cost of fracking in order to drive US frackers out of business. Without that additional 5 million barrels per day on the world's markets, Saudi Arabia and its OPEC allies would be back in the driver's seat again. As the price of oil fell below the cost to frack, it caused new US drilling to cease. Without new wells, it was only a matter of time until US production would start declining as a result of the natural steep production curve of fracked oil wells. Production drops 70 percent during the first year from the typical fracked well. In order to maintain production levels from an oil field, a substantial number of new wells need to be added. We know that this is not happening as evidenced by the 50 percent plunge in the domestic drilling rig count since October 2014.

The latest data from the Energy Information Administration (EIA) shows US oil production has been declining since the first of the year. During the week ending June 24, US production was 8.622 MMbbl/d, down 988 thousand bbl/d from the peak of 9.61 MMbbl/d. According to the Energy Information Administration, demand will be increasing even with low worldwide GDP growth.

The Energy Information Administration ((EIA) projects that consumption will still rise by 1.2 to 1.5 MMbbl/d in 2016 and 2017 using low GDP growth assumptions. The effect of Brexit negotiations are unknown but may trim these projections somewhat.

As production from fracking is certain to continue declining, an additional 500,000 bbl/d is projected to be produced from deep-water wells in the Gulf of Mexico in 2016 and 2017. The increase in Gulf production is for two primary reasons:

The first is because massive oil fields purchased and developed several years ago when oil prices were higher are now

### Members of the European Parliament (MEPs)

# MEPs	Country
96	Germany
74	France
73	UK (Not Counted)
73	Italy
54	Spain
51	Poland
32	Romania
26	Netherlands
21	Belgium
21	Czech Republic
21	Greece
21	Hungary
21	Portugal
20	Sweden
18	Austria
17	Bulgaria
13	Denmark
13	Finland
13	Slovakia
11	Croatia
11	Ireland
11	Lithuania
8	Latvia
8	Slovenia
6	Cypruss
6	Estonia
6	Malta
6	Luxembourg
751	

starting to produce substantial amounts. Freeport's deep water wells are an example.

The other reason is that smaller fields are being linked with underwater pipelines into an existing offshore platform. Chevron recently completed one of these so-called "Tiebacks" to its Tahiti platform 190 miles off the Gulf coast.

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

**Chesapeake Energy (CHK)** has taken a beating from the crash in oil and gas prices. CHK's debt load of close to \$10 billion 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.

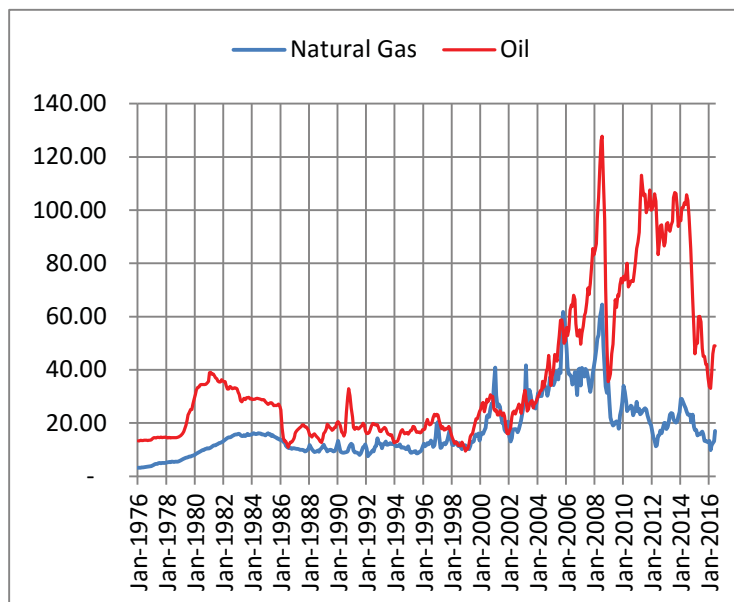
Since the beginning of the year, CHK has made a number of debt-to-equity swaps that reduced the amount of near-term maturities, and thus beneficial for CHK. The company still has a way to go, with \$723 million still due in 2017 and \$538 million in 2018, but it has a \$4 billion credit facility to tap that matures in 2019. CHK has more asset sales planned, along with expense reductions. It is also renegotiating pipeline contracts and settling related lawsuits.

CHK has a bright future with rising energy prices as long as it survives the current crisis. It is also an ideal target for a buyout from a company with the capital to exploit these natural resources. Carl Icahn holds 11 percent of the outstanding shares and has strong influence over management.

