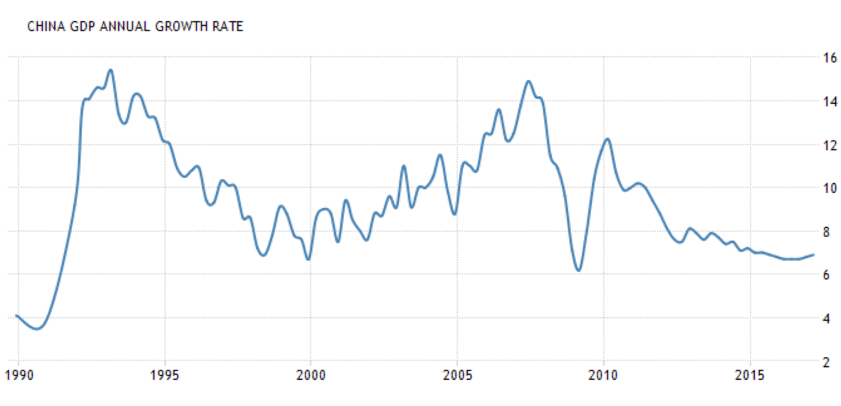
Friday May 26th, 2017

The Top-Down

It was a quiet week for economic news. Weekly mortgage applications and existing home sales were the notable releases. Refinance up on lower rates, home sales down on limited inventory. Housing prices in Los Angeles county are finally back to the last cycle high set in 2007. And in San Francisco prices declined (yes *declined*) for the first time since 2011. For a full account of all economic data use The Economic Calendar – Bloomberg.

The Federal Reserve made it official, the balance sheet unwind will begin next year. The "Ronco" plan as it was described by one economist, is to "set it and forget it". Phasing out reinvestment and slowly increasing the size of the runoff, adjusting it higher in three month increments. The minutes of the May FOMC meeting released on Wednesday also indicated that as long as economic conditions continue to improve, the Fed will gradually raise rates. Markets reacted favorably, erasing the prior week's loss with indexes hitting new all-time highs.

China came into focus this week as Moody's downgraded the country's debt rating for the first time in 30 years. The crux of the issue is that at the same time debt was ballooning to 250% of GDP growth was slowing.



This Rubicon between growth and debt will need to narrow or investors will be left [holding the bag](). On Wednesday noted short seller and China bear, Carson Block, said with certainty that the [“day of reckoning will come”.]() One small caveat, Block doesn’t know if it’s in “two months, two years or twenty years.”

Stillwater View: China has been slowing for seven years with little impact to our economy. Where the country has a much larger influence is in the materials and energy sectors. Collectively these two make up a small, yet volatile, segment of our markets. And China slowing has by and large been reflected in poor relative performance from both.

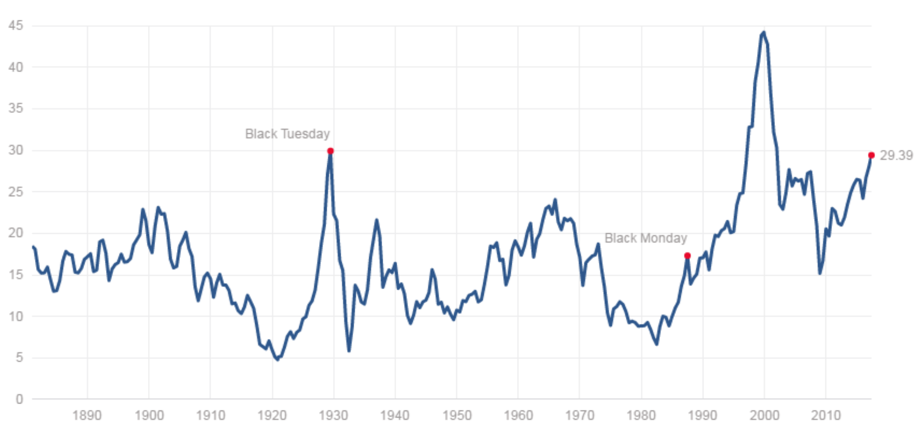
The Brazilian market was rocked last week by news of another scandal at the highest levels of government. Protests against President Michel Temer continued to rage again this week. While this news never comes at a good time, for Brazil it was particularly painful as the country was beginning to emerge from a lost decade of economic and political malaise. Global macro fund Discovery Capital Management was down 6% last week on long positions in Brazil. Pulling the $7 billion fund into a double-digit loss for the year. The situation also produced another cautionary example of the volatility risk in levered ETFs as the Direxion Daily MSCI Brazil 3X Shares suffered a 48% loss on Thursday of last week, an 18% rebound on Friday and another 8% drop on Monday of this week.

Stillwater View: Brazil was the B in the emerging powerhouse BRIC economies (Brazil, Russia, India, China) that drove global growth from 2002 to 2008. Of all the members, it has had the longest road back to stability. Along the way, it has been a widow maker for several macro funds. Most notably Michael Novogratz at Fortress in 2015. Like China, it’s influence on our markets has waned over the years.

