

2018: Bulls Versus Bears



Gray Emerson Cardiff, Editor

The *Sound Advice* Portfolio was up 6.2 percent in 2017. We have an average profit of 69 percent based on the prices at which each position was recommended.

We have been in a defensive mode, keeping in mind that the typical 50 percent decline caused by bear markets take a 100 percent recovery to break even, which often takes several years. Minimizing the damage from bear markets is a primary key to preserving capital and producing superior investment returns. This is a primary reason we have produced market-beating returns on average over the years.

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

18.69% in 2016 vs.
9.54% from the S&P 500

From 2000-2016
10.30% Annually vs.
2.37% from the S&P 500

At the beginning of each year, we as investors always look forward and wonder what to expect. Will the bulls stay in charge, or will the bears emerge from hibernation?

The Case for the Bulls

The bulls need the status quo to continue. This requires inflation to remain dormant, along with low interest rates that may be rising slowly but not too fast, while the Federal Reserve sells its \$4 trillion Treasury bond portfolio without disrupting the bond markets. Earnings will need to continue to grow at a robust rate, by 10 percent or more. Stock prices will also need to stay relatively high in relation to earnings and sales revenue. There also cannot be any geopolitical surprises, domestic political scandals, a shift in political leadership, or significant changes in the economies of the rest of the industrialized world. Steady as she goes.

The Case for the Bears

The bears need something to interrupt the status quo for a significant correction or new bear market. At the risk of sounding like Chicken Little, a number of potential developments warrant our watchful attention.

Domestically, inflation has been dormant which has allowed interest rates to remain low, especially long-term bond yields. If inflation heats up, interest rates are certain to escalate from market forces and a stronger reaction from the Federal Reserve. Inflation was tame in 2017, but the extremely low unemployment rate and growing shortage of labor is bound to introduce upward pressure on wages in 2018.

Aside from its mandate to control inflation, the Federal Reserve is conducting two balancing acts. First, in order to have the ability to stimulate the US economy out of its next recession, interest rates must be substantially higher than they are now, but they need to be raised without adversely impacting the economy. Second, the Federal Reserve also needs its balance sheet normalized, which is bloated by a factor of 5 as a result of the bonds it purchased during its quantitative easing programs needed to bail out the US economy from the 2008-09 meltdown. The Federal reserve will have to carefully sell some \$4 trillion of Treasury securities. Both of these balancing acts must be accomplished without disrupting the financial markets or slowing down growth materially, or even tipping the US back into a recession.

Internationally, there are several areas to watch. The Eurozone is the largest GDP outside of the US, and comprised of highly-indebted countries which are bound by a single currency. A melt-down could be on the scale of the one during 2008-09. Italy could be the epicenter, with enormous debt, a vulnerable banking system, and a slow-growing economy which is too big to bail out. Watch out for a populist election from a party demanding a vote on exiting the Eurozone.

As in the US, Europe's central bank (ECB) is unwinding its quantitative easing program. There is the potential for the ECB to miscalculate the impact of rising interest rates. A strengthening of the euro would make it hard on exporters and could send some countries, especially Italy, back into recession.

China is the second largest single-country economy with debt that has climbed to 200 percent of its GDP in order to fuel a building boom. Watch for a slow-down or reversal in real estate prices there. Although China's government seems to have a firm grip on the economy and controls over its financial system, a diversion to

any domestic crisis would certainly slow down growth which would have rippling effects around the world.

Then there is the potential for military conflicts with China in the South China Sea which could threaten shipping lanes vital to the rest of the world. Other potential hot-spots include North Korea and the Middle East.

The paradox is that interest rates worldwide are still historically low. Until they rise substantially, there simply isn't the room to reduce interest rates to induce much stimulation out of the next recession. Of course, rising interest rates always induce economic slowdowns, and run the risk of causing recessions.

Reasons to be Cautious

Obviously, we don't know what the future will bring. However, what we do know is that the US stock market is expecting the case for the bulls. We can see this because stock prices are high when measured against standard metrics.

Price to Earnings Ratio

One of those metrics is the trailing 12 months (TTM) price/earnings (P/E) ratio of the S&P 500 stock index. Estimates are that *operating* earnings for the S&P 500 will end up to be \$124.94 for 2017. (Information on earnings and sales revenue comes from Howard Silverblatt, a Senior Industry Analyst, Index Investment Strategy, for S&P Dow Jones Indices. You can download his entire spreadsheet at [sp-500 eps-est](#)).

