Stillwater Capital - This Week in the Markets

Clients and Partners,

Stillwater Capital is looking forward to another year of growth. Our firm is proud to announce that we are now a part of the Schwab Advisor Marketplace. Stillwater strategies are available to advisors and clients in separately managed accounts with a $100,000 minimum.

Stillwater offers wealth advisement, asset allocation, portfolio management, and alternative equity strategies through our Trinity Equity solutions. The name Trinity is derived from the utilization of long positions, hedges, and cash. The three pieces of the puzzle needed to produce absolute positive return regardless of market condition.

Thank you for your continued interest in Stillwater Capital, our commentary, and investment solutions.

Bryan Goligoski
Founder, Stillwater Capital LLC

The Top- Down

The labor market continues to tighten as 200,000 more people found jobs in December. The Labor Department reported this morning that unemployment stayed steady at 4.1%. Hourly earnings crept up 0.3% and labor participation remained at 62.7%.

Construction Jobs on the Rise

Source: The Los Angeles Times

Stillwater View: Given the backdrop of a strong economy with a tax and regulatory reform kicker, it's now or never for wage growth. And it's starting to look like it's now.

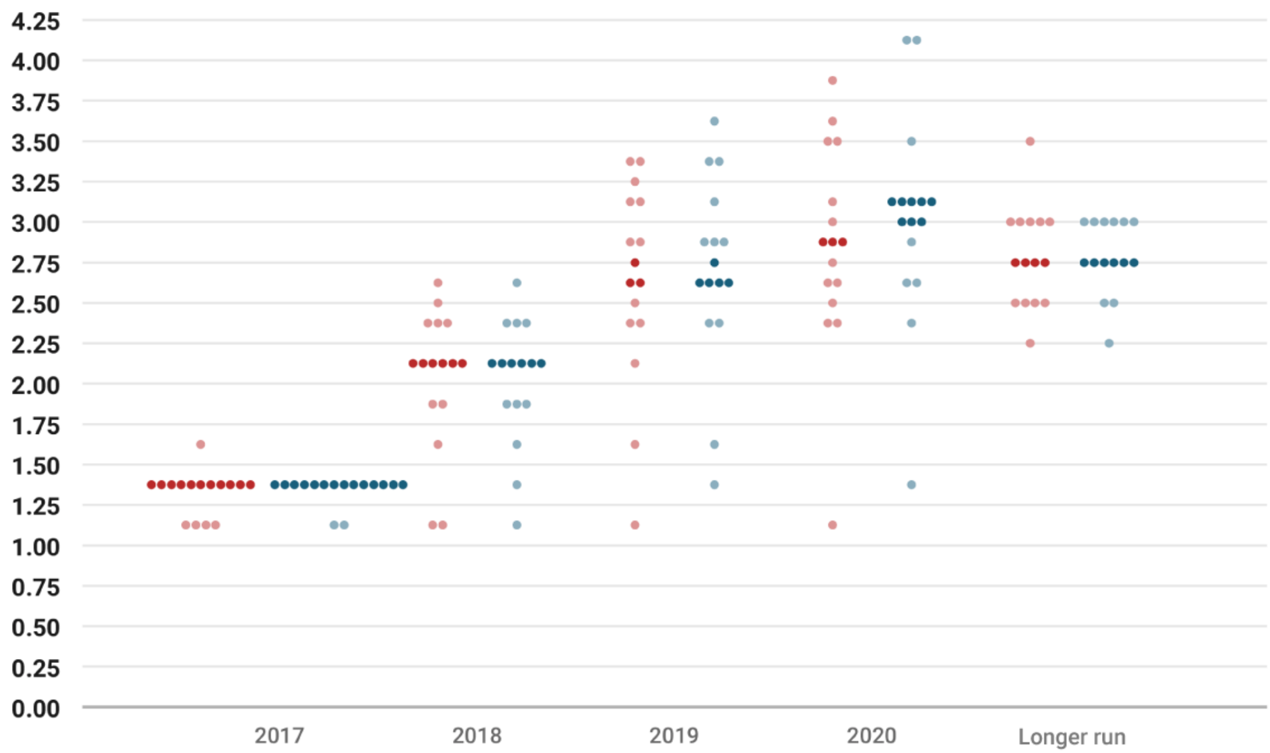
Rates are on the rise. In the Unites States, yields on the 10-year treasury touched 2.80% this morning. The highest since 2014. The move set off a selloff in rate sensitive utilities, real estate and dividend yielding equites as treasuries are now becoming the alternative to treasuries. Bill Gross provides his view on where we are headed and why he is avoiding the high-yield market.

