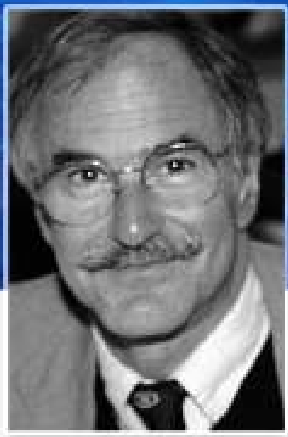
The PAD System Report



Regular Issue June 8, 2019 *S+P 500 2873 DJ 25984*

"THAT'S LIFE…

That's what all the people say…Ridin' high in April, shot down in May." And back on top in June! Was "Ol' Blue Eyes" singing about stocks? Probably not, but after "ridin' high" during a strong April, the Dow was "shot down" 1500 points in May, as the Trump Administration wielded the tariff axe, in the unshakeable yet completely mistaken belief that "trade wars are good and easy to win." The Chinese were not cowed by the bluster and threats, although, as of this writing, Mexico appears to have caved, albeit months ago. The damage to the American economy from the Chinese tariffs may have finally begun to show up in recent economic data, which are now suggesting that the slowdown in growth in the US is real. The potential damage for the US of the threatened Mexican tariffs would have been worse; even sycophantic Republican senators were up in arms.

The indefinite postponement of the Mexican tariffs, combined with the Friday employment report showing a sharp slowdown in monthly employment growth, were enough to ignite a sharp rally in the first week of June which wiped out much of the May decline in just one week. ("Back on top in June!") Of course we must ask, "why would slowing economic growth be such a positive for stocks?" Because the Fed will ride to the rescue with interest rate cuts which will prevent a recession!

This chain of reasoning is almost certainly wrong. The first weak link is that we are on the cusp of a recession. A slowdown in growth after the "sugar-high" of business and personal tax cuts was inevitable, and probably desirable if the economy was indeed close to "full" employment. But a recession means that output (and incomes) actually fall, which may not happen. Although prediction is an especially risky business (especially predicting the future), we do not yet see a recession coming. Neither does the Fed.

The second weak link is that the Fed will respond to the slowdown now with interest rate cuts, in spite of the fact that employment data is notoriously "noisy" and regularly revised. The best estimate of second quarter (April-June) real GDP growth comes from the Atlanta Fed: 1.4% as of June 7th, and this estimate incorporates the latest employment report. Since the Fed believes (as do we) that the long-run real growth rate for the US GDP is around 2.0%, there is no reason for the Fed to panic now. In fact, the suspension of the Mexican tariffs, which could have helped push the US economy closer to a recession, makes it even less likely that the Fed will

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The third weak link is that a ¼-point cut, or even two ¼-point cuts in the Federal Funds rate, will prevent an incipient recession. The Fed's interest rate weapon is not all-powerful, and it takes many months for a change in interest rates to percolate through the economy. The patron saint of monetarist economics himself (Milton Friedman) said that monetary policy acts "with long and variable lags."

The next scheduled FOMC meeting is Jun 18-19. If the Fed does not cut interest rates at that meeting, disappointed Wall Street traders are likely to drive stocks lower. This prospect should not alarm the Fed, which would lose some of its credibility if it appeared to be beholden to the whims of Wall Street.

Of course the stock market is not driven solely by interest rates. Corporate profits are the second leg of the 3-legged stool which supports stock prices. Here the outlook is cloudy at best. The first quarter of the year showed little if any profit growth, and this weakness will likely persist through the second and third quarters. Wall Street projects much faster growth in 2019's fourth quarter, and in 2020. But these rosy longer-term projections are almost always dialed back. Expect it to happen again as the reality of slow economic growth sinks in.

