



September 22nd, 2017

Stillwater News

Stillwater Capital was recently featured on Strategy Casters hosted by Charlie Wright of [Strategic Investor Radio](#). Hear Stillwater’s [mid-year recap and outlook](#), a profile of [Stillwater hedged equity strategies](#) and a [market update](#) with a focus on European and Emerging Markets.

The Top-Down

The [war of words](#) between President Trump and Kim Jong Un is escalating going into the weekend. Overnight, “Rocket Man” threatened a hydrogen bomb test over the Pacific while calling Trump “mentally deranged”. Futures are down slightly in the pre-market.

A Year of Escalating Tensions Over North Korea

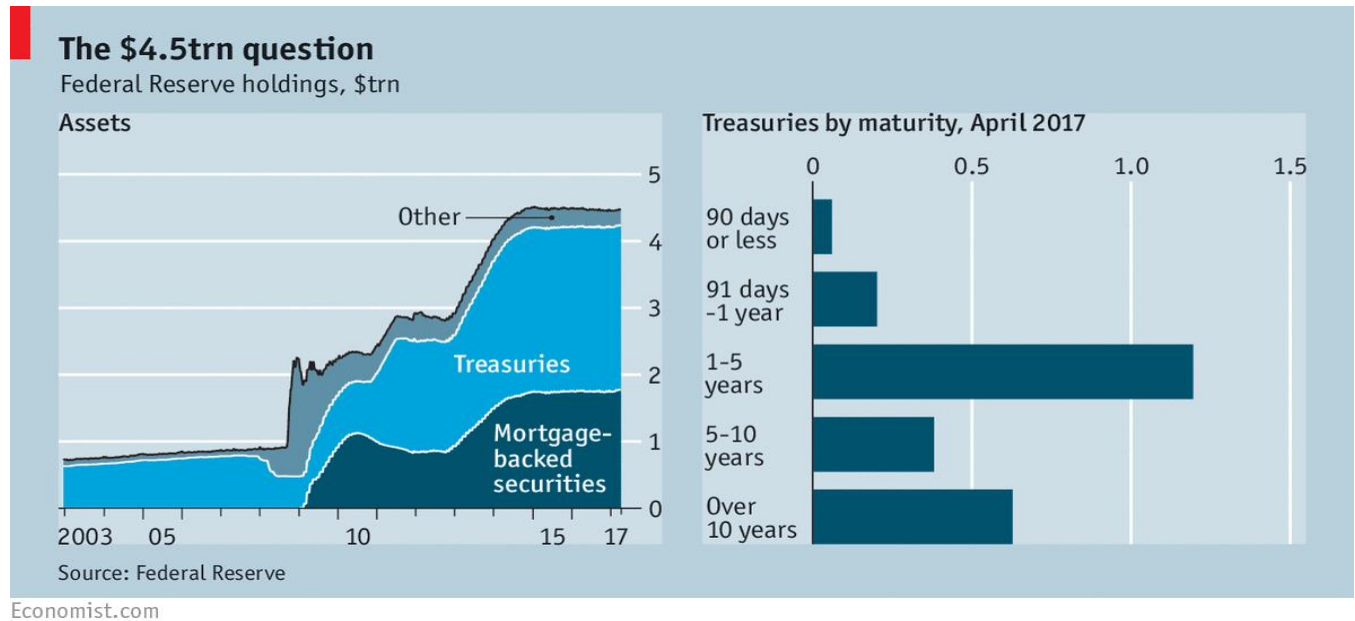
■ Number of missile tests



