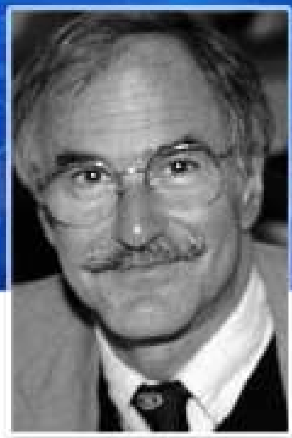
The PAD System Report



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RAGING BULL

The stock market appears unstoppable. Records fall almost daily. Valuations are stretched to the limit, speculation is rampant, investment newsletters (usually wrong at turning points) are dangerously bullish according to *Investors Intelligence*, the economy is barreling ahead, and the Fed is still spiking the punch bowl with zero short-term rates and QE4. So should we join the party like it's 1999? Actually, no. The 1999 party included the most extreme valuation ever recorded by the Shiller CAPE, and the 1990s bull run ended very badly: the S+P fell almost 50% by 2002 and did not exceed its early-2000 peak for 14 years.

Back then it was "internet" stocks, while today it is "meme" stocks. When the collapse comes, GameStop, AMC, and the like will tumble and the "little guy" will again be hurt. Internet stocks in 1999, Miami condos in 2006, and GameStop in 2021. There is a pattern here.

What is not forecastable is *when* the madness will end. What a prudent PAD investor can do is sell into the rally, hold substantial cash reserves, and wait for the inevitable. We will do just that.

The US economy is indeed growing fast, as the combination of expansionary monetary and fiscal policy, the reopening of many businesses, and the spread of vaccination, provide a powerful set of stimuli. Corporate profits will certainly rebound too. But you can actually have too much of a good thing, no matter what Mae West once said.[1] The problem is that an economy firing on all cylinders, with unemployment already back below 6%, could, by the end of the year, begin to approach its capacity. Then the danger is that we could have some overheating, evidenced by rising inflation. The Fed's chosen measure, which is broader than the CPI, and excludes volatile food and energy, is already rising at a little more than 3%. Even if this is not just a blip, it is not much of a problem yet, since it is close to what is in effect a range for the Fed's inflation target. The official (if murky) meaning of the current Flexible Inflation Targeting (FAIT) approach is that inflation can run above or below 2%, as long as it *averages* 2% over some unspecified period of time. So we would argue that the Fed has really decided that it should aim for 1-3% inflation, which is what many other central banks do, and it is thus not yet missing by much. In fact, most of the Fed's "undershooting" after the Great Recession also looks OK if the goal was 1-3% for price increases.

The problem is what happens if inflation creeps higher as the economy approaches the mystical level of capacity, aka "full employment." Then the Fed will have to take its two feet off the monetary accelerator, starting with 1) gradually reducing QE4 to zero, followed by 2) increases

[1] "Too much of a good thing can be wonderful."

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in the Fed Funds rate from its current level around zero. We expect that Wall Street will not be amused, and signs that these changes are coming sooner rather than later could easily spark a major selloff. As we have said before, "The Fed's job is not to protect investors from overoptimism. Remember that stocks go down faster than they go up."

PORTFOLIO STRATEGY: **Akamai** has been recently downgraded to a "5." This triggers a full review of its prospects, as noted in Rule 2 on pages 69-70 of *Outsmarting Wall Street*. Our decision is to sell some of our holding, because a "5" suggests potential underperformance just when we are concerned about the possibility of a major market decline. We will not sell all of our holding because we still like the long-term prospects of the company, and it does add some diversification to our portfolio. A decision to lighten up on **Google**, which is still ranked "1" for safety and for year-ahead performance, is based on the relative size of our position: this holding is well more than 10% of our total stock portion of our portfolio. A partial sale of **NXPI** is a further attempt to reduce our outsized exposure to semiconductors. NXPI is selling above the low end of its 3-5 year appreciation potential, and is the second largest holding in our portfolio.

Overall, our PAD portfolio has performed well, adjusting for its large cash position. The portfolio is approaching the milestone of $1,000,000, having started at $50,000 in 1987. The weighted average of our year-ahead performance ranks is 2.45 (very good) and our weighted-average safety ranking of 1.75 is far better than the Value Line median of 3.0.

Our portfolio MAP is at 21%, a little below VLMAP, which was last reported at 30%. But our weighted-average portfolio beta is 0.54 (and falling, after we lighten up tomorrow) which should protect us in a decline.

RECOMMENDATION: The market is expensive. We will lighten up on three stocks: Sell 100 AKAM, 5 GOOG, and 50 NXPI at the market open tomorrow (Friday). **A rally from here will require even more PAD selling.** Hold all remaining positions and at least 45-50% cash. (July 1, 2021 5:15 PM PDT)

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.