

The First Whiff



The *Sound Advice* Portfolio is up 5.0 percent this year, as compared to 1.05 percent for the S&P 500. We have an average profit of 50.7 percent based on the prices at which each position was recommended.

-- Gray Emerson Cardiff, Editor

The stock market is still obsessed with the price of oil. When oil goes up, so does the market. Normally the reverse is the case because the cost of energy is an operating cost for most companies, and lower oil prices means higher earnings. These days, however, the stock market views the price of oil as a barometer of the economic health of the world because stronger economies exert a higher demand for energy. To gain a better grasp on the direction of the stock market, it will help us to understand the moving parts of the oil market.

The most significant change in the landscape of the world's oil market in recent years occurred in the US, from the fracking boom which added nearly 5 million barrels a day to world supplies. That doubled US production. To put the increase into perspective, it was half of Saudi Arabia's output. Once the world's largest producer by a large margin, Saudi Arabia's 10 million barrel per day output was almost matched by US peak production. With oil prices north of \$100, US fracking was profitable and it was proliferating. As an oil glut appeared, Saudi Arabia launched a price war aimed at forcing the price of oil down below the cost of fracking in order to drive US frackers out of business. Without that additional 5 million barrels per day on the world's markets, Saudi Arabia and its OPEC allies would be back in the driver's seat again.

As the wind whistled out of the oil market, the price of oil fell below the cost to frack, causing new US drilling to cease. Without new wells, it was only a matter of time until US production would start declining as a result of the

natural steep production curve of fracked oil wells. Production drops 70 percent during the first year from the typical fracked well. In order to maintain production levels from an oil field, a substantial number of new wells need to be added. We know that this is not happening as evidenced by the 50 percent plunge in the domestic drilling rig count since October 2014.

The latest data from the Energy Information Administration (EIA) shows US oil production has been declining since the first of the year. During the week ending April 22, US production was 8.938 million barrels per day (MMbbl/d), down from 9.235 MMbbl/d during the week ending January 15.

This decline of 297 thousand bbl/d is the first whiff of the end of the oil glut. However, this decline is still modest in comparison to the 5 MMbbl/d frackers produced at the peak. US production has the potential to drop substantially more from here.

OPEC

Somewhat offsetting the decline in US production is increasing production in Iran. Now that sanctions have been lifted, Iran is gearing up. Oil production increased by 100,000 bbl/d in March, to 3.2 MMbbl/d, and exports rose to 2 MMbbl/d. Iran wants to increase its oil production to 4 MMbbl/d by the end of 2016 which will add 800,000 bbl/d to world supplies.

Iran is not about to cut production at the request of OPEC because it is still recovering from sanctions. The mid-April OPEC meeting in Doha did not result in agreements to cut production from either Saudi Arabia or Russia, which both produce more than 10 MMbbl/d. So why did oil prices rise the following week?

On the supply side, the inevitable substantial decline in US production is a large factor. Demand will also be increasing even with low worldwide GDP growth. The Energy Information Administration (EIA) projects that consumption will still be on the rise, by 1.2 to 1.5 MMbbl/d in 2016 and 2017 using low GDP growth assumptions. If monetary stimulus programs in Europe and elsewhere gain traction, and there are no new negative surprises from China, these estimates may prove to be low.

Condensate Versus Oil

US frackers produce a very light crude oil. What is not widely known or considered is that a substantial amount of it is so light that it is not actually considered oil.

The industry uses specific gravity to measure how heavy or light petroleum is relative to water. The American Petroleum Institute (API) rebranded the measure for oil as API gravity. Lighter crudes have higher API gravities. West Texas Intermediate (WTI) is light crude, with an API gravity in the vicinity of 40. Anything above that, especially above 45 is considered “condensate.”

This distinction is important. The financial markets do not consider condensate to be oil. In fact, futures contracts to deliver crude oil forbid condensate to be included in the delivery. Moreover, crude oil price quotes specifically exclude condensate.

However, the distinction is not made when the US Energy Information Administration (EIA) reports quantities of crude oil being produced and brimming in US storage tanks. What is actually being reported is crude plus condensate (C+C). Because condensate is included, these figures are over-stating the actual quantities of “honest-to-God” crude oil being produced and stored in the US. There may not be much of a glut of honest-to-God oil.

