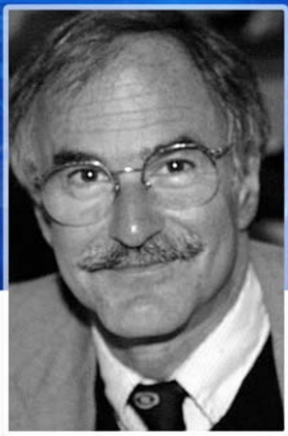
The PAD System Report



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GREECE AND THE DEBT TRAP

Greece now hogs the Financial Folly headlines. The Greeks lied about their fiscal position to get in the Eurozone, and they used complex derivatives sold by Goldman Sachs (!) to mask the extent of their fiscal deficits and debt. The economically uncompetitive Greeks need to drive down wages and prices, since the standard fix of devaluation is no longer available. And, at the same time, they have to reduce sharply their fiscal deficit. And maybe they will also need a bailout to avoid defaulting on their debt, which is uncomfortably large compared to their (shrinking) GDP. A Debt Trap, indeed. German taxpayers are also worried that if Greece is going to be bailed out, what will the message be for the other weak links in the euro area: Spain, Italy, and Portugal? Will a German bailout even be enough to save Greece? It is a fair statement to say that the hot potato of dangerous private sector leverage and debt has been partially transferred to sovereign governments around the world. Fiscal and economic austerity (with rising social discontent) looks inevitable for many low-saving countries. Americans, Brits, and others cannot afford sanctimony here: the extent of the problem goes far beyond the duplicitous and free-spending Greeks. In the US, the private banks (and bonuses) are back, but we are propping up a "zombified" Fannie Mae and Freddie Mac, AIG and Citicorp are government owned and still in deep trouble, and the US Federal Reserve is holding a trillion dollars of mortgage securities of unknown value. But we need not fall into the abyss. Economic growth could bail us out.

The US economy is indeed recovering. Steady rises in the Index of Leading Economic Indicators suggests we should have economic growth in 2010 and beyond. Although the recovery is still fragile, every additional quarter of economic growth will build confidence and momentum. (The world's second largest economy, China, is back to breakneck growth, which also helps to pull the world forward.) In anticipation of self-sustaining economic growth, the Fed is already starting to put in place its exit strategy. A little bump in the Fed's discount rate is the first baby step. Soon the Fed will stop adding to its balance sheet, and before the end of the year, in our opinion, will begin raising short-term interest rates. It is likely to use its new tool of paying interest on bank reserves to slowly nudge up short-term rates. It may also try to neutralize some of the mountain of excess bank reserves by offering its member banks the equivalent of time deposits. And it may even sell a bit of its outsized holdings of government securities.

This reversal of extreme monetary ease must be timed almost perfectly: too soon, and the economy could be pushed back into recession; too late, and the embers of inflation could be reignited. Since monetary policy acts with a lag on the economy, and economic data appears with a lag, Bernanke and Co. have a tough job facing them. At least the misguided attacks on the Fed have been quieted by the Chairman's reappointment. But new populist yelps will be heard as soon as the Fed begins raising rates in earnest. (The quarter-point boost in the discount rate was just a warmup and a chance to see if the financial markets would respond without panic. So far, so good.)

Monetary policy is in competent hands, but fiscal policy has a Greek tinge to it: the short-term fiscal position of the US is poor and the long-term outlook is frightening. Trillion dollar deficits may shrink a bit in a few years, but then the outlook darkens again, and the debt we add now just means even more interest to be paid in future years. While Americans are adept at dealing with immediate and tangible crises, the fiscal mess is neither immediate nor tangible. But it is no less real. The budget deficit projections for the US are not sustainable. Under current policy, the tsunami of pension and health care costs of the aging Baby Boomer generation will overwhelm Social Security, Medicare, and Medicaid, which are already a large portion of the federal budget. As interest rates rise, the servicing of the existing debt becomes even more onerous, as the jaws of the Debt Trap begin to close. While American bankruptcy/default is unthinkable, the degree of fiscal austerity (spending cuts and tax increases) and economic austerity (higher saving and lower consumption) necessary to avert a future crisis does not seem politically feasible, either here or in Greece. Perhaps the Germans will bail out the Greeks, but will the Chinese bail the Americans out of their Debt Trap? While economic growth will help, it is unlikely to be fast enough to enable the US to escape a trap. The only other way out for the US is through inflation. Inflation will reduce the real value of the debt; at the same time it will reduce real earnings and (thus consumption) of households, whose nominal wages will not keep up with inflation (think 1980s stagflation). America will fix fiscal policy before Armageddon, but continuing gridlock and hyperpartisanship in Washington could push us dangerously close to the edge of the cliff. Will we accept austerity any more willingly than the Greeks?

The stock market has had a mild and healthy correction. Further upward progress will require more growth at home and some stability abroad. Both are certainly possible in the short run, so we remain cautiously bullish for the rest of 2010. Do not expect a smooth ride, however.

