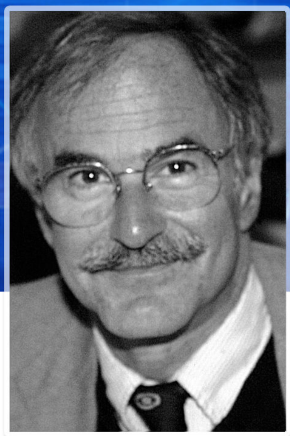
The PAD System Report



Daniel Seiver

Regular Issue May 31, 2018 *S+P 500 2705 DJ 24416*

THE ITALIAN JOB

Sometimes stock market selloffs seem to come out of the blue. The latest decline, though, comes straight from the green, white and red of Italy, with the government there in turmoil. This is of course nothing new for the Italians, but the two populist parties who had formed an uneasy coalition, The Five Star and Northern League, were blindsided by the President of Italy, who did not let them form a government. The likely result will be a quick new round of elections in Italy, which could serve as a referendum on staying in the Eurozone. Both the Five Star (left) and Northern League (right) seem to prefer exit, although they agree on little else. While polls show that the majority of Italians want to stay, polls also showed that Britons would reject Brexit, and of course that Hillary Clinton would be elected President. Italy is the third largest economy in the Eurozone, and has a very substantial debt burden: the Italian debt to GDP ratio is above 130%, and total government debt is nearly $2.7 trillion. Italian economic growth is anemic at best, with banks hobbled by a mountain of bad debt still on the books.

Thus Italy is a bigger headache than Greece, whose financial troubles led to stock market selloffs in many countries, including the US. If history is any guide, the Italians will muddle through their current crisis, as they have many others in the postwar period. But the news from Europe also includes more political instability in Spain, and even more troubling, an ECB board member suggesting that the ECB's QE program should be ended. Since the ECB is following the Fed's playbook, an ending of QE would be followed by a gradual rise in short-term interest rates, which is not a positive for stocks.

Adding to the financial malaise is a rising fear that the US and its major trading partners are heading toward a trade war. Contrary to well-known, albeit not well-thought-out, tweets, trade wars are bad, and hard to win. The Chinese are unlikely to cave in to threats from the US, and US exporters, like Boeing and American farmers, are likely to bear the brunt of retaliation. The Europeans, Canadians, Mexicans, and Japanese will also retaliate against the latest tariffs on aluminum and steel. An enormous irony (other than the fact that we "assured" world prosperity with the Smoot-Hawley tariff of 1930), is that the Chinese do lie, cheat, and steal when it comes to trade. And Chinese companies do pose security risks for the US. The Chinese telecom firm ZTE does all of this, yet President Trump has tweeted that he is worried about the effect that justifiable US sanctions on ZTE would have on *Chinese* jobs. Go figure. A second irony is that the other countries are our *allies*. Go figure. A third irony is that tariffs on inputs (like steel and aluminum) hurt all the downstream users, who are more numerous (in terms of jobs) than the producers.

The PAD System Report is published by Patience & Discipline Inc. Editor: Daniel A. Seiver
Website: PADSystemReport.com

Ok, don't even bother.

US stocks must also deal with the prospect of rising US interest rates. The FOMC has already telegraphed its next ¼-point increase coming in June. Barring a financial calamity, further increase will occur this year and next. With unemployment at 3.9%, and inflation poised to exceed the Fed's official target of 2%, the Fed may be forced to increase short-term rates even faster than the current plan. Long-term rates may not increase as much, although the US Treasury 10-year bond yield did recently pierce 3% before falling back on a fearful "flight to quality." Stock traders will remain on edge, though, since it is now well known that if the US yield curve "inverts," a recession becomes very likely. We still think a recession is years away, but rising inflation and interest rates could certainly put an end to the 2009-2018 bull market, already the second longest in history.

Our VL MAP valuation measure is still historically low at 45%. Other better-known measures of valuation are still high. Shiller's 10-year p/e ratio is above 32, which is higher than it was at the stock market peak in 1929. While corporate earnings are strong, the best quarter of growth is probably past. Economic growth over the next year is likely to pick up to 3% in real terms, but this is unlikely to fuel a dramatic increase in corporate profits after the effects of the tax cut wear off.

Politically, the US is headed for a midterm election that could lead to the Democrats taking control of the US House of Representatives. Although much can and will happen between now and November, the current odds are that the Democrats have a 55-60% chance of gaining control. This outcome would likely lead to legislative gridlock, which would block remaining components of the Trump legislative agenda and set up a truly brutal showdown in 2020. The state of our political discourse could easily deteriorate even further, (think Roseanne Barr and Samantha Bee) and greater policy uncertainty will hang like a cloud over the financial markets.