Close to 250 million barrels of condensate came from the Eagle Ford in 2015 alone. To put this into context, according to the EIA as of April 22, there were 541 million barrels of C+C sitting in all of the storage tanks in the US. Prior to the glut in 2014, there was as little as 356 million barrels of C+C in US storage tanks. The difference, 185 million barrels, defines the glut. More condensate than that came from the Eagle Ford in one year.

Data is lacking from other oil regions regarding amounts of condensate versus honest-to-God crude oil. But the amount of condensate produced in recent years is not insignificant, and the oil sitting in US storage tanks is a blend of condensate and crude.

Lifting the Exporting Ban

Finally in December 2015, the long-standing ban on exporting crude oil was lifted by Congress, opening outlets for the glut of crude and condensate sitting in America’s oil storage tanks. Venezuela and Mexico are eager customers for this blend. Venezuela can replace the light crude it imports from West Africa to blend with its ultra-heavy crude. Mexico has less sophisticated refineries that can only process light crude because it is easier to refine.

Financial markets anticipate major events ahead of their actual occurrences. The markets are getting the first whiff of a decline in the oil glut, but the implications go beyond the energy sector.

Inflation

The plunge in energy prices has been undermining inflation. Included in the list of consumer items measured

for the consumer price index are many energy-related items, including energy commodities, gasoline, fuel oil, and energy services. The near zero readings for consumer price increases are in contrast to the “core” inflation rate, which excludes these energy items along with the food sector.

The US core inflation rate has averaged 3.7 percent annually from 1957 through 2015, and is recently approaching that level again. The core rate of inflation increased at a 3.6 percent annual rate in both January and February. The March increase was slightly lower, at the annualized rate of 2.6 percent.

As energy prices recover, the gap will narrow between the widely watched consumer price index consumer, the accepted official measure of inflation, and the core inflation rate. As the perception of increasing inflation infiltrates the financial markets, the outlook for bonds and stocks in general will not be as positive as it is today.

Here is an update on all of the *Sound Advice* recommendations.

Energy Selections

A recovery in oil and gas prices translated into stellar profits in past cycles. Here are our energy selections, in alphabetical order.

Chesapeake Energy (CHK) has taken a beating from the crash in oil and gas prices. CHK’s debt load makes it an aggressive investment in the current environment of low oil and gas prices, and the risks increase with an extended period of low energy prices. This is why CHK is near the top of the list of Wall Street’s most hated stocks.

In an early March email update, we noted a classic short squeeze in CHK. With no new supporting news in the background, short interest in the stock had climbed above 40 percent of the entire stock float, as short sellers were borrowing stock from their brokerage firms and selling it, hoping to buy it back at a lower price, capturing a profit from the fall in the stock price.

A short position of such epic proportions is actually bullish because it means there is massive potential buying power in the wings. Short-sellers are traders, which means they will soon be buying back stock to cover their short positions. The latest update provided by the stock exchanges show that 132 million shares of CHK were short on 4/15/2016, which was 19.7 percent of the shares outstanding. This is still a very high percentage.

CHK has \$1.8 billion in debt payments coming due through 2018, but has a \$4 billion credit facility to tap. In addition, CHK has more asset sales planned, is slashing spending, and renegotiating pipeline contracts.

In April it was revealed that earlier this year, Chesapeake took advantage of its depressed stock and bond prices by purchasing \$60 million of its own convertible bonds for 53 cents on the dollar.

Chevron (CVX) is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling (upstream), to transporting and refining (downstream). Profits vary from these stages of production, depending on price demand for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. When oil prices are low, profit margins expand from refining.

The last day of April, CVX announced worse-than-expected earnings per share, posting a 39 cent loss versus \$1.37 earnings per share in the first quarter last year. The drilling (upstream) business suffered the most, but the loss was shaved by profits from refining (downstream) operations, although refining profit margins were lower due to growing fuel inventories and weak demand.

CVX was barely down one percent on the earnings news, and recovered nearly all of the loss by the end of the trading day. Evidently the market is looking forward to better earnings ahead due to the recent improvement in the price of oil.

