SoundAdvice

Advising Investors for 30 years October 2018 Issue October 1, 2018

Adding Carnival Cruise Lines

We are adding Carnival Cruise Lines (CCL) to our portfolio. This stock is a good value now, especially when compared to the rest of the market. Growth prospects are strong because of the company's dominance in the industry, efficiencies of scale, and favorable demographic trends driving a lasting increase in demand.

Carnival is the largest company in the cruise industry, operating 10 global brands including Carnival Cruise Lines, Princess Cruises, Holland America Line, Costa Cruises, P&O Cruises, Cunard Line, the Yachts of Seabourn, Ocean Village, AIDA, and P&O Cruises Australia. These brands operate over 100 ships with a current capacity for 220,000 passengers and served 12.1 million guests in 2017. This represented half of the cruise line market.

In comparison to alternative land-based vacations, a cruise vacation represents an exceptional value and convenience; providing accommodations, a generous diversity of food and choices, land tours with transportation, and a selection of daily on-board entertainment options. The mobility of cruise ships makes it possible to position them in the areas of highest seasonal demand, as well as to newly popular areas, such as in the Asia-Pacific.

Carnival's various brands are stratified, offering fares, itineraries, and amenities for customers with varying income levels. On the lower end (labeled "contemporary" experience) is the Carnival brand which offers seven days or less with a more casual ambiance. Many Princess and Costa cruises are also in this category. The middle levels (the "Premium" experience) last from 7 to 14 days with an emphasis on quality, comfort, style, and more destination-focused itineraries. The Premium brands include Holland America, AIDA (leading German brand), and P&O. At the higher end (the "luxury" experience) are the Cunard lines, which include the Queen Mary 2, Queen Elizabeth and Queen Victoria, and offer a very high standard of accommodation and service with exotic itineraries to ports that are inaccessible to larger ships. Of course, many of these classifications overlap, offering the ability to cross-sell to a wide range of vacationing passengers.

The *Sound Advice* Portfolio is up by 8.7 percent in 2018. The *Sound Advice* investment returns in prior years have been calculated independently by the Hulbert Financial Group. They are as follows:

From 2000-2017

9.6% Annually vs.

3.2% from the S&P 500

Gray Emerson Cardiff, Editor

Carnival's scale allows it to gain cost efficiencies in expenses, including marketing, port fees, maintenance, and general overhead. This efficiency of scale gives the company the ability to offer a good value to customers, in all income stratifications. This is a significant competitive advantage in the industry.

Demographic Demand

More than 96 percent of the US domestic market has yet to take a cruise, but a tsunami of demand is entering the market led by two age groups, the Baby Boomers and the Millennial generation. The Baby Boom generation likes to pursue an active lifestyle and has the desire along with the means to enjoy multigenerational cruising. Much of this generation is retiring and traveling for the first time.

The Millennial generation has now surpassed the size of the Baby Boom generation and represents the fastest growing demographic segment of the vacation industry. Millennials have a strong desire to travel and they actively share their new experience through social media and otherwise, which is a mindset that should continue to bolster growth for the industry. A recent study by the American Society of Travel Agents ("ASTA") indicates that the Millennial generation likes cruising as much as the Baby Boomer generation does. These demographic segments will drive demand for at least the next 10 years.

Cruise Ship Shortages

One new cruise ship costs close to one billion dollars on average. This capital cost makes it difficult to enter the market. Adding further difficulty are the marketing and startup expenses while running ships initially with low occupancies. That is why Carnival, along with its three largest competitors, Royal Caribbean, Norwegian, and MSC Cruises, carry 87 percent of cruise passengers around the world. Currently, there are not enough cruise ships floating around the world to meet growing demand. Due to its scale of operations and cash-flow, Carnival is well-positioned to expand.

To meet growing demand, the company is scheduled to receive 18 new ships between 2018 and 2022. In addition to increasing the advantages of scale, a newer fleet will command higher fares because of an improved mix of guest accommodations and a wide range of onboard amenities and features. These new ships are more fuel efficient, with many running on liquified natural gas (LNG). Some of the new ships will replace older ships in the fleet. The company will continue to make practical investments to enhance the amenities of older ships before they are replaced in order to maximize on-board revenue (which was 25 percent of total revenue in 2017).