RECOMMENDATION: VL MAP remains very low at 45%. Hold cash reserves of at least 65%. (5/31/2018 5:00 PM PT)

MODEL PORTFOLIO-C

PORTFOLIO STATISTICS:

Weighted year-ahead performance rank: 2.42; Weighted safety rank: 2.04; Portfolio MAP: 49%. (These statistics and more can be found on the subscriber's corner of our website.) Our weighted performance rank is still above average. Our safety rank is superior to the Value Line average of 3.0, which means our portfolio is very conservatively invested. Our portfolio MAP is low but slightly above the VL MAP of 45%, which reflects the general overvaluation of the market and our portfolio stocks. Our portfolio weighted average beta is less than 0.5, which is very defensive. Overall, we are well-positioned for a substantial market decline, and we have the requisite patience and discipline to wait for it. If the market stubbornly continues to rise, we will still make money, and will sell into the rally.

PERFORMANCE UPDATE:

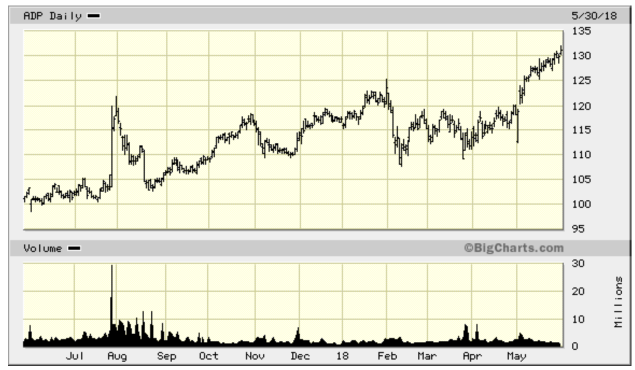
Hulbert Financial Digest no longer publishes performance statistics for stock market newsletters. (In their final report through 2015, our portfolio outperformed the market on a risk-adjusted basis at every time interval from one year to 25 years.) We will update our performance every 3 months in our full issues (February, May, August, November). On May 28, 2017 the S+P 500 Index was at 2416 and the Model Portfolio was worth $613,333. Today, the S+P is at 2705 (up 12%) and the Model Portfolio is worth $645,540 (up 5.3%). With 66% cash, we will likely earn far less than the market return. But we will sleep better, since we are prepared for a major decline, and will have the cash to pick up bargains when they appear.

PORTFOLIO STRATEGY: Our cash position is the highest it has ever been since the PAD System Report was first published in 1986. We are reluctant to raise it further unless the stock market rallies to new highs. In that unlikely event, we would reduce our MP holdings further to give us a 75% cash position. In the more likely event that the stock market either churns for the rest of the year, or actually drops by 20% or more (a common measure of a bear market), we will exert patience and discipline until stock prices are again reasonable.

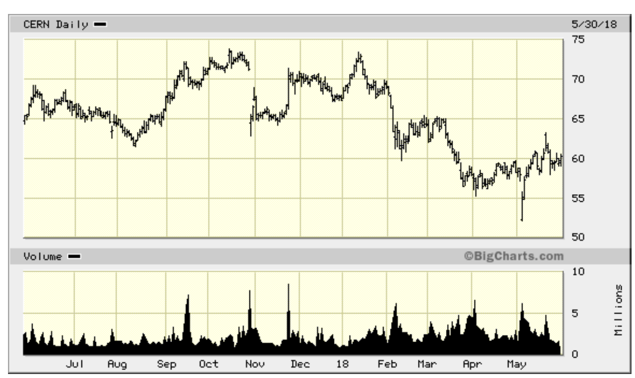
UPDATES ON PORTFOLIO STOCKS:

AECOM is stuck in a rut, and is now ranked "4" for year-ahead performance. The culprit is earnings. Fiscal 2018 will be a terrible year, with earnings down substantially. The most recent quarter was particularly weak compared to the year before. A turnaround will likely not come until 2019. We are willing to wait, however, since the world needs a lot more infrastructure spending. The US needs plenty, but the Trump administration seems unable to propose a viable plan. This is a shame, since an increase in infrastructure spending has bipartisan support, and is endorsed by most economic experts as a good way to boost long-term economic growth.

Automatic Data continues to set new all-time highs. Even though the stock is only a "3" for year-ahead performance, the company continues to increase earnings at a steady clip, buys back shares regularly, and increases its dividend every year. (In fact, ADP will increase its dividend twice this year.) ADP has a strong balance sheet and is an ideal conservative PAD stock. (Your Editor has owned this stock since 1988.) Our only concern is that the stock is approaching the low end of its 3-5 year appreciation potential of 135-165. A further rally in the market may force us to lighten up a bit.



Cerner is our other dog. Like AECOM, they are in an industry with excellent long-run growth prospects (in this case medical software) but their bottom line regularly disappoints. The first quarter was no exception, with earnings down a penny, while the rest of US industry surged. Value Line projects earnings will turn around in the current quarter, but we have heard this song before. The stock is ranked "4" for year-ahead performance, and Value Line has cut 3-5 year appreciation potential to 75-105. Our patience is wearing thin; we will look carefully at switching to another firm in this industry which has better bottom-line growth prospects.



