

## Tax Reform: Impact on Stocks



**Gray Emerson Cardiff, Editor**

The *Sound Advice* Portfolio is up 8.9 percent so far this year. We have an average profit of 72 percent based on the prices at which each position was recommended. We have been, and remain in a cautious and defensive mode.

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

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

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

In the closing days of September, the blueprint of the long-awaited tax overhaul plan was introduced. For us as investors, our job is not to be political, but to assess the ramifications of this tax package on the stock market as a whole, and on our holdings.

Although harder to quantify, the proposed changes in personal taxes are aimed at stimulating growth and are bound to benefit corporate earnings, to at least some degree. What is easier to quantify is the impact of the reduced maximum corporate tax from 35 percent to 20 percent.

Earlier this year, Michael Thompson, President and Chairman of Standard & Poor's Investment Advisory Services, estimated that every 1 percent decrease in the corporate tax rate would hypothetically contribute one percent to S&P 500's annual operating earnings.

Most companies do not pay at the highest tax bracket. The effective rate is estimated to be 25.6 percent for the companies in the S&P 500 index. This estimate, along with much of the information about to be presented, comes from Howard Silverblatt, a Senior Industry Analyst, Index Investment Strategy, for S&P Dow Jones Indices. Howard has a very illuminating spreadsheet that can be downloaded from the following address:

<https://us.spindices.com/documents/additional-material/sp-500-eps-est.xlsx>

With an effective rate estimated to be 25.6 percent for the S&P 500 index, the benefit of a reduction in the corporate tax rate to 20 percent would add 5.6 percent to the index earnings. The trailing 12-month (TTM) operating earnings for the S&P 500 is currently \$115.92 per share, so the benefit would be \$6.49 per share.

### Operating Versus Reported Earnings

There is a distinction that is worthy of a brief digression. Note that the above analysis used *operating* earnings for the S&P 500. *Operating* earnings are different from the *reported* earnings. *Reported* earnings are those on which we base our investment decisions, and are proper under GAAP – the Generally Accepted Accounting Principles. *Operating* earnings do not include unusual special charges for things like gains and losses on the sale of assets, or impairments on assets such as inventory, good will, contracts, or even on the value of a company's major assets, such as land, mineral rights, or oil leases.

Whenever considering a large group of companies, such as the 500 companies that make up the S&P 500 index, there are always special charges, at least on some of them. This is why *operating* earnings are usually 10 to 15 percent higher than the earnings that are actually reported. Moreover, GAAP does not define operating earnings, so it is left up to the management of an individual company to determine what is "unusual".

One of the most egregious examples of depending on *operating* earnings as a guide was during the 2008 financial crisis when there were massive losses on bad mortgage loans. Banks did not include in their *operating* earnings a significant portion of these losses because they were unusual. Although these loans were written off later, the profits were still included.

Today, most earnings projections are for *operating* earnings because they are

easier to project. While it makes sense to use operating earnings in the tax cut benefit analysis above, it is misleading to base other metrics on them, such as Price/Earnings (P/E) ratios. However, the media missuses this metric and invariably leaves out the term “operating” when quoting forward earnings projections, and Price/Earnings (P/E) ratios, based on those operating earnings.

As noted above, the *operating* TTM earnings for the S&P 500 is \$115.92 per share. However, the TTM “As Reported” earnings for the S&P 500 amount is \$104.02, which is a difference of 11.4 percent. This is significant. At a P/E of 24, this amounts to 285 points on the S&P 500 index.

### Anticipated or Not?

Of course, the question is how much of this tax cut benefit is already anticipated, and built into stock prices now.

Based on the *reported* earnings over the previous 12 months of \$104.02, and using an S&P 500 price of 2,500 (close to its current price), the TTM P/E of the S&P 500 is 24.03. Since the current recovery began in 2009, the TTM P/E ratio of the S&P 500 has averaged 19.0 (based on *reported* earnings), with a high of 24.34 and a low of 13.01.

Based on that context, we can say that today’s comparable P/E ratio of 24.03 is relatively high, indicating that the market is expecting good things to happen soon.

If we added the benefit of a corporate tax rate reduction to 20 percent, the TTM P/E ratio of the S&P 500 would be 22.6, which is still relatively high. Accordingly, the market is expecting even more good things.