A larger fleet enables the company to offer cruises in more lucrative and less-competitive markets in the Asia-Pacific. (China only represented 5 percent of Carnival's capacity in 2017.) Management believes the Chinese markets offer significant growth opportunities because of its growing middle class.

The company's cash flow allows the internal funding of capital expenditures while managing its debt level. At the end of 2017, the company's long-term debt was $8.3 billion. While this is a large amount, it is moderate when compared to the company's equity. The company's debt/equity ratio is 18.3 percent, which is low by most standards.

Income and Value

CCL currently pays a $2.00 annual dividend, a yield of slightly more than 3 percent (equivalent to a 30-year Treasury bond). The consensus is that CCL will earn $4.52 during the next year, which puts the forward price/earnings (P/E) ratio close to 14. During the last 5 years, the median P/E has been 19. Why is the stock cheap right now?

Earnings have been bumpy in recent quarters, due mainly to recent headwinds from rising oil prices and currency translations. On September 27, the company reported quarterly earnings of $2.41 per share which was above expectations. However, the company estimated that the current fourth quarter will come in lower than expected, at close to 67 cents per share, down from the previous estimate of 73 cents per share, primarily because of higher fuel costs. The stock dipped on that report, providing a buying opportunity. Over the longer run, these cost factors are bound to become less critical as the company grows and adds more fuel-efficient ships.

CCL has traded at an average enterprise value multiple of 11 during the last five years. A common practice is to multiply a company's EBITDA (earnings before interest, taxes, depreciation, and amortization) by such a multiple to calculate its enterprise value. Based on the most recent four quarters of EBITDA, an enterprise value multiple of 11 puts the enterprise value at $87 per share, which is substantially above the current stock price. Prior to the most recent quarter, the enterprise value was $74 per share.

As the industry and the company continues to grow, the enterprise value of the company will grow which is bound to push up the price of CLL.

The Portfolio

This bull market will become 115 months old on October 9, making it longer than the longest bull market in post World War II history, which ended in March 2000, and lasted 113 months. Both of our primary stock market indicators are warning us to be careful. Our Risk Indicator (page 10) is above 2.0, telling us that stocks are overvalued. This has only happed 5 times during the last 123 years. It has been early, as much as two years, but it has never been wrong. Additionally, our Diffusion Index of Lagging Indicators (page 11) is in caution mode. The concurrence of these two reliable indicators tells us that the risk in the market is higher than normal.

We are recommending that you have a substantial amount of cash on the sidelines. Our portfolio recommendations are made with regard to the money you have allocated to the stock market, and in accordance with our current cautionary mode. We believe that they are exceptionally strong values, trading at a significant discount to the rest of the market, which should give them buoyancy in both good and bad market conditions over the longer term.

Hedging the Portfolio

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

Energy & Natural Resource Selections

The Trump administration is continuing to pressure oil buyers around the world to cut off purchases of Iranian supplies. The curtailment of international investment will lead to significant reduction of Iran's natural gas industry for many years because Iran does not have the expertise to develop its resources alone.

Although Major OPEC oil suppliers have increased production to fill worldwide needs, they are not interested in glutting the market. On average, the OPEC countries needed an average of $77.68 per barrel (weighted by production) to balance their 2017 budgets. Saudi Arabia needs $83 a barrel to pay for its 2018 public spending.