We can go back to the end of 2009 to see the range of P/E ratios during the economic recovery. Based on *operating* earnings, the TTM P/E ratio has ranged from a low of 11.95 to a high of 21.38. With the S&P 500 closing out the year at 2673.61, the TTM P/E is 21.4, close to the high end of the historical range.

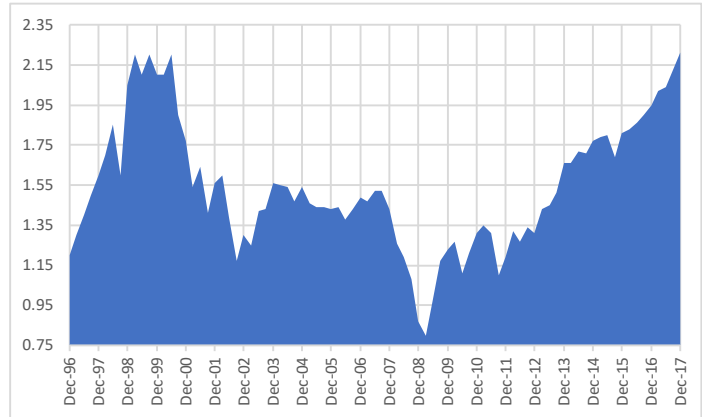
We should also look at *reported* earnings. This is an important distinction, one often not made by the media. Unlike *operating* earnings, *reported* earnings include unusual special charges for things like gains and losses on the sale of assets, and impairments on assets such as inventory, good will, contracts, or even impairments on the value of a company's major assets, such as land, mineral rights, or oil leases. In a large group of stocks, such as the 500 that make up the S&P 500 index, there are always special charges, which means reported are going to be lower. *Reported* earnings are proper under GAAP – the Generally Accepted Accounting Principles. Moreover, GAAP does not define operating earnings, so it is left up to the management of an individual company to determine what is "unusual".

Reported earnings for the S&P 500 are estimated to be \$114.70 for 2017. Based on *reported* earnings, the TTM P/E ratio has ranged from a low of 13.01 to a high of 24.34. At the year-end close of the S&P 500, the TTM P/E of *reported* earnings is 23.31, also close to the high end of the range since 2009.

Price to Sales Ratio

Another standard metric is the ratio of the price of the S&P 500 to the revenue from the sales of the underlying

S&P 500 Price to Sales Ratio



companies. The metric is at a lofty level, as can be seen in the chart.

Final figures are still being compiled for the fourth quarter. If we assume that fourth quarter sales grew at the relatively high growth rate they grew in the third quarter, revenue in 2017 would total \$1,228.7. That puts the year-end ratio at 2.18, very close to the peak levels achieved at the top of the bull market in the late 1990s, and considerably higher than at the peak of the last bull market in 2006.

Looking into 2018

Prior to the passage of the tax reform bill in the final days of 2017, *Operating* earnings for the S&P 500 are projected to grow by 16.3 percent in 2018, to \$145.31.

Howard Silverblatt, a Senior Industry Analyst, Index Investment Strategy, for S&P Dow Jones Indices, estimates that the effective tax rate of the S&P 500 companies was 25.6 percent in 2017. Michael Thompson, President and Chairman of Standard & Poor's Investment Advisory Services, estimates that each one-percent reduction will add one percent to the earnings of the companies that comprise the S&P 500. Accordingly, a 21 percent corporate tax rate is estimated to add 4.6 percent to the earnings of the S&P 500.

Adding 4.6 percent to the projected 2018 *operating* earnings of the S&P 500 raises the estimate to \$151.99. That puts the forward P/E at 17.6. To put that into context, the forward P/E (based on *operating* earnings) for the S&P 500 has ranged from 11.3 to 21.0 since the recovery began in 2009. The average was 16.0.

Prior to the passage of the tax reform bill, *reported* earnings for the S&P 500 are projected to grow by 18.0 percent in 2018 to \$135.40. That puts the forward P/E at 18.9. To put this P/E into context, the forward P/E (based on *reported* earnings) for the S&P 500 has ranged from 12.3 to 23.9 since the recovery began in 2009. The average was 17.7.

In both cases, the forward P/Es are not at the high end of the range, but they are well above average. Of course, these projected growth rates may not materialize. Earnings growth has averaged 6.7 percent annually since 2010 when the recovery began in earnest, for both *operating* and *reported* earnings. If we make a more reasonable assumption that earnings will grow at, say 10 percent in 2018, and then add

the 4.6 percent additional benefit from the corporate rate reduction, we are still looking at P/Es of 18.6 based on operating earnings, and 20.3 based on reported earnings – both of which are still at the high end of the historical range and considerably above average.