Source: Bloomberg and Nuclear Threat Initiative

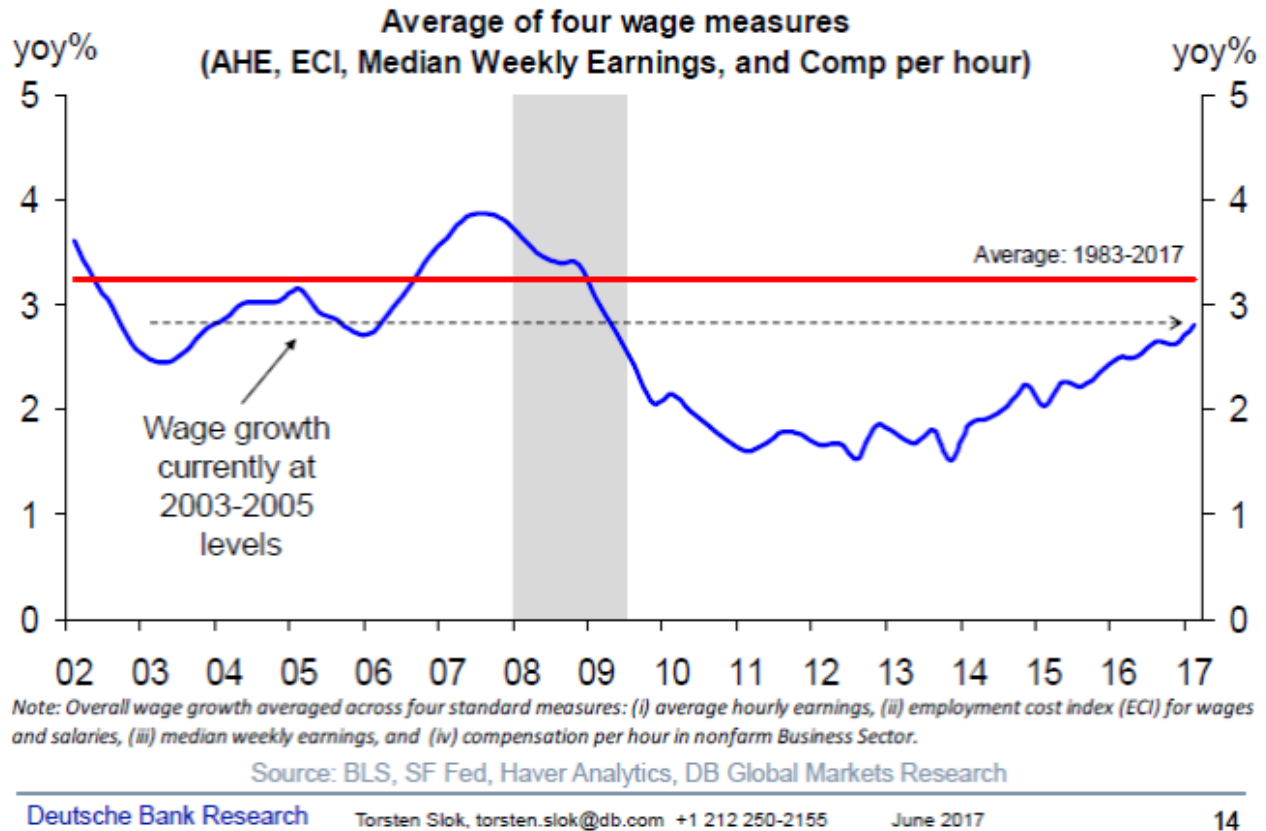
On Wednesday, the Federal Reserve gave the green light for the [balance sheet reduction](#) to begin next month. While well telegraphed by the Fed, this marks the turning point in the great quantitative easing [experiment](#). One, that by many measures worked as assets were reflat and the animal spirits for risk flowed again. But to participate you needed assets to reflate as wages have done little to validate the effort. Thoughts on the ‘out of control’ balance sheet from well-known bank analyst [Dick Bove](#).

Ten-years of balance sheet growth is finally being unwound.



While wage growth is finally getting back to the thirty-five-year average. Great Recession shaded in grey.

