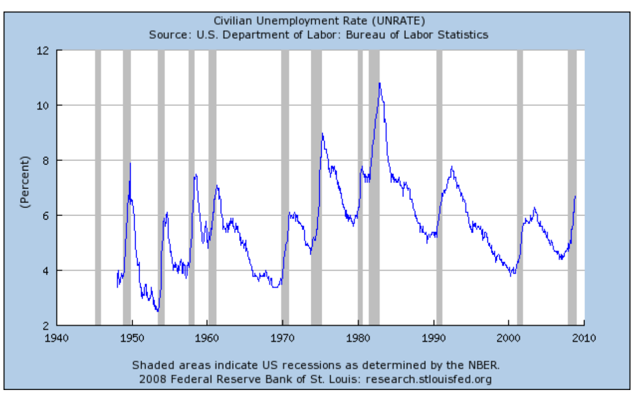
Regular Issue February 15, 2009 S+P 500 827 DJ 7850

HUNKER DOWN

The economic and financial news has been uniformly depressing. Corporate profits collapsing, foreclosures and bankruptcies, a sick stock market, a sicker job market, housing prices in free fall….No wonder that 30% of Americans think we are in a depression. Psychologically, we are. Economically, we are not, yet. A little historical perspective is useful: the accompanying chart shows unemployment rates over the last 60 years. While the current severe recession could easily match the peak unemployment of the 1981-82 contraction, we are nowhere near the levels of the 1930s, when unemployment hit 25% of the workforce.



We are living through the deflating of a massive real estate and credit bubble that took many years to create. The closest parallel is to Japan, whose history is eerily instructive. As Santayana said, "Those who cannot remember the past are condemned to repeat it." Here is what we need to remember: The Japanese bubble took decades to peak, and the Japanese economy and stock market have yet to fully recover from it.

The most dangerous parallel with today is that Japanese policymakers were too timid in their approach to the crisis as it unfolded, and they did not intervene soon enough to deal with troubled banks that were technically insolvent, the so-called "zombie banks." Sound familiar?

But we know what happened in Japan, so in theory we won't make the same mistakes. Unfortunately, we have been too timid with both the financial sector and the economy. We believe the real danger is that the economic stimulus package President Obama is getting ready to sign is not big enough, and the bank bailout (TARP, part deux), if ever fleshed out, will not clean enough of the toxic sludge out of the banking system. Republicans resisting both in the name of their children and grandchildren have it exactly wrong: if we don't act boldly now, we could suffer a lost decade, for which our offspring could rightly condemn us.

While we are on the topic of learning from history, here are four foolish ideas which can only hurt us now and in the future:

Foolish idea #1: Central bankers should never fiddle with asset bubbles (if they even exist), because the market knows best and will readjust on its own.

The fallen idol Alan Greenspan was a particular proponent of this idea. In spite of his uttering the infamous phrase "irrational exuberance," he refused to take any steps to cool off the tech boom. The subsequent costly recession was met with very low interest rates, which helped create the housing/credit bubble, which the Greenspan/Bernanke Fed blithely debunked or ignored. And where did that get us?

The "market knows best" part was also a Greenspan mantra for credit derivatives of all types, rightly called "financial weapons of mass destruction" by Warren Buffett. No need for regulation. No need for supervision or oversight. Healthy financial innovation. Well, we got our mass destruction.

Foolish idea #2: Those who bet the bank should be rewarded when the bets are panning out, but when they go bad, they should still be rewarded.

It takes a lot of nerve to run a business into the ground and take a bonus for your handiwork. Limits on executive pay are only the first step of a populist backlash which will inevitably go too far in shackling the American entrepreneurial spirit. But John Thain's area rug is an icon of hubris that matches Dennis Koslowski's shower curtain.

In the future, we can hope that compensation can be tied to long-term performance, and when risky bets go bad, the bonuses get clawed back. If this scheme pushes some brilliant financial engineers to leave finance, so be it. The stimulus bill will certainly create productive job opportunities for them as civil engineers.

Foolish idea #3: Tax cuts, especially for the wealthy, are a great idea when the economy is strong. They are a great idea when the economy is tanking. In fact, they are always a great idea, since government spending is a bad thing, and you have to "starve the beast."

We will not escape our current economic misery without massive government spending. The consumer is shell-shocked, businesses are shrinking to stay alive, and the rest of the world is tanking. All that is left is the US Government, which can still borrow long-term for 3.5%. We say take the money and spend it. Of course, in the long run, our children will inherit a massive fiscal imbalance that has been exacerbated by the Bush era's irresponsible tax cuts. Many will have to be reversed when our current calamity is under control.

Foolish idea #4: Buy American.