It is worth noting that analysts typically overestimate earnings growth when projecting one year in advance. According to FactSet (<https://insight.factset.com>), the overestimation has averaged 8.6 percent over the last 20 years. If we shave estimates by this factor, the current forward P/E ratios become close to the high end of their respective ranges, 20.35 for operating earnings (21.0 high, 16.0 average), and 22.16 for reported earnings (23.9 high, 17.7 average).

Understandably, this overestimation was substantially larger at the end of bull markets, after analysts have witnessed many years of growing earnings. The projection was 36 percent high for 2001, and 43 percent high for 2008. Of course, these disappointments resulted in market crashes.

The Best Bet for 2018

Intuitively, we know that stock prices are high, and these metrics confirm it. It is not safe to bet on events that are already anticipated by the market. If the events actually happen, there is usually not much of a positive reaction because they were already anticipated. Of course, if they don't happen, the disappointment will certainly translate into sinking prices.

Stock prices have been rising for a long time. This bull market will be 106 months old on January 9, making it one of the longest in post World War II history. Only the bull market that ended in March, 2000, lasted longer, for 113 months, which ended with a bear market that took prices down 50 percent.

Another reason for caution comes from our Risk Indicator (page 10) which has climbed to 1.93, close to the level of 2.0 which reveals a high-risk time for stocks.

The Portfolio

We must keep in mind that the market delivers returns in waves, and not in measured doses. We have already had a long wave up, and prices are historically high, whether we measure them by either *operating* or *reported* earnings, or by sales revenue. Accordingly, we are continuing to make our portfolio recommendations with caution in mind.

ETFs for Rising Interest Rates

The Fed's swollen bond portfolio has a preponderance of longer term bonds. That means that the upcoming reduction of the Federal Reserve's long-term bond holdings will add a disproportionate amount of upward pressure to long-term bond yields. This is important because our recommended ETFs are designed to benefit from an increase in long-term bond yields.

Rising inflation will also push up long-term bond yields in order to furnish investors with a real return in the vicinity of 3 percent. With inflation pushing above 2 percent, yields should be close to 5 percent, giving these ETFs a tremendous

upside potential.

Our recommended ETFs differ in the amount of leverage used. You can choose among them depending on your investment objectives and risk tolerance.

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

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

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

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

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

The most recent Dot Plot was taken at the December meeting when the Federal Reserve raised the Federal Funds rates another 0.25 percentage point to 1.25 percent. The median prediction was that the Federal funds rate would be 2.125 percent at the end of 2018, and 2.69 percent at the end of 2019. The FOMC is predicting that the Federal funds rate will rise in the months ahead because the Federal Reserve wants to bring short-term interest rates back to more normal levels from the extremely low levels used to stimulate the economy out of the 2008-09 crash.

We are using the Fed's dot plots of Federal funds as a means to predict changes in short-term interest rates, and making the assumption that long-term interest rates will move in tandem in order to maintain the same long-term real returns that exist today. While this should be a reasonable guide, it will be changes in inflation expectations that will ultimately govern long-term interest rates and the behavior of these ETFs.

Recently we have seen a flattening of the yield curve (the difference between short and long-term interest rates) because the Fed has been raising (normalizing) short-term interest rates while a perceived mild inflation rate has kept long-term interest rates low. However, we are predicting that this flat condition will change as inflation heats up, and forces long-term interest rates up from historically low levels. However, in the spirit of trying to be conservative, we can assume that the yield curve will remain as flat as it is today, which means that long-term Treasury bond yields move in accordance with the Dot Plot target points. Accordingly, long-term Treasury bonds would be yielding 3.62% by the end of 2018, and 4.18% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$17.63 to \$27.78 by the end of 2018, and to \$36.28 by the end of 2019.

TBT would rise from \$33.78 to \$45.75 by the end of 2018, and to \$54.65 by the end of 2019.

TBF would rise from \$21.87 to \$25.45 by the end of 2018, and to \$27.82 by the end of 2019.

