

Stillwater Capital - This Week in the Markets



The Economic Top- Down

Global markets are very well bid this morning on news that president Trump spoke with China's Xi by phone and a trade deal may be in the works. An announcement could come as early as two weeks when the G-20 gathers in Argentina.

Let's Make a Deal



Source: CNN

The September employment report came in on the strong side this morning with a gain of 250,000 workers, with wage growth cracking the 3% level. The only potential parachute on this market party dragster is interest rates. If a 3.30 yield on the 10-year doesn't get people's attention, we don't know what will.

10-Year Treasury Yields



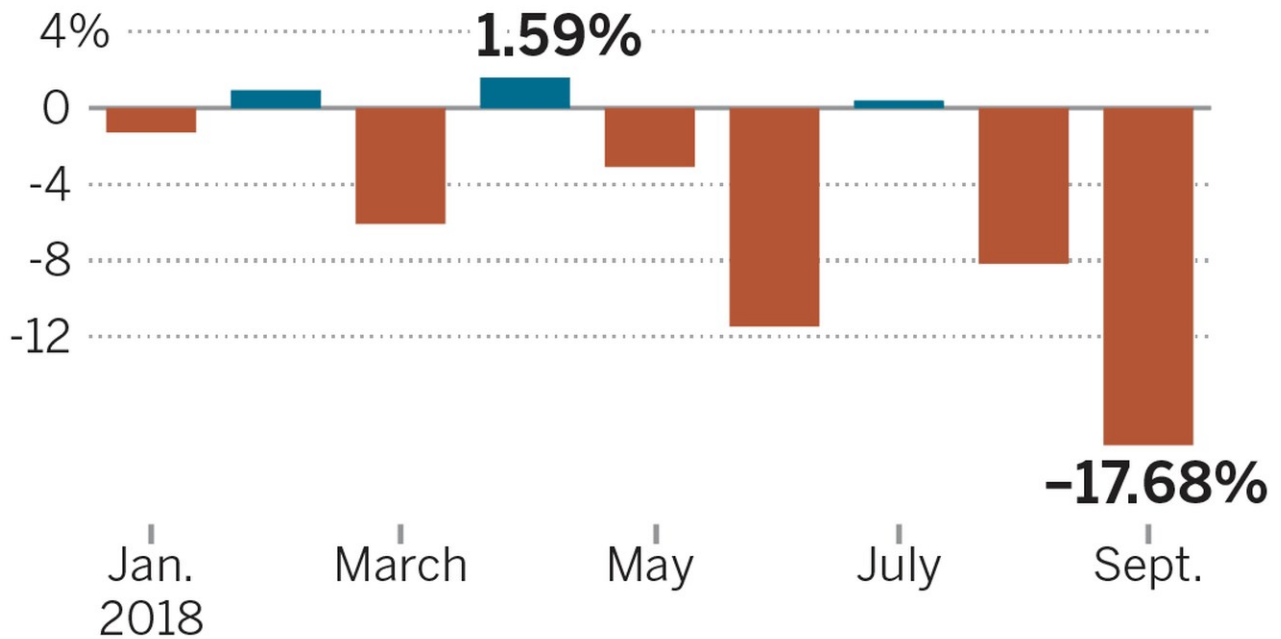
Source: Macrotrends

Residential real estate continues to be high on the list of concerns for the market. This week, we received more news expressing the need for concern. The Case-Schiller Home Price index showed slower appreciation than the market had hoped for, rising 5.1% against expectations of 6.0%. and to add insult to injury, homes being flipped are off big, with a 22% decline year over year.

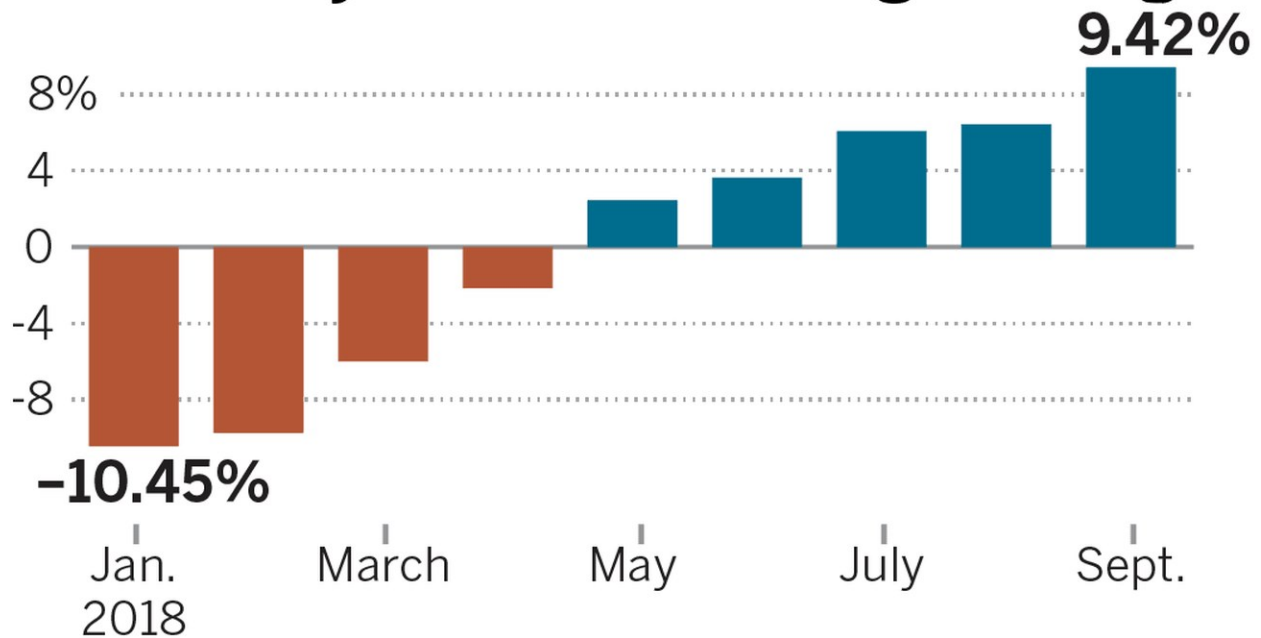
If you live in Southern California the headlines are getting even scarier. The volume of sales is rolling over and listings are up. Meanwhile prices remain relatively high.