Value Line has rolled out its 3-5 year appreciation potentials to 2013-2015. Combined with some market weakness, this has pushed the VL MAP back to the Neutral range. It would not take too much of a rally (11000?) to pull us back into the SELL range.

The *Hulbert Financial Digest*, the leading rater of investment newsletters, has released its performance data, updated through 2009. While the last ten years were a lost decade for the stock market (an average annual total return of -0.3% per year), the PAD System Report Model Portfolio-C gained an average 5.3% per year over the same time span, while taking less risk than the market. This performance is not a flash in the pan: for the entire 21-year rating period 1989-2009, the PAD System Report also beat the market on a risk-adjusted basis.

RECOMMENDATION: The VL MAP is now in the NEUTRAL range at 65%, but any rally could put us right back in the SELL range at 55%. We will prudently raise more cash reserves by selling UDN, and reinvesting only part of the proceeds in AMMD (see below). (2/28/10 4:15 PM PST)

MODEL PORTFOLIO-C

UDN may be tracking the US dollar better than FDPIX, but we are now convinced that the eventual and substantial dollar decline we are anticipating will be slow to materialize. It may be 2011 or later before we get a truly meaningful downtrend, in large part because the euro sickness and other financial follies keep footloose money in dollars, and because the Chinese seem to be willing to hold tight to their peg of the yuan, even though it is significantly undervalued against the greenback. The Chinese have a mind-boggling $2.4 trillion of foreign exchange reserves, but there is no obvious upper limit which would force them to revalue. If the yuan is not going to budge, and the euro, the only other major reserve currency, is going to remain under a cloud, the trade-weighted dollar will not fall very far. In fact, if the American economy grows faster than the Eurozone economy, the dollar could show more strength. We are thus no longer willing to hold our UDN. We will sell it now, and return to our bearish bet on the dollar in the future.

Rather than put all of the UDN proceeds into cash, we will put some of it back into the market in **American Medical Systems** (NDQ-AMMD). Although their urological and gynecological products may make investors squirm, AMMD is both profitable and growing. Health care reform is unlikely to hurt them, since their products will face growing demand from an aging population. The one surgical offering we will discuss here is coming to market this year: the GreenLight laser system for BPH (Benign Prostatic Hyperplasia), which afflicts many men over 60 (including the editor). This device is a minimally invasive procedure which shrinks an enlarged prostate with far fewer side effects than the old-fashioned TURP (TransUrethral Resection of the Prostate). AMMD will introduce many more new products over the next 3-5 years, driven by R+D which is a healthy 10% of revenues. Value Line estimates that earnings will nearly double over that time span, supporting a 3-5 year appreciation potential of 40-60. The stock is currently at 18. We will buy 400 shares at market.

We are still quite bullish on our other ETF, **TBT**, which is a leveraged bearish bet on long-term US Treasuries. We still expect a rise in the 30-year yield to at least 5%, with a rise to 6% or higher not out of the question. If you reread the first part of this letter, and do not own any TBT, you might want to add some for insurance against the US heading toward a Debt Trap over the next 3-5 years. Even if we were to ease our way out of it with more rapid growth and higher inflation, long-term interest rates will have to rise as a consequence.

First Solar continues to disappoint. The latest blow is that the Chairman of FSLR has sold 40% of his shares. With earnings declining, the stock has been hammered. While we are not ready to bail out yet, we have reduced the stock to a Hold even though it has attractive 3-5 year appreciation potential at the current price.

Our other alternative energy play has also been pounded. **Ormat** has reported some production problems with two of its geothermal projects, which will impact earnings in the short run. Even the class action lawyers are smelling blood in the water. We think Wall Street has overreacted. The stock is a buy up to 31, and subscribers who missed this one have another chance to buy it cheap.

On happier notes, **Intuitive Surgical** continues to barrel ahead, as earnings soar to new records. Even Value Line has grudgingly raised 3-5 year appreciation potential as part of its annual rollout. Nonetheless, the stock is still trading above the low end of its new 3-5 year appreciation potential, so we cannot recommend new positions. Since we have already lightened up, we will hold our remaining shares. The stock continues to be ranked “1” for year-ahead performance.

Celgene is still one of our favorites. The stock has rallied recently, but it can still be bought up to 60, with 3-5 year appreciation potential now boosted to 120-160. Celgene recently reported record earnings that were well above Value Line’s estimates. Growth should be rapid for the next 3-5 years. The company is rated “A+” for financial strength, spends a huge amount on R+D, and has price growth persistence of “80.” It is also ranked “2” for year-ahead performance.

Another stock with an excellent profile is **C R Bard**. Even though the stock is now pushing above 80, its 3-5 year appreciation potential is still good at 125-155. What is truly amazing about the stock is that it is ranked “A++” (highest) for financial strength, and has a “100” (highest) rating for price growth persistence, earnings predictability, and stock price stability. There may not be another stock in the Value Line universe with these ratings. This is a long-term keeper.

