

Is This Market Expensive?



The *Sound Advice* Portfolio is up 3.5 percent so far this year, as compared to 8 percent for the S&P 500. We have an average profit of 71 percent based on the prices at which each position was recommended.

Our current under-performance is the price for being cautious, but I think that the price is small considering the risk that a fully-priced market presents.

-- Gray Emerson Cardiff, Editor

The S&P 500 is 25.7 times its trailing twelve month earnings. Most analysts consider this expensive. At the peak of the previous bull market in July, 2007, the trailing twelve month (TTM) price/earnings (P/E) ratio was only 18.36. It was much higher at the peak of the bull market before that, in March, 2000, when the TTM P/E was 28.31.

Actually, from an historical perspective, these trailing P/E figures are not high. It was after these bull markets peaked that P/E ratios really soared. At the bottom of the last bear market, in March, 2009, the TTM P/E on the S&P 500 was 110.37, because earnings had fallen even faster than stock prices. As the recovery took place, earnings rose faster than stock prices, squeezing the TTM P/E below 20 by February, 2010.

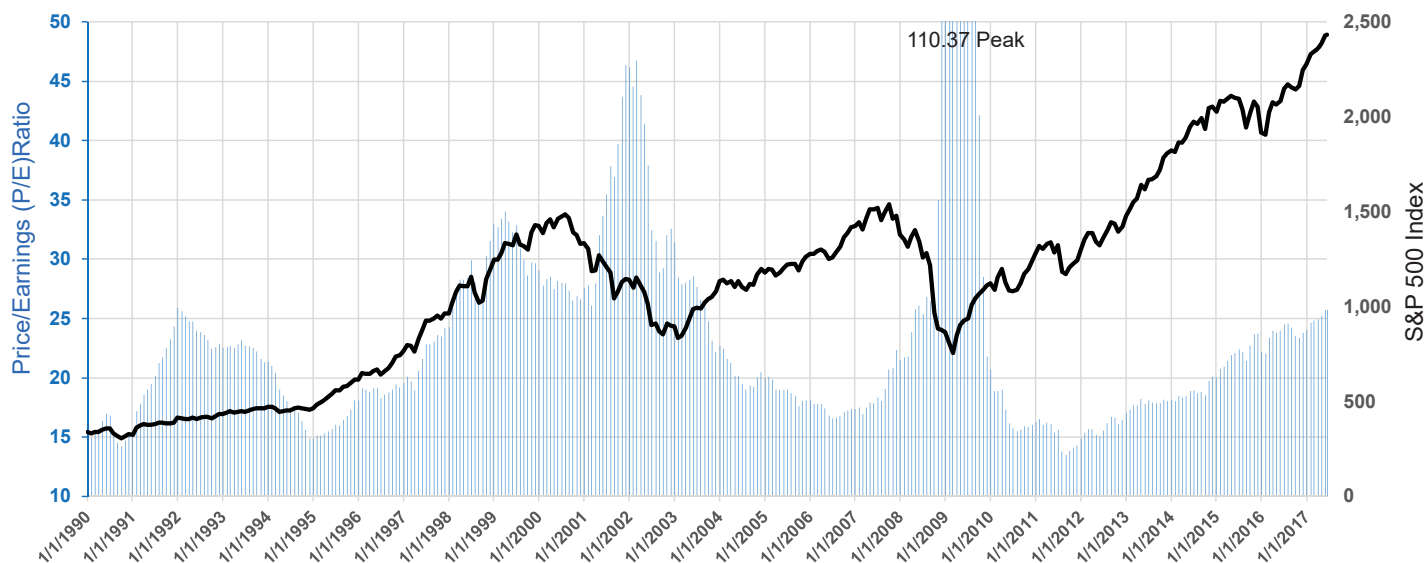
The same thing happened during and after the 2000-03 bear market, although not as dramatically. During that bear market, the TTM P/E climbed into the 40's as earnings fell faster than stocks. As stock prices hit bottom in early 2003, earnings started to rise faster than stock prices, squeezing P/E ratios again below 20 by mid-2004.