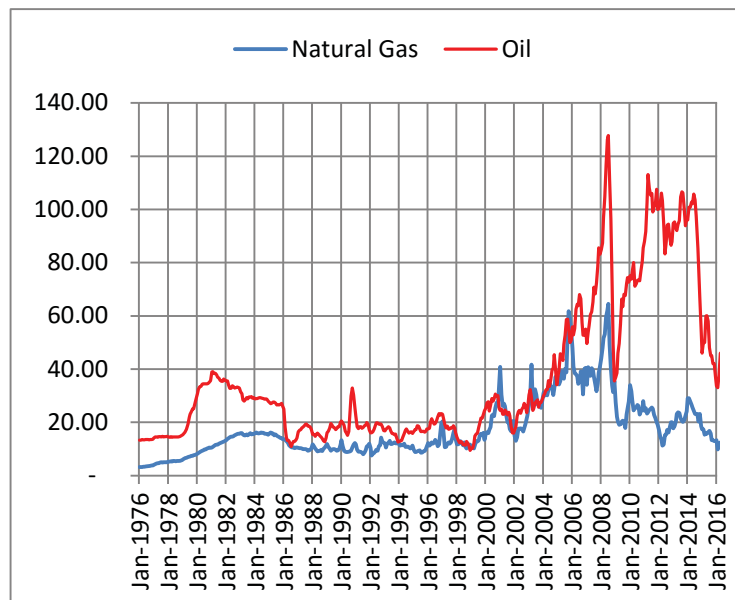
Although the company's recent earnings obviously do not cover the dividend, management has pronounced the annual dividend of \$4.28 per share as "sacrosanct." To make room for the dividend and combat low oil and gas prices, Chevron has been negotiating substantial cost reductions with its suppliers, reducing its contractors, and cutting its employee count, all of which the company predicts will amount to \$2.4 billion in savings.

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the recovery 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.

The drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$46 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to \$2.14 for one million BTUs, 5.8 million BTUs will cost \$12.41. So the same amount of energy is available for 27 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

The Cost of Energy Equivalents of Oil and Natural Gas



approximate the same amount of energy contained in a barrel of oil. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together, but remain substantially apart. This difference still translates into an expanding natural gas industry.

ICON Energy Fund Class S (ICENX) is also a diversified way to participate in the recovery with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sectors 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.

Transocean (RIG) makes deep-water drilling rigs and leases them to major oil producers around the world. RIG has been sharply impacted because the utilization of its rigs has fallen along with the drop in oil prices. RIG's metrics compare favorably to its peers, and we continue to recommend RIG because of its prospects for survival. Deep-water drilling is still a necessary source for the US and the world's oil needs, especially as US fracking drops off. Long-term profits from RIG should be stellar from here.

The plunge in oil prices cut day rates for deep-water drilling rigs by 50% in 2015, forcing RIG's revenues to drop 20 percent to \$7.3 billion. Transocean aggressively

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cut costs by scrapping rigs. As a result, EBITDA (earnings before interest, taxes, depreciation, and amortization) only fell by 8%.

While the offshore drilling business has been impacted by the oil crash, it is not completely dead. Highlights from RIG's most recent first quarter 2016 fleet status report estimated that 2016 out of service days increased by a net 56 days due primarily to contract preparations. The report also noted new activity on three of its deep water rigs: *Actinia* was awarded a three year contract offshore India at a day rate of \$101,000, *Deepwater Invictus* was awarded a two well contract offshore Trinidad at a day rate of \$350,000, and *Dhirubhai Deepwater KG2* was awarded a six month contract (location and day rate were not disclosed).

RIG is among Wall Street's most hated stocks. That is a good thing. The latest update provided by the stock exchanges shows that 102 million shares were short as of 4/15/2016, which was 28 percent of the entire number of shares outstanding. With short-sellers in the wings, with the requirement to inevitably buy back the shares borrowed from brokerage firms, this is a great deal of near-term buying potential, and a bullish factor.

Valero Energy (VLO) is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US, Canada, UK, and Ireland. Valero is one of the few energy companies that can benefit from lower oil prices because refining margins generally expand during such times. Valero's has the most flexible refineries, allowing the company to capture the highest margins among its competitors. Valero's refineries are also well positioned geographically, even for accessing the low-cost Maya crude from Mexico, heavy sour oil that Valero buys for an even larger discount than from glutted US oil.

VLO has retreated this year as a glut of gasoline has compressed "crack spreads", the cost of refining crude oil into gasoline and other petroleum products, due to large stockpiles and weak demand for refined fuels. However, this is bound to be a temporary situation.

VLO is a great value with a strong balance sheet and solid growth potential. The quarterly dividend was recently increased again to \$0.60 a share, for a yield of 4 percent.