Wage growth higher than its reputation

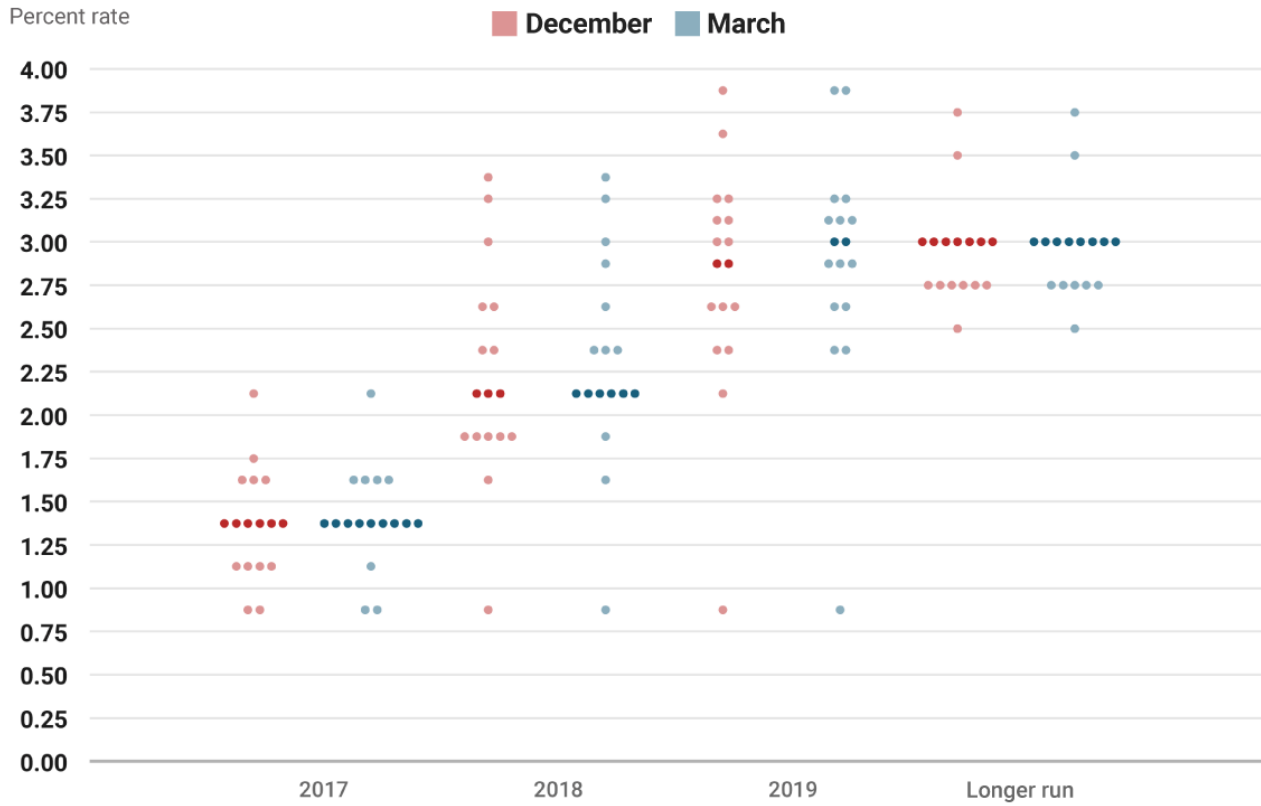


Stillwater View: Wall Street consensus is that the unwind has been so well advertised that nothing could possibly go wrong. It's hard to believe it's that simple.

The Fed also signaled that there is [one more rate hike](#) on the horizon for this year. If you [follow the dots](#) you will see a Fed funds rate twice that of where we are today. Minneapolis Fed President Neel Kashkari is the dove who sees no change necessary from today's level. [Doves and Hawks](#) at the Fed.

Where the Federal Reserve Board members see the Fed funds rate headed.

FED DOT PLOT



SOURCE: Federal Open Market Committee

BUSINESS INSIDER

Rates on the 10-year have spiked from a low of 2.04% on September 7th to above 2.25% this week, sparking a rally in the financial sector and a selloff in equity income sanctuaries like utilities and consumer staples.

Ten-year Treasury Yield



Deutsche-Bank provided their thoughts on why a [market calamity](#) could emerge again. "This includes valuations in many asset classes, the incredibly unique size of central bank balance sheets, debt levels, multi-century all-time lows in interest rates and even the level of potentially game changing populist political support around the globe. If there is a crisis relatively soon (within the next 2-3 years), it would be hard to look at these variables and say that there was no way of spotting them."

[Wells Fargo](#) said much the same to clients earlier in the week. "The synchronized global recovery that took hold in 2017 should gain in 2018, though restrained by ongoing global headwinds from high debt, slow labor recoveries overseas and political uncertainties around the world. We also anticipate that earnings gains will fuel moderately higher U.S. and international equity markets."

Thirty years of S&P 500 performance. Recessions in grey. The 1987 market crash is the barely noticeable dip in the far-left corner of the chart.



Stillwater View: Deutsche Bank and Wells Fargo have the checklist of what can go wrong. Meanwhile, most mutual fund managers remain fully invested for fear of lagging their benchmark.

The Bottom-Up

The [white-hot defense sector](#) got even hotter this week when it was announced that Orbital ATK would be [acquired by Northrop Grumman](#) in a \$9.2 billion deal. Shares of [Boeing](#) and General Dynamics have soared this year as the defense friendly administration has set a course for increased spending. Stillwater's dog in the hunt is [Huntington Ingalls Industries](#) (HII), the largest supplier of vessels to the United States Navy. Their corporate motto, "Hard Stuff Done Right".

The USS John F. Kennedy, the nation's second Ford-class aircraft carrier, begins to take shape at company's the Newport-News shipyard.



Stillwater View: Politics aside, there are indeed strong tailwinds for the defense sector as dollars allocated to fighting two wars kept spending on new defense programs in check.

Late Wednesday rumors hit the market that Advanced Micro Devices would be [providing some of the silicon](#) that will go into Tesla's self-driving cars. The news sent the shares 10% higher adding \$1.4 billion in market capitalization in 30 short minutes.

Stillwater View: This marks the second time in recent memory that Stillwater was on the wrong side of a short squeeze in the shares of AMD. First, it was over enthusiasm for cryptocurrency mines, and this time it was the excitement related to a driverless car that will not hit the market until 2020.