### Earnings Projections

Prior to the announcement of the tax package, the S&P 500 reported earnings was projected to be \$123.04 for the next 12 months. The difference between these projected earnings and the current trailing twelve month (TTM) reported earnings is 18.3 percent. That is a steep growth rate, especially compared to recent history. The average year over year growth rate has been 6.56 percent since 2009.

However, if we assume this 12-month earnings projection materializes, the forward 12-month P/E ratio of the S&P 500 is 20.3, which is still higher than the average of 19.0 for the current recovery.

If we throw in the benefits from the corporate tax rate cut to 20 percent, we get an added benefit of \$7.66. (Based on 5.6 percent of the S&P 500 *operating* earnings projected for the next 12 months of \$135.86.) If we add that benefit to the projected reported earnings, we get a total of \$130.71. That is a forward P/E of 19.1, which is almost exactly the same as the average of 19.0 since 2009.

From this close match, we can conclude that the market is already anticipating both the projected earnings growth and the benefit of a corporate tax rate reduction to 20 percent.

### Reasons to be Cautious

It is not safe to bet on events that are already anticipated by the market. If the events actually happen, there is usually not much of a positive reaction because they were already anticipated. Of course, if they don’t happen, the disappointment will translate into sinking prices.

We must keep in mind that the market delivers returns in waves, and not in measured doses. We have already had a long wave up, and prices are historically high relative to *reported* earnings. (Don’t be misled by typical reports that the P/E on the S&P 500 is “only” around 18. That P/E is using the S&P 500 *operating* earnings of \$135.86 projected over the next 12 months.)

The current bull market will turn 103 months old on October 9. It is close to double the average length of the 12 bull markets in modern history (since WW II), and is second to the longest of 113 months, which lasted into March 2000. If our current bull market is to become the longest in history, we have another 10 months to go. Of course, we cannot bank on that.

While examining history, we are reminded of another fact: The end of all bull markets have one thing in common -- rising interest rates. The *Sound Advice* portfolio is currently designed with a cautious approach, as suggested by the “Caution” signal in force by the *Sound Advice* Diffusion Index of Lagging Indicators (page 11) which is telling us that the stage is set for rising interest rates.

We have another reason to be concerned about rising interest rates ahead.

### Getting Back to Normal

In late September, the Federal Reserve announced that, in October, it would start reducing its current inventory of \$2.8 trillion of Treasury bonds and \$1.8 trillion of mortgage-backed securities. This is a reversal of quantitative easing, and will amount to quantitative tightening.

Recall that the Federal Reserve instituted three massive rounds of “Quantitative Easing” (QE) programs to pull the economy out of the 2008-09 melt-down. These involved buying large quantities of Treasury bonds and mortgage-backed securities.

In addition to pumping new money into the economy, these purchases pushed up the prices of these securities which forced their yields down. The downward pressure on bond yields and interest rates also stimulated the financial markets. As the Federal Reserve purchased these Treasury bonds and mortgage-backed securities, they were added to the Fed’s balance sheet as assets. The Fed’s assets grew by more than 5 times, from under \$900 million in 2008 to \$4.6 trillion. All of that is about to be reversed.

The Fed’s holdings include a preponderance of longer term bonds. The reduction of the Federal Reserve’s long-term bond holdings will add a disproportionate amount of upward pressure to long-term bond yields. This means that upward pressure will be more pronounced on the long end of the yield

curve. This is important because our recommended ETFs for rising interest rates are based on long-term bond yields.

### ETFs for Rising Interest Rates

Our recommended ETFs are designed to benefit from the normalization of the Federal Reserve's balance sheet and increase in long-term bond yields from their current historically low levels. They differ in the amount of leverage used. You can choose among them depending on your investment objectives and risk tolerance.

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

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

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

The price action of these ETFs is based on the changes in long-term treasury 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 September meeting. As usual, there were differences in the predictions among this group of informed experts. The median prediction was that the Federal funds rate would be 1.375 percent at the end of 2017, 2.125 percent at the end of 2018, and 2.69 percent at the end of 2019. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same yields as today's real return), long-term Treasury bonds would be yielding 3.24% by the end of 2017, and 3.99% by the end of 2018, and 4.55% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$19.13 to \$23.36 by the end of 2017, to \$34.04 by the end of 2018, and to \$44.06 by the end of 2019.

