Stillwater Capital - This Week in the Markets

The Top- Down

Things got a little weird yesterday afternoon when President Trump declared that he "wasn't thrilled" with Jerome Powell and Fed's current tightening cycle. The comments came during a Rose Garden interview with *CNBC's* Joe Kernen.

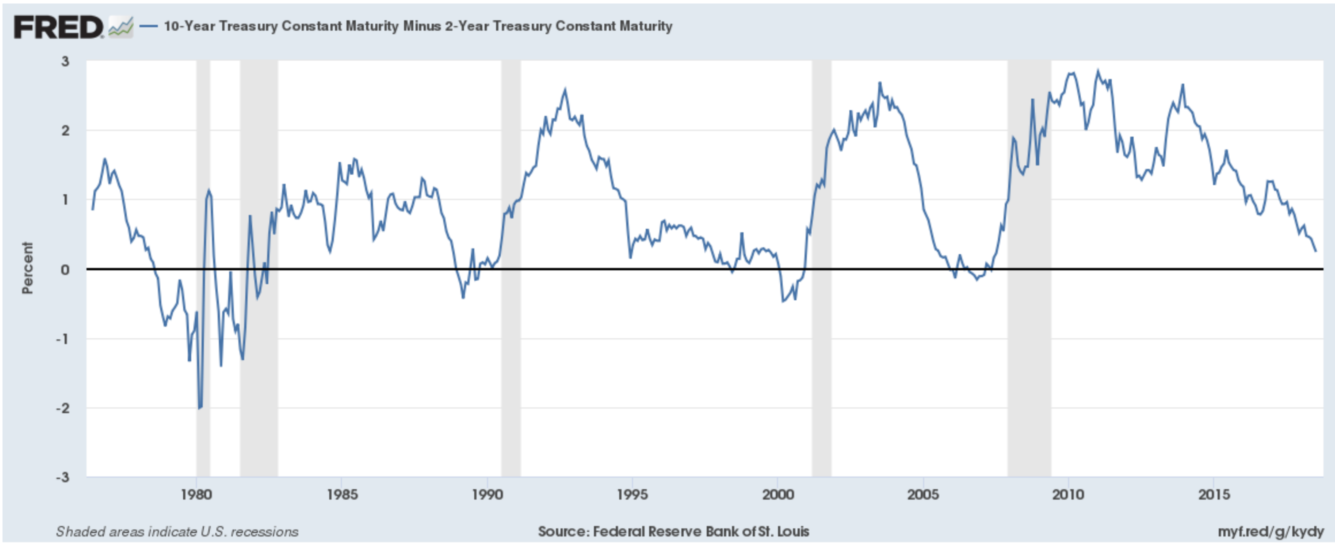
This breaks with a 20-year tradition of the White House having a hands off policy when it comes to the Fed. He reloaded this morning, Tweeting "Debt coming due & we are raising rates – Really?"

Trump and Powell

Source: Christian Science Monitor

Minneapolis Fed President Neil Kashkari penned a widely read piece this week, warning that "this time it's different" are the four most dangerous words in economics. He was applying his thoughts to the coming inversion of the yield curve and how it could influence the next recession. Kashkari has long been the most doveish of doves at the Fed. That being said, as a non-voting member his opinions only carry so much weight. His current view is the FOMC should stop jacking up the short end of the curve, as inflation is "well anchored" and curve inversion could be a part of what draws in the next recession.

Inversion Ahead



This week Fed Chair Jay Powell came out in favor of higher rates as the domestic economy continues to have an upward bias, and the consumer, who accounts for 70% of GDP, is by and large feeling the tailwind of strong job growth, asset reflation, and wage gains. In a prepared statement Powell said,

"Robust job gains, rising after-tax incomes, and optimism among households have lifted consumer spending in recent months. Investment by businesses has continued to grow at a healthy rate," he said. "Good economic performance in other countries has supported U.S. exports and manufacturing. And while housing construction has not increased this year, it is up noticeably from where it stood a few years ago."

On the subject of housing, the Commerce Department new home starts saw a 12% decrease in June. This was the biggest drop in two years and raises another red flag for the residential real estate market.