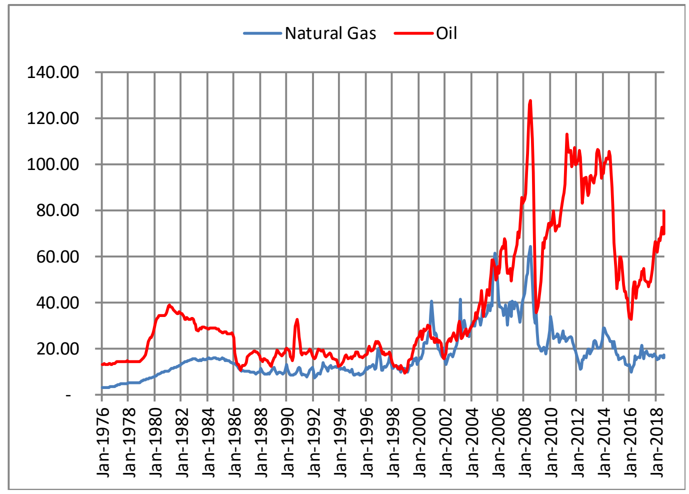
Rising worldwide demand, along with the potential for interference from geopolitical tensions on supplies, translate to favorable conditions for our selection of energy company investments.

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the growth of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. However, with the current market price for natural gas at $3.00 for one million BTUs, 5.8 million BTUs will cost $17.40. Thus, with a barrel of oil costing $80, the same amount of energy is available for approximately 22 cents on the dollar if it is in the form of natural gas rather than oil.

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

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

The Cost of Energy Equivalents of Oil and Natural Gas



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

The trailing twelve month's earnings amount to 82 cents per share. At $4.60 per share, the price/earnings P/E ratio is 5.5, still astonishingly low. The recent sale of its Utica shale assets in Ohio for $2 billion, will allow for substantial debt reduction in its $9.4 billion debt load and allow the company to focus on production from the Powder River Basin in Wyoming which is emerging as the industry's new growth engine.

Chevron (CVX) is bound to continue increasing production this year from the two massive Australian projects, the Gorgon and Wheatstone, both of which are swinging into production. Large investments in its 1.5 million acre position in the prolific Permian Basin are projected to boost output by 400,000 barrels of oil per day in the next few years, especially as new pipelines come on stream.

CVX has an attractive dividend that was increased (again) this year to $1.12 per share per quarter. The company's dividend is sacrosanct and has a history of increasing annually through thick and thin. Chevron is buying back its stock with $3 billion per year.

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

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

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

Real Estate Selections

Our posture is still defensive with regard to real estate stocks. In general, commercial real estate prices are historically high because low interest rates have pushed down real estate capitalization (cap) rates to historically low levels (like bond yields). The *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now.

Our two recommended REITs in the hospitality industry offer an excellent value. Both have new growth trends and pay attractive dividend yields which also reduces risk by putting a floor under the stock price. A major drag on the industry was the proliferation of Airbnb and similar competition but is changing in major metro areas. New York City is the most recent to pass a measure prohibiting transient rentals of fewer than 30 days at a time without the host being present. San Diego, Los Angeles, San Francisco, Boston, Washington DC, Philadelphia and Miami have also passed similar measures.

Both of these hospitality REITs have reported several hotel transactions during the last several years at cap rates ranging from 4.9 to 6 percent. To be conservative and to anticipate a rise in capitalization (cap) rates along with interest rates in general, we use a cap rate of 7.0 percent for valuation purposes.

Hersha Hospitality (HT) has recently sold the Hyatt House in Gaithersburg MD, and the Holiday Inn Express in Chester NY, at a combined capitalization rate of 4.9 percent.

Hospitality REITs Comparison Table

Company	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate ($Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	22.03	6.0%	9.3%	8,246	33.88	-35.0%
Hersha	HT	22.67	4.9%	9.0%	2,575	29.63	-23.5%
Hospitality Properties	HPT	28.84	7.1%	9.5%	11,748	47.78	-39.6%
Host Hotels & Resorts	HST	21.10	3.8%	8.3%	22	25.75	-18.1%
Apple Hospitality	APLE	17.49	6.9%	8.9%	6,783	23.80	-26.5%

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 7.0 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 7.0 percent cap rate valuation of each company's real estate portfolio.

Hospitality Properties (HPT) is trading at a large 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.

