

The 2018 Trade War: The Beginning



Gray Emerson Cardiff, Editor

The median tenure of an active equity manager is eight years, according to Morningstar. The last time rates were in a significant uptrend was from 2003 to 2006. That means most active money managers have never operated in a rising interest rate environment – a phenomenon that they have not seen before.

That is alarming, but nothing new. The industry turns over regularly, and each interest rate cycle has taken the majority of managers by surprise. They were unprepared for the bear markets that typically erase 50 percent of stock equities, requiring a 100 percent recovery to break even. I have watched it happen many times since the early 1970s. It is worth giving up some upside to be defensive at times like this.

The *Sound Advice* Portfolio is up by 3.8 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

10.54% Annually vs.
2.68% from the S&P 500

At midnight, May 31, US tariffs went into effect for aluminum and steel products coming from Canada, Mexico, Japan, and the European Union (EU). These tariffs were enacted by the first salvo when President Trump signed the executive order on March 8. The second salvo was launched on March 22, when President Trump signed an executive memorandum to impose approximately \$50 billion of regulatory tariffs on Chinese imports.

Both of these salvos were launched with a warning period before the tariffs would actually take effect. The deadline for the China tariffs will be this month. By June 15, a final list will be released of \$50 billion in imports from China that would be subject to 25 percent tariffs, which are to be put in place shortly thereafter. June 30 is the date for announcing investment restrictions meant to prevent Chinese “theft” of U.S. technology.

As investors, our job is not to be political, but to evaluate the fallout from political events, and to adjust our investments accordingly. The essential question is whether a full-blown trade war has started. On the surface, it looks like negotiating tactics. However, the negotiations are not going well. The resolve is strong on all sides, especially in China.

Made in China 2025

China’s resolve is evidenced by a mandate it calls *Made in China 2025*, which is aimed at making China independent, without reliance on strategic western products and technology. The mandate prescribes the elimination of foreign suppliers by 2025, with the stated goal that Chinese companies own 80 percent of specific domestic markets. Two requirements are overtly protectionist, and are specifically prohibited by the World Trade Organization (WTO): one is that a large part of a product’s value be created in China; the other sets a specific market share for domestic producers.

To protect many of its markets, Beijing imposes tariffs on products that its trading partners do not. To do business in China and to avoid steep tariffs, US companies report that they are required to enter into joint ventures with Chinese companies, and are compelled to turn over their intellectual property and technological secrets.

Both sides have a great deal at stake, more at stake politically than economically. A simulation by the think-tank Oxford Economics projects that a 25-percent US tariff on \$60 billion worth of Chinese exports would reduce China’s growth by approximately one-tenth of one percent this year. The impact would be somewhat less next year. The Oxford simulation concluded that the impact on the US economy would be less than on China’s.

The Oxford simulation lines up with some basic figures. \$60 billion is close to 0.5 percent of China’s GDP. The impact of the tariffs would be a fraction of that because much of the goods will still come into the US or will be diverted to different markets. The \$60 billion is close to 0.3 percent of the US GDP, so the impact will be lessened.

Politically, however, both sides have everything at stake. To stay in

power, the Chinese communist party needs GDP to continue growing rapidly. To do that, jobs need to be created at a torrid pace. The government also needs to follow through on its *Made in China 2025* mandate. On the other side, Trump looks at countries with trade deficits as “losers” and those with surpluses as “winners.” He also has a loyal base and campaign promises to keep for re-election hopes in 2020.

The Portfolio

Just as the market was slipping off its Friday, January 26, peak, we published our February issue on the following Friday, February 2, and recommended that you should have a substantial amount of cash on the sidelines and wait for a substantial correction. Since that exuberant market close on January 26, the market has been rocky to say the least.

One of our reasons for recommending caution came from our *Sound Advice* Risk Indicator (page 10), which measures the struggle for capital between the stock and real estate markets, which rose very close to 2.0 in January, revealing a very high-risk time for stocks. There have been only 5 times in the past 100 years that this indicator has risen above 2.0, and it was always prior to major market tops.