TBT would rise from \$35.58 to \$40.65 by the end of 2017, to \$52.26 by the end of 2018, and to \$62.06 by the end of 2019.

TBF would rise from \$22.41 to \$23.65 by the end of 2017, to \$27.16 by the end of 2018, and to \$29.60 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, 0.04 percent (4 basis points) every day, and thus go nowhere through the end of 2017. By the end of 2017, TMV would decline to \$18.38 (3.9%), TBT would decline to \$34.75 (2.3%), and TBF would decline to \$22.19 (1.0%). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

### Energy & Natural Resource Selections

The US Energy Information Administration (EIA), the agency in charge of collecting data, projects that increasing demand through 2018 will absorb increasing production in the US oil patch. This outlook translates to flat oil prices for the foreseeable future. However, there are trends that should be beneficial to certain sectors of the industry, and our portfolio selections are selected with these in mind.

**Chesapeake Energy (CHK)** expects a 15 percent drop in third-quarter production because of Hurricane Harvey, which forced the company to stop work in the Eagle Ford shale region of Texas. To help the company hit its target of oil volumes averaging about 100,000 barrels per day in the quarter, the company expects to bring 120-130 new wells into production in the fourth quarter, mostly in the oil-focused Eagle Ford, and the coal-rich Powder River Basins.

Chesapeake has a portfolio of close to 8 million net acres of oil and gas assets inside the US, in the Powder River Basin, Eagle Ford, the Marcellus and Utica shale, along with the Haynesville/Bossier and Anadarko Basin regions. These large domestic assets make CHK well situated to participate in the resurgence of the US shale drilling boom. CHK has reported total earnings of 57 cents for the previous four quarters. The consensus is that CHK will earn 82 cents per share during the next four quarters. Based on the current price of CHK, the forward P/E ratio is close to 5 – very cheap. A forward P/E ratio of 10 puts the stock at \$8.2, nearly double the current price.

**Chevron (CVX)** announced in September that it plans to invest \$4 billion in a large, 1.5 million acre position in the prolific Permian Basin to boost its output by 400,000 barrels of oil per day in the next few years. This increase will add to other holdings that are set to increase production and revenue, 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. CVX is well-positioned to see earnings growth in the years ahead, along with an attractive dividend that management says is "sacrosanct."

**Chicago Bridge & Iron (CBI)** has recovered close to 70 percent since its drubbing following the surprisingly disappointing second quarter earnings report. CBI is expected

to show a loss of \$1.72 per share for 2017, primarily because of the losses reported in the first two quarters. Built into the 2017 expected loss are positive earnings expectations of 53 cents and 59 cents for the third and fourth quarters respectively. In 2018, the average consensus is that CBI will be back on track with earnings of \$2.27 per share.

Patrick Mullen took over as CEO on July 1 and is “resetting” the company culture by enhancing efficiency and risk management, optimizing interface management, and accelerating innovation. He is also focusing on driving growth by improving customer collaboration. In recent months, CBI has added to its backlog of contracts in the Middle-East, China, and central Asia, as well as a Phillips 66 storage terminal in Texas. The other primary objective is to strengthen the company’s balance sheet. The company has decided to sell its Technology business which will likely result in sale proceeds in excess of \$2 billion which, after taxes, could be used to virtually eliminate the company’s \$1.8 billion of debt. The intent is to negotiate a long-term strategic alliance with the ultimate buyer.

**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 \$51.50 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$3.00 for one million BTUs, 5.8 million BTUs will cost \$17.40. Thus, the same amount of energy is available for approximately 34 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart shows the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a

barrel of oil. The fact that natural gas provides energy for pennies on the dollar will translate into an expanding natural gas industry.

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

**Valero Energy (VLO)** announced in September that it entered into a joint venture with Magellan Midstream Partners to expand and develop the marine facility in Pasadena, Texas. Phase 1, which is expected to be operational by early 2019, consists of a storage terminal with a capacity of 1 million barrels, and a marine dock with the capacity to handle vessels with drafts up to 40 feet. The second phase, expected to be operational by early 2020, is planned to expand the storage capacity by 4 million barrels and one more marine dock. This dock would be capable of handling vessels with a 45-foot draft.

