



## Economics & Financial Markets

Philip L. Miller – 646-415-9141  
Chief Strategist  
[pmiller@sisresearch.com](mailto:pmiller@sisresearch.com)  
[www.sisresearch.com](http://www.sisresearch.com)

### United States Equity Markets

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## Caterpillar (CAT) added to Recommended List

### Introduction

Closing Price: \$32.32  
52 Week Range: \$31.70 to \$85.96  
Market Cap: \$19.49 B  
Div Yield: 5.14%  
PE: ttm 5.71  
PE range 5 years: High: 25.85 – Low: 5.70

### Earning 2008 & Q408

- Caterpillar Inc. on Tuesday January 26, 2008 announced their 2008 earnings despite troubled times achieved a record for sales and revenues totaling \$51.32 billion for the full year 2008, up 14% from 2007. Profits for the year also were up 5% and were a record \$5.66 per share as compared to \$5.37 the prior year.
- They reported Q408 sales and revenues of \$12.92 billion a 6% gain from Q407 with profits of \$1.08 down 28% from Q407, resulting mostly from higher cost of sales and administration costs.

### CAT Stated Outlook

- Caterpillar also announced that: “Financial markets remain under stress and our expectations for 2009 have deteriorated.”
- Caterpillar announced a cut of 20,000 job citing deteriorating conditions
  - The infrastructure and commodities boom has collapsed and been delayed
    - Road
    - Retail store

- High-rises
- Other projects
- Emerging market have been deteriorating which were a major area of growth
- Global industries have been slowing most particularly:
  - Mining and
  - Energy
- Financial markets remain under stress
  - Credit extremely tight affecting
    - Construction and
    - Equipment purchases

## **Reasons for Placing CAT on Recommendation List**

### Current Economic Outlook

- On January 26, 2009 NAR announced that existing home sales rose by 6.52%.
- More importantly NAR announced that single home inventories had fallen to 8.7 months from a high of 11.6%. This was the lowest inventory rate since June of 2007.
- Leading indicators were positive for the first time in 5 months as reported on January 26, 2009 by the Conference Board. More importantly money growth and the yield curve the two leading indicators of the leading indicator index, have been positive for the past four months.
- The FFBond spread (10 year note less fed funds) is one of the strongest indicators of the health of the financial institutions, and the spread is currently at a multi year high of 2.5%. This enables banks to begin lending.
- Building permits were reported on January 22, 2009 to be the lowest ever recorded for the second month in a row. December's 2008 permits broke the record from November 2008. This series began in 1960 when the population in the country was approximately one half what it is today. This data is seasonally adjusted but not population adjusted. The October 2008 reading was the 6<sup>th</sup> worst of all time. Implication there is very little downside here, and with existing home inventories declining and lowered interest rates residential building has likely reached its low point.
- On January 5, 2008 the Commerce Department reported that residential construction was at historic lows, but nonresidential construction was up 1% again, and up 9.2% y/y, and has been rising continuously since 2003. (We expect this to slow, but we have been expecting non residential construction to slow for the past year also). Also the levels are at historic highs.
- In late November, President elect Obama announced a major initiative to invest in infrastructure within the U.S. The response from the markets was very positive.

### Future Expectations

#### Stimulus Package

- Since the announcement in December many of the construction, related national engineering, and construction material company's stock price jumped between 30 and 50% during the month of December from their recession lows, just to give back much of that gain.

- CAT currently is trading near a 5 year low and has tumbled 62% from its highs, and like the other infrastructure companies has given back most of its 50% price increase, from its lows following the announcement of the Obama stimulus package.

#### Recession Ending

- The markets always rebound prior to the end of the recession, and rebound when there is some expectation that the cause of the recession has been sufficiently addressed.
- We argued that there were three test that the conditions were in place for the recession to end:
  - Citigroup and Bank of America – When they encountered trouble TARP immediately assisted.
  - Auto Industry- TARP more protractedly assisted when needed
  - Retail while weakened – there has not yet been major store closings, resulting from a weaker than usual holiday season. Non Durable retail has been benefiting from lowered gasoline prices.
- When the systems are in place for systemic fallout is when the markets have historically rebounded. The three passed tests indicate that those systems are in place.

### **Summary**

When conditions look the worst often times the price of stocks mimic those sentiments, especially when the company issues dismal outlook for next year. Historically, these are often the best buying opportunities, because all the bad news is generally out there, and new news releases will either reiterate the bad news or be better news than the already really bad news. Everyone has know for months that the international trade for CAT will be declining because of the World Recession, and a slowdown in the emerging market growth mostly China and India, that is why CAT despite a record year is selling at less than 40% of its highs. There was nothing unexpected from the earnings report.

As dismal as construction appears there are positive signs that conditions will get better sooner rather than later: 1) there has been very limited new home building meaning that this number can go nowhere but up, 2) residential inventories have been coming down and are at the mid 2007 levels, 3) meaning that there will be demand for new homes soon, given that inventories of existing homes has been declining and 4) new home prices last month increased indicating. again that new home inventories are low and the market is stabilizing.

Total construction which surprisingly has held up all year, but is expected to come down, during the next few months is still at elevated levels, and if the stimulus package becomes a reality, as is expected, the economy should begin to turnaround. Construction in 6 months will likely be showing real signs of a major turnaround. To the extent that the market outlook is 6 to 9 months out, and CAT's stock price has been hammered it is likely that we are very close to multiyear lows for this company with major upside potential of as high as 50 to 70% in 2009, with limited downside risk.

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**Price Chart:**

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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