SoCal Residential Real Estate

Year-over-year home sales change



Year-over-year home listings change



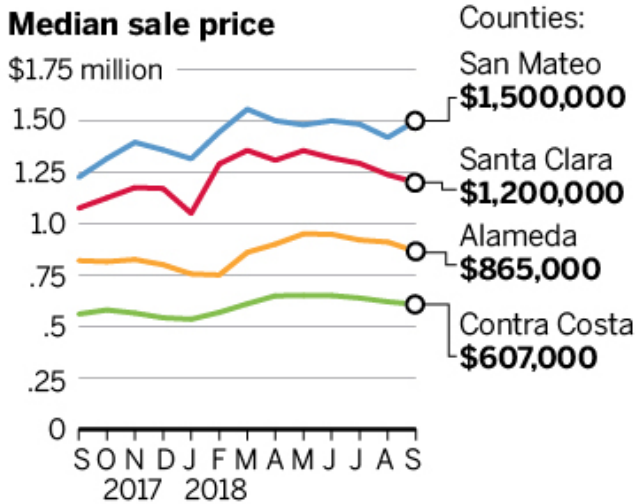
Source: Zillow

It's a similar story in the San Francisco Bay Area, where prices appear to have hit a plateau earlier this year while the volume has seen a material decline since summer.

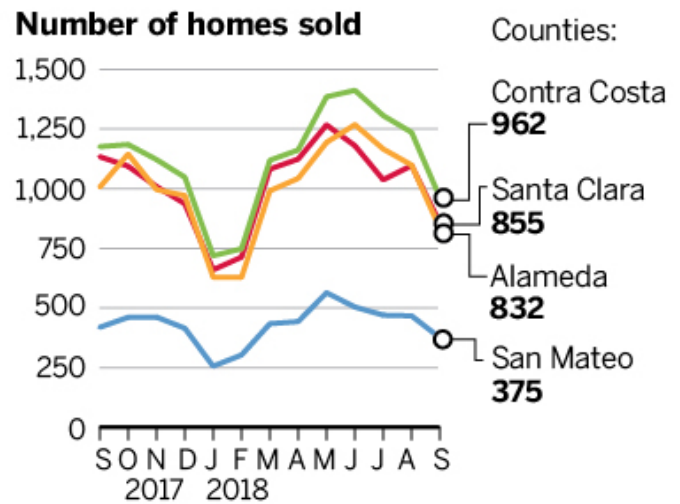
The White Hot Bay Area Cools

MEDIAN HOME PRICES IN THE BAY AREA

Latest monthly figures on median home prices for resale single-family homes.