**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.

One of Chevron's most significant projects is the Gorgon LNG export facility which was constructed over the last 6 years over the Gorgon and Jansz-lo gas fields located

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



100 miles off the northwest coast of Australia. The first of three infrastructures (referred to as "trains") has recently commenced operating and is expected to reach full production in 6 to 8 months and deliver the equivalent of 90 thousand bbl/d of oil.

Chevron's other major project, the Wheatstone LNG project, also in Western Australia, is due to begin production next year. Both of these projects will boost cash flow.

**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 \$49 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to \$2.93 for one million BTUs, 5.8 million BTUs will cost \$17. 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

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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 sectors 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 long-term profit from RIG should be very good from here.

As an indication of RIG's survivability, the company expects to have positive free cash flow for the rest of 2016. Despite heavy capital expenditures, the company estimates 2016 free cash flow to be \$18 million. RIG reports a backlog of orders totaling \$14.6 billion, nearly all of which is for ultra deep-water floaters.

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 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 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, especially as US production

declines and OPEC volumes recapture market share. Gulf Coast volume will also be expanding because of recently expansions of capacity in the region.

One of the largest foreign assets owned by a foreign company in the UK is VLO's Pembroke Refinery in Wales which was purchased in 2011 and refines 270,000 bbl/d of crude into gasoline, jet fuel and heating oil, all of which is sold inland. Although CEO Joe Gorder calls this facility a "gem" it remains to be seen how Brexit will affect the export of refined products from Britain to continental Europe. VLO is a great value with a strong balance sheet and solid growth potential. Any impact from Brexit should not be critical to the company. The quarterly dividend was recently increased to \$0.60 a share, for a yield above 4 percent.

## Real Estate Selections

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, and the average real estate investment trust (REIT) does not present a particularly good value.

In the longer run, a rising economy will push up rental rates which will more than compensate for added interest expenses caused by rising mortgage interest rates. However, this benefit is most likely to translate into profits only on real estate stocks offering an extraordinary value now.

**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. Based on the latest trailing four quarters financials, including the most recent 2016 first quarter, we value HT at \$30.29 per share which is nearly 50 percent higher than the current price. The dividend yield above 5 percent is attractive and lowers the risk profile.

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 FFO. 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.

**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 in October 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.

First quarter per share FFO climbed 17.4 percent, following FFO growth of 12.9 percent in 2015.

**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.

Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

### 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.

**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. The company is well positioned with several break-through drugs and treatments.

The company believes that the public markets have yet to fully recognize Pfizer's oncology recipes for treating cancer. Pfizer's therapy for metastatic breast cancer, *Ibrance*, has exceeded expectations in treating 28,000 patients.

PFE has other growth drivers in the broader oncology portfolio, including Pfizer's partnership with Merck which involves the development on the anti-PD-1 immuno-oncology treatment, *Avelumab*. Pfizer's broad portfolio of immuno-oncology therapies and existing pipeline of drugs may also benefit the company from a pricing standpoint.

**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.

In June, SYK reached a new 52-week high after reporting strong quarterly earnings of \$1.24 per share.

Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions. The latest acquisition was in May, Stanmore Implants Worldwide Limited, which has a portfolio of off-the-shelf implant systems aimed at saving limbs.

The most significant acquisition in recent years was MAKO Surgical, which recently received FDA clearance for its knee and hip applications, enhancing SYK's robotic reconstructive solutions. MAKO sold 7 robots during the quarter with encouraging trends in MAKO's procedures in knee and hip replacements.

**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.

Close to three-quarters of AGU's earnings now come from its retail stores offering farm products, and the rest comes 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.

**Alcoa Aluminum (AA)** is a fully integrated aluminum producer, which means it operates in all phases of production, starting with its mining operations (upstream) and ending with its finished products (downstream). Alcoa's full integration gives it control over the supply chain, and makes it possible to enjoy larger profits from its downstream operations when aluminum prices are low.

In the final days of June, Alcoa officially filed to 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 is called Arconic, with the stock symbol of "ARNC" and will combine its value-added businesses and to precision engineering along with advanced manufacturing the aerospace structures, jet engines, automotive and commercial transportation markets.

Alcoa Chairman and CEO Klaus Kleinfeld said, "The separation will allow each new company to pursue its own distinct corporate strategy and unlock the full value of each business." We believe it should do just that.