Both phases have long-term commitments in place from customers, and require an investment of \$820 million from each JV partner. This project is a significant step in improving VLO’s portfolio of logistics capabilities and its supply chain.

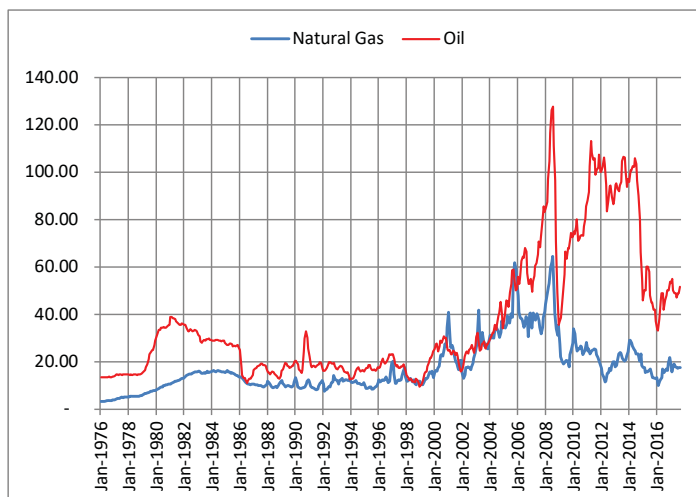
VLO began to climb as hurricane Harvey approached the Gulf coast and threatened the domestic hub of refineries located there. Although Valero has refineries in the region, the market saw a greater benefit to VLO coming from the damage to other refineries and the likelihood of widening crack spreads – the difference between the price of oil and the price of gasoline and other refined products. In the wake of the storm, crack spreads did indeed rise steeply (by 50 percent). VLO continued to climb as well.

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

Valero is well-positioned to take advantage of this conundrum because it has the flexibility to refine substantial quantities of both US light sweet as well as heavy sour crude. It also has access to the US pipeline network for delivery to its gulf coast locations.

This flexibility allows VLO to capture the highest margins among its competitors. It can take advantage of the best discounts for its feedstocks, whether it’s low or high-quality crude, or light sweet or heavy sour.

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



## Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	22.00	6.0%	10.8%	9413.79	38.62	-43.0%
Hospitality Properties	HPT	28.49	7.2%	10.3%	11,445.5	47.26	-39.7%
Hersha	HT	18.67	6.0%	8.8%	2,286.7	19.55	-4.5%
Host Hotels & Resorts	HST	18.49	4.3%	10.1%	22.2	26.30	-29.7%
Apple Hospitality	APLE	18.91	6.3%	8.0%	5,862.4	20.62	-8.3%

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

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

### Real Estate Selections

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

**Hersha Hospitality (HT)** has completed its upgrading cycle. As future quarters are included, the trailing income will include upgrades to the portfolio, which is bound to cause the net operating income and the net asset value to increase.

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

Based on the latest trailing four quarters’ financials, including the most recent 2017 second quarter, and using a 7.5 percent cap rate to evaluate the company’s real estate portfolio, we value HT at \$19.55 per share which is higher than the current price. The dividend yield is attractive and lowers the risk profile.

**RLJ Lodging Trust (RLJ)** is selling at a steeper discount to its hotel assets than HT. Based on the latest trailing four quarters’ financials reported, including the most recent 2017 second quarter, and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value RLJ at \$38.62 per share which is considerably higher than the current price. The high dividend yield is attractive and lowers the risk profile.

RLJ completed its merger with FelCor Lodging Trust which gave RLJ a stronger presence across the United States and will save roughly \$22 million from the elimination of duplicative corporate general and administrative costs.

**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.

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

### Medically-Related Selections

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

**Boston Scientific (BSX)** launched in September the *Resonate* family of implantable cardioverter defibrillator (ICD) and cardiac resynchronization therapy defibrillator

(CRT-D) systems to improve heart failure management. These implantable devices alert physicians of worsening heart failure by combining data from heart sensors with the ability to provide weeks of advance notice of an impending heart failure event, giving physicians the ability to pivot from reactive heart failure treatment to proactive care.

