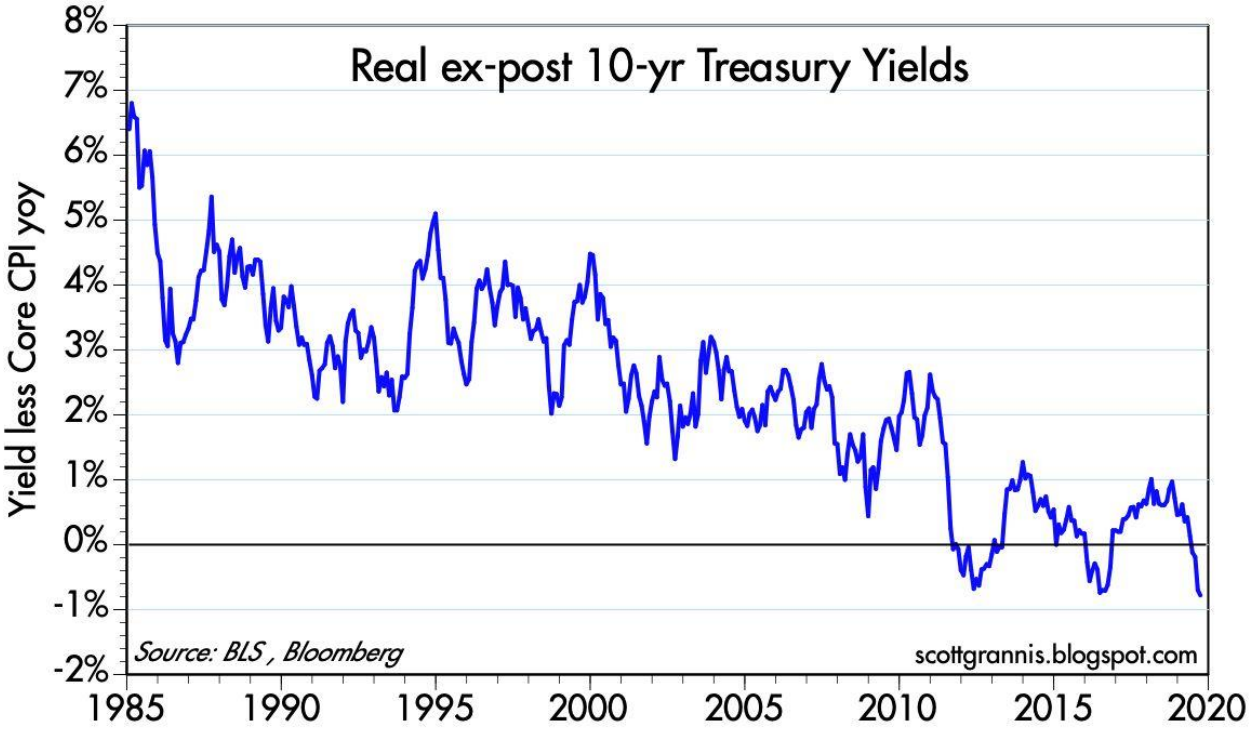
The Outlook: Oct. 9, 2019

The Big Picture, Even Simpler: Fear Is Good, Not Bad.

Here's the picture at its simplest. This market has a few real things to fear, but many strong companies' stocks are too cheaply valued to pass up.

One of the most profound investment rules of all time is: "Fear is good, not bad." This rule isn't easy to grasp, because it *feels* upside down. But the whole history of the market shows, time and time again, that the truly dangerous times to invest are when the market is optimistic, valuing lots of stocks as if it's certain that emphatically good news will just keep coming. We have not had that kind of market for 10 years, which is exactly why we've enjoyed (kind of) the longest bull market in history. There have been endless crises, nightmares and waves of threatening news during the decade. The past year's "Trade War!" is just the latest. As Outlook has mentioned once or twice these past 10 years, when everyone is fearful and the market is handing out great companies for pennies, we do not sell. We buy.