While our Risk Indicator detects the seasons that roll across the market’s landscape, which we call supercycles, our second reason came from our *Sound Advice* Diffusion Indexes of Leading and Lagging Indicators (Page 11) which detects the more visible business cycles that are the storms which we actually perceive as weather -- the bull and bear markets that fluctuate along the path of Supercycles. On January 25, when the leading and lagging economic indicators were released, our *Sound Advice* Diffusion Index of Lagging Indicators switched into a Caution Signal.

This bull market will become 111 months old on June 9, making it only 2 months shorter than the longest in post World War II history, which ended in March, 2000, and lasted 113 months. The last two bear markets took prices down 50 percent, which required a 100 percent recovery just to break even. Our portfolio recommendations are made in accordance with the caution signal currently prevailing the *Sound Advice* Diffusion Index of Lagging Indicators.

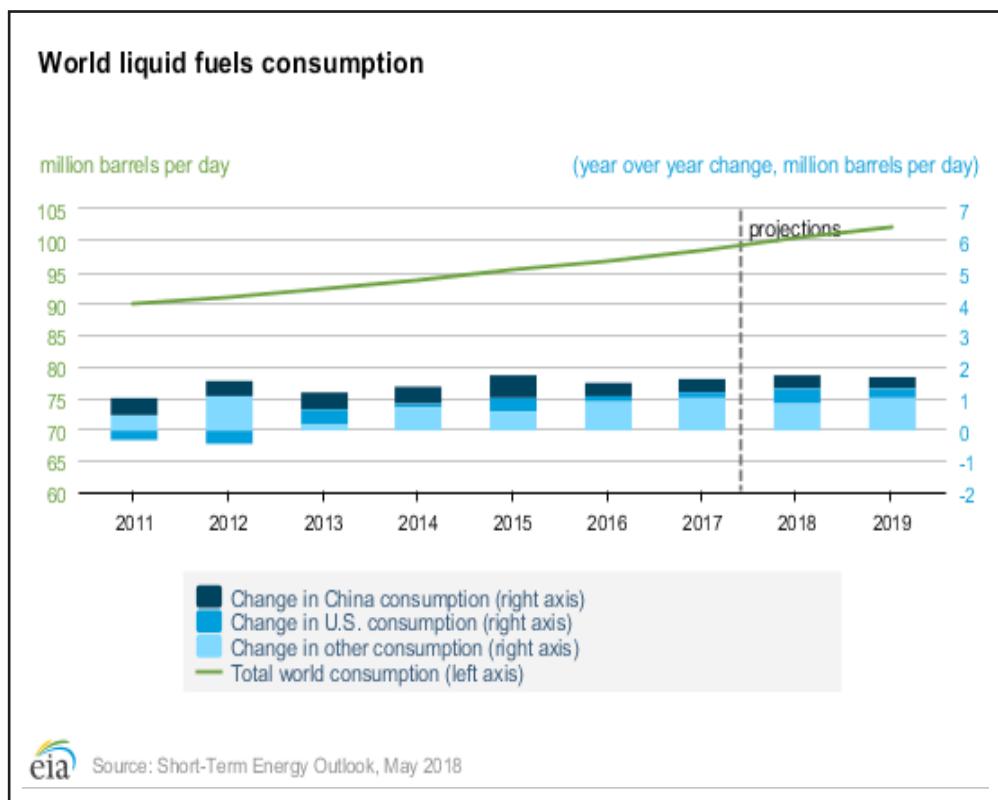
Energy & Natural Resource Selections

Until recently, Iran has been exporting roughly two million barrels a day (MMB/D) of crude oil. Europe has been purchasing one-quarter of that volume but is likely to go along with US sanctions, as it did in 2012 when all of its oil imports from Iran we cut. Japan has already started lowering its purchases from Iran. India’s oil giant IOC is now looking for alternative barrels to replace its 140,000 b/d of purchases from Iran. South Korea has also started reducing its purchases from Iran to 300,000 b/d from 360,000 b/d last year, and is expected to continue to reduce purchases given its alignment with the US. A total of one-million b/d is being choked off of world supplies.

