SoundAdvice

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Looking Ahead into 2019

For the first time in nearly a decade, 2018 saw a change in the weather on Wall Street. A blustery storm arrived near the end of the year, ushering in an alarming disturbance and sending stocks hovering on the brink of a bear market. In early 2018, our *Sound Advice* indicators enabled us to see what was ahead for the year, and we can use them again now to project the most likely scenario ahead for 2019.

At the beginning of 2018, we advised that a storm was coming. The February 2, 2018, issue of *Sound Advice* was called *Caution: Storm Warning*. We recommended that you should have a substantial amount of cash on the sidelines and wait for a substantial correction.

The *Sound Advice* Indicators

On January 25, 2018, the Conference Board released its leading and lagging economic indicators, which caused our *Sound Advice* Diffusion Index of Lagging Indicators (page 11) to switch to a Caution Signal. The next day the S&P 500 peaked at 2,872.87 and a 10 percent correction followed.

Then in July, the *Sound Advice* Risk Indicator (page 10) climbed over 2.0. A reading over 2.0 had only happened five times in the last 123 years. In each of the five previous times, this reading marked the beginning of a major peak in the stock market – in 1906, 1928, 1937, 1965, and 1998. Stock prices often stayed high for many months, sometimes even a couple of years. However, in all cases, it marked the beginning of a major top. This time the market peak was within three months. A substantial correction followed, bringing stocks down 20 percent which qualifies as a bear market.

Our Risk Indicator told us that stocks were a high-risk investment. Throughout modern history the Risk Indicator has been like a pendulum, swinging from high-risk times (above a reading of 2.0) to low risk times (below readings of 1.0). The swings usually take many years. However, during these swings in both directions there have been very profitable bull markets, which have been detected by our Diffusion Indexes.

Gray Emerson Cardiff, Editor

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

From 2000-2018

9.6% Annually versus.

2.8% from the S&P 500

The Next Signal

Our next bull market signal will come from our Diffusion Index of Leading Indicators. This happens when the economy softens sufficiently to bring down interest rates. We can already see this happening in the rest of the world, especially in China and Europe. The growth of the US economy is not immune to the rest of the world, and the fear of a slowdown here has been a primary factor in undermining US stocks recently. The Federal Reserve increased the federal funds rate at its December 19 meeting because there are no current signs of weakness in the US economy. However, the Federal Reserve said it now expects to increase interest rates fewer times in 2019.

When we see a zero reading from our Diffusion Index of Leading Indicators, we can expect a major upswing in stock prices. As usual, the atmosphere will be scary, and stocks will have been battered. Until then, we are continuing to recommend that you have a substantial amount of cash on the sidelines. Our portfolio recommendations are made regarding the money you have allocated to the stock market, and in accordance with our current cautionary mode. We believe that they are exceptionally strong values, trading at a significant discount to the rest of the market, which should give them buoyancy in both good and bad market conditions over the longer term.

Hedging Pays

ProShares UltraShort S&P 500 (SDS) was the best performing position in our portfolio since the last issue. In fact, it was the only positive return out of all the positions, bringing in an 18.3 percent return for the month.

Until we get our next signal from the Diffusion Index of Leading Indicators, we will be in a Caution mode, and we continue to recommend hedging your portfolio with this is a reverse ETF. It essentially short-sells the market and will benefit from down-drafts in the S&P 500. It is designed to produce two times the daily fluctuations of the S&P 500 index. A decline of say, 1.0 percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it is performing as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

Energy & Natural Resource Selections

US oil producers produced a record 11 million barrels per day in 2018, 16 percent higher than 2017. The US became the largest oil producer in the world, outpacing Saudi Arabia and Russia. Now that large oil firms have begun drilling for shale, production is projected to rise another 11 percent in 2019.

Of course, the added supply has forced oil prices down. One to 1.5 million barrels a day was supposed to be choked off world markets by US sanctions against Iran after November 4, but the sanctions were delayed at the last minute by 180-day waivers for China, India, Greece, Italy, Taiwan, Japan, Turkey, and South Korea.

The drop of oil prices caused a significant retreat in the prices of our energy and natural resource portfolio selections. However, the oil market is likely to stabilize during the next four months as the end of the waivers approaches.

