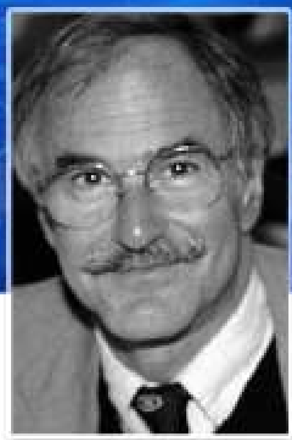
The PAD System Report



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DENTISTRY AND SLEDGEHAMMERS

Whatever worried the market in May was forgotten in June. Even though the Fed did not cut rates at its most recent meeting, members of the FOMC (including Chairman Powell) made it clear that the Fed would indeed ease up if the economy showed signs of weakening further. That was all Wall Street needed to rally back to all-time highs.

The Fed is concerned that a ramping up of the trade war with China could weaken the world economy (and the US economy) enough to warrant providing some additional monetary stimulus via a cut in short-term interest rates. Indeed, Powell faced his first dissent as one FOMC voting member was in favor of an immediate rate cut. With inflation still running below the Fed's target of 2%, it could be argued that there is room for more stimulus without damaging the Fed's hard-won inflation-fighting credibility.

This is a plausible argument, but the Fed must be careful for several reasons: first, the economy is still growing at about 2% in real terms, which many believe is about as fast as it can grow, given slow growth of the labor force and slow growth of labor productivity. With the economy somewhere near "full" employment, and wages beginning to show growth in real terms, there is still the risk of a pickup in inflation. The Fed certainly does not want to reduce rates in July and then have to raise them again in September. The June employment report, to be released on Friday July 5th, will be key: a return to strong growth in employment will make it harder for the Fed to reduce interest rates, and Wall Street will likely sell off even though the economic news will be good for American workers. On the other hand, another weak employment report may convince the FOMC to reduce rates at their July 30/31 meeting. A strong rally in stocks (which we will not chase) would then ensue.

Whether this putative easing of monetary policy can keep the bull market rallying is hard to know. Stocks are not cheap, the economy's growth is slow enough to keep corporate profits from growing much faster than 4-6%, and any step up in the trade war with China will have two negative effects on the economy: growth will slow further as exports are hurt, and prices will rise faster as imports become more expensive. This would be a miniature version of stagflation, which cannot be cured by monetary policy.

We believe it is unlikely that the Chinese will cave in to Trump's demands. They would lose a lot of face if they did so. There is of course no doubt that the Chinese have violated the rules of the WTO with impunity and that they should be

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punished for it. But a tariff war is the wrong tool for the job. It is akin to removing a tooth with a sledgehammer. And the backswing may hit the dentist in the head.

We also worry that Trump's advisers are spoiling for a war with Iran. (Apparently we came within 10 minutes of an airstrike.) While any outbreak of hostilities would lead to a knee-jerk selloff in stocks, the longer term consequences could be serious: the mullahs would have someone to blame for Iran's self-inflicted economic miseries, and Iranian proxies could create more unrest and violence throughout the Middle East. And the price of oil would probably go up if there were hostilities around the Strait of Hormuz.

It is hard to guess what else could go wrong (or right) since Trump is nothing if not unpredictable. But his manifest lack of qualifications for the job could exacerbate any crisis. It has all worked out so far, but this is not a good backdrop for a sustained market rally.

PORTFOLIO STRATEGY: The weighted average of our year-ahead performance ranks is 2.41 (very good) and our weighted-average safety is 2.05 (excellent). Our performance rank has been hurt by downgrades for **Edwards Lifesciences** (from "1" to "2"), **ON Semi** (from "2" to "3") and **Cognizant** (from "3" to "4"). None of these are a worry; we knew the CTSH downgrade was coming after a bad earnings report. (We would become concerned if Cognizant was downgraded to "5.") Portfolio MAP is 51%, which is only a bit worse than Value Line MAP.

RECOMMENDATION: The VL MAP is at 55%. If the stock market manages to rally from here, we will find a way to raise more cash, possibly lightening up on Thermo Fisher, which is selling above the high end of its 3-5 year appreciation potential. Hold cash reserves of 65%. (6/30/2019 12:30 PM PT)

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.