Source: CoreLogic



BAY AREA NEWS GROUP

Source: The San Jose Mercury News

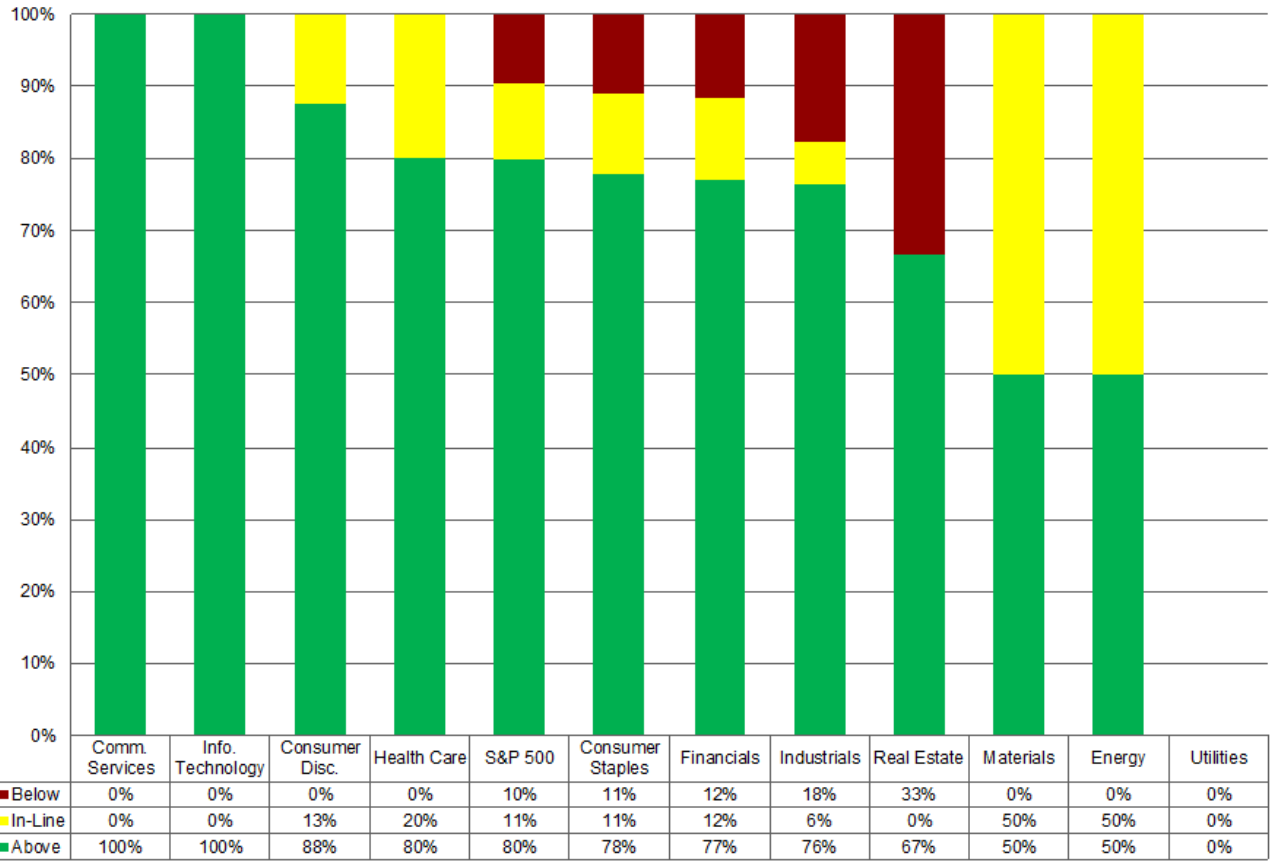
Our View: There are really very few ways to continue to whistle past the graveyard. Rates are headed higher, home valuations are on the expensive side, the affordability gap is huge, and we are in the late innings in this economic cycle. All of which adds up to some well founded angst.

The Fundamental Bottom Up

As Bloomberg reports, earnings were not the savior to the market this quarter. Meanwhile, the game of sandbagging continues, where a full 80% of earnings for S&P 500 companies came in "above expectations".

The Expectation Game

S&P 500 Earnings Above, In-Line, Below Estimates: Q3 2018
 (Source: FactSet)



Source: FactSet

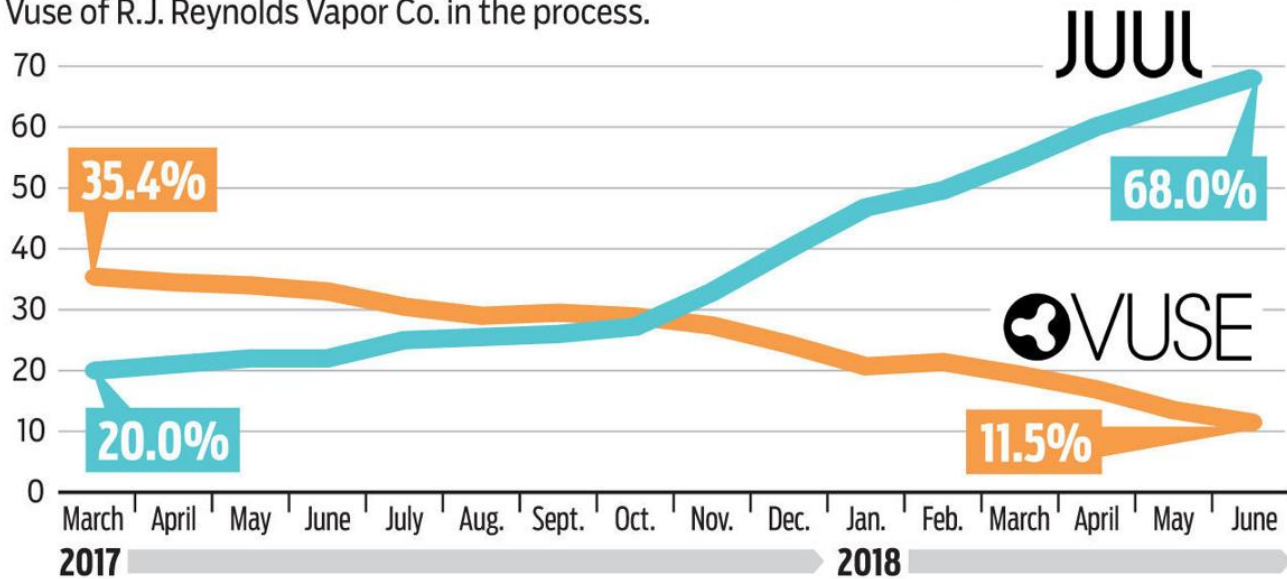
Our View: Maybe Wall Street should check it's expectations machine. It doesn't seem to be working very well.

