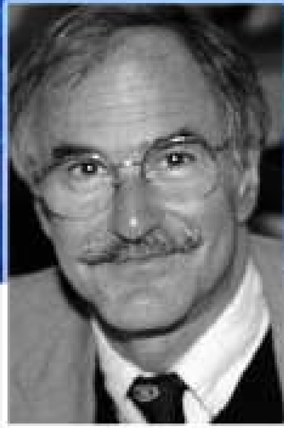
The PAD System Report



Regular Issue May 31, 2021 *S+P 500 4204 DJ 34529*

JEROME POWELL AT THE BAT

The stock market has continued to soar beyond our expectations. This of course happens to us in every bull market, since we always underestimate just how high stock prices can go before reality sets in. To offset this decades-old tendency, we tend to limit our cash reserves to 50%, although we did break that limit in the previous bull run. If we are trying to maintain a fixed percentage of cash reserves in a rising market, we are forced to sell just to maintain that fixed percentage, which has also worked for us in the long run.

In the short run, we believe that the current economic boom, which should continue through this year and probably 2022, will push corporate earnings higher. But we also believe this is already baked into current stock prices. At the same time, this economic boom will push the economy close to "full employment" in less than a year, which will put pressure on the Fed to begin dialing back its Quantitative Easing program of $120 billion a month, followed by a decision to end their policy of zero short-term interest rates.

The Fed needs to dial back because its dual mandate requires them to keep inflation low, which the FOMC defines as 2% (on average) measured by its own inflation indicator, which is the Personal Consumption Expenditure (PCE) deflator, excluding food and energy, which is often called the "core" PCE deflator (CPCE). This measure is superior to better known measures, such as the CPI, because it is broader in scope, and will not be directly influenced by volatile food and energy prices. By the end of the year, if the economy does approach 4.4% unemployment (the current prediction of the independent and non-partisan Conference Board), or even move beyond that, the Fed will be forced to "tap on the brakes" to make sure that inflation does not rise too rapidly, and to therefore ensure that inflation expectations (π^e in the textbooks) do not rise significantly above (say) 3%. The Fed has said it is willing to tolerate 3% inflation for a while, since its FAIT (flexible average-inflation targeting) policy is designed to essentially keep inflation in a *range* between about 1 and 3%. (Most other central banks already have a range for a target, which actually makes sense compared to a single-point target.) But what the Fed cannot tolerate is even faster inflation which convinces Americans (π^e) that the Fed will not keep inflation in the 1-3% range. This would damage the Fed's credibility, and could feed on itself, forcing the FOMC to tighten monetary policy much more than forecasters now expect.

The latest inflation data have to be a concern: the CPCE deflator is *already* 3.1% above a year ago, and the economy is continuing to gain speed. Job openings are at a record high, and employers are being forced to raise wages. This is of course an excellent outcome for the

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average American worker, but it increases the possibility that businesses will then raise prices faster to compensate for rising labor costs. This pressure becomes more intense as the economy reaches or passes the "full employment" rate of unemployment.

What makes the Fed's job even harder is that almost any change in monetary policy takes 6-12 months to have a real effect on the economy. This "effectiveness lag" means that the Fed has to act well before the economy achieves full employment. Yet the majority of the FOMC, led by Jerome Powell, have often stated that the Fed should wait until the economy is running red-hot before raising rates, since monetary policy did tighten "too soon" in the last economic expansion, with the Fed never even hitting its 2% inflation target. But this time could be different: we have no experience with an economy surging after a year-long pandemic lockdown. In addition, some workers will need to change occupations and industries, since some sectors of the economy may never fully recover, even as other sectors expand significantly. In technical terms, this may mean that "full employment" is associated with a *higher* level of the unemployment rate than the 3.5% we achieved in January 2020.

Why is all this so important for the stock market? *Because stock prices will respond instantly to any change in ultra-easy monetary policy.* A richly-priced market with pockets of froth (GameStop again) could drop very fast and very far. If stock traders decided that the Fed waited too long to start watering down the punch, and then waited too long to take away the proverbial punch bowl, the negative response could be even worse. Powell is in the batter's box over the next 12 months. And, unlike mighty Casey[1] we cannot afford to have mighty Powell strike out.