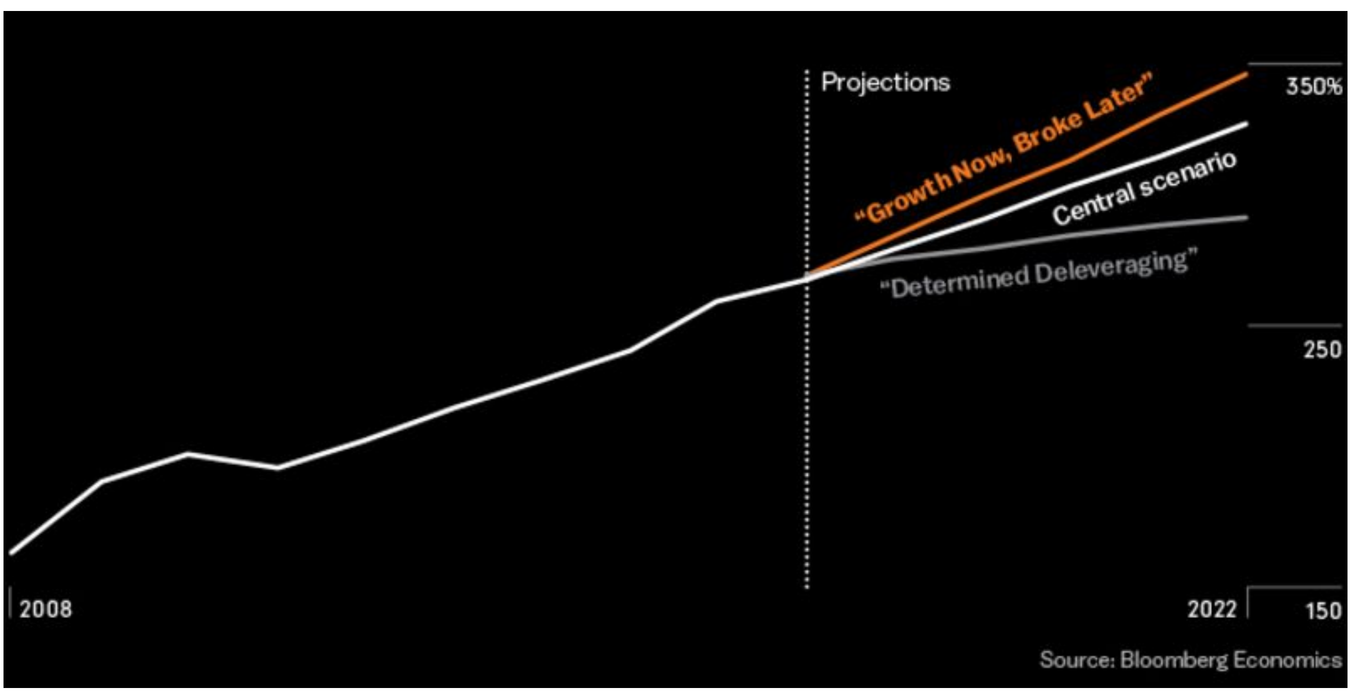
U.S. Housing Starts

Source: Commerce Department

China continues to grow, albeit not at a rate that the market. Second quarter GDP growth fell to 6.7%, the slowest advance since 2016. And as market observers point out, this downshift is occurring *before* tariffs even begin to flow through.

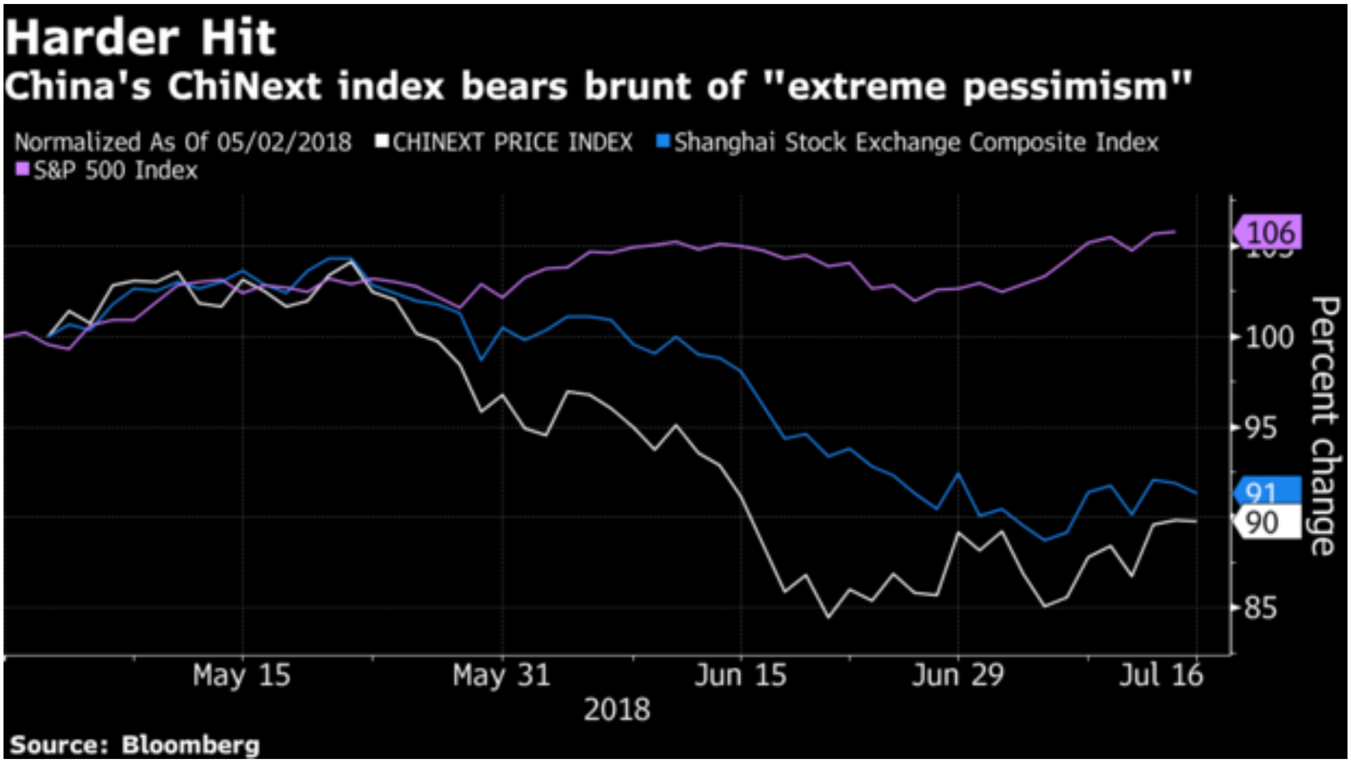
The Stillwater View: The China "growth miracle" has been financed with debt, both public and private. And as this the case in any situation when borrowing fuels growth and then growth slows there is a prevailing risk the economy will have what can only be described as a Wiley Coyote moment.

China Growth Over a Debt Cliff



One underwater China based hedge fund is doubling down on its wager that growth will rebound, and that investors should turn that sad frown upside down. That being said, the fund making that call this call, Spring China Opportunities, has a 17% hole it needs to dig itself out of before their current clients start making any money.

China & U.S. Diverge



The Stillwater View: While we like to think we have a well-tuned skeptical eye, we must admit that we could not get out of our own way with one China centric long/short position, NetEase. First it was a long. Then a short. And now a long again. We currently sit with a 20% loss in the name that has produced a 60bp drag on performance.

Why do we point this out and disclose something that on paper makes us less marketable? Our biggest frustration in this business remains that anyone with an opinion can get air time and their past recommendations or market calls are rarely mentioned, let alone critiqued. That's why we welcome, value, and appreciate full transparency

In other top-down macro news, weakness in the metals and mining sector has economists and strategists concerned that the recent underperformance is a canary in the global growth coal mine. Dr. Copper is certainly saying something, the market just isn't sure what to make of it yet.

Miners & Metals

Meanwhile, there are no canaries in the Baltic Dry Goods Index, as it is flashing a green light to the late cycle global growth narrative.

The Baltic Dry Index

Aside from being one of the Police's best singles, "canary in a coal mine" is one of Wall Street's favorite and most overly flogged phrases. It's meaning goes back to the early days of mining when the risk of methane poisoning was high, but the technology used to detect it was low. At the time, miners would take a caged canary down into the shaft with them and if the bird took "the big nap", it was time to get out.