The third leg of the stool is valuation. What p/e should be assigned to profits in 2019 or 2020? Looking backward, the Shiller 10-year p/e for the S+P is still quite elevated. It will certainly drop when 2009's low earnings are dropped from the 10-year average, but stocks will still not look cheap. The forward-looking VL MAP is probably at 55% right now, which says that stocks are not cheap compared to earnings 3-5 years from now. (For perspective, VL MAP reached 190% at the depths of the last bear market.) Of course, neither of these measures tell us when the stock market will decline, how far it will decline, or even if it is going to decline. What they do tell us is that it will be a tough ride up from here if we are depending on investor optimism to lift the market to new highs. And the downside risk is high.

Much could happen in the coming months that could depress investor optimism. Although it is especially hard to predict what economic policies will emerge from Trump-induced policy chaos, we expect more trade trouble, since the wonders of tariffs (ours anyway) are undiminished in his mind, and his self-selected advisers will reinforce his long-discredited mercantilist ideas.

But there is also the threat of Brexit, which is looking more and more like a no-deal crash-out in the fall. Some of the shock waves will lap at our shores. And don't discount the trouble-making of Trump's bromantic dictators, especially little rocket man Kim of North Korea, and Trump's dear friend and world-class troublemaker Putin. The mullahs in Iran can still make trouble too. And China's Xi cannot lose face by caving in to the Donald's demands.

And then there is the 2020 election. If the Democrats survive primary season, and unite behind their candidate (admittedly both huge ifs) Trump will probably lose, and Wall Street will cry hard in anticipation. We may all shed tears during what will almost certainly be a truly ugly contest, with "Putey" creating as much havoc as possible.

RECOMMENDATION: VL MAP remains low at 55-60%. The market is still vulnerable, and another serious correction or bear market could start at any time. Continue to hold cash reserves of 65%. (6/9/2019 1:20 PM PT)

MODEL PORTFOLIO-C

PORTFOLIO STATISTICS:

Weighted year-ahead performance rank: 1.91; Weighted safety rank: 2.04; Portfolio MAP: 52%. (These statistics and more will eventually be found on the subscriber's corner of our website, which has recently attracted some Russian trolls.) Our weighted performance rank is far above average. Our safety rank is far superior to the Value Line average of 3.0, which means our portfolio is very conservatively invested. Our portfolio MAP is now almost even with VL MAP. With our large cash holding, our portfolio weighted average beta is less than 0.5, which is very defensive.

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 31, 2018 the S+P 500 Index was at 2706 and the Model Portfolio was worth $645,540. Today, the S+P is at 2873 (up 6.2%) and the Model Portfolio is worth $663,680 (up 2.8%). With 65% cash, we should earn about 1/3 of the market return on the upside, and thus our one-year risk-adjusted performance is quite good. (All of these statistics exclude dividends on the S+P, dividends on our portfolio stocks, and earnings from our cash reserves. Given today's yields, if we add them all in, our relative performance would be even better.)

PORTFOLIO STRATEGY: Our cash position remains historically very high. We added to it slightly with our sale of WBA, which we certainly do not regret. We will probably not raise cash further unless the market surges to new highs. Until we are completely "back on top in June," sit tight. However, if the market isn't "shakin' come July," watch out!

UPDATES ON PORTFOLIO STOCKS:

Automatic Data just won't quit. A spike upward in early June erased the May selloff and drove the stock to yet another all-time high. The stock is still a "1" for year-ahead performance, and a "1" for safety. In addition, ADP has a superb "95" for price growth persistence, an A++ for financial strength, and a top "100" for earnings predictability, which gives us even more confidence in Value Line's projections of future growth. ADP raises its dividend every year, and its beta is only 1.0. Too bad the stock is too expensive to buy now, but we can hold this ideal PAD stock, as the Editor has done since 1988. If we ever have another bear market, this stock should be at the top of subscribers' Buy Lists.