Beyond the end of the waivers, the curtailment of international investment will lead to a significant reduction of Iran's natural gas output for many years because Iran does not have the expertise to develop its resources alone. Another supply restriction comes from the economic meltdown in Venezuela, which has the world's largest oil reserves. Production there has fallen to 1.2 million barrels a day today from 3.2 million barrels in 2006.

The oil price drop is causing smaller shale producers to cut back their 2019 budgets. There is also pressure on Saudi Arabia to reduce production because it needs $83 a barrel to support its public spending.

The US just became a net exporter of oil, which will also help alleviate the over-supply of oil. We are still importing nearly half of our oil needs because most US refineries were constructed prior to the US shale boom and designed to process imported crude oil which is a heavy (thick) and sour (high sulfur) grade. 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 supplies. Meanwhile, US storage tanks in Cushing, Oklahoma, are brimming with the light sweet crude fracked from US shale and is available for importing.

For the above reasons, the worst of the glut should be behind us. The stabilization of the global oil market is bound to translate to recoveries in this sector in the months ahead.

Adams Natural Resources (PEO) was added to the portfolio in our early December email update. It is replacing the **ICON Energy Fund Class S (ICENX)** as a diversified way to participate in the expansion of the energy sector with a basket of substantial companies.

Unlike an open-end fund like ICENX, that can only be bought and sold after the market closes at its net asset value (NAV), PEO is a closed-end fund, which means it trades like a stock and can be bought and sold during market hours. The price of PEO is not tied directly to the NAV of the underlying portfolio, so it can trade at a discount or a premium. This is an advantage now because PEO is currently trading at a substantial discount to its NAV. Although PEO has typically traded at a discount over the last several years, the discount now is as large as it gets, at 16.8 percent. In addition, PEO also has a lower expense

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ratio of 0.78 percent, versus the industry average of 1.14 percent.

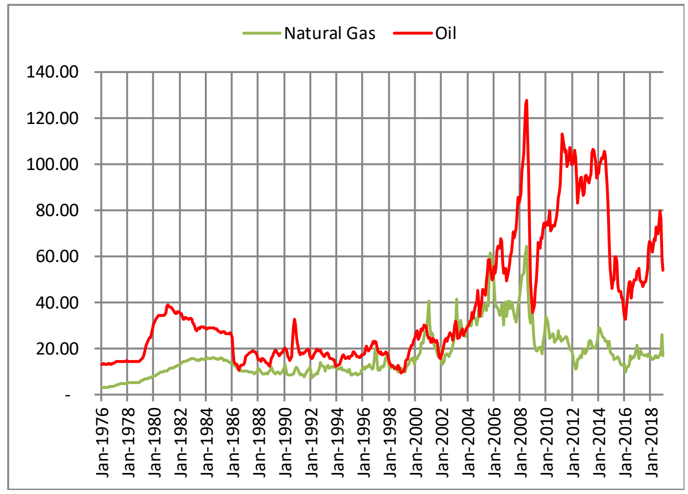
The management of PEO is effective, headed by Greg Buckley and Mike Kijesky, both of whom have close to 20 years or more of experience managing energy equities. Prior to joining Adams Funds 9 years ago, Mr. Kijesky was an Equity Analyst and Portfolio Manager at both McHugh Associates and Cutler & Company, LLC. Mike also has considerable corporate experience, having worked at Air Products & Chemicals, Inc., and Rohm & Haas Company. Greg Buckley began covering the energy sector in 1999. Prior to joining Adams Funds 5 years ago, Mr. Buckley worked at BNP Paribas as an Equity Analyst and Portfolio Manager. His past experience also includes managing a long/short Energy fund at Citadel LLC and working as an Energy Analyst at Pioneer Investments.

PEO is a candidate for steady income. This fund has been in operation since 1929 and has 80+ years of distribution history. PEO has an objective and recent history of making quarterly distributions that add up to at least 6 percent annually. These distributions are usually a mix of dividends and long-term capital gains. Occasionally the distributions contain a portion of a return of capital in order to meet the 6 percent goal. In 2018, PEO distributed $1.17 per share which was comprised of 43 cents dividend income, 39 cents long-term capital gains, and 35 cents return of capital.

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the growth of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. However, with the current market price for natural gas at $2.69 for one million BTUs, 5.8 million BTUs will cost $17.17. Thus, with a barrel of Brent crude oil costing $54, the same amount of energy is available for approximately 32 cents on the dollar if it is in the form of natural gas rather than oil.