A Canary Headed to the Coal Mine

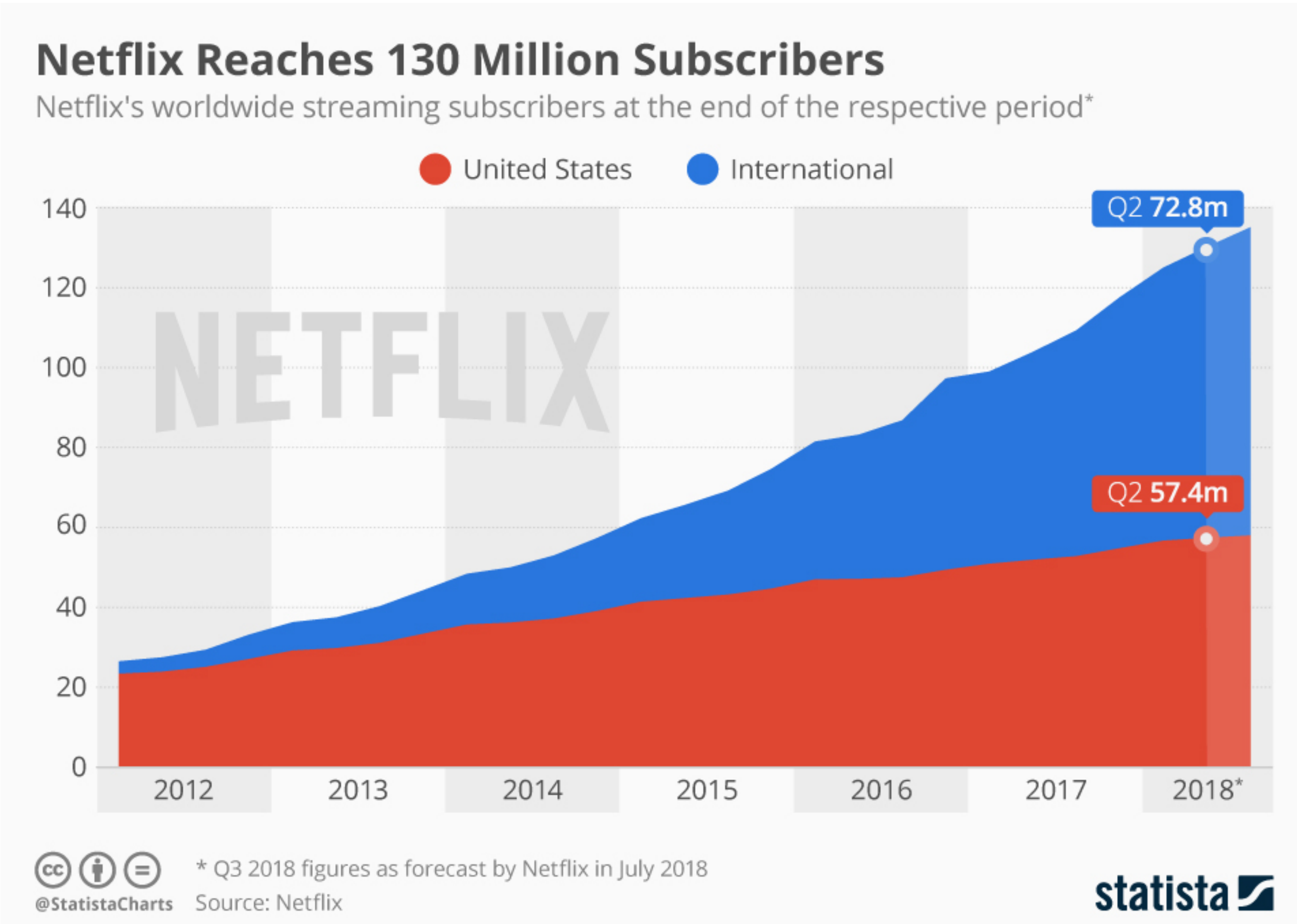
Source: Smithsonian

Today it is applied to just about every indicator, false or otherwise, that the Street uses to look for trouble ahead. But with so many canaries out there, and so many observers on the lookout for them, the canary in the coal mine market is a fairly efficient tool.

The Bottom-Up

And then it happened, Netflix finally disappointed enough to leave a mark. On Tuesday the company reported that subscriber growth came in at 5.2 million users. This was a million shy of the mark Wall Street set. The stock is now down 15% in July. Analysts and portfolio managers were quick to make the rounds opine on what happens next.

Up and To The Right



Goldman Sachs released a research piece this week highlighting five highly profitable stocks that will work well in an inflationary world. They include the aforementioned Netflix and market darling Nvidia.