The early reviews of the news are that this was Tesla keeping Nvidia in check. Letting them know that they won't be the sole source provider. The Wall Street analyst community, on the other hand, couldn't help themselves in [heaping praise](#) on the company and what this does for their technology roadmap. On Thursday AMD's foundry partner [clarified the comments](#) saying they were misrepresented and the company works with companies "like "Apple, Google and Tesla. Let the wild rumpus roar.

“There should be a place where only the things you want to happen, happen” – Where the Wild Things Are



In other Tesla related news, Jefferies initiated coverage of the company with an [underperform](#) and price target of \$280, a full 25% below where the shares are trading. Analyst Philippe Honchos wrote, “It is with a bit of a heavy heart that we initiate coverage of Tesla at Underperform.”

Stillwater View: While appreciative of the overvaluation thesis, Stillwater would like to remind everyone that whether it be with a heavy or light heart, stocks themselves don't care how you feel. Checking your emotional connection to shares makes for better investment outcomes. Buy the car, not the stock.

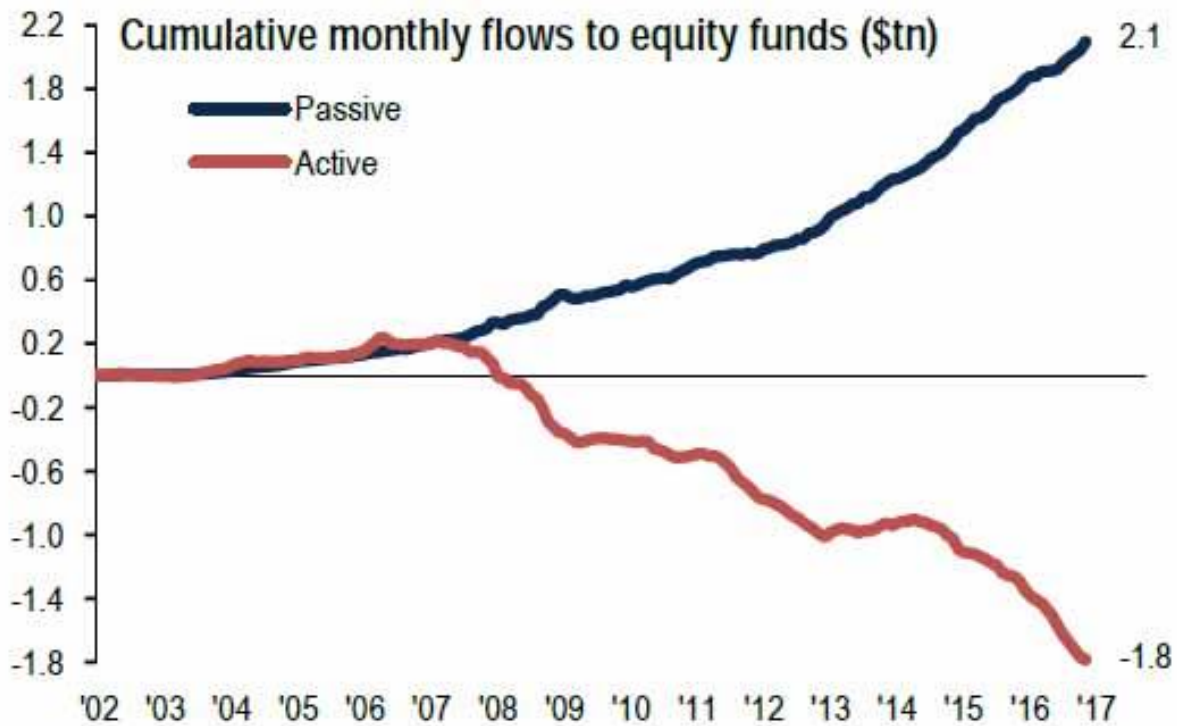


Up and Down Wall Street

Asset growth at Vanguard and BlackRock continues unabated as the two have combined to attract 90% of ETF flows this year, according to [InvestmentNews](#). Both focus on providing low cost market exposure with fees that average less than 10 basis points. Actively managed funds have seen outflows of \$183 billion while \$671 billion has gone into passive in the last 12 months.

The pain trade keeps on rolling for actively managed funds.