Take a look at the chart below. The black line shows the price of the S&P 500 according to the right-hand scale. The blue bars show the current TTM P/E ratio, according to the left-hand scale.

What may be considered expensive at one time is not necessarily so at another. In fact, by this measure, stocks are most expensive at the bottom of bear markets – at a fabulous time to invest.

The problem is that the trailing earnings is the only empirical data we have. We can look back with certainty at the recent past to make concrete calculations and form our projections about the future. It is true that TTM P/E ratios rise toward the end of bull markets, but there is not a particular TTM P/E ratio that is a tip-off that stocks are too expensive. If earnings are about to fall, just about any P/E ratio is expensive. However, if earnings are set to continue rising, even a 25+ TTM

S&P 500 Annual Trailing 12-Month P/E Ratio



P/E ratio may not be all that expensive.

So, the question we should be asking is: Are earnings about to rise or fall? We should not focus on whether the TTM P/E is too high.

Earnings Growth Expectations

According to FactSet Research Systems, Inc. (www.factset.com), analysts are expecting second quarter earnings to be 6.6 percent higher than the same quarter one year ago. For all of 2017, earnings are projected to grow by 9.9 percent. Based on these projections, the forward twelve-month P/E ratio for the S&P 500 is 17.7. If these projections materialize, the market is not all that expensive. As long as earnings continue growing, the bull market may have more life. Of course, we know what happens if the projected growth does not materialize. We will be looking back at the peak, saying that the market was indeed expensive.

The second quarter earnings growth projection is heavily weighted by the energy sector, which is pushing up the growth rate because it will be compared to a depressed quarter one year ago. Without the energy sector, the upcoming second quarter's 6.6 percent projected growth drops to 3.7 percent, according to FactSet.

At the end of the 2017 first quarter, the S&P 500 growth for the second quarter (including energy) was projected to be 8.7 percent. Growth expectations have dimmed since then to 6.6 percent. Undoubtedly, volatile and sinking oil prices tarnished outlooks.

Another reason for caution is the fact that the expectation of 8.7 percent is historically high for times other than from the depths of a crash. The average since 2010 is 6.56 percent.

In going over history, we are reminded that the market delivers returns in waves, and not in measured doses. We have already had a long wave up. The current bull market turned 99 months old on June 9. It is getting 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 at least another 13 months to go. Of course, we cannot bank on that.

While going through history, we are reminded of another fact: That 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.

Getting Back to Normal

In its June 14 meeting, the Federal Reserve raised their Federal funds rate by another quarter point (25 basis points). The Fed said that the economy is strong enough to continue normalizing interest rates from the "Quantitative Easing" (QE) programs that forced interest rates down to historically low levels in order to bail the economy out of the 2008-09 melt-down.

The primary mechanism for forcing interest rates down during those three rounds of QE, the Fed purchased \$4.5 trillion of Treasury and mortgage-backed securities. These purchases bloated the Fed's balance sheet by close to 5 times the normal amount. Nearly three years ago, the Fed stopped adding to its holdings with the end of its Quantitative Easing programs. Since then, it has simply been replacing securities as they matured, keeping the overall portfolio the same size. To do this, the Fed has been buying \$17.5 billion per month of Treasury bonds and \$24 billion per month of mortgage securities.

In May, the Federal Reserve conclusively decided to start a program to "normalize" its balance sheet by shrinking its holdings. This will be accomplished by allowing a fixed dollar amount of holdings to mature each month without reinvesting the proceeds in similar securities. In the June meeting, more details were decided.

The plan is to start reducing the Fed's current inventory of \$2.8 trillion of Treasury bonds. Holdings will be reduced by \$6 billion per month initially, and gradually by \$30 billion per month. To wind down the current holdings of \$1.8 trillion of mortgage-backed securities, holdings will be reduced by \$4 billion per month initially, and gradually by \$20 billion per month.

