

Part two of Stillwater's around the world tour of the financial markets last year, and how it sets up this one, has arrived. This week, we go sector by sector, and go deeper on what they did, and why. We also try to make reasonable assertions as to what could happen this year given the Covid vaccine rollout, a new administration in Washington, the continuation of stimulus-palooza, and the possibility that interest rates might start to normalize at higher levels.

Barely a Hike in Sight



To the last point, if rates rise materially, and speculative parts of the market continue to rally into uber bubble valuations, I am probably checking out of the professional investment game and starting my Hunter S. Thompson inspired campaign of getting elected sheriff of the tiny town of Red Lodge, Montana, because nothing will make sense anymore. What's the worst thing that could happen?

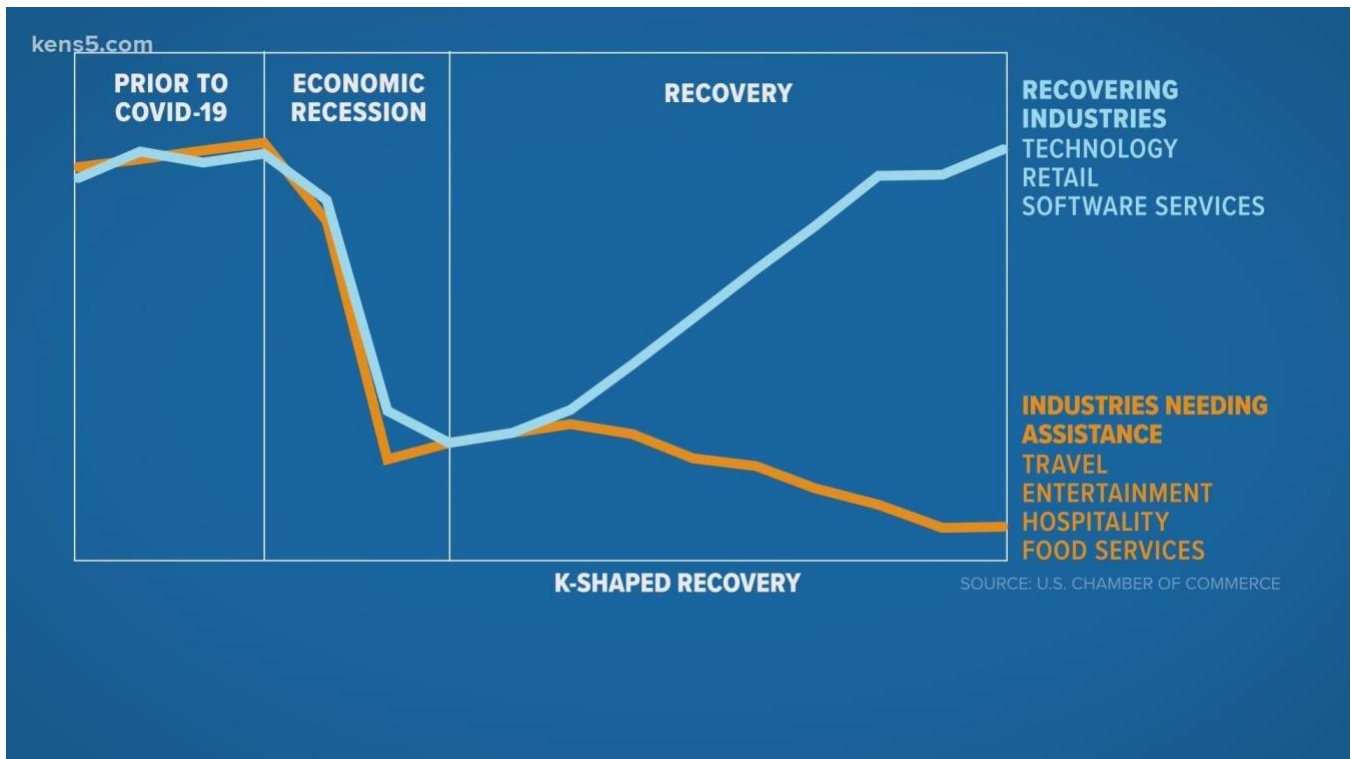
Bryan...2022!



Everything Changes

Following our theme from last week that everything has changed, yet so many things have stayed the same, we begin with the most telling aspect of the Covid pandemic, and the freezing up of the global economy, as it looks now like the 'immaculate recession'. A miracle of all miracles, given how dire things looked in February and March, but was it indeed immaculate, and the snap-back is going to be stronger than anyone thinks? Or has the bifurcation of the economy into a K shaped recovery going to have a lasting impact, and a lasting headwind? We believe the latter, but the market is screaming the former.

Not so Special K



The other event that happened this time around, is the Federal Reserve stepped in and stopped markets from being markets, backstopping losses and supported the most stressed portions of the high yield with direct asset purchases via junk ETFs. To even make this a real ballgame, the Fed will have to step back at some point and let real pricing take effect again. Until then, the wild rumpus will roar, and Jerome Powell reigns as King Max.

'Oh, please don't go...'