The Erosion Factor

As we point out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.03 percentage points (3 basis points) every day, and thus go nowhere. By the end of 2018, TMV would decline to \$16.71 (5.2%), TBT would decline to \$32.84 (2.8%), and TBF would decline to \$21.64 (1.0%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Energy & Natural Resource Selections

OPEC countries need oil prices high to balance their budgets. The table below shows the price of oil they required to balance their 2017 budgets. The average, the OPEC countries needed was \$77.68 per barrel (The average is weighted by production). With oil prices below these necessary prices, OPEC will continue to urge for oil production cutbacks wherever they can exert pressure. These cutbacks are advantageous for US oil and gas producers which have more production coming on

Requisite Oil Prices

Prices Needed to Balance 2017 Budgets

OPEC Country	Balancing Price	2016 Oil Production
Algeria	63.80	1,348,361
Angola *	83.00	1,769,615
Ecuador *	78.00	548,521
Libya	102.00	348,686
Iran	54.70	3,990,956
Iraq	54.10	4,451,516
Kuwait	46.50	2,923,825
Nigeria *	127.00	1,999,885
Qatar	46.80	1,522,902
Saudi Arabia	73.10	10,460,710
United Arab Emirates	68.00	3,106,077
Venezuela *	216.00	2,276,967
Weighted Average	77.68	34,748,021

Competing Country	Balancing Price	2016 Oil Production
Russia	49.90	10,551,497
US	n/a	8,856,809

Source of Oil Production: US Energy Information Administration

Source of Balancing Prices: International Monetary Fund

* Estimated figures provided by RBC Capital Markets

stream from the fracking boom.

Chesapeake Energy (CHK) has a portfolio of close to 8 million net acres of oil and gas assets inside the US, in the Powder River Basin, Eagle Ford, the Marcellus and Utica shale, along with the Haynesville/Bossier and Anadarko Basin regions. These large domestic assets make CHK well situated to participate in the resurgence of the US shale drilling.

CHK is in a favorable position to benefit from the secular shift to clean burning natural gas fuel for power generation globally and in the Asia-Pacific region in particular, led by China's transition away from coal. The consensus is that CHK will earn 86 cents per share during the next four quarters, starting with 23 cents for the fourth quarter. At \$4.00 per share, CHK's forward P/E ratio is close to 4.7 – very cheap. A forward P/E ratio of 10 puts the stock at \$8.60, more than double the current price.

Chevron (CVX) is set to see an increase in production and revenue in 2018, including the two massive Australian projects, the Gorgon and Wheatstone, both of which had required large capital outlays that are no longer needed in CVX's forward-going cap-ex budget. The company is making large investments in its 1.5 million acre position in the prolific Permian Basin to boost its output by 400,000 barrels of oil per day in the next few years. CVX is well-positioned to see earnings growth in the years ahead, along with an attractive dividend that management says is "sacrosanct."

Chicago Bridge & Iron (CBI) is being purchased by McDermott International (MDR) by issuing 2.47 shares of MDR for each share of CBI. The news was disappointing to the shareholders of both companies the day after the announcement, as evidenced by a drop in the prices of both stocks. We do not view the news as favorable because it is not an attractive value proposition for CBI shareholders.

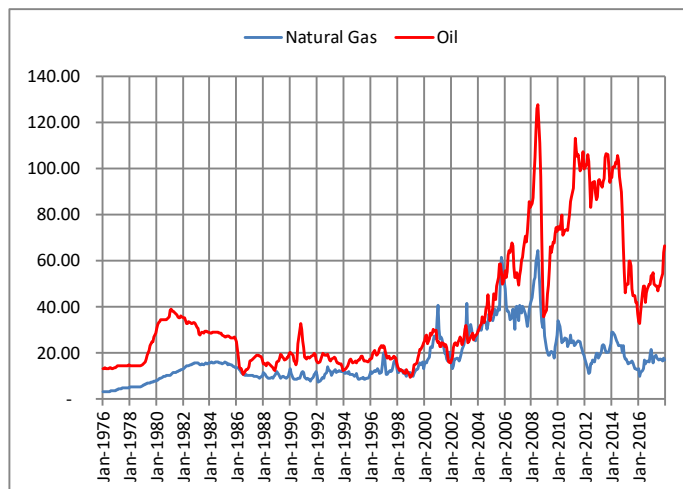
As we noted in our email update, CBI's earnings will generate 70 percent of the combined company's earnings, in exchange for 47 percent of the combined equity. McDermott projects that there will be synergies and cost savings, which if they materialize, could equalize the deal. If they don't, it will likely prove to be a bad deal for CBI stockholders. Moreover, the international exposure introduced by MDR makes the combined company more complex and less predictable.

The combined company does not appear to present the value that CBI did, and the upside is simply not as clear as it was with CBI alone. We would rather invest elsewhere, in a company that is clearly an outstanding value. Accordingly, we are recommending selling CBI.

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

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the growth of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is

The Cost of Energy Equivalents of Oil and Natural Gas



more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At the current price of \$66.62 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$2.96 for one million BTUs, 5.8 million BTUs will cost \$17.17. Thus, the same amount of energy is available for approximately 26 cents on the dollar, if it is in the form of natural gas rather than oil.