The curtailment of international investment will lead to significant reduction of Iran’s natural gas industry for many years. The US is pressuring the French natural gas company, Total, to back out of its South Pars joint venture with Iran. China, is also an investor but does not have experience developing LNG exporting projects.

Meanwhile Venezuela’s production has dropped 40 percent since 2014, and the former oil czar said crude production in the OPEC nation will continue to plummet in the aftermath of President Nicolas Maduro’s re-election. He predicts production will drop to 900,000 b/d from 1.4 MMB/D currently.

On the other side of the equation, worldwide GDP growth is exerting demand. See the green line on the chart below.



Major OPEC oil suppliers are announcing larger production to fill worldwide needs. However, these suppliers are not interested in glutting the market. On average, the OPEC countries needed \$77.68 per barrel (weighted by production) to balance their 2017 budgets.

Rising worldwide demand, along with the interference from geopolitical tensions on supplies, and the need for oil prices above \$78 per barrel in OPEC countries, 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. At the current price of \$67 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$2.95 for one million BTUs, 5.8 million BTUs will cost \$17.11. 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 above 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 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. Countries in Asia and in the Middle East. China's transition away from coal will account for most of this increase.

Chesapeake Energy (CHK) has climbed substantially since our last issue. The rise was driven primarily by rising oil and gas prices which will help CHK produce positive cash flow. First quarter cash flow was negative, but today's oil and gas prices turn it positive. First quarter earnings of 34 cents per share brought the trailing annual earnings to 94 cents. The P/E is still astonishing low. The company's debt of \$9.40 billion makes CHK a high-risk investment, but the profit potential is substantial and becomes more certain at today's oil and gas prices.

CHK has a large US portfolio of oil and gas properties -- in the Powder River Basin, Eagle Ford, the Marcellus and Utica shale, the Haynesville/Bossier, and in the Anadarko Basin regions. These large domestic assets make CHK well situated to participate in the resurgence of the 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.

Chevron (CVX) has also been buoyed by higher oil and gas prices. We have been predicting that Chevron is set to see an increase in production in 2018. Chevron's total production of crude oil and natural gas increased 6.6 percent, compared with last year's corresponding period to 2,852 thousand oil-equivalent barrels per day (MBOE/d).

Production is bound to continue increasing. The two massive Australian projects, the Gorgon and Wheatstone, 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. CVX also has an attractive dividend that was just increased (again) to \$1.12 per share per quarter.

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 our portfolio because the company 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.

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	23.40	5.6%	8.4%	7351213.33	28.10	-16.7%
Hospitality Properties	HPT	28.95	7.0%	9.5%	10,873.7	42.76	-32.3%
Hersha	HT	21.27	5.3%	9.2%	2,402.9	24.98	-14.9%
Host Hotels & Resorts	HST	21.63	3.7%	7.9%	20.1	22.99	-5.9%
Apple Hospitality	APLE	19.03	6.3%	8.2%	6,156.9	21.19	-10.2%

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.

Real Estate Selections

Our posture is still defensive with regard to real estate stocks. 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. Two REITs currently exist in the hospitality industry along with one mutual fund.

Hersha Hospitality (HT) is worth at least \$24.98 per share, which is higher than the current price. The valuation is based on the latest trailing four quarters’ financials, including the most recent 2018 first quarter results released at the end of April, and using a 7.5 percent cap rate to evaluate the company’s real estate portfolio. Hersha has reported several hotel transactions during the last several years at cap rates ranging from 4.9 to 8 percent. The most recent sales were the Hyatt House in Gaithersburg, MD, for \$19.0 million and the Holiday Inn Express in Chester, NY for \$8.4 million, two older, suburban assets at a combined capitalization rate of 4.9 percent. To be on the conservative side, we can use a cap rate at the high end of this range of 7.5 percent for valuation purposes.