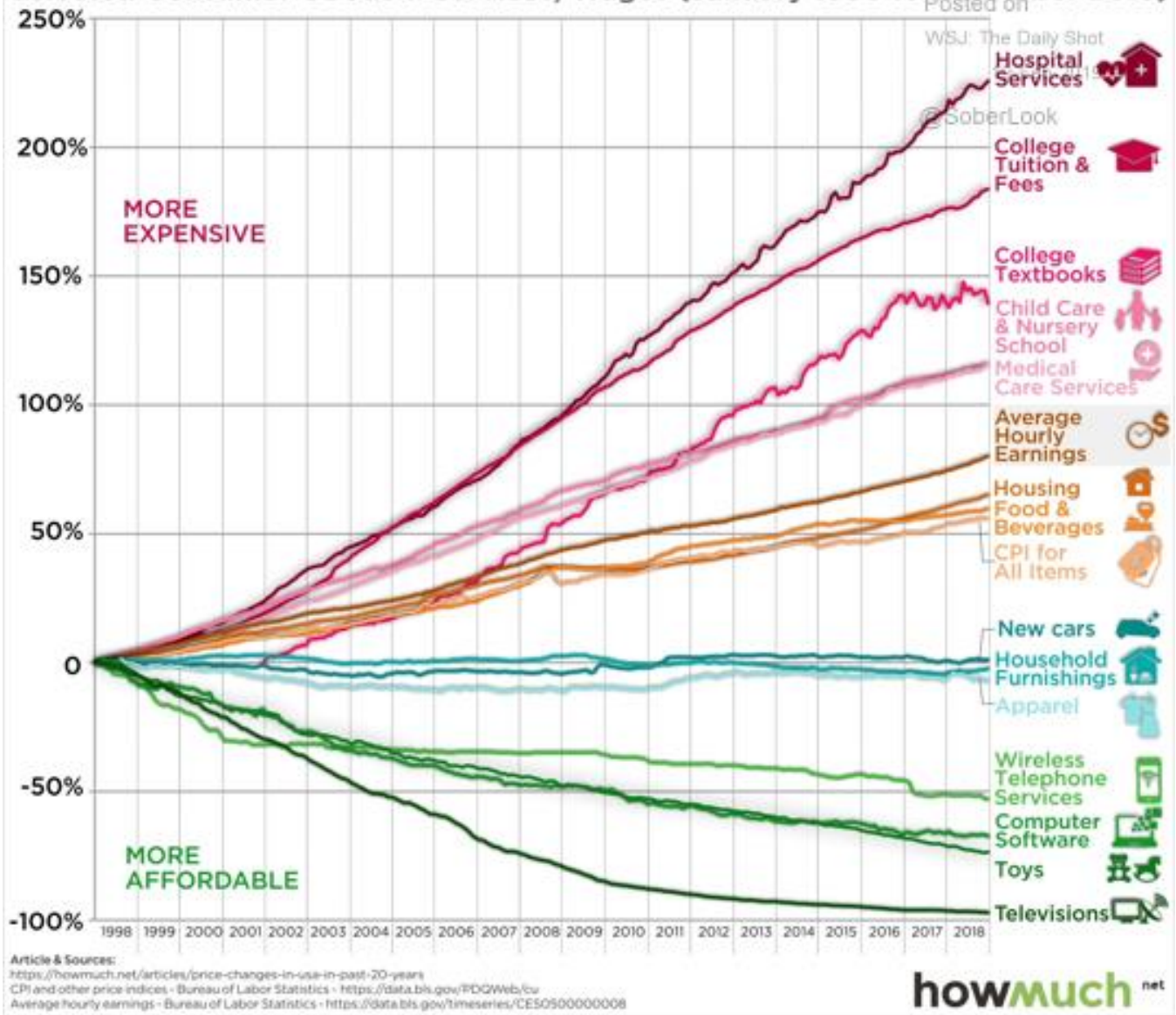


And as we mentioned last week, the world's biggest and most relevant central bank stands ready to continue to artificially support markets until the dead dragon of inflation rises from the theoretical scrap heap of economic ashes. Tell the kids carrying student loans, or the family of four cutting a \$2,000 monthly check for respectable health insurance that inflation doesn't exist. It's real, and it's economically painful for those most impacted this go around.

Prices Up, Prices Down

20 Years of Price Changes in The United States

Selected Consumer Goods & Services, Wages (January 1998 to December 2018)



Everything Stays the Same

It worked, that's the biggest thing that stayed the same. It all worked, and asset prices not only stabilized, they rocked higher. Forget how it happened, though we all know it was somewhat artificial, but quantitative easing worked once again. And the resiliency of the markets cannot be underestimated. Mind you, prior to the break higher in 2014 and the parabolic move that followed, the S&P 500 traded in a sideways pattern for close to twenty years. When the next consolidation phase establishes itself again, is on a 'to-be-determined' basis, but for now the upper end of the range is pushing higher.