Based on the latest trailing four quarters' financials, including the most recent 2018 second quarter results released in July, and using a 7.0 percent cap rate to evaluate the company's real estate portfolio, Hersha is worth $29.63 per share which is substantially greater than the current price of the stock. This value should be a conservative estimate because Hersha's two premier hotels in Miami were closed because of Hurricane Irma, and have not been contributing to income during the last 4 quarters. The Courtyard Cadillac Hotel, following its conversion to an Autograph Collection hotel, is now open. The Parrot Key Hotel and Resort is scheduled to open in the fourth quarter. Both of these hotels will offer enhanced quality in a strong market.

RLJ Lodging Trust (RLJ) is also selling at a steep discount to its hotel assets. Based on the latest trailing four quarters' financials reported, including the most recent 2018 second quarter results released in August, and using a 7.0 percent cap rate to evaluate the company's portfolio, we value RLJ at $33.88 per share which is also substantially higher than the current price.

We anticipate improvement in net operating income (and thus the value of the stock) because of the company's mission to sell its non-core assets since the merger with FelCor. So far this year, RLJ sold three legacy FelCor assets: the Fairmont Copley Plaza in Boston, the Embassy Suites Marlborough, and the Philadelphia Sheraton Society Hill, for a capitalization rate close to 6 percent. The Philadelphia Sheraton was also sold for $95.5 million, a 5.6% cap rate.

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 fund 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

Boston Scientific (BSX) received FDA approval in late September for its drug-coated stent, Eluvia, to treat narrowed arteries in the leg, a painful condition caused by plaque buildup. Eluvia is a tiny wire mesh with a drug-polymer coating that releases a chemotherapy drug, paclitaxel, for a year to prevent reclogging. This new stent targets 8.5 million people in the US. Eluvia was approved in Europe since 2016, and the company estimates the global market size to be $1 billion.

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

Stryker (SYK) is best known for its orthopaedic devices for artificial knees and hips. The company also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. The company's strong balance sheet allows it to make strategic acquisitions. The most recent was in September of Invuity, the leader in advanced photonics and single-use, lighted instruments that deliver enhanced visualization for a wide variety of clinical applications, including orthopaedic and spine surgery, general surgery, and women's health procedures, and is a recent entrant into the enhanced energy market.

Recent acquisitions are now paying off. Mako's surgical robots are now being used in the majority of the Mako knee surgeries since the launch in mid-2016. The 2017 acquisition of Novadaq Technologies has enhanced SYK's position in the endoscopy market and expanded Stryker's capabilities in imaging. Stryker's acquisition of Vexim in 2017 expanded SYK's portfolio of minimally invasive technologies and complements Stryker's interventional spine business.

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

Financials

Our two choices are still good values. A less stringent regulatory environment will give banks the ability to shed excess capital and increase leverage. The Federal Reserve recently completed the second part of the annual “stress tests” and reported favorable results for both of our recommended banks which meant they were allowed to increase their dividends and share buy-back programs.

JP Morgan Chase (JPM) expected to earn $9.12 in 2018. At a forward P/E ratio of, say 16, which is below the market average, JPM would be $146. JPM is still cheap in comparison to the rest of the market. The company recently announced an increase in its quarterly dividend to 80 cents from 56 cents a share, and that it will buy back up to $20.7 billion in stock.

Wells Fargo (WFC) is expected to earn $4.56 per share in 2018. At a P/E ratio of 16, WFC would be $73. WFC is also currently cheap in comparison to the rest of the market. WFC is expected to earn $5.22 per share in 2019. A P/E ratio of 16 puts the stock at $83. The company recently more than doubled its stock buyback target to $24.5 billion and increased its quarterly dividend to 43 cents a share from 39 cents.

Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. Small Caps are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger, which is usually quite profitable.

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

Special Situations

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

Apple (AAPL) introduced its latest versions of iPhones in September. Although the volume of sales has been flat, the stock price has been on the rise because the prices and margins of the new phones are high. Additionally, revenues from services for iPhones are growing. Revenue from services, including Apple Music, Apple Pay, and the App Store has climbed over 30 percent in the last year.

We added AAPL to the portfolio at $116.30 and have continued recommending its purchase until recently. As the stock rose above 215, we switched from a “buy” to a “hold” because the trailing twelve-month (TTM) P/E ratio was rising above that of the market as a whole. At the recent price of $225, the TTM P/E ratio is above 20. We advise waiting for a dip.

