<u>The Outlook: Feb. 25, 2021</u>

Understanding the market: John Deere . . . and Tesla.

Up 400 points yesterday, down 600 points (or so) today. A "sea of green" yesterday, a "sea of red" today. Those "sea of red" days do focus our minds on that very human question, don't they: "We've made so much money. Shouldn't we sell before it's too late?

The only good way to answer that question is to ask two very basic—and <u>very</u> different—questions:

- We own strong businesses. How are they doing?
- Is the market giving those businesses valuations which are silly and dangerous?

The first answer is clear: "They're doing very well. They are mostly showing remarkable strength in sales and earnings, even though they're mostly just <u>beginning</u> to come out of downcycles which plunged to their bottoms last year."

The second answer isn't as perfectly clear . . . but it's not very foggy, either: "They're mostly valued as if the market expects that surging strength, above, to continue through 2021 (at least), but they're <u>not</u> valued as if the market expects them to walk on water."

At Outlook we don't own much of Deere, but let's use it as an example. The "Farm Equipment King" caught everyone's eye a couple of days ago with an 18% dividend hike. Here is a chart which needs a little explaining.

Wall Street's Profit Forecasts for Deere, Changing Over Time

The red line is "the Street's" earnings forecasts for Deere for the year 2021. Those forecasts are first made <u>three years earlier</u>—we can see the red line begin in 2018. And we can see a never-ending pattern which governs this kind of work: the cleverest minds on the Street <u>always</u> lag behind reality . . . both up and down. As sales and earnings turn down, the Street only gradually wakes up to the fact, and lowers its profit forecasts "too little, too late" as a rule. But exactly the same thing happens on the way up: the Street's best analysts never realize how fast companies like Deere will recover, and they raise their profit

forecasts “too little, too late.” This isn’t a knock on smart people; it happens because they are human beings first, and “clever” second . . . and we humans always find it tough to imagine big changes from whatever’s happening today.

That first green circle tells us that only 6 – 8 months ago, the world thought Deere might make $8.50 in profits per share, or so, in 2021. And it informs us that today, the world thinks Deere will make almost $16/share. In the last 30 days, the “Street’s” forecast for Deere’s profits has risen 20%. In 6 months, the forecast has risen 80%.

If our first reaction to this news is: “They’re not very reliable, those forecasts, are they?”, then we should stick with that reaction, because we’ve discovered the truth.

Before leaving Deere, one last question: “How has the market’s valuation of Deere changed, as the company’s profit forecasts have skyrocketed?” The answer? “Not at all.” A year ago Deere traded around $166, which was about 19 times the earnings forecast. Today Deere trades around $350 . . . about 19 times the earnings forecast. What has changed is what is going on inside Deere itself. It was slogging slowly but firmly out of the swamp. Now it’s coming out of the blocks like Usain Bolt. 19 times earnings for a company accelerating like Mr. Bolt, with the financial strength of Hercules, is not remotely “silly or dangerous.” It only reflects the high likelihood that today’s $16 profit forecast is, as usual, “too little, too late,” and will keep being bumped higher by the human beings on the Street.

Exactly the same basic story describes Caterpillar, Cummins, Freeport, Conoco, Exxon, Micron and Texas Instruments, among Outlook’s core companies.