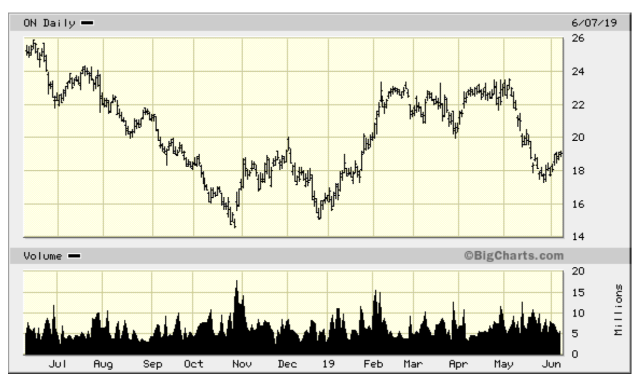
Cognizant has run into rough weather. The company will report a rare down year for earnings this year, and Wall Street has punished the stock. We have held Cognizant for a long time, and are not willing to give up yet. We have the luxury of staying with the stock while the new CEO turns the company back into a growth machine. We would not be surprised if Value Line reduces the year-ahead performance ranking to a subpar "4," but a reduction to a "5" would trigger a full-scale review under the PAD rules.

Edwards Lifesciences recovered nicely from the market's May selloff. The stock is now ranked "1" for year-ahead performance, with A+ financial strength, and a solid "80" for price growth persistence. Value Line has also bumped up 3-5 year appreciation potential to 210-315. R+D expenditures are above 10% of revenues, which is a strong sign that the management is investing in the long-run future. This health play is well worth holding.

Fiserv is right back at its all-time high set in early April. The merger with Firstdata should close this year, although US antitrust authorities have not given their blessing yet. 2019 Earnings should rise almost 10%, and as always, are partly driven up by FISV's stock buybacks. These buybacks have reduced shares outstanding by half in the last 15 years! Unfortunately, the stock is trading within our adjusted 3-5 year appreciation potential of 85-105. Another stock to look at if we have a bear market. Hold for now.

Granite Construction has been weak. First quarter earnings were below Wall Street's estimates, and there will clearly be no trillion-dollar infrastructure "deal" as long as Trump is President. But the world's infrastructure needs are gigantic. So we will be patient here. 3-5 year appreciation potential is high at 75-115, and we will live with the year-ahead performance ranking of "4."

ON Semiconductor sold off in May with all the other semiconductor stocks. All have a lot to lose from an escalating trade war with China, and ON could have a down year for earnings in 2019. But the stock is now really cheap (3-5 year appreciation potential is 30-45), and 2020 should see a resumption of earnings growth. ON is our riskiest stock with the highest beta in the portfolio. It is likely to lose its "2" ranking for year-ahead performance. But the long-term future is bright, and we are patient.



Thermo Fisher is back at its all-time high. Our best science play should log strong earnings this year, with more growth to come. This stock fits the old Wall Street adage to "buy the shovel makers, not the gold miners." TMO makes a lot of shovels! But the stock has surged to the top if its 3-5 year appreciation potential, and we think Value Line's long-term projections are reasonable. So if we have to lighten up this year, we will look at selling TMO.

Taiwan Semiconductor rode high in April and was shot down in May. Earnings will be flat in 2019, since growth in China is slowing, and the US-China trade war is heating up. But appreciation potential is good, the dividend yield is generous, and the long-term outlook, as TSM transitions to its newest 6-nanometer technology next year, is very bright. Hold.

ADVICE: Hold all long positions. Hold cash reserves of at least 65%.

Shares	***Company (Ticker)***	***Recent Price***	***Value***	***Advice***
250	Automatic Data (ADP)	167	41,750	Hold
320	Cognizant (CTSH)	62.8	20,096	Hold
92	Edwards Lifesciences (EW)	183.8	16,909	Hold
604	Fiserv (FISV)	89.7	54,179	Hold
350	Granite Construction (GVA)	42.3	14,805	Hold
1000	On Semiconductor (ON)	19.1	19,100	Hold
1100	Taiwan Semiconductor (TSM)	38.8	42,680	Hold
80	Thermo Fisher (TMO)	281.7	22,536	Hold
CASH	Money Mkt Fund		431,626	
TOTAL			$663,680	*Advice change

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. The **Google ebook version is available for $9.95 on our website.**