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

Valero Energy (VLO) is in a unique position to benefit from

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

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

Real Estate Selections

Commercial real estate prices are historically high because low interest rates have pushed down real estate cap rates to historically low levels (like bond yields). Our posture is still defensive with regard to real estate stocks. The *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. Two REITs currently exist in the hospitality industry along with one mutual fund.

Hersha Hospitality (HT) suffered from the disruption from Hurricane Irma to their south Florida properties, which led to the closure of six hotels in September. Following the dissipation of the storm, the company's primary focus was devoted to resuming operations at four of those least impacted by the storm. The disruption was more significant at the Cadillac Miami Beach and Parrot Key hotels where more substantial reparations are

Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	21.97	6.0%	10.8%	9413.79	38.21	-43.1%
Hospitality Properties	HPT	29.85	6.8%	10.1%	11,616.3	48.11	-38.0%
Hersha	HT	17.40	6.4%	9.0%	2,257.6	19.19	-9.4%
Host Hotels & Resorts	HST	19.85	4.0%	9.4%	21.6	25.75	-22.9%
Apple Hospitality	APLE	19.61	6.1%	8.2%	6,114.9	21.86	-10.3%

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

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

required. The company sees a recovery in 2018 based on the reopening of the Miami Convention Center and a diminished supply of competing hotels. Meanwhile, revenue growth remained healthy from its eight hotels on the West Coast and its 10 New York City hotels.

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

Based on the latest trailing four quarters’ financials, including the most recent 2017 third quarter results released at the end of October, and using a 7.5 percent cap rate to evaluate the company’s real estate portfolio, we value HT at \$19.19 per share which is higher than the current price. This valuation is low because of the impaired third quarter income, but should be improving in 2018 along with income. The dividend yield is attractive and lowers the risk profile.

RLJ Lodging Trust (RLJ) is selling at a steeper discount to its hotel assets than HT. Based on the latest trailing four quarters’ financials reported, including the most recent 2017 third quarter, and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value RLJ at \$38.21 per share which is considerably higher than the current price. The high dividend yield is also attractive and lowers the risk profile.

Third Avenue Real Estate Value Investor Fund (TVRVX) is loaded with good values substantially below net asset value (NAV) with strong growth prospects. Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value. Just as we do at *Sound Advice*, they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

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

Medically-Related Selections

The cloud of uncertainty still blankets the healthcare industry now that the repeal and replacement of the Affordable Care Act (Obamacare) is dormant. We are comfortable with our current recommendations in this sector based on their own individual merits.

Boston Scientific (BSX) has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs. BSX’s medical products are well suited for an aging population.

In December, BSX announced its acquisition of Apama Medical which produces radiofrequency balloon Catheter systems to defend against atrial fibrillation. The acquisition will strengthen its BSX’s electrophysiology portfolio.

Stryker (SYK) is best known for its orthopaedic devices for artificial knees and hips. The company provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products.

Stryker’s healthy balance sheet has allowed it to make many acquisitions in the recent past which are now paying off, such as Mako whose surgical robots have been used in 50 percent of the 9,400 Mako knee surgeries since the launch in mid-2016. In 2017, it purchased Novadaq Technologies to enhance its position in the endoscopy market and expand Stryker’s capabilities in imaging. Stryker also acquired the majority of Vexim in 2017 to expand its portfolio of minimally invasive technologies and complements Stryker’s interventional spine business.

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

Financials

Banks will benefit from rising interest rates. Our two choices are good values now, and the benefits from rising interest rates are not built into earnings projections.

JP Morgan Chase (JPM) expects to earn \$6.89 per share in 2017. Strong growth is expected in the immediate years ahead. JPM is expected to earn \$7.68 per share in 2018. At a forward P/E ratio of 15, JPM would be \$102 by the end of 2018. JPM is still currently cheap in comparison to the rest of the market.

Wells Fargo (WFC) expects earnings to be \$4.05 per share in 2017, and \$4.32 per share for 2018. At a P/E ratio of 15, WFC would be \$65 in 2018. WFC is also currently cheap in comparison to the rest of the market.

Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. Small Caps are pure

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plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger, which is usually quite profitable.

Third Avenue Small-Cap Value Investor Fund (TVSVX) invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund (TVRVX). Management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value, and the ability to consistently grow NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

Special Situations

The rest of our portfolio falls into other market sectors, with companies that are presenting extraordinary values within their respective industries. Here they are in alphabetical order.

Apple (AAPL) has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial rating. Although this is a premier growth stock, its P/E is still at a discount to the rest of the market. AAPL had \$216 billion of overseas cash which is 25 percent of its market capitalization. A repatriation of that cash hoard is likely to spur investment in growth avenues inside the US as well as share buy-backs and dividend increases.