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

**Stryker (SYK)** is assured continued growth by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase (and obesity trends continue), more and more hip, knee, and spinal procedures will be needed. Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions.

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

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

### Financials

Banks will benefit from rising interest rates, as long as they are fiscally fit. The Federal Reserve's most recent "Stress Test" on US banks revealed that US banks have sufficient levels of capital to weather severe situations similar to those of the 2008-09 melt-down. Our two recommended banks were given the stamp of approval to proceed with their respective dividend increases and share buyback programs.

**JP Morgan Chase (JPM)** has a strong balance sheet. As a result of passing the latest Federal Reserve Stress Test, JPM increased its quarterly dividend to 56 cents per share and is proceeding with a \$19.4 billion share buyback program. JPM is benefitting from strong loan growth.

The earnings estimate for 2017 is \$6.82 per share. Strong growth is expected in the immediate years ahead. JPM is

expected to earn \$7.72 per share in 2018. At a forward P/E ratio of 15, JPM would be \$116 by the end of 2018. JPM is still currently cheap in comparison to the rest of the market.

**Wells Fargo (WFC)** increased its quarterly dividend to 39 cents per share and is proceeding with its \$11.5 billion share buyback program after passing the latest Stress Test. Earnings are expected to be \$4.16 per share in 2017, and \$4.48 per share for 2018. At a P/E ratio of 15, WFC would be \$67 in 2018.

### 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)** unveiled a number of new devices in September, most notably its premium smartphone, dubbed the iPhone X, will retail at a relatively high price point, beginning at \$999. With the global market booming, there is expected to be plenty of demand for the iPhone X. This product also establishes a foundation for Apple to enter the frontier of augmented and virtual reality. The iPhone X series are bound to produce very high gross margins.

The more affordable iPhone 8 and 8 Plus are aimed at the mainstream market. These new iPhones inaugurate a badly-needed upgrade cycle. The iPhone 8 will likely account for most of customer upgrades in the coming quarters, both in the US and in the Chinese market.

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Earnings are widely estimated to grow at double-digit rates for the next few years, stemming from direct iPhone sales, a booming services business, along with new additions to the Apple Watch and Apple TV programs.

The company has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial rating. Earnings growth should also lead to dividend increases and more stock buy-backs.

**Conduent (CNDT)** is no longer presenting a good risk/reward profile, and we recommend selling this stock. Earnings are expected to amount to 85 cents during the upcoming four quarters, which puts the forward P/E ratio close to 20. This is a high P/E by most standards and only deserving of the most predictable and highest growth companies. The current P/E ratio already anticipates high growth, which may not happen, at least to the expected degree, raising prospects for disappointments.

**Intel (INTC)** has moved up slightly since we recommended it last month. This well-established leader in micro-processing chip innovation and production has extensive research and development (R&D), which gives it a one to two year lead over the rest of the chip industry.

In late September, Tesla announced that it will be using Intel's chips instead of those from Nvidia to power its massive infotainment console. The new Model 3 and new versions of Tesla's Model X and Model S will rely on the Intel chips. Tesla is also considering switching to Intel's chips for its Autopilot system.

Based on the company's 2017 earnings guidance of \$3.00 per share, the current price/earnings (P/E) ratio is close to 12, which is a low P/E by itself, and considerably below the rest of the market. The current dividend yield is also above 3%, which lowers the risk profile, and is even more than the yield on 30-year Treasury bonds.

The company has been making significant changes that are now leading to renewed growth, and is bound to generate stronger growth in the foreseeable future. These stronger growth prospects make INTC under-valued at its current price.

Emerging growth became visible in the second quarter earnings report, with overall sales up 9 percent on increasing revenue.

The other significant acquisition is for Mobileye, a leading provider of assisted-driving software. Management expects Mobileye's revenues to have an immediate positive effect on Intel's earnings. As in the Altera acquisition, Intel is planning to leverage Mobileye's technology with Intel's, providing a boost to most of Intel's business sectors.

The Mobileye acquisition launches 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.

In addition to its acquisitions for synergistic technology,

Intel is investing heavily in artificial intelligence (AI), and has begun offering products from its AI Products Group.