Real Estate Selections

As in the case of bond yields, low interest rates for so many years have pushed down real estate capitalization (cap) rates (the yield before debt payments are considered) to historically low levels. As a result, commercial real estate prices are historically high, and the average real estate investment trust (REIT) does not present a particularly good value.

In the longer run, a rising economy will push up rental rates which will more than compensate for added interest expenses caused by rising mortgage interest rates. However, this benefit is most likely to translate into profits

only on real estate stocks offering an extraordinary value now.

Hersha Hospitality (HT) is a real estate investment trust in the hospitality sector, which owns and operates high quality upscale hotels in urban gateway markets. The Company's 55 hotels totaling 8,654 rooms are located in New York, Boston, Philadelphia, Washington DC, Miami, and select markets on the West Coast.

We expect strong growth in funds from operations (FFO) over the longer term because many of HT's major properties have been undergoing renovations and not producing their full income potential. FFO actually declined in the first quarter by \$563,000, or 4.1%, from a year earlier due to renovation disruption at six of the Company's properties.

Even with ongoing renovations in 2015, the year saw an 18.7 percent growth in FFO. As renovations are completed and rooms are put back on line, revenue and FFO should climb substantially higher. New acquisitions will also contribute to growth.

HT is selling at a discount to its hotel assets. Based on the latest trailing four quarter's financials, including the most recent 2016 first quarter, we value HT at \$30.29 per share which is nearly 50 percent higher than the current price. The dividend yield above 5 percent is attractive and lowers the risk profile.

Retail Opportunities Investment Corp (ROIC) is a real estate investment trust (REIT) that specializes in the acquisition, ownership and management of grocery-anchored shopping centers located in densely-populated, metropolitan markets across the West Coast.

ROIC began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. As new properties are added, along with tenant upgrades, FFO is bound to continue rising.

At the end of April, ROIC posted revenue of \$56.1 million in the period, exceeding Street forecasts, and 24.3 percent higher than one year ago. Per share FFO climbed 17.4 percent. This follows FFO growth of 12.9 percent in 2015.

So far in 2016, ROIC has committed \$155.2 million in grocery-anchored shopping center acquisitions, as well as two additional properties under contract for a total of \$91.2 million.

The dividend was also increased by 5.9 percent. This attractive dividend lowers its risk profile.

Third Avenue Real Estate Value Investor Fund (TVRVX) is loaded with good values substantially below 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, when making decisions on whether to buy, hold,

or sell a particular company. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams in order to come up with their estimates of intrinsic value. Just as we do at *Sound Advice*, they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

TVRVX has a number of distinguishing characteristics. This is a global real estate fund. 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 in distressed times.

Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

Medically-Related Selections

This sector is defensive because medical needs persist regardless of financial conditions. The world's demographic aging trends, and the commensurate increase in medical care needs, translate into strong growth prospects for this industry.

Boston Scientific (BSX) produces medical products well suited for an aging population. The company's mission is 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 has more than 900 US patents.

In the final days of April, BSX reported surprisingly high earnings of 28 cents per share. The stock jumped more than 10 percent on the news. The earnings increase was significant because it was higher sales from the cardiovascular segment. BSX is seeing improvement in the adoption of its Synergy stent and Watchman surgical device for the prevention of strokes.

Pfizer (PFE) has an arsenal of new pharmaceutical products, with 88 in clinical development and 30 in late stage development or registration. PFE has rebuilt its pipeline and transformed its R&D approach. The company is well positioned with several break-through drugs and

treatments.

Shortly after Pfizer and Allergan received a request for additional information from the US Federal Trade Commission with respect to their merger, the Treasury department introduced new rules regarding "inversions" aimed at blocking PFE from buying Allergan and relocating to Ireland which would have reduced PFE's taxes. Oddly enough, PFE climbed 10 percent after the news, which indicates that PFE was paying too much for Allergan.

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

In April, SYK reported earnings of \$1.24 per share, 10.4 percent higher than one year ago, which exceeded expectations. Growth was bolstered by new product launches and initiatives to improve sales and marketing. Operating revenue rose across all of the business segments. The highest increase (12%) was in the Neurotechnology and Spine segment, followed by MedSurg sales growth (3.4%), and the Orthopedics segment (3.3%).

Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions. The most significant recent acquisition was MAKO Surgical, which recently received FDA clearance for its knee and hip applications, enhancing SYK's robotic reconstructive solutions. Other recent acquisitions include Small Bone Innovations, Pivot Medical, Berchtold Holding, as well as Trauson Products, China's largest manufacturer of orthopedic implants.

Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still HQL) is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last one, five, and ten year periods.

Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. This is especially true during a recovering economy. Small-cap stocks perform better than large-cap stocks because 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. They also tend to be domestic companies without substantial overseas exposure, and therefore are not buffeted by the currency fluctuations that currently haunt larger companies. Here more than ever, attention to value is paramount.

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. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), 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.

Agrium (AGU) is a Canadian company offering a broad mix of agricultural products, from wholesale fertilizers to retail farm products, aimed at increasing the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while population and per-capita income increases. This translates into a need for greater crop output per acre through the use of AGU's products.

Close to three-quarters of AGU's earnings now come from its retail stores offering farm products, and the rest comes from its wholesale sales of fertilizers, mostly nitrogen-based but also from potash and phosphates. This diversification protects AGU from swings in the markets and brings steady sources of free cash flow for future growth.

This is a good value with a growing dividend.

Alcoa Aluminum (AA) is a fully integrated aluminum producer, which means it operates in all phases of production, starting with its mining operations (upstream) and ending with its finished products (downstream). Alcoa's full integration gives it control over the supply chain, and makes it possible to enjoy larger profits from its downstream operations when aluminum prices are low.

In the first half of this year, Alcoa will be splitting its upstream and downstream operations into two separate companies. Management is making this move to unlock value, and we believe it is certain to do just that. To lower the debt burden before the split, the company is focusing on selling non-core assets. During the first quarter, asset sales totaled \$750 million.

Aluminum prices have rallied sharply in recent weeks. If prices stay at these levels, markets will be anticipating better forward earnings for AA.

Disney (DIS) has built an empire in family-oriented

entertainment. No one does a better job with its charming film characters, consumer products, and theme parks. CEO Iger's decisions over the past decade to acquire Marvel, Lucasfilm, and Pixar are paying off.

2016 is starting off well, with *Star Wars: The Force Awakens*, grossing more than \$2 billion, not counting substantial amounts of merchandising revenue, which puts it just behind 2009's *Avatar*'s \$2.79 billion, the highest grossing movie in history. *Zootopia* was released in early 2016 and has grossed more than \$900 million, becoming the highest grossing March release of all time in the US. *The Jungle Book* grossed \$240 million within weeks of its release, and its success unlocks a pipeline of live action fairy tales including a sequel to *The Jungle Book*, a Tinker Bell movie, and a spin off of 101 Dalmatians.

Disney plans several more episodes and related offshoots of the *Star Wars* franchise into 2019, along with more *Indiana Jones* movies and more *Avengers* and *X-men* movies.

The success of these movie franchises will add to investor enthusiasm and should make DIS less dependent on its cable TV stations, especially ESPN, which are under pressure from cable platforms offering skinnier bundles with fewer required stations.

Ford (F) is in our model portfolio because it is an extraordinary value. Ford's new all-aluminum F-150 truck, which gets close to 30 miles to the gallon, has been Ford's best-selling vehicle in the US for 34 consecutive years, and the company's most profitable product.

On the cost side, Ford has been reducing the number of platforms it uses to produce its models, from 27 in 2007 to 9 by the end of 2016, which will continue to save billions through economies of scale and give Ford more agility to adapt to changes in demand.

In the last days of April, Ford reported first quarter earnings of 61 cents a share for the first quarter, more than double the 29 cents a share reported for the first quarter of 2015.

In the third quarter, Ford will be introducing a new Super Duty F-Series truck which finance chief Bob Shanks said should help lift earnings in the back half of this year.

Ford is expected to earn at least \$1.95 per share in 2016, which puts the stock price close to 7 times earnings, an incredible discount from the rest of the market. The dividend yield is close to 5 percent which lowers the risk.

Freeport-McMoRan Copper & Gold (FCX) is the world's largest copper producer. It also has significant oil and gas assets which it acquired at the top of the market in 2013. This was particularly unfortunate because FCX took on a large amount of debt to make the acquisition. The added leverage, along with sinking prices on these commodities, has decimated FCX.

FCX reported first quarter EBITDA (earnings before interest, taxes, depreciation, and amortization) of \$873

million, down from \$919 million in the previous quarter. However, there are some bright spots developing.

Commodity prices, including copper, have increased substantially in recent weeks which should boost second quarter earnings. In addition, severe cost-cutting has reduced recovery costs for copper.

