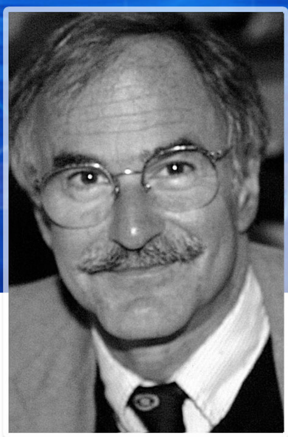
The PAD System Report



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AMERICA ROLLS THE DICE

Many of us in the prediction business expected Clinton to win, and expected the market to fall if Trump pulled the upset. We were wrong. Although Clinton won the popular vote by several million, the unexpected loss of key states like Ohio, Pennsylvania, and Michigan made the difference in the Electoral College. Trump won these states, and others, by promising to bring back jobs in manufacturing and coal mining, and by promising to deport millions of illegal aliens, and to keep them out with a wall.

It is unlikely that these policies can be carried out successfully. Although Trump has scaled back his deportation plans from 11 million to just the 2-3 million with criminal records (Obama has been busy deporting this group for years), many of these workers do jobs that are not sought after by native-born Americans. With net migration from Mexico near zero in recent years, it is unlikely that a wall (or fence) is even needed to "keep them out." And manufacturing jobs? Real US manufacturing output is at a record high. The problem is that US manufacturing *employment* is not. While manufacturing output is up almost 30% from 1998, manufacturing employment is down by over 5 million workers, as each worker is more productive than in 1998. This technological change cannot be reversed. Of course, huge tariffs on Chinese goods could temporarily boost domestic manufacturing, but this would raise prices for everything imported from China, and could spark a trade war which would hurt American exports and could lead to a recession.

The outlook for coal is even dimmer. Coal's share of the US power generation market has been falling since 1988, and natural gas will likely surpass it for the first time in 2016. (Natural gas is by far the "cleanest" of fossil fuels and is cheap.) And coal mining employment has dropped by two-thirds in the last 30 years, driven by technological change, a movement to Western coal, and increasing world-wide environmental concerns. These jobs are not coming back. The coal industry could benefit from the elimination of EPA regulations, or even the gutting of the EPA itself, but the world is moving away from coal, and the majority of Americans realize that climate change is real, and that a hotter planet will eventually endanger all earthlings.

Can any of Trump's promises be kept? The best candidate is infrastructure, since most economists and policymakers agree that the US needs massive investments in water and sewers, electricity generation, roads, bridges, ports, airports, water transportation, and the internet. Investments in these sectors will make Americans more productive, and will also create jobs in the short run, and perhaps even speed up economic growth in the short run too. With the

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US still able to borrow for 30 years at 3%, we can easily finance this spending, and there is no need to rely on the private sector to undertake these investments, many of which have returns which could not be captured by private firms.

Many of Trump's other promises can be turned into policy, and herein lies the main explanation of the post-election stock rally: a reduction in regulation of all types will clearly boost corporate profits. For example, bank stocks have rallied sharply in the hopes that Dodd-Frank will be repealed. Repeal would certainly boost bank profits, and allow the largest banks to increase their leverage and thus their return on equity. Rolling back labor, environmental, and consumer regulations will also boost corporate profits. And a pro-business Supreme Court can overturn many laws and regulations which restrict corporate profits.

Can anything smudge Wall Street's view through rose-colored glasses? First, even a Republican Congress may not support all of Trump's legislative proposals, and the remaining (albeit shell-shocked) Democrats may put up a fight. Second, the euphoria among Trump supporters will fade when it becomes clear that many of his promises will not, and cannot, be kept. So some of his grass-roots support will wither quickly. Third, many of Trump's loyalists, like Ben Carson, will be in charge of vast government bureaucracies, while having no public sector or even executive experience. This is a recipe for bad policy, and much confusion. Fourth, Trump's foreign policy could alienate our allies and encourage our enemies. The world will not be safer for us if we encourage aggressive nationalists like Putin and Xi. Fifth, and perhaps most dangerous, no one really knows which Trump will govern as President. Will it be the short-tempered, fact-free, tweeter-in-chief (Waterboarding!), or the diplomatic, clever businessman who listens to reason (No Waterboarding!). America has rolled the dice, and Wall Street has assumed a lucky seven. Many other rolls are possible.

