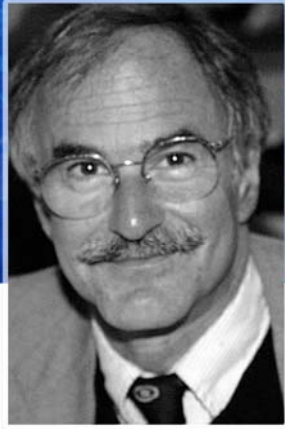


The PAD System Report



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THE CHINA CARD

Economic growth slowing sharply. Check. Dollar falling. Check. Short-term interest rates not falling. Check. Housing weak. Check. Corporate profit growth slowing. Check. Stock market down. Hmmm. Getting five out of six forecasts right is scant solace when the one that got away is the Bull Market that just won't quit. This run will require large doses of patience and discipline, as was true in the late 1990s. Back then we were lonely and unhappy bears until the market finally tanked. With the VL MAP at 35% and falling, we are not going to throw in the towel now. (In fact, MP-C will make some new bets on the declining dollar, and rising long-term interest rates.)

The economy, which has been slowing for a year, almost stopped in the first quarter, with real GDP growth a scant +0.6%. Housing again dragged the growth rate down, as did a decline in net exports. The American consumer was the main engine of growth, spending like a sailor on shore leave. Inflation got worse, up 4% at an annual rate, and even the Fed's favorite "core" measure is still up 2.2%, above the Fed's comfort zone. While the economy may grow a little faster the rest of the year, the continued drag from housing, which may finally slow consumer spending, will keep growth below trend. Corporate profit growth will continue to decelerate (we are down to 6.4% yearly growth in the first quarter). The big mystery *du jour* is why this slow growth in GDP has not pushed up

the unemployment rate. We expect the mystery to be solved in two ways: first, productivity growth will turn out to be weaker than expected, and second, the unemployment rate will gradually start to rise. If we are right, this will do further damage to consumer spending and corporate profit growth, and, in the short term, make inflation worse. We also expect the dollar to continue its decline as part of the adjustment to the enormous and unsustainable US current account deficit. The new factor here is that the Chinese are finally ready to seriously diversify their \$1.2 trillion of foreign exchange reserves. Playing this China Card will have major effects on the US. Whether the Chinese will be any smarter than the Japanese were during their bubble (think Rockefeller Center) is an open question. The key is that China will play the card slowly, as they try to do in all matters. But they will certainly let their currency continue to appreciate, and in the future slow their rate of dollar asset accumulation. The Chinese (and the Japanese too) have absorbed a stupendous amount of US debt; their purchases are the main reason that long-term interest rates in the US have remained as mysteriously low as they have. As this prop is ever so slowly removed, long-term interest rates in the US will likely rise, even as short-rates stay where they are. The Fed cannot reduce short-term rates until inflation **and** inflationary expectations are back in the 1-2% comfort zone. Since GDP-measured inflation is running at 4%, and

inflationary expectations, according to the Fed's own minutes, are creeping up a bit, we will see no reductions in short rates for some time.

If we are right (and we are batting 1,000 if you don't count the stock market), US housing will suffer even more as mortgage rates continue to creep up, while slowly rising unemployment makes it even harder for home buyers to get mortgage financing. The longer the bear market in housing persists, the more likely there will be spillover to the rest of the economy. Even if all of our forecasts are correct, whether and when the Bull will choke on the bad news is an open question. A torrent of liquidity, financing frenzied M&A activity and private equity buyouts, seems to propel stocks ever higher.

Of course, the rising US market looks like a piker compared to the Chinese market, which has quadrupled in two years. Speculation is rampant, and rookie Chinese investors are now opening brokerage accounts at the rate of 300,000 **per day**. Even Alan Greenspan has weighed in on this one. When the Chinese market does tank, will the Chinese government be able to deal with the anger of millions of naïve investors? Will a Chinese meltdown spread to the rest of the world, including the US? This is the other Chinese card which could be played at any time. This is indeed the Year of the Pig. Roast pork, anyone?

RECOMMENDATION: Continue to hold at least 50% cash and short positions until the VL MAP returns to 100%. Since we expect total returns on stocks, bonds and real estate to be negative over the next 6-12 months, the 5% return on money market mutual funds may be the best game in town. (We are no longer recommending adding to TIPS holdings, since we expect long-term rates to go up, dragging TIPS down in the short term.) An alternative for cash holdings is euro- or sterling-denominated bank deposits, although these deposits will lose value if the dollar rallies. (We are no longer

recommending yen-denominated deposits, since the yen may be the one currency that does not rally against the dollar.) The Model Portfolio will continue to stick to a plain vanilla money market fund for its cash. (5/31/07 4:15 PM PST)

MODEL PORTFOLIO-C

The housing sector is sicker than ever, and housing stocks continue to underperform. Housing prices are falling in many parts of the country, and inventories of unsold homes are at high levels. Many more mortgages will have their interest rates reset this year and next, and the subprime mess is not over. If our economic forecasts are correct, there is still substantial downside in homebuilder stocks, and we will stay short both **Lennar** and **KB Home**. Value Line ranks both stocks as "5" for timeliness. Stay short.

FirstFed has rallied again to the mid 60s, in spite of the housing collapse. Negative amortization is still a large portion of reported profits, and mortgage originations are down sharply. But we have seriously underestimated the ability of management to maintain profitability while the California housing market implodes. We will throw in half the towel at this time. If the company is using smoke and mirrors to hide a decline in profit, our remaining short position will pay off. Cover one-half of FED short position.