Chart 3: Passive smashing active



Note: based on EPFR Global's monthly dataset (more comprehensive coverage)

Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

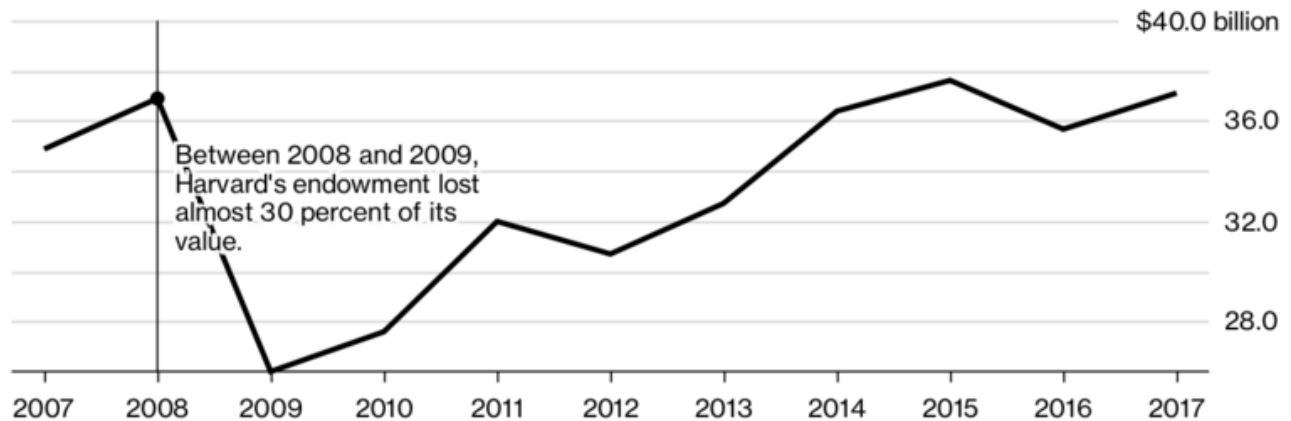
Struggles at the [Harvard Endowment](#) continue as investment returns lagged peers with an 8.1% return in the 2017. This follows on a loss of 2% in 2016. College endowments use a June fiscal year-end and the [average reported return](#) thus far is 13.3%. Dartmouth and MIT came in ahead of the class with gains north of 14%. [Harvard Magazine](#) has the detailed report.

Harvard Endowment's total assets under management.

Endowment Giant

Harvard's endowment hit a record high among all U.S. schools in 2015, topping \$37.6 billion.

■ Assets Under Management, as of June 30



Source: Harvard Management Co.

Bloomberg

Stillwater View: Harvard, along with many endowments, follow a similar cyclical pattern of investment strategy overgrowth followed by a massive brushfire and re-organization. In January, newly named CEO [Nirmal "Nary" Narvekar](#) announced plans to lay-off [half the staff](#) and streamline the investment process. Doing away with all internally managed hedge funds. He is the fourth person to lead the endowment in the last 10 years.

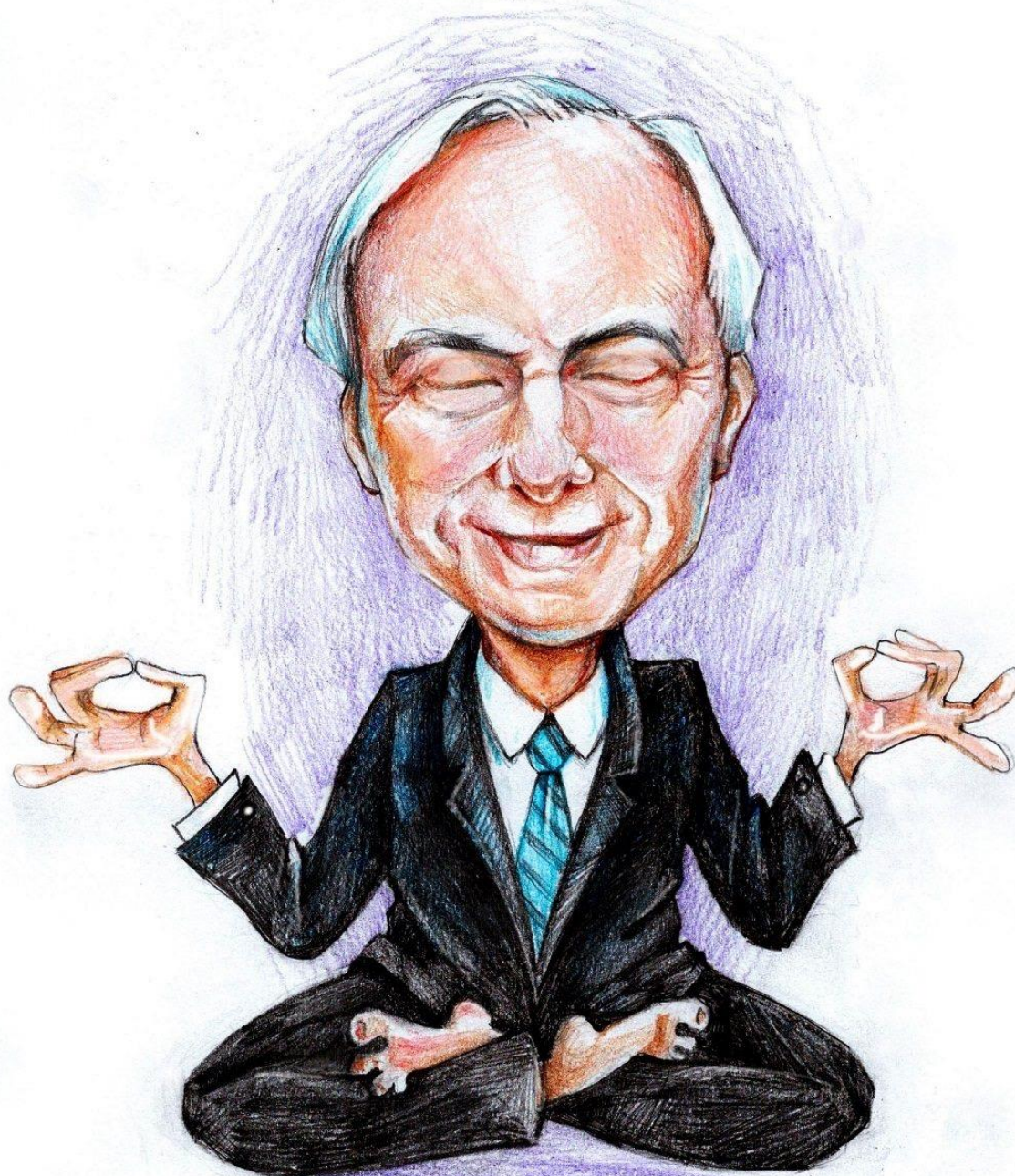
While there is most certainly money to be made in management of the actual endowment, the real dollars should be paid to anyone who can provide a plan that can stop the revolving door.