Ten Year Treasury Yield

Source: Macrotrends

The Fed Reserve held rate steady when they gathered for Janet Yellen's final FOMC meeting this week. The current fed-funds target range is 1.25% to 1.50%. The Jerome Powell led Fed is expected to raise rates three times this year. With a 'normalization ceiling' sitting 75 to 100 basis points higher from where we are today.

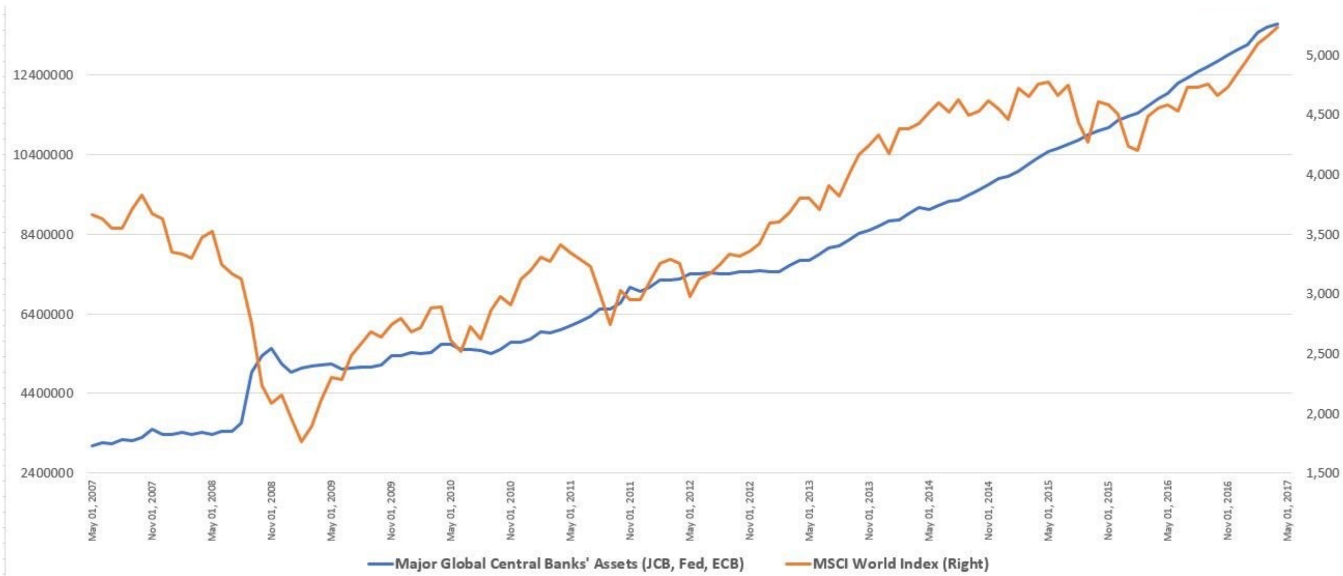
The Dot Plot



Source: Business Insider

Former Fed Chair Alan Greenspan made the rounds in New York this week, speaking on both CNBC and Bloomberg TV. When asked if he felt there was irrational exuberance, he offered the view that both bonds and stocks were in a bubble, the latter being the one to watch. Mark Grant of Hilltop Securities called Greenspan flat out ‘wrong’ based on the sheer amount of central bank liquidity still sloshing around in the system.