There is no uncertainty about the course of monetary policy over the next few years. The Fed (which will be led by Janet Yellen until 2018) will be raising rates. The bond market has already sold off in anticipation of tighter money. The Fed will certainly raise short rates by ¼ percent in December, and will likely forecast several more increases in 2017. If the economy does pick up speed, perhaps in response to Trump policies, the Fed will be tapping the brakes regularly to keep inflation down. With unemployment hovering around 5%, more rapid growth could push up wages and prices, which will force the Fed to act. The economy can withstand rising interest rates, although a rising dollar could hurt the very manufacturing sector Trump has promised to "bring back." Of more concern to us is the long-run makeup of the Federal Reserve. Trump can appoint two new members to vacancies in early 2017, and can replace both Yellen and Stanley Fischer (vice-chair) in 2018. Appointing loyalists with no central banking experience and extremist views (like gold bugs or supply siders) will justifiably frighten the stock market and bond market.

The Trump rally has pushed the VL MAP down to 35%, which tells us that stocks are fully valued, if not overvalued. With interest rates rising, the bulls have to bank on rising corporate profits to push the market higher. The realities and uncertainties of a Trump administration may make further gains even more difficult to achieve. Historically, the first year of a new administration is not a strong one for stocks.

RECOMMENDATION: VL MAP is deep in the SELL range at 35%, and could easily touch 30% soon. Hold cash reserves of at least 50%. See below for portfolio advice. (11/28/2016 6:20 PM PST)

MODEL PORTFOLIO-C

PORTFOLIO STATISTICS:

Weighted year-ahead performance rank: 3.74;

Weighted safety rank: 2.42; Portfolio MAP: 57%. (These statistics and more can be found on the subscriber's corner of our website.) Our weighted performance rank is significantly worse than the Value Line average of 3.0, but for several of our stocks, like FISV and TSM, we think Value Line's rank does not match its short-term earnings growth projections. Our safety rank is much better than the VL average of 3.0. Our portfolio MAP is now 57%, low by our standards, but higher than the latest reported Value Line MAP of 35%. Our portfolio weighted average beta is around 0.5, which means we are prepared for a 2017 selloff.

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 February 29, the S+P 500 Index was at 1967 and the Model Portfolio was worth $537,020. Today, the S+P is at 2202 (up 11.9%) and the Model Portfolio is worth $585,100 (up 9.0%). We will continue to trail the market if stocks continue to rally, but we are still showing a respectable gain this year. If stocks do fall, however, we will outperform the market, as we have done during every previous correction or bear market, and we will have lots of cash to put to work when prices are cheap again.

PORTFOLIO STRATEGY: We are making no changes in our portfolio or our cash position. We are hunkered down for tough times ahead, but we own enough stock to participate in a further rally. We will lose NXPI to a buyout next year, but we may not replace it if the market is still overvalued at that time.

UPDATES ON PORTFOLIO STOCKS:

<u>Long positions</u>:

AECOM, our infrastructure play, has been a star performer since the election, since both parties are keen to rebuild America's crumbling infrastructure. Since the rest of the world also needs to repair and build infrastructure, AECOM should have a tailwind for many years. Although the stock price is now close to the low end of Value Line's 3-5 year appreciation potential (40-60), we think this range is too conservative, since it assumes that earnings will be growing at about 10% per year, but that the stock p/e will only be 70% of the market average p/e in the future.

Automatic Data reached another all-time high during the Trump rally**.** The stock is being driven higher by a strong fiscal 1st quarter earnings report. The company increases its dividend every year, and now earnings are back on a solid growth path, augmented by a large stock buyback program. The company has a top rank for financial strength (A++), and earnings predictability (100), with a near-top rank for price growth persistence (95). But at a p/e of 24, a lot of the good news is already priced in.