The Fed acknowledged that this process will be tantamount to a series of interest rate hikes. Upward pressure will be more pronounced on the long end of the yield curve because the Fed's holdings include a preponderance of longer term bonds. The reduction of the Federal Reserve's long-term bond holdings will add upward pressure to long-term bond yields. This is important because our recommended ETFs for rising interest rates are based on long-term bond yields.

Ending QE in Europe

The financial world is tied together with a complicated net of arbitrages. Ultra-low interest rates in other parts of the industrialized world have been holding down US interest rates.

To fend off deflationary forces, Europe has copied the US QE programs. European Central Bank (ECB) has been buying 60 billion euros (\$67 billion) per month of its version of Treasury bonds.

At the end of June, at an ECB conference, president, Mario Draghi, said:

"All the signs now point to a strengthening and broadening recovery in the euro area. Deflationary forces have been replaced by reflationary ones. While there are still factors that are weighing on the path of inflation, at present they are mainly temporary factors that typically the central bank can look through."

This statement marks the beginning of the end of QE in Europe. It is only a matter of time until the ECB will start reducing its monthly bond purchases. Draghi has not said when the purchases might be scaled back, but analysts think the ECB is likely to give a signal at its September 7 meeting. Since the current monthly bond purchases are slated to run at least through year end, it is likely that purchases could be

reduced to 40 billion euros a month in the first half of 2018, and then to 20 billion euros in the second half before ceasing at year end.

The ending of QE in Europe is important because as Europe normalizes its interest rates, the downward pull on US interest rates and bond yields will diminish.

ETFs for Rising Interest Rates

Our recommended ETFs are designed to benefit from the normalization of interest rates 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 17 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 June 14 meeting. As usual, there was a wide difference 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 2017, 2.125 percent at the end of 2018, and 3.00 percent at the end of 2019. These medians were unchanged from the March 15 meeting.

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 3.22% by the end of 2017, and 3.97% by the end of 2018, and 4.8% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$19.38 to \$23.70 by the end of 2017, to \$34.52 by the end of 2018, and to \$51.63 by the end of 2019.

TBT would rise from \$35.70 to \$40.82 by the end of 2017, to \$52.47 by the end of 2018, and to \$68.62 by the end of 2019.

TBF would rise from \$22.41 to \$23.96 by the end of 2017, and to \$27.17 by the end of 2018, and to \$31.07 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. Here is what would happen to each ETF:

TMV would decline to \$18.67 by the end of 2017 (3.6%).

TBT would decline to \$35.06 by the end of 2017 (1.8%).

TBF would decline to \$22.28 by the end of 2017 (0.6%).

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 shale drilling boom is on again, thanks to cost-cutting and the use of better technology. The most prolific areas include the Permian Basin and Eagle Ford, where drilling costs have declined below \$36 per barrel. The Bakken is coming back to life with production increasing again. There is a full-on land rush in the Wyoming Powder River Basin, where it is being discovered that the geology there is similar to that of the Permian. Even the Marcellus and Utica shale plays that stretch across the eastern US, which are typically gas-producing, are now yielding more crude.

The US Energy Information Administration (EIA), the agency in charge of collecting data, projects that 2017 US production will end up increasing to 9.3 million barrels per day, up from 8.9 million in 2016, and increase further to 10 million barrels per day in 2018 (exceeding for the first time the previous record on 9.6 million barrels per day set in 1970).

This increasing US production prompted OPEC members to extend voluntary production cuts into March 2018, which were originally set to end last month in June.

Along with increasing world supplies, primarily stemming from increasing US production, the EIA also forecasts increasing worldwide demand that will absorb the added supplies. The EIA forecasts that net global petroleum and liquid fuels inventories will decline by about 0.2 million barrels per day in 2017, and then increase slightly in 2018 by (a scant) 0.1 million barrels per day.

This outlook translates to flat oil prices for at least the next 18 months. However, beneath this stagnant forecast, 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 \(CHK\)](#) is a purely domestic producer and well situated to participate in the resurgence of the shale drilling boom. The company 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. The company expects oil output to grow by 10 percent this year with the goal of doubling it in 2018.