Power Move



The other thing that stayed the same, is that hope won out over despair, and the exceptionalism of our efforts to combat what for a while looked un-combatable. Not to diminish the two million deaths worldwide, and the 400,000 domestically, but we did it, we won again. Vaccines are being rolled out, the stimulus floodgates are open, job losses have stabilized, and for those with access to aid and free flowing capital markets, their income statements and balance sheets survived. And the sun rose again in our beautiful America.

Exceptional



Technology

We start our tour of the markets by sector with the hottest dot of all the hot dots, technology. For a multitude of reasons, partly because global networks and the data that travels along them will need to increase capacity to handle a forever changed working environment where the office takes a backseat to mobile communication and working from home. Add to that the power of cloud computing, and the asset light model of deploying technology across the enterprise, and you are talking about a tailwind for four letter NASDAQ stocks with the force of a category five hurricane.

Ones & Zeros, Uber Alles



One of the strongest segments of the tech economy is the semiconductor sector, which has been trading like nothing shy of a parabolic rocket since the market bottom. Years ago, when semis were tied to the personal computer market, there actually was a cycle. For those of us who traded them back in the day, we need our memory card erased. This cycle has legs the like of which have never been seen, with processing power in demand across every corner of the economy. And while you can't rationalize valuations at this point, we also can't come up with a decent reason why they should be sold. Which is a scary place to be when you are looking to put money to work in a bubble environment.

Moving on Up, Way Up

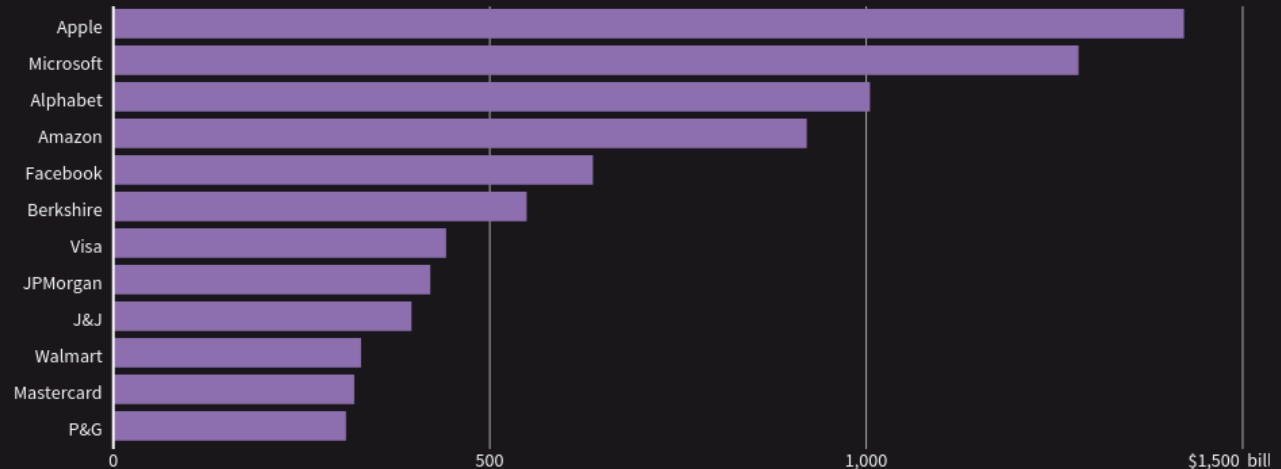


While there are many smaller winners who have produced eye popping performance last year, at the end of the day, it comes down to the five horseman of the technology arena and the six billion dollars in market capitalization they represent. With autopilot investing in indexes, and emotionless quants running the show, it's no wonder the big keep getting (much) bigger.

