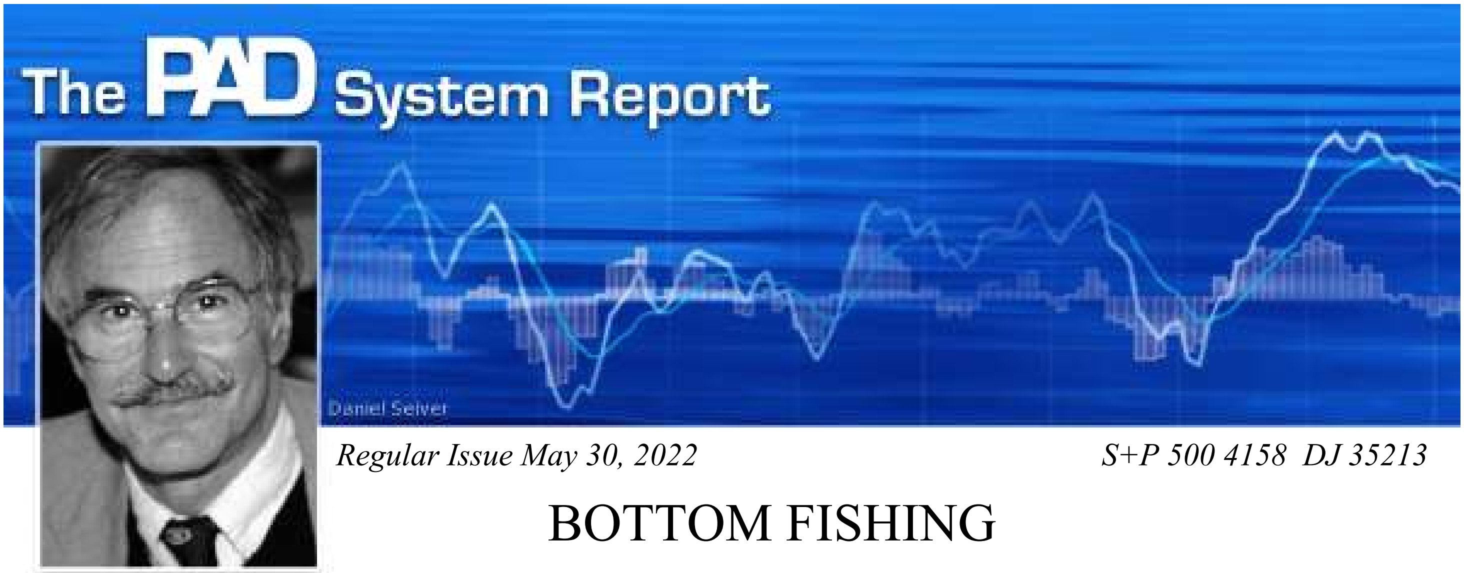


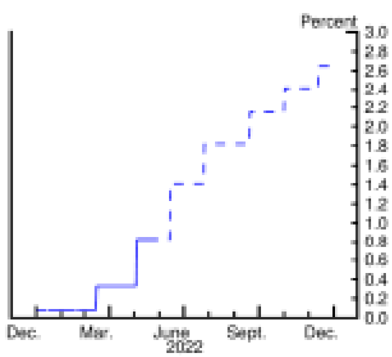
Regular Issue May 30, 2022 *S+P 500 4158 DJ 35213*

BOTTOM FISHING

The S+P 500 came very close to bear market territory (traditionally defined as a 20% decline on a closing basis) before rallying strongly late in the month. Wall Street defines searching for, and betting on, the low point of a decline as “bottom fishing.” This is a risky business, as another colorful Wall Street adage has it: “trying to guess the bottom is like trying to catch a falling knife.”

We think Wall Street traders have grabbed the knife too soon: the Powell Fed is far from finished raising short-term interest rates.

1. Federal Funds Rate Path



Source: CME DataMine; Federal Reserve Board staff calculations.

While three more ½-point increases in the Fed Funds rate this year are supposedly baked in the cake, FOMC Governor Waller expects the Fed Funds rate to reach 2.65% by the end of the year.[1] This forecast suggests almost 2 percentage points of increases this year, including, in Waller’s chart reprinted here, a mysterious jump in June that looks like a ¾-point increase.