This valuation is low because the company’s two premier hotels in Miami were closed because of Hurricane Irma, and have not been contributing to income (which is the basis for valuating the company’s assets). Hersha management expects the Courtyard Cadillac Hotel to resume operations following its conversion to an Autograph Collection hotel during the second quarter of 2018 while the Parrot Key Hotel and Resort is expected to remain closed

for repairs and renovations through the end of the second quarter of 2018. Management sees a recovery in 2018 based on the reopening of the Miami Convention Center and a diminished supply of competing hotels.

The company will be deploying the proceeds of the most recent sales to repurchase more of HT stock. CEO Jay H. Shah considers the stock to be at a deep discount to the market value. HT’s attractive dividend provides a nice yield and reduces risk by putting a floor under the stock price.

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 first quarter, and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value RLJ at \$28.10 per share which is higher than the current price. The high dividend yield is also attractive and lowers the risk profile.

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. The company is on pace to complete the sale of these assets by the first quarter of 2019. So far this year, RLJ sold two legacy FelCor assets for \$119.2 million and three other properties for \$300 million, 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. The primary use of the funds continues to be the reduction of debt.

Management is encouraged by the transaction landscape, with ample liquidity and general lack of quality

product available in the market, and anticipates sales of more non-core assets plus other opportunistic sales will generate an additional \$200 to \$400 million of proceeds in 2018.

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

The cloud of uncertainty surrounding the Affordable Care Act (Obamacare) still blankets the healthcare industry. Our current recommendations in this sector are based on their own individual merits. The decision by Congress to suspend the medical device tax for another two years will benefit both BSX and SYK.

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, and the company's stream of new inventions acquisitions add to promising growth prospects.

The recent acquisition of Apama Medical will expand BSX's arrhythmia solutions which fall under its Electrophysiology (EP) segment. To further expand its EP segment, Boston Scientific announced plans to acquire Securus Medical, which is a developer of thermal monitoring systems for the continuous measurement of esophageal temperature.

Boston Scientific's growth is bolstered by its expansion in emerging markets, including Brazil, Russia, India and China (BRIC). In the first-quarter, business from emerging markets grew by 17 percent.

Stryker (SYK) provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products,

but is best known for its orthopaedic devices for artificial knees and hips.

Stryker's healthy balance sheet has allowed it to make many acquisitions which are now paying off, such as Mako whose 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

After passing through the House and the Senate, regulatory relief for banks is set to be signed into law by President Trump. A primary benefit from a less stringent regulatory environment will be the ability to shed excess capital and increase leverage. Both of our bank selections will benefit from this regulatory relief as well as reduced tax rates. Rising interest rates also increase spreads on loans.

Our two choices are good values now.

JP Morgan Chase (JPM) is expected to earn \$8.78 in 2018. At a forward P/E ratio of 15, which is substantially below the market average, JPM would be \$131.70 by the end of 2018. JPM is still cheap in comparison to the rest of the market.

Wells Fargo (WFC) is expected to earn \$4.71 in 2018. At a P/E ratio of 15, WFC would be \$70.65 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 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) carries the highest A++ financial rating, with a pristine balance sheet showing as much cash as long-term debt.

Although this is a premier growth stock, its P/E is still close to the rest of the market. With this first quarter report, the trailing four quarters of earnings add up to \$9.99, giving AAPL a trailing twelve-month (TTM) P/E ratio close to 19 which is close to the market as a whole.

Intel (INTC) 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.

Recent acquisitions are contributing to growth, including the 2017 Mobileye acquisition which added \$151 million in revenues during the first quarter. The 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.

The company now expects its 2018 earnings to be \$3.85 per share, which makes the P/E ratio close to 14, substantially below the rest of the market. The company has the size, diversity, and industry dominance to offer a relatively safe investment in a high-growth, and often high-risk business.