A Billion Here, a Billion There

Top U.S. market cap companies

Largest S&P 500 companies by stock market value



Data as of Jan. 29, 2020

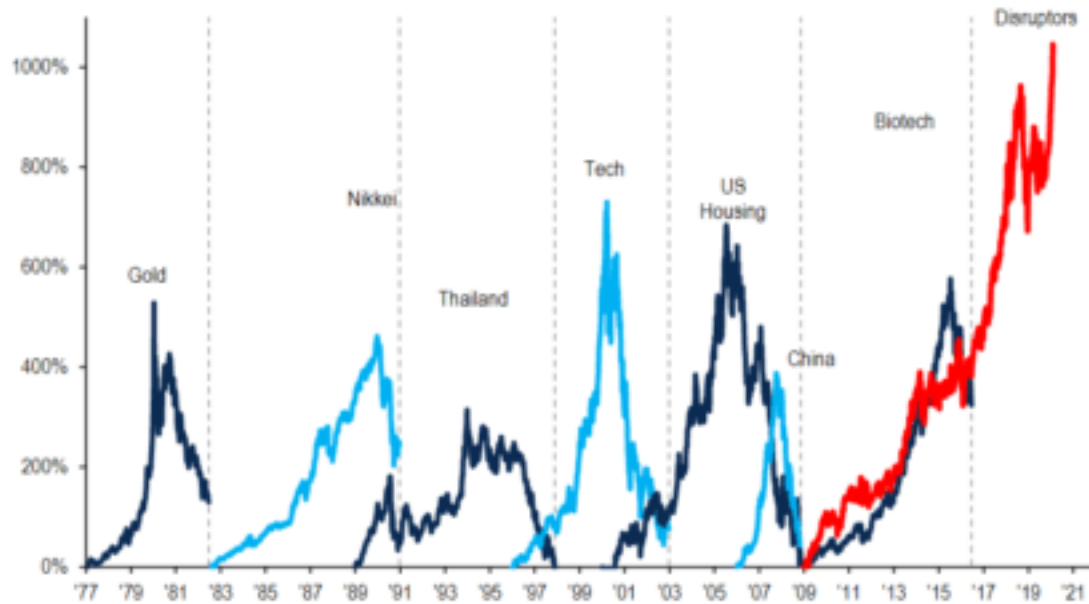
Source: Refinitiv

Lewis Krauskopf | REUTERS GRAPHICS

Bottom line to this, and it really is painful to have to say given that we proudly wear the hat of a skeptical bull, is that we are for sure in a bubble, rational or otherwise. This makes it hard to navigate, as our strategies don't 'rent' stocks. And what we would say is this, until the Fed takes their foot off the short end, risk is going to be the fashionable trade, as a 1% to 2% risk-free yield isn't very compelling given what else is out there.

Disruption

Chart 2: History of asset bubbles past 40-years



Source: BofA Global Investment Strategy, Bloomberg. Note: Gold (XAU Currency), Japanese Equities (NKY Index), Thai Equities (SET Index), Tech (NDX Index), US Housing (S5HOME Index), Commodities (SHCOMP Index), Disruptors (DJECOM Index + NYFANG Index constituents, equal weighted)

“Stay at Home”

There are bubbles, and then there are real serious world class bubbles. If we can confidently say one thing today, it is that the class of stocks known as ‘stay to homes’ are in a bubble the likes of which we haven’t seen since the dot.com boom of 1999-2000. Not that the trade wasn’t founded on good principals, it’s simply a theme that has truly ‘jumped the shark’, as the saying goes.

Bruce and the Fonz



This cohort is led by Zoom, and followed up with Logitech, Peloton, Crowd Strike, Chewy, Slack, Roku, Carvana, Snowflake, Airbnb, and DoorDash, to name a few. A great trade that will happen this year is when the rotation from what worked into what hasn't kicks in. From what levels we can't say, but with a high degree of certainty, it will happen. The chart below shows how the 'stay at homes' did the day after Pfizer's vaccine drug showed 90% efficacy back in early November. Past will indeed be preview, we think.

Powder Waiting for a Spark

Ticker	Name	Space	Returns	
			Mon, Nov 9 (vaccine)	2020 Through Nov 8
QDEL	Quidel Corp	Virus testing	(28.1%)	277.8%
W	Wayfair Inc	Online shopping	(21.9%)	233.2%
PTON	Peloton Interactive Inc	Home workouts	(20.3%)	341.8%
ZM	Zoom Video Communications Inc	Video conferencing	(17.4%)	635.0%
ETSY	Etsy Inc	Online shopping	(17.1%)	230.2%
DOCU	DocuSign Inc	Remote document signing	(14.7%)	212.6%
CWH	Camping World Holdings Inc	RVs & campers	(14.4%)	99.4%
ZS	Zscaler Inc	Cloud computing	(14.2%)	222.7%
TDOC	Teladoc Health Inc	Remote health	(13.7%)	146.2%
SHOP	Shopify Inc	Online shopping	(13.6%)	162.8%
YETI	YETI Holdings Inc	Outdoor equipment	(12.4%)	68.9%
ROKU	Roku Inc	TV streaming	(12.4%)	89.2%
Z	Zillow Group Inc	Real estate	(12.1%)	157.8%
CHWY	Chewy Inc	Online shopping	(11.7%)	142.5%
CRWD	CrowdStrike Holdings Inc	Cloud computing	(10.7%)	184.3%
CHGG	Chegg Inc	Remote schooling	(10.0%)	103.7%
PYPL	PayPal Holdings Inc	Online payments	(8.9%)	87.4%
NFLX	Netflix Inc	TV streaming	(8.6%)	59.1%
FDX	FedEx Corp	Package delivery	(5.7%)	87.4%
HD	The Home Depot Inc	Real estate	(5.0%)	32.5%
Average			(13.6%)	178.7%

Industrials

All things considered; the industrial sector acted like you might expect last year. From a theoretical par on January 1st through the market bottom on March 23rd, the XLI industrial ETF lost 50% of its value. By the end of the year however, it would return to par, but not much else, and hasn't made you a dime in three months. That's not to say there haven't been 'stay at home' standouts like John Deere, but for the most part it's been a tough trade. If there is going to be a legit re-opening of the economy, lean long the sector. Valuation is fair, and the tailwind is in place, and while the upside might not be stunning, owning things like railroads is going to make you some reasonable gains.

Moving Product



Financials

Much like the industrial sector, banks, brokers, trading houses, insurance companies, and money centers have done pretty much what you might expect given the bomb that was dropped in March of last year, and then the counter measures the Fed deployed in early spring. The Chicago Fed's measure of the health of economic conditions is signaling all clear.