Economist Scott Grannis wrote, last week, about the market's long-lasting state of anxiety. The clearest sign of that, he remarked, has been the market's endless willingness to buy long-term bonds yielding less than the inflation rate. Here's the picture.

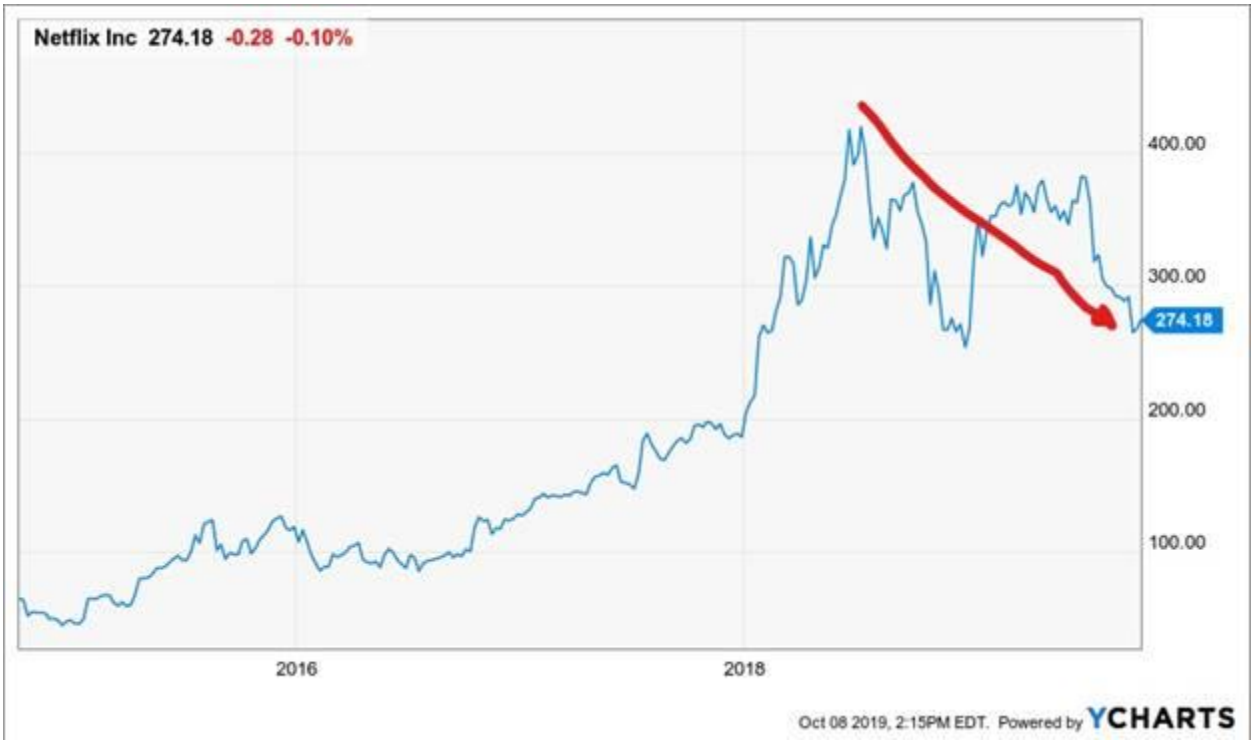


It takes a little explaining. Since about 2011 (looking at the right-hand end of the chart) 10-year Treasury bonds have been so desired, in the investment world, that buyers have been happy with zero returns after inflation, on average. Back in the 1980's and 1990's, bond buyers needed at least 2% more than inflation, and often 4% to 7%. Here's Mr. Grannis' second way of looking at it.

Remember that we must always turn bond charts upside down to compare them with stock charts (because bond prices move opposite from bond yields.) When we do that above, we see something almost, well, "inconceivable:" a 37-year bull market in bonds, starting around 1982 and traveling right into 2019.