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

The Cost of Energy Equivalents of Oil and Natural Gas



Chesapeake Energy (CHK) will see production double during the next two years if the proposed acquisition of WildHorse Resource Development closes in 2019. The increase in cash flow, along with the $1.9 billion sale of its Utica shale assets, will help pay down debt.

For 2018, CHK is expected to earn 85 cents per share. At the current stock price, the price/earnings P/E ratio is astonishingly low. Evidently one of the company's Directors, Archie Dunning, agrees because he purchased 2.1 million shares on December 21.

Chevron (CVX) is the largest oil producer in the US from low-cost oil assets. In addition to its (downstream) oil and gas production, Chevron also refines products. The refining operations (upstream) tend to benefit from lower oil prices while the downstream production benefits from rising prices. This diversification adds financial stability during times of volatile oil prices.

CVX has an attractive annual dividend of $4.48 per share. The company's dividend is sacrosanct and has a history of increasing annually through thick and thin. At a price of $50 per barrel of oil, because of its diversified and low-cost operations, Chevron can generate enough cash to pay the current dividend, fund its capital spending plan, and buy back some of its stock which is planned at $3 billion per year.

Valero Energy (VLO) 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

We continue to be selective when choosing real estate stocks because commercial real estate prices are historically high as low interest rates have pushed down real estate capitalization (cap) rates to historically low levels (like bond yields). The *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now.

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

Both of our selected hospitality REITs have reported several hotel transactions in recent years at cap rates ranging from 4.9 to 6 percent. Hersha recently sold the Hyatt House in Gaithersburg MD, and the Holiday Inn Express in Chester NY, at a combined capitalization rate of 4.9 percent. So far this year, RLJ sold three legacy FelCor assets: the Fairmont Copley Plaza in Boston, the Embassy Suites Marlborough, and the Philadelphia Sheraton Society Hill, for a capitalization rate close to 6 percent. The Philadelphia Sheraton was also sold for $95.5 million, a 5.6% cap rate.

To be conservative and to anticipate a rise in capitalization (cap) rates along with interest rates in general, we use a cap rate of 7.0 percent for valuation purposes.

Hersha Hospitality (HT) is worth $26.64 per share which is substantially greater than the current price of the stock. This value should be a conservative estimate because Hersha's two premier hotels in Miami, the Courtyard Cadillac Hotel and the Parrot Key Hotel, were closed because of Hurricane Irma. Bringing them back on line will add substantially to revenues in the next four quarters. The Cadillac Hotel was opened three months ago and has performed very well, pacing 50% higher room revenue than in 2016. The 148-room Parrot Key Hotel & Villas opened in December after an extensive renovation and will ramp up into the high season in Key West.

In December, the Board of Trustees authorized a

Hospitality REITs Comparison Table

Company	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7% Cap Rate ($Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	16.40	8.0%	11.4%	8,174	34.49	-52.5%
Hersha	HT	17.54	6.4%	8.2%	2,466	26.64	-34.2%
Hospitality Properties	HPT	23.88	8.5%	10.6%	11,775	48.26	-50.5%
Host Hotels & Resorts	HST	16.67	4.8%	11.2%	24	28.56	-41.6%
Apple Hospitality	APLE	14.26	8.4%	10.2%	6,628	23.25	-38.7%

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 7.0 percent, which is close to the average cap rate on recent hotel transactions. The last column shows the discount or premium at which the stock is trading based on a 7.0 percent cap rate valuation of each company's real estate portfolio.

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

new share repurchase program of up to $50 million of HT's outstanding common shares in 2019.

RLJ Lodging Trust (RLJ) is worth $34.49 per share which is also substantially higher than the current price. We anticipate improvement in net operating income (and thus the value of the stock) because of the company's mission to sell its non-core assets since the merger with FelCor, and to renovate and upgrade significant properties, including the Louisville Marriott Downtown, one of Louisville's largest hotels with 616 rooms which is in the final stretches of a $30 million renovation.

Third Avenue Real Estate Value Investor Fund (TVRVX) distributed $2.64 in December, $2.23 of which was a long-term capital gain and the balance was a dividend.

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.

This fund 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.

Medically-Related Selections

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

The company has made acquisitions that have added numerous products with significant growth potential, including Claret Medical, VENITI and Augmenix. All of these are leaders in high-growth markets and will enhance the company's category leadership strategy and leverage existing capabilities.