Good Times, Good Times

After spiking early in pandemic, Chicago Fed's National Financial Conditions Index has fallen into negative territory again

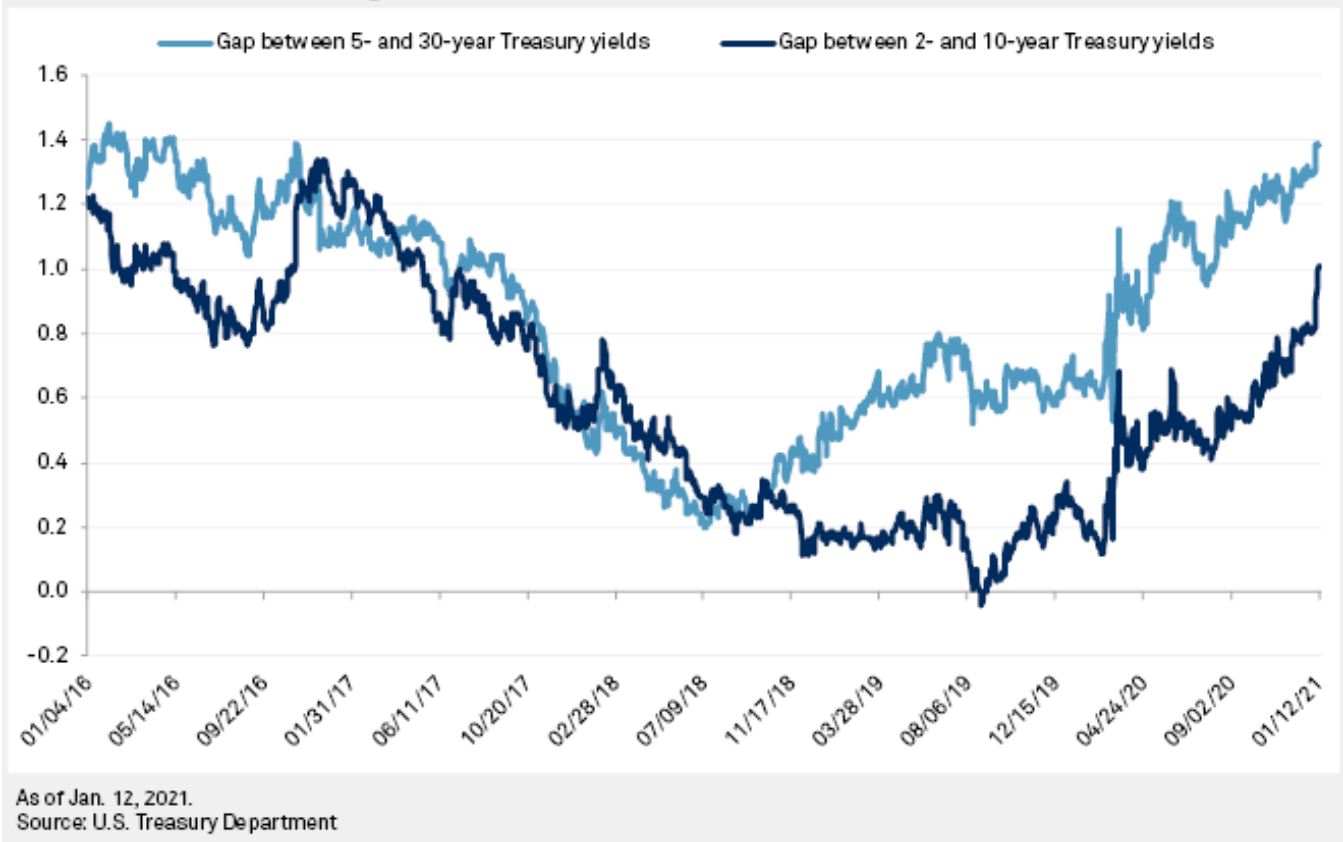


Data compiled Jan. 11, 2021.
Source: Federal Reserve Bank of Chicago

From trading par, to down 50%, and now back to par. More so than industrials, financials probably have greater upside because of our belief that the yield curve is going to continue to steepen as rates normalize and the long end stops pricing in the worst. We strongly believe the part of the trade that says recession is at the doorstep is over.

Curve Widening

Gap between short, long Treasury yields widens to levels not seen in years (%)