The consensus is that CHK will earn 65 cents per share in 2017. A forward P/E ratio of 10 puts the stock at \$6.5. A forward P/E ratio of 15 puts the stock close to \$10.

Chevron (CVX) released a company update in June, stating that it is continuing to keep its overall debt level in the range of 20 to 25 percent of capital. Chevron's current debt level is 24 percent, which is relatively low compared to its peers, Royal Dutch Shell (32%) and British Petroleum (38%), and not far from Exxon Mobil's 19%. Chevron also announced plans to further strengthen its financials by continuing with cost reductions, optimizing its capital expenditures (cap-ex), and divestitures.

As we have noted in past issues, Chevron has a huge reserve base and production is set to increase in 2017 from several areas, including the two massive Australian projects, the Gorgon and Wheatstone, both of which have required large capital outlays that are no longer needed in CVX's forward-going cap-ex budget. CVX should see significant improvements in earnings in the quarters ahead based on increasing production.

Chicago Bridge & Iron (CBI) is well positioned to benefit from increased US infrastructure spending and expansion, especially for the energy sector.

On June 27, the Delaware Supreme Court ruled in favor of CBI in its \$2 billion dispute with Westinghouse. This removed a large cloud that was hanging over the stock.

We are recommending that you invest now if you have not yet done so. If you followed our initial recommendation, we recommend that you average down by investing an equal dollar amount again.

A significant but smaller concern still exists regarding cost overruns on two natural gas plants. However, in accordance with industry standards, CBI contracts limit the company's liability for cost overruns. In the first quarter, CBI charged \$82 million to reserves as a buffer for future overruns. The fact that this charge was made likely scared investors into fearing that there are more to come. The first quarter charge is supposed to incorporate all that is known or reasonably expected by the company. Accordingly, future charges for cost overruns should not be material.

The other issue has to do with unpaid change orders amounting to \$166 million payable to CBI relating to the construction of the Cameron Liquefied Natural Gas (LNG) plant. This does not seem like it should be an issue because these change orders are typically the responsibility of the owner, not the engineering firm, such as CBI.

To put these numbers into perspective, CBI's annual revenues are currently above \$10 billion. The company expects revenues to be \$12 billion next year.

CBI made a dramatic dive in recent weeks, by more than 50 percent at one point. This was a clear over-reaction. That

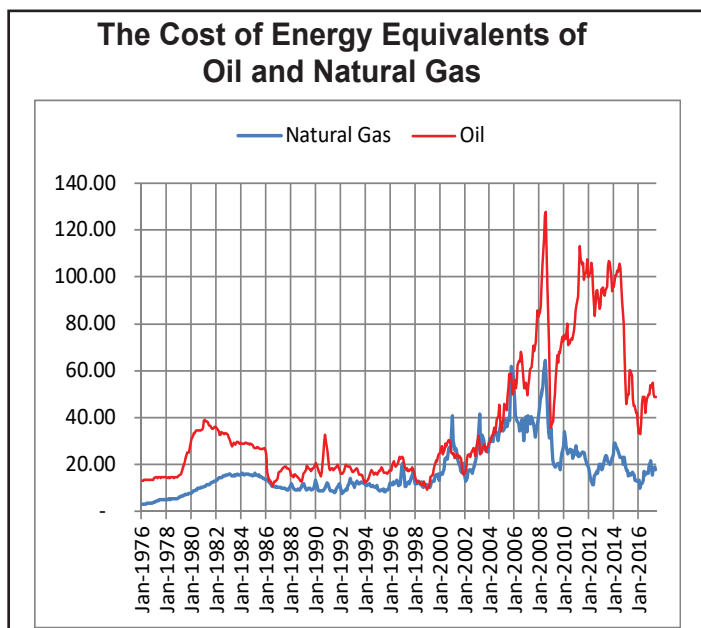
drop in the stock price discounted CBI's market capitalization by \$1.6 billion, which anticipated a disaster scenario. Anything short of that will be very good news, as evidenced by the 40 percent gain in CBI on June 27 when the Delaware Supreme Court ruled in favor of Chicago Bridge & Iron.