The recent takeover of Millipede is another strategic fit because it is synergistic with Boston Scientific's heart-valve repair and replacement segment. Millipede's IRIS Transcatheter Annuloplasty Ring System can meet the needs of a currently underserved patient population that requires less invasive options to treat functional mitral regurgitation in patients with progressive heart failure.

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

The company's strong balance sheet allows it to make strategic acquisitions, many of which are coming to fruition, including the 2016 acquisition of Mako's surgical robots which are now being used in the majority of knee surgeries. With nearly 600 surgical robots around the world, Stryker's robotic surgical system has become the first complete robotic technology used for knee and hip replacement procedures.

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

Bank stocks have been weak because of the fears of slowing economic growth and the resulting decline of interest rates. Our two selections have not been immune and have become astonishing values.

JP Morgan Chase (JPM) is expected to announce earnings on January 11 of $2.23 for the quarter. JPM is still expected to earn $9.25 for 2018, an increase of 34 percent over the previous year. JPM is very cheap in comparison to the rest of the market. At the relatively modest P/E ratio of, say 13, JPM would be $120 which is substantially above the current stock price.

Wells Fargo (WFC) is also currently cheap in comparison to the rest of the market. WFC is expected to earn $4.50 in 2018. At a P/E ratio of 13, WFC would be $58.50, substantially above the current stock price.

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) distributed $2.05 in December, $1.98 of which was a long-term capital gain and the balance was a short-term capital gain.

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 turned into a value stock, especially in view of the $237 billion in cash in the company's coffers. This amounts to $47.42 per share. Subtracting this cash from $160 per share means we are actually paying $112.58 per share for the company. Earnings were $11.91 for the year that ended in September, which means we are paying a P/E of less than 10 for one of the premiere growth companies in the country.

Carnival Cruise Lines (CCL) announced earnings in late December of 70 cents per share, which exceeded expectations. For the year, CCL reported earnings of $4.44 per share on revenue of $18.9 billion.

Along with the favorable earnings report, the company gave a disappointing earnings outlook, citing unfavorable changes in fuel prices and currency exchange rates that are expected to shave 3 cents per share off earnings in the current quarter ending in March. The company expects 2019 earnings to range from $4.50 to $4.80 per share, which puts the forward price/earnings (P/E) ratio close to 14. During the last 5 years, the median P/E has been 19.

In November, construction began on its latest class of ship that will offer 5,200 berths and operate on liquefied natural gas (LNG). To meet growing demand, the company is scheduled to receive 18 new ships between 2018 and 2022. In addition to increasing the advantages of scale, a newer fleet will command higher fares because of an improved mix of guest accommodations and a wide range of onboard amenities and features. These new ships are more fuel efficient, with many running on liquified natural gas (LNG). Some of the new ships will replace older ships in the fleet.

CCL is a good value, especially when compared to the rest of the market. Growth prospects are strong because of the company's dominance in the industry, efficiencies of scale, and favorable demographic trends driving a lasting increase in demand.

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

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

Intel is now the beneficiary of all of Apple's modem business, which means that all of Apple's iPhones use Intel's modems exclusively. The third quarter's earnings reflected a 130 percent jump in Intel's cellular modem sales over the same quarter last year.

This has prompted improving earnings estimates from a consensus of $4.13 per share to $4.53 per share, an increase of close to 10 percent. Stronger growth prospects make INTC under-valued at its current price because it deserves a higher P/E. The current P/E is close to 10 which typically characterizes a company with poor growth prospects. At a P/E of say,15, which is closer to the rest of the market, the stock price would be $68 per share.

International Business Machines (IBM) is a growth stock but is not priced like one. The growth portion of the company is more than half of the company's revenue from its so-called "Strategic Imperatives" which includes cloud-computing revenue, analytics, mobile and security. Within those imperatives is IBM's cognitive-solutions segment, which includes software, analytics and its artificial intelligence platform, it calls "Watson", which can "think" like a human. Watson works in ten industries, including agriculture, customer service, human resources, gold mining, supply chain, manufacturing, building management, automotive, marketing and advertising.

The company still expects its 2018 earnings to be "at least $13.80 per share", giving the stock a price/earnings ratio below 10, far below the rest of the market. The $6.00 per share dividend now provides a yield of 5 percent. This is a good time to invest in this long-term growth company at a good value.