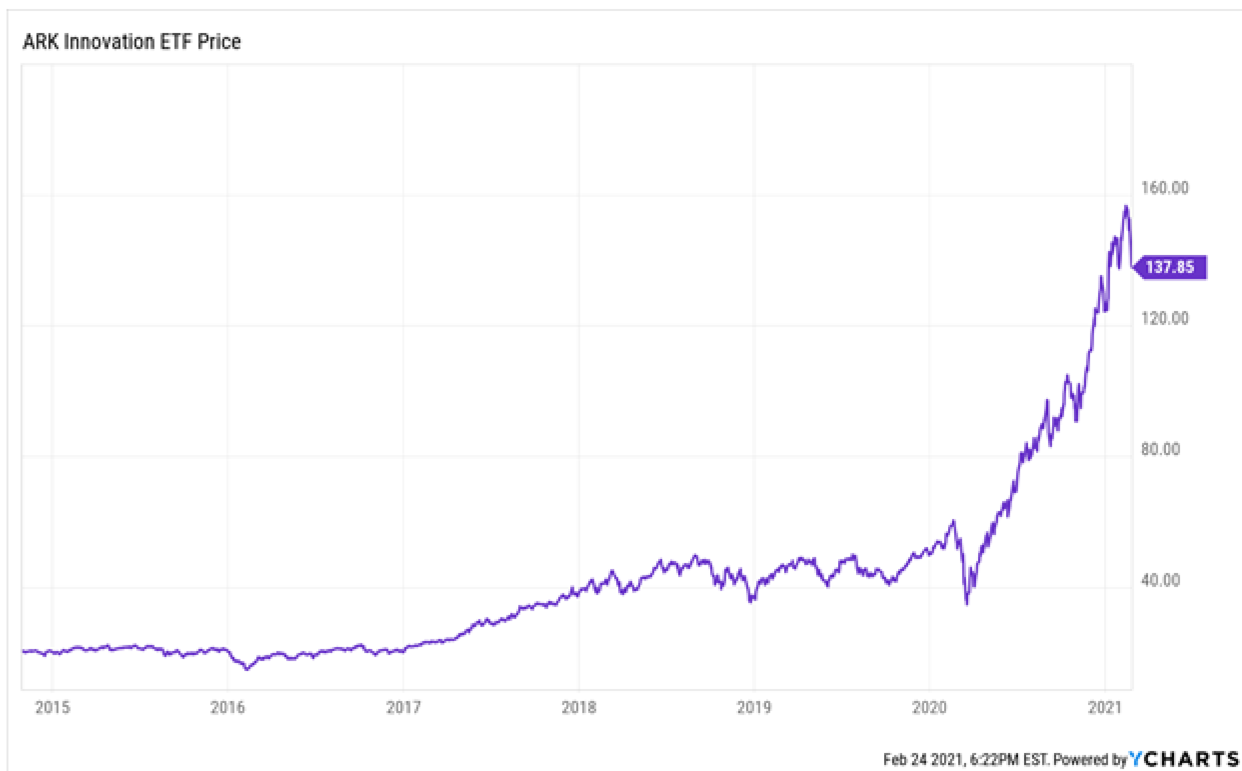
“But is the market giving any businesses valuations which are silly and dangerous?”

The answer is as emphatic a “Yes!” as we can shout from the rooftops. It might even be, “Good heavens, yes!” or something stronger depending on our tastes in words. Here are a couple of pictures:

Tesla: 74 cents in earnings . . . valued at 1000 times, or so

There's poor old Tesla, the object of Outlook's raised eyebrows a few times. But poor old Tesla has retaliated by making Outlook look silly . . . so far. At today's $700 per share or so, the market thinks Tesla is worth about 10 times as much as General Motors, and maybe 5 times as much as the biggest 5 carmakers in the world, combined. Pardon the raised eyebrows . . . they just won't go down. "Walk on water" begins to hint at the nature of the market's attitude toward Tesla. But that comment doesn't shed enough light. It begins to hint at the nature of a small slice of the market toward Tesla: the professional and amateur speculators who've chosen to roll the dice—and will keep it up until things end badly. A few tenths of a percent of the 31 billion shares traded in the market every day belong to Tesla. That's actually a big share for any company, much less an "emerging" company (to be polite) like Tesla—but it does help us grasp the galactic scale of the total market, and understand that Tesla's "walk on water" valuation has been created by a tiny part of that galactic-scale crowd.

Now for one last chart. Below we see a "celebrity among celebrities" in today's investment world: the Ark Investment group's flagship fund. Ark is carrying on a long tradition on Wall Street: that of the daring professional who bets the ranch; sticks with the bet when those with less nerve and capital back out; and hits such performance home runs that she seems to walk on water herself . . . for a while. Tesla has been Ark's name from the beginning, and has made it that "celebrity among celebrities."



But the Ark funds are filled to the brim with Tesla's: biotech Tesla's, green energy Tesla's, emerging market (poor country) Tesla's. As a group they all look like Tesla: slim to zero earnings, galactic-scale hopes and expectations, walk-on-water valuations.

Let's return to our second question: "Silly and dangerous valuations?" Our answer was "Certainly." We've seen why. Silly and dangerous valuations last longer and get sillier than seems remotely possible to down-to-earth investors. Then they have Big Problems. Will those big problems, affecting a pretty small slice of the gigantic market, bring down everything?

Outlook's answer is, "Yes . . . but not for long." Not long ago we used the post-1999 performance of Dotcom Bubble Cisco and Stodgy Caterpillar to make this point. Two good companies, both strong. But Cisco hasn't recovered its Dotcom peak value in 20 years. Caterpillar is up 600% in the same 20 years, from its "Dotcom peak."

That's why investing wisely means asking two big questions: "How's our business doing?" and "Is the market's valuation dangerous?" 20 years ago Cisco was not a "walk on water" company in any way: it was strong, highly profitable, and had a clear path to a long future. But its silly valuation made Cisco untouchable, as an investment. Today we see a market whose largest part is companies valued reasonably or even cautiously; but with a slice of companies valued at "cruising for a bruising" levels. That's a formula for some trouble down the road . . . but not "torpedo under the waterline" trouble. So we hold, as usual.

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