The consensus among 6 analysts is that CBI will earn \$3.34 per share in 2017. The lowest estimate among these 6 analysts is \$2.77. The highest is \$3.75. The company's earnings guidance is \$3.50 to \$4.00 per share. For 2018, the consensus among 7 analysts is that CBI will earn \$4.12 per share, with the lowest being \$3.43 to the highest of \$4.75.

Even if we take the lowest 2017 estimate of \$2.77 per share, the stock is trading at less than 8 times earnings. At the earnings consensus of \$3.34, CBI has a P/E ratio of 6.5. At a P/E ratio of 10 times this consensus, the price of the stock would be \$33.40.

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 \$47 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$3.04 for one million BTUs, 5.8 million BTUs will cost \$17.63. Thus, the same amount of energy is available for approximately 38 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.



Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	20.02	6.6%	13.5%	6,458.1	43.16	-53.6%
Felcor Lodging	FHC	7.25	6.6%	9.1%	2,699.7	11.39	-36.4%
Hospitality Properties	HPT	29.57	6.9%	10.2%	11,369.9	47.89	-38.3%
Hersha	HT	18.76	6.0%	9.1%	2,292.9	21.16	-11.3%
Host Hotels & Resorts	HST	18.48	4.3%	9.6%	21.0	24.69	-25.1%
Apple Hospitality	APLE	18.84	6.4%	7.5%	5,510.5	18.81	0.2%

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

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) has been seeing recent increases in its crack spreads, the difference in the amount a refiner pays for crude oil and the amount for which it sells the resulting refined products such as gasoline and jet fuel. How much a refiner pays for its crude oil depends greatly on what type of oil it is and the feasibility of transporting it to the company’s refineries.

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. Moreover, east and west coast refineries do not have adequate 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.

Real Estate Selections

Our posture is still defensive with real estate stocks. Commercial real estate prices are historically high because low interest rates have pushed down real estate cap

rates to historically low levels (like bond yields). Accordingly, the *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. Two currently exist in the hospitality industry.

The table above shows the comparative values of other hospitality REITs. **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. **Apple Hospitality (APLE)** is trading at close to its net asset value.

Hersha Hospitality (HT) has upgraded its portfolio this year by selling the Courtyard by Marriott in Alexandria, VA, and the Residence Inn in Greenbelt, MD. These sales were based on a 7.4 percent cap rate. 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 first quarter, and using a 7.5 percent cap rate to evaluate the company’s real estate portfolio, we value HT at \$21.16 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. The company is on a mission to upgrade its assets by purchasing properties in high growth markets with barriers to entry while seizing opportunities to sell at high prices, such as the recent sale of two of its New York City hotels at a lofty 4.7 percent cap rate.

Based on the latest trailing four quarters’ financials reported, including the most recent 2017 first quarter, and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value RLJ at \$43.16 per share which is considerably higher than the current price. The high dividend yield is attractive and lowers the risk profile.

In late April, RLJ announced it will merge with FelCor Lodging Trust (NYSE: FCH). Each share of FelCor common stock will be converted into 0.362 shares of newly issued common shares of RLJ stock. Accordingly, the price on the above table for FCH is 0.362 times the current price of RLJ, which is the effective price RLJ is paying. The merge is expected to close by the end of 2017 which will expand RLJ's portfolio to 160 hotels. The merger is estimated to save RLJ close to \$20 million in annual administrative expenses.

Third Avenue Real Estate Value Investor Fund (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.

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.

Medically-Related Selections

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

Boston Scientific (BSX) won European approval in June for its Vercise Gevia Deep Brain Stimulation (DBS) system for use in treating Parkinson's disease. The device works by stimulating certain areas in the brain with electrical signals. Its DBS system is another example of the company's mission to transform lives through innovative medical solutions that improve the health of patients around the world.

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.

