

The Outlook: Feb. 18, 2020

Problems Worth Worrying About

Outlook's clients and friends are used to our point of view, which sound-bite specialists might reduce to: "What, me worry?" We do believe—very strongly—that the business and investment worlds are almost always a lot healthier than most of the worried daily news and anxious commentary make them out to be. Because we believe that so strongly, we've kept our clients fully invested through the 11 solid years of "worried news" since the end of the "Great Financial Calamity" and Bear Market in March, 2009.

We've been right, of course . . . so far. But here's a good question: "If we're not as worried about the market's current "nightmares" as the market crowd seems to be . . . what are we worried about?"

A useful way to think about "problems worth worrying about," for investors, is to separate them into two kinds: problems on Wall Street (the market), and problems on Main Street (the real economy.) The Dotcom Bubble and Bust was a problem which began with dangerous behavior on Wall Street. It spilled over to Main Street because when speculative bubbles are both widespread and extreme, they will certainly affect the real world when they blow up. (The Main Street recession following the Dotcom Bust was pretty mild, though.) The 2007 – 2009 Mortgage Bubble and Bust was a problem which began with dangerous behavior on Main Street. It spilled over to Wall Street, of course, whose terrified reactions then made the Main Street problem catastrophically worse. (Meaning a pretty terrible recession.)

"What are we worried about?" Wall Street tops our list, not Main Street, as we stand here in in early 2020.

"Celebrity" Tech Stocks Up 54% in 6 Weeks

Note: FANG+ is an index of 10 large tech companies.

Source: FactSet



By *Gunjan Banerji*
Feb. 17, 2020 5:30 am ET

The “FANG+ Index” (the green line above) is 10 “celebrity tech” stocks: Facebook, Apple, Amazon, Netflix, Google, Alibaba, Baidu, Nvidia, Tesla and Twitter. (Of course Tesla is a car company, not a tech company, but we won’t quibble about labels today.) The problem worth worrying about is completely obvious: 54% in 6 weeks, for stocks which were not valued the least bit cautiously to begin with, means “Trouble” is coming somewhere down the road.

The headline over that Wall Street Journal chart, only a couple of days ago, was: ***“Why Mess with a Winning Strategy? Investors Bet on Tech!”*** and further, ***“Many Investors Have Stopped Looking for Bargains, Jumping Instead into the Market’s Biggest Winners.”*** We often comment, at Outlook, that both headlines and the news stories under them are usually grossly misleading; usually giving us a distorted and partial view of the “whole story.” Not that headline, though. It got right to the heart of it.

Now, becoming silly about valuation (both way too high and way too low) is a fact of life about the market—about “Wall Street.” There are almost always a few handfuls—even armloads—of stocks which are “living in a fact-free world,” as one skeptic recently put it. It is the nature of the market that they can live there for a long time; and they can begin with valuations which are “silly,” then spend that long time getting to “3 times silly,” or 5 or 10 times. The ancient saying, among speculators, is “The market can stay irrational longer than you can stay solvent.” “Longer” indeed . . . but not forever. Fact-free worlds don’t last. Facts always destroy them. When investors fail, it’s very often because the long wait made them doubt their own good judgment . . . and abandon it, with awful consequences.

So the genuinely “worrisome” thing isn’t that the market is acting ridiculously toward handfuls of stocks. It’s how many handfuls or armloads are getting the silly treatment—and how many times “silly” they’ve risen to.

Let’s glance at Shopify.

Shopify, 2 Years: Sales Doubled, Net Loss Tripled . . . Stock Quintupled.

