May 19, 2017

The Top-Down

Another week, another swarm of controversy from the White House. This time the market took notice. What changed from Tuesday's close to Wednesday's open? Evidence emerged that created a clear path to an investigative process that will take the focus off the growth agenda and put risk back on the table.

Stillwater View: *The historic playbook for moments like this has been to ride out the volatility, as unpleasant as that can be, or reduce market risk and exposure through hedges. I agree with Jeremy Seagel and Jim Chanos that if "tweet risk" is truncated the market will react favorably as the tax reform genie is already out of the bottle.*

It was reported this week that household debt in the U.S rose to a level not seen since 2008. The biggest driver has been the growth in student and auto loans. Mortgage debt remains the largest overall component at 68%.

Stillwater View: *This is a good near term sign for consumer confidence and spending. The cautionary counter is that delinquencies doubled from 4.5% to 9.0% two years after the last peak.*

In all likelihood, the Fed funds rate is headed higher. With that in the market's back pocket the focus is turning to the unwind of the Federal Reserve's massive balance sheet.

The Fed currently holds $4.4 trillion worth of Treasuries and mortgage bonds purchased during four rounds of quantitative easing. This is up from $850 billion before the global financial crisis of 2008-2009. Steve Liesman at CNBC explains why it's quickly becoming a focus of the market. Look for this subject to begin to occupy an increased level of bandwidth as the correlation between balance sheet expansion and the performance of the S&P 500 will have some worried that this unwind will create a headwind for the markets.

Stillwater View: Quantitative easing was medicine for an economy as near death as anyone would like to admit. Banks were frozen, credit spreads blown out, asset prices deflated and unemployment was through the roof.

Eight years later the patient is leaving the hospital. Headed back out into a new world that looks a lot like the old pre-crisis one. Banks are liquid, asset prices are up, the economy is nearing full employment, and animal spirits are alive and well. And while the financial markets will miss QE, it will be back to visit us after the next recession.

For a full account of all reported economic data use The Bloomberg Economic Calendar

The Bottom-Up

This week CNBC highlighted the 50 most intriguing private companies with their CNBC Disruptor 50.

Daniel Yergin, the elder statesman of energy and author of two of the most important books on the subject, *"The Prize"* and *"The Quest"*, wrote that we "would not see $100 a barrel again."

Stillwater View: Yergin's thoughts are consistent with the theme that supply will keep a structural ceiling on the price of crude oil. Companies in the energy sector that can show margin expansion and profitability growth in this new reality will be rewarded. Favorable on EOG Resources and Daniel Yergin.

Ascena, the parent company of Anne Taylor, is this week's retail tragedy. On Thursday, the stock feel by 25% after guiding down earnings on weaker sales.

Stillwater View: Rarely is a sector as universally loathed as retail is today. Yet it still lacks a compelling fundamental argument as to why now is the time to start getting invested. Any earnings or discounted cash flow model is a stab in the dark at best as there is no visibility whatsoever. At some point book or liquidation value takes over, but we aren't there yet. Marc Lasry, founder of $12 billion Avenue Capital, thinks we are a year away before it's time to buy the debt. In the meantime, short the equity.

Tesla founder and CEO Elon Musk made headlines on Thursday when he said the market capitalization for his company was "higher than we have any right to deserve".

Stillwater View: Tesla is what is referred to as a contentious "battleground" stock. Those long the name compare it to an early Amazon where the valuation will catch up once the full genius of Elon Musk is realized. The shorts on the other hand say the math doesn't pencil as it's currently worth more than both Ford and General Motors with only 1% market share. Either way, I'm on the sideline. For the time being at least. If competition ramps up as expected and Tesla fails to deliver, the valuation issue will take care of itself.

Up and Down Wall Street

The Skybride Alternative (SALT) Conference was noticeably quiet this year. Several speakers repeated comments made last week at the SOHN Conference. Notable interview with Skybridge's Gayeski on Regulatory Reform, Global Markets.

The SEC put the brakes on a plan to introduce a quadruple levered S&P 500 exchange traded fund. Levered ETFs represent only a small percent of the overall market. But that small percent adds up to $44 billion in assets.

Stillwater View: Levered ETFs are not to be considered credible investment vehicles. "Thank You" cards should be sent to: Securities & Exchange Commission, 100 F Street NE, Washington D.C, 20549.

In a related article, Mutual Funds Ate the Stock Market, And Now ETFs Are Doing It, Bloomberg columnist Justin Fox wrote that "The investment industry keeps coming up with new products that more perfectly match customer needs, but it also invariably overdoes it. Which I guess is what most industries do, but in investing, there *is* a weird cyclicality to it."

Stillwater View: There are 8,000 mutual funds in the U.S. and 2,000 ETFs. With only 4,000 stocks to go around the math says there are simply way too many of the former.

Global macro hedge funds have an almost mythical persona on Wall Street. The ability to go anywhere and invest in any asset class sounds adventurous and lucrative. One small hitch, it's hard. Highlighted once again by the rise and fall of John Burbank and Passport Capital.

Stillwater View: Macro funds have an uncanny ability to massively outperform for a few years. Raise an enormous amount of money. Clip a hansom fee. And then fail to show that previous performance was repeatable. This was the story of the MainStay Marketfield mutual fund, one of the earliest "liquid alternative" funds in existence.

In 2009, the fund lost 13% while the broad market went down 37%. In 2010, it went up 31% against a 26% gain for the same broad market. This was a two-year period of performance nirvana with downside protection and upside capture. The mutual fund would grow from $2 billion in assets to an astonishing $24 billion four years later. But beginning in 2013 something changed and Marketfield began to significantly underperform. With it currently down to $500 million in assets the experience proved to be another cautionary tale of the risk to chasing performance.

Diversions

Marriage rates down. Children being born out of wedlock up. And fracking is to blame.

Avocado toast redux. Australian real estate magnet Tim Gurner blames $19 avocado toast and $4 coffees for millennials inability to buy a first home. It would take 60 years of kicking the habit to buy a home in New York and 72 in San Francisco.

With graduations time upon us you are provided with inspiring thoughts of life lessons and the future from Sheryl Sandberg, Will Ferrell and Admiral William McRaven

While a few years on, the words from McRaven stand up to time. If you want to change the world, start by making your bed. Find some friends along the way to help you out. When you are up to your neck in mud, start singing. And most importantly, never ever ring the bell.