RECOMMENDATION: VL MAP was last at 30%, so we will continue to hold 45% cash reserves. We will again sell more stock if the market continues to rally. Our substantial cash position means that PAD investors are prepared for the inevitable decline, but will still profit from a further rise in stock prices. (5/31/2021 6:30 PM PT)

MODEL PORTFOLIO-C

PORTFOLIO STATISTICS:

Weighted year-ahead performance rank: 2.25; Weighted safety rank: 1.78; Portfolio MAP: 28%. (These statistics and more will be found on the subscriber's corner of our website this summer, since we are winning our website battle with Russian bots.) Our weighted performance rank and safety rank remain far superior to the VL average of 3.0. Our portfolio MAP is now only a smidge below VL MAP. We are still happy holding our 12 remaining stocks. Our portfolio weighted-average beta (counting cash as zero beta), is around 0.54, which is very defensive.

PERFORMANCE UPDATE:

Hulbert Financial Digest no longer publishes performance statistics for many 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, 2020, the S+P 500 Index was at 3044 and the Model Portfolio was worth $759,000. Today, the S+P is at 4204 (up 38.1%) and the Model Portfolio is worth $991,553 (up 30.6%). With about 30-45% cash during the past 12 months, our one-year risk-adjusted performance exceeds the market. As we have said before: "while our portfolio should outperform when and if the market tanks again, we are likely to trail the S+P if the bull market continues." (All of these performance statistics exclude dividends on the S+P, dividends on our

[1] "Casey at the Bat," by Ernest Thayer

portfolio stocks, and meager earnings from our cash reserves. Given today's yields, if we add them all in, the comparisons would change very little.)

PORTFOLIO STRATEGY: **PRA Health Sciences** was sold after running up on merger news. This was an easy way to raise cash in a high-priced market. We may be forced to raise more cash if the market continues to rise.

UPDATES ON PORTFOLIO STOCKS:

Akamai has now recovered most of the ground it lost in the February-March selloff. First-quarter earnings bounced back, and were above VL's estimate. 2021 earnings should come in at least 15% above 2020, with further growth in 2022. But all is not well here. Value Line's 2024-26 estimates do not show substantial long-term growth, and yet a higher *relative* p/e has been applied to those earnings. We have taken Value Line to task for making these relative p/e's too low (Fiserv), but in this case, AKAM's might be too high. We will watch this one carefully, and might need to sell some or all of the shares. We are not bothered very much by the year-ahead performance ranking of "4," which should improve soon. What we want to see is more long-term potential which is not based on a higher p/e. Hold for now.

Alphabet, a/k/a Google, seems unstoppable. We sold a bit since it was the largest holding, but the runup to 2400 has kept it as our largest holding. This is of course a nice problem to have. Even though the stock has run up sharply, it still has almost the median 3-5 year appreciation potential of our portfolio. In addition, it is ranked "1" for year-ahead performance, "1" for safety, "95" for price growth persistence, A++ for financial strength, and has a beta below 1. Some companies do become a verb or noun and then later collapse (think Xerox and Polaroid), but we think tech giants Facebook and Amazon will take more public heat, and are therefore in more danger, than Google. (Your Editor has now weaned himself off the Chrome browser, and uses Brave, which is faster and has much better privacy features. Of course, the searches are still done with Google!)

Amgen has made some progress since our last review. What we like most is its 3-5 year appreciation potential (300-370), which is the second-highest in the portfolio. We also like the fact that the company spends 16% of revenues on R+D. This of course hurts short-run earnings, but boosts long-term potential. We also like its top-rated financial strength of A++, its yield of 3%, and below-average beta. Hold.

Automatic Data broke through to another all-time high. ADP's dividend, which is raised every year, yields 2%. This is a safe holding which has performed very well over the decades. Our major concern is that the price is once again above the low-end of its 3-5 year appreciation potential, even with the projected continuation of a premium p/e. We may have to lighten up once again, but hold for now.

Edwards Lifesciences made another all-time above 95. The stock also had its 3-5 year appreciation potential boosted to 110-145, which gives it a little room to go before it moves above the low end of this range, which is always a warning sign. Earnings per share should recover nicely in 2021, after a flat 2020, as the pandemic reduced all non-emergency medical procedures. R+D is a very healthy 17% of revenues, which is a big PAD plus for the long-term.

Fiserv also broke through to a new all-time high before settling back a bit. Earnings continued to grow right through the Pandemic Recession, as they did through the Great Recession, and for many years before that. Nonetheless, VL refuses to assign them a premium p/e for this enviable record. We always bump up their 3-5 year appreciation potential to reflect at least a modest premium, and so our adjusted 3-5 year appreciation potential is 130-170. When the stock penetrates this range, we will look at lightening up again. Hold for now.