John W. Weeks bridge on the Harvard campus.



Ray Dalio made the rounds this week promoting his book [Principles](#), appearing on [CNBC](#) and [Bloomberg](#) with Charlie Rose. By his own admission, Bridgewater is facing a “really bad year” after having made money for clients in 23 of the last 26 years. While he has publicly stated that he is starting to dance “[closer to the exits](#)”, Ray shared his observation that a recession is not on the horizon and we are in a pretty good economic sweet spot.

Ray Dalio living in the now.



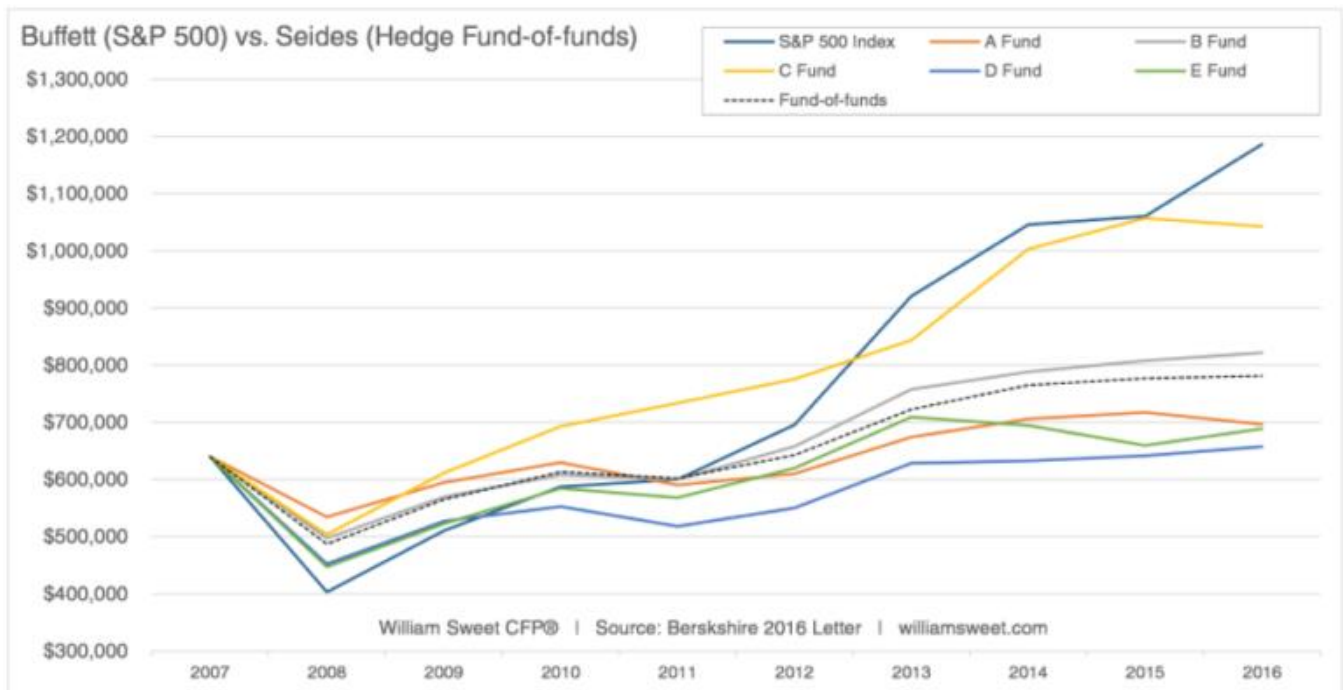
ValueWalk

At \$160 billion, Dalio's hedge fund Bridgewater has the ballast to endure stormy seas while the rest of the hedge industry continues to face choppy waters. [Pine River](#) is shutting down their master fund after assets fell below \$300 million. [Hugh Hendry](#) is getting out after 15 years in global macro

trading, saying we are in the “death throes of the global macro hedge-fund entity”. [The “Mooch”](#) is selling [SkyBridge](#) to the Chinese.