Wall Street won’t like that, and also will not like what may be in store for 2023. The FOMC knows that monetary policy is not actually tight until the Fed Funds rate is above the “neutral rate.” In simple terms, this is the real Fed Funds rate (the nominal rate minus inflation) which would keep the economy at full employment with inflation at the Fed’s target of 2%. But the inflation rate, measured by the Fed’s preferred PCE Deflator, is right now about 5-6%. Our own calculations suggest that the Fed Funds rate will have to rise another percentage point in 2023, unless inflation comes down significantly in the next 6-9 months. Governor Waller also points out that the Fed’s reduction of its $9 trillion of assets will soon reach an annual rate of $1 trillion per year. Sales of long-term bonds could easily drive up long-term rates by ½ point. Also not what Wall Street wants to see.

In our opinion, inflation will not be coming down very quickly, since disruptions in world supply chains are not about to end: the Ukraine

[1] “Responding to High Inflation, with Some Thoughts on a Soft Landing,” May 30th speech, available at The Federal Reserve’s website FederalReserve.gov.

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war will not be over soon, as the Ukrainians, with even more powerful weapons provided by the Western powers, will continue to inflict heavy losses on the incompetent Russian army. Tighter sanctions on Russia will also further disrupt energy markets. In addition, the coronavirus continues to mutate around the world, which will also keep supply chains from returning to pre-pandemic efficiency.

Labor costs in the US are rising too. The US labor market is red-hot, with the number of vacancies almost twice as high as the level of unemployment. A tight labor market is good for workers, who are able to bargain for larger wage increases. While workers are still not getting increases big enough to match CPI inflation, average hourly earnings are now rising at about a 6% rate. In the face of rising labor costs, and rising input costs, firms can maintain profit margins in the short run only by increasing prices. The Fed will have to break this wage-price spiral with high enough interest rates to slow the economy, while convincing businesses and workers that inflation will come down a lot, and soon.

This is the Fed's "soft landing," with currently-elevated inflation coming down sharply without a recession. Their reasoning, laid out in Governor Waller's speech, is that *vacancies* will fall sharply as the Fed raises rates, but that *unemployment* will not rise much at all as inflation falls back toward 2%.

This is certainly possible, but we think it is a Goldilocks scenario where everything has to go "just right." And remember what happened to Goldilocks: chased out of the house by the bears.

RECOMMENDATION: VL MAP is probably around 65% right now. This suggests that about one more down leg could give us a long-term buy signal. Until that time, we will continue to hold about 50% cash. (5/30/2022 at 6:30 PM PST)

MODEL PORTFOLIO-C

PORTFOLIO STATISTICS:

Weighted year-ahead performance rank: 2.64; Weighted safety rank: 1.73; Portfolio MAP: 56%. (These statistics and more can be found on the subscriber's corner of our website.) Our weighted performance rank and safety ranks are better than the VL average of 3.0. Our portfolio MAP is rising, albeit still a little below VL MAP. We still like our 12 remaining stocks, several of which are getting pretty cheap (see our discussion below). Our portfolio weighted-average beta (counting cash as zero beta), is around 0.47, which is our protection against another down leg in the market.

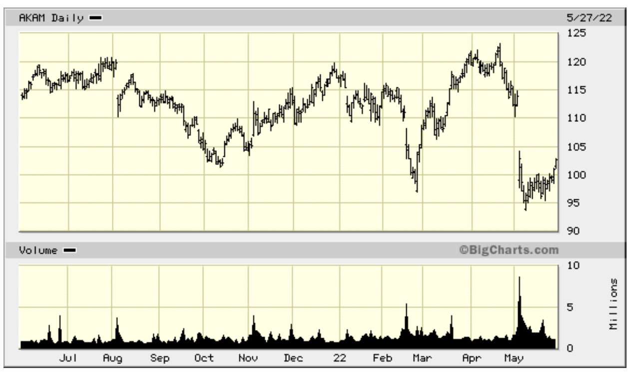
PERFORMANCE UPDATE:

