June 2, 2017

The Top-Down

This week, the Federal Reserve released the May Beige Book showing modest growth with continued labor market tightening. The ISM Manufacturing Index came in at 54.9. Any reading above 50 is positive for the industrial sector. Auto sales were mixed with Ford reporting above consensus and GM well below.

But everything took a back seat to this morning's May jobs report from the Commerce Department. Non-farm payrolls increased 138,000 versus a 184,000 estimate. This number was modestly disappointing and April was revised down to 174,000 from an original 211,000. The unemployment rate ticked down a tenth to 4.2%. The ten-year treasury slipped below 2.20%.

Stillwater View: The May employment number, while not a blowout, provides overhead cover for the Fed to continue with the rate hike plan. The ten-year appears to be headed to 2.0%, creating a headwind for banks in the near term. ISM positive for industrial companies. The outlook for autos remains challenging.

PIMCO was out this week with their call to stop taking the markets for granted and raise cash on rallies. In their annual Secular Outlook piece entitled Pivot Points, the firm says there is a 70% chance of recession in the next five years and that central banks have not effectively restocked the tool chest to deal with it.

Stillwater View: There is a 100% chance that PIMCOs 70% chance of recession comes true. Every decade since the 1930's has seen at least one recession. They average 8 to 10 month's and are a necessary part of the economic cycle. The flattening of the yield curve this week had some thinking that you weren't going to need to wait five years to see it.

For a full account of all economic data use The Economic Calendar - Bloomberg

The Bottom-Up

Money center banks had a tough week due to the previously mentioned yield curve flattening and J.P Morgan, Bank of America and Morgan Stanley confirmed that weak fixed income trading would negatively impact second quarter results.

Stillwater View: Banks were front and center during the post-election rally last fall with the lion's share of the gain coming in the thirty days between November 8th and December 8th. Since then they have traded sideways. Why is this important? When money center banks show strong performance, and the yield curve is upwardly sloped, the overall market tends to do very well. When neither do, the question very quickly becomes why and is there an ominous message that the market is missing.

Negative view on Wells Fargo as the damage from the fake accounts scandal will linger longer than the market is discounting. This week the head of wealth management at Wells, David Carroll, stepped down after 38 years at the bank.

The "phrase breaking up the big banks" has been replaced of late by a movement to support a "21st century Glass-Stegal". Forget the semantics, for all intents and purposes they are one and the same. One month ago it appeared almost certain that we would see meaningful banking reform. In an about face, Treasury Secretary Steve Mnuchin's backed off the administrations earlier commitment.

Stillwater View: Morgan Stanley's CEO James Gorman made a forceful statement on the subject a few years ago when he said "If you want to run a hedge fund, be my guest. Just don't do it with Morgan Stanley's balance sheet."

A strong case for the "21st Century" movement is AIG, the insurer that blew up their balance sheet by venturing into risky products. When the housing market boom went bust in 2008 AIG was selling derivative insurance products to the holders of questionable mortgages that wanted to hedge against losses. A perfectly legitimate business for an insurer to be in. But they took it too far and began selling the derivatives to anyone on Wall Street that wanted to bet against mortgages. Instead of hedging their positions, AIG remained on the long side of the looming sub-prime bust. The result was a $150 billion bailout sponsored by the U.S. Treasury Department.

Healthy lenders are good for the economy, as are investment banks and wealth managers. Keep the stable businesses on the balance sheet and separate out the risk.

This thoughtful yet ominous piece on the long-term outlook for oil ran on Bloomberg and the charts quickly became talking points. They tell a cautionary story of decreased future demand due to greater fuel efficiency and the rise of electric vehicles. The oil industry expects there to be demand for 110 million barrels a day in 2040. Up from 90 million today. If the counter argument is correct actual consumption would be 75 million, a full 30% less.

Stillwater View: Oil markets are notoriously short sighted, focusing on the latest EIA statistics or decisions from OPEC. Stepping back there is indeed a long-term risk that demand will be negatively impacted by the shift to hybrid vehicles. In related news, the WSJ reported that oil and the markets have decoupled with the correlation of the two dropping from .60 two years ago to .20 today. A sign that the commodity is not the barometer of economic growth it once was.

Up and Down Wall Street

China has company as S&P and Moody's are getting ready to downgrade Illinois to near junk. This is a big deal for a lot of reasons, including that it happened during a period of economic expansion. Imagine what the math will start to look like in a contraction.

Wall Street legend Leon Cooperman made the rounds this week to discuss his settlement with the SEC and his outlook on equities, "somewhat ahead of the fundamentals", the economy and fixed income, "bonds look scary". And while Amazon appears expensive, it is indeed a "religion".

Stillwater View: Lee is one of the great gentlemen of the business. Unfortunately for he and Omega Advisors the damage was done and half of the firm's $8 billion in assets went out the door last year.

Steve Cohen is getting back in the game and is looking to raise $20 billion in the biggest hedge fund launch ever. To be clear, Steve was never out of the game. This is more of a re-launch where he will use his existing $11 billion in family office assets and raise an additional $9 billion. Cohen was forced by the SEC to stop managing outside money and turned the original SAC Capital into the Cohen family office, Point 72.

Stillwater View: Managing a hedge fund has many appeals, foremost is the compensation structure. At 2%, the management fee alone is one of the highest in the business. Layer onto that the 20% participation in client profits, and the numbers get big quickly.

Here is a basic example. Institution A invests $10 million with Hedge Fund B on January 1. One year later the investment has appreciated by 10% or $1,000,000. In the traditional 2% management fee and 20% of profits model the fund manager grosses $200,000 in management fees from the $10,000,000 and $200,000 in performance fees from the $1,000,000 profit. Net return to the investor is 6% after an all-in 4% fee to the manger. Apply that math to the $16 billion he ran at SAC and there is a very good reason why Stevie Cohen lives here, and here, and here…

Diversions

On Wednesday, the guitar the Grateful Dead's Jerry Garcia played for nearly two decades was sold at a charity auction to benefit the Southern Law Center. It went out for a cool $1.9 million. Another legendary six string, Willie Nelson's Trigger , is still out there touring after all these years.

It was reported this week that the Los Angeles Dodgers are currently valued at $2.5 billion, the second highest in the majors behind the New York Yankees. This for a ball club that hasn't won the World Series since Ronald Reagan was President. During that time, the boys in pinstripes have won four with the Red Sox and Giants adding three apiece. Proof once again that it's all about location. Friday trivia, without using the internet, where does the name "Dodger" come from?

Down to only 22 in 1987, the California Condor population is now back above 200 after years of effort. Proof of their resurgence can be seen live via this Condor Cam stream of a two-month-old chick living high in the Los Padres mountains above Ventura, California. Sticking with the flightless bird theme, here is the best commercial shown during game one of the NBA Finals last night.