Cephalon has rallied on the heels of a fourth quarter earnings “beat” and increased company guidance for 2010 sales and earnings. Cephalon continues to grow internally and via acquistions.

Long-term favorite **Stryker** has regained its “1” ranking for year-ahead performance, while still offering excellent 3-5 year appreciation potential of 100-125. The company reported good earnings growth for the fourth quarter of 2009, received a litigation settlement, and repatriated foreign earnings at a very favorable tax rate. And the Boomers aren’t getting any younger.

Taiwan Semiconductor is still ranked “4” for year-ahead performance. We expect this ranking to return to “3” soon, as TSM earnings have been trending upward for several quarters. In addition, Value Line has raised 3-5 year appreciation potential to 15-30, making this $10 stock look awfully cheap for long-term PAD investors.

Cognex has turned the corner, and Value Line has raised its year-ahead performance ranking to “3.” Revenue for the fourth quarter of 2009 rose 25% over the previous quarter, and Cognex expects continued growth in 2010. Unfortunately, Value Line has maintained 3-5 year appreciation potential at 25-40, which means that the price at 19 is not that far from the low end of the 3-5 year appreciation potential..

FEI remains cheap at 21, with 3-5 year appreciation potential of 50-75. But Value Line has reduced year-ahead performance to “4”, reflecting weaker earnings for the most recent quarter, and company guidance suggesting lower earnings for the current quarter. The order backlog is still high, and the long-term future for nanotechnology is still very bright.

Martek stock is also very cheap at 20, with 3-5 year appreciation potential recently boosted to 50-70. Earnings are growing again, and the outlook for DHA is as positive as ever.

Thermo Fisher got through the Great Recession with only a 3% decline in earnings for 2009 vs. 2008. Earnings and revenues are already growing again, so the outlook for 2010 is very positive. Value Line has nudged up 3-5 year appreciation potential to 60-80, but the current price is still too close to the low end of that range to get us excited. The stock is a good one for conservative investors, though: financial strength is “A” and price growth persistence is an excellent “90”.

Linear Technology still has lots of appreciation potential, but Value Line continues to rate the stock a “4” for year-ahead performance. We expect this ranking to be boosted soon, though. Linear recently reported earnings that were well ahead of expectations. And they have increased their dividend again.

<u>ADVICE</u>: Sell all UDN at market. Buy 400 shares AMMD at market. Hold remaining stocks. Switches are OK, and the maximum buy prices of our current favorites are listed below. Only a few qualify for purchase at current prices. Stocks which have already had partial sales are listed as Holds.

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
250	Automatic Data (ADP)	41.6	10,402	Buy @ 38
100	Bard C.R. (BCR)	83.8	8,378	Buy @ 63
200.13	Celgene (CELG)	59.5	11,912	Buy @ 60
102.12	Cephalon (CEPH)	68.7	7,013	Buy @ 50
178.6	Cognex (CGNX)	18.9	3,376	Hold
202.4	Cognizant (CTSH)	48.1	9,972	Hold
300	FEI Corp (FEIC)	21.3	6,381	Buy @ 25
100	First Solar (FSLR)	105.8	10,575	Hold*
328.13	Fiserv (FISV)	48.2	16,301	Buy @ 47.5
50	Intuitive Surgical (ISRG)	347.1	17,357	Hold
175	II-VI (IIVI)	28	4,907	Hold
150	Johnson and Johnson (JNJ)	63	9,450	Buy @ 51
258.99	Linear Technology (LLTC)	27.2	7,037	Buy @ 29
300	Martek Biosciences (MATK)	19.8	5,949	Buy @ 25
300	Ormat (ORA)	28.9	8,679	Buy @ 31
385.95	Polycom (PLCM)	26.1	10,077	Hold
827.1	Power Shares Dollar Bearish (UDN)	26.7	22,117	Sell*
100	Precision Castparts (PCP)	112.8	11,275	Hold
400	Proshares Ultra Short Treasuries (TBT)	47.1	18.820	Hold
200	Sigma Aldrich (SIAL)	47.7	9,538	Buy @ 33
323.30	Stryker (SYK)	53.1	17,167	Buy @ 52
1450	Taiwan Semiconductor (TSM)	9.8	14,137	Buy @ 15
200	Thermo Fisher (TMO)	48.8	9,754	Hold
126.20	Transocean (RIG)	79.8	10,073	Buy @ 75
CASH	Money Mkt Fund		42,400	
TOTAL			$302,817	*Advice change

WWW.PADSYSTEMREPORT.COM: subscribers can renew online, and check the status of their subscription. Subscribers also have access to back issues and the current issue in PDF format. The subscribers-only blog has been regularly updated to keep you current on our latest thinking between market letters. We have recently added a regularly updated 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 for $5 -$10, shipping included. A number of public libraries also have copies.