NXPI ran up to a new high beyond 210, and then after a pullback, pushed back up to 211. There is no stopping the semiconductor sector, which is having one of its greatest booms ever. Shortages of all types of semiconductors has meant surging earnings for NXPI, with no signs of a slowdown. We did sell some NXPI when the stock tripled from purchase price (in accordance with PAD rules), and we will certainly sell some more if it quadruples (around 240).

ON Semiconductor has not been as strong as NXPI in recent months, but the stock has still had an excellent run from 10 to 40 in little more than a year. We have lightened up more than once, since it is a "four-bagger" from purchase,

but we may have to lighten up again, since the low end of its 3-5 year appreciation potential is 45, just a tad above the current quote. The new CEO wants to spend more on R+D, which is fine with us. The latest quarterly 10-Q report shows R+D already above 10% of sales, which is an absolute requirement for most semiconductor companies.

Science Applications fell out of bed in late March. The stock has recovered part of that loss, which was a direct response to a surprisingly weak fourth quarter, and a forecast of more of the same for 2021. The long-term outlook is still good, and SAIC is still winning lots of government contracts. As we have noted before, the stock has by far the most 3-5 year appreciation potential of any of our portfolio holdings, and it also has a p/e which is 35% below the market p/e. We are taking the long view here, and will hold for better times.

T Rowe Price has continued to march upward along with the stock market, since its fund-management revenues are largely tied to the level of stock prices. Even better, it is also a play on an aging population which is still saving for retirement. Better still, it offers pure-no load funds with low costs, so it can gain market share from high-cost funds. However, the stock is above the low-end of its corrected 3-5 year appreciation potential (180-225), which, as we predicted, was misstated by Value Line. (NOTE: The Editor has some of his retirement funds with T Rowe Price, and has been very satisfied with their level of customer service.)

Taiwan Semiconductor has become a center of attention in the emerging economic cold war between the US and China. The *Economist* magazine even put them on the cover of a recent issue. TSM has a stranglehold on the most advanced semiconductors in the world, having left Intel far behind. Unfortunately, China believes that Taiwan is still part of mainland China, and Chairman Xi would like to make China the world leader in semiconductors. There is always the possibility that the Chinese will try to make that happen with a hostile acquisition of the island….but not yet. A more immediate problem is that the stock is selling above its 3-5 year appreciation potential. Even though we have lightened up here more than once, we may want to do so again this year. Until then, enjoy the dividend (you can get a US tax credit for the portion withheld by Taiwan), and enjoy above-average year-ahead performance and A++ financial strength.

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Thermo Fisher is buying PPD for $20 billion, which will make TMO an even stronger play in the clinical research market, which is a nice complement to its very-profitable laboratory supply business. Management estimates that the purchase will be instantly, and substantially, accretive to earnings. The company stock has not responded to the news and has been moving sideways. But the last 10 years have been very good: up by a factor of 10. We have lightened up more than once during this run, and since it is our smallest holding, we will probably just let it ride. VL has not yet adjusted its long-term forecast for the PPD acquisition, which could easily drive 3-5 year appreciation potential to 500-600.

ADVICE: Hold all long positions. Hold cash reserves of at least 45%.

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
400	Akamai (AKAM)	114	45,600	Hold
30	Alphabet (GOOG)	2412	72,360	Hold
200	Amgen (AMGN)	238	47,600	Hold
200	Automatic Data (ADP)	196	39,200	Hold
250	Edwards Lifesciences (EW)	96	24,000	Hold
450	Fiserv (FISV)	115	51,750	Hold
300	NXPI (NXPI)	211	63,300	Hold
800	On Semiconductor (ON)	40	32,000	Hold
400	Science Applications (SAIC)	90	36,000	Hold
300	T Rowe Price (TROW)	191	57,300	Hold
500	Taiwan Semiconductor (TSM)	117	58,500	Hold
50	Thermo Fisher (TMO)	469.5	23,475	Hold
CASH	Money Mkt Fund		440.468	
TOTAL			$991,553	*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. Although out of print, it is regularly available on Amazon.com. The **Google ebook version is available for $9.95 on our website.** A number of public libraries still have copies of the physical book.

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