In 2017, Apple inaugurated a badly-needed upgrade cycle by introducing the iPhone 8 and 8 Plus, aimed at the mainstream market, and its premium smartphone, dubbed the iPhone X, which retails at a price point beginning at \$999. In both cases, interest-free financing is available to make the cost relatively painless. Prior to the introduction of these phones, Apple's products, other than iPhones had been accounting for most of the company's revenue growth. Earnings are widely estimated to grow at double-digit rates for the next few years, stemming from increasing direct iPhone sales, a booming services business, along with new additions to the Apple Watch and Apple TV programs. Earnings growth should also lead to dividend increases and more stock buy-backs.

In December, the Silicon Valley Business Journal noted the US Patent & Trademark Office published a number of patent applications filed by Apple in 2017. One shows Apple's ideas for adding more human features to products like Siri, its smart voice and artificial intelligence assistant. Another filing was regarding the gaming and electronic sports industry.

Other patents are healthcare-related and highlights Apple's increased emphasis on wellness applications to compliment the Apple Watch which already measures heart rate and other biometric data. These filings followed the 2016 patent filings for the Apple Watch which included "Breathing Synchronization and Monitoring" and "Radio Navigation for Swimmers".

Intel (INTC) has the size, diversity, and industry dominance to offer a relatively safe investment in a high-growth, and often high-risk business. Intel can leverage new technology into its existing large platform without introducing unacceptable risks. A history of established cash flow and an attractive dividend, along with the currently low P/E ratio, diminishes the risk profile of the stock. Yet, substantial growth prospects have been introduced that now justify a higher P/E and thus, a higher stock price.

In 2017, Apple became one of Intel's major customers because Intel became the sole supplier of the modems, transceiver chips, and the power management chips for Apple's iPhone 8 and X models.

Also in 2017, Intel partnered with Advanced Micro Devices (AMD) to build discrete GPUs (graphics processing units) for ultra-thin laptops and notebooks. Previously, AMD has lacked the of financial resources to compete with NVIDIA which has a 70% share of the GPU market. Intel has lacked the GPU technology. The AMD-Intel partnership should also enable Intel to capture more of the data center and self-driving markets.

The 2017 Mobileye acquisition launched Intel into the burgeoning assisted-driving and autonomous vehicle arena, and extends to markets for autonomous ships, planes, drones, and a wide range of weapons. Tesla has announced that it will be using Intel's chips instead of those from NVIDIA to power its massive infotainment console. The new Model 3 and new versions of Tesla's Model X and Model S will rely on the Intel chips. Intel is also a supplier to Alphabet's GOOGL Waymo self-driving car unit. Fiat Chrysler has joined Intel's automotive partner base. The company's team also includes BMW.

Earnings for 2017 are estimated by the company to be \$3.25 a share. The current price/earnings (P/E) ratio is still modest and considerably below the rest of the market. The current dividend yield is also attractive which lowers the risk profile.

International Business Machines (IBM) is turning into a growth stock but it is not priced like one. Watson, IBM's super computer, is the closest thing to artificial intelligence because it can "think" like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient.

IBM is working on becoming a leader in quantum computing. It is teaming up with nine other firms to board to help commercialize the technology. One is JPMorgan which will focus on applications for the financial industry including trading strategies, portfolio optimization, asset pricing and risk analysis. Another is Daimler (owner of Mercedes Benz) which will focus on applications to develop new materials and manufacturing processes, logistics, and driverless cars. Samsung is also teaming up to provide applications in the semiconductor and electronics industry.

IBM is a good value now. The company expects 2017

earnings to be \$13.80 per share. The stock is still selling at a P/E ratio substantially below the market. At \$160 per share, the stock is only 11.6 times earnings, as compared to the overall market of 24. A P/E ratio of 15 puts IBM above \$200 per share.

While we are waiting for growth, the \$6.00 annual dividend provides an attractive yield.

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

NCR recently collaborated with Samsung to launch the NCR Silver Quantum, a point-of-sale (POS) commerce station featuring an integrated payment device with mobile wallet acceptance capability, customer display, loyalty scanner, and Samsung Galaxy tablet. It also gives merchants a more efficient way to manage back-office operations.

The company expects to earn \$3.10 to \$3.20 per share for 2017. The P/E is currently below 11, a considerable discount to the rest of the market. At a P/E ratio of 15, the stock belongs close to \$47 per share.