This week *Bloomberg* profiled the two Stanford graduate students who founded e-cigarette company Juul. With the market taking off, the company is now worth \$15 billion, netting Adam Bowen and James Monsees a cool billion each. Whether the product is at all better for you than the original flame lit kind is up for debate. Let the war for the soul of America's children continue.

E-Cig Market Share

Percent of market share

The Juul electronic cigarette, which is shaped like a USB flash drive and a pen, has surged into the top market share for the category in recent months. Juul, made by Juul Labs Inc., overtook Vuse of R.J. Reynolds Vapor Co. in the process.



Source: Nielsen data provided by Wells Fargo Securities analyst Bonnie Herzog

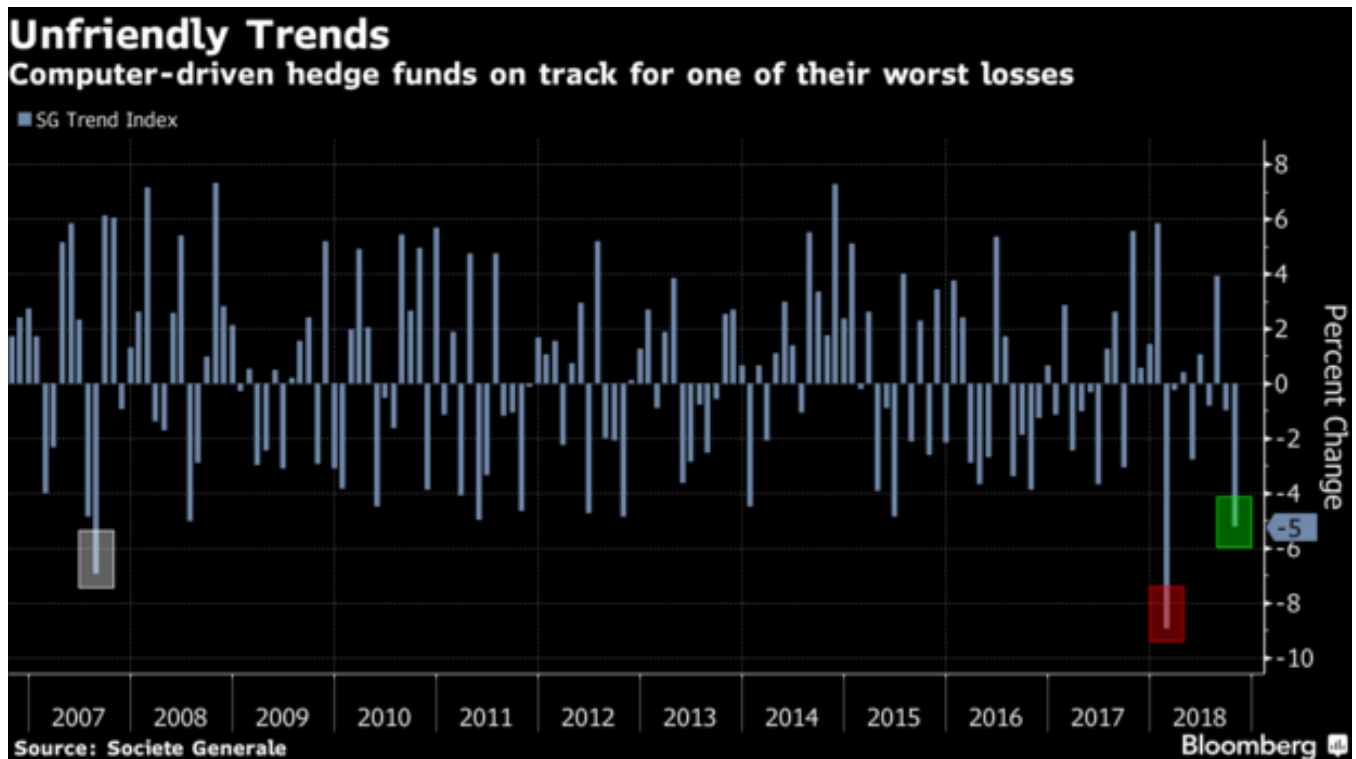
CASSANDRA SHERRILL/JOURNAL

Source: Winston-Salem Journal

Hedge Funds

Hedge funds did it again, failing to show they can protect on the downside when markets correct. As *Bloomberg* points out, correlations have risen and the machines have been throwing out the baby, the bathwater, and the tub. Not a very pleasant scenario given the high stakes game of showing a profit and being able to clip a performance fee by year end. Trend followers have been hit particularly hard facing their third worst month in 10 years, with *Bloomberg* calling it a "bloodbath".