Stronger growth prospects make INTC under-valued at its current price because it deserves a higher P/E. At a P/E of, say 18, which is still below the market, the stock price

would be close to \$70. The current dividend yield is also attractive, with an annual dividend of \$1.20 a share which was just increased by 10 percent.

International Business Machines (IBM) is in our portfolio because it is turning into a growth stock but is not priced like one. The growth portion of the company was 47 percent of first quarter earnings, 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 the first quarter, IBM’s Strategic Imperatives grew 15 percent.

The company 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.

The first quarter was the second consecutive quarter for revenue growth after 22 consecutive quarterly declines. This is a good time to invest in this long-term growth company at a stunningly 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. This technology is driving the new Amazon Go store, which is bound to drive the entire supermarket industry to implement self-checkout technology. Amazon Go, Kroger, and Walmart are leading the cutting edge of grocery stores, but NCR is the power behind the trend.

NCR is executing its strategy becoming a software-led enterprise. The Services business had a strong first quarter from both a revenue and margin perspective. The 8% top line growth is being supported by the continued execution of the company’s transformation initiatives as it modernizes its Services business.

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NCR reported earnings expects operating earnings to be \$3.30 to \$3.45 in 2018, before non-recurring paper changes for its transformation plan. Thirty-five percent of annual earnings are expected in the first half of the year with the balance in the second half. This makes NCR an outstanding value, with a P/E less than 10, a considerable discount to the rest of the market. With its new growth prospects, NCR deserves a much higher P/E. At a P/E ratio of, say 15, which is still a discount to the rest of the market, the stock belongs above \$50 per share.

Symantec (SYMC) announced in April that it availed its Advanced Threat Protection (ATP) customers to its powerful threat detection technology, the Symantec Targeted Attack Analytics (TAA) technology which is used by its own world-class research teams, to uncover some of the most notable cyber-attacks in history.

This company 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."

Symantec's recent acquisitions of LifeLock and Blue Coat have refocused the company and provided a broader suite of products. Symantec is bound to benefit from LifeLock's wide subscription base and allow it to cross-sell Norton and LifeLock services. The Blue Coat assets should enhance Symantec's enterprise business with top-line growth and margin expansion with protection services for both cloud and mobile customers.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation. The company's record high of \$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.

The company recently declared a 20% increase in the quarterly dividend, raising it to \$0.12 per share. There is \$50 million remaining under the previously approved \$200 million share repurchase program.

ETFs for Rising Bond Yields

During the QE programs, the Federal Reserve was buying gargantuan amounts of Treasuries causing the Fed's holdings to grow by more than 5 times, to \$4.6 trillion. Quantitative easing (QE) has been reversed into quantitative tightening. The Federal Reserve has started

to reduce its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities.

The Federal Reserve's swollen Treasury bond portfolio has a preponderance of longer term bonds. That means that the reduction of the its Treasury 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. 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 March meeting when the Federal Reserve raised the Federal Funds rate another 0.25 percentage point to 1.5 percent. The median prediction was that the Federal funds rate would be 2.125 percent at the end of 2018, which was unchanged from the December Dot Plot. However, the 2019 prediction was 2.875 which was higher than December's median.

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. We are predicting that this flat condition will change as inflation heats up, and forces long-term interest rates up from historically low levels.

The Personal Consumption Expenditures (PCE) index was released again at the end of May, which is the Federal Reserve’s preferred method of measuring inflation. The PCE rose 2 percent year-over-year in April, April. A 2 percent inflation rate is now the norm, and is bound to increase in the months ahead because the US labor market is the tightest it has been in decades.

Historically, investors demand a real return in the vicinity of 3 percent. With inflation at 2 percent, and trending upward, yields should be close to 5 percent, giving these ETFs a tremendous upside potential. 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 3.65% by the end of 2018, and 4.40% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$19.46 to \$26.89 by the end of 2018, and to \$38.51 by the end of 2019.

TBT would rise from \$36.43 to \$45.20 by the end of 2018, and to \$57.43 by the end of 2019.

TBF would rise from \$22.80 to \$25.40 by the end of 2018, and to \$28.63 by the end of 2019.