Symantec (SYMC) is the world's leading cyber security company offering organizations strategic, integrated solutions to defend against sophisticated attacks across endpoints, cloud, and infrastructure. Symantec operates one of the world's largest civilian cyber intelligence networks, allowing it to see and protect against the most advanced threats. Our mantra with this stock has been "If there ever was a more certain growth industry, protection from cyber espionage is it."

In December, Oracle partnered with Symantec in order to offer Symantec's Integrated Cyber Defense System on Oracle's Cloud Marketplace.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation. The

company's record high of \$2.54 billion backlog reveals a robust pipeline with major governmental organizations like the US Department of State, Environmental Protection Agency (EPA), US Army Corps of Engineers, and the US Air Force. TTEK has a very healthy balance sheet. The strongest growth is coming from the Water, Environment and Infrastructure segment.

Xerox (XRX) made good progress in 2017, optimizing its balance sheet to support both a strong cash flow in the future as well as its investment-grade credit profile. The company has \$1.8 billion in cash. Earnings are expected to be in the range of \$3.28 to \$3.44 for 2017. This puts XRX below 10 times earnings - very cheap, especially in comparison to the rest of the market. The dividend yield is also attractive.

XRX has new separate leadership and goals which is bound to translate into better focus execution. CEO, Jeff Jacobson, is bringing a new enthusiastic corporate culture and a three-year strategy for growth by rolling new products aimed at mid-size companies which are stronger growth targets than large-scale businesses.

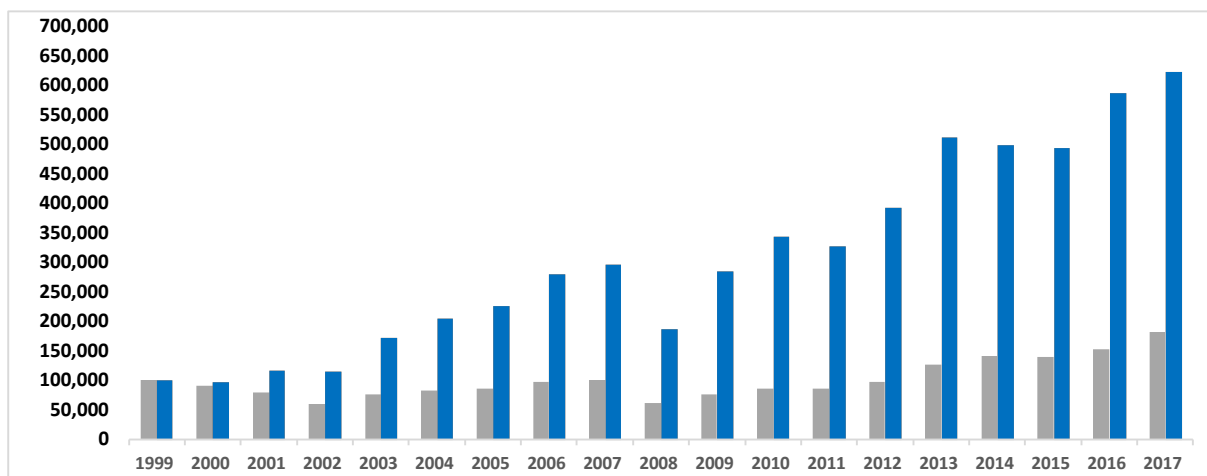
Activist investor Carl Icahn still has his 9.7 percent stake in XRX and is introducing four new board members to increase his influence and control on management. Icahn has a track record on improving stockholder value when he invests heavily in a company and then gets involved in spur growth.

Hedging the Portfolio

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

Sound Advice vs the S&P 500

This chart shows the growth of \$100,000 invested in the S&P 500 (in gray), which would have grown to \$181,971, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$620,567.