[Warren Buffet](#) will collect on his ten-year old \$2 million charity bet with Ted Seides of Protégé Partners that the S&P 500 would outperform hedge funds. Ted gives us the [six reasons](#) why he lost, while Barry Ritholtz counsels investors to [bet with Buffett, not against him](#). Thank you Captain Obvious. Anyone want to take the other side of Mr. Buffett’s call that we will see [Dow 1,000,000](#) in 100 years?

Performance of S&P vs. Seides’ selected funds through year-end 2016. Courtesy of Berkshire Hathaway.



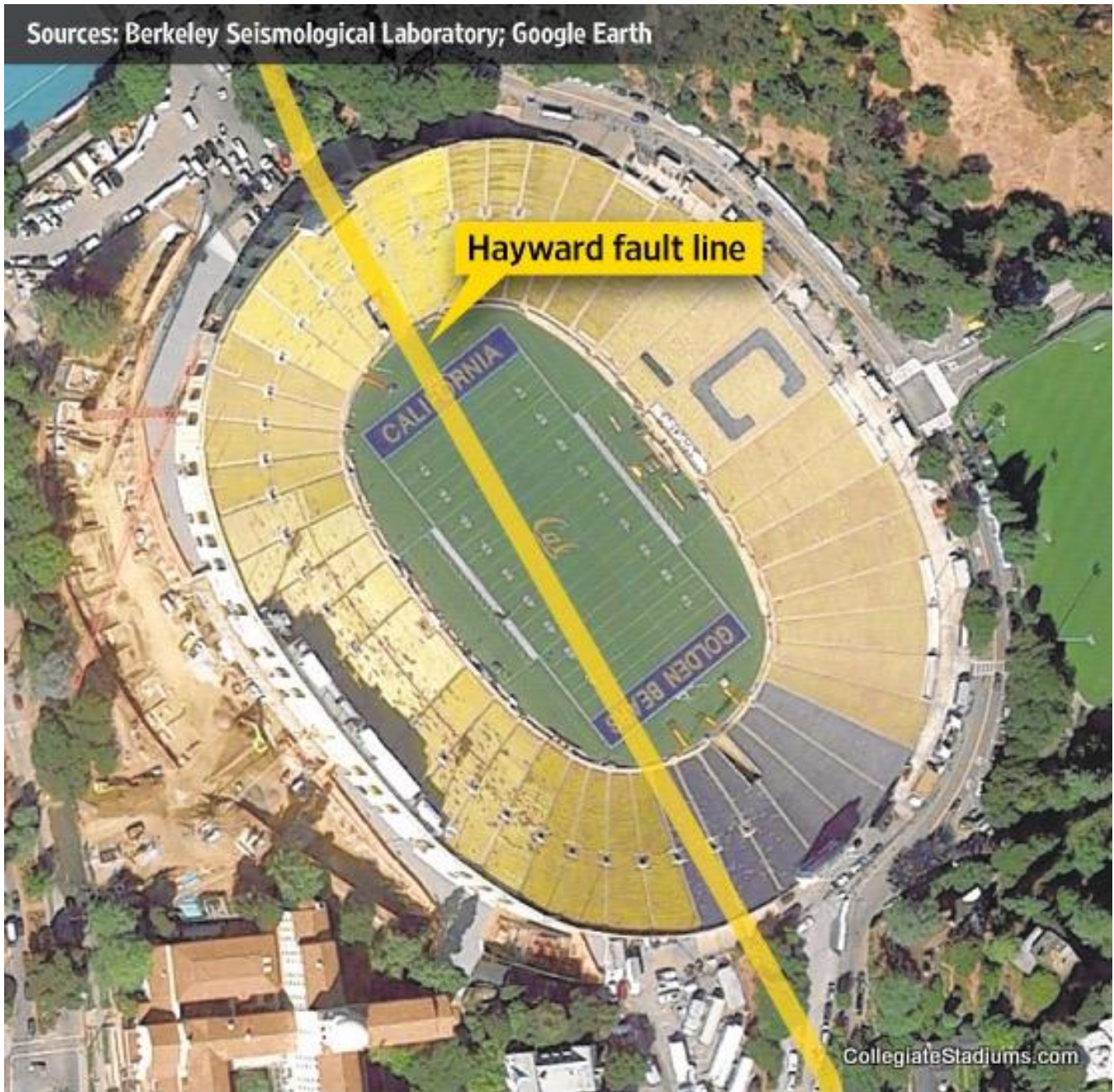
Stillwater View: The wager has been fun to watch and it highlights an important point that is lost in the headlines. Hedge funds aren’t supposed to act like the S&P. Nor should they beat them in a market rally like the one we have had. They are called alternatives for a reason, and should be structured as return enhancers or downside protectors.