Keeping the Firehose Flowing



Source: Citi

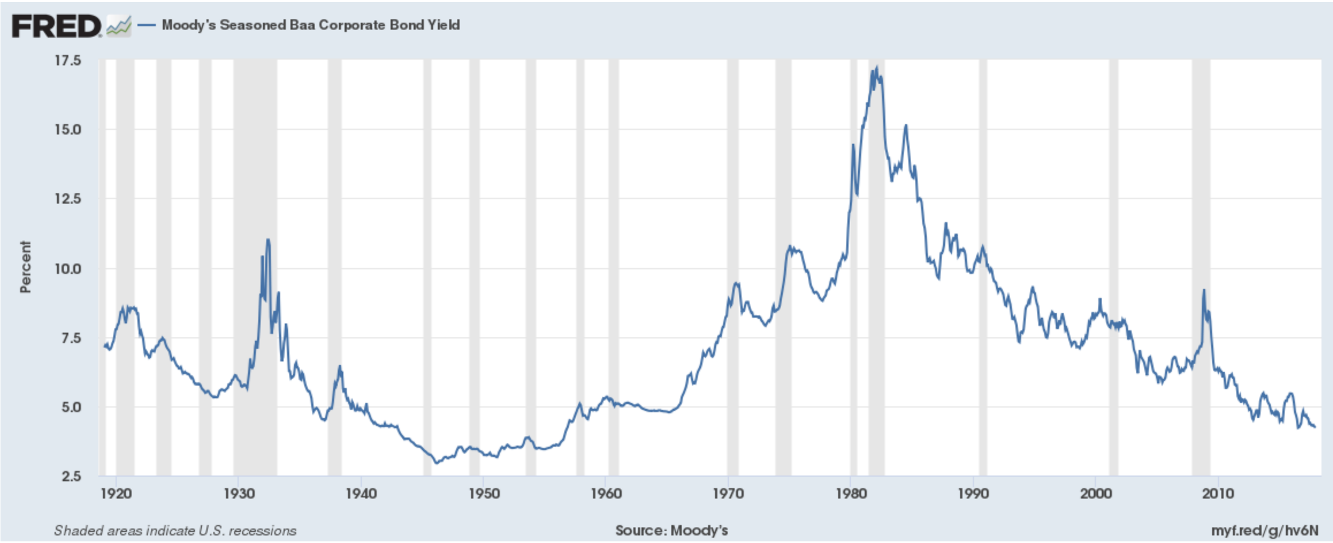
Interest Rates

Wrapping up our four engines of the market this week, we turn our attention to the final driver: interest rates. The timing couldn't be better, as a rising yields have caused the equity market to pause from its historic ascent.

For starters, rates are important because they represent the cost a lender is willing to extend to a borrower. Restrictive policies are designed to act as a governor and prevent the economy from overheating and inflation to take hold.

On the flip side, low rates are designed to spur borrowing, the taking of economic risk, and to stoke the economic 'animal spirits'. Central banks have been using ultra accommodative monetary policy since 2009 to give the global economy enough lift to prevent a stall out. Judging by what we are seeing here in the U.S and around the globe, they succeeded.