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$4.04	0.00%	BUY	\$4.50
Chevron	CVX	\$125.58	3.44%	BUY	\$128.00
Chicago Bridge & Iron	CBI	\$16.15		SELL	
Fidelity Select Nat. Gas Fund *	FSNGX	\$23.73	0.52%	BUY	\$25.00
ICON Energy Fund Class S *	ICENX	\$12.41	0.44%	BUY	\$14.50
Valero	VLO	\$92.30	2.60%	BUY	\$95.00
Real Estate					
Hersha Hospitality Trust	HT	\$17.52	6.39%	BUY	\$19.19
RLJ Lodging Trust	RLJ	\$22.41	5.89%	BUY	\$24.00
Third Avenue Real Estate Value Investor *	TVRVX	\$34.35	0.47%	BUY	\$37.00
Medically Related					
Boston Scientific	BSX	\$25.19	0.00%	BUY	\$28.00
Stryker Corp.	SYK	\$155.62	1.09%	BUY	\$160.00
Tekla Life Sciences Fund	HQL	\$19.66	0.00%	BUY	\$22.00
Financials					
JP Morgan Chase	JPM	\$107.79	2.08%	BUY	\$110.00
Wells Fargo	WFC	\$61.30	2.54%	BUY	\$65.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$23.30	0.28%	BUY	\$25.00
Special Situations					
Apple	AAPL	\$171.08	1.33%	BUY	\$178.00
Intel	INTC	\$46.22	2.36%	BUY	\$49.00
International Business Machines	IBM	\$154.04	3.90%	BUY	\$165.00
NCR Corp	NCR	\$34.01	0.00%	BUY	\$35.00
Symantec	SYMC	\$28.48	1.12%	BUY	\$35.00
Tetra Tech	TTEK	\$48.45	0.74%	BUY	\$52.00
Xerox	XRX	\$29.45	0.95%	BUY	\$33.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$17.69	0.00%	BUY	\$22.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$21.89	0.00%	BUY	\$24.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$33.87	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$40.77	0.00%	BUY	\$48.00

This table has live prices, charts & buy limits on our website: <http://www.soundadvice-newsletter.com/members>

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

See our website for live pricing and buy limits: <http://www.soundadvice-newsletter.com/members>

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

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

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

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

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

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

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

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

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

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

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$15.6 million in stocks and to \$1.72 million in houses.

The New York Times
"Cardiff's equation reveals an elegant financial minuet as each market takes turns outperforming the other."

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 \$618 million, or **39.7 times** more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the **SoundAdvice** Risk Indicator would have provided.

The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6. **Based on latest median house price of \$319,600 for October, and with the S&P 500 at 2673.61 at the end of December, the SoundAdvice Risk Indicator reads 1.93.**

The SoundAdvice Risk Indicator



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

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

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

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

Current Status

The **SoundAdvice** Diffusion Index of **LEADING Indicators** dropped to zero in September because of weakness in the employment and building permit components caused by the temporary impact of the hurricanes. While this was an official reversal of our Caution Signal, we did not change our cautious approach to the market because it is likely that this Aggressive signal will be reversed soon, as the affected area begins to rebuild and hire the massive number of workers needed for rebuilding.

Indeed, the leading indicators rebounded in October and in November (the most recent data). The Conference Board commented that the strength in the leading indicators became more widespread. As a result of this strength, the **SoundAdvice** Diffusion Index of **LEADING Indicators** jumped from zero to 100 percent for November.

Our next official "Caution" signal will come from a 100 percent reading on the **SoundAdvice** Diffusion Index of **LAGGING Indicators**, which was 66.7 percent in November. The one lagging indicator that kept this Diffusion Index from rising to 100% was the Duration of Unemployment, which is certain to recover in the months ahead as people go back to work in the areas affected by the hurricanes (as well as in the recent wildfire areas of California). Even if there is no improvement in the lagging indicators in the months ahead, this Diffusion Index of lagging indicators would still hit 100 percent in February. With any strength, it will be sooner.

Track Record of the SoundAdvice Diffusion Indexes

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Sep-17	2,492.8		
Ave +/-	30.5%		3.8%

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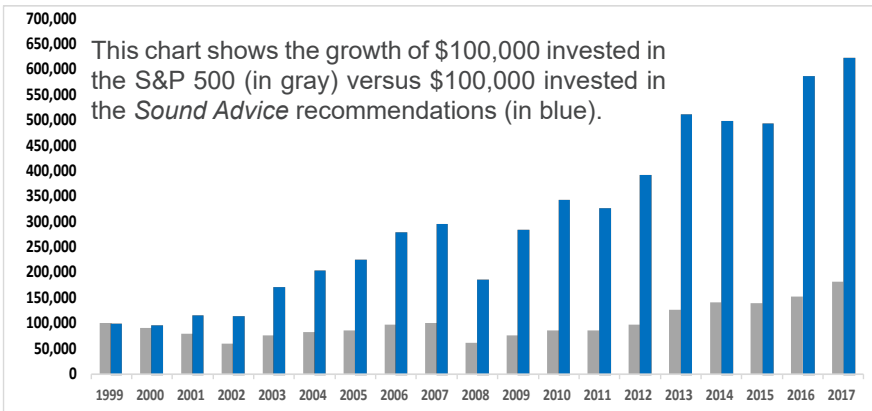


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This is the book that explains all of the **SoundAdvice** indicators, including the Diffusion Indexes and the Risk Indicator, and exactly how they work, along with a detailed history to back up the track records. Visit the web

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