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

**International Business Machines (IBM)** announced in late September its new

Integrated Analytics System, a new unified data system designed to give users fast, easy access to advanced data science capabilities and the ability to work with their data across private, public or hybrid cloud environments. The architecture of the new system combines software enhancements and supports a wide range of IBM data services, including the Watson Data Platform.

IBM is not priced like a growth stock, but it is turning into one. Watson, the Company's super computer, is the closest thing to artificial intelligence because it can "think" like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient. IBM is the leader in that field and on a solid path to provide a growing abundance of opportunities in the months and years ahead.

The company expects 2017 earnings to be \$13.80 per share, which is in line with the consensus of analysts. IBM is a good value now. The \$6.00 annual dividend provides a dividend close to 4 percent and puts a floor under the stock because the yield would become even greater if the price of the stock declined. The stock is selling at a P/E ratio substantially below the market. A P/E ratio of 15 puts the stock above \$200 per share.

**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.

The company's 2017 earnings guidance is in the range of \$3.32–\$3.42 per share. At a P/E ratio of 15, the stock belongs close to \$50 per share.

**Symantec (SYMC)** is likely to benefit from the Equifax cybersecurity breach that could impact 143 million U.S. consumers, which equates to roughly 44% of the U.S. population. This is because Symantec now owns LifeLock which protects against identity theft. Our mantra with this stock has been "If there ever was a more certain growth industry, protection from cyber espionage is it."

The Equifax’s breach occurred between mid-May and July when names, Social Security numbers, birth dates, addresses and driver’s license numbers were stolen from the database. This data has no shelf life, unlike credit card numbers which can be cancelled.

Equifax also offers a number of credit monitoring and identity-theft protection services which are similarly priced to LifeLock. The LifeLock plans not only include real-time credit monitoring, but also provide liability compensation and other services.

Symantec 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.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation. The acquisitions of Coffey and INDUS corporations have swelled TTEK’s backlog of contracts and increased prospects for more Federal contracts in the IT sector. The company’s backlog is now \$2.3 billion, which 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, which should continue to bolster growth. TTEK has a very healthy balance sheet.

**Xerox (XRX)** has new separate leadership and goals which is bound to translate into better focus execution. CEO, Jeff Jacobson, is bringing a new enthusiastic corporate culture and a three-year strategy for growth by

rolling out 29 new products aimed at mid-size companies which are stronger growth targets than large-scale businesses. An area of focus is “smart-label” technology directed at food and drug companies. Smart labels are printed electronic circuits that allow items to be identified and tracked in real time. They can be produced for a fraction of the cost of silicon sensors and used on small packages. This is a wide-open and high-growth market.

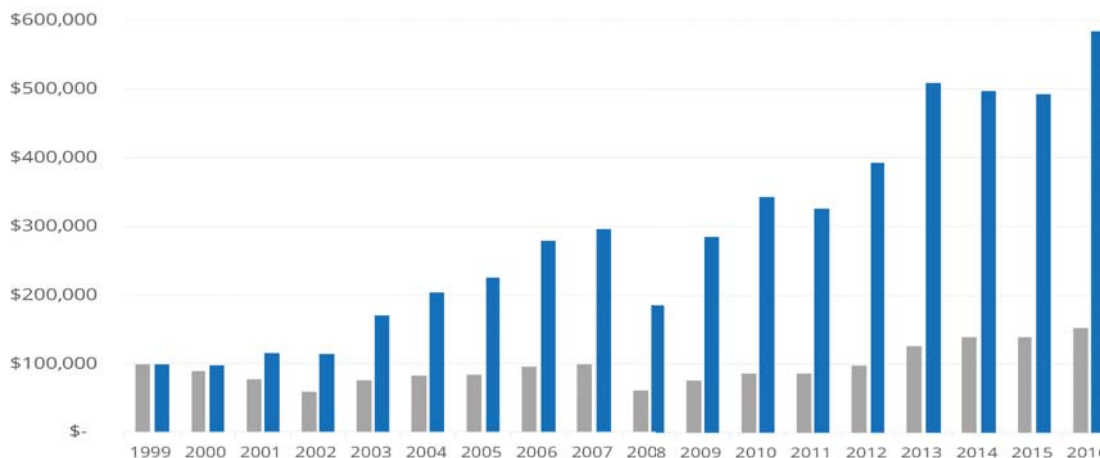
XRX is still cheap relative to the rest of the market, especially with new growth paths to be implemented under the watchful eyes of Carl Icahn who holds 9.77 percent of the stock. The company’s full year 2017 earnings guidance is from \$3.20 to \$3.50. At the current stock price, the price/earnings ratio is below 10 which is substantially below the market average. The dividend yield is also attractive.