Yields on Intermediate Grade Corporate Debt

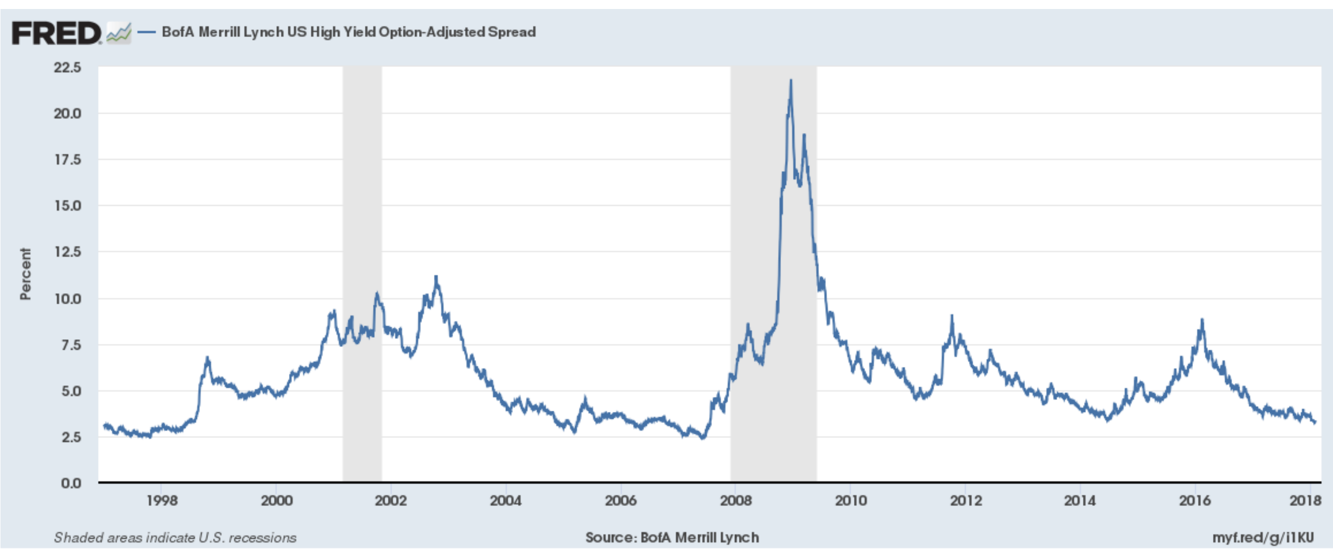


Source: Saint Louis Federal Reserve

The difference between the interest rate the highest quality borrower and lower quality borrowers pay is known as the 'credit spread'. Narrow spreads indicate a higher level of risk taking as there is little difference being charged borrowers with very different abilities to repay the debt.

Alternatively, when spreads widen it's a sign that the appetite for risk is on the decline. At the peak of the global financial crisis, General Electric was having trouble floating overnight paper to fund the basic cash flows. At their peak, speculative debt traded 22% over high-grade corporates.

Credit Spreads



Source: Saint Louis Federal Reserve

Stillwater View: For a whole boatload of really good reasons interest rates matter. They matter as a cost to borrow and as an indicator of where the Fed wants to steer the economy. They also show the markets willingness to take risk. Credit sits ahead of equity in the corporate capital structure, and as the saying goes, 'debt doesn't lie'.

For these reasons, it's the fourth engine on our markets airplane. An accommodative low rate environment produces a strong tailwind for growth. The last eight years have been as good as it gets in that regard, and markets are reaping the rewards.

Rising rates and widening spreads operate in just the opposite manner. Increasing yields and aversion to credit risk have created tailwinds that have been known to put an economy down. Or at the very least, slow down the airspeed and make for a tough landing.

