

The 2018 Trade War: The First Battle



Gray Emerson Cardiff, Editor

The *Sound Advice* Portfolio is down 1.36 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

The first salvo came on March 8, when President Trump signed an executive order enacting tariffs on steel and aluminum. On Thursday, March 22, as President Trump signed an executive memorandum to impose approximately \$60 billion of regulatory tariffs on Chinese imports, the Dow dropped 724 points. On the following day, China retaliated with \$3 billion of tariffs on selected US products, and promised more to come. The Dow dropped another 400 points. Of course, the market was terrified of a full-blown trade war.

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. If it has, we are likely looking at more damage to the stock market than the correction so far. The answer lies in assessing the resolve of both sides.

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 that 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.

Specifically, *Made in China 2025* covers 10 market sectors:

- 1) Cutting edge and next-generation information technology, including cybersecurity;
- 2) High-end numerical control tools and robotics to provide China with greater manufacturing efficiency as labor costs rise;
- 3) Aerospace equipment allowing China to be a world leader in aviation and outer space exploration;
- 4) Oceanic engineering equipment and hi-tech ships to bolster maritime security of China's territorial claims in the South China Sea and the East China Sea;
- 5) Advanced railway equipment to further advance China's high-speed railway systems;
- 6) Energy-saving vehicles using alternative fuel;
- 7) Power equipment to generate clean power;
- 8) Agricultural machinery to advance production of large tractors and high-performance combines;
- 9) New-age materials like graphene and nano materials;
- 10) Biomedicine and high-performance medical devices for development of advanced chemicals and medical equipment.

The Chinese government is investing heavily in *Made in China 2025*, currently close to \$1.5 billion, including subsidies, loans, and bonds, to support domestic hi-tech enterprises and encourage more Chinese firms to expand overseas and acquire foreign firms with cutting-edge technologies. Local Chinese authorities have committed an additional \$1.6 billion through 2020.

To protect many of its markets, Beijing imposes tariffs on products that its trading partners do not.

For example, a Jeep Wrangler that costs \$41,000 in the US costs \$71,000 in China because of the tariffs Beijing imposes on every automobile, SUV, and truck that is brought into China that is not made there. These taxes largely explain why only five percent of the cars in China are imported, compared to 25 percent in the US.

Made in America - Now

On the campaign trail, Trump promised to avenge China's "rape" of the US economy -- its "theft" of American jobs and

technology. The executive memorandum signed on March 22 was billed as a historic move against Chinese “economic aggression.” It specifically ordered US trade officials to provide a list of products Beijing has identified as strategic in the 10 sectors of its *Made in China 2025* mandate. Punitive tariffs will be aimed initially at these products. Trump said, “It could be about \$60 billion, but that really could be a fraction of what we’re talking about.”

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. Last August, Trump instructed Trade Representative Robert Lighthizer to investigate these allegations, which would violate US intellectual property under section 301 of the Trade Act of 1974. After seven months, officials produced strong evidence that China uses foreign-ownership restrictions forcing American companies to transfer technology to Chinese firms, and that Beijing directs Chinese firms to invest in the US with the purpose of obtaining large-scale transfers of technologies viewed by the Chinese government as strategic. The investigation also uncovered strong evidence China is active in cyberattacks on US companies stealing trade secrets.

Reciprocity

Trump claims that he is not a protectionist. He is quoted as saying, “I’m absolutely a free-trader. I’m for open trade, free trade, but I also want smart trade and fair trade.” He says that his aim is to replace “one-sided” existing trade deals with agreements based on “fairness and reciprocity.” As he signed the executive memorandum on March 22, he looked at the cameras and told viewers that “we will do to them what they do to us” and to remember the word “reciprocal”.

The Trump administration is not the first to want reciprocity in trade. A new book, *Clashing Over Commerce: A History of US Trade Policy*, by Douglas A. Irwin, Professor of Economics at Dartmouth College, offers an interesting history of trade. He cites a number of times that were remarkably similar to today.

