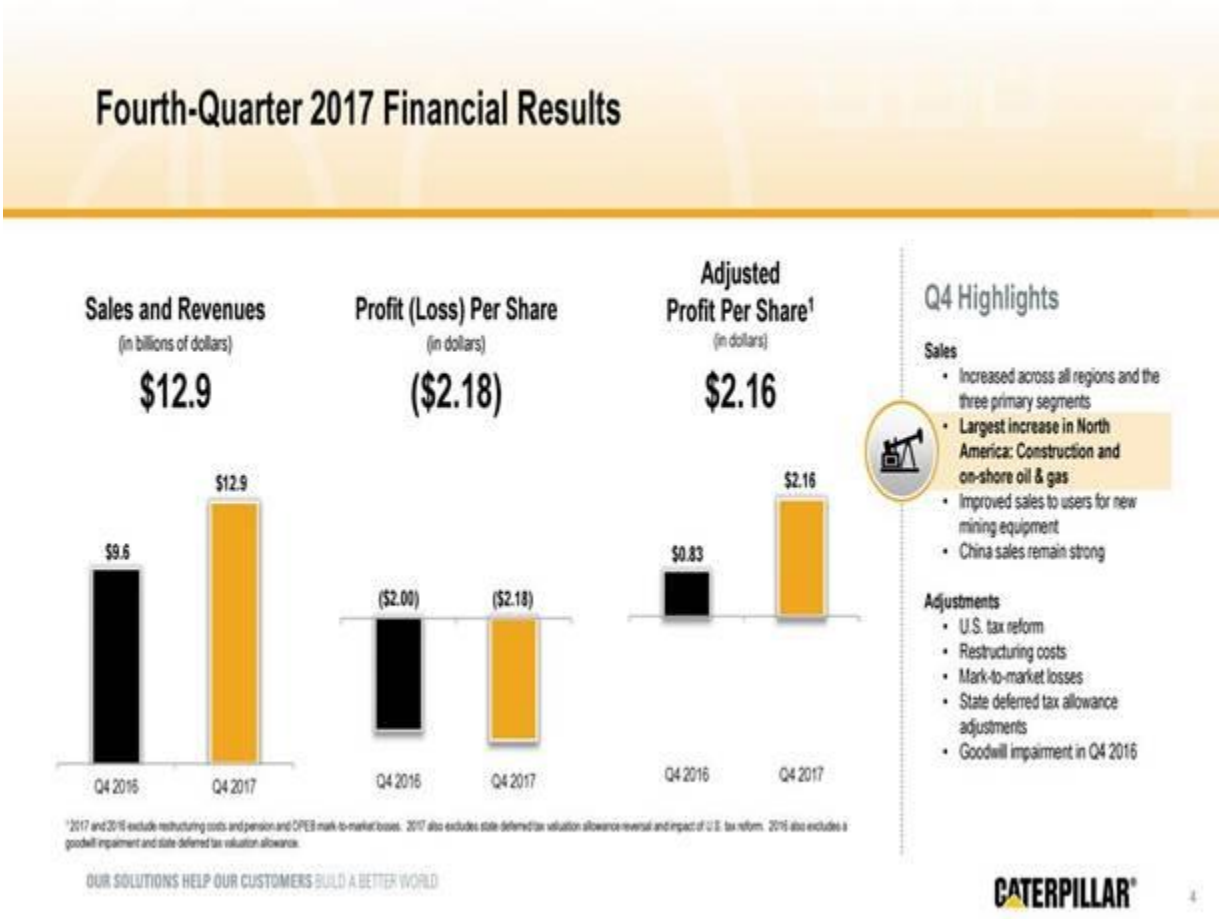
The Outlook: Jan. 25, 2018

CAT and Freeport update their stories: from "shocking and abysmal" to "exciting but frightening."

Caterpillar (heavy equipment) and Freeport-McMoRan (copper) reported earnings today. Both results were impressive, highlighting outstanding management and staff performance in two companies which have gone through their own trips to hell since 2014 and—as happens so often in American companies—fixed the damage and strengthened themselves so effectively that they are showing explosive profit growth, even in the early stages of recovering sales.

Outlook's golden investment rule is to look for strong companies which the market hates, at the moment, because they are going through serious problems. No matter how often the market sees it happen, it never gives enough credit to the near-miracles performed by a company's fast, determined actions to fix serious problems. Even though serious problems are a fact of life for cyclical companies, the market never believes the cycle will keep behaving normally (meaning, "change direction eventually") until it has jumped up and down on the company's battered stock, long enough and hard enough to push it into territory which can only be described as "just silly." Then the market sniffs the air, narrows it eyes, and thinks "Hmm. This outfit might have a future, after all." And it's off to the races on the upside—even though the recovering firm's "near-miracles" of climbing earnings have hardly even begun to show themselves.

