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The Big Picture, 2018 and Forward: Judgment and Nerve, Again

We are paid, at Outlook Capital Management, to take care of people's life savings. While most of our clients have considerable savings, none have money to burn. That heavy responsibility, and the principle that we invest our clients' and our own money the same way, tend to keep reminding us what really matters, to excel in the investment world. What really matters is not something new, but very old: good judgment and steady nerves.

It's easy to see how much that mattered in 2008 – 2009, when sheer terror ruled the investment world. But judgment and nerve matter just about as much right now: nine years into a bull market, with the last two years giving us returns impressive enough so that our natural reaction is to think, "Good heavens, let's put that in the bank and keep it safe!", and with an emphatic majority of experts with media megaphones instructing us watch out, if we know what's good for us.

Judgment tells us we must listen carefully to what many of the experts have to say. But the years of experience which support that judgment tell us something else: Many "experts" indeed know a great deal about their subjects; but not very many actually apply all that knowledge with good judgment and sense. In the investment world—and some others—it often takes nerve to do that, because no matter how clearly our knowledge and judgment tell us we are very likely right, we all fear the consequences of being wrong.

Here's the Big Picture in early 2018, in Outlook's judgment:

- The unusual 9-year age of this Bull Market does not matter; nor does the market's 300% gain in value. The market has only gained 75% in value since its pre-Calamity peak, 10 years ago. For perspective, that figure is more useful than the market's "big" gains from its terrified and ridiculous lows.

- First among "things that matter" are the profits and cash flow per share which most large U.S. companies look reasonably likely to make, over the next 1 – 3 years. That "reasonably likely" path is "pretty strong," by historical standards. It was already "pretty strong," but it shifted toward the "even stronger" end of that range with the corporate tax cuts. That observation is arithmetic, not political opinion.

- Second is the *valuation* of those reasonably-likely rewards, represented by today's share prices compared to profits, cash flows and dividend returns. Those valuations aren't the "screaming buys" of the 2009—2012 market, or the 2015—2016 energy and commodity-based sectors. But they're either "average" or "somewhat above average" by any reasonable measurement. They are not even close to "silly," except in the eyes of the loudest few doomsayers—who are always with us, and equally loud at every stage of the market's cycles.

- Third, and most important, among "things that matter" is the strength of the various "up" cycles which are the engines behind most industries. There are many such engines. Today we'll glance at the up-cycle running the show in the oil and commodity sectors.

"Cycles" is a funny word. We all kind of get it—we know what a cycle is, having heard them mentioned a few thousand times—but in truth it's also an eye-glazing word. When Outlook or anyone else asserts we're in an "up" cycle, we deserve no more than a polite nod unless we actually explain it. Here we go. "Cycles" are, at bottom, free markets and free people reacting sensibly to big price changes . . . and thereby making those big price changes reverse themselves, eventually.

Outlook moved more emphatically into big oil and commodity companies, last year, because of very big price drops in energy and commodity markets. Those drops badly hurt producers and suppliers of oil and commodities, and they protected themselves from further harm by drastically cutting their efforts to find and produce their oil-and-commodity products. On the demand side, when oil and commodities became a lot cheaper, consumers bought more of them . . . or made plans to eventually buy more—because they could afford more, or because they could make more money with the suddenly cheaper cost of oil-and-commodity components of whatever products they happened to make.

Yes . . . this is rock-bottom economics. It's basic supply and demand, the stuff taught in the first economics class any of us mistakenly wandered into, in college or before. The really amazing thing about it isn't that it's complicated. It is not. It's easy and perfectly sensible. The amazing thing is that so many people don't believe it, or at least don't understand it—including an astonishing collection of "experts"—despite the fact that in our own personal lives we faithfully obey the rules of supply and demand, every single time. Somehow we find it hard to imagine that the necessary reactions to price changes which govern our behavior do exactly the same for Conoco, Caterpillar, GM, IBM and thousands of other companies, big and small—and hence fulfill the golden rule of free markets: "the cure for low prices is low prices" (and vice versa.)

Of course the villain of the story, throwing dust in our eyes, is "time." Cycles reverse themselves because people act sensibly . . . but not right away. They ebb and flow, lunge and backtrack, disbelieve a falling market for a time, then see the light and either correct course or go bankrupt if they were too slow, and in many other ways act human when things suddenly change. So the "cure" miraculously created by low prices, or high prices, takes an uncertain amount of time and proceeds in the kind of tangled, weaving, up-and-down path which strongly tempts us to think, "This time is different. This time the cycle won't work." (And, we discover, "experts" are just as tempted that way as everyone else.)

At Outlook we're pretty sure the last few years of fairly drastic capital-spending and supply cuts in oil, copper and other commodities is going to have a powerful, long-lasting effect on global supply; while long-term global demand was already unstoppable, and has been encouraged by 3 to 5 years of much lower prices. We saw the typically fast, effective steps taken by our companies to strengthen themselves financially during the down-cycle, and produce at significantly lower costs through the next up-cycle. We saw the market doubting all that, during the downcycle, as usual; and we see the market grasping those realities, today, but still misunderstanding the magnitude of their longer-term effects . . . also as usual. So we bought, and we'll keep buying. We've done well . . . and we expect to do even better, with patience.

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

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