Hulbert Financial Digest no longer publishes performance statistics for many stock market newsletters. (In their final report through 2015, our portfolio outperformed the market on a risk-adjusted basis at every time interval from one year to 25 years.) We will update our performance every 3 months in our full issues (February, May, August, November). On May 31, 2021, the S+P 500 Index was at 4204 and the Model Portfolio was worth $991,533. Today, the S+P is at 4158 (down about 1%) and the Model Portfolio is worth $982,993 (down a tad less than 1%). While we are only matching the market over the last year, for the last three months, we are down only 1% while the S+P is down about 5%. PAD really shines in bear markets. (All of these performance statistics exclude dividends on the S+P, dividends on our portfolio stocks, and meager earnings from our cash reserves. Given today's yields, if we add them all in, the one-year comparisons would change very little.)

PORTFOLIO STRATEGY: Market weakness has raised our cash percentage to 52%, which we consider defensive enough. If we do get another down leg, we will be well-positioned to build a "Buy List" and acquire stocks cheaply.

UPDATES ON PORTFOLIO STOCKS:

Akamai tanked at the beginning of May because Wall Street did not like first-quarter earnings. It was a bad quarter, but adjusted for one-time charges, they only missed by 3 cents. But that's Wall Street. The stock has since recovered somewhat, and it is below its new 3-5 year appreciation potential of 135-185. (Part of the apparent first quarter miss was the purchase of Linode, which is supposed to be immediately accretive to earnings.). Akamai still has the lowest beta in the portfolio, even after the early-May drop. We are happy to hold this cloud and cybersecurity play.



Alphabet, a/k/a Google, has taken a real beating in the market downturn. As we said in February, antitrust and privacy concerns could continue to weigh on the stock. At the current price, though, much of this has been discounted. Google now has enough 3-5 year appreciation potential (4585-5605) so that, at the current quote, it actually meets the PAD 100% Rule for purchase (See page 12 of *Outsmarting Wall Street*). If VL MAP gives us a Buy signal, we will certainly consider adding to our position. Google still is ranked "1" for both year-ahead performance and for Safety, with top financial strength (A++) and a beta of only 0.9.

Amgen, after hiccupping at the beginning of May, has roared back to challenge its all-time high. The company is a very safe biotech play, with a dividend yield over 3%, A++ financial strength, a below-market p/e, and a low beta of 0.70. R+D is a humongous 20% of sales, which should lead to a steady stream of new drugs. Value Line's 3-5 year appreciation potential of 320-390 should be easy for Amgen to achieve.

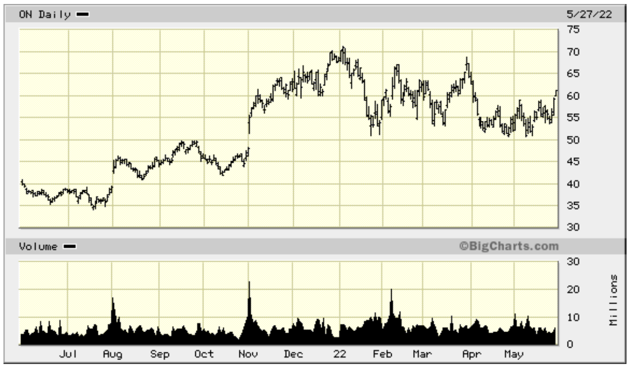
Automatic Data has now recovered more than half of its early-year decline. The dividend still goes up every year, and Value Line estimates that earnings will rise at 9% a year for the next 3-5 years. Repurchases of stock continue. The company has A++ financial strength, and price growth persistence of "95" on a scale of 5-100. Although 3-5 year appreciation potential is only 240-295, PAD has done very well holding the stock through thick and thin. The Editor paid a split-adjusted $4 a share for it in 1988.

Edwards Lifesciences took a large tumble in late April-early May. It has only bounced back a bit in late May. As an added insult, Value Line has downgraded EW to a "4" for year-ahead performance. Although the company continues to grow earnings, the premium p/e which it still has (40) means that any growth slowdown will be punished. We are still willing to stay the course, though, since their main focus is treatment of heart disease. Unfortunately, the demand for their products will continue to grow relentlessly, and EW spends 17% of revenues on R+D, which should keep them at the forefront of technology.