**Disney (DIS)** has built an empire in family-oriented entertainment with its charming film characters, consumer products, and theme parks. CEO Iger's decisions over the past decade to acquire Marvel, Lucasfilm, and Pixar are paying off. Disney plans several more episodes and related offshoots of the *Star Wars* franchise into 2019, along with more *Indiana Jones* movies and more *Avengers* and *X-men* movies. *The recent success of The Jungle Book* unlocks a pipeline of live action fairy tales including a sequel to *The Jungle Book*, a Tinker Bell movie, and a spinoff of 101 Dalmatians.

The success of the movie franchises and theme parks will add to investor enthusiasm and should make DIS less dependent on its cable TV stations, especially ESPN, which are under pressure from cable platforms offering skinnier bundles with fewer required stations. Although to that point, Iger believes that a new multi-channel platform cannot be launched without ESPN, whether it is 30 or 150 channels.

In June, Disney's new theme park in China opened on June 16 in Pudong, just outside of Shanghai. Chairman Bob Iger says the opening of the park all opens the opportunity for the entire Company as it plants a stake into the largest market in the world in terms of people.

**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.

Brexit is a negative for Ford. Goldman Sachs is trimming its earnings estimate by 7 percent because the UK accounts for 8 percent of sales. This would lower Ford's previously expected earnings from \$1.95 per share in 2016 to \$1.81, which still puts the stock price close to 7 times earnings, an incredible discount from the rest of the market. The dividend yield is close to 5 percent which lowers the risk.

**Freeport-McMoRan Copper & Gold (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. The production from these wells are now increasing.

Freeport has instituted an asset-sales program to raise \$5-\$10 billion to reduce debt. The company needs to raise \$2 billion this year to pay off maturing debt. So far asset sales amounting to \$1.4 billion have occurred. The company can issue FCX shares which would not be a dilution as long as proceeds are used to pay down debt.

Carl Icahn is the largest FCX shareholder with 88 million shares, which means moves are being made under his watchful eyes. The reduction of debt increases the company's likelihood of survival. The stock market agrees as evidenced by the uptrend in FCX since the asset sale plan was announced in January.

**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 June, NCR released the fastest version of its transaction processing solution, Authentic. It is also the first major payments platform to be compliant with the most stringent security standard (PA-DSS 3.1).

We have noted that NCR is an undervalued stock. Prior to Brexit, NCR expected its 2016 earnings to be in the range of \$2.90-\$3.00. NCR is a worldwide stock which could be affected by Brexit. However, even trimming earnings by ten percent still puts the stock price close to 10 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 transforms Symantec into a pure-play security vendor with fresh capital for acquisitions and R&D to bolster growth. This new-found focus and capital should launch a new growth phase for SYMC. The restructuring is also aimed at reducing operating expenses by \$400 million annually which is on track.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets. TTEK

recently purchased Coffey International which is a good fit and should improve TTEK's growth in the next few years.

Tetra Tech's backlog of business has climbed 18 percent over the last year, due in large part by the Coffey acquisition. TTEK's most recent acquisition of the IT solutions firm INDUS Corporation is bound to help Tetra Tech secure federal contracts in the IT sector.

The company expects full-year earnings in the range of \$2.70 to \$3 per share, which puts the price/earnings ratio between 10 and 11 – a substantial discount to the rest of the market.

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

Carl Icahn recently purchased 82 million XRX shares. To improve management efficiency and focus, Icahn is coaxing the company to split into two separate companies, one with the printers and other equipment and the other offering the IT services. Mr. Icahn believes XRX is undervalued and that share earnings will likely improve in 2016.

In June, Xerox agreed to put Icahn's lieutenant, Jonathan Christodoro, on its board, as well as in the company's governance and finance committees. XRX jumped 2 percent the day of the news.

## 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. The Brexit backlash has lowered the prospects for rising US bond yields for the near term. US Treasuries are an attractive hiding place for uncertain capital. At this writing, long-term Treasury bond yields are currently 2.31 percent, down from 2.67 percent at the end of last month before Brexit.

Shortly after the Brexit vote, it was reported on June 29 that US consumer spending, which accounts for more than two-thirds of US economic activity, increased 0.4 percent in May after surging 1.1 percent in April.

Despite the healthy consumer spending, Brexit makes it unlikely that the Federal Reserve will raise interest rate soon. Federal Reserve Chair Janet Yellen said that "the US central bank needed to be sure there was no shock from the outcome of the British referendum before tightening monetary policy further."

