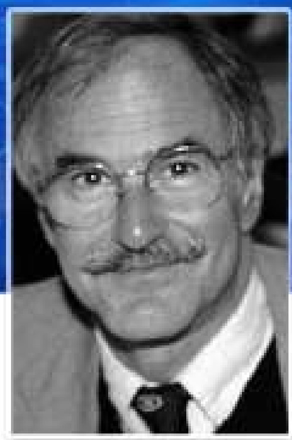
The PAD System Report



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STAGFLATION: PART DEUX

Hollywood churns out mindless sequels to horror movies at a rapid rate (Godzilla has 29), but the economy has waited more than 40 years for the sequel to the 1970's stagflation. The beast back then was eventually slain by Paul Volcker, but not until America had suffered through the deep 1981-82 recession.

The sequel stars Jerome Powell (Paul Volcker has ascended to a well-deserved spot in the central bankers' Valhalla), and the plotline has been altered considerably: OPEC was a key player in the original, increasing oil prices by a factor of 12 between 1970 and 1980. Today's key players are disrupted supply chains (Covid and the Ukraine war) and a red-hot labor market, both of which are putting pressure on firms to raise prices to maintain profit margins.

Today's beast is also less frightening: inflation, as (mis-) measured by the CPI, is still well below the 1980 level of 14%. The unemployment rate for most of the 70s and early 80s was between 5% and 10%, a far cry from today's 3.6%. So the stagnation part of the beast has not appeared yet at all. And don't be fooled by the blip in first quarter real GDP: the small decline was a result of both inventory runoff after a buildup in the last quarter of 2021, and a huge increase in the nation's trade deficit, as imports rose much faster than exports.

But this less-frightening beast provides no solace for the Powell Fed, which must start attacking inflation with short-term interest rates near zero in nominal terms and very negative after subtracting inflation. Perhaps a better metaphor is the tried-and-true punchbowl at the party: the Fed let the party go on far too long, and now must take away the punchbowl while keeping the inebriated party guests from wrecking the house.

As we have stated before, the Fed must avoid tightening too much too fast and sending the economy into a recession, or tightening too little and too slowly and letting inflation become more entrenched and harder to eradicate.

Wall Street does not like either scenario, and stocks have been falling for most of 2022, as traders belatedly realize that interest rates are going to keep rising under even the best possible outcome of tamed inflation and no recession. But the worst is yet to come. If the Fed really wants to cool off inflation, it must raise short-term rates above zero in real terms. So even if the Fed's preferred measure of inflation (now around 6%) cools down to 3-4%, the Fed Funds rate will probably have to rise to at least 4%. That will probably be enough to induce a recession. (For comparison, Paul Volcker raised short-term rates to 20% back in the day.)

But the Fed is only equipped to deal with "demand-management." And part of the problem is on the "supply side." Supply chains are still disrupted by Covid, especially in China, while the Ukraine war and sanctions on the invading Russians have created another adverse supply shock. The Ukraine war could drag on for many months, and with even tougher sanctions on Russian exports of energy, the "supply shock" will persist or even grow.

As Econ 101 students are taught, a strong enough supply shock can cause both a recession and more inflation regardless of what the Fed does. When the stock market fully realizes what even a modest Part Deux will do to the economy and interest rates, the party-goers rush for the exits could bring down the house.

RECOMMENDATION: Hold all positions and at least 50% cash. In spite of the correction, VL MAP is only at 55% and the market could fall a lot further. (May 2, 2022 11:30 AM PDT)

PORTFOLIO STRATEGY: Our PAD portfolio has held up well in this decline. The weighted average of our year-ahead performance ranks is 2.64 (good) and our weighted-average safety ranking of 1.71 is far better than the Value Line median of 3.0. Our portfolio MAP has now reached 68%, above the VL MAP. Our relative improvement in this measure reflects both higher 3-5 year appreciation potentials, and, unfortunately, falling prices. But you can't buy stocks cheaply unless the market tanks! Our portfolio weighted-average beta is 0.46, and our cash percentage is 53%, both of which are very defensive. We are prepared for a bear market.

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.