Fiserv has been falling for a year. The stock is now trading well below its new (adjusted) 3-5 year appreciation potential of 155-195. Earnings are still growing steadily, and Value Line thinks they will continue to grow for 3-5 years at 11%. And yet the company now sells at a discount to the overall market p/e! We will consider adding to our position if the stock market sags again.

NXPI continued to sell off with the market, and has rallied back a bit with the market too. Although the stock is now below its new 3-5 year appreciation potential of 230-245, we will be looking to sell some shares at 230, since the stock will be almost a 4-bagger from purchase. We still like the company, but we also still have an outsized exposure to semiconductors.

ON Semiconductor got an enormous boost in its 3-5 year appreciation potential to 75-115. Earnings are still in a powerful uptrend, but the stock is still pretty close to the low end of that range. This is partly a result of the low p/e Value Line (and the market) are assigning to its surging earnings. This strengthens the case for a takeover at a good premium to the current price.



Science Applications lost a big contract that will mean flat earnings for 2022. And yet the company has a large backlog of work, and has opportunities to bid on many new contracts. Even though beta is a relatively high (for us) 1.20, the company's prospects are really uncorrelated with the state of the business cycle, since almost all of its earnings come from long-term government contracts**.** This is a real plus for the portfolio, since a number of our companies will see a negative impact if the Fed does cause a recession. In addition, the company has a lot of 3-5 year appreciation potential (135-200) and sells at a 30% discount to the market p/e.

T Rowe Price sagged further as the market fell in April and May, and the stock has only begun a tentative rally from its low point under 120. The company's earnings are certainly negatively affected by the level of the stock market, since Assets Under Management (AUM) is the main source of their income. But the long-run trend of the stock market (and therefore AUM) is up, and TROW should also be able to take some business away from other mutual fund families, since it is a pure no-load fund family with lots of index funds, which will continue to be popular with American savers. The yield is now over 4%, as the dividend has been raised again. With 3-5 year appreciation potential of 250-305, the company meets the 19% Rule for purchase at the current quote (See page 46 of *Outsmarting Wall Street*.) We will certainly consider buying more if we get a VL MAP Buy signal.

Taiwan Semiconductor continues in its own private bear market. This has made the stock much cheaper relative to its 3-5 year appreciation potential of 135-185, and the company's modest dividend makes it even more attractive. Future growth should continue at breakneck speed, since TSM is the world leader in semiconductors. As long as the Chinese do not invade Taiwan, of course. We do not think this will happen, and the US plans to make Taiwan as indigestible as Ukraine has been for Russia. TSM is also trying to diversify its foundries around the world. In any case, we will hold our remaining shares for now.

Thermo Fisher continued to fall to 520 before rallying a bit. Unfortunately, VL has cut 3-5 year appreciation potential to 565-690, mainly because VL is now assigning a lower p/e to future earnings. In addition, TMO will have a down year for earnings on a GAAP basis, since it must deduct some noncash merger-related costs resulting from its recent acquisition. We are still willing to hold, however, since this is our smallest holding, and it fits one of our favorite adages: "don't buy the gold miners, buy the shovel makers." TMO makes the shovels for many of the biotech gold miners.

ADVICE: Hold all long positions. Hold cash reserves of at least 50%.

Shares	*Company (Ticker)*	*Recent Price*	*Value*	*Advice*
300	Akamai (AKAM)	103	30,900	Hold
20	Alphabet (GOOG)	2256	45,120	Hold
200	Amgen (AMGN)	255	51,100	Hold
200	Automatic Data (ADP)	225	45,000	Hold
250	Edwards Lifesciences (EW)	101	25,250	Hold
450	Fiserv (FISV)	101	45,450	Hold
250	NXPI (NXPI)	196	49,000	Hold
600	On Semiconductor (ON)	61	36,600	Hold
400	Science Applications (SAIC)	87	34,800	Hold
250	T Rowe Price (TROW)	130	32,500	Hold
500	Taiwan Semiconductor (TSM)	94	47,000	Hold
50	Thermo Fisher (TMO)	572	28,600	Hold
CASH	Money Mkt Fund		511,713	
TOTAL			$982,993	*Advice change

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 available for $9.95 on our website.** A number of public libraries still have copies of the physical book.