As mentioned in prior issues, Freeport has instituted an asset-sales program to raise \$5-\$10 billion to reduce debt. Management is focused on this issue as evidenced by the time spent on this topic during the first quarter conference call. So far this year, Freeport has announced asset sales amounting to \$1.4 billion. CEO Richard Adkerson said the company is “advancing discussions on additional transactions.” He also said “the scarcity of quality assets in the copper business is attracting significant interest from potential purchasers.”

As we have reported previously, Carl Icahn has a stake of 88 million shares, which makes him its largest shareholder. Mr. Icahn usually has a plan in mind aimed at fixing the current problems, and coercing management into adapting his ideas. The board of directors has been restructured which was likely done to avoid a proxy fight with Icahn.

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.

First quarter earnings were 38 cents per share, higher than anticipated. NCR has been acquiring companies to strengthen its software and services segments in addition to hardware. During the first quarter, NCR changed the earnings reporting structure into reporting segments of software, services, and hardware. For the first quarter, revenue increased 1 percent for software, 4 percent for services, and declined 11 percent for hardware.

Blackstone recently purchased \$820 million in convertible preferred stock that is perpetually convertible into NCR common stock at \$30 per share. Blackstone is a savvy private equity and advisory firm, with a successful track record. Blackstone evidently sees that it can accelerate NCR's transformation into a software-driven business, and add significant value to NCR above \$30.

We have noted that NCR is an undervalued stock, even at \$30. NCR raised its 2016 earnings estimates to be in the range of \$2.90-\$3.00, which puts the stock close to 10 times earnings, far below the market average.

Symantec (SYMC) is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. Nearly all of the Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

In January, Symantec sold its subsidiary Veritas to the Carlyle Group. The sale transforms Symantec into a pure-

play security vendor with fresh capital for acquisitions and R&D to bolster growth. This new-found focus and capital should launch a new growth phase for SYMC.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets. TTEK recently purchased Coffey International which is a good fit and should improve TTEK's growth in the next few years.

TTEK's recent acquisition of INDUS Corporation, an information technology (IT) firm offering spatial and water information management capabilities to US government customers, will expand TTEK's key clients, to include the Environmental Protection Agency. The acquisition is a good fit with TTEK's water management expertise and offers increased growth potential.

TTEK reported first quarter earnings of 38 cents per share, beating expectations. The company expects full-year earnings in the range of \$2.70 to \$3 per share, which puts the price/earnings ratio between 10 and 11 – a substantial discount to the rest of the market.

Xerox (XRX) is continuing to transform from a seller of printers and copiers to a company providing information technology (IT) services and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenue. We have been emphasizing that XRX is very cheap relative to the rest of the market.

Carl Icahn recently purchased 82 million XRX shares. To improve management efficiency and focus, Icahn is forcing the company to split into two separate companies, one with the printers and other equipment and the other offering the IT services. Mr. Icahn believes XRX is undervalued and that share earnings will likely improve in 2016.

ETFs for Rising Interest Rates

We are recommending three ETFs designed to benefit from the normalization of interest rates and long term bond yields. As discussed previously, bond yields are bound to increase in the months and years ahead as energy prices recover, the US economy continues to strengthen, and inflation begins to heat up.

These ETFs differ in the amount of leverage used, and 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, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds. The prices of these ETFs fluctuate in accordance with the daily

fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. In its December meeting, the Federal Reserve's Federal Open Market Committee (FOMC) unanimously decided to begin normalizing interest rates.

The most recent Dot Plot was taken at the March meeting. Of particular interest in the details of the March Dot Plot is the sharp difference in the predictions among this group of informed FOMC experts. The lowest prediction was that the Federal funds rate would end 2016 at 0.625 percent. The highest was 2.125 percent.

Long-term Treasury bond yields generally move in accordance with changes in short-term rates because investors usually want a real rate of return (above the inflation rate) in the proximity of 3 percent. As mentioned previously, inflation, (including food and energy), has been bouncing around zero. At this writing, long-term Treasury bond yields are 2.67 percent. With inflation near zero, this is close to the real return.

A reasonable forecast would use the median points of the March Dot Plot, which predicts that the Federal funds rate will be 0.875% by the end of 2016, 2.0625% by the end of 2017, and 3.00% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same as today's real return), long-term Treasury bond yields would be yielding 3.545% by the end of 2016, 4.733% by the end of 2017 and 5.67% by the end of 2018.