Stryker (SYK) announced in June its new robotic-assisted surgical total knee replacement used with its current MAKO Triathlon Total Knee System which was introduced in 2016. This robotic technology is expected to enhance and provide a highly successful surgical solution for total knee replacements.

Although 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. Continued growth is assured 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.

Tekla Life Sciences Investors (HQL) is an excellent 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

At the end of June, the Federal Reserve released the results of its annual Comprehensive Capital Analysis and Review, commonly known as the "stress test" on US banks. The results are used to determine whether the banks are able to maintain sufficient levels of capital under severe situations similar to those of the Great Recession. The stress test also approves (or not) a bank's plans to distribute capital to its investors. For the third year in a row, all 34 banks were deemed capable of handling a severe recession. This is the first time every bank's capital distribution plans were given the stamp of approval. Of course, bank stocks responded favorably, including our two recommendations.

JP Morgan Chase (JPM) received approval to increase its quarterly dividend from 50 to 56 cents per share and to proceed with a \$19.4 billion share buyback program.

JPM is cheap in comparison to the rest of the market. The earnings estimate for 2017 is expected to be \$6.66 per share. Strong growth is expected in the immediate years ahead. JPM is expected to earn \$7.55 per share in 2018 and \$8.44 in 2019. At a forward P/E ratio of 15, JPM would be \$100 per share by the end of 2017, \$113 by the end of

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2018, and \$126 by the end of 2019.

JPM has maintained solid capital levels and has a strong balance sheet. The company has a common equity “Tier 1 ratio”, well exceeding minimum requirements. JPM did not have a losing quarter during the 2008-09 meltdown.

Wells Fargo (WFC) received approval to increase its quarterly dividend from 38 to 39 cents per share and to proceed with an \$11.5 billion share buyback program.

WFC is also a strong value and a timely investment. Even without any deregulatory benefits, WFC’s 2017 earnings are expected to be \$4.45 per share. At a forward P/E ratio of 15, WFC would be \$67 per share by the end of 2017. WFC has been a laggard because of the scandal regarding unauthorized account-opening practices. However, this issue is now history. As with other banks, WFC will be a beneficiary of rising interest rates, and deregulation could expand business opportunities.

Small Caps

Small caps tend to be domestic companies without substantial overseas exposure. Numerous studies show that small caps perform better over the long run than the market as a whole. They 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.

Arconic (ARNC) was eliminated from the portfolio in our June 26 email update when it was reported that this company provided the exterior panels for London’s Grenfell Tower, the site of the devastating fire. The combustibility of these panels exacerbated the extent of the fire. Arconic’s brochure for these panels contains a blunt warning that they have a fire risk, which means the company was aware of the potential problem. In fact, these panels are not allowed in the US. Aside from the bad press and image, there are bound to be liabilities ahead for ARNC.

Apple (AAPL) is getting closer to releasing its new iPhone 8, inaugurating a badly needed upgrade cycle. The iPhone 8 is rumored to recognize the face of its

authorized user. To compete with Samsung, Apple’s fiercest competitor, the iPhone 8 will be waterproof with the highest rating of IP68, which means it will withstand being submerged in 1.5 meters of water for 30 minutes. It will also offer wireless charging.

Samsung has 22.4 percent of the market share of smart phones – nearly double that of Apple’s 11.8 percent share. Slightly more than one-half of Apple’s revenue comes from its iPhones, so a gain of just one percent in market share translates to 14 million iPhones, which would add 7 percent to revenue. Apple has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial rating.

Conduent (CNDT) is a turnaround company with fresh new management and specific growth goals. CNDT is the company that Xerox purchased in 2010 called Affiliated Computer, and was spun off in January after 6 years of mismanagement as evidenced by falling operating margins. Still, this was the growth side of the old Xerox, with expertise in transaction-intensive processing, analytics, and automation. This side of the business had an 86 percent contract renewal rate.

Carl Icahn holds 9.77 percent of the stock, which means he has influence and a reason to see growth. Icahn has 3 directors on the 9-person board with a focus on shareholder performance.