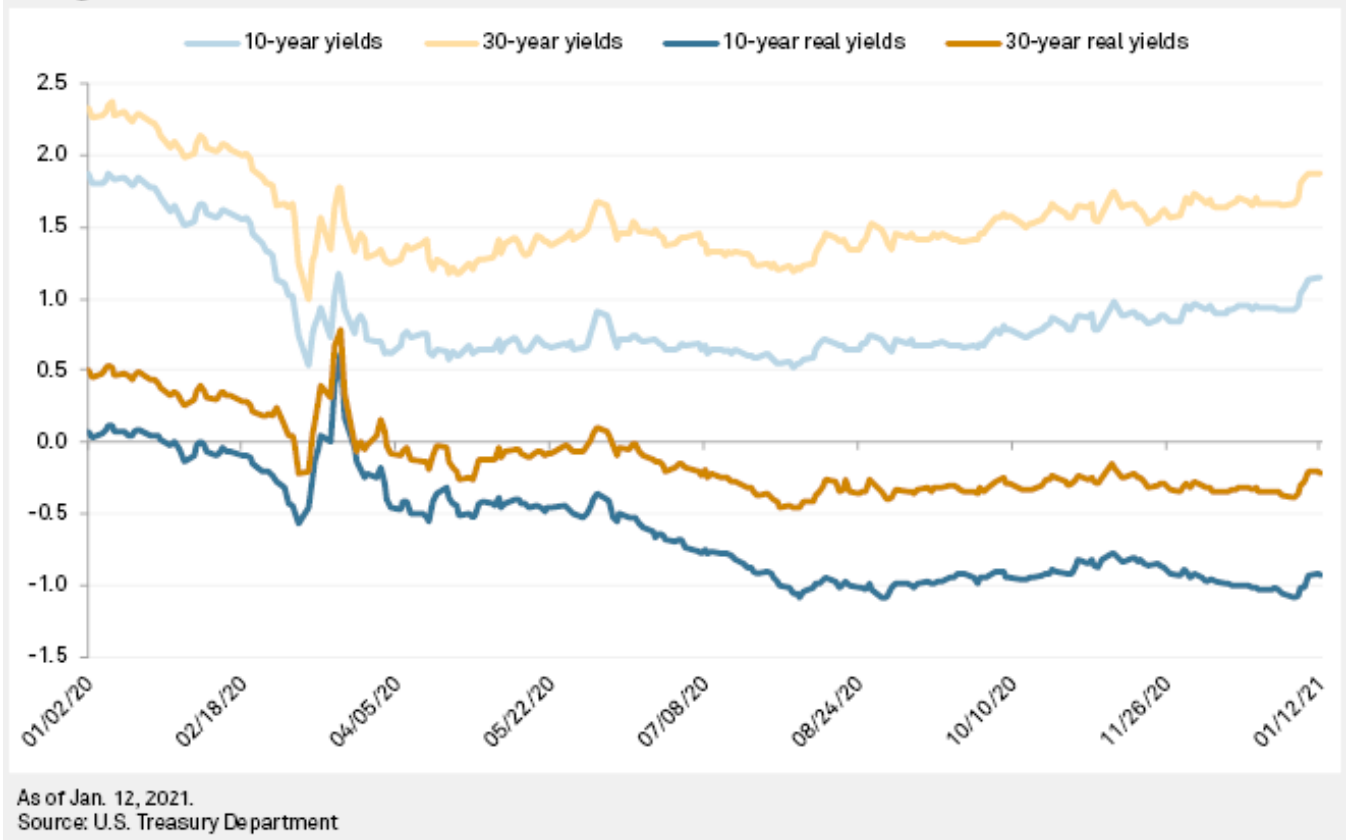


Consumer Discretionary

Aside from (mostly) being on the wrong side of last year's tech bubble, the second thing we got wrong was the efficacy of stimulus, PPP, and extended unemployment benefits, and how that would allow the consumer to continue to spend on products of the discretionary kind. Notice how yields popped after the Georgia special election? This was due in large part to the green light it signaled for a tsunami of money from an un-divided, Democratic lead, government in Washington D.C. These things matter, and they price in very efficiently.