Here is what would happen to each ETF:

TMV would rise to \$34 by the end of 2016, to \$60 by the end of 2017, and to \$91 by the end of 2018.

TBT would rise to \$51 by the end of 2016, to \$74 by the end of 2017, and to \$98 by the end of 2018.

TBF would rise to \$26.6 by the end of 2016, to \$32 by the end of 2017, and to \$37 by the end of 2018.

A conservative forecast would use the lowest points of the March Dot Plot, which predicts that the Federal funds rate will be 0.625% by the end of 2016, 1.625% by the end of 2017, and 2.125% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same as today's real return), long-term Treasury bond yields would be yielding 3.295% by the

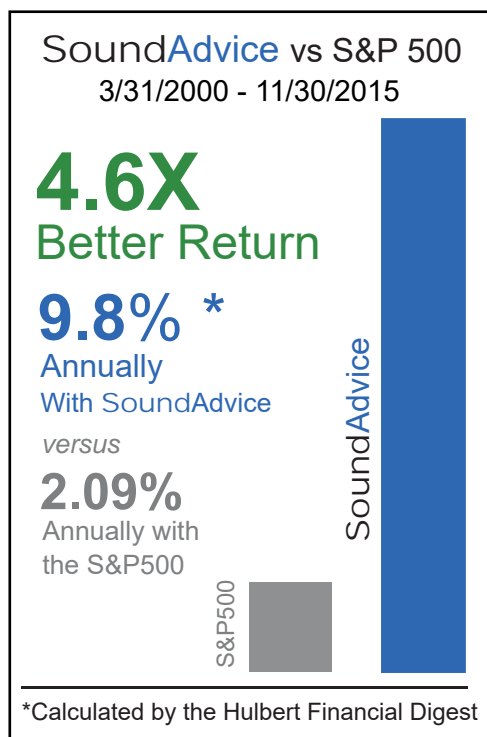
end of 2016, 4.295% by the end of 2017 and 4.795% by the end of 2018.

Here is what would happen to each ETF:

TMV would rise to \$30 by the end of 2016, to \$49 by the end of 2017, and to \$61 by the end of 2018.

TBT would rise to \$46 by the end of 2016, to \$65 by the end of 2017, and to \$75 by the end of 2018.

TBF would rise to \$25.5 by the end of 2016, to \$30 by the end of 2017, and to \$32 by the end of 2018.



The Erosion Factor

As we have pointed out in the past, 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 for the next two years. Here is what would happen to each ETF:

TMV would decline to \$19.9 by the end of 2016 (6.9%), and to \$18.5 by the end of 2017 (13.3%).

TBT would decline to \$35.8 by the end of 2016 (3.8%), and to \$34.6 by the end of 2017 (7.0%).

TBF would decline to \$22.2 by the end of 2016 (1.5%), and to \$22.2 by the end of 2017 (2.5%).

While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Hedging the Portfolio

Since June 2015, our *Sound Advice* Diffusion Index of Lagging Indicators (page 11) has been issuing a caution signal. At times like this, it is vital to confine portfolio selections to special situations and focus on value.

The **ProShares UltraShort S&P 500 (SDS)** is a reverse ETF, which means it moves in the opposite direction of the market. This ETF 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.

Income With Growth	Symbol	Price / NAV	Yield	Action	Limit
Hersha Hospitality Trust	HT	\$19.29	5.81%	BUY	\$24.00
Retail Opportunity Investment Corp	ROIC	\$19.67	3.66%	BUY	\$21.00
Diversified Growth					
Agrium	AGU	\$86.12	4.06%	BUY	\$95.00
Alcoa	AA	\$11.17	1.07%	BUY	\$11.50
Boston Scientific	BSX	\$21.92	0.00%	BUY	\$22.00
Disney	DIS	\$103.26	1.33%	BUY	\$107.00
Ford Motor Company	F	\$13.56	5.16%	BUY	\$15.00
NCR Corp	NCR	\$29.09	0.00%	BUY	\$33.00
Pfizer	PFE	\$32.71	3.67%	BUY	\$34.00
Stryker Corp.	SYK	\$109.01	1.39%	BUY	\$115.00
Symantec	SYMC	\$16.65	3.60%	BUY	\$23.00
Tekla Life Sciences Fund	HQL	\$18.30	0.00%	BUY	\$20.00
Tetra Tech	TTEK	\$29.40	1.09%	BUY	\$32.00
Third Avenue Real Estate Value Investor	TVRVX	\$28.82	1.53%	BUY	\$30.00
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$19.67	0.00%	BUY	\$20.00
Xerox	XRX	\$9.60	2.92%	BUY	\$12.00
Energy/Natural Resources					
Chevron	CVX	\$102.18	4.19%	BUY	\$105.00
Fidelity Select Nat. Gas Fund	FSNGX	\$24.49	0.00%	BUY	\$25.00
ICON Energy Fund Class S	ICENX	\$12.30	0.00%	BUY	\$13.00
Transocean	RIG	\$11.08	0.00%	BUY	\$14.00
Valero	VLO	\$58.87	4.08%	BUY	\$69.00
Aggressive Growth					
Chesapeake Energy Corp	CHK	\$6.87	0.00%	BUY	\$7.50
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$21.38	0.00%	BUY	\$28.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$22.79	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$37.21	0.00%	BUY	\$44.00
Freeport-McMoRan	FCX	\$14.00	0.00%	BUY	\$15.00
S&P 500 ProShares Ultra Short ETF	SDS	\$18.72	0.00%	BUY	\$24.00