Goldman's Top-Five Inflation Picks

Goldman's highest net margins and return on assets basket

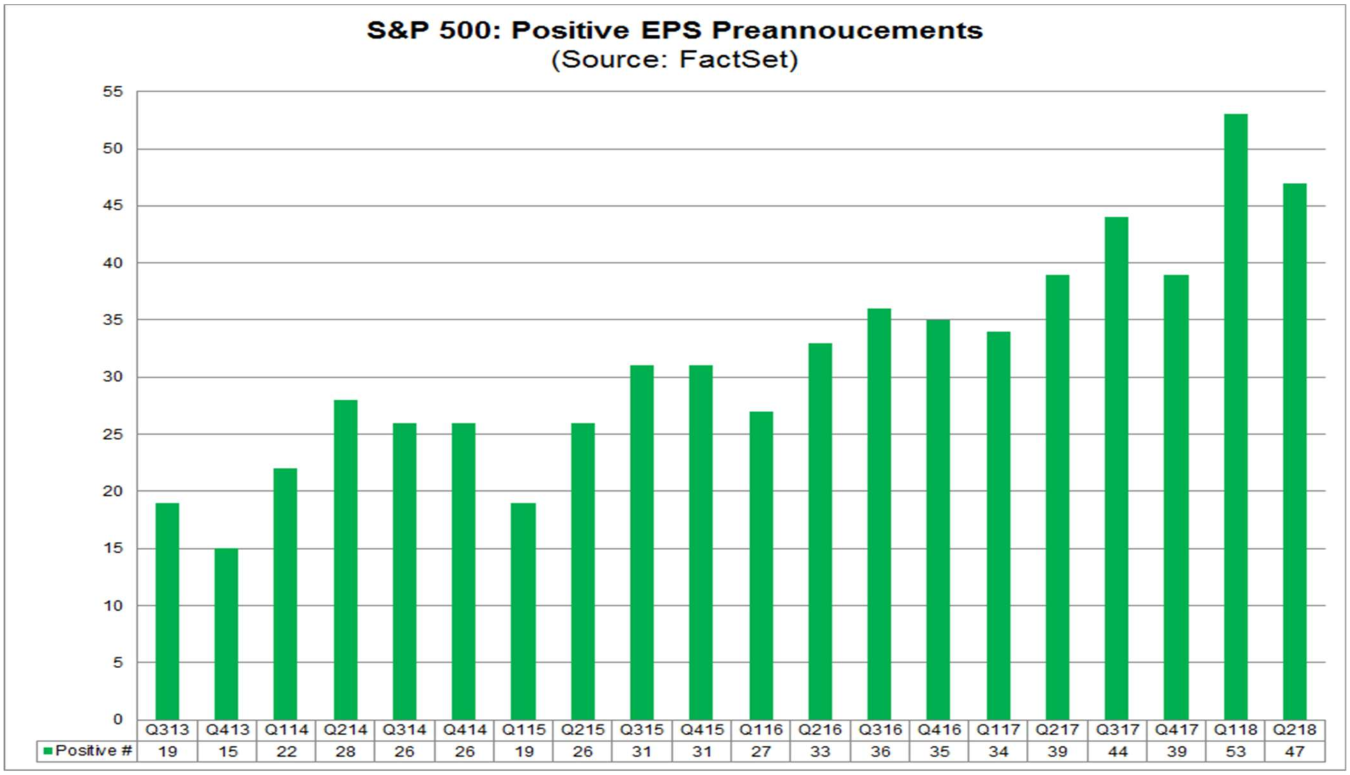
Company ▼	Sector	Upside to GS target
AbbVie (ABBV)	Health care	41%
Biogen (BIIB)	Health care	12%
Facebook (FB)	Technology	9%
Micron (MU)	Technology	23%
Nvidia (NVDA)	Technology	23%

Source: Goldman Sachs. Pricing as of July 12

CNBC

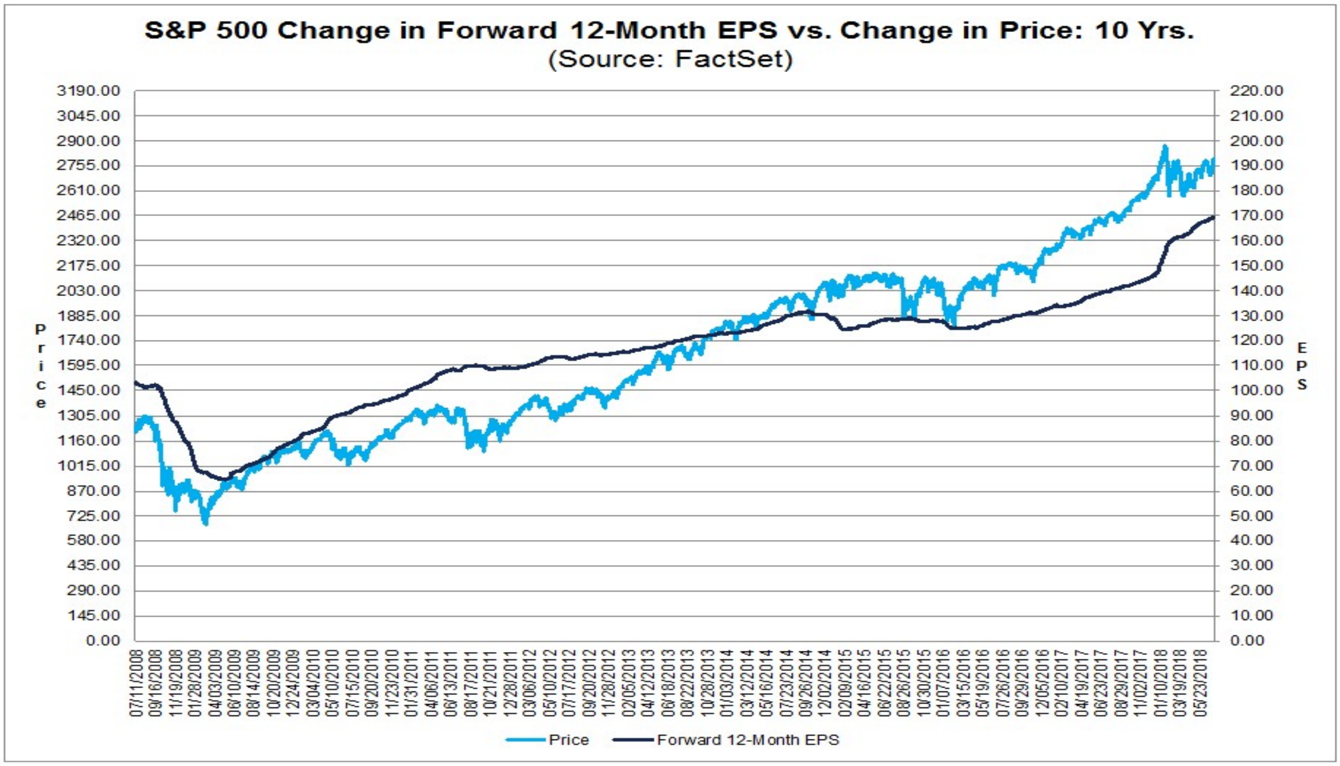
As we head into the heart of second quarter earnings season next week, the trend continues to be the markets friend and surprises to the upside are moving higher.

Earnings Surprises in Q2



The Stillwater View: Two things continue to support an equity market that has seen a decent degree of stagnation and churn this year: a positive trend in employment and continued earnings growth. So far these tailwinds have overshadowed looming macro concerns. Predicting how long it will last is what makes a market.