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

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

In December, NCR purchased JetPay, which will enable the addition of cloud-based payments platform point-of-sale terminals for retail and hospitality. The acquisition will help the company expand its market and diversify revenue streams toward more software services and recurring revenue.

NCR remains a good value. The Company confirmed its 2018 earnings per share estimate of $2.55 to $2.75. This puts the current P/E under 10, a considerable discount to the rest of the market.

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

ETFs for Rising Bond Yields

Fears of an economic slowdown ahead have also undermined our recommended ETFs, designed to benefit from an increase in long-term bond yields. However, long term interest rates remain historically low and are bound to be moving up in the months and years ahead.

These 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 bond indexes, only in the opposite direction, and then multiplied by the leverage each ETF uses. For example, a decline of say, 1.0 percent in their respective benchmark bond indexes will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent.

The Dot Plot

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

The most recent dot plot was taken at the December 19 meeting. The median prediction from the members was that the Federal funds rate would be 2.875 percent by the end of 2019.

We are using the Fed's dot plots of Federal funds as a means to predict changes in long-term interest rates under the assumption that long-term interest rates will move in tandem with them. This should prove to be a conservative assumption because today's yield curve (the difference between short and long-term interest rates) is unusually flat, offering very little additional yield on longer term bonds. However, in the spirit of trying to be conservative, we can assume that the yield curve will remain as flat as it is today, which means that long-term Treasury bond yields move in accordance with the dot plot and will not rise any faster. Accordingly, long-term Treasury bond yields would climb from 3.02 percent currently to 3.52 percent by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from $18.23 to $23.58 by the end of 2019.

TBT would rise from $35.15 to $41.71 by the end of 2019.

TBF would rise from $22.39 to $24.40 by the end of 2019.

These projections should prove to be conservative because the Federal Reserve has become a seller of Treasuries rather than a large buyer, as it reverses into quantitative tightening after many years of quantitative easing. During quantitative easing, the Federal Reserve's portfolio of Treasuries swelled by more than 5 times, from under $900 billion in 2008 to $4.6 trillion. The Federal Reserve has a long way to go to get back to normal.

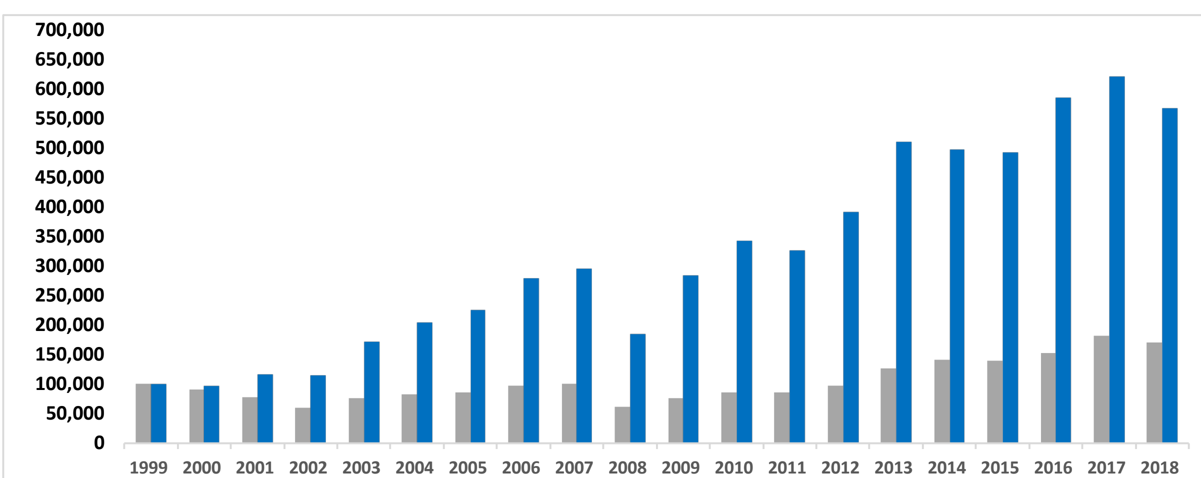
The Federal Reserve's swollen Treasury bond portfolio has a surfeit of longer-term bonds. That means that the reduction of its Treasury holdings will add a disproportionate amount of upward pressure to long-term bond yields.