As one of the least affected countries, the US economy should continue to improve after the shock of Brexit wears off. The way the US stock market recovered 3 days after the vote indicates it may be sooner than later. In any case, the continued improvement in the US economy will ultimately lead to increases in inflation over the longer term.

Because the current prices of these ETFs are so low, they present compelling long-term investments, even if we may need to wait a couple of years. .

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, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds. The prices of these ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. In its December meeting, the Federal Reserve's Federal Open Market Committee (FOMC) unanimously decided to begin normalizing interest rates. As part of the FOMC's economic projections, each of the 17 members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot", and medians are taken to formulate the Federal Reserve's official prediction.

The most recent Dot Plot was taken at the March 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 0.625 percent. The highest was 2.125 percent.

In view of the subsequent Brexit backlash, it seems appropriate to use the lowest points of the March Dot Plot, which predicts that the Federal funds rate will be 0.625% by the end of 2016, 1.625% by the end of 2017, and 2.125% 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 2.685% by the end of 2016, 3.685% by the end of 2017 and 4.185% by the end

of 2018.

Here is what would happen to each ETF:

TMV would rise to from \$16.76 to \$21 by the end of 2016, to \$35 by the end of 2017, and to \$44 by the end of 2018.

TBT would rise from \$36.69 to \$51 by the end of 2016, to \$52 by the end of 2017, and to \$60 by the end of 2018.

TBF would rise from \$21.05 to \$22.5 by the end of 2016, to \$27 by the end of 2017, and to \$29 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 \$16.2 by the end of 2016 (3.6%), and to \$15.1 by the end of 2017 (9.9%).

TBT would decline to \$31.2 by the end of 2016 (1.7%), and to \$30.2 by the end of 2017 (4.8%).

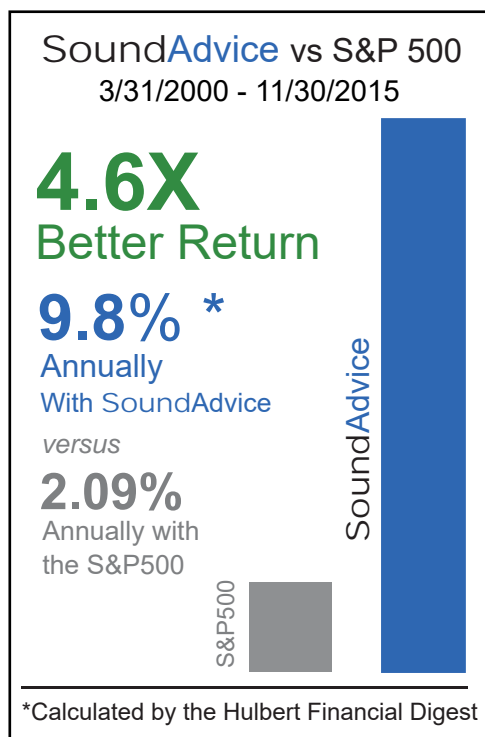
TBF would decline to \$21.9 by the end of 2016 (0.5%), and to \$20.8 by the end of 2017 (1.4%).

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

**Hedging the Portfolio**

Since June 2015, our *Sound Advice* Diffusion Index of Lagging Indicators (page 11) has been issuing a caution signal. At times like this, it is vital to confine portfolio selections to special situations and focus on value.