That's exactly what Caterpillar and Freeport have been experiencing. As Outlook has noted, their operating business results are "impressive," but their stock gains are "exciting" and "frightening" at the same time. Here's what CAT has done, for example:



Here are the Cliff Notes on this spectacular example of "operating leverage" (sales pop, profits explode) in manufacturing companies . . . and why Outlook likes them so much:

- Quarterly sales up 34%.
- Quarterly earnings up 160%.

Impressive and exciting indeed. Now let us explore the "frightening" part.

There's an old remark along the lines of "Courage? Hah! He didn't have sense enough to be scared!" In the investment world, being frightened after we've made a shocking amount of money is a good thing. It shows we've been around the block a few times, earning some bruises and scars—and wisdom. We might strongly suspect, for example, that the bearded young digital-games players hanging out in San Francisco, making lordly pronouncements about crypto-currencies turning the world upside down, peeling off ten or twenty million from their Bitcoin fortunes to set up charitable foundations aimed at solving world hunger or abolishing the gasoline engine, were not a bit "frightened" by Bitcoin's galactic gains . . . until a couple of weeks ago, possibly. Now they've earned their first mild bruises, and one or two might even think about it. We older folks, on the other hand, began getting concerned about CAT less than halfway through the two-year story, below.

Caterpillar Since Early 2016: Stock Price, and 2-Year Forward Earnings Estimates

The lesson from this chart really matters. The blue line is CAT's stock price: up 188% since its cyclical bottom, two years ago. The orange line is Wall Street's earnings-per-share forecast, for CAT, two years in the future. For example, in January of 2016—at the chart's far left corner—the best minds on Wall Street thought CAT would earn $4.02/share by 2017, having just earned $4.23/share in 2015 (which was a plunge into the abyss from its peak earnings of $8.71 in 2012.)

"Best minds" isn't sarcasm. As Outlook has noted before, many very smart and hard-working people make careers out of analyzing the business operations of companies like Caterpillar. They know their companies very well, and they pay attention to every detail which might hint at how CAT's condition might change over the next year or two. Yet, see the orange line. It rises . . . always too late, always much too little. CAT earned $6.88/share in 2017. Only six months ago, that's what Wall Street thought it might earn by 2019. Today, the Street thinks CAT might earn $9.26/share by 2019. Today, CAT told the investment world it expects to earn between $8.25 and $9.25 this year: 2018. At Outlook we would bet a lot (and we are, in fact) that the 2018 number will be the top end of that range: $9.25 or beyond.

The lesson of this chart is that people—clever Wall Streeters or the rest of us—find it nearly impossible to imagine big changes, even when centuries of history tell us that big changes are exactly what happen, over and over again, in certain areas of life such as business and commodity cycles, and the stock market's behavior in response to those cycles. Simple fear is one of the main reasons it's so hard. We own something which has climbed 160% in two years. We aren't bearded Bitcoin guys: we have scars, and we remember how much it hurt when we got them. Fear constantly whispers, "Don't be greedy. Get out

while you're ahead," and the whisper makes it quite a bit harder to keep calmly sifting the facts and judging CAT's future.

But we shall, anyway. It is easy to forget how CAT got to this point. From mid-2014 it fell from $112 to $60, taking profits down with the ride, as the global energy and commodity industries plunged into blackness. (Commodities got a headstart as early as 2012.) Quarter after quarter, year after year, CAT's rolling 3-month worldwide sales reports were so bad, so long, that we struggle for words: "abysmal," "shocking," and "depths of hell" aren't too bad. CAT and its energy and commodity peers had their own awful bear market, right in the middle of the continuing 9-year bull market since 2009. So the "fact" that the overall bull market has lasted 9 years is a pretty trivial piece of information, isn't it, when we look at what has actually happened to CAT rather than at the near-daily screaming headlines along the lines of, "Aging Market at All-Time Highs! Teetering on Edge of Cliff, Say Experts!"

CAT's report today, and Freeport's, carried not the slightest hint of tottering age or teetering cliffs. They painted perfectly clear pictures of outstanding operating businesses, surging forward as their customers pound on their doors waving fistfuls of cash—because their customers, themselves, went through the same depths of hell as CAT and Freeport, and they are climbing out a lot stronger than when they went in. That orange line of forward-looking earnings estimates is going to act as it always does when companies have been down there, and muscled their way out: underestimate how far and fast those companies can now run. We won't . . . and we're not about to sell.

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