The Erosion Factor

As we point out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.03 percentage points (3 basis points) every day, and thus go nowhere. By the end of 2019, TMV would decline to $17.23 (5.5 percent), TBT would decline to $34.08 (3.0 percent), and TBF would decline to $22.13 (1.2 percent). While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Sound Advice vs the S&P 500

This chart shows the growth of $100,000 invested in the S&P 500 (in gray), which would have grown to $170,645, versus $100,000 invested in the *Sound Advice* recommendations (in blue), which would have grown to $566,867.



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

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Adams Natural Resource Fund	PEO	$14.57	6.00%	BUY	$15.50
Chesapeake Energy Corp	CHK	$2.10	0.00%	BUY	$2.50
Chevron	CVX	$108.79	4.12%	BUY	$112.00
Fidelity Select Nat. Gas Fund *	FSNGX	$17.66	0.70%	BUY	$19.00
Valero	VLO	$74.97	4.27%	BUY	$79.00
Real Estate					
Hersha Hospitality Trust	HT	$17.54	6.39%	BUY	$19.00
RLJ Lodging Trust	RLJ	$16.40	8.05%	BUY	$18.00
Third Avenue Real Estate Value Investor *	TVRVX	$24.56	0.66%	BUY	$27.00
Medically Related					
Boston Scientific	BSX	$35.34	0.00%	BUY	$37.00
Stryker Corp.	SYK	$156.75	1.33%	BUY	$162.00
Tekla Life Sciences Fund	HQL	$15.11	0.00%	BUY	$16.00
Financials					
JP Morgan Chase	JPM	$97.62	3.28%	BUY	$102.00
Wells Fargo	WFC	$46.08	3.73%	BUY	$48.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund *	TVSVX	$15.84	0.41%	BUY	$18.00
Special Situations					
Apple	AAPL	$157.74	1.85%	BUY	$160.00
Carnival Cruise LInes	CCL	$49.30	4.06%	BUY	$53.00
Intel	INTC	$46.93	2.56%	BUY	$50.00
International Business Machines	IBM	$113.67	5.28%	BUY	$116.00
NCR Corp	NCR	$23.08	0.00%	BUY	$25.50
Symantec	SYMC	$18.90	1.48%	BUY	$21.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	$18.23	0.00%	BUY	$20.00
ETF - ProShares Short 20+ Year Trsry	TBF	$22.39	0.00%	BUY	$24.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	$35.13	0.00%	BUY	$38.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	$42.92	0.00%	BUY	$45.00

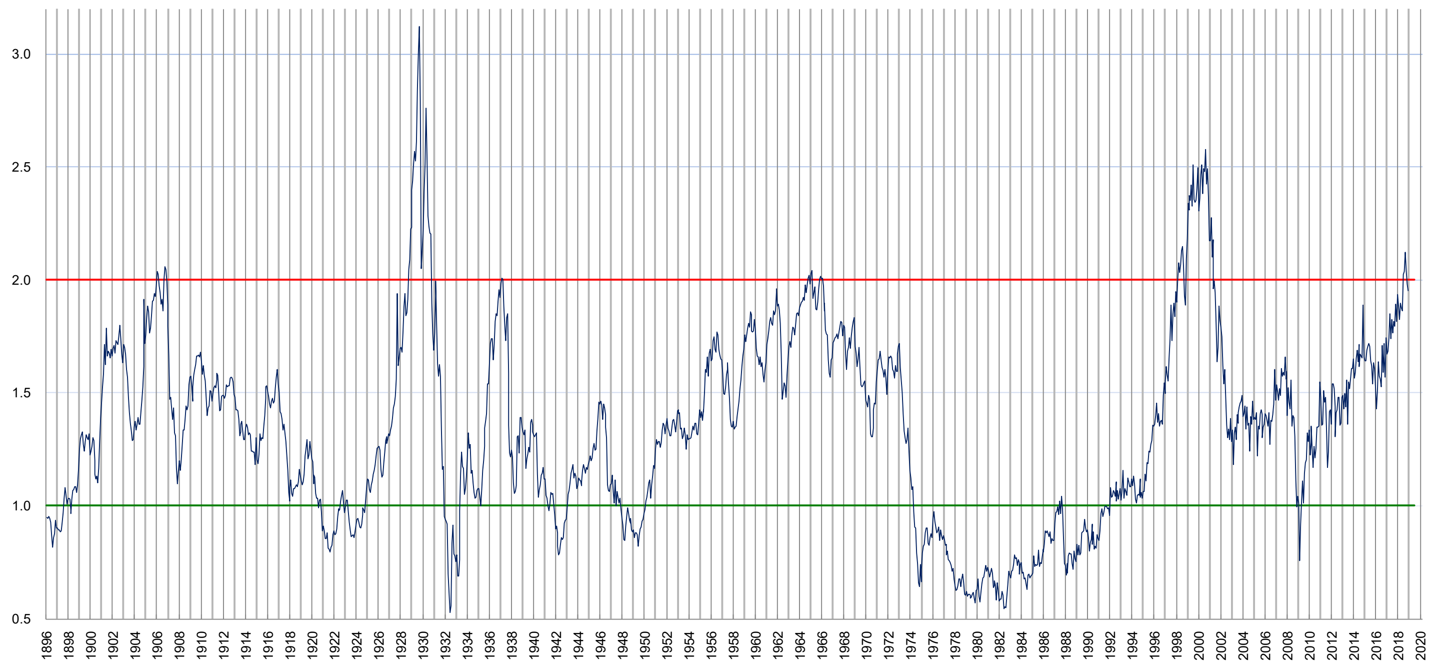
Notes to the table: The right hand column is the highest recommended price limit for purchases.
* It is not possible to offer live pricing on our recommended mutual funds.