Secretary of State, Thomas Jefferson, also claimed to be a free-trader, but in 1793 he documented a long list of barriers that foreign countries had placed against American goods. Jefferson’s solution to reciprocity was through retaliation: “Where a nation imposed high duties on our productions, or prohibits them altogether, it may be proper for us to do the same by theirs.” However, the US was not a large enough economy back then to impose its will on the rest of the world, so the idea faded away for the next 100 years, until the US became a net exporter in the 1890’s, and foreign tariffs and barriers were interfering with US economic progress. In 1901, President McKinley was quoted: “*Reciprocity treaties are in harmony with the spirit of the times ...*”. The last full-blown trade war was inaugurated by the passage of the Smoot-Hawley Tariff Act in 1930, which raised duties on hundreds of imports, just when the US was deep in the throes of the Depression. Foreign retaliation was devastating

to American exports. The Smoot-Hawley Tariff Act is widely agreed to have exacerbated the Depression.

In 1934, Franklin D. Roosevelt and his Secretary of State, Cordell Hull, convinced Congress to pass the Reciprocal Trade Agreements Act, which marked a major shift away from protectionism toward reciprocity, by giving the President the authority to reduce tariffs and enter into trade agreements with other countries. The General Agreement on Tariffs and Trade (GATT), was instituted after World War II, which formalized the concept of reciprocity, and targeted discriminatory policies against American exporters. The European Economic Community (EEC) was subsequently formed which removed taxes among members, but established a common external tariff. Negotiations to reduce the external tariff led to the 1967 revisions to GATT. The next round of negotiations with other countries to reduce their tariffs led to another revision again in 1993, and established the World Trade Organization (WTO) in order to settle disputes and protect intellectual property rights.

From this brief history, we can see that much of what the *Trump Administration is attempting is not new, and in the tradition of past administrations.*

Further US Resolve

This resolve goes beyond Trump himself. PhD economist Peter Navarro was the architect of Trump’s “America First” campaign. From the beginning of Trump’s Administration, Dr. Navarro has been the director of the Office of Trade and Manufacturing Policy. His thinking on China was laid out in two of his books: *Death by China* and *Crouching Tiger: What China’s Militarism Means for the World*. In these books, Navarro describes China as “turning into the planet’s most efficient assassin”, and urges regulators to bring actions against it through the World Trade Organization.

Even while staunch free-trade advocate Gary Cohn led the economics team, and while Navarro reported to Cohn, it was Navarro who pushed Trump to force a renegotiation of NAFTA by threatening to pull out. Cohn resigned over the issue, and left Navarro in a more powerful position. Of course, Navarro is proud of Trump for taking long-overdue action. Further support is coming from many Congressional leaders, and much is bipartisan, including Senate Minority Leader Chuck Schumer.

Global Impact

Both sides have a great deal at stake. Christine Lagarde, IMF Managing Director, warns that a global trade conflict could undermine the broadest world recovery in years.

At the moment, each country has 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, with comparable retaliation (which is only \$3 billion so far), 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 smaller. Commerce Secretary Wilbur Ross says that tariffs are bargaining chips for better trade deals.

Politically, however, both sides have everything at stake. To stay in power, the Chinese communist party needs GDP to continue growing rapidly and creating jobs at a torrid pace for massive employment growth. 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. Moreover, we may see additional direct measures to thwart the transfer of intellectual property, which may have deeper economic impacts. Accordingly, political forces on both sides may prompt further escalations of tariffs, which would cause more economic harm. The likelihood of further escalation is bound to be negative for the stock market.

The Portfolio

In the January issue of Sound Advice (Caution: Storm Warning), just as the market was slipping off its peak, we recommended that you should have a substantial amount of cash on the sidelines and wait for a substantial correction. Our reasoning for recommending caution came from several sources. Our *Sound Advice* Risk Indicator (page 10), which detects the seasons that roll across the market's landscape that we call supercycles, was approaching 2.0. Our *Sound Advice* Diffusion Index of Lagging Indicators (page 11), which detect 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 -- had switched into a Caution Signal. We also noted the lofty level of the S&P 500 index in relation to earnings and revenues of the underlying stocks in the index.

This bull market will become 109 months old on April 9, making it only 4 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.