### Hedging the Portfolio

Our **SoundAdvice Diffusion Index of LAGGING Indicators** (page 11) is warning us to be cautious. Accordingly, we are also recommending a reverse ETF that essentially short-sells the market and will benefit from down-drafts in the S&P 500.

The **ProShares UltraShort S&P 500 (SDS)** 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 \$152,379, versus \$100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to \$584,161.

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$4.30	0.00%	BUY	\$5.50
Chevron	CVX	\$117.50	3.68%	BUY	\$120.00
Chicago Bridge & Iron	CBI	\$16.80	0.00%	BUY	\$19.00
Fidelity Select Nat. Gas Fund	FSNGX	\$24.43	0.51%	BUY	\$28.00
ICON Energy Fund Class S	ICENX	\$12.53	0.43%	BUY	\$14.50
Valero	VLO	\$76.93	3.12%	BUY	\$79.00
Real Estate					
Hersha Hospitality Trust	HT	\$18.67	6.00%	BUY	\$20.00
RLJ Lodging Trust	RLJ	\$22.00	6.00%	BUY	\$24.00
Third Avenue Real Estate Value Investor	TVRVX	\$34.07	0.48%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$29.17	0.00%	BUY	\$30.00
Stryker Corp.	SYK	\$142.02	1.20%	BUY	\$150.00
Tekla Life Sciences Fund	HQL	\$21.48	0.00%	BUY	\$24.00
Financials					
JP Morgan Chase	JPM	\$95.51	2.35%	BUY	\$98.00
Wells Fargo	WFC	\$55.15	2.83%	BUY	\$57.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$23.01	0.28%	BUY	\$24.00
Special Situations					
Apple	AAPL	\$154.12	1.48%	BUY	\$165.00
<b>Conduent</b>	<b>CNDT</b>	<b>\$15.67</b>	<b>0.00%</b>	<b>SELL</b>	
<b>Intel</b>	<b>INTC</b>	<b>\$38.08</b>	<b>2.86%</b>	<b>BUY</b>	<b>\$40.00</b>
International Business Machines	IBM	\$145.08	4.14%	BUY	\$160.00
NCR Corp	NCR	\$37.52	0.00%	BUY	\$40.00
Symantec	SYMC	\$32.81	0.98%	BUY	\$37.00
Tetra Tech	TTEK	\$46.55	0.77%	BUY	\$48.00
Xerox	XRX	\$33.29	0.84%	BUY	\$35.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$19.13	0.00%	BUY	\$25.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$22.41	0.00%	BUY	\$26.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$35.58	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$46.65	0.00%	BUY	\$56.00

**Notes to the table:** The right hand column is the highest recommended price limit for purchases. Prices are as of 9/29/2017. See our website for live pricing and buy limits:

<http://www.soundadvice-newsletter.com/members>

**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 \$14.7 million in stocks and to \$1.7 million in houses.

### The New York Times

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

But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$585 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. **The latest reading is 1.81.** This reading reveals that stock prices are above average in relation to house prices.

## 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.

We have been operating under a "Caution" signal since June 2015. Since then, the Fed's Quantitative Easing program has been keeping interest rates artificially low. However, that program has been reversed now that the Fed is selling its bonds to reduce its balance sheet.

**The SoundAdvice Diffusion Index of LAGGING Indicators was 66.7 percent in August (the most recent data).**

Our next signal will come from the SoundAdvice Diffusion Index of **LEADING Indicators** when it drops to zero. **The latest reading was 33.3 Percent.**

### 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
Ave +/-	32.1%		3.8%



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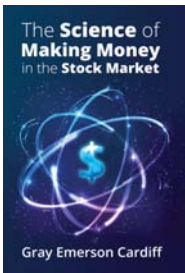
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