Cerner, one of our health care plays, has been sick since August along with most healthcare stocks. In Cerner's case, recent earnings missed the Wall Street projection by a penny, but more seriously, the next quarter will also fall short of previous forecasts. Revenues are also coming in below target. Adding insult to injury, Value Line has knocked the stock down to a "4" for year-ahead performance. We think the decline is overdone, and the stock is reasonably priced relative to its 3-5 year appreciation potential of 70-90. The company's main thrust is to make healthcare more efficient, and CERN spends 12% of revenues on R+D to keep its products competitive. We will hold.

Cognizant suddenly recovered today from a spate of bad news, including reports of potential bribery in India, and the recent departure of its CEO. The turnaround came with the publication of a letter to Cognizant from Elliott Management, a large shareholder, which suggested some changes in corporate strategy. This was enough to push the stock up 7%. We are in for the long haul, and can live with the year-ahead performance rank of "4." Earnings should set records every year for the foreseeable future, as they have for more than a decade.

CVS Health has also been in the sick bay, with the stock down sharply since May. The biggest part of the selloff occurred when CVS announced much lower earnings expectations for next year. Apparently Walgreen's has been eating CVS's lunch, and CVS may lose 40 million prescriptions next year. Value Line has piled on with a year-ahead performance ranking of "4." We will hold for now, but we need to see some good news and some stock price basing over the next few months.

Fiserv has run up in the Trump rally. Higher interest rates will actually benefit the company's bottom line, and faster growth in the economy and employment will also bolster their results. These tailwinds should enable the company to continue to set earnings records every year. We would be the first to admit that Wall Street has finally driven the price high enough to fully discount the future, and thus we have lightened twice in the last year. We may have to lighten up again in 2017. The stock has risen by a factor of 7 since the last bear market.

NXP Semiconductor continues to hang around 100, and we will hold until the Qualcomm purchase closes in 2017 at an all-cash price of $110. This will mean a 10% return in less than a year, which will likely be much better than most stocks. We will reinvest the proceeds if we can find bargains next year.

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ON Semiconductor is back above 12. The acquisition of Fairchild Semiconductor is complete, and should add to earnings right away. If Value Line is right, and earnings more than double over the next 3-5 years, this stock will soar. In technical terms, the stock seems to hit a ceiling around 13, and once this barrier is taken out, it should be onward and upward. It would also not be surprising, given the merger trend in the industry, if an offer for ON materialized in the next year or two.

Rowan Drilling has again bounced back from its lows, as oil prices have stabilized, and a Trump victory suggests that more areas in the US may be opened to drilling. Although the stock looks cheap compared to its 3-5 year appreciation potential of 30-40, it is likely that earnings will disappear completely next year as a lot of its rigs are now idle. We are willing to hold as a portfolio hedge against rising oil prices.

Thermo Fisher now owns our former PAD favorite FEI, which will juice earnings in the future. Rapid growth in earnings, however, must be set against a lofty stock price which discounts much of this future growth**.** A rally from here may force us to put Thermo on the Sell List.

Taiwan Semiconductor pushed above 30 to a new record high. The stock is up 50% from its low for the year, and it pays a nice 3% dividend to boot. With “A” financial strength and price growth persistence of “90,” the stock is a solid PAD holding. We are not put off by Value Line’s “4” for year-ahead performance, because this rank should change soon. Earnings growth is accelerating.

ADVICE: **Hol**d all long positions. Hold cash reserves of at least 50%.

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
500	AECOM (ACM)	37	18,485	Buy @ 22½
250	Automatic Data (ADP)	96.6	24,143	Hold
200	Cerner (CERN)	50.9	10,174	Buy @ 45
320	Cognizant (CTSH)	57	18,224	Hold
120	CVS (CVS)	74.8	8,974	Buy @ 70
502	Fiserv (FISV)	106.6	53,518	Hold
250	NXP (NXPI)	99.1	24,765	Hold
1000	On Semiconductor (ON)	12.1	12,100	Buy @ 9
600	Rowan Drilling (RDC)	16.2	9,726	Hold
1450	Taiwan Semiconductor (TSM)	29.7	43,007	Buy @ 19
80	Thermo Fisher (TMO)	140.3	11,226	Hold
CASH	Money Mkt Fund		350,750	*Advice change
TOTAL			$585,110	

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, and we plan electronic updates of chapters**. A number of public libraries still have copies of the physical book.