The investment landscape has changed. The first quarter's correction exposed the risk in the market, and has tainted the full-throated optimism that was blinding investors to the risks they were taking. Our portfolio recommendations are made with the changing landscape in mind, in accordance with the caution signal recently

given from the *Sound Advice* Diffusion Index of Lagging Indicators.

ETFs for Rising Bond Yields

Quantitative easing (QE) has been reversed into quantitative tightening. In a titanic reversal, the Federal Reserve has started reducing its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities. 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, from under \$900 million in 2008 to \$4.6 trillion recently. The Federal Reserve is now reducing its inventory back to more normal levels by methodically selling its massive Treasury holdings. The Federal budget passed in the first quarter will add to the Federal Deficit. Estimates are that annual deficits will rise above \$1 trillion beginning in 2019. Of course, this increases the need to sell Treasury securities which will add upward pressure on yields.

The Federal Reserve's swollen (and growing) 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. Historically, investors demand a real return in the vicinity of 3 percent. With inflation steadily pushing above 2 percent, 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 3.6% by the end of 2018, and 4.35% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$19.42 to \$26.83 by the end of 2018, and to \$38.54 by the end of 2019.

TBT would rise from \$36.27 to \$44.99 by the end of 2018, and to \$57.28 by the end of 2019.

TBF would rise from \$22.70 to \$25.28 by the end of 2018, and to \$28.53 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 \$18.84 (3.0%), TBT would decline to \$35.74 (1.5%), and TBF would decline to \$22.60 (0.5%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Energy & Natural Resource Selections

On average, the OPEC countries needed \$77.68 per barrel (weighted by production) to balance their 2017 budgets. With oil prices below the necessary price, OPEC countries will continue to urge for oil production cutbacks wherever they can exert pressure. These cutbacks and resulting price stability are advantageous for US oil and gas companies.

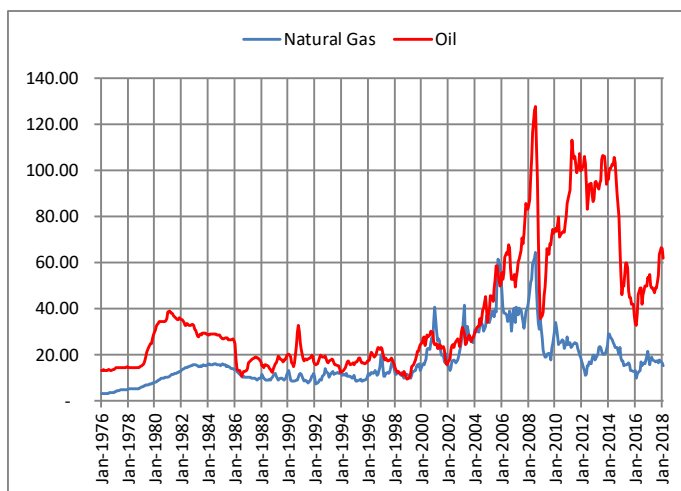
Chesapeake Energy (CHK) has a large US portfolio of oil and gas properties -- in the Powder River Basin, Eagle Ford, the Marcellus and Utica shale, the Haynesville/Bossier, and in the Anadarko Basin regions. These large domestic assets make CHK well situated to participate in the resurgence of the US 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) is set to see an increase in production and revenue in 2018, including the two massive Australian projects, the Gorgon and Wheatstone, both of which had required large capital outlays that are no longer needed in CVX's forward-going cap-ex budget. 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 is well-positioned to see earnings growth in the years ahead, along with an attractive dividend was just increased (again) to \$1.12 per share per quarter, up 4 cents from the previous 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.

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 \$65 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$2.73 for one million BTUs, 5.8 million BTUs will cost \$15.83. Thus, the same amount of energy is available for approximately 24 cents on the dollar, if it is in the form of natural gas rather than oil.

The Cost of Energy Equivalents of Oil and Natural Gas



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

Valero Energy (VLO) is in our portfolio because it 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. Commercial real estate prices are historically high because low interest rates have pushed down real estate cap rates to historically low levels (like bond yields). 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) has reported several hotel transactions during the last several years at cap rates ranging from 4.9 to 8 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.