The Erosion Factor

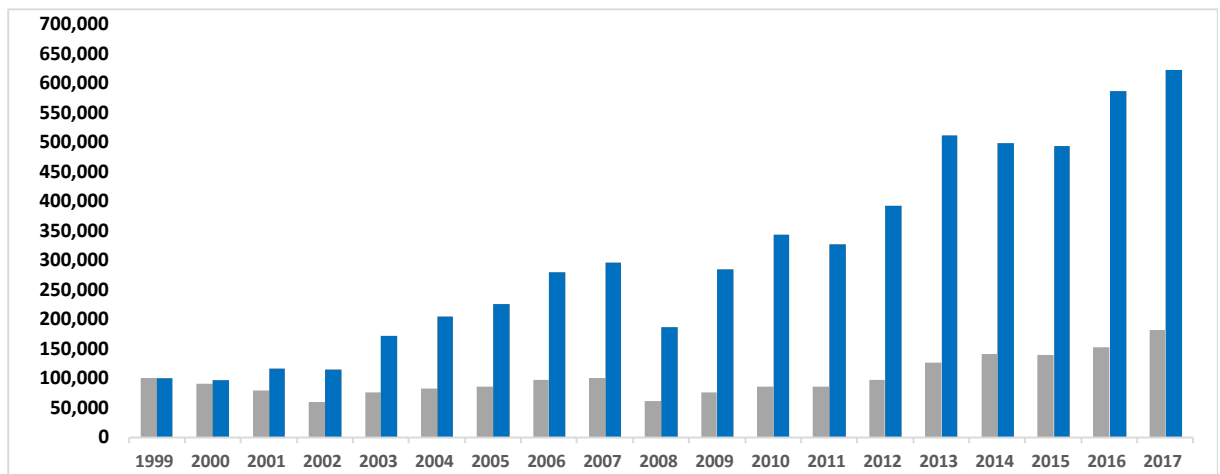
As we point out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually 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 \$18.99 (2.4%), TBT would decline to \$36.00 (1.2%), and TBF would decline to \$22.71 (0.4%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Hedging the Portfolio

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 \$181,977, versus \$100,000 invested in the Sound Advice recommendations (in blue), which would have grown to \$608,800.



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$4.47	0.00%	BUY	\$4.80
Chevron	CVX	\$124.30	3.60%	BUY	\$129.00
Fidelity Select Nat. Gas Fund *	FSNGX	\$21.65	0.57%	BUY	\$23.00
ICON Energy Fund Class S *	ICENX	\$11.27	0.48%	BUY	\$12.00
Valero	VLO	\$121.20	1.98%	BUY	\$125.00
Real Estate					
Hersha Hospitality Trust	HT	\$21.27	5.27%	BUY	\$23.00
RLJ Lodging Trust	RLJ	\$23.40	5.64%	BUY	\$25.00
Third Avenue Real Estate Value Investor *	TVRVX	\$33.08	0.49%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$30.39	0.00%	BUY	\$32.00
Stryker Corp.	SYK	\$174.02	0.98%	BUY	\$177.00
Tekla Life Sciences Fund	HQL	\$18.70	0.00%	BUY	\$20.00
Financials					
JP Morgan Chase	JPM	\$107.01	2.09%	BUY	\$112.00
Wells Fargo	WFC	\$53.99	2.89%	BUY	\$57.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$20.25	0.32%	BUY	\$22.00
Special Situations					
Apple	AAPL	\$186.87	1.56%	BUY	\$194.00
Intel	INTC	\$55.20	2.17%	BUY	\$57.00
International Business Machines	IBM	\$141.31	4.25%	BUY	\$150.00
NCR Corp	NCR	\$30.10	0.00%	BUY	\$33.00
Symantec	SYMC	\$20.78	1.35%	BUY	\$23.00
Tetra Tech	TTEK	\$54.95	0.87%	BUY	\$57.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$19.46	0.00%	BUY	\$23.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$22.80	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$36.43	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$38.72	0.00%	BUY	\$41.00

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.