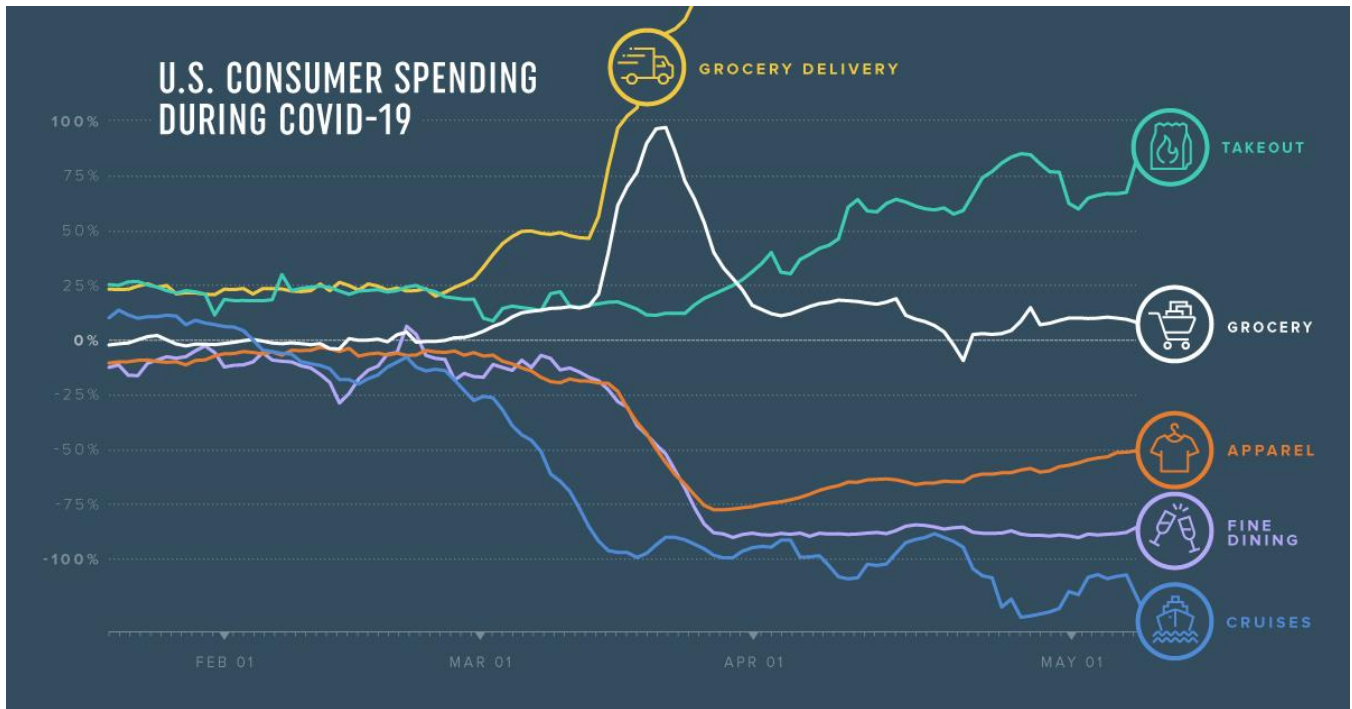
Yields Pop

Long US bond yields climb on hopes of new stimulus (%)



Though we are light on links these days, this one to the J.P. Morgan [research piece](#) focusing on how Covid has changed buying habits of consumers is worth taking a look at. While all things brick and mortar were already on their collective asses coming into the pandemic, the shutdown hopefully has drawn in the inevitable dirt napping. On the flip side, products made accessible and shipped direct to the consumer are booming like never before, and you can't even attempt to put that genie back in the bottle. Just look at how takeout has risen and delivered groceries have spiked off the page, while fine dining has flatlined.

Insta-to-the-Cart

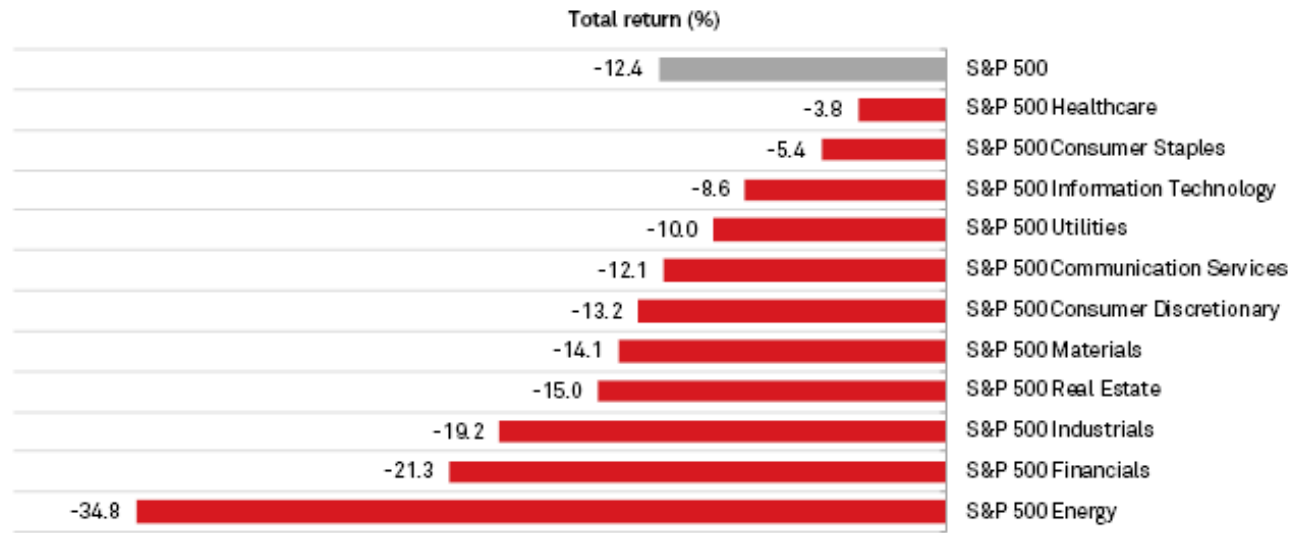


Staples

Consumer staples played their part during the pandemic to a tee, going down far less than the overall market, and recovering in a very pedestrian way. So pedestrian, that while risk has been partying like it's 1999 (yes, we went there), if you go by the staples indexes you haven't made any real money, expect for a percent or two in dividends in five months. That said, these are field soldiers in a world of growth admirals and generals.