If anyone in the world looked at a stock chart showing that kind of sustained optimism, she would wonder whether such old things as caution, anxiety and downright fear had been outlawed. Of course, they haven't been . . . they've just been living in the stock market for the last decade, which is why so many investors have been happy to safekeep their money in bonds, and receive nothing in return.

Fear in the stock market is good, not bad, because it always exaggerates problems, hence hands great values to investors with some patience, some nerve and some understanding of the companies they own. And the total lack of fear, when it exists in the market as a whole or in any specific company's stock, is deadly—and that word is not an exaggeration. One of the things which has fogged up many investors' ability to "see" a market mostly riddled with fear has been the constant antics of a small group of what we should call "celebrity" stocks. Netflix, below, has been one of them.



At $420 per share in mid-2018, Netflix traded somewhere around 100 times earnings. Since then—following the red arrow—it's plunged 35% or so . . . so it only trades around 85 times earnings, today. Pardon this next chart, which is very busy.

Fiscal Period Ending	EPS Estimate	YoY Growth	Forward PE	Low	High	# of Analysts
Dec 2019	3.26	24.39%	84.30	2.85	3.89	34
Dec 2020	5.59	71.68%	49.10	3.52	7.08	35
Dec 2021	8.95	60.20%	30.65	6.10	10.57	16
Dec 2022	12.32	37.60%	22.28	8.88	15.63	9
Dec 2023	16.68	35.39%	16.45	12.66	19.59	5
Dec 2024	18.42	10.40%	14.90	16.22	21.27	3
Dec 2025	23.28	26.41%	11.79	20.38	27.17	3
Dec 2026	28.45	22.22%	9.65	23.89	33.84	3
Dec 2027	34.09	19.81%	8.05	29.37	38.92	3
Dec 2028	39.34	15.42%	6.98	33.81	44.88	2

Once or twice, over the years, Outlook has remarked about the highly-intelligent, hard-working nature of Wall Street analysts. This chart is their work. If we follow that "Forward PE" column in the middle, we'll grasp how those analysts justify 85 times earnings as a sound valuation for Netflix common stock. In 10 years, if Netflix' earnings grow between 20% and 72% per year, today's stock price will only be 7 times

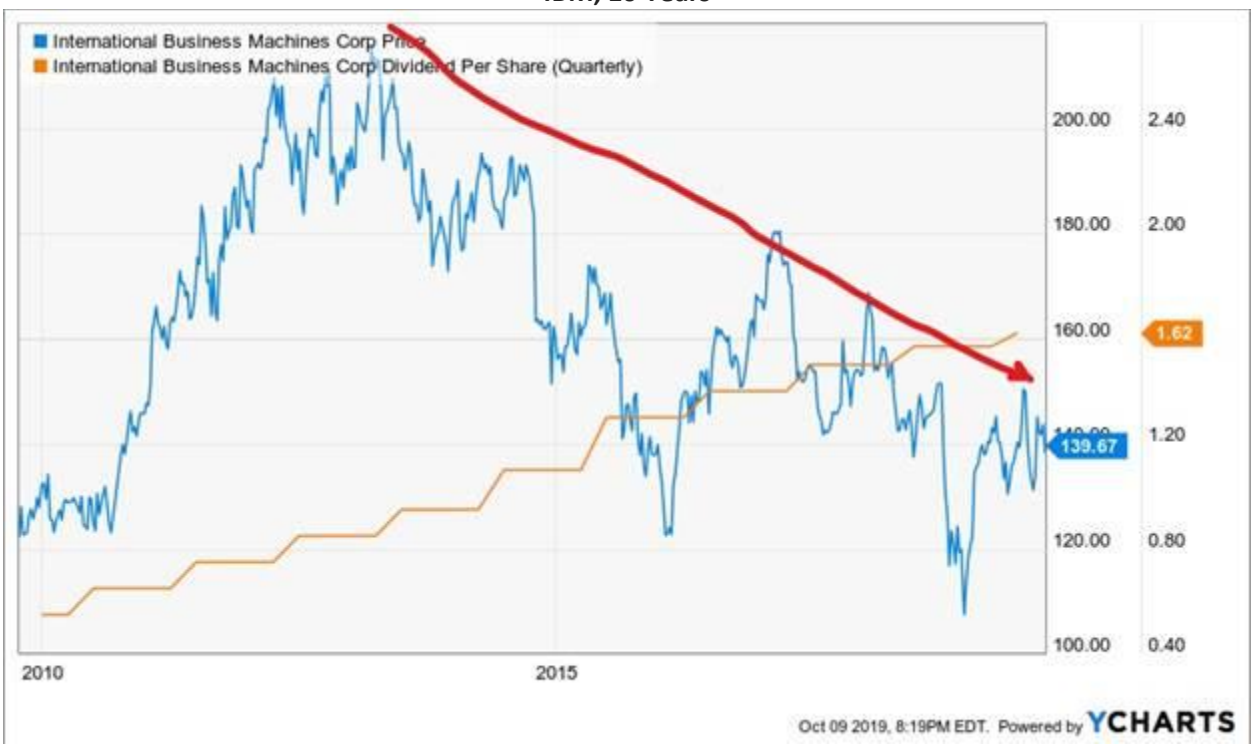
earnings. The idea is that we should consider 7 times earnings so ridiculously cheap, for a company like Netflix, that obviously the stock will rise well beyond today's $274 per share, sometime before we get to the year 2028.

