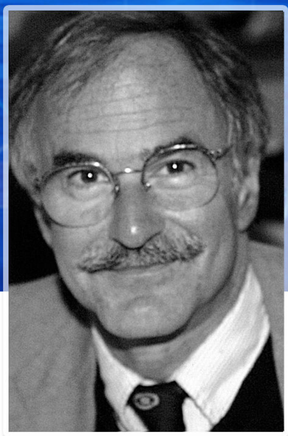
The PAD System Report



Daniel Seiver

Monthly Update December 27, 2016 S+P 500 2269 DJ 19945

HAPPY HOLIDAYS!

Americans may be deeply divided about Trump, but the stock market is not. A powerful rally began in early November and is still setting records, as the Dow flirts with the magical 20,000 mark. The second longest bull market ever, which began in March 2009, is now likely to survive until its 8th birthday in March. It only needs about 2 more years to exceed the longest ever, the 1990s monster which did not end until 2000.

We were skeptical that the market would rally sharply in 2016, in part because we thought corporate profits would be weak. They were. Rising stocks and flat to down earnings is of course possible if p/e's rise, which they did. Robert Shiller's 10-year CAPE is now over 28, only eclipsed by the irrational exuberance of the last months of the 1990-2000 bull. (This longest bull market ever ended very badly.) VL MAP, another measure of stock valuation, is now at 30%, which is historically very low and another signal that stocks are overvalued. The key difference between the two measures is that the CAPE looks backward, which the VL MAP looks forward. But they are both at dangerous levels.

We also thought stocks would be held back by rising interest rates, and they were not, since the Fed spent almost all of 2016 not raising rates. And yet the bulk of the gain for the year occurred after the election, which was accompanied by a sharp upward move in long-term interest rates, and, in December, a ¼-point nudge upward in the Fed Funds rate. But the bull roars ahead. The Fed is likely to raise short rates at least 3 times in 2017, but stocks are taking this too in stride, riding a burst of optimism.

The Fed might raise rates faster, if inflation picks up in 2017. The US unemployment rate is already at 4.6%, and fiscal policy is likely to be stimulative, with more spending (defense and infrastructure) and lower taxes. This is a standard recipe calling for monetary restraint. The Fed may finally take away the eggnog punch (spiked for years with the rum of easy money), just when the party guests start breaking furniture (Dow 20,000! Another round, bartender!)

Two predictions: it is likely that a Trump administration will roll back as many pesky government regulations as possible, which should boost business profits in the short run. But some of these pesky regulations, such as those which protect our air, water, and land, are of real long-term value. Imagine US city air on a par with Beijing or Delhi. Expect environmentalists to fight the new administration in the court of public opinion, and in the federal courts. Expect what's left of Big Labor to fight too, along with Democrats who are spoiling for a fight after eight years of gridlock.

It is also likely that a Trump administration will impose punitive tariffs on China. This could lead to a trade war which will make the economies

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of all countries worse off. Economists will speak out against these tariffs, but they are no more likely to be heeded than they were in 1930 when the USA passed the Smoot-Hawley tariff act.

We are not willing to predict other policies of the incoming Trump administration, because we do not think there will be consensus among the various Republican factions in Congress, or even in the executive branch itself. So the actual inauguration, and the commencement of the messy process of actually governing (rather than tweeting) a divided country, may lead the stock market to quickly drop its rose-colored glasses and swear off the eggnog for a while.

RECOMMENDATION: VL MAP is very low at 30%. We are making no changes in the Model Portfolio at this time, since it is already at 60% cash. Hold cash reserves of at least 50% and enjoy the holiday season while it lasts! (12/27/2016 6:10 PM PT)