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	19.44	6.8%	10.2%	7258533.33	32.98	-41.1%
Hospitality Properties	HPT	25.34	8.1%	10.0%	10,770.0	41.91	-39.5%
Hersha	HT	17.90	6.3%	9.2%	2,402.9	21.70	-17.5%
Host Hotels & Resorts	HST	18.64	4.3%	9.4%	20.1	24.05	-22.5%
Apple Hospitality	APLE	17.57	6.8%	8.9%	6,114.9	21.89	-19.7%

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.

Based on the latest trailing four quarters' financials, including the most recent 2017 fourth quarter results released at the end of October, and using a 7.5 percent cap rate to evaluate the company's real estate portfolio, we value HT at \$21.70 per share which is higher than the current price. This valuation is low for several reasons.

The 2017 net operating income was impaired because the company was forced to close six south Florida hotels in September because of Hurricane Irma. Management sees a recovery in 2018 based on the reopening of the Miami Convention Center and a diminished supply of competing hotels. Outside of Florida, there were also some significant new acquisitions in the fourth quarter. The company is also divesting out of its non-core, underperforming properties. In February, HT announced the sale of 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. The company will be deploying the proceeds of this sale 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 selling at a steeper discount to its hotel assets than HT. Based on the latest trailing four quarters' financials reported, including the most recent 2017 fourth quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value RLJ at \$32.98 per share which is considerably higher than the current price. The high dividend yield is also attractive and lowers the risk profile.

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

This is a global real estate fund which means it is not confined to US real estate with low cap rates. Management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business. Management

also searches for opportunities in different aspects of a real estate company's capital structure by investing in senior debt in addition to equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities.

Medically-Related Selections

The healthcare industry is still blanketed by uncertainty over future Congressional efforts to repeal and replace the Affordable Care Act (Obamacare). The entry of Amazon into the healthcare and pharmaceutical industries is also a disrupting force that is changing the landscape. We are comfortable with our current recommendations in this sector based on their own individual merits.

Boston Scientific (BSX) has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs. BSX's medical products are well suited for an aging population, and the company's stream of new inventions and products add to promising growth prospects. Boston Scientific is experiencing impressive growth in all of its segments and plans to launch key innovative products to capture untapped growth opportunities in high-growth markets.

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 in the recent past 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

Sound Advice is published monthly by S.A. Newsletters, LLC. ©2018 S.A. Newsletters, LLC. Editor: Gray Emerson Cardiff. Executive Editor: Linda Cardiff. Subscription rate: \$99 per year. Send subscription requests to: Sound Advice, 140 Town & Country Drive, Suite E, Danville, CA 94526. Phone: (925) 838-6710. Fax: (925) 838-0522. Information presented in Sound Advice may be used provided the newsletter—its name, address, and website—is mentioned as the source. The information contained herein has been carefully compiled from sources believed to be reliable, but accuracy cannot be guaranteed. When securities are initially recommended herein, the editors, affiliates, and associates of the editors do not have positions in such securities and are required to wait at least 2 business days from the date *Sound Advice* is posted before placing orders for them. After the initial recommendation, editors and staff members may own stock of any or all of the securities discussed herein. Gray Emerson Cardiff owns all of the stocks mentioned herein.

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

Both of our bank selections will benefit in 2018 from reduced tax rates and from rising interest rates. Our two choices are good values now.

JP Morgan Chase (JPM) will use its tax savings from its reduced effective tax rate to 19 percent to invest across all of their business sectors which will accelerate growth. The consensus is now \$8.78. 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) also expects its 2018 effective tax rate to drop to 19 percent, and is now 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) has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial rating. Although this is a premier growth stock, its P/E is still at a discount to the rest of the market.

AAPL has \$216 billion of overseas cash which is 25 percent of its market capitalization. A repatriation of that cash hoard is likely to spur investment in growth avenues inside the US as well as share buy-backs and dividend increases.

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 that are now leading to renewed growth. The 2017 Mobileye acquisition launched Intel into the burgeoning assisted-driving and autonomous vehicle arena, and extends to markets for autonomous ships, planes, drones, and a wide range of weapons.