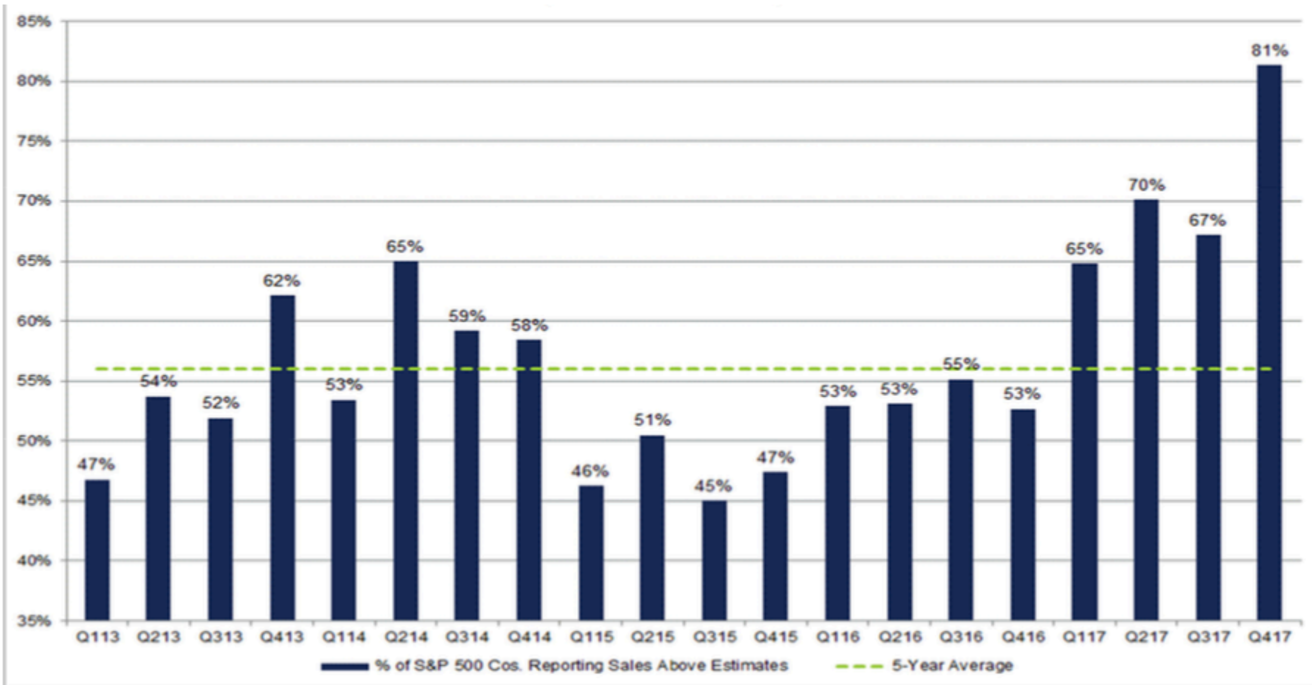
Flaps Down at Kai Tak International

Source: Airliners.com

The Bottom-Up

Nearly half of the S&P 500 have reported earnings and the upside revenue 'surprise' trend is your friend, at least if you are long this market. If 81% holds, it will mark the highest percentage of companies beating the Street has seen since tracking began in 2008.

Upside 'Surprise' to Estimates



Source: FactSet

The consumer products sector has been notably absent from the rally this year. What started off as a raincloud, has turned into a decent sized storm, because of the combination of 'risk on' in the market, higher yields, and fundamental headwinds to the traditionally reliable space.

Procter & Gamble, Colgate-Palmolive, and Church & Dwight along with Clorox have all mentioned the squeeze taking place where input costs are on the rise, and yet pricing power remains elusive.

Consumer Goods Rolling Over

Source: Nasdaq

Stillwater View: Times are changing for staples and it's getting tougher to find consumer related areas where the race to lower margins isn't taking place. Add to this the uncertainty regarding their bond proxy status, and the headwinds are indeed real.

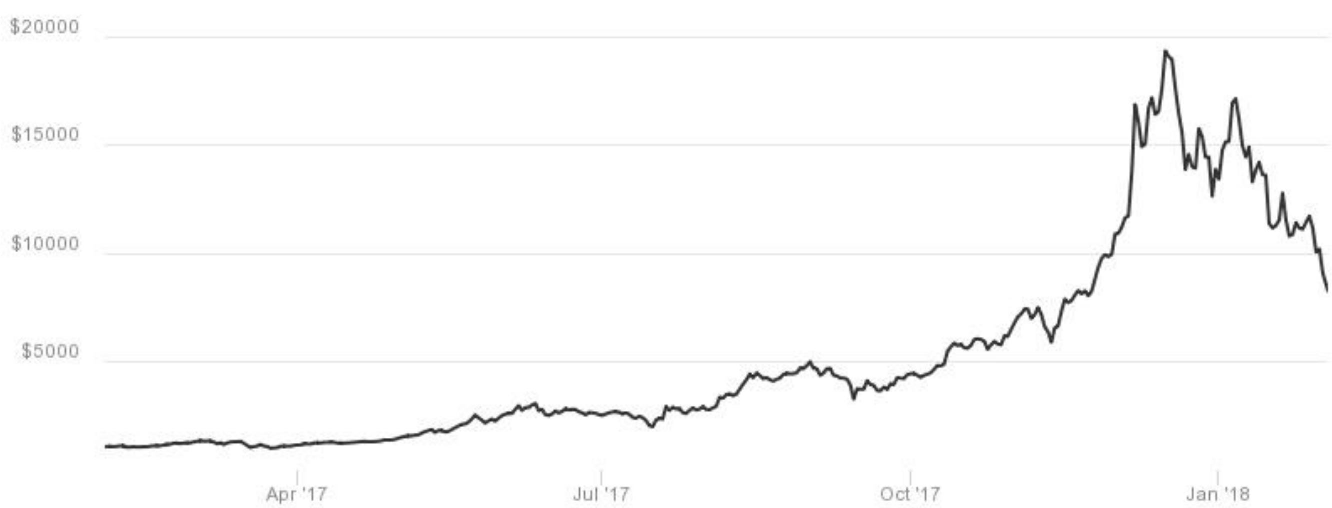
As of last night, most of the large cap technology companies have reported earnings. The sector remains the best game in town for those looking to participate in this market as Apple, Amazon, Facebook, and Netflix have all cleared the growth bar…again. Google was the lone exception.

The Tech Climb Continues

Source: Nasdaq

Bitcoin has been moving off the front page as it, and the other cryptocurrencies, have been selling off. This morning the group is trading down another 10%. With the aggregate value of the crypto complex dropping from $500 billion to $400 billion in the past 24 hours.