Notes to the table:

Prices are as of 4/29/2016. See our website for live pricing and buy limits:

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

The right hand column is the highest recommended price limit for purchases.

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. The table above divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

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 underperforming 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 \$12.3 million in stocks and to \$1.58 million in houses.

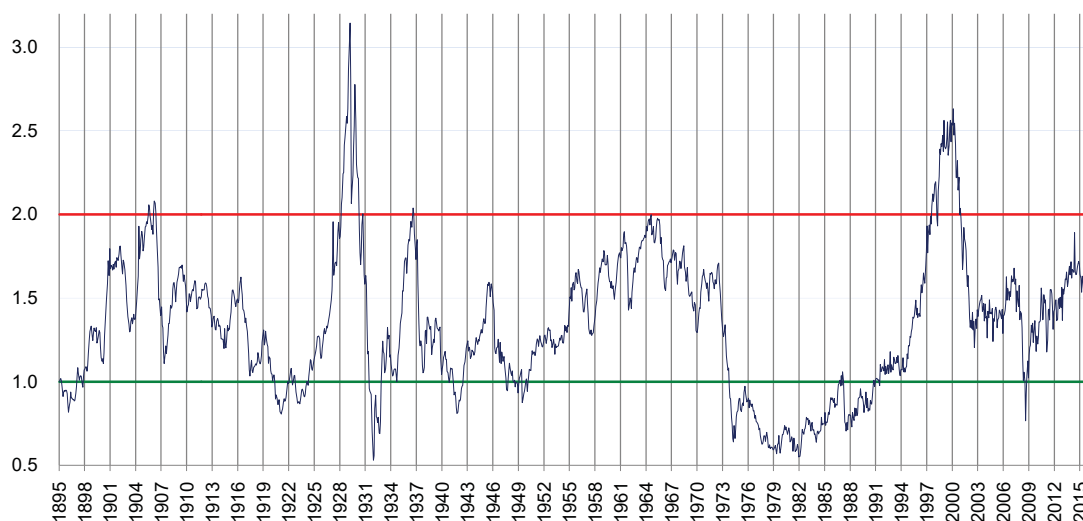
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$488 million, or 39.7 times more money—the 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 SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.65. This reading reveals that stock prices are close to 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 Turbulent Markets* for a complete explanation of the SoundAdvice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



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 March, 2015.

The previous zero reading was 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.

However, the March 2015 signal was usurped by the SoundAdvice Diffusion Index of LAGGING Indicators, which 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.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09.

The most recent Caution signal came in June 2015, based on the June 2015 release of the May lagging economic indicators. This was just after the S&P 500 peaked at 2,130.82 on May 27, 2015.

We are still in Caution mode. Our next signal will come from a zero reading from the SoundAdvice Diffusion Index of LEADING Indicators, which will reverse our current Caution signal. This Diffusion Index read 33.3 percent based on the most recent March 2015 leading indicators. It is interesting to note that a zero reading is not on the horizon if all of the selected underlying leading indicators remained unchanged.

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 31.5 percent. During "Caution" signals, the S&P 500 increased an average of 2.4 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 +/-	31.5%		2.4%

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the SoundAdvice Diffusion Indexes and their track record. (You received a copy of this book with your paid subscription, and you will also receive an updated copy when you renew your subscription.)

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