Economists of all stripes can harangue their captive college students on the subject of protectionism, but, like King Canute and the incoming tide, we seem to be unable to convince the American public or politicians of the folly of protectionism. The Hawley-Smoot ("holy smoke") tariff of 1930 helped turn a recession into the Great Depression. A Buy American provision, even if slightly modified, is in the stimulus bill that Obama will sign. This will invite retaliation from our trading partners, which will hurt our exports and kill at least as many jobs as Buy American "creates." When will we ever learn?

Enough talk of economic misery and folly. Let's look at the stock market.

Um…ah….Well, this is not a pretty picture either. Every rally since the November lows has been punctured, and we are now sagging toward a test of the DJ 7500 low, with 8000 failing to hold. There is no safe haven as blue chips, red chips, white chips and potato chips all get crushed, including some of our PAD-C favorites. It is possible that the onslaught of bad economic news, combined with confusion in Washington, will take the market below its previous lows. We will hunker down and ride it out.

While Value Line has been reducing 3-5 year appreciation potentials of dozens of stocks every week, the weak market has kept the VL MAP in strong "Buy" territory. If the PAD System is worth anything, this signal is telling us to hold on for better times. In fact, Value Line is getting ready to "roll out" its 3-5 year projections to 2012-2014. This normally gives an instant boost to the VL MAP, often as much as 10 points. As a consequence, some of our MP-C stocks will get their 3-5 year appreciation potentials increased enough to bring their current prices back into the Buy range (details are discussed below).

We are not big on blowing our own horn, but in these troubled and uncertain times it pays to have a long-term perspective. According to the *Hulbert Financial Digest*, the leading independent rater of financial newsletters, for the 20-year period ending December 31, 2008, the PAD System's Model Portfolio C outperformed the market on a risk-adjusted basis. While this is no guarantee of future performance, it does suggest that our approach has met the test of time, through bull and bear markets.

Unfortunately, bulls like us will have to be very patient. The stock market will have trouble making forward progress as long as the depth and breadth of the economic decline, and the adequacy of the policy response to it, remain unclear. There is no doubt that this will be the worst economic contraction since the Great Depression. But it is possible that the stimulus package, plus a bank cleanup package, plus some help for housing could help the economy bottom out before the end of the year.

RECOMMENDATION: The VL MAP is far above 100%. We are bullish on the market and will remain fully invested. Subscribers should be putting the rest of their cash to work in some of our favorite PAD stocks. (2/15/09 3 PM PST)

MODEL PORTFOLIO-C

Precision Castparts, one of our latest additions, has rewarded us with a nice rally, but it is now above its maximum buy price. If the Value Line rollout is strong enough, we may get a new buy price of 65. The chart pattern suggests that this stock is ready to run higher. Strong earnings growth will be the driver.

II-VI, our other new addition, fell out of bed right after we bought it. An earnings warning was the culprit, and Value Line and others have slashed earnings forecasts for the next several quarters. We like the comeback prospects here, since earnings should start growing sequentially in about 6 months. The stock has recovered, and the chart suggests that others are bottom fishing here too. The stock is a buy up to 25.

Aflac has been crushed by reports that it is exposed to the financial crisis through some of its stock holdings. We think the collapse has been vastly overdone, as investors dump anything associated with finance. But considering how little we know about Aflac's balance sheet, we would hold off on new purchases until the air clears a bit. Hold.

Arthrocare has got to go. Value Line has ceased coverage, the stock has been delisted to the pink sheets, and there is no telling what the company ever did earn. Sell.

On Assignment is still ranked "2" for year-ahead performance, and has lots of 3-5 year appreciation potential, even though Value Line has cut this to 13-20. Earnings may go flat is 2009, but this is good compared to most firms. At 8 times earnings, this is a bargain.

We still like **FEI.** If science is going to be restored to its rightful place, FEI will benefit by selling the tools to nano-level researchers. Earnings for 2008 were terrible, but there should be a sharp bounceback for 2009. The stock has lots of 3-5 year appreciation potential. FEI stock will complete a bottom formation if it rises above 20, which would still give subscribers a chance to get in below the maximum buy price of 22 ½.

First Solar is shining again. Solar energy's promise will be fulfilled in the next decade, and FSLR will be one of the industry leaders. Our only problem is that Value Line has slashed 3-5 year appreciation potential a lot. Even after the rollout, subscribers will be unable to buy under the PAD rules. But hold it if you have it. It is our portfolio's largest stock holding.

Fiserv is an excellent choice for conservative PAD investors. The stock has enormous appreciation potential, is well-ranked for year-ahead performance, and is safer than most stocks. And earnings are still growing.

Healthways has recovered, but the bad news is not all in yet. Next year's earnings will fall to $1, and we are worried enough to give up, especially with so many other attractive stocks available cheap. Sell.

Intuitive Surgical sliced right through 100 before moving to the recovery room. But we think the worst is over. There is still enormous appreciation potential here for a company which could triple its earnings over the next 5 years.