These stronger growth prospects make INTC undervalued at its current price. The company has the size, diversity, and industry dominance to offer a relatively safe investment in a high-growth, and often high-risk business. Even at \$50 per share, the forward P/E is 14, substantially below the rest of the market. At a P/E of, say 18, which is still below the market, the stock price would be close to \$64. 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 a good value now. The company expects 2018 earnings to be at least \$13.80 per share. The stock is still selling at a P/E ratio substantially below the market. At \$160 per share, the stock is only 11.6 times earnings. A P/E ratio of 15 puts IBM above \$200 per share.

While we are waiting for growth, the \$6.00 annual dividend provides an attractive yield. IBM has increased its dividend each year, for the past 22 years. IBM still generates over \$12 billion of free cash flow each year, which can be used for continued investment, as well as share buybacks and dividends.

IBM is turning into a growth stock but it is not priced like one. Watson, IBM's super computer, is at the heart of IBM's new growth business which the company calls "Strategic Initiatives" which will soon account for one-half of the company. Watson is the closest thing to artificial intelligence because it can "think" like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient. Watson is behind IBM's booming cloud business, which had revenue growth of 24% in 2017.

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. Kroger is leading the race by rolling out its “Scan-Bag-Go” technology to over 400 stores this year. Walmart, which already has the technology in some stores is now testing the service in 120 more this year, and already has it in its 600 Sam’s Club stores. B.J.’s Wholesale Club has launched the service in a handful of stores and plans to add it to about 100 clubs this year. 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 an outstanding value, with a P/E currently below 12, which is 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 16, which is still a discount to the rest of the market, the stock belongs above \$50 per share.

Symantec (SYMC) is the world’s leading cyber security company offering organizations strategic, integrated solutions to defend against sophisticated attacks across endpoints, cloud, and infrastructure. Symantec operates

one of the world’s largest civilian cyber intelligence networks, allowing it to see and protect against the most advanced threats. Our mantra with this stock has been, “If there ever was a more certain growth industry, protection from cyber espionage is it.” Fourth quarter operating gross profit was up 15.5 percent and operating income surged 40 percent.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation. The company’s record high of \$2.54 billion backlog reveals a robust pipeline with major governmental organizations like the US Department of State, Environmental Protection Agency (EPA), US Army Corps of Engineers, and the US Air Force. TTEK has a very healthy balance sheet.

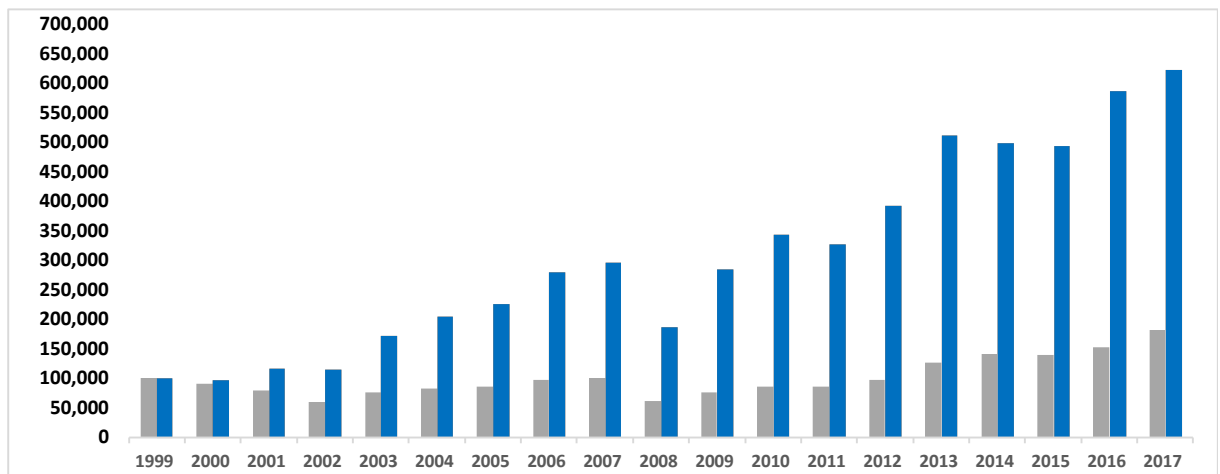
The company’s Water, Environment and Infrastructure segment revenues continued on a solid growth trajectory, benefiting from strong US federal and Infrastructure projects. Fiscal first quarter (fourth quarter calendar) reached a record high, and operating earnings per share of 81 cents were up 33 percent from a year ago.