S&P 500 Earnings



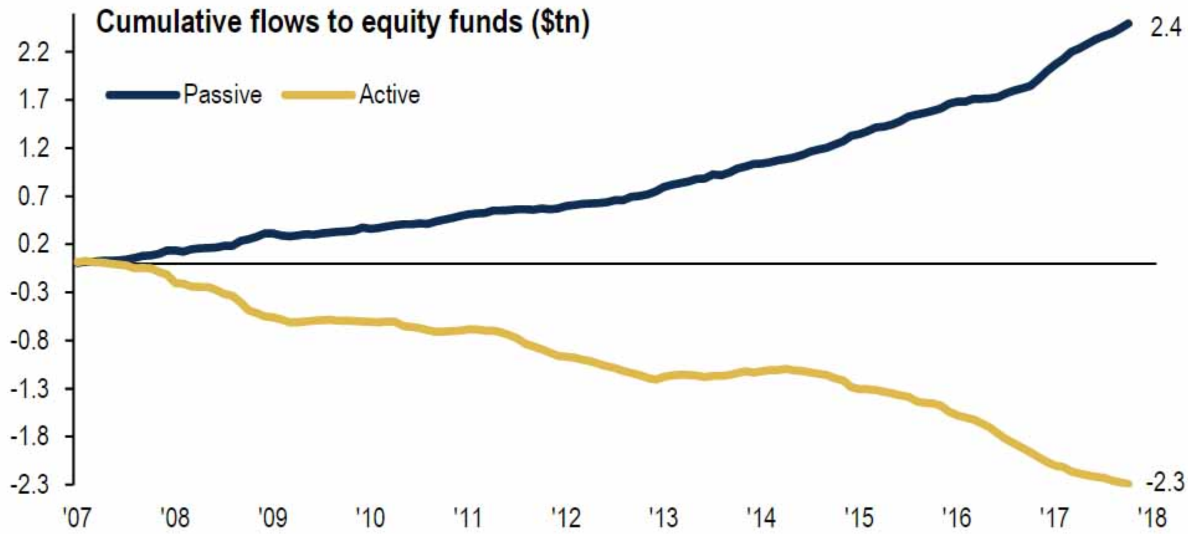
Up & Down Wall Street

Portfolio manager are getting more frustrated with the narrow leadership of this market by the day. To provide some context, eight companies have made up 99% of the S&P 500's 4% return this year. Those stocks that have lead the charge? You guessed it, Google, Amazon, Facebook, Apple, Microsoft and Netflix. If you didn't own all six but instead held the rest of the S&P 494, you have made no money in 2018.

Larry Fink, Chairman and CEO of BlackRock, commented on this very narrow market during the company's earnings release earlier this week. He called this moment a "pivotal" one where clients are trying to figure out the amount of risk they can take, the reward offered, and the uncertainty they need to endure to get there. While flows continue into the BlackRock's ETF business, they have slowed as of late.

The Trillion Dollar Pair Trade

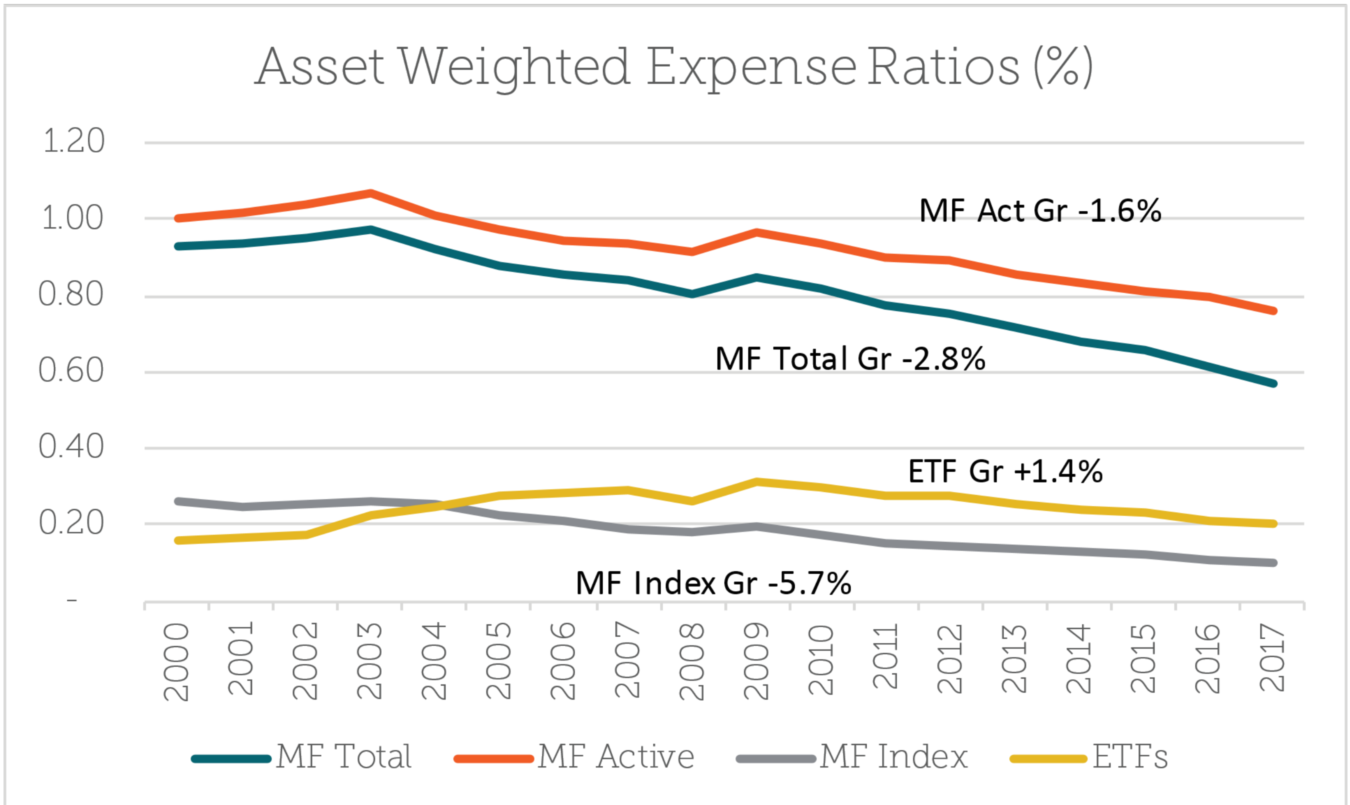
Chart 1: Passive hubris, active humiliation



Source: BofAML Global Investment Strategy, EPFR Global

Which brings us once to the subject of fees on Wall Street. The good news, investors have never been in a better position to benefit from the "race to zero". Truth be told, it isn't a race at all, just a very long marathon. We googled the subject and the phrase has been coming up to describe fee compression for a decade, if not longer. At of the close of last year, there was 60 basis points of spread between active and passive mutual funds. Charlie Ellis provides us a look at why "survivorship" makes active management look better than it actually is.