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

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

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

Capital Competition: Real Estate versus Stocks: The **Sound**Advice Risk Indicator



There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 120+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation based on the ratio of the S&P 500 Stock Index to median price of new houses for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

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

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

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

But though an investment beginning with $25,000 in 1895 could have made money being in either stocks or housing, had an investor followed the signals of the ***Sound Advice*** Risk Indicator he or she would have made $391 million, or <u>26 times</u> more money than by simply holding stocks though the ups and downs.

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

The New York Times

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

above 2.0 again. On Tuesday, September 3, 1929, the Dow peaked at 318.17. The October crash marked the beginning of a decline that lasted until July 8, 1932. Houses had declined only by 15 percent compared with the 85 percent loss in stocks. The relative superior performance of houses caused our Risk Indicator to fall below 1.0 at the beginning of 1932.

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

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

It would not be until March 1998 when the Risk Indicator would cross 2.0 again, after stocks were up by more than tenfold. The Dot-Com bubble would push stocks higher into early 2000, but then began another 50 percent retracement. A switch to houses would produce a 44 percent gain through the end of 2008 while stock prices were lower by 17 percent. In February 2009, with the Dow careening down through the 700s once again, the Risk Indicator quietly dropped below 1.0 to 0.77 as the S&P tumbled under 700. Since then, the stock market has delivered stunning gains as the S&P 500 has quadrupled. ***For the sixth time in the last 123 years, the Risk Indicator rose above 2.0 again in July 2018.***

Based on the latest median house price of $309,700 for October, and with the S&P 500 at 2,506, the *Sound Advice* Risk Indicator reads 1.86, revealing the risk in stocks is above-average.

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

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

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

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

After each "Aggressive" signal, the S&P 500 climbed an average of 30.0 percent. During "Caution" signals, the S&P 500 either crashed, meandered, or climbed, recording an average increase of 2.8 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Sep-17	2,492.8	Jan-18	2,823.8
Ave +/-	30.0%		2.8%

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

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

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

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

This Diffusion Index gave us a zero reading in April, 2009, close to the bottom, officially giving us an "Aggressive" signal. That signal came at a

Over Please...

time when the Risk Indicator was below 1.0, which revealed that Supercycle 5 came to an end, and that Supercycle 6 was born.

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

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

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

Current Status

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

Our next signal will come from the Diffusion Index of LEADING Indicators, when it drops to zero, which would take a surprising softening in the US economy. The latest reading for this Diffusion Index is 33.3 percent.

Concurrence

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

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

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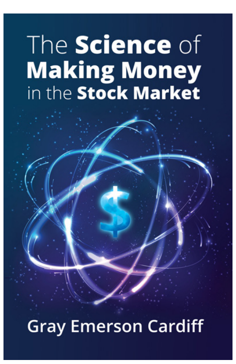

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