Cognizant stock took a tumble in early May, and has not recovered. We are not concerned. The long-term record of this PAD star is outstanding. Earnings go up *every* year, normally by double-digits, including straight through the worldwide Great Recession of 2007-09. The stock is a ten-bagger since the market low of 2009. The company is strong financially, and recently instituted a dividend. The stock is ranked "1" for year-ahead performance, and still has some 3-5 year appreciation potential left. Hold.

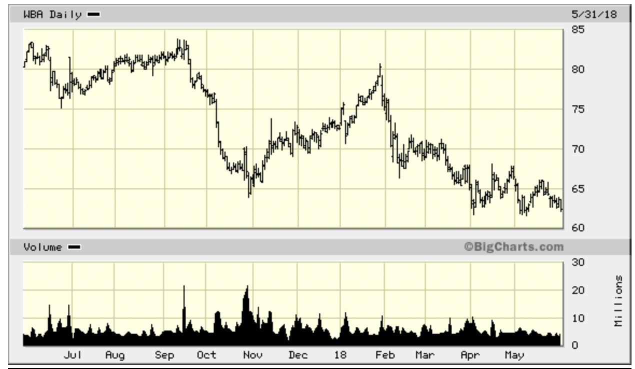
Fiserv recovered fully from its early year slump, and is now close to its all-time high. (All data are adjusted for the recent 2-for-1 stock split.) Earnings are still in a steady uptrend, and the stock is ranked "2" for year-ahead performance. While Value Line still insists on giving the company a below-market 3-5 year p/e, it has gradually nudged this ratio up. We still adjust the 3-5 year appreciation potential to reflect a more reasonable future p/e, but even our 3-5 year projection is only 65-85, and the stock is trading well within that range. So in 2018 we may have to sell a few more shares of this PAD star, which is also a 10-bagger since 2009.

ON Semiconductor is again close to its all-time high. The stock is ranked "1" for year-ahead performance, and the company should continue to report record earnings over the next 3-5 years. We still consider ON to be a possible acquisition candidate, but it may be that no foreign firm will be allowed to buy them, thus decreasing their attractiveness as a takeover candidate. The stock is more volatile than most of our portfolio, with a beta of 1.4, but financial strength is improving. Hold.

Thermo Fisher has been gyrating between 200 and 220 for most of the year. Earnings have been in a strong uptrend for years, even though the pace is slowing. The problem here is that the market has already rewarded Thermo with a superpremium p/e, and the current price is already well within the 3-5 year range of 185-250. We may also have to lighten up here if the market rallies significantly.

Taiwan Semiconductor has been weak this year. Instability in the Korean peninsula, combined with bellicose rhetoric from China, has weighed on the stock. Yet the company, the world's largest semiconductor foundry, and a technological leader, is still reporting higher earnings ever year. The price weakness, combined with a bump in 3-5 year appreciation potential to 50-65, means the stock is not overvalued in the high 30s. The 2018 annual dividend will be announced next week and should be at least as large as last year's $1.16. (If you own the stock, the 20% of the dividend withheld can be claimed on your tax return as a tax credit.)

Walgreens Boots, which replaced CVS, has already rewarded us by underperforming both the market and CVS! We still like Walgreen's long-term prospects, though. Health care will remain a growth industry. The stock has more 3-5 year appreciation potential than any other stock in our portfolio, and is ranked "1" for year-ahead performance. Financial strength is A+, Safety is above average at "2," and earnings are projected to grow at 10% per year. The growing dividend is a bonus. Yet the stock's p/e is only 60% of the market average. Hold.



<u>ADVICE</u>: Hold all long positions. Hold cash reserves of at least 65%.

(Portfolio on next page)

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
500	AECOM (ACM)	33	16,500	Hold
250	Automatic Data (ADP)	130	32,500	Hold
200	Cerner (CERN)	59.7	11,940	Hold
320	Cognizant (CTSH)	75.4	24,128	Hold
604	Fiserv (FISV)	72.6	43,850	Hold
1000	On Semiconductor (ON)	25.1	25,100	Hold
1100	Taiwan Semiconductor (TSM)	38.7	42,570	Hold
80	Thermo Fisher (TMO)	208.3	16,664	Hold
120	Walgreen's Boots (WBA)	62.4	7,488	Hold
CASH	Money Mkt Fund		424,800	
TOTAL			$645,540	

WWW.PADSYSTEMREPORT.COM: subscribers can renew online, and check the status of their subscription. Subscribers also have access to back issues, the current issue in PDF format, and the PAD Portfolio Excel spreadsheet, which summarizes short-term rankings, 3-5 year appreciation potentials for all PAD portfolio stocks, and measures of the Portfolio-weighted overall ranking for year-ahead performance, safety, and MAP.

Note: New subscribers baffled by the details of the PAD System should purchase a copy of Daniel Seiver's *Outsmarting Wall Street* (3rd edition, Probus/McGraw Hill, 1994). This book contains a full discussion of the PAD System and all of its rules. Although out of print, it is regularly available on Amazon.com. The **Google ebook version is now available for $9.95 on our website.** A number of public libraries still have copies of the physical book.