Passive v. Active Fee Compression



Source: Morningstar Direct

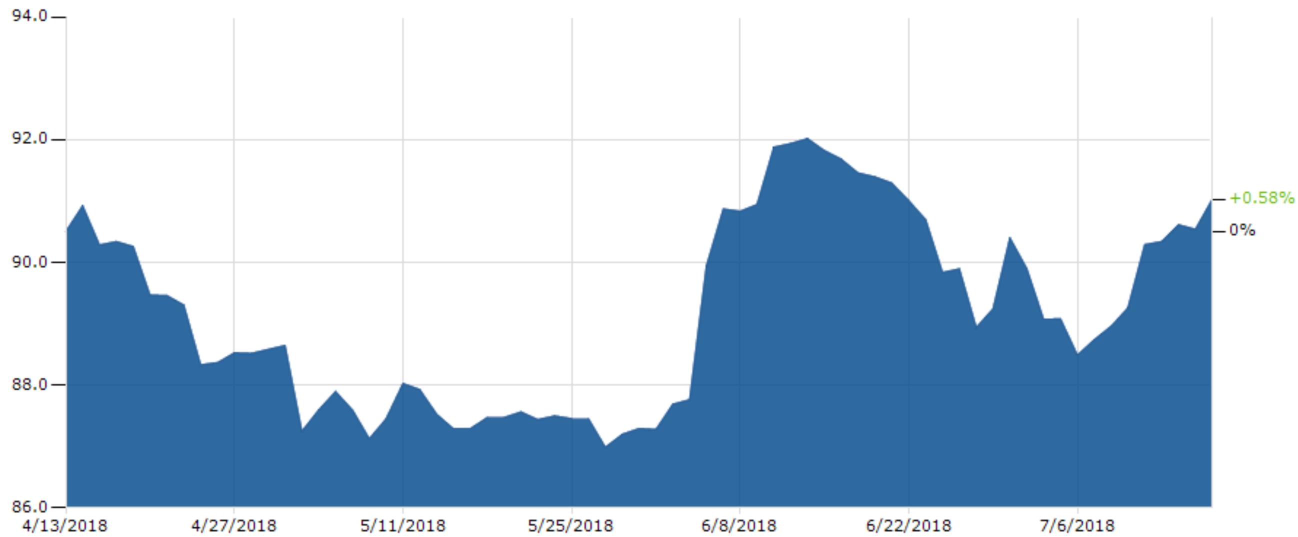
CNBC's "Delivering Alpha" produced some headlines worth noting. Oaktree founder Howard Marks continues to advocate for de-risking in a late cycle world. He and Citadel's Ken Griffin think that Bitcoin has no value. Meanwhile, "the Bannon Cannon" announced he is going to be listing his very own digital currency.

Steve Bannon

In news that should surprise no one, Mark Chanos thinks Elon Musk is overpromising on Tesla's delivery capabilities and cracked back at him for insinuating that Chanos uses insider information.

The Stillwater View: The firm still holds a 3% short position in Tesla and is currently flat on it. While it's as crowded as the day is long, the concern remains that there is a potential cash flow problem that could impact the debt side of their balance sheet. It may not last forever, but the bonds are saying something. And as my short selling mentor once taught me, equity can do what it will but debt never lies. Earlier this year George Soros took the other side.