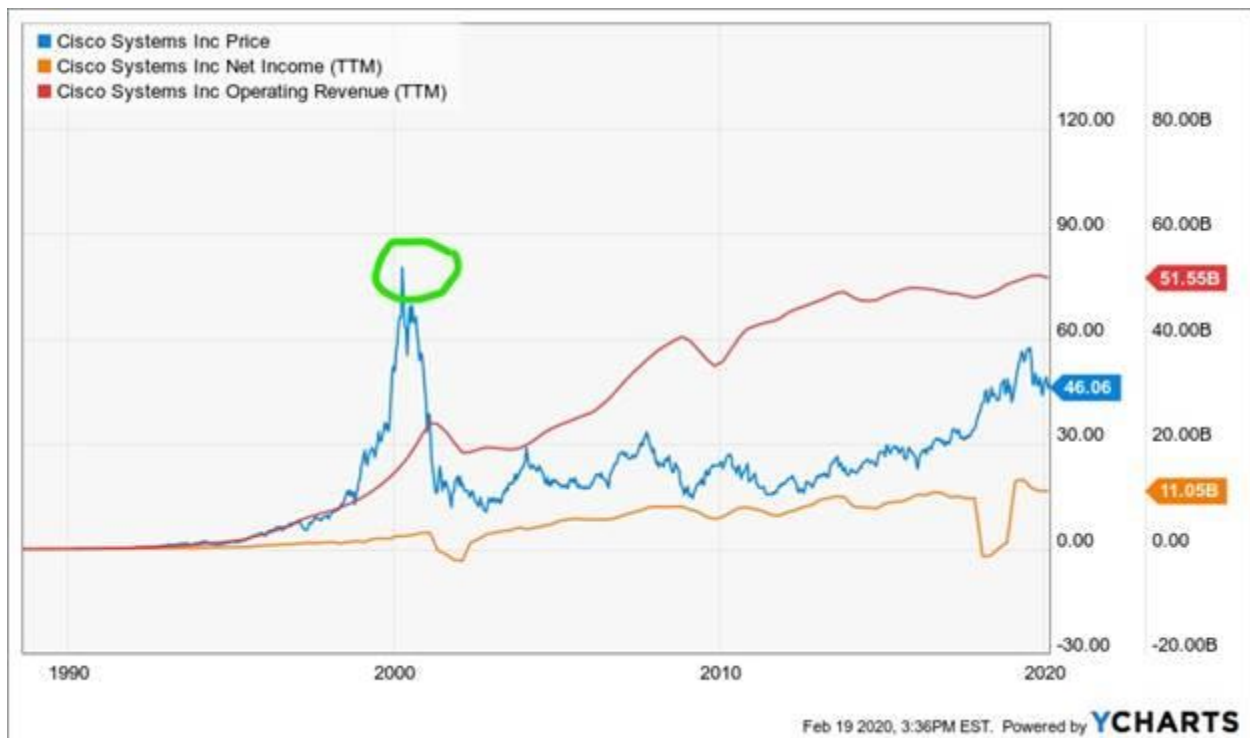


Shopify is a 15-year-old company which went public 5 years ago. It helps small businesses set up online, offering them most of the software and payments tools they need to succeed. It was a great idea, and the company has succeeded wonderfully, offering technology with great value to its customers. For its one million small-business customers across 175 countries, it gets the job done, at very affordable prices.

A famous speculator once said, “All bubbles begin with a hint of truth before exploding into insanity.” In Shopify’s case—very much like those ten giant “Fang+” companies—there is much more than a hint of truth. There is a solid core of truth; of real Main Street value and achievement as real operating businesses.

Now let’s pause for a look back in time at another company with a “solid core of truth,” etc. The Way-Back Machine has delivered us to the year 2000, and there is Cisco, the pioneer in internet hardware, building the routers and servers which let the world into the Age of the Internet.