Failing to Compute



Source: Bloomberg

Our View: The bottom line here is that hedge funds tend to trade the same way and keep the process in place until it all breaks down. With so much of the trading today being driven by the machines, we will, with fairly high confidence, have a one day drop to the tune of 15% to 20%, and that is both tough to time and tough to hedge. It's simply inevitable given the state of affairs today.

Not everyone was crying in their beer at the end of the month. David Einhorn managed to put up a positive 1% month in October after suffering through what has been a nightmare year for his firm. Even with the small gain, Greenlight Capital is still down 25% on the year. Bill Ackman on the other hand is having a pretty decent one after three he would rather forget. As of mid-year he was up 12.5%. Dan Loeb's Third Point got slammed pretty hard in October, dropping 6.9%.

Three Headed Monster



Source: Barron's

Our View: While we long for the Golden Era of hedge funds to return, there is no turning back the clock. The market has evolved, Stillwater along with it, offering hedged and alternative equity strategies that are liquid and have a 1% flat management fee attached. Which is a pretty good deal considering that the market for this kind of solutions sits at a much higher level.

Markets

If it felt like October was bad, its because it was. Up through Wednesday, it was clocking its worst month since 2009. Every single excuse in the book has been thrown out there, from an earnings peak, cost inflation caused by tariffs, and the looming midterm elections. At the end of the day there was no real fundamental reason. It was once again led by trading of the mystery machine kind.

Red October

No End in Sight S&P 500 experiencing worst month since 2009



Source: Bloomberg

Our View: Stillwater's came into this correction hedged. Which essentially means we had more foam on the runway when the market pounded onto the tarmac this month. It won't protect against all of the downside, but it does ensure that you can more easily walk away from a rough landing.

If You Are Sitting In a Exit Row...

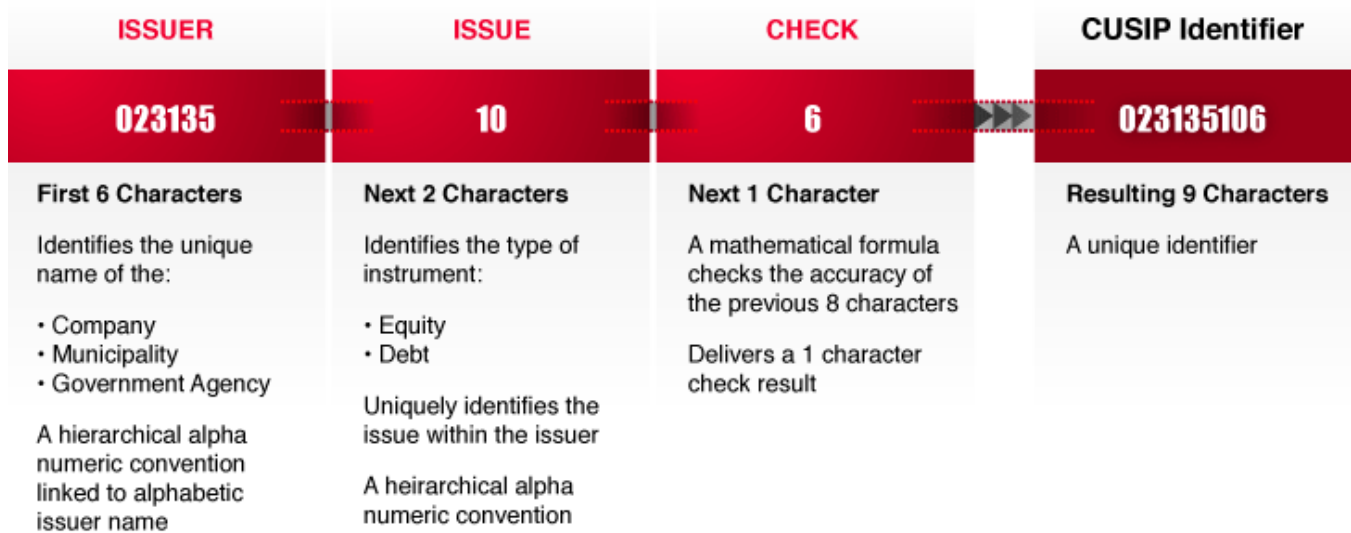


Source: Honolulu Star Bulletin

Since we are going to lay blame for much of this on algorithmic trading we feel compelled to offer a basic primer on how that world works. The reason this is important is because billions of dollars have come out of fundamental stock picking funds and into those managed by machines.

The logic behind programmatic trading is, or at least it should be, emotionless. The machines don't know the fundamentals of an Apple, Exxon, or Pfizer. They know CUSIPS. Every security has one and identifies against all other securities. Think of it as fingerprint, as no two CUSIPS are the same.