Tesla August 25 Notes Currently Yielding 7%

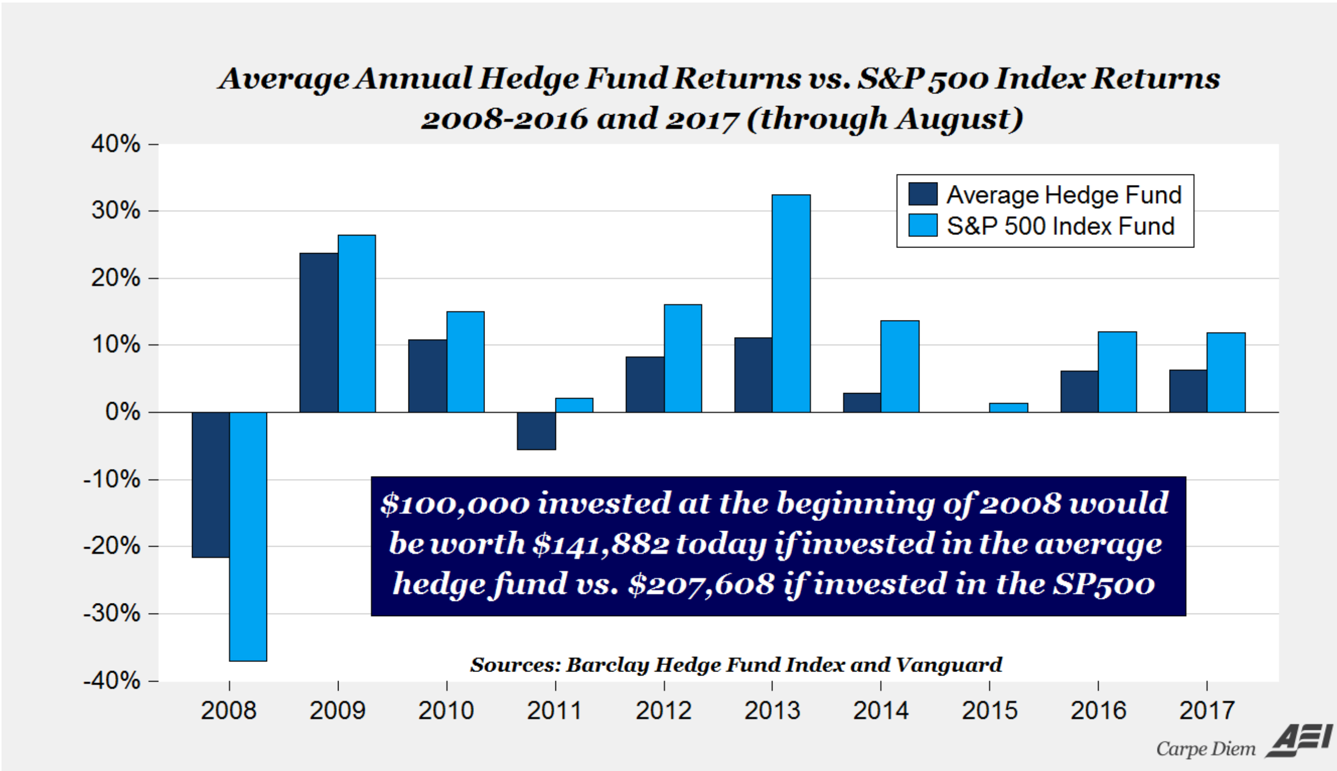


Source: Business Insider

For the inner wonk inside all of us there is the report from I H S Markit titled "The Economic Contribution of Tesla to California"

Steve Cohen's Point 72 joins Citadel's multi-strategy portfolio with a solid 7% gain through mid-year, neither of which have done anything to change the view of the head of the Illinois pension fund, Marc Levin, that hedge funds do nothing but destroy value for institutional investors. Members of the exclusive Tiger 21 held an airing of their grievances last year and the same issues continue to hang over the industry.

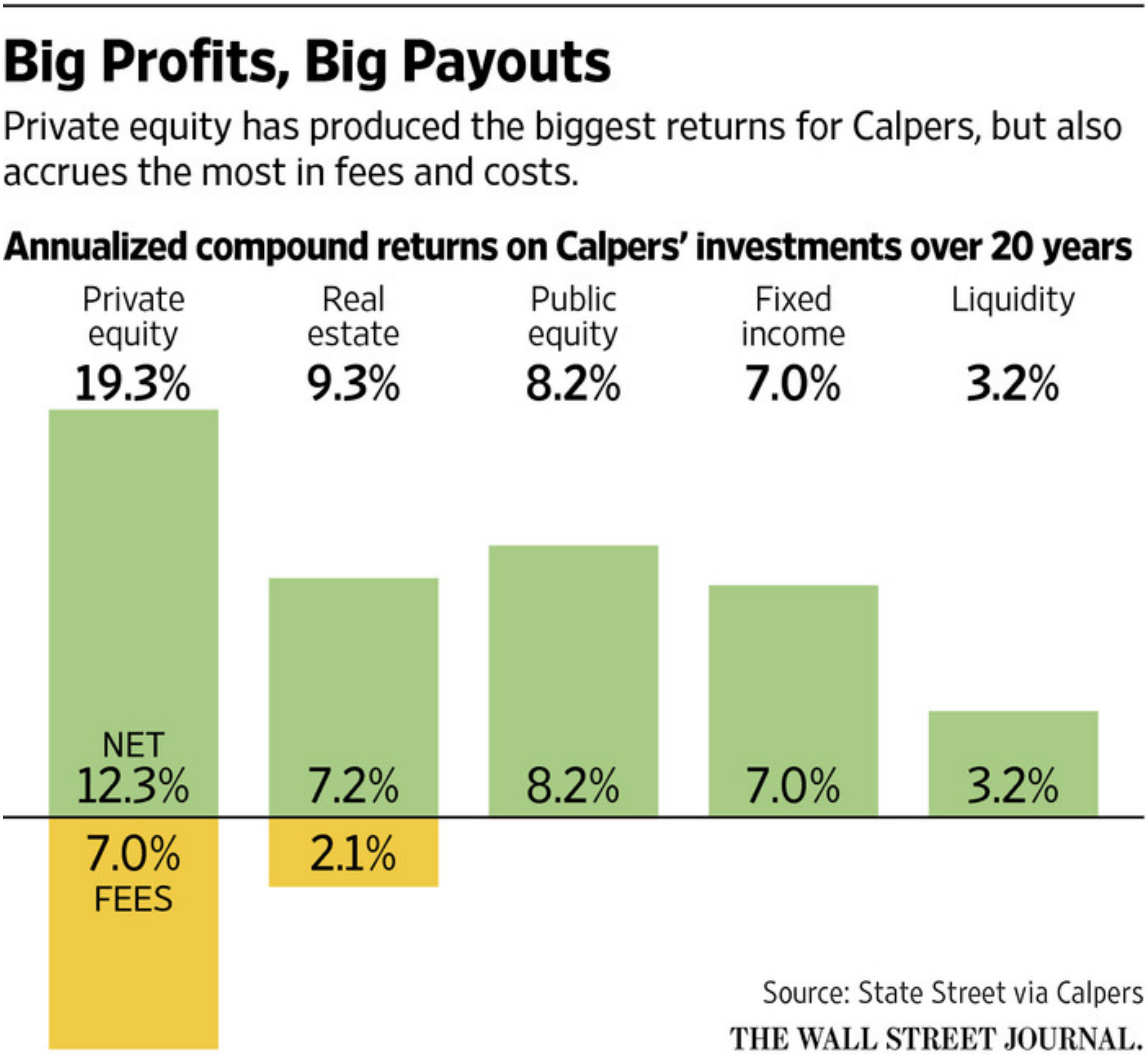
One Out of Ten Ain't Bad…Right?



Source: Seeking Alpha

In a rarity on Wall Street, private equity firms are actually raising management fees. Bloomberg reports that TPG, Blackstone, Apollo and Hellman & Freidman are all moving upstream to 1.25% from the 0.75% management fee average. The reason? Investors demands for higher returns and the fact that P/E funds have delivered the goods.

P/E Fees



Diversions

The British Open, or The Open Championship, kicked off yesterday at Carnoustie. True fans of golf love this tournament for several reasons. The first one being, the schedule permits for extensive viewing for those who love the game. Secondly, West Coasters can watch live action beginning at 10:30 pm that carries over into almost continuous all day coverage. And lastly, There is the natural beauty of the landscape set against the North Sea.

This year is once again special as Carnoustie is one of the iconic courses on the Open circuit. This will be the 8th championship played at the course that dates back to the early 1800's. The finishing hole is said to be one of the hardest in major golf. Just ask Jean Van de Velde.

Why is This Man Smiling?