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 this stock.

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

At a P/E of, say 18, the stock price would be close to $75. The current dividend yield is also attractive, with an annual dividend of $1.20 a share.

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International Business Machines (IBM) is turning into a growth stock but is not priced like one. The growth portion of the company was more than half of the quarterly revenue, for the first time, from its so-called "Strategic Imperatives" which includes cloud-computing revenue, analytics, mobile and security. Within those imperatives is IBM's cognitive-solutions segment, which includes software, analytics and its artificial intelligence platform, it calls Watson, which can "think" like a human.

In September, IBM announced new artificial intelligence (AI) services from Watson for nine industries, including agriculture, customer service, human resources, supply chain, manufacturing, building management, automotive, marketing and advertising. The company still expects its 2018 earnings to be "at least $13.80 per share", giving the stock a price/earnings ratio of less than 11, far below the rest of the market. The $6.00 per share dividend now provides a yield of 4 percent. This is a good time to invest in this long-term growth company at a good value.

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

NCR owns nearly three-quarters of the burgeoning self-checkout market and is well-positioned to benefit. Using their smartphones, or a handheld scanner provided by the store, customers scan items from the shelves as they add them to their cart. At checkout, they input either device into the register, and it spits out the tally.

NCR remains a good value, with a P/E close to 10, a considerable discount to the rest of the market.

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."

At the end of September, Symantec named three nominees of the activist hedge-fund investor, Starboard Value, to its board. A month ago, Starboard took a 5.8 percent stake in SYMC and pushed for five nominations to help improve operations.

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

In September, Tetra Tech won a $60-million engineering services contract from the County of Los Angeles. Under the three-year contract, Tetra Tech will design and plan means to ensure retention, capture and conveyance of surface water, recycled water, and stormwater.

ETFs for Rising Bond Yields

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

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

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

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

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

The Dot Plot

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

The most recent Dot Plot was taken at the September 26 meeting. The median prediction from the members was that the Federal funds rate would be 2.375 percent at the end of 2018 and increase to 3.125 by the end of 2019.

We are using the Fed's dot plots of Federal funds as a means to predict changes in long-term interest rates under assumption that long-term interest rates will move in tandem. This should prove to be a conservative assumption because today's yield curve (the difference between short and long-term interest rates) is extraordinarily flat, offering very little additional yield on longer term bonds. 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 3.575% by the end of 2018, and 4.325% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from $20.92 to $25.40 by the end of 2018, and to $36.54 by the end of 2019.

TBT would rise from $38.3 to $43.63 by the end of 2018, and to $55.60 by the end of 2019.

TBF would rise from $23.40 to $24.97 by the end of 2018, and to $28.19 by the end of 2019.

These projections should prove to be conservative. The yield curve is bound to return to its traditional steeper shape and widen as inflation heats up and forces long-term bond yields to rise from today's low levels. Additionally, the Federal Reserve has become a seller of Treasuries rather than a large buyer, as it reverses into quantitative tightening after many years of quantitative easing. During quantitative easing, the Federal Reserve's portfolio of Treasuries swelled by more than 5 times, from under $900 million in 2008 to $4.6 trillion. The Federal Reserve has a long way to go to get back to normal.