Construction of a CUSIP



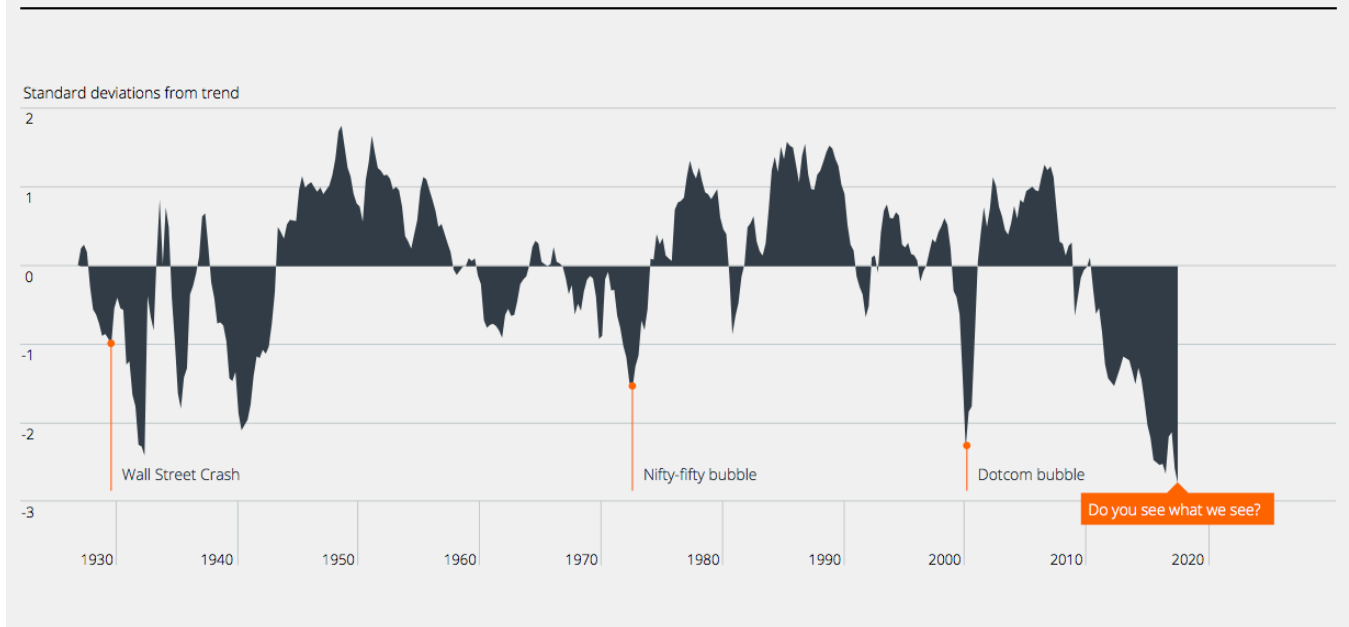
Source: CUSIP Global Services

What a profitable trading program will do is look back at how one CUSIP, or collection of CUSIPS, trade is related to others. If you asked your algorithm to identify two collections that are not correlated it may come back with a basket of growth or a basket of value stocks. But keep in mind, you didn't ask it anything about fundamentals. You just two wanted to baskets of CUSIPS that didn't trade like another. In this case, you were brought back basket A (growth) and basket B (value), and they just happened to be currently trading at a historically high distance (standard deviation) from each other.

Wide Delta

US equities – value vs growth differential has never been this extreme

Source: Woodford, based on Fama and French data



Source: Woodford

Once your program identified for you the two baskets, in reality there are thousands, you then wanted to know how to make this into a profitable trading algorithm. When these programs start running at high RPM's, things can get interesting. And not always interesting in a good way as all kinds of damage can be done to the engine.

Where There Is Smoke...