Source: PGA.com

Billionaire investor Ron Burkle has listed his Frank Lloyd Wright Mayan inspired Ennis House in Los Angeles for $23 million. Burkle purchased the home in 2001 for $4.5 million and then invested $17 million to repair and restore damage caused by the 1994 Northridge earthquake.

The Ennis House

Source: Architectural Digest

Burkle is a known commodity in the architectural trophy house market. He owns the legendary Greenacres estate in Beverly Hills and purchased Bob and Delores Hope's John Lautner designed Palm Springs residence in 2016 for $13 million. A cool $37 million less than the original $50 million asking price.

Hope's Palm Springs Residence

Source: Pinterest

In slightly less pricy, yet no less interesting real estate news, the Eastern Sierra ghost town of Cerrro Gordo sold for $1.4 million last week. And on the ominous Friday the 13th no less. Whomever owned it previously put together a really nice website to chronicle the history and current state of the property.

Cerro Gordo

Source: The Los Angeles Times

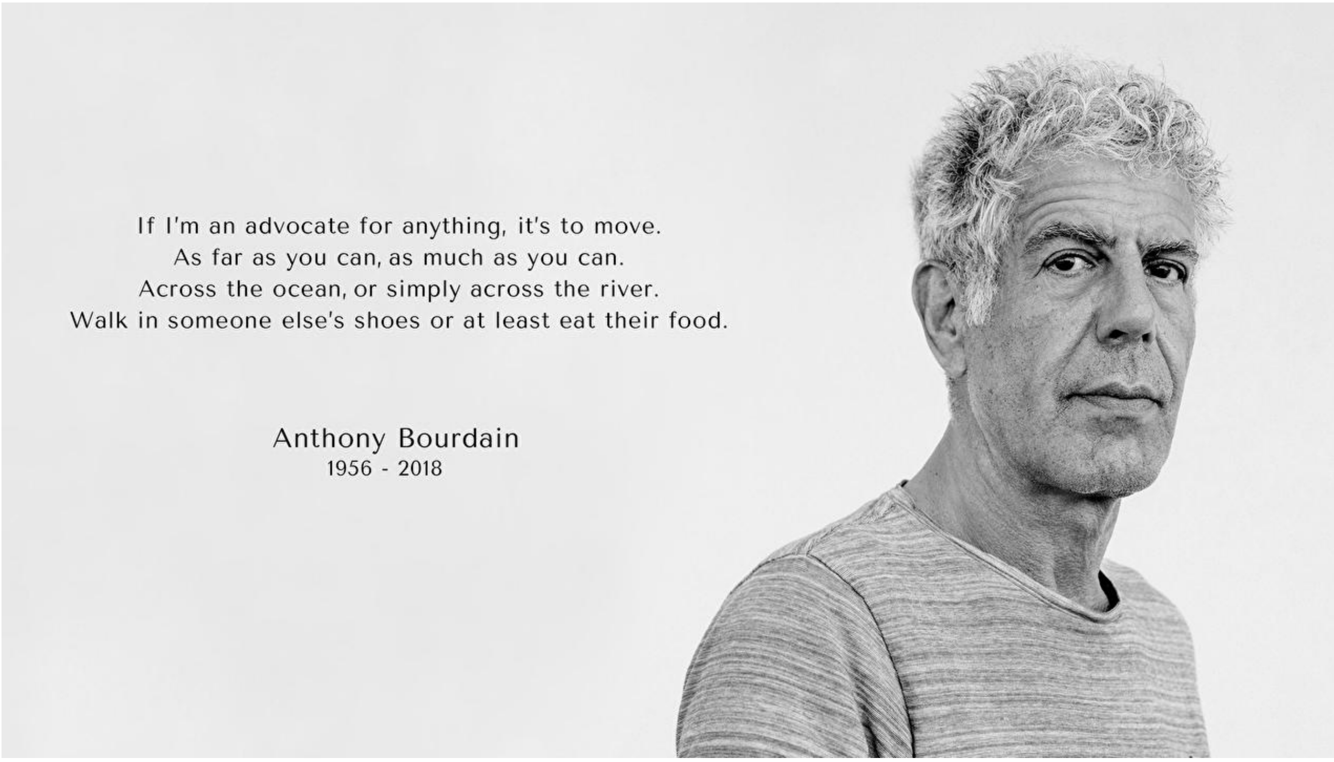
The Stillwater View: To be clear, the buyers put up $1.4 million for 20 buildings and 300 acres of Southern California(ish) real estate. I believe they call this "winning". Can't wait to see what they do with the place.

In news that came out yesterday, the Brady Bunch House in Studio City, California has hit the market for $1,885,000. The listing agent, Ernie Carswell, says of the house "this is postcard of exactly what homes looked like in the 1970's". And indeed it is.

The "Brady Bunch" House

Source: Los Angeles Times

With the slight passing of time it has become easier to remember Anthony Bourdain for what he was despite the circumstances of his death. It was indeed too soon.



I speak for myself, and maybe for you as well, when I confess that the anecdote for a case of the Sunday night blues was Bourdain and the world he brought to your living room. With that as inspiration, I give you the Stillwater Capital top 10 episodes of all time…at least by our dubious standards. Enjoy the binge watching courtesy of Daily Motion.

1) No Reservation, San Francisco – Anything including *The House of Prime Rib* is good by us.

2) No Reservations, Montana – Jim Harrison scares the hell out of me…even from the grave.

3) No Reservations, Burgundy – Look past the fact that Ludo comes off as a French prick. He's actually a very cool cat.

4) The Layover, Seattle – Vintage Bourdain in the Pacific Northwest. Mud shark? Really?

5) Part Unknown, The Congo – Captain Willard and "Chef" go up-river.

6) Parts Unknown, Japan with Masa – "Second child syndrome." Simply brilliant.

7) Parts Unknown, Libya – Clear look into a dark place.

8) Parts Unknown, Lyon with Daniel Boulud – Some get to shake Sinatra's hand. Some don't. In the culinary world Paul Bocuse was Sinatra, Lennon, and Elvis all wrapped up in one.

9) Parts Unknown, Vietnam with President Obama – Sipping noodles with a standing President of the Unites States is cool, regardless of party affiliation.

10) Parts Unknown, Scotland. "Everything changes, nothing changes at all." Say no more.

The Stillwater View: Stay golden Pony Boy, stay Golden.

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