<u>The Outlook: July 12, 2017</u>

CAT, Cummins, Deere: History Says "Patience"

<u>History</u> is surely the single most valuable aid to clear thinking. It gives us perspective, which helps us see "the big picture." It's not infallible—nothing is—but it always helps. For investors, long-term charts meet that description exactly: not infallible, but *always* helpful.

10 Years of Caterpillar: Sales and Stock Price

10 Years of Cummins: Sales and Stock Price

We have commented before on those remarkable pictures, watching Caterpillar's and Cummins' stock prices take off like a rocket in early 2016, long before even the first small, hesitant signs of improvement in the two companies' business performance. Like people in general, the market is an odd mixture of strengths and weaknesses: sometimes wonderfully far-sighted; sometimes amazingly short-sighted. The far-sightedness was in charge in early 2016, as the market finally decided that it made no sense to value these two strong companies as if there was no possibility of a brighter future.

Caterpillar has gained 83%. Cummins has gained 90%. Deere is not shown, but it's the same kind of company and acted the same way: up 70%. For all 3 companies, those gains happened despite only the tiniest of "green shoots" of improvement in sales and earnings. So a good question, today, is: "Shall we sell? Surely the market's rocket ride since last year has already anticipated the best of the future turnaround in these firm's business results?"

History won't provide the whole answer—but it will help. Notice the circles around 2008 – 2009, the last awful plunge in CAT's and Cummins' (and Deere's) business results and stock prices. The market also put on its far-sighted hat back then, didn't it? The stocks took off like the same rocket, 6 to 12 months before the companies' first hesitant signs of improvement in business.

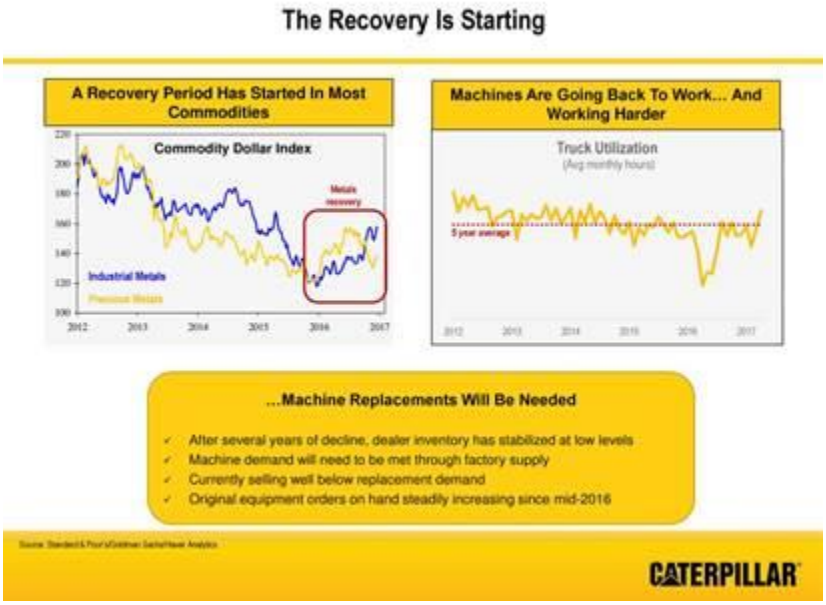
CAT's operating revenues have grown only 7% from their abysmal bottom, last September. The stock is up 83%, as mentioned. Back in 2009 – 2010 almost the same thing happened: 150% stock gain, with only a 12% sales gain during the first 2 quarters of weak recovery. Notice, though, that Caterpillar's story was not over, by a long shot. Over the first 2 years of business recovery, CAT's sales grew 80% . . . and its stock gained 350%. We're fairly happy we did not leave that extra 200% behind, back in 2010 when we asked ourselves, "Shall we sell, surely we've seen the best of the rocket ride?"

That's history's answer to our question. It amounts to a simple reminder of how downturns and upturns work: good companies suffer a lot for a while, but if they've kept their heads up and kept marching on, the benefits are often fairly staggering, in their size and length. The rest of the answer, though, must

focus on exactly what's going on in these businesses this time. History certainly rhymes, but it does not exactly repeat itself, and we must look at the exact nature of our businesses, today.

Here are a couple of pictures.

Mining is only one of CAT's 3 big divisions . . . but it took the most pain, by far, since 2012. That "Machine Shipment" chart on the right is as awful a spectacle as any company would ever wish to see. Machines sold to CAT's mining customers are down about 80% since 2012.



And the next chart may be CAT's first "green shoot," but it's a sickly shade of pale green. Denise Johnson, in charge of Mining for Caterpillar, gave a talk recently in which this chart was typical, and

matched the tone of her remarks: "Things might be looking up, possibly, or at least not plunging farther into darkness, we hope." But her bullet point above are important. They say, in essence, "Equipment cycles must turn up eventually. They cannot last forever. Machines wear out; our buyers' businesses begin to improve; the world eventually needs more output from mines, not less."

Here's the last picture, from Deere.

Worldwide Construction & Forestry
2Q 2017 Overview

($ millions)	2Q 2017	2Q 2017 vs. 2Q 2016
Net Sales	$1,466	↑ 7%
Operating Profit*	$108	↑ 46%

*2Q 2017 operating profit impacted by:
- + Shipment volumes
- + Price realization
- – Warranty costs
- – Sales mix

See the far right. Second-quarter sales grew 7% . . . a pale green shoot. But operating profits grew 46% . . . green all right, not pale at all.

Good manufacturing companies—and CAT, Cummins and Deere are Olympic gold medalists, as manufacturing companies—work very effectively on lowering their costs and improving future productivity, while they're enduring the shocking pain of cyclical downturns. They have tremendous "operating leverage," to use the jargon. That simply means that when sales finally show up again, their profits explode, reaching prior historical peaks at much lower sales levels than before. That picture above is the very earliest such profit explosion, from Deere. And that, in turn, is why the market's first "rocket ride" in such stocks tends to be merely the first stage.

These are outstanding companies, which have done outstanding work during some bad years. They are going to earn the benefits of that hard work in the years ahead, and so will we.

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