Hedging the Portfolio

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

Sound Advice vs the S&P 500

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



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$3.02	0.00%	BUY	\$3.25
Chevron	CVX	\$114.04	3.93%	BUY	\$118.00
Fidelity Select Nat. Gas Fund *	FSNGX	\$21.65	0.57%	BUY	\$23.50
ICON Energy Fund Class S *	ICENX	\$11.27	0.48%	BUY	\$12.50
Valero	VLO	\$92.77	2.59%	BUY	\$96.00
Real Estate					
Hersha Hospitality Trust	HT	\$17.90	6.26%	BUY	\$19.00
RLJ Lodging Trust	RLJ	\$19.44	6.79%	BUY	\$23.00
Third Avenue Real Estate Value Investor *	TVRVX	\$33.08	0.49%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$27.32	0.00%	BUY	\$29.00
Stryker Corp.	SYK	\$160.92	1.06%	BUY	\$168.00
Tekla Life Sciences Fund	HQL	\$19.22	0.00%	BUY	\$21.00
Financials					
JP Morgan Chase	JPM	\$109.97	2.04%	BUY	\$119.00
Wells Fargo	WFC	\$52.41	2.98%	BUY	\$56.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	\$20.25	0.32%	BUY	\$22.00
Special Situations					
Apple	AAPL	\$167.78	1.36%	BUY	\$185.00
Intel	INTC	\$52.08	2.30%	BUY	\$54.00
International Business Machines	IBM	\$153.43	3.91%	BUY	\$163.00
NCR Corp	NCR	\$31.52	0.00%	BUY	\$35.00
Symantec	SYMC	\$25.85	1.08%	BUY	\$28.00
Tetra Tech	TTEK	\$48.95	0.82%	BUY	\$53.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$19.42	0.00%	BUY	\$22.50
ETF - ProShares Short 20+ Year Trsry	TBF	\$22.70	0.00%	BUY	\$23.50
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$36.27	0.00%	BUY	\$39.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$40.96	0.00%	BUY	\$43.00

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 \$15.5 million in stocks and to \$1.73 million in houses.

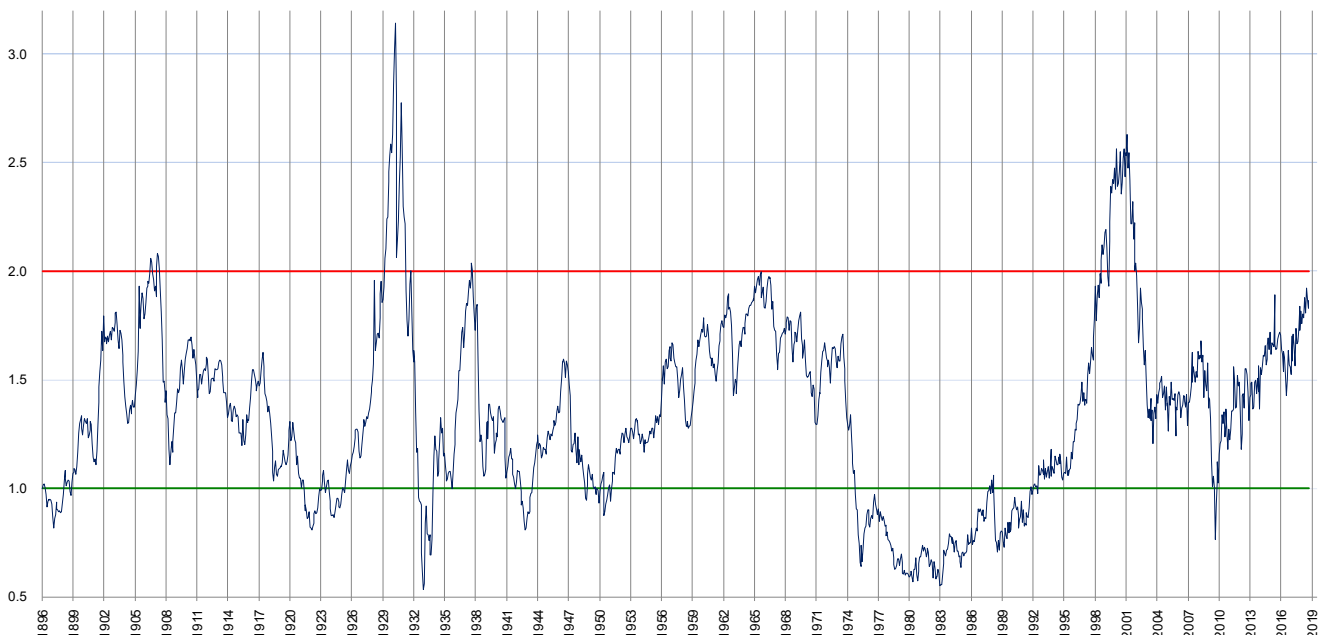
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the **SoundAdvice** Risk Indicator he would have made \$617 million, or 39.7 times more 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 \$324,900 for January, and with the S&P 500 at 2637.50 at the end of March, the SoundAdvice Risk Indicator reads 1.83, 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.