Putter Off the Tee

Market performance of the S&P 500 index and sectors in March



Data compiled April 1, 2020.
Total return calculated between Feb. 28, 2020, and March 31, 2020.
Source: S&P Global Market Intelligence

Running down the list from spice maker McCormick, Coca-Cola, Proctor & Gamble, to Colgate, owning the group has been like watching paint dry as graffiti is being sprayed everywhere. Sadly, if this cohort of the market can't show up and perform when the world looks like it's coming to an end, and rates fall through the floor, when are they going to perform. While the downside is pretty limited, consumer staples are going to go nowhere in 2021, in our humble opinion.

Brighten Your Whites



Energy

Oh petroleum, dear petroleum, how loved you once were. And that's as poetic as I get. That said, I spent a lot of my career in the oil patch and learning the business in the field and on the road. It's been a tough road these last few years as the oil and gas sector has fallen into irrelevance as a long term investment. Even the biggest integrated names like Chevron, Exxon, and Royal-Dutch Shell are on the investment committee chopping block due to risk of cuts to the dividends at a time when they are being forced to lever up to keep the production machine running.

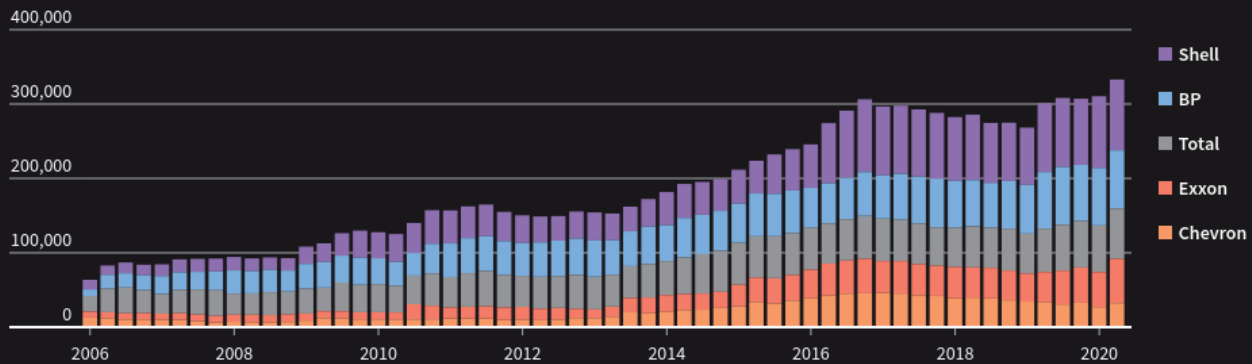
'Can you lend me a buck?'

Big Oil' rising debt

The world's top oil and gas companies held a record amount of debt at the end of the first three months of 2020, putting pressure on their balance sheets

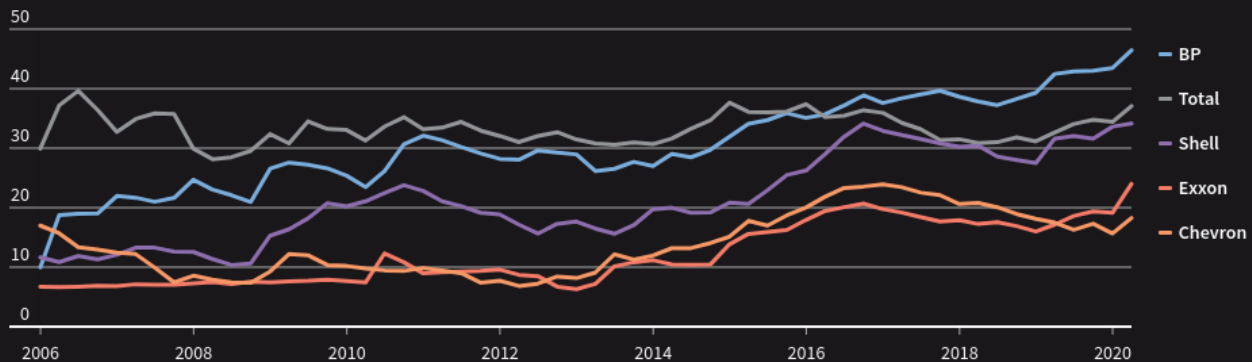
TOTAL DEBT

In millions of USD



GEARING

Total debt as percentage of market capitalization



Refinitiv Eikon

Ron Bousso | REUTERS GRAPHICS

While we can say that investing in the oil patch right now is looking for needles in the haystack or diamonds in the rough, it is one hell of a place for speculators looking make swing trading money and then flatten their investment book by the weekend. And that's okay, because it's going to be a very bumpy ride with opportunities on both sides of the long/short ledger. Just make sure you bring the Dramamine, because while some see a sunset, others see a glorious sunrise, in this very volatile trade.

Looking East or West?



And with that, our tour of the market sectors is complete. As always, we hope you enjoyed the journey. We have two more stops before *This Year in the Markets* is complete. The next stop we take a look at what strategies and funds really performed, or didn't last year, and what that looks like going into 2021. Then next Friday we take an irreverent look at 'shit we plan on doing when the pandemic ends'. Quick preview, one thing involves a Wednesday and Thursday trip to the Masters again. Just like Dustin Johnson, we like the sandwiches too.

Skipping Balls on Sixteen



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