International Business Machines (IBM) is turning into a growth stock because of its artificial intelligence division based on Watson, the Company’s super computer that 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. We have only begun to see and imagine the uses of artificial intelligence. 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.

IBM is a good value now. The company expects 2017 earnings to be “at least” \$11.95 per share. Other analysts are estimating earnings to be in the vicinity of \$13.80. At \$160 per share, \$12 earnings per share puts the P/E ratio at 13.3. A P/E ratio of 15 puts the stock at \$180. At earnings of \$13.80, a 15 P/E ratio puts the stock over \$200.

IBM recently raised the annual dividend (for the 22nd year in a row) to \$6.00 which is close to a 4 percent yield.

NCR Corp (NCR) is expanding its cloud and software license offerings while the hardware side is seeing strong demand for its Self-Checkout and ATM edge platforms. The company now anticipates 2017 earnings per share to be in the range of \$3.32–\$3.42. At a P/E ratio of 15, the stock belongs close to \$50.

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.

Symantec (SYMC) is a turnaround situation, fueled by the disposition of under-performing past acquisitions and making new ones, particularly LifeLock and Blue Coat. Management’s focus is to perpetuate and integrate the synergies of these new acquisitions into Symantec’s operations. LifeLock’s identity theft solutions add new growth dimension to SYMC because consumers pay two to three times more for identity protection than for endpoint malware protection.

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. If there ever was a more certain growth industry, protection from cyber espionage is it.

Tetra Tech (TTEK) has a healthy balance sheet and 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, US Army Corps of Engineers, and the US Air Force, which should continue to bolster growth.

Xerox (XRX) completed its 1 to 4 reverse stock split in mid-June. You now have one-fourth the number of shares at four times the price. Fractional shares were redeemed in cash. The dividend is also four times greater, at 25 cents per quarter, for the same annualized yield. The company’s full year 2017 earnings guidance is now multiplied by four,

to range 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.

Since the spin-off of Conduent (CNDT), 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. Xerox is 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 dividend yield is also attractive.

SoundAdvice Investment Returns
Calculated Independently by the Hulbert Financial Digest
SoundAdvice in 2016 = 18.69% vs. S&P 500 = 9.54%
SoundAdvice from 2000-2016 = 10.30% Annually vs. S&P 500 = 2.37% Annually

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 performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.



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The Science of Making Money in the Stock Market

This is the book that explains all of the SoundAdvice indicators, including the Diffusion Indexes and the Risk Indicator, and exactly how they work, along with a detailed history to back up the track records.

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Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$4.96	0.00%	BUY	\$5.50
Chevron	CVX	\$104.12	4.15%	BUY	\$112.00
Chicago Bridge & Iron	CBI	\$21.57	1.30%	BUY	\$25.00
Fidelity Select Nat. Gas Fund	FSNGX	\$23.16	0.54%	BUY	\$28.00
ICON Energy Fund Class S	ICENX	\$11.55	0.47%	BUY	\$14.50
Valero	VLO	\$67.09	3.58%	BUY	\$70.00
Real Estate					
Hersha Hospitality Trust	HT	\$18.76	5.97%	BUY	\$20.00
RLJ Lodging Trust	RLJ	\$20.02	6.59%	BUY	\$22.00
Third Avenue Real Estate Value Investor	TVRVX	\$32.69	0.50%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$27.82	0.00%	BUY	\$29.00
Stryker Corp.	SYK	\$138.81	1.22%	BUY	\$147.00
Tekla Life Sciences Fund	HQL	\$21.05	0.00%	BUY	\$24.00
Financials					
JP Morgan Chase	JPM	\$91.15	2.46%	BUY	\$95.00
Wells Fargo	WFC	\$55.78	2.80%	BUY	\$59.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$21.98	0.30%	BUY	\$24.00
Special Situations					
Apple	AAPL	\$143.68	1.59%	BUY	\$158.00
Arconic	ARNC	\$22.82	1.58%	SELL	
Conduent	CNDT	\$15.78	0.00%	BUY	\$18.50
International Business Machines	IBM	\$154.13	3.89%	BUY	\$160.00
NCR Corp	NCR	\$41.23	0.00%	BUY	\$43.00
Symantec	SYMC	\$28.06	1.14%	BUY	\$34.00
Tetra Tech	TTEK	\$45.70	0.79%	BUY	\$49.00
Xerox	XRX	\$29.12	0.96%	BUY	\$31.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$19.38	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	\$35.70	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$12.71	0.00%	BUY	\$14.00

Notes to the table: The right hand column is the highest recommended price limit for purchases. Prices are as of 6/29/2017. 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.

