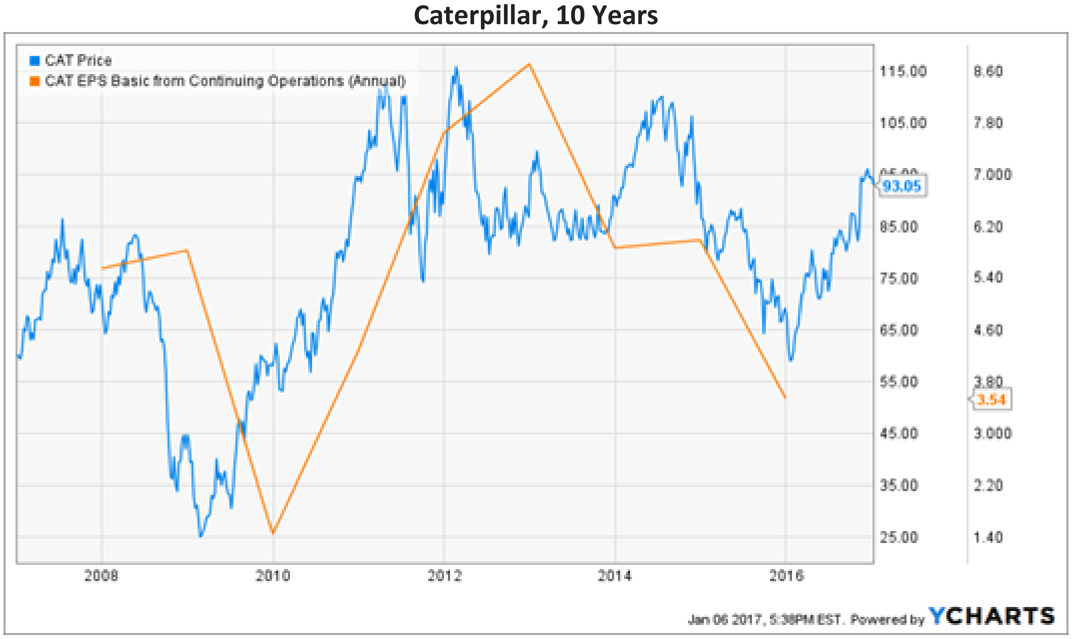
The Outlook: Jan. 6, 2017

Caterpillar and friends: staying aboard the rocket.

Caterpillar, Last Year

Caterpillar, 10 Years



It's still only the first week of January, so those "Forecasts for 2017" are overflowing everyone's inboxes. One example, today, was worth thinking about: "Wall Street's Mega-Bull Predicts S&P 500 at 2500 by Year-End!" That turns out to mean that the Mega-Bull is forecasting a 12% return on the broad stock market, this year. We all might have blinked at that number, wondering at the notion that a 12% return on the market seems, at the moment, to be the most wildly optimistic daydream on Wall Street.

After pondering that for a while, it began to make a certain kind of sense: not because it's a brilliant insight, but because it's a clear reflection of the general feeling in the investment world right now. We'd sum that feeling up this way: "7 years of Bull Market; completely unexpected post-election rally after a completely unexpected election result; rising interest rates; trouble all over the world; how much longer can this last?" So when the most bullish forecaster among the prestigious firms on the Street predicts 12%, he probably does feel out on a limb compared to the great majority of his colleagues.

So the Big Question is: "After 7 years of Bull Market, and after a fairly spectacular 2016 for many Outlook core stocks, how optimistic should we be? Shouldn't we be hearing warning bells?"

Those 2 Caterpillar charts pose the question pretty starkly. There's 2016, on top: a <u>41%</u> total return for Caterpillar. (Versus the market's 12%.) And there are CAT's annual earnings (orange) on the 10-year chart: still plunging off the cliff as 2016 opened, while the stock seemed to defy gravity and rocket up in the opposite direction. Early last year the market appeared to adopt Outlook's point of view on Caterpillar (strong company, wonderfully managed through a bad downturn which must eventually end) and stormed onto the bandwagon, driving up the stock despite the near-total absence of any evidence that CAT's <u>business</u> upturn had actually begun.

At Outlook we have often observed that "the safest time to invest in any financially strong, well-run company is when the market <u>really</u> hates it—not just dislikes it, but hates it so much it drives the company's valuation to silly lows." Of course that's also the scariest time to invest, because the pessimism about the company and stock are on the galactic scale at such times, but the valuation is silly, the company will come back, and the stock will rocket up. But having lived through all that, it's fair to ask, "What shall we do once that rocket has happened?"

Here's Outlook's simple answer: "Stay aboard. We want a lot more, and we're likely to get it."

The foundation to that answer is part solid reasoning, part experience. The reasoning part says Caterpillar (like other Outlookcompanies) will show very surprising profit growth when its business upturn actually happens, because management did its job so well during the downturn. The experience part says the market <u>nearly always</u> underestimates the strength of those returning profits, and reacts to that surprise by liking the stock even more. So when a stock like CAT (or Freeport, Deere, Cummins, and others) finally bottoms out during "bad times" the subsequent good times very often last far longer than the investment world expects. As always, those good times proceed in ebbs and flows . . . but they are worth the ride. We're taking it.

© Dave Raub
Outlook Capital Management, LLC
125 S. Wilke Road, Suite 200E
Arlington Heights, IL 60005
847-797-0600