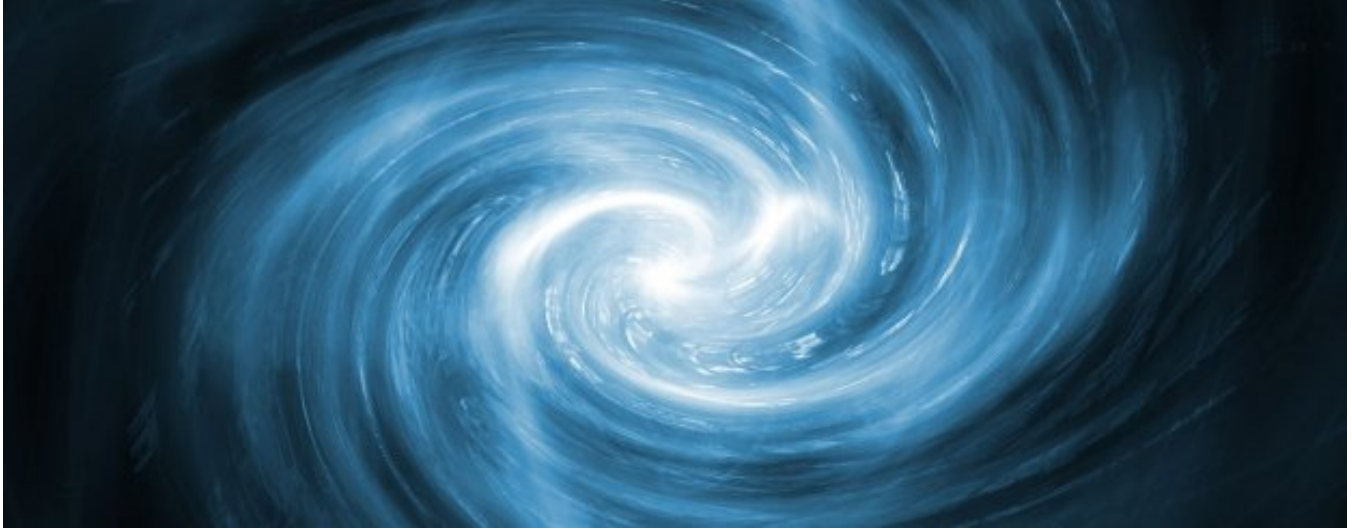


Source: Edmunds

The computing power and level of programming is so advanced that trading programs can run in Nano-seconds and create their own internal market vortexes. These vortexes can cause extreme market moves on the upside, and as we experienced last month, on the downside.

Because programs have become such a big part of the market volume, it can get very scary at times when programs say things like “sell all the CUSIPS that are up the most and buy the CUSIPS down the most”. Which is essentially what happened in October when he who was first, actually became last.

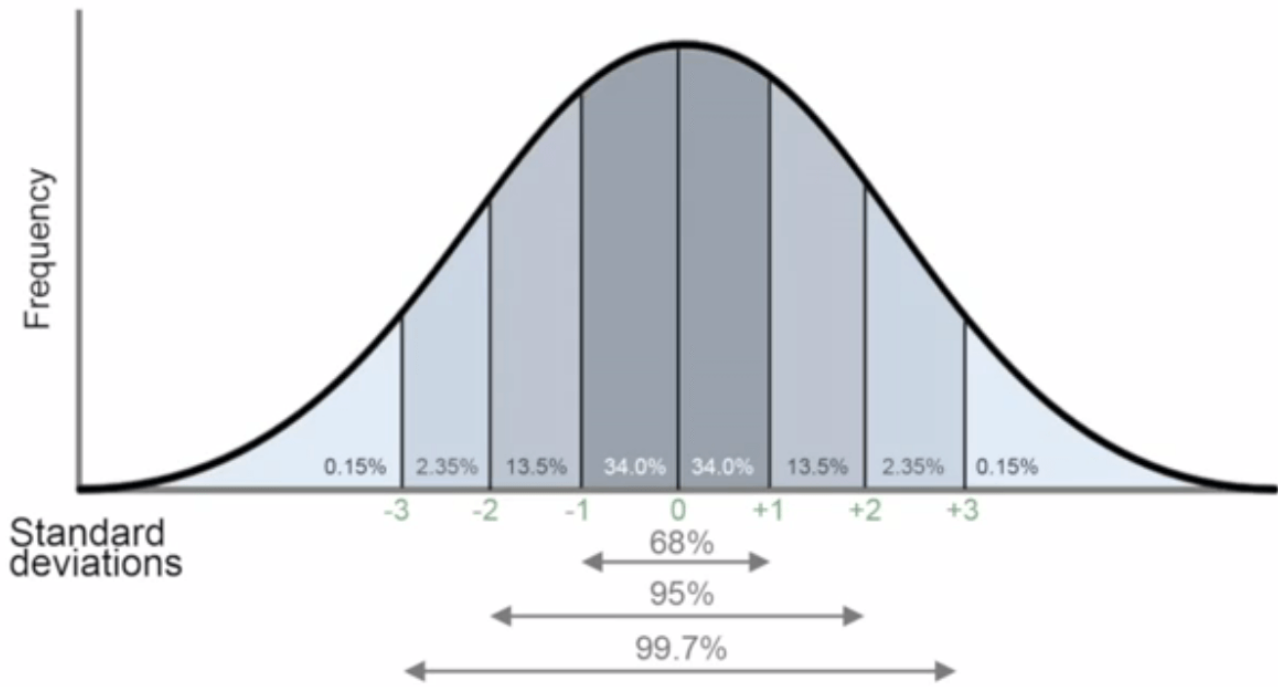
Swirling Vortex



Source: NASA

To settle all this imagery down, let's go back to the bell curve and standard deviation. Most of you know that all outcomes reside someplace on the bell curve. The right tail represents the few really good ones, while the left tail exemplifies a few very bad ones. While there is a lot of randomness on the edges, most everything still happens around the middle.