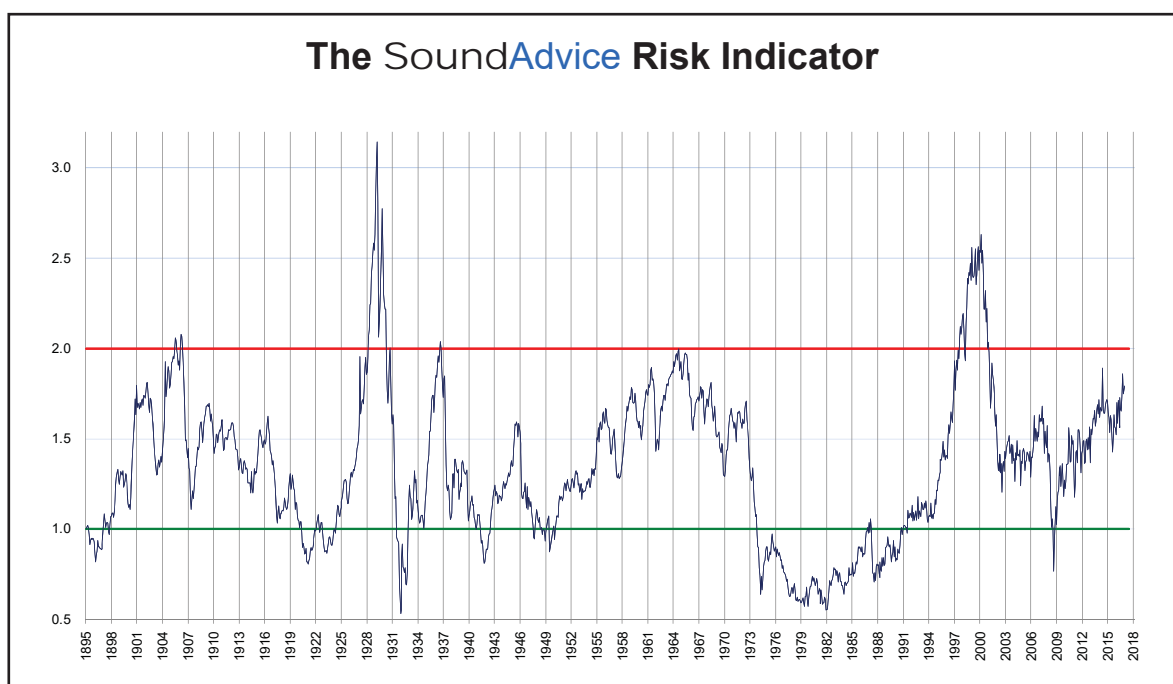
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$14.1 million in stocks and to \$1.65 million in houses.

But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$561 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.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

The latest reading for the SoundAdvice Risk Indicator is 1.79. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See ***The Science of Making Money in the Stock Market*** for a complete explanation of the SoundAdvice Risk Indicator and its track record.



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. For every indicator that is unchanged from its value during the six-month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be (1.5)/3 or 50 percent.

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 the June 2015 release of the May lagging economic indicators.

The SoundAdvice Diffusion Index of LAGGING Indicators was 66.7 percent in May (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 for May was 33.3 Percent.**

Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32.1 percent. During "Caution" signals, the S&P 500 increased an average of 3.5 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
Ave +/-	32.1%		3.5%

See *The Science of Making Money in the Stock Market* for a complete explanation of the SoundAdvice Diffusion Indexes and their track records.

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