The 35 analysts behind this chart have written hundreds of pages of deep analysis of Netflix—probably thousands, actually. We would be genuinely impressed by the painstaking detail in these reports, if we happened to see them. Yet somehow these highly-intelligent people, after all their hard work, have ended up with complete nonsense. It's nearly impossible for a young person to believe this kind of thing can happen. We have to be old and bruised enough to have actually seen it happen, again and again, right in front of our eyes, to believe it—in every field of human endeavor, not just investments.

It's not always possible to offer a simple sentence, aimed at such analysis, which points to the common-sense holes in the deep analysis. But it often is. For Netflix (like Tesla, another celebrity) it's this: "There are too many tough, strong competitors who can and will offer nearly the same product . . . long before we get anywhere close to 2028." Netflix and Tesla have nice products; but they don't have a cure for cancer with 17 years of patent protection.

That's a glance at the market's small celebrity crowd, which gets a lot of eyeball attention. Here's a glance at the other end of the market, where caution, anxiety and outright fear are in charge.

IBM, 10 Years



IBM isn't an Outlook company, but it shares the "anxiety neighborhood" with many of ours, and makes the point very well. The company has been trying to fix some pretty-deep problems for 6 years or so—not life-threatening problems, just "stagnation" ones. Hence the 35% drop in its share price since 2013. IBM has to do something, once again, which it did 20 years ago under CEO Lou Gerstner: it's an

elephant, but it must show that it can still dance (in Mr. Gerstner's words.) It must shift its emphasis to growing lines of business from stagnating ones.

The jury's still out on whether it will succeed. But IBM still has great financial strength; it pays a 4.3% cash dividend return; and it trades at 10 times earnings. That's a galaxy away from 85 times earnings. It is also almost 3% above the cash return on those 10-year Treasury bonds . . . and IBM is extremely likely to succeed well enough to keep growing its dividend, which the bonds will never do.

So we have a market, today, which is so concerned with the Trade War and other fearful problems that it's glad to lock in a zero-to-negative return, after inflation, for the next 10 years with bonds. It's the same market which is so riddled with anxiety that it values IBM as if it has zero chance of dancing again; and as if its cash dividend with that 4.3% yield hasn't kept rising year after year (orange line), while the elephant is trying to shuffle into a dance again.

These are pictures, as clear as can be, of a fearful market—mostly fearful, with a few pockets of silliness. The silliness is a permanent part of the market's nature . . . <u>but it does not define this market</u>. Fear defines it; and anxious, doubtful and generally cheap valuations. That is just why it's so worthwhile for us to endure the endless anxiety. It tells us to buy, not sell.

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