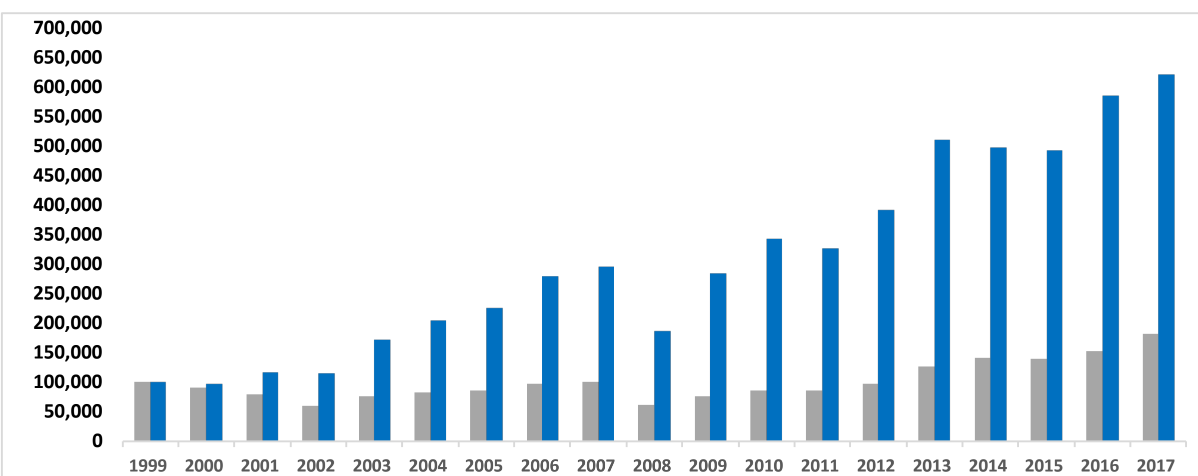
The Federal Reserve's swollen Treasury bond portfolio has a preponderance of longer term bonds. That means that the reduction of its Treasury holdings will add a disproportionate amount of upward pressure to long-term bond yields.

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 $20.36 (2.7%), TBT would decline to $37.32 (1.6%), and TBF would decline to $23.23 (0.7%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Sound Advice vs the S&P 500

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



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	$4.49	0.00%	BUY	$5.00
Chevron	CVX	$122.28	3.66%	BUY	$129.00
Fidelity Select Nat. Gas Fund *	FSNGX	$25.53	0.49%	BUY	$27.00
ICON Energy Fund Class S *	ICENX	$13.01	0.42%	BUY	$14.50
Valero	VLO	$113.75	2.11%	BUY	$118.00
Real Estate					
Hersha Hospitality Trust	HT	$22.67	4.94%	BUY	$24.00
RLJ Lodging Trust	RLJ	$22.03	5.99%	BUY	$24.00
Third Avenue Real Estate Value Investor *	TVRVX	$31.64	0.51%	BUY	$33.00
Medically Related					
Boston Scientific	BSX	$38.50	0.00%	HOLD	$37.00
Stryker Corp.	SYK	$177.68	0.96%	BUY	$180.00
Tekla Life Sciences Fund	HQL	$20.43	0.00%	BUY	$22.00
Financials					
JP Morgan Chase	JPM	$112.84	1.99%	BUY	$118.00
Wells Fargo	WFC	$52.56	2.97%	BUY	$58.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	$21.61	0.30%	BUY	$23.00
Special Situations					
Apple	AAPL	$225.74	1.29%	HOLD	$215.00
Carnival Cruise LInes	CCL	$63.77	3.14%	BUY	$68.00
Intel	INTC	$47.29	2.54%	BUY	$52.00
International Business Machines	IBM	$151.21	3.97%	BUY	$155.00
NCR Corp	NCR	$28.41	0.00%	BUY	$30.00
Symantec	SYMC	$21.28	1.32%	BUY	$23.00
Tetra Tech	TTEK	$68.30	0.70%	BUY	$72.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	$20.92	0.00%	BUY	$23.00
ETF - ProShares Short 20+ Year Trsry	TBF	$23.40	0.00%	BUY	$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	$38.33	0.00%	BUY	$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	$33.10	0.00%	BUY	$41.00