Diversions

Two once proud NFC West teams took to the field last night at Levi’s Stadium, as the Anaheim Rams of Los Angeles by way of St Louis and now just the Los Angeles Rams took on the San Francisco 49ers of Santa Clara. The Rams [prevailed](#) in a shootout. You could have attended the game for less than the price of [two pretzels](#).

College football officially gets into the conference swing of things as Alabama takes on the resurgent [Vanderbilt Commodores](#) and USC faces a surprising 3-0 [California Golden Bear](#) team. Leave it to the smart guys at Cal to build a stadium on an earthquake fault. Enjoy the game and “[Roll on you Bears!](#)”

Memorial Stadium, Cal Berkeley Campus



In *very* high-end real estate news, one-third of [Molokai](#) is for sale for a cool \$240 million.

The Molokai Coast



For slightly less than half of that, you can live in the newly listed 9,710 square foot condominium, ‘The Pinnacle’ that sits atop the [Woolworth Building](#) in Manhattan. If it sells for anywhere near the \$110 million asking price, it will eclipse the previous record for a downtown apartment, set at \$51 million, when a unit in [Chelsea’s Walker Tower](#) sold in 2014.

The Woolworth Building, 233 Broadway, New York



In more earthbound, yet still jaw-dropping real estate news, this classic 2,000 square foot California ranch home in the quiet Silicon Valley neighborhood of Sunnyvale recently sold for [\\$2.5 million](#). A tender \$800,000 over the \$1.7 million asking price. The [Google/Apple/Facebook/Netflix](#) effect continues to drive Valley real estate to new heights.

1129 Prunelle Court, Sunnyvale, California



Stillwater View: This author grew up in the [94087](#) and considers himself lucky to have had a front row seat in Silicon Valley's semi-early beginnings. During the tech bubble of the late '90s I advised my parents to sell the "inflated" residence that I called home. I now make it an annual point to apologize for that counsel and profoundly thank them for fading my advice.

[Toys "R" Us](#) filed for bankruptcy protection this week. The retailer couldn't adjust to a changing retail landscape and was saddled with too much debt from a [\\$6 billion](#) KKR led buyout back in 2005. But since *Diversions* is committed to keeping it entertaining, and in this case local, we are going to take it back to quieter days in Sunnyvale. There, the [Toys "R" Us](#) was a place you both looked forward to visiting but also feared going in, as it was rumored to be haunted. John Davidson and Fran Tarkington validated the story on [That's Incredible](#).

Stillwater View: How the 1982 docudrama that chronicled the poltergeist didn't win Oscar gold remains a mystery. Fire up some Orville Redenbacher's and grab the Red Vines while you enjoy [part one](#) and [part two](#) of this classic. Stick it out to hear Putt" O'Brien tell the story of a teddy bear dropping into an unexpected downward dog. Godspeed, Johnny Johnson. Thanks for scaring the bejesus out of me in the bike aisle!

Original Toys R' Us, Sunnyvale, California



In a world where headlines are often too tough to read, it was uplifting to come across one that wasn't. On Tuesday, the *Los Angeles Times* ran "[Life Lessons in an old Fishing Hole](#)". It told the story of "[Lee's Pool](#)" on the North Umpqua River in Oregon.

Lee Spencer has been caretaker of the steelhead hole for 20 years, and the tale of how he got there and his perspective on living, provides a view into a life filled with a different kind of quota.

[Lee Spencer on the North Umpqua River, Oregon](#)



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