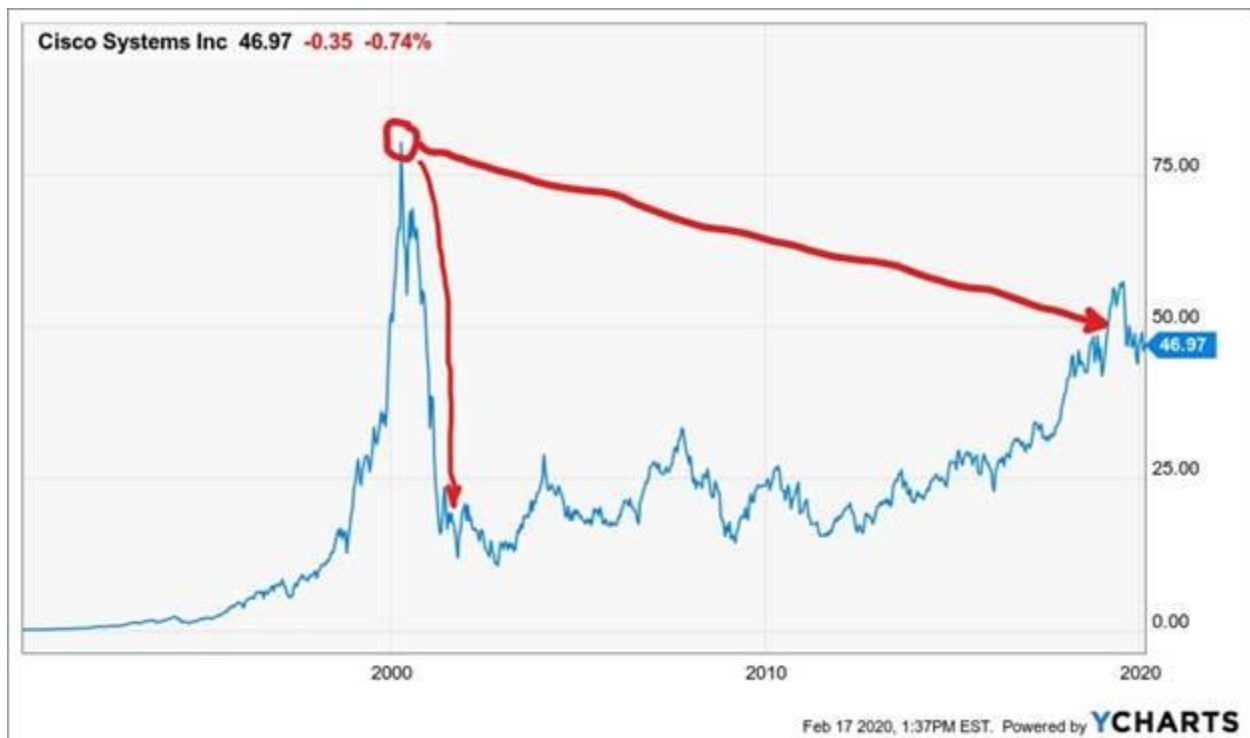
Cisco, Lifetime: Sales (red), Earnings (orange), Stock Price (blue)



Hmm. As Cisco stood on that green-circled brink in 2000 (blissfully unaware of the future, perhaps), its annual sales were \$15 billion, annual earnings were \$2.5 billion (and had been positive for 10 years or so) . . . and stock price was around \$80, which was a price/earnings ratio of 222 times. As Shopify stands today, its annual sales are around \$2 billion; annual earnings are minus \$125 million and not only have been negative forever, but have been getting more negative as Shopify's sales grow . . . and its stock price, at \$543, is 125 times sales per share. That statistic has no meaning, really, other than expressing the idea of "optimistic beyond belief," or possibly "priced for perfection on the galactic scale."

What happened next? A train wreck, of course.

The Year 2000: Cisco Systems on the Brink



Cisco fell from \$80 to \$12, then spent the next 14 years wallowing down there between \$15 and \$25 per share. At today's \$47, it's still 40% lower than its peak, back there at the brink . . . when it was priced for perfection on the galactic scale. Yet, as the first Cisco chart shows, this company has been wonderfully profitable upon steadily-growing annual sales for the past 15 years. But it's 40% lower than its peak, nevertheless.

Let's finish, for now, with one more glance at our first worry:

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Among those 10 stocks in the FANG+, only Tesla is “priced for perfection on the galactic scale.” Three more—Amazon, Netflix and Twitter—are merely “priced for endless good news,” if not quite for “perfection.” The other 6 aren’t valued anywhere near “silly,” much less “3, 5 or 10 times silly.” They’re emphatically not “cautiously” or “doubtfully” valued—which is where we find real values—but they’re generally in the “fairly confident” to “emphatically confident” range of values.

That is not “dangerous behavior” on Wall Street. Instead we’d call it “normal handfuls of silliness,” but when we glance at the fairly numerous examples like Shopify, we must say this: “The handfuls are getting bigger. We must beware of the day they become overflowing armloads.”

When that day arrives, what will happen to the kinds of companies Outlook’s clients own—which are mostly valued at the opposite end of the FANG/Shopify scale? The answer must wait a couple of days, since we’ve gone on long enough for today. But here’s a hint. When any market’s most popular, “celebrity” stocks run into their day of valuation reckoning, the spillover effects of the reckoning wash over nearly everything, for a little while, no matter how far it stood from the “priced for perfection” brink. But what happens next—after that “little while”—will probably surprise most of us.

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