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

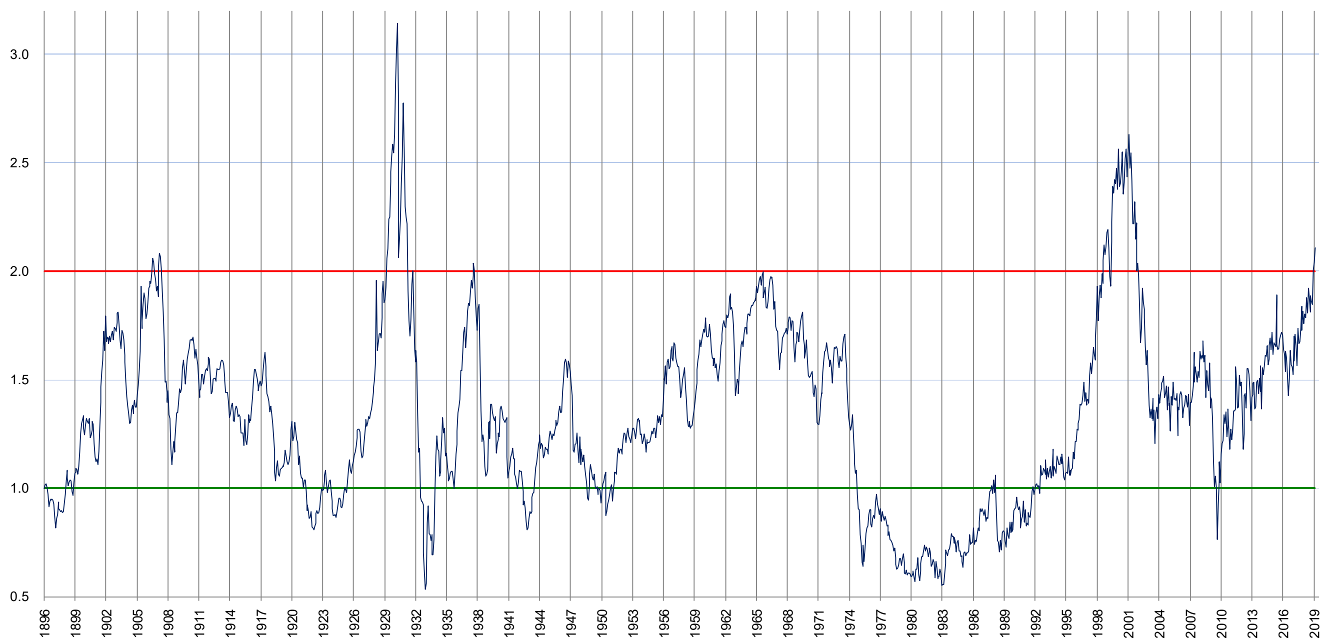
Notes to the table: The right hand column is the highest recommended price limit for purchases.
See our website for live pricing and buy limits: **http://www.soundadvice-newsletter.com/members**
* It is not possible to offer live pricing on our recommended mutual funds.

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 **Sound**Advice 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 120+ 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 based on teh ratio of the S&P 500 Stock Index to median price of new houses 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 label this new tool the **Sound**Advice "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 **Sound**Advice 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 **Sound**Advice 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.

But though an investment beginning with $25,000 in 1895 could have made money being in either stocks or housing, had an investor followed the signals of the **Sound**Advice Risk Indicator he or she would have made $452 million, or <u>26 times</u> more money than by simply holding stocks though the ups and downs.

A brief walk through history shows just how reliable this indicator is.

The first recorded time the Risk Indicator rose above 2.0 was in February 1906, after the eight-year-old Dow-Jones average doubled since 1903. The market peaked in the first quarter of 1907. A massive sell-off in October would later be labeled the Panic of 1907. Stock prices trended downward for 14 more years until the end of 1921 while, searing inflation after World War I boosted house prices 48 percent. The combination of falling stock prices and rising real estate prices forced the Risk Indicator to fall below 1.0 in 1920, just in time for the Roaring 20's when stock prices tripled. Then, in October 1928, the Risk Indicator rose above 2.0 again. On

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

Tuesday, September 3, 1929, the Dow peaked at 318.17. The October crash marked the beginning of a decline that lasted until July 8, 1932. Houses had declined only by 15 percent compared with the 85 percent loss in stocks. The relative superior performance of houses caused our Risk Indicator to fall below 1.0 at the beginning of 1932.

As America's GNP began posting positive gains and with 46 percent growth in three short years, stock prices would triple. Then the Risk Indicator crossed 2.0 in March 1937. This time, the signal came only one month before the zenith in stock prices. As stock prices retreated 50 percent, house prices remained relatively steady, causing the Risk Indicator to fall below 1.0 again in June 1941, within 9 months from the bottom.