We have found a short sale to replace the covered half of FirstFed. **Reliant Energy** (NY-RRI) is an electricity provider based in Houston, TX. The company is returning to profitability after three years of losses, but the stock price has run far ahead of future earnings projections. Value Line 3-5 year appreciation potential is 9-16, while the stock trades at 26. Financial strength is a very low C+, and beta is a high 1.65. The company is on the wrong side of the global warming problem. In the last bear market, the stock declined from \$37 to \$1. Sell 200 shares short at market.

The runup in the market has convinced us to do our annual "housecleaning" early this year. We are giving up on **Home Depot** and **Wells Fargo**. Home Depot has gotten rid of its controversial and very highly-paid CEO, but the company is now mired in an earnings decline tied to weakness in housing. Since we expect the housing sector to get worse, and interest rates to rise, we are giving up. Sell all HD at market.

Wells Fargo stock has gone nowhere since we bought it, even though earnings are still growing. The stock is reasonably priced, with decent 3-5 year appreciation potential. But in a rising interest rate environment, WFC is likely to struggle. Sell all WFC at market.

We will replace these very large cap stocks with three smaller companies which should grow faster, with less interest rate sensitivity. Our first choice is **Fastenal** (NDQ-FAST), which is an industrial and construction supply wholesaler and retailer. FAST is a small fraction of the size of behemoth Home Depot and it is growing steadily even with the homebuilding slump. Earnings in 2007 should grow at a double-digit rate, and pick up more speed by 2010-12. Financial strength is a strong A and price growth persistence is an excellent 95. Appreciation potential is 60-85. Buy 150 FAST at market.

Our second choice is **Netflix** (NDQ-NFLX) Your Editor has recently started a \$4.99 a month subscription, and is impressed with the speed of delivery, the ease of ordering, and the wide range of choices (over 70,000 DVDs). Hard to beat 2 movies a month for \$5, and there are more expensive plans for bigger users. You can even stream movies to your computer. While Blockbuster is a threat, we believe Netflix can beat them with a stronger internet business model with no bricks and mortar. NFLX has extraordinary 3-5 year appreciation potential of 55-90. Buy 200 shares at market.

Our third choice is our first foray into

nanotechnology, **FEI Company** (NDQ-FEIC). FEI is a leader in producing scanning electron microscopes (SEM) and transmission electron microscopes (TEM), both of which are vital for almost all nano-level applications. This is a bet that the shovel maker will profit no matter who finds the gold in the world of nanotechnology. And FEI is very profitable. Earnings should almost double between 2007 and 2010-12. Appreciation potential is 60-90. Buy 200 shares at market.

We are also going to use a chunk of our massive cash reserves to make two direct bets on our economic forecast. In order to bet directly against the dollar, we will begin buying shares of **Profunds Falling US Dollar Investor** mutual fund (FDPIX). This no-load fund is designed to move up when the US dollar falls. The fund is available through several deep discount brokers as a no-transaction fee (NTF) fund, so it is very simple and cheap to make a long-term direct bet against the dollar. We will purchase \$10,000 of the fund now and \$10,000 more on the 15th of every month until we have invested \$50,000.

Our second direct bet is **Rydex Inverse Long Government Bond Investor** mutual fund (RYJUX). This no-load fund is designed to move up when long-term interest rates on government bonds move up. This fund is also available through deep discount brokers as an NTF fund. The only drawback here is that the expense ratio appears high, but we will swallow hard and pay up for an easy way to bet that long-term rates are headed up. We will purchase \$10,000 of the fund now and \$10,000 more on the 15th of every month until we have invested \$50,000.

Portfolio news: **Taiwan Semiconductor** will pay a 9 cent per ADR dividend and 0.5% stock dividend in June. Although earnings have gone flat, there is a lot of appreciation potential here.

Cephalon has rallied over 80, and is now to be added to the NASDAQ-100 Index.

Although appreciation potential is low, we have already reduced our holding by half.

Stryker and **Fiserv** have both moved to all-time highs. Fiserv jumped on the news that it is selling some assets to TD Ameritrade.

Linear Technology jumped after it reported a \$3 billion accelerated stock buyback plan. This news offset the fact that earnings are flat. Appreciation potential here is still very high.

Martek is stuck around 20, but the research on DHA is very exciting. The latest:

DHA shows benefits against Alzheimer's tau protein in mice.

ADVICE:

Cover 100 FED at market. Sell short 200 RRI at market. Sell all of HD at market. Sell all of WFC at market. Buy 150 FAST at market. Buy 200 NFLX at market. Buy 200 FEIC at market. Buy \$10,000 of FDPIX now and buy another \$10,000 on the 15th of the next four months. Buy \$10,000 of RYJUX now and buy another \$10,000 on the 15th of the next four months.

<i>Shares</i>	<i>Company (Ticker)</i>	<i>Recent Price</i>	<i>Value</i>	<i>Advice</i>
102.12	Cephalon (CEPH)	83.01	8,477	Hold
-200	FirstFed Financial (FED)	56.38	+489	Cover ½*
288.13	Fiserv (FISV)	59.25	17,072	Hold
296.74	Home Depot (HD)	38.87	11,534	Sell*
-200	KB Home (KBH)	45.89	+1095	Hold
-100	Lennar (LEN)	45.65	+680	Hold
277	Lincare Holdings (LNCR)	40.09	11,105	Hold
258.99	Linear Technology (LLTC)	35.89	9,295	Hold
312	Martek Biosciences (MATK)	20.93	6,530	Hold
323.30	Stryker (SYK)	67.31	21,761	Hold
1437	Taiwan Semiconductor (TSM)	10.91	15,678	Hold
294.86	Walgreen Co (WAG)	45.13	13,307	Hold
216.39	Wells Fargo (WFC)	36.09	7,810	Sell*
CASH	Money Mkt Fund		208,240	
TOTAL			\$333,073	*Advice Change

Note: Short positions are entered as net change only, which is the method used by the HFD.

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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.