Bitcoin



Source: CoinDesk

Last month the EIA announced that the United States was on its way to becoming the world's largest oil producer, surpassing Saudi Arabia and Russia. This comes as the commodity has rebounded and producers that rely on horizontal fracking are pumping once again. Societie General's Mark Keenan provides a look at the composition of the three legs of the oil price stool.

E&P and Oil Service ETFs

Source: Nasdaq

Stillwater View: While the easy money has been made, now is when things get interesting. The bear case is that the domestic oil producers will ruin the party as they turn on the pump. On the flip side, the last two times crude traded above $100 it came with a backdrop of synchronous global growth. Near term the commodity looks extended, longer term we should be challenging $80 and higher.

Up & Down Wall street

Greenlight Capital, the $9 billion hedge fund founded by David Einhorn, is off to a truly terrible start in 2018. CNBC reported that his fund was down more than 6% in January. His 'bubble basket' of short positions continues to move against him as large cap technology stocks have rocketed higher this year. By contrast, Capital Group's $150 billion Growth Fund of America was up 7.85% in January. And no, that's not a typo!

Eihnohn's Bubble Basket

Source: Zacks

Dan Loeb, last year’s top performing long-short equity manager, provides a look at how Third Point is keeping a close eye on what could possibly tip the market’s perfectly stacked apple cart.

Third Point’s Four Things

1. Decelerating growth: "Since growth is already at a high level, further acceleration is less likely. That means that average returns will likely be lower and volatility higher this year."

2. Rising inflation: "Low inflation has been a critical support for the market because it has allowed the Fed to be unhurried in its rate normalization. … We are watching closely to see how a tightening labor market and recently announced wage hikes will shape the future path of inflation."

3. Less earnings growth: "The momentum of earnings growth is at a peak and its normalization could create greater volatility compared with the tranquility of 2017."

4. Recession: "A recession would come as a surprise to investors and would likely lead to a substantial market decline given the expansion in valuations in recent years and the concern that the Fed would not have enough ammunition to sufficiently stimulate the economy."

Source: Third Point

Stillwater View: The rise of Loeb’s Third Point is nothing shy of astonishing. The Santa Monica, California native started off with $3.0 million in ‘friends and family’ money in 1995. Today he manages over $18 billion with annualized returns that have nearly doubled that of the S&P 500.

Third Point Founder Dan Loeb

Source: Third Point

Diversions – Super Bowl Special Edition

Super Bowl LII kicks off on Sunday at 6:00 eastern on NBC. Hall of Famer Al Michaels will be calling the game, a fitting tribute in a sports year where we lost two broadcast legends, Keith Jackson and Dick Enberg.

With two days to go before the first snap, the Eagles are the 5 point underdogs. Which suits Chris Long and his teammates just fine. *Philadelphia Magazine* explains ‘How a Stupid Latex Mask Saved the Eagles Season’.

Chris Long as the ‘Underdog’

Source: New York Daily News

Stillwater View: Readers of this publication know that as of late, the heart has been in the right place, while the head has been making the right pics. In that spirit, the beautiful Tom Brady and his crusty sidekick Bill Belichick will win again. Ughhhhhh!

It appears as though the Eagles fans reputation precedes them as ‘Philly Style’ tailgating has once again been banned from the parking lots. If you are hosting the party this year and want to try something traditional, put the Philly Cheesesteak on ‘Garbage’ Bread in the oven and watch out.

If you call New England home, or just like to ride the Pats bandwagon, there is the very predictable Lobster Roll. In terms of the latter it really does come down to the bread. A brioche slider makes for a nice appetizer, while the classic Wonder Bread hotdog bun creates something more substantial.

A Proper Lobster Roll

Source: The Elements of Living

While ratings were down for the NFL this year, those that tuned in were a little more entertained than in years past as Rodger Goodell lifted the ban on 'spontaneous displays of emotion'. And with that, the floodgates of fun opened.

From fake tug-of-war, hide and seek, faux weightlifting and bowling, it was great to see the players putting the 'fun' into the NFL again. *USA Today* ranks their Top-36 performances of the year.

It was the Minnesota Vikings 'serving' Thanksgiving Dinner after a touchdown against Detroit that gets our vote. Runner ups, the Pack go 'powerwalking' and the Lions make like the 'Rockettes'.

High Knees Boys, High Knees!

Source: NFL

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