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 the Sound Advice Diffusion Index of Lagging Indicators to 100 percent. However, interest rates were held artificially low by the QE program. That has changed now. What was once quantitative easing has been reversed into quantitative tightening because 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 is a titanic reversal. The Fed's assets grew by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion, and now it is being reversed back to more normal levels. This means that we will no longer have a QE program holding interest rates artificially low.

Current Status

The **SoundAdvice** Diffusion Index of **LEADING Indicators** dropped to zero in September because of weakness in the employment and building permit components caused by the temporary impact of the hurricanes. While this was an official reversal of our Caution Signal, we did not change our cautious approach to the market because it is likely that this **Aggressive** signal will be reversed soon, as the affected area began to rebuild and hire the massive number of workers needed for rebuilding. Indeed, the leading indicators rebounded, pushing this Diffusion Index to 100 percent for February (the latest data).

As a result of this strength, the **SoundAdvice** Diffusion Index of **LAGGING Indicators** climbed to 100 percent for December, giving us a new Caution Signal in January. The lagging indicators continued to show strength in February, causing another 100 percent reading.

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%		3.1%

Now Available for Kindles and I pads



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

address below or type "The Science of Making Money in the Stock Market" into Amazon.com's search box: Only \$2.99 (Free for Kindle Unlimited). Free to share with friends and relatives.

<https://www.amazon.com/Science-Making-Money-Stock-Market/dp/153334471X/>

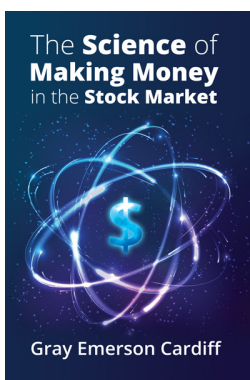
To Renew Your Subscription to SoundAdvice

Renew online: go to www.soundadvice-newsletter.com
or fax or mail in this renewal coupon order.

- * Top rated by Hulbert for the best track record in both up and down markets 2000-17
- * 10.5% annual return with Sound Advice versus 2.7% with the S&P 500

GREAT DEAL: 12 Month Renewal for \$99.

BEST DEAL: 24 Month Renewal for \$169.



With your renewal,
you will receive the latest edition of:

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 famous Risk Indicator, and exactly how they work so that you can update them yourself.



E-mail: _____
To receive your Printer-Friendly Issues and updates between Issues)

- Send me my Issues by regular mail. **Add \$25 (\$50 for two years) to cover printing and postage costs.** (But keep me posted by e-mail between Issues about important events.)

Phone (_____) _____ - _____ (In case we have a question about your order)

- Enclosed please find my check payable to: **SoundAdvice**

- Please charge my **Visa** or **MasterCard**: Card #: _____

Expiration Date: _____ Security Code: _____ (the 3 Digit Number on the back of your credit card)

SoundAdvice / 140 Town & Country Drive/ Suite E/ Danville, CA 94526
Fax 925-838-0522,
or call 800-866-0026

(cut along dotted line)