For Whom the Bell Curve Tolls



Source: Magoosh.com

So how does this relate to program trading and algorithms? Because most of the time outcomes are “average”, and algos are designed to make money most of the time, and they are designed to produce a large number of small wins. All within a couple of standard deviations of the middle.

When algos team up together or start fighting with each other, you get the previously mentioned vortexes traveling at red line speed. And that, dear readers, is what gets you 10% inter-month swings in the market with winners standing on home plate and losers crashed out into the wall.

Ouch...



Source: USA Today

Our View: So there are the new rules and yes, you are meant to be both scared and confused. Scared because it means that the vortexes (February & October 2018) are going to happen more often. Confused because you probably can't compete against that on a day-to-day and month-to-month basis. If you stay long term focused, you should make out just fine.

As a well-known market observer once said, there are still no crybabies allowed in the casino. And unlike the ones you find on the Las Vegas strip, the ones on Wall Street can change the rules without you truly knowing it. Good luck out there.

Vegas...baby!



Source: MintPress News

Diversions

The Wall Street Journal did the work for Stillwater this week when they wrote about the “101 Ways to Live, Work and Goof Off More Ambitiously” This is a truly great, and very creative, piece of writing. Enjoy!

Here are our top ten...

3. Train a spider monkey to sit on your shoulder and give you a tiny high-five every time you say something clever



12. Eat an ambitious amount of Domino's Pizza, then stand the 23 empty boxes upright in a row to demonstrate the domino effect

14. Interview a very ambitious person in the aftermath of a major failure. This is when the ambitious are at their most intellectually productive. And their least chatty.

21. Just for today, carry around a small, Bluetooth speaker and blast a triumphant theme song when you enter a room. Good: "Eye of the Tiger." Confusing: "I'm A Little Teapot."

29. Remove the word "just" from your vocabulary. It makes you sound wishy-washy, and its Scrabble tiles score more in "justice" or "jujitsu."

“just”

37. Teach your dog to play “near-death experience.” Playing dead is for losers.

39. Go Medieval on your home security detail by building a moat. Fill it with Evian.

66. Instead of whipping out your phone the second your partner heads to the bathroom, sit for a second and contemplate your place in the universe. Have you achieved oneness? Okay, now you can Tweet about it.

73. Speak loudly into your Amazon device: “Hey, Alexa! I’ll be the one answering the questions from now on!”



100. If you're in the wrong job, be smart enough to walk away from it. And creative enough to get the video of your stunt to go viral.

Source: The Wall Street Journal

East Bound and Down

Greetings from the great state of Texas, where the road goes on forever...

Marfa was as strange, and at the same time exceptional, as was advertised. Well worth a day of your time if you find yourself in Far West Texas. Tony Bourdain did, and it was awesome.

Prada on I-90



Source: Gray Malin

The Hotel Paisano is the Chateau Marmont of this tiny piece of scrub brush country with a population of 1,700.

The Chateau Tejas



Source: Tramonte

News flash from Austin, this town is growing like a weed with lots of out of towners having discovered it. Oh wait, that's not a flash at all, that could have been written every year for the past decade.

Dimensional Funds, the half a trillion dollar purveyor of factor based mutual funds, grabbed a big piece of land a few years back and built their regional headquarters. Great town, lower cost of living, good schools, and far fewer homeless than their home port of Santa Monica. What's not to like?

DFA Regional Headquarters



Source: Dimensional Funds

Our View: DFA has done a masterful job of empowering financial planners and registered investment advisors to take much of the investing confusion away and allow people to focus on the things they can control like fees and taxes.

Let the broad global market do what it should, to provide you with an steady annual return of about 10% over the long haul. And if you stick with the plan and the market co-operates, you will double your money every 7 years. What's not to like about that as well?

The Rule of 72

$$\frac{72}{\text{Rate of Return}} = \text{Time for Investment to Double}$$

Source: Calculator Soup

Last night the author of this fine financial publication got to live himself a country music song as I enjoyed a Mad Dog Margarita at the Chili Parlor Bar here in Austin. The venue, and drink itself, was made famous by Guy Clark in the song "Dublin Blues".

"I wish I was in Austin, at the Chili Parlor Bar, drinking Mad Dog Margaritas and not caring where you are."

Texas Chili Parlor, Austin



Source: RoadFood

Our View: Full disclosure, like a true Californian for the longest time I thought Guy was talking about a cold place in a parlor that served drinks. Turns out the Mad Dog Margaritas aren't half bad, and neither is the chili.

Not sure our traveling contingent knew what it was getting itself into when we bought ourselves tickets to the #3 LSU versus #1 Alabama game. Turns out that the Crimson Tide have been the Bayou Bengals "daddy" for more years than the latter would like to admit.

Death Valley, the stadium where LSU plays, has a raucous reputation. Looking forward to living one of every college football fans biggest dreams on Saturday night. If that isn't enough to fire up your soul for weekends this time of year, Kenny Chesney's "Boys of Fall" will.

Saturday Night Lights



Source: Reddit

Our View: The Bayou Bengals by three, or Alabama by a whole lot more. Geaux Tigers!

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