The Bottom-Up

Mohamid El-Erian opines that momentum and liquidity have taken over and President Trump is no longer driving the market.

Earnings growth has long been a driving factor in market performance. In Q1 the S&P 500 notched 16.5% year over year growth, the best since 2011. This remains important to the market as earnings and profitability growth are the best counter to current high valuation. And to be clear, we are at high historical valuation. But even Bob Shiller, creator of the Shiller CAPE ratio, thinks that stocks can still run.



Stillwater View: Valuation is challenging to this market. But rarely do markets roll over on that alone. Looking out onto the horizon the biggest concern should be an unruly rise in interest rates as the Federal Reserve goes chasing non-existent boogiemen. Janet Yellen has made it clear that the equity market is on its own at this point. Quantitative easing has done the job and assets have been reflated, maybe even more than anticipated.

As expected, OPEC extended production cuts an additional nine months to reduce inventories and support prices. The market yawned as the commodity had already rebounded in anticipation. CNBC reported what they believe needs to happen for this move to have an impact. Energy 101: West Texas Intermediary (WTI) and Brent Crude represent much of the world market and the latter generally trades at a premium to the former. If you follow the oil markets it's important to know the difference .

Stillwater View: Buy the WTI linked crude complex with the commodity in the mid-$40's and sell it in the mid-$50's. More upside risk than downside at this point.

The auto parts industry headwinds continue as both AutoZone and Advanced Auto Parts reported slowing sales. This is on top of the continued news of sub-prime delinquencies. Marc Andreesen chimes in that today's auto manufacturers are like Nokia right before it got crushed by Apple. Last week I mentioned the "battleground" nature of Tesla. This week the tandem of Bernstein's auto and technology analysts highlighted why.

Stillwater View: The news this week from AZO and AAP only solidified the view that autos and auto related companies are facing strong headwinds. Still hold an unfavorable view on the sector as we are in the early innings of this down cycle.

Up and Down Wall Street

Management gospel from Larry Fink, CEO of BlackRock. The world's largest asset manager.

The *Wall Street Journal* ran a series of articles this week on the shift in asset management from human to artificial intelligence. From the very serious, The Quants Run Wall Street Now and The Old-School Hedge Fund is Going Quant to the more comical Wall Street's Endangered Species: The Ivy League Jock, the *Journal* covered it all. The Chartered Financial Analyst program is now on board and beginning in 2019 you will need to understand computer science to pass the CFA exam. Paul Tudor Jones is also increasing his exposure to data mining to gain an edge. And just so those in finance don't feel like they were being singled out, there was this story on how industry veteran Mickey Drexler missed the digital boat in retail. And because of it J. Crew is now facing down a wall of debt and an uncertain future.

Stillwater View: The speed at which big data is changing how companies do business has those that are slow to adapt at a huge disadvantage. On Wall Street, qualitative analysis has been taking a back seat to quantitative for some time. Analyzing the comment trends on glassdoor.com and using satellite data to track the global movement of freight are relatively cheap and easy compared to paying a well pedigreed analyst to do the same thing. And the computer doesn't talk back, take vacation or play office politics. It's a brave new world out there and those that fail to evolve will be left behind.

Diversions

Fortune's Adam Lashinsky Riding Shotgun with Uber CEO Travis Kalanick. His new book, *Wild Ride: Inside Uber's Quest for World Domination* is out just in time for summer reading.

Start Your Engines. Monaco Grand Prix kicks off at 4:30 a.m. Pacific on Sunday followed by the Indianapolis 500 at 8:00 a.m.

Start Your Barbecue. With Memorial Day weekend upon us, it's time to get your grill on with the best barbecue rib recipe I know of. Thank you, Twillard Mayweather.

Jerry Perenchio, a giant in the art and entertainment world, passed away on Tuesday at the age of 86. His "21 Rules for the Road" will remain timeless.

1) Stay clear of the press. No interviews, no panels, no speeches, no comments. Stay out of the spotlight -- it fades your suit.
2) No nepotism, no hiring of friends.
3) Never rehire anyone.
4) Hire people smarter and better than you. Delegate responsibilities to them. Doing so will make your job easier.
5) You've got to know your territory. Cold!
7) Do your homework. Be prepared.
8) Teamwork.
9) Take options, never give them.
10) Rely on your instincts and common sense. If you go against them you generally regret it.
11) No surprises. We don't give them. We don't want to get them.
12) Never lose sight of what business you're in. Stick to your "last."
13) When you suit up each day it's to play in Yankee stadium or Dodger stadium. Think big.
14) If you have a problem, don't delay. Face up to it immediately and solve it.
15) Loose lips sink ships!
16) Supreme self-confidence, never arrogance.
17) A true leader is accessible -- no job too big, no job too small.
18) Communication is our business. You can reach any of your associates anytime, anywhere, anyplace.
19) If you make a mistake, admit it. Just don't make too many.
20) Don't be a "customer's person" (man or woman).
21) Always, always take the high road. Be tough but fair and never lose your sense of humor.

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