Linear Technology has rallied nicely. Linear spends a ton on R+D, and is constantly rolling out new and faster analog chips. The stock is yielding as much as US T-bonds. A good quality tech investment at current prices.

Martek has finally caved in to the bear market. The stock is back to its maximum buy price at 25, and subscribers who missed this one have another chance to get on board. Omega-3s are still good for what ails you, and Martek is the leader here.

Ormat has been ticking up steadily. Geothermal is hot! The stock's year-ahead performance ranking is back up to "3," but Value Line cut ORA's 3-5 year appreciation potential to 60-90, meaning the stock can only be bought up to 30, under the PAD rules. Soon the VL projections will be rolled out, and then the stock should be buyable up to 32 ½ or even 35.

Taiwan Semiconductor has been strong, even though earnings will be weak for the next three quarters. The stock is still the leading semiconductor foundry, and its technology is leading edge. The stock can be bought up to 9.

Transocean has begun recovering even though the price of oil has not. The chart pattern looks good, and the stock is selling for about 5 times 2009 earnings. The company's rigs are still in demand, and we do not believe that oil will stay under $40. This is a great diversification play for tech investors like us.

Thermo Fisher appears to have bottomed last November, and has completed a nice chart formation. The fundamentals are strong, with no sign of a letup in earnings growth. The stock be bought up to 35, which is below the current price. Don't miss this one if it drops back to that level.

Trimble Navigation turned south after it issued an earnings warning for 2009. Value Line responded by cutting 3-5 year appreciation potential sharply to 35-50. Nonetheless, even though the next three quarters will look weak, we are in for the long haul. We still like GPS and we still like Trimble.

Profunds Falling US Dollar Investor has been weak as the dollar has remained a safe haven for nervous investors around the world. This will not last. At some point the dollar will weaken because the attraction of US debt securities will fade. As appetite for risk returns, the dollar will resume its long-term decline, necessary to correct our current account imbalance. Hold.

Rydex Inverse Long Government Bond Investor has been our 2009 star as bond traders have suddenly realized that lending Uncle Sam trillions of dollars at 3% for 30 years is a mug's game. America's credit rating could drop below AAA as soon as 2012. If the Fed really does decide to start buying long treasuries as part of quantitative easing, it will be directly monetizing the ballooning budget deficits. Hold.

ADVICE: SELL all of ARTC at market. Sell all of HWAY at market. Use the proceeds and our remaining cash to BUY 20 ISRG, 40 RIG and 50 FISV all at market.

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
200	Aflac (AFL)	20.51	4,102	Hold*
256.43	Arthrocare (ARTC)	5.45	1,398	Sell*
250	Automatic Data (ADP)	37.17	9,293	Buy @ 38
200.13	Celgene (CELG)	52.31	10,469	Buy @ 62 1/2
102.12	Cephalon (CEPH)	77.19	7,883	Hold
353.6	Cognex (CGNX)	13.18	4,660	Buy @ 15
302.4	Cognizant (CTSH)	21.17	6,402	Buy @ 22 1/2
300	FEI Corp (FEIC)	17.53	5,259	Buy @ 22 1/2
150	Fastenal (FAST)	34.49	5,174	Buy @ 33
100	First Solar (FSLR)	144.45	14,445	Buy @ 85
288.13	Fiserv (FISV)	35.27	10,162	Buy @ 50
404.85	Healthways (HWAY)	11.43	4,627	Sell*
50	Intuitive Surgical (ISRG)	112.09	5,605	Buy @ 160
350	II-VI (IIVI)	20.28	7,098	Buy @ 25
258.99	Linear Technology (LLTC)	24.45	6,332	Buy @ 27 1/2
300	Martek Biosciences (MATK)	24.14	7,242	Buy @ 25
1300	On Assignment (ASGN)	4.42	5,746	Buy @ 6 1/2
300	Ormat (ORA)	34.24	10,272	Buy @ 30
385.95	Polycom (PLCM)	14.81	5,716	Buy @ 17 1/2
150	Precision Castparts (PCP)	67.22	10,083	Buy @ 55
830.28	Profunds Falling US Dollar (FDPIX)	25.12	20,857	Hold
2484.24	Rydex Inverse Long Gvt Bond (RYJUX)	14.27	35,450	Hold
323.30	Stryker (SYK)	43.19	13,963	Buy @ 53
1450	Taiwan Semiconductor (TSM)	8.29	12,020	Buy @ 9
200	Thermo Fisher (TMO)	39.92	7,984	Buy @ 35
86.20	Transocean (RIG)	60.15	5,185	Buy @ 80
450	Trimble Nav (TRMB)	15.33	6,899	Buy @ 17 1/2
CASH	Money Mkt Fund		1,200	
TOTAL			$245,524	*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 and 3-5 year appreciation potentials for all PAD portfolio stocks.

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.