The **ProShares UltraShort S&P 500 (SDS)** is a reverse ETF, which means it moves in the opposite direction of the market. This ETF 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	\$17.15	6.53%	BUY	\$21.00
Retail Opportunity Investment Corp	ROIC	\$21.67	3.32%	BUY	\$22.00
Diversified Growth					
Agrium	AGU	\$90.42	3.87%	BUY	\$99.00
Alcoa	AA	\$9.27	1.29%	BUY	\$10.50
Boston Scientific	BSX	\$23.37	0.00%	BUY	\$24.00
Disney	DIS	\$97.82	1.40%	BUY	\$107.00
Ford Motor Company	F	\$12.57	5.57%	BUY	\$15.00
NCR Corp	NCR	\$27.77	0.00%	BUY	\$33.00
Pfizer	PFE	\$35.21	3.41%	BUY	\$37.00
Stryker Corp.	SYK	\$119.83	1.27%	BUY	\$120.00
Symantec	SYMC	\$20.54	1.56%	BUY	\$21.00
Tekla Life Sciences Fund	HQL	\$17.19	0.00%	BUY	\$20.00
Tetra Tech	TTEK	\$30.75	1.04%	BUY	\$32.00
Third Avenue Real Estate Value Investor	TVRVX	\$28.94	1.52%	BUY	\$32.00
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$19.93	0.00%	BUY	\$22.00
Xerox	XRX	\$9.49	2.95%	BUY	\$12.00
Energy/Natural Resources					
Chevron	CVX	\$104.83	4.08%	BUY	\$105.00
Fidelity Select Nat. Gas Fund	FSNGX	\$24.89	0.00%	BUY	\$27.00
ICON Energy Fund Class S	ICENX	\$12.26	0.00%	BUY	\$13.00
Transocean	RIG	\$11.89	0.00%	BUY	\$13.00
Valero	VLO	\$51.00	4.71%	BUY	\$60.00
Aggressive Growth					
Chesapeake Energy Corp	CHK	\$4.28	0.00%	BUY	\$5.50
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$16.76	0.00%	BUY	\$24.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$21.05	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$31.69	0.00%	BUY	\$39.00
Freeport-McMoRan	FCX	\$11.14	0.00%	BUY	\$12.00
S&P 500 ProShares Ultra Short ETF	SDS	\$17.81	0.00%	BUY	\$21.00

**Notes to the table:**

Prices are as of 6/30/2016. 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 \$12.18 million in stocks and to \$1.7 million in houses.

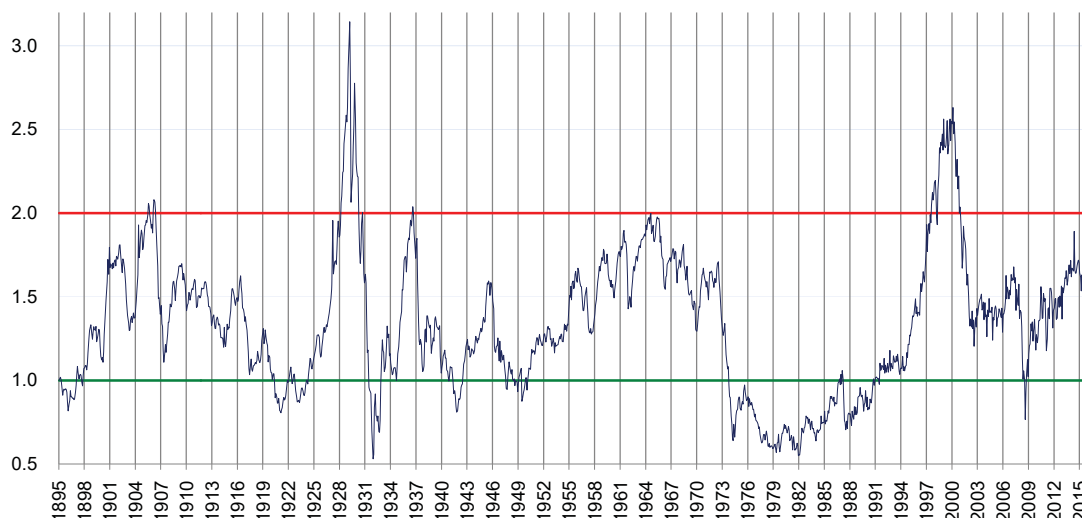
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$484 million, or 39.7 times more money—the 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 SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.54. This reading reveals that stock prices are close to 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 Turbulent Markets* for a complete explanation of the SoundAdvice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



## 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 March, 2015.

The previous zero reading was 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.

However, the March 2015 signal was usurped by the SoundAdvice Diffusion Index of LAGGING Indicators, which 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.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09.

The most recent Caution signal came in June 2015, based on 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.

We are still in Caution mode. Our next signal will come from a zero reading from the SoundAdvice Diffusion Index of LEADING Indicators, which will reverse our current Caution signal. **This Diffusion Index read 33.3 percent based on the most recent May 2016 leading indicators. It is interesting to note that a zero reading could happen next month if we see a rise in unemployment claims in June from 276,000 to above 283,100, and building permits remain above 1,188,000.**

### 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 32.0 percent. During "Caution" signals, the S&P 500 increased an average of 2.5 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.0%		2.5%

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the SoundAdvice Diffusion Indexes and their track record. (You received a copy of this book with your paid subscription, and you will also receive an updated copy when you renew your subscription.)

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