

## The Outlook: April 27, 2018

### *Fear is the worst enemy: CAT's "high water mark."*

In Outlook's 41 years in the investment world, we've learned to believe completely in just a few "Golden Rules." Here's one of them: *"Fear is an investor's worst enemy."*

When we investors really understand that Rule, we remind ourselves about it with startling frequency: from several times a day, often enough; to once a week or so, when things are going unusually well. The reason goes right to the heart of the nature of markets and the nature of good investing. Markets—being crowds of normal people highly concerned about their money—spend most of their time either teetering on the brink of panic or only one long stride away from that brink. So they are easily pushed over it by a rumor or news item which looks threatening at first glance (the very first glance.)

At such times the market never thinks. It takes that quick glance, disconnects its brain, and runs. Then we investors have an instantaneous, stark choice: we can either disconnect ourselves and run after it, which is always what we feel like doing; or we can think hard before acting. The great majority of the time, if we can bring ourselves to do that, we'll find our brains telling us to do something frightening: turn our backs on the market and do exactly the opposite.

Last week gave us two of those "first glance" news items which so easily trigger cliff-diving plunges by an anxious market: a now-famous remark about "high water" by a Caterpillar manager; and the crossing of the 3% yield barrier by the 10-year Treasury bond. We'll deal with the bond later; let's look at Caterpillar today.

## 2018 Outlook – End Market Assumptions

### Construction Industries

- North America – strength in building construction, infrastructure and pipeline activity
- Asia/Pacific – strength across the region primarily driven by China
- EAME – high business confidence and stability in oil producing countries
- Latin America – recovery that started in 2017 is expected to continue, region remains below historical levels

### Resource Industries

- Favorable commodity price levels driving higher production, declining parked fleets and higher machine utilization
- Improving miner profitability expected to drive higher equipment sales
- Strong global economic conditions supporting higher sales to heavy construction and quarry and aggregate customers
- Mining industry recovery continues

### Energy & Transportation

- Oil and Gas – strength in well servicing and gas compression in North America; drilling and offshore weak
- Power Generation – up after a multi-year downturn, industry remains at low levels
- Industrial – expected to be up primarily due to projected demand in EAME
- Transportation – increase primarily from growth in rail services; locomotive and marine challenges continue

Pardon this first chart. Here Caterpillar uses words instead of pictures to tell us how 2018 is looking across its 3 major operating groups: Construction, Mining and Energy/Transportation. (Those 3 groups also name the global industries which buy CAT's heavy equipment.) Despite the dense cloud of words, it's worth a look because Caterpillar is saying, in so many words, "This year won't be perfect, but it looks remarkably good for our major business lines—better than it's looked for a long time. And one of the most striking things about what we're seeing right now is that in most areas this strong rebound is clearly in its early stages, following lengthy downturns and lengthy periods of "bumping along the bottom" in sales to our major customer groups."

Those were the words. The numbers for Caterpillar were as close to "spectacular" as any old-fashioned, hard-industrial company ever gets. As analyst Leo Nelissen put it, commenting on CAT's average 31% sales gains and the market's subsequent stomping upon the stock, it was a quarter "When Perfect Wasn't Good Enough." Why? Well, we can never know exactly what goes in the market's mind, but a good guess is that Caterpillar's CFO used the term "high-water mark for the year" to describe CAT's first-quarter sales and earnings. Those few words were all the first glance the market's crowd of speculators needed, as "Sell!" buttons were struck so hard and fast that medical intervention may have been needed up and down Wall Street. As always, the facts—which would be obvious with a second glance—didn't matter. Caterpillar's seasonal sales patterns usually make the second quarter of each year the "high water mark." In 2018, the CFO remarked, it looks like those honors might go the first quarter because selling prices rose faster than product costs, and product costs will be catching up as usual. It was a little like a theater manager introducing a show to a crowded audience, and remarking proudly on the wonderful qualities of the theater, including the latest "fire-proof" building materials. If his crowd happened to be entirely composed of the market speculators who pounded down CAT, they'd have panicked and run for the exits as soon as the word "fire" was spoken, who cares what words came next.

So they'd have missed the next picture:

## Full Year 2018 Outlook

	<u>Previous Outlook</u> <sup>2</sup>	<u>Current Outlook</u> <sup>3</sup>
Profit Per Share	\$7.75 – \$8.75	\$9.75 – \$10.75
Restructuring Costs	~\$400 million	~\$400 million
Adjusted Profit Per Share <sup>1</sup>	\$8.25 – \$9.25	\$10.25 – \$11.25

<sup>1</sup> Excludes restructuring costs

<sup>2</sup> As of January 25, 2018

<sup>3</sup> As of April 24, 2018

Here is Caterpillar telling us it expects to earn around \$10.75 per share this year . . . 24% higher than the company expected only a couple of months ago. CAT's current stock price of \$145 is only about 13 times that profit figure. The market as a whole trades around 17 to 18 times expected profits, and of course the Facebooks and Amazons trade at 25 to 80 times, being creations from a different universe as far as the market is concerned—at the moment.

Fear is an investor's worst enemy. It is the only force strong enough to persuade us to disconnect our brains after only a first glance at supposedly "bad" news. Its strength lies in the nature of the market: a galactic-sized crowd of speculators who are quite capable of pounding down any stock—for a while—no matter how trivial, disconnected from reality or downright silly the "first glance" reason might be. Good investors can't do anything to stop this behavior, except turn their backs on the speculating mob and their own fears, and do the opposite of what that mob would like to persuade us to do. Caterpillar (like every other Outlook asset) is an outstanding company just beginning to earn the rewards of working hard and effectively through tough times. We'll hold it and buy more when we can.

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