As U.S. corporations expanded to meet growing demand, and the economy came to a rolling boil during the Eisenhower years, the stately rise would multiply stock prices by ten times until November 1964, when the Risk Indicator crossed over 2.0 again. The stock market would continue to climb into 1968, and then crash in1975, wiping out the inflation-adjusted gains scored by investors since 1954. However, a switch to an investment in houses would avoid all that and double in price by the time the next signal came for stocks in May 1974, as the Risk Indicator fell below 1.0 again, as the Dow careened below 700.

It would not be until March 1998 when the Risk Indicator would cross 2.0 again, after stocks were up by more than tenfold. The Dot-Com bubble would push stocks higher into early 2000, but then began another 50 percent retracement. A switch to houses would produce a 44 percent gain through the end of 2008 while stock prices were lower by 17 percent. In February 2009, with the Dow careening down through the 700s once again, the Risk Indicator quietly dropped below 1.0 to 0.77 as the S&P tumbled under 700. Since then, the stock market has delivered stunning gains as the S&P 500 has quadrupled.

Based on the latest median house price of $328,100 for July, and with the S&P 500 at 2913.98 at the end of September, the SoundAdvice Risk Indicator reads 2.05, revealing a historically high-risk time for stocks.

As remarkable as the **Sound**Advice Risk Indicator has been, it does not pinpoint the exact time. In the past 123 years, its signal has ranged from being only one month before the zenith to as much as two years early. While the Risk Indicator has been early, it has never been wrong. An expensive crash was inevitable. A 50 percent decline took a 100 percent recovery just to break even.

To help us narrow down the timing as well as gage the potential severity of an upcoming decline, we have our Diffusion Indexes.

Business Cycles and Stocks:
The **Sound**Advice Diffusion Indexes

Track Record of the **Sound**Advice Diffusion Indexes

After each "Aggressive" signal, the S&P 500 climbed an average of 31.0 percent. During "Caution" signals, the S&P 500 either crashed, meandered, or climbed, recording an average increase of 3.8 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
Sep-17	2,492.8	Jan-18	2,823.8
Ave +/-	31.0%		3.8%

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 **Sound**Advice 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 **Sound**Advice **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

Over Please...

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

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

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

Current Status

The Diffusion Index of LAGGING Indicators climbed to 100 percent for December, giving us a new Caution Signal in January, very close to the peak in the market. The latest data for August caused a 33.3 percent reading.

Our next signal will come from the Diffusion Index of LEADING Indicators, when it drops to zero, which would take a surprising softening in the US economy. The latest reading for this Diffusion Index is 66.7 percent.

Concurrence

There are times when signals from the Risk Indicator and the Diffusion indexes are out of sync, when one is signaling caution and the other is not. This occurred in August 1987, when the Diffusion Index of Lagging Indicators switched into caution mode, just prior to the October 1987 Crash that took stocks sharply for a brief period. Non-concurrence also occurred in March of 2008, when the Diffusion Index of Lagging Indicators switched into caution mode, just prior to the 2008-09 bear market crash. Both of these crashes were brutal, but relatively short-lived. Once the Risk Indicator plunged below 1.0, a very profitable bull market followed.

Then there are times when both indicators concur, signaling the same thing at roughly the same time. This happens when the Risk Indicator is above 2.0, indicating the end of a supercycle, and the Diffusion Index of Lagging Indicators switches into caution mode, indicating the end of a business cycle. Of course, this concurrence indicates that a more vicious and potentially longer-lasting bear market, or series of bear markets, is bound to follow, eventually taking stock prices down substantially – usually by 50 percent -- until the Risk Indicator falls below 1.0 again. We have this concurrence today.

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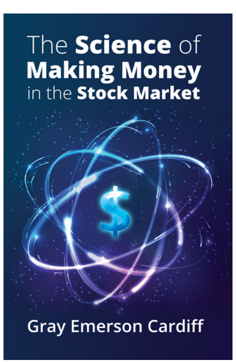

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