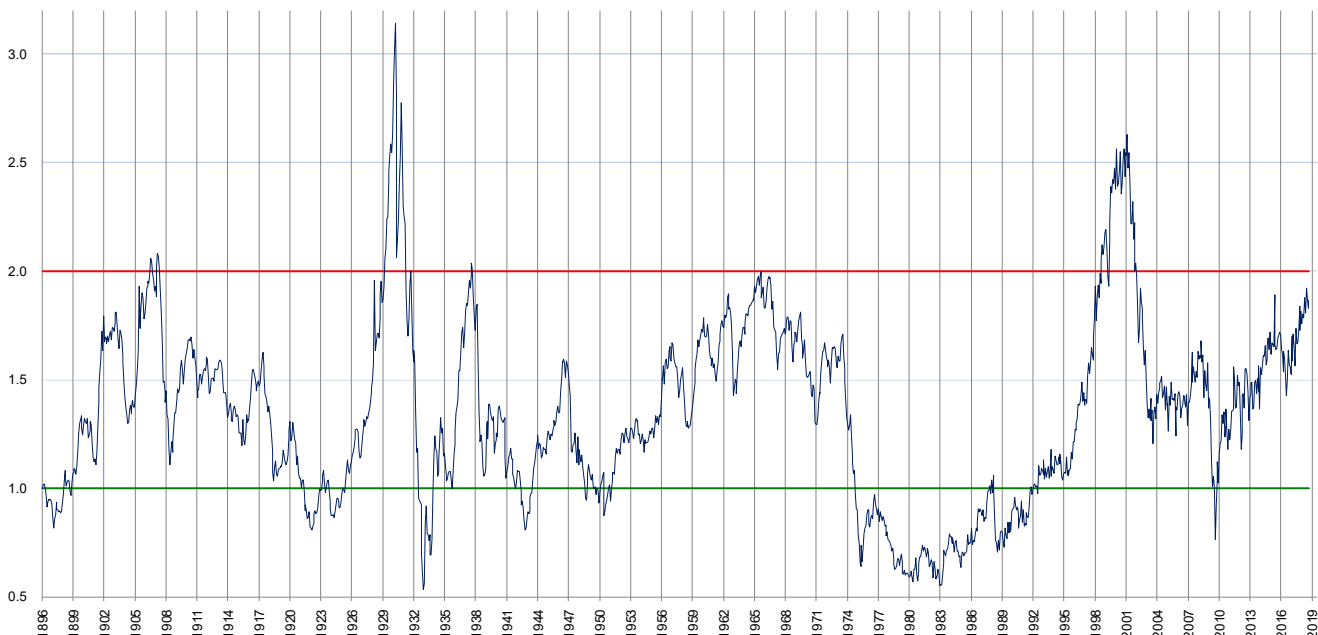
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$15.9 million in stocks and to \$1.78 million in houses.

But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$632 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 the latest median house price of \$335,400 for March, and with the S&P 500 at 2705.27 at the end of April, the SoundAdvice Risk Indicator reads 1.85, which reveals that it is a high-risk time for stocks.**

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

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.

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The Science of Making Money in the Stock Market

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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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. Instead 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 **SoundAdvice** 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. This Diffusion Index has continued to show strength. The latest data for April caused another 100 percent reading.

Our next signal will come from the **SoundAdvice** Diffusion Index of **LEADING Indicators**, when it drops to zero, which would take a surprising softening in the US economy. This Diffusion Index was 66.7 percent for April.

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	Jan-18	2,823.8
Ave +/-	30.3%		3.3%

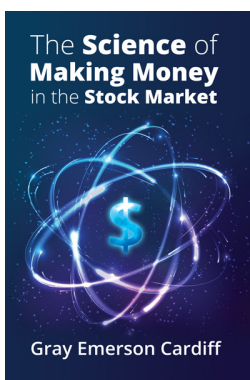
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